U.S.-RUSSIA ECONOMIC RELATIONSHIP: IMPLICATIONS OF THE YUKOS AFFAIR

HEARING

BEFORE THE

SUBCOMMITTEE ON
DOMESTIC AND INTERNATIONAL
MONETARY POLICY, TRADE, AND TECHNOLOGY

OF THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

OCTOBER 17, 2007

Printed for the use of the Committee on Financial Services

Serial No. 110–71

U.S. GOVERNMENT PRINTING OFFICE

39–909 PDF WASHINGTON : 2008

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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U.S.-RUSSIA ECONOMIC RELATIONSHIP: IMPLICATIONS OF THE YUKOS AFFAIR

Wednesday, October 17, 2007

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON DOMESTIC AND
INTERNATIONAL MONETARY POLICY,
TRADE, AND TECHNOLOGY,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2 p.m., in room 2128, Rayburn House Office Building, Hon. Luis V. Gutierrez [chairman of the subcommittee] presiding.

Present: Representatives Gutierrez, Sherman; Paul, Lucas, Roskam, and Marchant.

Chairman GUTIERREZ. The Subcommittee on Domestic and International Monetary Policy, Trade, and Technology will come to order. The subject of today's hearing is, "The U.S.-Russia Economic Relationship: Implications of the Yukos Affair."

First, I would say good afternoon and thank you to all of the witnesses for agreeing to appear before our subcommittee. I think that we have assembled an excellent panel of experts that will help the subcommittee get to the heart of this very complex subject matter.

I yield myself 5 minutes.

The purpose of this hearing is to discuss U.S.-Russian economic relations with an emphasis on the implications of the Yukos affair. This hearing will provide the subcommittee with an opportunity to closely examine the matter, including the losses suffered by U.S. shareholders, and determine what impact this incident will have on future U.S. investment in Russia. Quite simply, U.S. and other would-be foreign investors need to know whether the rules of law will be upheld in Russia.

The subcommittee won't answer that question today, but hopefully we can shed some light on this issue, and motivate the Administration to start asking the Kremlin some tough questions when it comes to protecting the interests of U.S. investors. Yukos Oil Company was initially created in 1993 by decree of the Russian government, but in 1996, Yukos became the first entirely private Russian oil company. By all accounts, Yukos was a successful private enterprise, growing substantially under the leadership of CEO Mikhail Khodorkovsky who took significant steps to apply Western standards of accounting and corporate governance to Yukos.

Yukos continued to progress. Yukos continued its progressive trend in 2001 by becoming the first Russian oil company to publish quarterly reports in accordance with international standards. The

company also hired several dozen Western European and American-based accountants. As a result of these reforms, Yukos was widely recognized as Russia's most transparent corporation and enjoyed a good reputation in the West.

With the help of international investors, Yukos continued to expand, and by April of 2003, as a result of an agreed merger with Rosneft, Yukos was poised to become Russia's largest oil company and one of the world's largest, non-state-owned oil companies. And that's when things started to unravel for Yukos and its CEO. In October of 2003, Khodorkovsky was arrested and later charged with tax fraud.

Less than a week after his arrest, the Russian government froze ownership of 44 percent of Yukos' shares. In July of 2004, Yukos was officially charged with evading payment of over $7 billion in Russian taxes. Later that same year, the Russian government sold Yukos' main production unit through a questionable auction process to recover some of the nearly $30 billion in alleged back taxes and penalties. Our witnesses today will add significant detail to the questionable Yukos auction and the entire unwinding of the company. But suffice it to say that the course of events I just briefly outlined caused the value of Yukos shares to plummet. And in the end, U.S. investors were never compensated for their losses.

While we still don't exactly know how many Americans have suffered financial losses from the Yukos affair, some estimates put the total of U.S. investor losses as high as $6.7 billion. Those who lost are not just institutional investors but include individual investors as well as public and private pension plans. Instances like the Yukos situation create an uncertainty among potential investors, which could result in substantial loss of investment for Russia and impede its integration into the global economy.

Treatment of American shareholders in the Yukos affair is the focus here, but there are several other key issues which I think the witnesses should discuss. Beyond the Yukos affair, Vladimir Putin's actions in the energy sector represent an assertion of government control over a primary source of economic growth in Russia in recent years. For example, in June 2006, Russia's officials announce that no foreign entity would be allowed to own greater than a 49 percent stake in all but the country's smallest oil and gas fields, keeping the richest reserve for Russian state-controlled energy companies. Neither the United States nor European companies impose such restriction on Russian companies, and it is something that should be examined and detailed here today.

The United States and Russia signed the bilateral investment treaty, BIT, in 1992, but the treaty has not been ratified by Russia. Ratification of the BIT would provide protection for U.S. investors against the types of actions taken by the Russian government in the Yukos case. The failure of Russia to ratify the BIT has been a key weakness in the U.S.-Russia economic relationship. Compared to investors from other nations, U.S. investors are at a disadvantage.

For example, 38 countries including Russia, Germany, Ireland, Italy, Spain, and the United Kingdom have concluded bilateral investment treaties with Russia that have also been ratified. The presence of the treaties allow Yukos investors from these countries

to sue the Russian government, but that option is not available to U.S. shareholders.

I want to take this opportunity to call on the Bush Administration to persuade Russia to ratify the BIT. By ratifying the BIT, President Putin would send a strong message to U.S. investors that investing in projects in Russia is safe and that the Yukos situation is the exception, not the rule.

Again, thanks to our panel of witnesses, and I now recognize Dr. Paul for his opening statement.

Congressman?

Dr. PAUL. Thank you, Mr. Chairman.

As you know, I have consistently favored a policy of non-intervention with regards to foreign affairs and to economic policy. Where there may well be problems with the Russian economy in terms of failed privatization and government expropriation of assets, etc., there's no reason that these issues should concern the U.S. Government.

Four nations could easily criticize the United States for its weak dollar policy, which favors our exporting industries while harming the exporting industries of our trading partners; for our eminent domain policies, which make a mockery of property rights; and for Sarbanes-Oxley, which unfairly burdens companies operating in this country and causes companies to move to foreign capital markets, we would understandably resent this intrusion into our affairs.

While I empathize with the investors who have lost money through the Yukos incident, the fact remains that markets are fraught with risk. Our loose monetary policy and stimulation of credit have led to expectations of permanent, positive economic growth. The technological bubble and the housing bubble have caused many to believe that markets can only go up. When bubbles burst, when stocks decline, something must have gone awry and the government is called upon to right the wrong.

While many innocent investors are lured into the stock market as a result of our flawed, expansionary government policies leading to visions of ever increasing wealth and may not be entirely at fault for their losses, the principle of caveat emptor seems to have been forgotten. In the case of a burst asset bubble or a stock's decline in price, some investors will lose out. It might be painful. It may have come about through injustice and government meddling, but government wrongdoing cannot be undone by more government wrongdoing.

Neither at bailout, as in the case of the housing bubble, nor attempted government pressure on a foreign government, as in the case of Yukos, are appropriate reactions to the losses of investors. I wish the investors affected in the Yukos incident well, but urge my colleagues to resist the temptation to intervene in Russia's internal affairs.

I yield back the balance of my time.

Chairman GUTIERREZ. Thank you very much, Congressman.

We will now proceed to the witnesses that we have. Thank you.

First on our panel is Mr. Timothy Osborne. Mr. Osborne is director of GML, a private equity fund which is the owner of a majority stake in Yukos Oil Company. He serves as senior partner of

Wiggin, Osborne & Fullerlove, an international tax law firm based in the United Kingdom, where he has practiced since 1978.

Prior to joining his current firm, Mr. Osborne was articled at Lavelle, White & King. Mr. Osborne's specialty areas of business and law include company, commercial, and tax work for clients with international interests. Mr. Osborne received an LLB in 1972 at University College, London.

Second, we have Mr. Anders Aslund. Mr. Aslund is a senior fellow at the Peterson Institute for International Economics. He previously served as the director of the Russian and Eurasian program at Carnegie Endowment for International Peace and is co-director of the Carnegie Moscow Centers Project on Economics of the post-Soviet states.

Mr. Aslund is also an adjunct professor at Georgetown University. Mr. Aslund has served as an economic advisor to the government of Russia, the Ukraine, and to the President of Kyrgyzstan. He was a professor at Stockholm School of Economics and director of Stockholm Institute of East European Economics.

Mr. Aslund has worked as a Swedish diplomat in Kuwait, Poland, Geneva and Moscow. He is a member of the Russian Academy of Natural Sciences and co-chairman of the Economics, Education, and Research Consortium, and chairman of the Advisory Council of the Center for Social and Economic Research in Warsaw.

Mr. Aslund is the author of several books on Russia, including: "Building Capitalism: The Transformation of the Former Soviet Bloc"; "How Russia Became a Market Economy"; "Gorbachev's Struggle for Economic Reform"; and "Russia's Capitalist Revolution: Why Market Reform Succeeded and Democracy Failed."

Third, we have Mr. Clifford G. Gaddy. Mr. Gaddy was born in 1946 in Winston-Salem, North Carolina. He earned his Ph.D. in economics from Duke University in 1991. He has held various teaching and research positions at Duke, Georgetown, and Johns Hopkins University, and at the Brookings Institution in Washington, D.C., where he is currently a senior fellow and senior in foreign policy and global economy and development programs. He has published several books and a large number of articles on the Russian economy.

And finally, we have Mr. David Satter. Mr. Satter is a research fellow at the Hoover Institution, and a former Moscow correspondent for the Financial Times of London. He has written on Russia and the former Soviet Union for 3 decades. He is also a senior fellow at the Hudson Institute and a visiting scholar at the Johns Hopkins University School of Advanced International Studies.

Satter has written two books about Russia, "Age Of Delirium: The Decline and Fall of the Soviet Union," and "Darkness At Dawn: The Rise Of the Russian Criminal State." "Age" is also being made into a documentary film by the Russian director, Andrei Nekrasov.

I mispronounced that name.

Mr. Satter began his career as a police reporter for the Chicago Tribune. In 1976 he was named Moscow correspondent for the Financial Times where he worked for 6 years before becoming a special correspondent on Soviet Affairs for the Wall Street Journal. He

graduated from the University of Chicago and Oxford University where he was a Rhodes Scholar and earned a B.Litt degree in political philosophy. Welcome to you all.

Mr. Osborne, you may proceed.

STATEMENT OF TIM OSBORNE, WIGGIN OSBORNE FULLERLOVE, LONDON

Mr. OSBORNE. I would like to thank Chairman Gutierrez for convening this hearing today and I respectfully request that my full written statement be entered as part of the record.

Chairman GUTIERREZ. Without objection, so ordered.

Mr. OSBORNE. My name is Tim Osborne. I'm a director of GML Limited, formerly known as Group Menatep, Ltd., the majority shareholder in Yukos Oil Company.

Yukos was, before its demise, the largest oil company in Russia and the fourth-largest oil company in the world. The past 4 years have seen a veritable onslaught against Yukos by the authorities in Russia and American investors as all Yukos investors worldwide have suffered. We should be alarmed at the lack of investor protection and willingness to ignore shareholder rights in Russia.

The Yukos case was about the illegal seizure of legitimate private assets using trumped-up charges all for the political and financial benefit of the Russian state. I call our attention to four principles of free market capitalism that are being undermined in Russia today: transparency in capital markets; maximizing shareholder value; protecting investors; and adherence to the rule of law.

Free, open, and transparent markets are an essential element if buyers and sellers in any marketplace are to trade with confidence. Public and accurate disclosure of all material information is a basic ingredient of a more efficient market. Accurate information is what separates investing from roulette, and if Russia restricts the flow of information about publicly owned companies, American investors will be paying Russian roulette with their financial future.

If all that investors can buy is a minority share in a state-owned enterprise and if critical information about the controlling shareholder, an ultimate parent is restricted by that very government, there is neither transparency nor investor protection. Yukos was the first Russian company to adopt Western standards of corporate governments with its American depositor receipts trading over the counter in the U.S. market since 2001.

By 2003, U.S. investors including state pension funds and individuals held approximately 15 percent of the shares in Yukos, worth in excess of $6 billion. In 2003, Yukos was preparing to go fully public in the United States, preliminary submissions have been made to the SEC, and under Mr. Khodorkovsky's leadership, Yukos and GML were willing voluntarily to accept the stringent reporting, transparency, disclosure and internal control requirements of Sarbanes-Oxley, a distinguished product of this committee.

The Russian government's effort to investigate and dismantle Yukos in my view was in part directly related to Yukos efforts to integrate with the West. In the United States and other Western markets, corporate managers act with a rational business purpose to maximize value for all shareholders. American securities laws contained a set of rights for shareholders in order to protect their

financial interests. In Russia today, state-owned enterprises often acting further into the Kremlin's political and strategic objectives rather than in the interest of shareholders.

Rosneft, the Russian state-owned oil giant and the recipient of most of Yukos' major assets, in its July 2006 prospectus said: "The Russian government, whose interest may not coincide with those of other shareholders, controls Rosneft, and may cause Rosneft to engage in business practices that do not maximize shareholder value." The issue of protecting the interests of investors, particularly individual investors, is an important principle of the American free-market economic system, regardless of whether the protection is for investments in the United States or overseas markets.

U.S. shareholders, investors, institutional investors, consumers, and others should be protected. Russia is an emerging market where U.S. investment will and should occur more and more often. It's therefore increasingly important to minimize the risk to U.S. citizens of non-market factors. Russia is a growing segment of the U.S. economy and there should be laws to protect U.S. investor rights.

There's a very important role for government in ensuring free, open, and efficient markets. The application of the rule of law, a share in a company is a property right, and it must be enforceable in law. So we need honest, independent courts and tough independent regulators. The role for government is as a neutral policeman, not as a player and referee at the same time. In Russia, the courts are responsive to political pressure and the regulator and the regulated are one and the same.

Respect for the rule of law in Russia appears to be a principle in jeopardy. The courts outside Russia are reaching this conclusion. Each time the Russian authorities' allegations regarding Yukos, its founders and employees, have come before an independent court outside Russia, the court has found the allegations to be unsubstantiated, invalid, and politically motivated. On this basis, the Swiss Supreme Court has rejected mutual assistance requests and the courts in England have refused extradition requests. All of these events beg the crucial question: From an American investor perspective, how can you have confidence in your ability to enforce in Russia your property right in a Russian publicly owned company without an independent judiciary applying the rule of law to serve as arbiter of your claim?

In conclusion, Mr. Chairman and members of the committee, the Yukos affair is a dark cloud having over American investors and their ability to invest in Russia with confidence. I believe there must be a change of course in Russia with significant economic and political reforms to protect investors and free-market principles. American investors should be wary until they can be confident that their rights and interests will be protected according to internationally recognized standards of corporate governance, business transparency, and the rule of law.

At the moment, Russia appears to be heading in the wrong direction. It must abide by its international commitments and aspire internally to internationally recognized standards.

Thank you again for convening this important hearing, and I welcome your questions.

[The prepared statement of Mr. Osborne can be found on page 42 of the appendix.]

Chairman GUTIERREZ. Thank you.

Mr. Aslund, please?

STATEMENT OF ANDERS ASLUND, SENIOR FELLOW, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. ASLUND. Thank you very much, Mr. Chairman.

I would like to thank you for this opportunity to speak on an important topic, the implications of the Yukos affair for the U.S.-Russia economic relationship, and I want to focus on three topics: the U.S. Government's reaction; possible legal recourse; and plausible future remedies. As we have heard, Yukos was essentially subject to lawless confiscation through aberration of Russian tax laws.

At its peak, Yukos market capitalization was $45 billion in October 2003, and since 15 percent of Yukos shares were traded in New York, but was $6.7 billion at the peak. The best approximation of the total losses of American investors is exactly that. Throughout this process, President Putin has denied any involvement, but he has also repeatedly, somewhat in contradiction, denied that Yukos would be bankrupted, confiscated, or nationalized.

In fact, President Putin has hardly uttered a true word throughout this process. His central motive was to enhance his political control by jailing the most politically active businessmen while the state company Rosneft seized Yukos' assets. Many foreign investors, including at least three major American fund management companies, naively believed President Putin's words, and they lost billions of dollars because of his Russian miscarriage of justice. Even so, remarkably, the U.S. Government has not tried to defend American shareholders. Three months after the arrest of Yukos executive Lebedev, President Bush said, "I respect President Putin's vision for Russia: a country of peace within its borders with its neighbors and with the world; a country in which democracy and freedom and rule of law thrive."

Reassured, Putin went ahead and had Khodorkovsky arrested 4 weeks later. Before the fire sale of Yugansk, Yukos' main oil field, U.S. Secretary of State Colin Powell stated in October 2004, "The Russian people came out of the post-Soviet Union era in a state of total chaos—a great deal of freedom, but it was freedom to steal from the state—and President Putin took over and restored a sense of order in the country and moved in a democratic way." Last summer, President Bush revealed, "But one thing I found out about Vladimir Putin is that he is consistent, transparent, and honest. I know he's always telling me the truth."

International law offers various safeguards against the confiscation of private property abroad; and, as you mentioned, Mr. Chairman, the most direct remedy is a bilateral investment treaty, and indeed the United States and Russia signed such a treaty in 1992. The U.S. Senate ratified it, but unlike most European countries, the United States has failed to convince Russia to ratify it so that it assumes legal force. And European shareholders have also two other legal options: one is a 1994 multilateral treaty, the Energy Charter Treaty; and the European Court of Human Rights in

Strasbourg, and the United States, unfortunately, is not a party to either of these options.

Thus, European citizens have three international options to sue Russia, while American citizens in this case have none. To conclude, first, American shareholders probably lost $6 to $7 billion in the confiscation of Yukos. Second, the U.S. President and Secretary of State have in no way protested against this confiscation. Third, because of U.S. Government neglect, American shareholders of Russian companies have considerably weaker legal protection than European shareholders. This absence of legal safeguards harms U.S.-Russian economic relations and U.S. investments in Russia, which are both remarkably low in any comparison.

The first remedy must be that U.S. top officials speak up in defense of its citizens. Second, the United States should persuade Russia to ratify the bilateral investment treaty of 1992, as you suggested, Mr. Chairman. In the longer term, the United States needs a bilateral free trade agreement with Russia which would include investment guarantees, but that presupposes that Russia first becomes a member of a World Trade Organization.

Thank you, Mr. Chairman, and I would happy to respond to any questions.

[The prepared statement of Mr. Aslund can be found on page 24 of the appendix.]

Chairman GUTIERREZ. Mr. Gaddy?

STATEMENT OF CLIFFORD GADDY, SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. GADDY. Thank you very much, Mr. Chairman, Thank you for your introductory comments, and I thank also Congressman Paul for his comments.

My own comments here will focus on the business climate inside Russia, which exhibits some specific features that are important to understand. First, however, I think it's important for us to be realistic about what is at stake when we talk about U.S.-Russian economic relations in general. The direct U.S. stake in Russia's economy is quite small.

For most of the past decade-and-a-half, since the fall of the Soviet Union, our direct investment in Russia has been less than one-tenth of one percent of total U.S. direct investment abroad. Now, with Russia's recent oil windfall, this investment has grown, but it still remains small. And even with the windfall, we still sell less of our products to Russia than we do to the Dominican Republic, less than half of 1 percent of total U.S. exports.

Having said that, our economic interaction with Russia should be much bigger. Russia is sound, macro-economically and physically. It has 140 million consumers still with unmet, pent-up demand from decades of living with consumer goods shortages under communism, which should be a potential bonanza for U.S. and other Western companies. When expected returns are this high but investment and trade remains small, one can suspect perceived high risk on the market. Specifically, it is what is usually referred to as political risk, or risk to the investors property rights. The investor wants to know, will the money I commit and the earnings I make

be secure from appropriation by other parties, whether they be criminals or the state?

And there is indeed a perception of high risk of this kind in Russia, but I'll argue that this risk stems from the lack of knowledge about the rules that prevail in Russia, and really, the key is to understand those rules. There are three elements of these rules that I would like to emphasize: First, it's the formal tax system; second, the informal tax system; and, third, what I call the phenomenon of relational capital, the formal tax system.

One early priority for Mr. Putin when he came in was a thorough overhaul of a dysfunctional tax system. His motive was to collect the wealth he needed to realize a stated goal of building a so-called strong state. The resulting Russian tax system has mostly clear and transparent tax rules. The rates are basically reasonable. Administration is strict, but the problem is it's not always fair, and I'll get to that point in a second, because it relates to my third factor of relational capital. But let me turn to informal taxes. What am I talking about.

There are two main types of informal taxes in Russia. First of all, companies in Russia are "asked" to make "voluntary" contributions to off-budget infrastructure funds, social funds, road funds, and the like. The second form of informal taxes is excess cost of productions. Large and successful companies are expected to order equipment and other inputs from local manufacturing enterprises, even if the products are not competitive. These informal taxes are not prescribed by formal laws, but they are mandatory and failure to pay them exposes the owner to serious risk.

The difficulty is to know exactly what is expected. The informal taxes are therefore like part of the iceberg that lies beneath the surface, hidden but dangerous; it's the part that can cause shipwrecks. One victim of the hidden iceberg was Yukos. Mr. Khodorkovsky refused to pay the excess costs. He tried to be, economically speaking, a cost minimizer, that is a profit maximizer, in a system that dictated that he be a cost maximizer.

Now, the key characteristic of both formal and informal taxes is that the administration can be highly discretionary. Whether or not you are deemed to have paid your taxes depends on the judgment of individual political officials. In my written testimony I refer to this as a "protection racket." This means that success on the Russian market depends not just on the machines and equipment you have, the management you have, but also your connections to the right people and that's what I term "relational capital," because you can invest in it. However, this is bad, because it diverts effort and money away from investment and other factors, production. But if you don't do it, you will be at a competitive disadvantage.

Now, economically, as an economist, I think this system is bad for Russia. But the real question for us here is what are the implications for U.S. businesses, and is there any need for U.S. government action? Surely, this system imposes extra cost on businesses. U.S. businesses would like to have lower costs. More important, I think they want the competition to be fair. I think they want a level playing field. It's not clear that this system disadvantages American, U.S., or other foreign investors. It may be possibly more

difficult for outsiders than Russians to acquire adequate information.

But I think that ultimately the burden rests on the businesses. The costs are calculable and the rules are knowable. They can make the business decision. It is up to them to make these decisions on their own. The question of whether or not the outside world, especially governments, can influence this system, is not at all clear to me. There's certainly no magic bullet, and in my written testimony, I especially warn against what might seem to be a straightforward answer to this of an anti-corruption campaign. The Russian situation is not so simple, and an anti-corruption crusade might not be as desirable as it might seem.

Thank you very much.

[The prepared statement of Mr. Gaddy can be found on page 33 of the appendix.]

Chairman GUTIERREZ. All of the written testimony will be entered into the official record without objection.

And, Mr. Satter, please continue.

STATEMENT OF DAVID SATTER, RESEARCH FELLOW, HOOVER INSTITUTION

Mr. SATTER. The Yukos affair represented a turning point for post-Soviet Russia. Ever since succeeding to the Presidency, Putin has worked to concentrate power in his hands, eliminated federalism in violation of the Russian constitution, subordinated the legislature, controlled the press, and subordinated the courts.

With the arrest of Mikhail Khodorkovsky, however, he also acted to ensure that the nation's oligarchs would serve only political candidates backed by the regime. His goal was to place the nation's wealth in the service of his own political faction, choking off political opposition, and completing the transformation of Russia into a controlled society with a permanent political leadership.

Khodorkovsky would hardly qualify as an international cause celebre if his arrest were an isolated incident unrelated to the political struggles within Russia. There's no better example of the corrupt way in which property was divided up under Yeltsin than the way in which Khodorkovsky obtained control of the Yukos Oil Company. It was as a result of an auction in which his bank, the Menatep bank, was both the manager and the principal beneficiary. Unlike the other oligarchs, however, Khodorkovsky understood that the Russian rules of bandit capitalism were unacceptable internationally and he took steps to transform Yukos, introducing Western standards of accounting and corporate governance. He also began to exercise his rights as an honest businessman, as he saw fit, including the right to finance opposition political parties. In the end, I believe it was this that sealed his fate. The Russian bureaucracy depends on businessmen's violations of the law and in particular tax avoidance in order to facilitate a steady flow of bribes, and to ensure that businessmen live in fear and so are amenable to political control.

Khodorkovsky broke with that system and his example had to be suppressed in order for the system itself to survive. The Yukos affair casts a long shadow over Russian economic and political life. In the post-Yukos system, no individual doing business is com-

pletely secure in Russia. Khodorkovsky was not only Russia's richest citizen, he was also the head of its most enlightened company. It was a measure of Yukos' success that on the eve of Khodorkovksy's arrest, the company was on the brink of attracting as much as $25 billion in foreign investment from Exxon-Mobil.

Given the rise in oil prices, Yukos could not have gone bankrupt for purely economic reasons. Yukos proposed various restructuring schemes for paying back the alleged tax debt, all of which were rejected. The purpose was to break up the Yukos Oil Company and distribute its assets to state-run energy concerns that were run by Putin's closest cronies. The aftermath of the Yukos affair makes it highly unlikely that Putin and his cronies will ever give up power. Yugansk-Neftegaz, which was the principal production unit of Yukos, was sold to a previously unknown company called the Baikal Finance Group at about half of its real value.

The state oil company, Rosneft, then purchased Baikal Finance. Yukos had filed for bankruptcy in Texas and wanted an American injunction barring Gazprom and its Western financiers from participating in the auction. It was apparently out of a desire to avoid legal complications that the Baikal Finance Group, an obvious shell company, emerged to bid for Yugansk-Neftegaz. The sale duplicated the tactics used by Yeltsin era oligarchs during privatization. It was also illegal, because in tax settlement cases, non-core assets must be disposed of first.

Ugansk-Neftegaz was the core of Yukos. Under these circumstances, it is very risky for the Putin regime and the people connected with it to give up power, because the same tactics that they used against Yukos can easily be used against them. The Yukos affair, therefore, contributed significantly to the downfall of democracy in Russia. And it was with a certain moral stupidity that Western companies reacted favorably to Rosneft's London IPO, suggesting that for many of them the ethical and legal questions involved in the destruction of Yukos are simply not relevant.

Finally, the Yukos case has emboldened the Russian leadership to use coercive tactics against foreigners. The best examples of this are the pressure which was brought to bear on Royal Dutch Shell to hand over its control of the Sakhalin-2 oil project to the state-run concern Gazprom in light of supposed environmental violations, which were forgotten the moment the company was handed over. Under these circumstances, there are certain steps that the United States needs to take. In the first place, we need to bear in mind that we gain nothing from giving undeserved grants of legitimacy to the Russian government in economic matters or in political matters.

Such grants include membership in the G8, which is restricted to industrial democracies. Russia is not an industrial democracy. They also include membership in the WTO and the rescinding of the Jackson-Vanik amendment. We need to create the conditions for Russia to understand that it will be held to the same rules of legal and moral behavior as the Western countries, whose society it seeks to join. And we should be wary of attempts by Russian companies to acquire U.S. assets with strategic significance, both in light of the fact that Russia is determined to prevent such acquisition when it comes to its own strategic assets and because in the

aftermath of the Yukos case no Russian company can be regarded as truly independent of the Russian state.

[The prepared statement of Mr. Satter can be found on page 50 of the appendix.]

Chairman GUTIERREZ. Thank you all very much.

I just have some general questions of the panel.

Mr. Osborne, Mr. Aslund, Mr. Gaddy, who owns what was once Yukos today? Who owns it?

Mr. OSBORNE. The majority of the assets have now gone to Rosneft, the Ugansk-Neftegaz went through the original option process via Viscount Finance. The other production facilities and major assets have gone to Rosneft through the current bankruptcy auctions at generally lower prices.

Chairman GUTIERREZ. And who is this?

Mr. OSBORNE. Rosneft—it's a state-controlled company—shares are available on the London market.

Chairman GUTIERREZ. So you can buy shares to the state-owned company?

Mr. OSBORNE. Yes.

Chairman GUTIERREZ. Okay. And that's who owns what was once Yukos? They own it?

Mr. OSBORNE. Yes, Rosneft currently has market capitalization of $91 billion. Yukos, if it were alive, would probably have $100 billion or plus. But Rosneft, partly because it's more indebted, partly because it's not as transparent and less well-managed; it's worthless.

Rosneft has taken over about 95 percent of the former Yukos assets and the means, as Mr. Osborne mentioned, has been through many of these bankruptcy auctions which took place this last summer. But they were by and large exclusive in the sense that other companies understood that it would be seen as a hostile act to the Russian government to try to be against Rosneft.

Chairman GUTIERREZ. Okay. Mr. Gaddy, as you look at the rules in play in Russia, post-Soviet Union, and you look at the Yukos affair specifically, who benefitted other than the Russian state? Did anyone in particular in your examination benefit from the demise of Yukos and its demise, particularly any particular person?

Mr. GADDY. Yes, to be frank, as I sort of suggested there, Mr. Khodorkovsky was in the process of making Yukos into a very Western-style company that would focus on the bottom line, reduce costs as much as possible in order to increase profits as much as possible, a laudable, normal goal for a Western market-oriented company. In doing so, however, he reexamined some of the contracts that the company's subsidiaries in the Yukos empire had with various supplier enterprises, some big manufacturing plants throughout Russia, and was going to cancel those contracts and seek low-cost suppliers—again, a normal thing to do if you're a businessman.

But the fact of the matter was that what was at stake were thousands, probably tens of thousands of jobs, and there are some interesting cases that the people in question reacted, especially the politicians who depended on them. It's like losing a plant in one of your districts, and so, I mean, it's a complicated matter. There are certainly more beneficiaries—not just sitting in the Kremlin. There

were beneficiaries in many local cities, towns, plants, and factories around Russia—to me, partly explains, I think.

Mr. Satter gave a very nice description of the political threat that Mr. Khodorkovsky may have represented to the Kremlin, but the fact of the matter is whatever brought him down initially there were a lot of people who were willing to jump into the fray and give an extra kick. He had a lot of enemies.

Chairman GUTIERREZ. Mr. Aslund, who do you think benefitted? Anybody other than the Russian state?

Mr. ASLUND. Normally in Russian state companies you have substantial kickbacks by various means, which are normally very firmly concentrated to the top management and to the chairman of the company.

Chairman GUTIERREZ. Mr. Satter, any comment?

Mr. SATTER. Well, the people around Putin benefitted. Rosneft is staffed by and directed by people with close connections to Putin. What we have seen is a transfer of the country's wealth from the Yeltsin era oligarchs to the KGB cronies of Putin who now not only monopolize power but also wealth and property.

Chairman GUTIERREZ. Well, maybe we could examine who might have benefitted in terms of whether it is those close to the president, those in political positions and governmental positions, that may have benefitted personally. I understand that we kind of have this general rule of thumb that was transferred back to the Russian state through this corporation, but it seems to be an awful lot of money, something that was worth nearly $50 billion on an open market was sold for $9 billion, and there have been estimates given by the panel today that if it were transparent, it could be worth $100 billion today. It's an awful lot of money somewhere put either directly today or potentially the money that is there.

Mr. Paul?

Dr. PAUL. Thank you, Mr. Chairman.

I have no doubts about the apparent political chicanery surrounding the Yukos affair, but I have some questions about dealing with responsibility and jurisdiction in trying to sort this all out. I have a couple of questions, and they can be for anybody on the panel. Investors in the United States, basically, receive a full regime of protective self-regulatory protections coupled with SEC oversight. Foreign companies that list their shares or their ADRs on the NASDAQ or the New York Stock Exchange or the American Stock Exchange must meet and maintain financial corporate governance standards.

Companies that are quoted in the pink sheet, like Yukos, do not need to fulfill any such requirements, and for these reasons the SEC has used companies listed on the pink sheet as "among the most risky investments," and advises potential investors to heavily research the companies in which they planned to invest.

I have two questions: Did investors, our investors basically, American investors, fail to do their homework and conduct their own due diligence about Yukos and the overall regulatory oversight of the Russian financial markets; and, number two, why shouldn't shareholders of investment funds demand full disclosure if their money is being invested in this manner if they are uncomfortable with such an investment?

If they don't get satisfactory answers, then they can just forget about the investment. Does anybody care to comment?

Mr. ASLUND. If I may start, first, I think we should clarify here that Yukos books were quite clear. No plausible complaint has been made by them. The tax case that has been made against them in Russia has been because they used loopholes in the tax system as it existed; and, retroactively, this has been considered a crime to utilize these loopholes.

PricewaterhouseCoopers has withdrawn its audit from Yukos for 10 years, but this can only be understood as a matter of Russian pressure on PricewaterhouseCoopers. I don't think it discredits the books. Yukos, if anything, seems to have a very good standing. At least no plausible complaints have been made about them as far as I understand. There is essentially one problem here, and that is confiscation. And the way to handle confiscation is normally an investment for bilateral investment protection agreement, which as we have discussed is not enforced with regard to Russia.

And the failure, I mean, there were of three major investment funds well known here in the United States, which are not publicizing how much money the lost on Yukos. I am not going to give their names, but the reason was that they believed in President Putin's words. President Putin stated about half a dozen times in the course of one year that Yukos would not be bankrupted, etc.; and these foolhardy investors believed in President Putin's word. That was a mistake. It's not a problem of their financial analysis as we have seen Yukos has later on succeeded very well in terms of assets. That is Rosneft today. So the problem is one of political analysis and investment protection. Nothing else.

Dr. PAUL. But wouldn't an investor recognize that there was a lot of political risk in investing in Russia at that time?

Mr. ASLUND. As David Satter emphasized here, Yukos turned everything around. As late as 2002, oil companies were still privatized in Russia. Yukos was the first in a trend and it started a trend of re-nationalization that investors still are very hesitant to believe in. Russia stock market value is still about 100 percent of GDP, the normal level for Western Europe. So there's still a big belief in the property rights in Russia, if you look up on the stock market.

Dr. PAUL. Mr. Satter, you wanted to add something?

Mr. SATTER. I just wanted to say that the investors, in order to have made a wise decision, would have had to understand the nature of Russian society. They would have had to understand the lawlessness of the society, the lawlessness of the regime, because they were looking at a company which was transparent, well-organized, well-run, and obviously prospering. But is it fair to expect the investors to have had a more profound understanding than our own government had and to have achieved that understanding in the face of all the misleading things that were said by our government, whose responsibility it was to understand the political situation.

Chairman GUTIERREZ. Mr. Gaddy, do you want to wrap up with the response to Mr. Paul?

Mr. GADDY. Yes, I think the question is it's very easy in hindsight to see that the investors made the wrong decision. They made

a gamble. But it was really Mr. Khodorkovsky making a gigantic gamble himself by the very act of making his company so transparent, so Western-like, and in an environment, as I described, which simply could not tolerate such an entity. He was actually counting—I mean, he's not naive—on the system moving in that direction.

In fact, if you look at Mr. Khodorkovsky's entire career from the time he was a kid, you know, in the Komsumol, a young Communist league trying to play the new system, he was always one step ahead of where things were going. He always gambled. He always gambled correctly. This, of course, was the biggest gamble of his life, and it was with maybe his life at stake. But he made a mistake. Investors followed him, but the conclusion I think is in the expression that Professor Aslund used. They were foolhardy in that sense. In hindsight we say yes, but at the time it seemed like a nice gamble to make.

Were you an investor?

Chairman GUTIERREZ. No. I wasn't an investor, but I heard President Bush say he looked him in the eyes—looked—saw Putin's. Well, the investors probably took that into account. Sure, it was somewhere written. He looked him in the eyes and saw his heart, saw a good man. Sounds like a place to invest to me, but anyway—

[Laughter]

Chairman GUTIERREZ. So, next we're going to have Congressman Lucas, please, for 5 minutes.

Mr. LUCAS. Thank you, Mr. Chairman.

Isn't it fair to say, gentlemen, that Yukos is the most high-profile example of the changes that have gone on under the present Administration?

I read accounts in the popular media that the successor to the old KGB—what do we call it now, the FSB—that it seems to have evolved down to a network that has present or past players in that particular organization at every level of relevance throughout the economy of Russia. It would seem, and you can comment on this if you care to, but it would seem that if the accounts in the popular press are correct, it just simply reflects the reality of the environment in Russia. And if you're going to be an investor, if you're going to be a participant in any way, you have to accept that much as the old Soviet army had Commissars at every level to assist the generals and the commanders, so you'll have the people to assist you in your decision-making process.

Is that a fair observation in the popular press of the realities as they exist now in the economy in Russia?

Mr. OSBORNE. I think it's fair to see that happening. I think Yukos was certainly the first example and perhaps the most flagrant example of the people in the Kremlin who are clearly from the FSB taking control of all, particularly the energy companies. But Yukos, I think, was singled out for special attention because of the animosity felt to Mr. Khodorkovsky by President Putin because of the perceived political ambition.

Mr. GADDY. I think it's also important to realize that this phenomenon that you describe of oversight and control of the FSB people is predominantly in the strategic sectors of oil and gas, maybe

some of the metals. I think that's important to point out, because most American businesses that are active in Russia now are looking at Russia are not in those strategic sectors. They will encounter as they will describe to you problems with corruption at a more petty level, including sometimes officials of these institutions, these law enforcement institutions. But they in my opinion are at very low risk of being expropriated in the way that Mr. Khodorkovsky was or in the case of Royal Dutch Shell or some of the other big oil companies. It's a more "normal" sort of environment in an emerging market.

Mr. SATTER. I think that it's important though for an investor to understand that although not every company and not every investor is going to be treated the way Yukos was treated, nonetheless, there are no guarantees. For Yukos to have been dismantled the way it was, it was necessary to ignore completely the rule of law. Comparable lawlessness prevails throughout the Russian economy. It may not affect a given investor in a given situation, but under certain circumstances, it may well.

Mr. ASLUND. Yes, I would say that we see a clear pattern now of re-nationalization where Yukos was the first case we have seen the Gazprom gas company picking out quite a few assets cheaply and not very legally. We are seeing anything that is close to the military being picked off by state companies. You should not be in the sensitive sectors Dr. Gaddy emphasized, and, you should not be too big and you should not be too close to the state.

So if you are a small, retail shop or a small producer, then you enjoy a lot of satisfaction and you can see a lot of Western companies that are doing very well in that area. So I don't object to your picture, but it's partial. You have another part of Russia, which is actually flourishing in a good sense.

Mr. LUCAS. So depending on how big the porcupine is and how hard you hug it, it depends the result that will come from it. But as investors we have to bear that in mind when decisions are being made and understand that this is the reality depending on the sector and the part of the economy. It is just the reality of place and not be naive about it.

Mr. SATTER. In Russia, the law does not protect you. Circumstances may protect you. You may be protected by the fact that no one has any interest in causing trouble for you, but you are not protected by the law.

Mr. LUCAS. Thank you. Mr. Chairman?

Chairman GUTIERREZ. Mr. Roskam, you are recognized for 5 minutes.

Mr. ROSKAM. Thank you, Mr. Chairman.

Mr. Aslund, I think in your testimony you said that in your opinion European investors were in a stronger position compared to American investors. I would assume you mean European investors in Russia compared to American investors in Russia. First of all, is my assumption correct?

And could you elaborate on that a little bit?

Mr. ASLUND. I elaborate on that more in my written testimony. First, bilateral investment treatments are by and large in force, and these are particularly designed to defend foreign investors against confiscation, goes back to the issue. And they offer arbitra-

tion in third country in those cases, exactly what you want to have. So that's the straightforward remedy.

In addition, you have the Energy Charter Treaty, which was concluded by 51 countries and 46 have ratified it, the United States left out. It came into force in 1997. Russia has said that it's not ratifying it, but it abides by its rulings, and, therefore, this seems to be the favorite of the shareholders in Europe now to sue Russia for Yukos confiscations through the Energy Charter Treaty.

The third venue, which is less popular, is the European Court of Human Rights in Strasbourg, which is attached to the Council of Europe. Although it's focusing on human rights, it also deals with commercial conflicts. The most high-profile Russian commercial case that has been there is Vladimir Gusinsky, who accused the Russian state of having lost his media empire, and he won a judgment with substantial damages to Gusinsky. The Russian state acknowledges the Council of Europe, and Russia even chairs the Council of Europe this year. So this is the third possibility of suing Russia.

The Yukos shareholders in this country are now trying to sue the Russian state or senior Russian officials for concrete crimes they have committed, usually on the territory of the United States, for example, insider trading or other securities violations.

Mr. ROSKAM. Are there dissimilarly situated plaintiffs in this case? In other words are American plaintiff-investors in the Yukos affair, are they at a different situation procedurally or a different posture than European plaintiff investors?

Mr. ASLUND. Yes, European investors have three different legal venues to utilize that are not open to American investors.

Mr. ROSKAM. And is it ripe yet? Have the European investors, has there been any settlement yet or any attempt? Or, is it still very much in the beginning stages procedurally in those three venues?

Mr. ASLUND. I can't answer that question, since I deal with this, I'm approached by various investors from time to time in confidence.

Mr. ROSKAM. I understand.

Mr. ASLUND. I don't deal with them. I mean, I am not involved in their affairs, but of course I receive information. Almost all of them are extremely quiet about it, because they think that we have a greater chance of winning damages from the Russian government if they keep it as a private arbitration issue, which is not publicized. So therefore we can't know.

Mr. ROSKAM. I understand.

Mr. Osborne?

Mr. OSBORNE. Yes, I represent the majority shareholder in Yukos, and we have brought a claim under the Energy Charter Treaty against the Russian government, which is I think the great advantage that European and each of the Charter Treaty's signatories have over the U.S. investors, because they have a direct route to the Russian federation.

As Mr. Aslund said, the Russian federation signed the treaty. It hasn't been ratified but there's a provision in the treaty that binds them on the basis that they haven't opted out. It's a slow process.

It's a minimum $30 billion claim. It's likely to be more like $50 billion by the time we do the math.

The tribunal was constituted and decided to bifurcate the hearing, firstly to hear issues of jurisdiction admissibility, and then if we survive that, they'll go on to the substance.

Unfortunately, one of the arbitrators—and the one appointed by us, so we couldn't complain—had to retire, because he was given a job by Mr. Bush. And we just reconstituted the committee so that we had a procedural hearing before the end of the year and the 2-week hearing on jurisdiction admissibility will be sometime in the first 6 months of 2008. Then there will probably be another 2 or 3 years before we get a final decision.

Chairman GUTIERREZ. We do things a little bit alike. You're from Illinois. I gave you extra time.

[Laughter]

Chairman GUTIERREZ. Mr. Sherman, from California.

Mr. SHERMAN. Yes, Mr. Chairman, thank you for holding these hearings.

We need to focus not only on what happened in Russia and the Russian government's actions, but whether American investors are adequately warned of the difficulties that they can experience investing in Russian companies or investing in Russia or investing in American companies that have exposure to Russia.

To put our current situation in context, relations between the United States and Russia are at an all-time low since the end of communism. Both sides have done everything they can to destroy what should be a natural alliance between the American people and the Russian people. Today or yesterday, Putin was in Tehran embracing the idea of a nuclear Iran. This is not in the interest of Russia.

The Iranians help the Chechen terrorists. It has never been in the interest of Russia to see Iran become nuclear, and yet perhaps just out of spite for the United States, Putin takes this stance. Then you contrast that with the Vice President's speech in the Baltic states through our relatively inane idea of putting missile defense in the Czech Republic in Poland, and I'm not at all surprised to see poisonous relationships between our two countries when both sides are adding one helping of poison onto the other.

I would hope that Russia would establish an image in the world as being in a place where the rule of law applies, where investors can make investments without political risk. That is in the interest of not only Russia but the entire world, especially as we become more concerned with energy resources in this world. Now, looking at the particularities of the Yukos situation, I want to ask each of the panelists a question.

Who is Stephen Patrick Lynch? Dozens of stories identify him as an American who bought at action some $1.5 billion worth of Yukos assets for a discount price of $300 million. As far as I know, no one has made an effort to find out who he is and what his history is. I'd like to know if any of the panels think he or the American financiers of that deal might have any liability under U.S. law for participating in a process that has damaged Yukos and its U.S. shareholders.

Let's hear each panelist in turn.

Mr. OSBORNE. I met Mr. Lynch. I know no more about him than you just described.

I think it's not quite correct to say that he bought $1.5 billion worth of assets for $300 million because out of that is also a liability of $800 million to GML for the loan that is involved with those assets, which are the assets currently in the Netherlands, and there are other liabilities to Rosneft.

Over and above that, I have no further comments.

Mr. SHERMAN. Okay. And I wasn't stating as a fact that he got an incredible deal, just that that's what limited amount I've been able to see in the press, which was why I have four experts in front of me who can tell me what really happened.

Mr. Aslund?

Mr. OSBORNE. Well, I think that it's true as far as I'm aware that he did bid $300 million for the company, but I think it's equally possible to perceive that as a huge risk, because there is no guarantee that the Dutch courts will acknowledge the validity of the Russian bankruptcy. They may well not. There are plenty of people out there arguing that the assets in the Netherlands should go first to legitimate creditors, IGML, and then to the shareholders that have been badly treated in the West.

Mr. SHERMAN. Thanks for embellishing on your comments and let's move on to Mr. Aslund.

Anything to add, Mr. Gaddy?

Mr. GADDY. I can't help you. I never heard of him.

Mr. SHERMAN. Mr. Satter?

Mr. SATTER. I've heard of him, but I can't add anything.

Mr. SHERMAN. How important is it to Russia to be viewed by the World Business Community as a place where the rule of law applies, and are there those in Russia who say, "We don't really want foreigners doing business within our borders. We would just as soon have Russian companies do all the business within our borders and so if foreigners fear to come within the jurisdiction of our courts, that's a good thing."

Perhaps Mr. Satter has a comment?

Mr. SATTER. I think they do want foreign investment, but you're right. There's a mood in Russia now which is really very retrograde and it consists of the idea that they have their values, we have our values; in fact, their notions of human rights and legality that they try to foist on us are just their way of defying us. A lot of this comes from the Russian Orthodox Church. But it has the effect of reinforcing and rationalizing the atmosphere of lawlessness in the country.

Mr. SHERMAN. So you're saying that in Russia you don't always have rule of law and fairness to business linked with human rights and democracy. If I add a business dispute heard in the Austro-Hungarian Empire or the German Empire before World War I, I think I would get a relatively fair verdict. And yet at the same time you wouldn't want to describe either of those countries as a democracy.

Are you saying that there is an attitude that treating businesses fairly is just part and parcel of this larger concept, which some in Russia reject?

Mr. SATTER. We're talking about objective decisions that are handed down by courts in which people who may be very unequal in terms of the power they wield, nonetheless count on a fair decision. Well, that's contrary to what exists in Russia today. In Russia today, those who have power can count on a decision in their interest rather than a decision based on the law.

The political system in the country is also very much related to the lawlessness. Under present circumstances, the laws are so poorly written and so arbitrarily interpreted that anybody can find himself in violation under certain circumstances, and that makes people very, very cautions.

Mr. SHERMAN. Thank you, very, very much.

I'm going to let Mr. Aslund finish up. We're well over 5 minutes.

Mr. Aslund, please?

Mr. ASLUND. Thank you very much.

I would like to pick up on this question. Mr. Putin himself stated one year ago that foreigners should not be allowed to participate in market trade, and that should be reserved for the indigenous population; market stalls should be reserved for Russian citizens, and this has been implemented in law quite fiercely.

A week ago, President Putin said that there were far too many foreign managers in Russian companies and that this was unacceptable. Russian television state television pursues the hard-core nationalist propaganda, so we should not blame anybody but Mr. Putin. This comes straight from him. Let me give you two numbers: in 1999, Russia's GDP in dollar terms was $200 billion. This year it will be more than $1.2 trillion. It has increased 6 times in 8 years. So therefore Mr. Putin and others have a sense that they are walking on water. Why should they be nice, when they as well can be nasty, so they prefer to do that.

Chairman GUTIERREZ. Thank you, Mr. Aslund.

Let me, first of all, thank all of the panelists. We have been greatly enriched by your testimony, your written testimony and by your verbal testimony here. We're going to proceed as a subcommittee to write to the Administration to find out what the Administration is or isn't going to do based on the testimony here today about the Yukos investors here in the United States and see if we can't get some answers either from Treasury or from the White House on this issue about how they're going to pursue this.

And secondly, I think it's very important that we look to the future. I mean Russia does have a sovereign wealth fund of over $130 billion, and at some point you can only invest so much in your own country. You're going to have to invest elsewhere, and it seems interesting to me that both Russia—and China has even more: billions of dollars that they wish to invest. That means they're going to buy things with it and obviously they may be coming our way to which to buy things. I think it's important that we settle old disputes before we enter into new negotiations with the former Soviet Union today, Russia. And so your testimony has been wonderfully enlightening to all of us, and I thank you so much.

I want to note that some members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for mem-

bers to submit written question to these witnesses and to replace their responses in the record.

This hearing is adjourned. Thank you.

[Whereupon, at 3:15 p.m., the hearing was adjourned.]

A P P E N D I X

October 17, 2007

"US-RUSSIA ECONOMIC RELATIONSHIP: IMPLICATIONS OF THE YUKOS AFFAIR"

TESTIMONY OF ANDERS ÅSLUND

SENIOR FELLOW
PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

OCTOBER 17, 2007

COMMITTEE ON FINANCIAL SERVICES
SUBCOMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY, TRADE, AND TECHNOLOGY
UNITED STATES HOUSE OF REPRESENTATIVES

Mr. Chairman,

I would like to thank you for this opportunity to speak on an important topic, the impact of the bankruptcy of the Yukos oil company on US shareholders. I want to discuss the US government's reaction, possible legal recourse, and plausible future remedies.[1]

The Yukos Affair

In 2003, Yukos oil company was Russia's most valuable company. A majority of shares were held by a group of owners led by Mikhail Khodorkovsky, who was also CEO. Yukos had been privatized cheaply, as were most Russian companies, in 1995. It led the revival of the country's old oil fields, drawing on international technology and expertise that boosted Russia's oil production by 50 percent from 6 million to 9 million barrels a day between 2000 and 2004.

Yukos' shares were traded freely on the two main Moscow stock exchanges (RTS and MICEX), and about 15 percent of the companies stocks were traded over-the-counter (OTC) in New York as American Depository Receipts (ADRs). Most of them were held by American institutional investors, and some by individuals. Yukos was one of the greatest success stories in the Russian economy, and its stock price skyrocketed in the early 2000s. Its market capitalization peaked at $45 billion in October 2003, which means that the US ownership might have been some $6.7 billion. This figure is the best approximation of the total losses of American investors, because the value of these shares is now minimal.

In early July 2003, the Yukos executive Platon Lebedev was arrested and, on October 25, 2003, so was Mikhail Khodorkovsky, the CEO and main owner. The actual accusations were long nebulous, but eventually Khodorkovsky was charged with tax fraud. Yukos was the largest private taxpayer in Russia, although it minimized its profit taxes by legally registering its subsidiary companies in low-tax regions in Russia. The authorities reopened audited tax returns and denied the legality of various tax shelters. Initially, they slapped Yukos with $3.4 billion in back taxes, penalties, and interest for 2000. Then the biased tax authorities did the same for later years as well, ending up with the startling number of $32 billion, and the amount continues to rise, most of which represents penalties.

Although there are many possible reasons for the demise of Yukos,[2] two stand out. First, by jailing the wealthiest and most outspoken businessman, President Putin

[1] This testimony draws on my book *Russia's Capitalist Revolution* to be published by the Peterson Institute next month. As a matter of disclosure, I want to clarify that I am not involved in any of these legal suits. I want to thank Gary Hufbauer for helpful comments. Ivan Yuryk has contributed with research assistance. The views expressed are my own and represent none but myself.

[2] Khodorkovsky made high-profile charitable donations and set up the nonprofit Open Russia Foundation in 2001. He promoted civil society, democracy, transparency, the rule of law, education, and economic development in Russia. He pursued numerous campaigns. Initially, Khodorkovsky demonstrated how Yukos had increased production and efficiency, while paying its taxes. He proceeded to advocate the construction of a private oil pipeline to China and another to Murmansk at Barents Sea, which would break the state-owned Transneft's monopoly. He criticized state-dominated Gazprom for its inefficiency and advocated a bigger role for Yukos in gas, complaining that Yukos was forced to flare billions of cubic meters of associated gas because of Gazprom's refusal to grant Yukos access to its monopolized gas

consolidated his authoritarian rule. Second, the state-owned company Rosneft absorbed almost all Yukos assets, which would be worth some $100 billion today, at a minimal cost, while Rosneft currently has a market capitalization of $91 billion.[3]

While denying that he had instigated Khodorkovsky's arrest, Putin explained to Western visitors that it was necessary because Khodorkovsky was buying up Russian politics. Putin's central motive was to enhance his political control by jailing the most politically active oligarch. At the same time some of his aides wanted to seize Yukos assets.

In the ensuing process against Khodorkovsky and Yukos, Russia's legal authorities violated every rule in the book. No credible legal tax case existed to begin with. The Russian authorities dismissed the first two judges because of their impartiality. The offices of several defense counsels were raided, and they were harassed and punished. All rules regarding arrest, confiscation, and communication were violated. Khodorkovsky was denied bail, which is otherwise customary in nonviolent cases.

In the end, Khodorkovsky was sentenced to eight years in jail and sent off to East Siberia. Many other Yukos employees were condemned to lengthy prison sentences on the flimsiest of grounds. Yukos' main asset, Yuganskneftegaz, was sold off in a fire sale in December 2004, to an unknown shell company, Baikal Financial Group, for an uncontested bid for $9.35 billion. This sale was premature; noncore assets did not go first as they should in an executive auction; no real competing bids were allowed; the bidder was a temporary shell company representing Rosneft; the sale price should have been about twice as high; and state banks financed Baikal's bid. The obvious purpose was to confiscate Yukos' finest oil field, which produced two-thirds of Yukos' oil, and give it to Rosneft. After the auction, Putin was the first to clarify that he knew who the owners of the shell company Baikal were.[4] His economic advisor Andrei Illarionov called this sale "the scam of the year," which caused his demotion.

Treatment of American Shareholders

The treatment of American shareholders in Yukos is the focus here, but naturally the confiscation of several billions of dollars of U.S. property has broader implications for U.S. investors, the U.S., and the U.S.-Russia relationship.

Trade in Yukos' stocks has continued uninhibited, and the sthares are actually still traded however minimal their price, leaving the enterprise value at a speculative $0.7 billion.

In a series of public statements throughout this process, Putin continuously denied any involvement. On October 27, 2003, two days after Khodorkovsky's arrest, he responded to protests: "But there will be no meetings and no bargaining over the law enforcement bodies and their activities, so long, of course, as these agencies are acting within the limits of Russian legislation.... Neither the executive authorities nor even the

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pipeline system. In 2003, Khodorkovsky conducted extensive negotiations with both Chevron Corporation and ExxonMobil about selling a large part of Yukos.

[3] The reasons why Rosneft's market capitalization is considerably less is than the value of Yukos' assets are partly its greater indebtedness, partly a lower shareholder evaluation of this less transparent and state-dominated corporation.

[4] "President Putin's Remarks on Results of Yuganskneftegaz Auction," NTV Segodnya, December 21, 2004, Federal News Service.

Prosecutor's Office can deprive someone of their freedom, even for the period of pre-trial detention. Only the court has this power...and before the court, as before the law, all should be equal."[5] Yet Putin ignored the many declarations of the Moscow Collegium of Lawyers that the prosecutors violated the procedural norms in the investigation against the Yukos managers.

Before a visit to Rome in early November, Putin declared that the state did not want to destroy Yukos: "I am categorically against re-examining the results of privatization ... This is why there will not be a deprivatization or a re-examination of the results of the privatization, but everyone will have to learn to live according to laws."[6] In Rome, he stated with implicit reference to Khodorkovsky: "Having made their billions, they spend tens, hundreds of millions of dollars to save their billions. We know how this money is being spent —on what lawyers, PR campaigns and politicians it is going, and on getting questions like these asked."[7] The last words referred to the French journalist who posed the question.

On June 17, 2004, Putin told reporters: "The Russian administration, government and economic authorities are not interested in bankrupting a company like Yukos...the government will try to ensure that this company does not go bankrupt."[8] On September 6, he said: "I don't want to bankrupt Yukos.... Give me the names of the government officials who want to bankrupt Yukos and I'll fire them."[9] On September 24, he reasserted: "We shall do this in strict accordance with the law. I want to stress it— in strict accordance with the law.... The state did not set before itself the task to nationalize this company or lay hands on it. And there is no such aim now..."[10]

In spite of his many unequivocal declarations to the contrary, Putin disregarded the law, successfully bankrupting and confiscating Yukos. He hardly uttered a true word about the Yukos affair. He insisted that the state must not interfere in the judicial process, but all the details indicated that prosecutors and judges received daily instructions from the Kremlin to be ruthless and lawless.

Foreign investors' belief in Putin's declarations was so great that the Yukos stock price held up well for half a year after Khodorkovsky's arrest until April 2004, and thereafter the ensuing decline was gradual. The stock price vacillated sharply with prosecutors' public statements, suggesting that insiders speculated on the basis of these allegations. Foreign investors, who were naïve enough to believe in Putin's words, lost billions of dollars, but the biggest losers kept quiet so as not to reveal their folly to their shareholders. Russia's stock market took a break in 2004, but then it surged again.

At least three well-known major American fund management companies made big bets on Yukos stocks and held on to them, reassured by Russian declarations that Yukos would not be bankrupted. Nobody doubted the value of the real assets. According to well-informed American investment bankers, one of these US fund made a major loss

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[5] Vladimir V. Putin. Remarks by President Vladimir Putin on Yukos Affair at Government Meeting. RTR Vesti Program, October 27, 2003, Federal News Service.
[6] Vladimir V. Putin. Interview with the ANSA Italian news agency, Corriere della sera newspaper and the RAI Television Company, November 3, 2003. www.kremlin.ru.
[7] Vladimir V. Putin, Introductory Words and Answers to Questions from Journalists at Press Conference about the Results of the Russia-EU Summit. Rome, November 6, 2003. www.kremlin.ru.
[8] Interfax, Tashkent, June 17, 2004.
[9] Catherine Belton, Putin: Tell Me Who Wants Yukos Broke. *The Moscow Times*, September 9, 2004.
[10] Vladimir V. Putin, Speech at the World Congress of News Agencies, September 24. www.kremlin.ru.

of a few billion dollars on Yukos, while two other US funds lost about half a billion dollars each. Thus, the total losses to US institutional and individual shareholders amounted to several billion dollars, and a reasonable guess is $6-7 billion. None of the really big losers from Yukos has publicized its losses, because they do not want to scare off their investors. The many shareholders who have complained tend to be individual investors with much smaller holdings.

US Government Reactions

When American shareholders lose billions of dollars because of miscarriage of justice in a major country, one might have expected that the US government would protest. Although the Yukos affair attracted considerable and daily international publicity, no major government tried to defend its shareholders. A scrutiny of major US statements on this and related topics is bewildering.

On September 27, 2003, three months after the arrest of the Yukos executive Lebedev, President George W. Bush had the following warm words to say about President Putin, after having hosted him at Camp David: "I respect President Putin's vision for Russia: a country at peace within its borders, with its neighbors and with the world, a country in which democracy and freedom and rule of law thrive."[11] Not surprisingly, Mr. Putin felt reassured and went ahead with the arrest of Khodorkovsky four weeks later.

Several senior US officials intervened once—in October 2004—but only to express in private messages to Russian counterparts their fears that Russia's oil production would decline during the then expected Russian confiscation of Yugansk. Instead of condemnation, on October 18, 2004, US Secretary of State Colin Powell uttered his forceful support for Putin: "The Russian people came out of the post-Soviet Union era in a state of total chaos—a great deal of freedom, but it was freedom to steal from the state and President Putin took over and restored a sense of order in the country and moved in a democratic way."[12] It is difficult to read this statement issued just before the Yugansk confiscation as anything but a tacit approval of the confiscation of billions of dollars of assets, partly held by US funds ad invidviduals.

In the end, President Putin let Yukos be confiscated through arbitrary taxation and kangaroo courts. All the remaining assets of Yukos were sold off last summer in auctions that were biased in favor of Rosneft, which acquired most of the assets cheaply.

The Yukos affair also changed Russia's economic policy. After all, the accusation against Yukos was that it followed the letter of the new tax code and utilized one of its loopholes. Putin's program of structural reform came to a screeching halt. The Yukos affair showed the KGB men around Putin that they could seize Russia's biggest private companies if they just lied. The road to large-scale renationalization through lawless government interference lay open.

US President George W. Bush, however, has not wavered in his publicly expressed confidence in Putin. On July 1–2, 2007, Bush honored Putin by inviting him to his father's summer house in Kennebunkport, Maine. At the ensuing press conference,

[11] The White House website, www.whitehouse.gov. (accessed July 3, 2007).

[12] "Interview with the USA Today Editorial Board," October 18, 2004, US Department of State website www.state.gov (accessed July 15, 2007).

Bush revealed: "But one thing I've found about Vladimir Putin is that he is consistent, transparent, honest and is an easy man to discuss our opportunities and problems with." "I know he's always telling me the truth."[13]

In no way has the US government expressed public concern about the confiscation of billions of dollars of bona fide Ameircan investments in Yukos shares. No protest against this multi-billion dollar confiscation has been apparent.

Possible Legal Recourse

What legal recourse against Russian government confiscation of US private property in Yukos shares could the US administration have provided?

In current international law, a number of possibilities exist. Yukos shareholders live in many countries, and they are now investigating their legal options. A large number of legal suits are under way in many countries, but it is difficult to gain an overview because many shareholders hope to achieve beneficial settlements out of court by keeping quiet. Predominantly, these legal cases are instigated by relatively small individual investors, while the big institutional investors do not want to reveal how much they have lost.

The most direct remedy is through a bilateral investment treaty, which many countries have concluded with one another. The United States and the Russian Federation signed such a treaty on June 17, 1992. This treaty was supposed to guarantee "prompt, adequate and effective compensation in the event of expropriation," and provide "the right to third party international arbitration in the event of a dispute between a U.S. investor and the Russian government." The U.S. Senate ratified this treaty on August 11, 1993, but the United States has failed to persuade Russia to ratify this treaty, so it lacks legal force. The main reason for this failure of ratification was that a parliamentary majority long opposed President Boris Yeltsin, but that was no longer true from December 1999.

By contrast, 38 countries, including Belgium, France, Germany, Ireland, Italy, Luxemburg, the Netherlands, Norway, Spain, Sweden and the United Kingdom, have concluded bilateral investment treaties with Russia that have also been ratified, allowing Yukos shareholders in those countries to sue the Russian government, but that venue is not open to American shareholders.

After 1998, the United States has almost stopped concluding bilateral investment treaties. The U.S. has tried to make them more ambitious, but the consequence has been that only one has been concluded (Uruguay in 2006). The U.S. has instead tried to include investment guarantees in free trade agreements, but no free trade agreement can be concluded with Russia until that country has become a member of the World Trade Organization. Thus, a free trade agreement is not an option.

In 1994, a multilateral treaty, the Energy Charter Treaty, was signed by most European countries, the former Soviet countries and some other countries. A total of 51 countries signed it and 46 of them have also ratified this treaty, which also contained substantial clauses against confiscation. The treaty came into force in 1997. The United States, however, abandoned these negotiations early on in 1991 and has never signed this

[13] "President Bush Meets with President Putin of Russian Federation," White House press release, July 2, 2007, available at www.whitehouse.gov (accessed July 13, 2007).

treaty. Russia signed the Energy Charter Treaty, but although it has not ratified the treaty, it has committed itself to abide by this treaty, and major suits in Europe are under way on this basis, but again this option is not open to U.S. shareholders.

Citizens in European countries have a third legal opportunity, namely to appeal to the European Court of Human Rights in Strassbourg. It is attached to the Council of Europe, an organization of which Russia but not the U.S. is a member. The verdicts of the European Court of Human Rights are formally accepted by the Russian government, which renders them potent in commercial cases. Thousands of cases concerning Russia have been raised there, and the Russian government regularly loses. One prominent case that the Russian government lost was raised against Vladimir Gusinsky. The European court established that the Russian state had forced him to give his media empire to a state-dominated company. However, U.S. citizens have no legal recourse to this international court.

At present, a number of legal cases have been raised against the relevant Russian companies and individuals in the United States. In the absence of any binding bilateral treaty, sundry legal cases focus on assertions that the defendants committed securities crimes in the United States, including insider trading and racketeering. It is too early to judge the eventual success of these legal suits.

Other Legal Ramifications: Possible Money-Laundering

Another issue that naturally arises in this context is possible money-laundering. If, as appears to be the case, current Russian top officials illegally appropriate large state assets for their personal benefits, they are likely to transfer substantial assets abroad, which may pass through the American banking system. Money-laundering might not be apparent in the Yukos affair, but it is in other cases of illicit enrichment by Russian state officials.

The best documented recent case is Minister of Communications Leonid Reiman, a friend of Putin from foreign intelligence in St. Petersburg. In May 2006, Reiman lost a civil case in Zurich, Switzerland. The court established that he had committed major crimes in Russia, that he owned large chunks of Russia's telecommunications, which he oversaw as minister, and that he created a vast international money-laundering scheme to conceal his diversion of state assets.[14] The countries involved were primarily Luxemburg and Bermuda, and the main bank used was German Commerzbank.

The news was suppressed in Russian media and Reiman remains on his post also after the last government changes. In July 2007, his apparent assets were assessed at $5.9 billion, when Reiman apparently capitalized his assets by selling them to a friendly businessman.[15] Reiman has continuously been a state employee while amassing this fortune through privatizations and preferential licenses.

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[14] Gregory L. White, David Crawford, and Glenn R. Simpson, "Why Putin's Telecom Minister is in Investigators' Sights Abroad; German and Swiss Probes Tag Leonid Reiman as Owner of Businesses he Oversees; Commerzbanks's Unusual Role," *Wall Street Journal*, October 17, 2006.

[15] Neil Buckley, "Russian Phone Feud Is Settled," *Financial Times*, July 30, 2007.

Conclusions

The outcome of a large number of ongoing court cases is not clear as yet, and my testimony is by no means intended to prejudge their outcome. However, a number of major conclusions can be drawn.

First, in the last couple of decades, the confiscation of the Yukos oil company is one of the biggest confiscations that has hit U.S. shareholders, probably in the order of $6-7 billion. It is all the more remarkable, because at the time of the confiscation Russia was enjoying a prolonged economic boom.

Second, in their public statements the leading representatives of the U.S. administration, the President and the Secretary of State, have not protested against this confiscation but on the contrary expressed general support for President Putin's actions.

Third, a little noticed fact is that American shareholders of Russian companies have considerably weaker legal protection than European shareholders against confiscation by the Russian government, because the U.S. has not bothered to establish binding treaties with Russia that would safeguard its citizens. European investors benefit from a safer legal environment in this regard.

It is difficult to escape the impression that the current US administration has done nothing to establish appropriate legal defenses for American shareholders of Russian companies. Unfortunately, Yukos is not likely to be the single case, because a wave of renationalization is currently under way in Russia.

How can this situation be remedied? To begin with, one would expect US top officials to protest against the confiscation of billions of dollars bona fide investment by American citizens. In several cases, Putin has moderated his actions after loud, public, and concerted Western protests. The easiest legal option is probably to persuade Russia to ratify the bilateral investment treaty of 1992, which should not be that difficult, but it does not appear to be on the U.S. agenda.

In the longer term, adequate legal guarantees can be best accomplished through the conclusion of a bilateral free trade agreement between the United States and Russia, but that presupposes that Russia becomes a member of the World Trade Organization. During President Putin's first term, Russia's accession to the WTO was an important goal. In November 2006, Russia concluded a substantial bilateral protocol with the U.S. on Russia's accession to the WTO. Unfortunately, President Putin has increasingly downplayed the significance of the WTO. Last June, he went as far as to call the WTO "obsolete;" Russia's progress toward accession has slowed down; and German Gref, the Minister for Economic Development and Trade, who has been Russia's foremost advocate of WTO membership, was dismissed from the government last month. Russia's government still professes its aim to join the WTO, but its determination has waned.

The absence of any legal safeguard for American investment in Russia can nothing but harm and hold them back. The Russian state officials that carried out the confiscation of Yukos have by no means been punished but have only had their appetite vetted. This is apparent from the current wave of renationalization in Russia, which further deters Americans from investment in Russia. My conclusion is that the United States has an interest in stronger mutual treaty obligations between the U.S. and Russia safeguarding investments. Also bona fide Russian businessmen have an interest in such treaty obligations. Although a WTO accession does not have direct bearing on

investment, it can serve as a useful tool, providing a basis for a bilateral free trade agreement, which would contain guarantees for the protection of investment.

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House Financial Services
Subcommittee on Domestic and
International Monetary Policy, Trade, and Technology

"U.S.-Russia Economic Relationship:
Implications of the Yukos Affair"

October 17, 2007
Washington, DC

Issues in the U.S.-Russia Economic Relationship

1. My comments on the U.S.-Russian economic relationship will focus on the business climate in Russia, which exhibits some specific features that are important to understand. First, however, it is important to be realistic about what is at stake when we talk about U.S.-Russian economic relations.

The U.S. Stake in the Russian Economy

2. The direct US stake in Russia's economy is small. As a place to sell our goods, or a place with such exceptional advantages of cost, quality, and so on that we want to use it as a place to produce, Russia for the most part is close to marginal for American business as a whole. There are, of course, some exceptions, some specific industries and markets, that are highly important for US companies. To take one such example, Russia is the single biggest market for chicken in the world, outside of the U.S. itself. Russians consume 25 percent of all chicken exported by American producers.
3. The truly important part of the Russian economy that matters for the outside world, including the United States, is oil and gas. This is a complex topic and must be treated separately. Other than oil and gas and some other primary commodities, most of the Russian economy is not internationally competitive. Because the portion of the non-oil economy that is capable of participating in the international economy is so small, and because Russia is so far away from us, it is not surprising that the Russian market is not very significant for the U.S. economy.
4. We sell less of our products to Russia than we do to the Dominican Republic. In numbers, this means Russia accounts for less than half of one percent of total U.S. exports. Until quite recently we committed even

less of our money. For most of the past decade and a half since the fall of the USSR, our direct investment in Russia constituted about less than one-tenth of one percent of total U.S. direct investment abroad. (Again, countries like Dominican Republic or Costa Rica are good comparisons.) This has recently changed, however. Like so much else about the Russian economy, the reason for the change lies in oil and gas and the way the wealth from those industries has trickled down into the entire economy. From individual households to government coffers, many parts of society have benefited.

A Reversal of Financial Fortune

5. The most dramatic change has been in the area of state finances. Here we have witnessed one of the most dramatic reversals of fate in recent economic — and geopolitical — history. In 1998 Russia was a country so impoverished and whose meager finances had been so mismanaged that it was essentially bankrupt. It was so depleted of foreign reserves that denial of a bail-out to the tune of $15 billion or so could bring down a government.

6. When Vladimir Putin assumed the post of prime minister in August 1999, the country's foreign reserves were down to under $8 billion and falling. By October, they were at $6.6 billion. Meanwhile, Russia's debt to the International Monetary Fund was $16.6 billion. Russia was thoroughly bankrupt and practically in receivership.

7. Fast forward now to this past summer. In August 2007, Russia's foreign reserves were well over $400 billion. In addition, it had another $130 billion in its so-called oil stabilization fund. (The IMF, in the meantime, had total lendable funds of less than $250 billion.) Right now, the Russian government continues to add cash to the foreign exchange reserves and stabilization fund at a rate of $170 billion a year.

8. Russia has thus come a long way since the days when it was desperately dependent on the financial largess of the West. Indeed, as holder of one of largest current account surpluses in world, it is one of the biggest financers of the U.S. current account deficit.

The Two Pillars

9. The explanation for the reversal of fortune is hardly a secret. The Russian economy rests on two pillars: oil and gas. In exactly the eight years of Putin's tenure, the value of those commodities has soared. The increase in wealth flowing into Russia from oil and gas is staggering.

10. Consider the income from one component alone — crude oil exports. Roughly eight and a half years ago — on February 11, 1999 — the price of Urals oil was less than $9.00 a barrel. Russia was producing barely 6 million barrels a day. Today, the price is $87.00, and Russia produces

nearly 10 million barrels a day. Almost every drop of the increased output has been shipped abroad to the world market. Look at the difference. In the first three months of 1999, crude oil export revenues totaled barely $2 billion. Right now, Russia earns that much in crude exports in less than a week.

11. People say: "But there's more there than just oil." Indeed, there is — more and more each year. The pillars support more. The visual image is a platform resting on the pillars I mentioned. Piled on that platform, higher and higher, is business activity in retail, wholesale, consumer goods, construction, real estate. This is the "non-oil economy."

12. So, yes, Russia's non-oil sectors are growing as a share of the total economy. Is oil then becoming less important for Russia? No. It is just the opposite. Oil becomes more important, because more businesses and more jobs depend on the flow from oil and gas.

How the System Works: Formal Taxes...

13. Because this oil boom has coincided almost precisely with Putin's tenure as Russia's president, it is tempting to attribute all the economic success of his regime to world oil prices. And yet this would not be quite correct. Putin was graced with a windfall of gigantic proportions, true. But it was his achievement — his greatest achievement — that such a big share of the oil windfall was collected to the central government. Through an early and thorough overhaul of a dysfunctional tax system, Putin ensured that government, especially the federal government, collected the wealth needed to realize his stated goal of building a "strong state."

14. To illustrate the increased flow of oil wealth into Russia, I just now cited the dramatic increase in crude oil export revenues. But what is supporting the economy is more than just crude and more than just the cash earned from selling it abroad. It is the total rent from oil and gas.

15. This rent — popularly referred to as excess profits or windfall — is the aggregate market value of these commodities (whether exported, or even sold at all, at the market price) less the normal costs of extraction, including a normal rate of profit. The single most important thing to know about the Russian economy is how this total rent is distributed, or shared, throughout the economy. To understand this, one needs to look below the surface of the formal Russian economy.

... and Informal

16. In theory, Russia's new oil stabilization fund is supposed to absorb the oil and gas windfall. In fact, because the fund is based only on income from oil exports — while Russia's oil and gas rent is much greater than just oil export revenues — the stabilization fund last year absorbed only about 14 percent of total rent.

17. The rest? It is distributed throughout the economy in other forms to different claimants. The owners of the resource companies — the oligarchs — keep a healthy amount as profits. Some of the rest is collected by government in taxes other than those that go straight to the stabilization fund. But an important part of the rent is distributed by the mechanism of "informal taxes." These include price subsidies (on natural gas, not oil — very little oil is sold at subsidized prices), to bribes, kickbacks, and "voluntary contributions" to especially local governments.

18. The most important type of informal tax, however, is excess costs of production. Oil and gas companies order equipment and other inputs from local manufacturing enterprises, even if the products are not competitive. Such orders sustain activity at these local enterprises, which also means jobs, incomes, and tax revenues for local budgets. In other words, by placing the orders, the resource companies share some of the rents locally.

19. It is obvious why the recipients of the shared rents find this system attractive. But why do the original owners of the rents share them? The answer is that they have to. This is implicit in the word "taxes." When I say that these are "informal" taxes, I mean that they are not prescribed by formal laws. In practice they are just as mandatory. Writing about the so-called voluntary contributions by businesses to local government "infrastructure funds," "social funds," and the like, one Russian scholar used the term "mandatorily voluntary." The same goes for the excess costs. They are all mandatory in the sense that failure to pay them exposes the owner to serious risks.

20. Another term for what is going on is "protection racket." In a protection racket, there is a threat against which someone offers to protect you. The catch is that the threat emanates from the protector himself. Here, the threat is the loss of property rights. Sharing rents locally is one way to pay the protection money. There is also a national version of the protection racket, designed primarily for the very largest companies. At that level the "payment" may be different. Companies are expected, for instance, to pursue certain policies in their foreign activity that further the geopolitical interests of the Russian state, even if they sometimes don't quite make sense from a strict business perspective. In either case, local or national, the principle is the same: if you haven't kept current on your protection payments, you won't have friends when the threats mount.

21. It is very important to recognize the informal rent-sharing. This is the part of the iceberg that lies below the surface. That's the part that is hidden, and the part that tends to be larger. It's the part that can cause shipwrecks. One victim of the hidden iceberg was YUKOS. Khodorkovsky miscalculated. He refused to pay the excess costs. He tried to be a cost-minimizer (profit maximizer) in a system that dictated that he be a cost-maximizer.

Putin as Rent Manager

22. In any protection racket, the person who threatens you and the person who offers to protect you from the threat are one and the same. The protection racket in Russia that I've described is one in which the contrived threat is the loss of property rights. Who then is the protector? Who is it in Russia that has the ability to credibly threaten the property rights of even the biggest companies in Russia? It is Mr. Putin. He is the chief protector. He is the overseer of the protection racket. More broadly, he oversees the entire rent sharing system.

23. The oil and gas rent gave Putin the power to achieve his main objectives: strengthening the state and maintaining social stability. However, the mere existence of the rent was not enough. The rent had to be managed. That required skill and purpose. In his capacity as manager of the rent, Putin has done three things and done them very well from the vantage point of his own goals. First, he has managed the collection of the rent. Second, he has defined priorities for the use of the rent. Third, he has managed the actual process of rent sharing.

24. (1) Collection: His management of rent collection spans both the informal and formal rents. Putin inherited a large and unwieldy system of informal rent sharing that my colleague Barry Ickes and I described as "Russia's Virtual Economy." Rent was distributed informally and mainly locally. Putin reformed this system. In fact, he continued and perfected reforms already initiated in the late Yeltsin era. While he permitted much informal rent sharing to continue, his main priority was to formalize and centralize rent collection. He collected the rent to the Center through formal taxes.

25. (2) Priorities: Putin defined clear priorities for the use of the formal rent. One main use has been to re-establish Russia's sovereignty. He learned a big lesson from the Gorbachev and Yeltsin experience. Putin's macroeconomic and fiscal stability measures have been exemplary. His number one goal was to get rid of the public foreign debt. Obsessively, he paid off Russia's entire remaining debt to the IMF in January 2005 — three and half years ahead of schedule. He did a similar thing in August 2006 with the Paris Club debt, retiring some $23 billion.

26. (3) Manage the process: The third thing Putin has done is to successfully manage the rent sharing process itself. This is important because of the inherent tension in rent sharing. If not kept under control, it could tear the country apart. Putin kept the old protection racket that had been run by regional officials and elites. But he brought it under his central control. He made sure that governors would see their primary task as enforcing centralized rent collection. This was the reason for his reform of the political system with direct appointment of governors. Putin needed governors to serve as "regional rent managers" within a national structure of "Russia, Inc."

27. Putin's model for managing Russia, Inc. comes from his study, beginning in his KGB days, of the concept of "strategic planning." His 1997 dissertation for a graduate degree in economics focused on that theme. Under his scheme, Putin plays the role of chief executive officer of Russia, Inc. He manages the organization on the strategic level. Others — his "division managers," some of whom we know as oligarchs, others as governors — implement the strategic directives within well-defined bounds.

28. The rent-management model helps us understand why discussions of state versus private ownership in today's Russia can be confusing. Renationalization is not necessarily an objective for Putin. In his scheme, what is important is not who has formal (legal) ownership of a company — property rights are always contingent in Putin's model — but rather who controls the rent flows, to what ends.

29. Secure control of rent flows by players loyal to the Kremlin is essential, regardless of whether the company in question is privately owned or state owned. As discussion of the protection racket shows, private ownership of a company is not necessarily an obstacle to its performing its function in the rent sharing system. Conversely, state ownership alone may not be enough to ensure that the rents are properly distributed. There must be loyal agents in the right positions in those state companies.

Doing Business in Russia: Knowing the Rules

30. The system I have described provides for a very specific business climate that places extra burdens on any company, but especially foreign companies.

31. In any investment situation, business wants the highest possible returns and lowest possible risks. Russia is a place where returns are high, and there is good reason to think they will continue to be high. However, the risks are high as well.

32. As in any country, Russia has two kinds of risks for businesses. One type of risk is inherent to any market. This is competitive risk, that is, the risk that companies may, for instance, have misjudged customers' tastes and their own ability to compete. It therefore depends on the companies' own abilities and those of its rivals.

33. The second type of risk, usually referred to as political risk, relates to the institutional or environmental factors that impact the security of the investor's property rights. The investor asks: Will the money I commit and the earnings I make be secure from appropriation by other parties — criminals or the state?

34. The discussion above about informal taxes suggests a first specific feature of political risk in Russia. Just as failure to pay formal taxes in any country exposes the company to penalties, including possible loss of property,

nonpayment of informal taxes is risky in Russia. The difficulty is to know exactly what is expected. In contrast to formal taxes, informal taxes are not prescribed by law and specified in detail. They may be highly discretionary. The informal taxes — and therefore the property rights that are contingent on paying those taxes — depend on the judgment of individual political officials.

35. The implications of this fact for businesses are profound. It means that success on the Russian market depends not just on the amount and quality of your company's physical capital (machines and equipment), on the abilities of its work force and management, but also on your connections with the right people — what can be termed your "relational" capital.

36. The point of referring to this as relational *capital* is that it can be accumulated. You can invest in it. This, however, is bad because it diverts scarce time, effort, and money away from investment in the other factors of production. (For American firms it may also have them run afoul of laws here such as the Foreign Corrupt Practices Act. Although that is not certain: many, if not most, of the practices would not fall under FCPA.) But if you don't invest in relational capital, you will be at a competitive disadvantage.

Lowering the Costs of Business in Russia

37. Knowing that you must pay informal taxes and invest in relational capital, knowing what those informal taxes and how to pay them, how much to invest in relational capital and where ("in whom") to invest — all this is essentially knowledge of the rules of the game in Russia. You cannot read these rules in a book. But they are knowable. And the costs they entail are calculable. For the business person, this is all that's needed to make a business decision. The business person weighs all the costs, the expected returns, and the risks. The businesses can and should make these decisions on their own.

38. U.S. businesses would of course like for the costs of doing business in Russia be lowered. Even more important, they want the competition be fair — they want a level playing field.

39. The need to pay informal taxes and invest in relational capital imposes extra costs on businesses. But is it a barrier to fair competition? That is not clear. It does seem that it is more difficult for outsiders than Russians to acquire adequate information about the rules of the game. But that can be overcome. One common way is to partner with a Russian company that already has the right contacts, knows the rules, and has the skills to play by those rules. (You acquire some relational capital, if you will.)

40. That leaves the question of whether the outside world can influence this system so as to reduce the cost of doing business. There is no magic bullet. Although it might seem that this is a straightforward case of

excessive corruption in a country, the Russian situation is not so simple and an anti-corruption crusade might not be as desirable as it might seem.

Corruption in Russia

41. Although I have referred to a system that includes bribery, kick-backs, sweetheart deals, and rackets, I intentionally avoided using the term "corruption." The term is confusing. We are all against corruption. But corruption serves a purpose. We need to understand the purpose in Russia. The notion of rent sharing offers such a context.

42. Corruption is omnipresent in Russia. Some of the protection rackets are for personal enrichment; others are part of the system of rent sharing for the purpose of social stability (providing jobs and incomes), or for state interests. The fact that the same behavior can have different motivations reminds us of the classic observation by the journalist Yuliya Latynina when writing of theft in the Russian economy in the 1990s. It is a mistake, she wrote, to think that Russian enterprise directors are divided into those who steal and those who don't steal. They all steal. It's just that some steal *from* the plant and others steal *for* the plant. That is, in the later case, their theft helps keep the plant alive and thus preserves jobs and incomes for workers.

43. Latynina was writing during the pre-oil boom era of the 1990s. But it's very much the same today. From the standpoint of the manager of the rent sharing system and *all those who benefit from that system*, there is "good" corruption and there is "bad" corruption. Good corruption greases the wheels and broadens support for the system. Bad corruption allows personal greed to undermine the system. The job of the system manager (Mr. Putin) is to limit the bad corruption while encouraging the good corruption.

44. It should evident that there might be a problem with an anti-corruption campaign in this context. The rent sharing system has millions of beneficiaries. You may conduct a survey to ascertain whether the Russian people are against corruption. When asked this way, it is like asking whether they like being ripped off, harassed, and humiliated by people more powerful then they. They hate corruption by that definition. But you will find a different answer if you ask, say, the thousands of workers at noncompetitive "dinosaur" manufacturing factories in Tomsk oblast' whether it was bad to demand that the YUKOS subsidiary Tomskneft' place orders with those plants, even though those orders were part of a local protection racket involving extortion, kickbacks, bribes, and other corrupt practices. Khodorkovsky said he was against corruption and refused to play that game. He made many enemies in Tomsk.

45. It all depends on who benefits from corruption, and to what purpose. Most people who benefit from the excess costs mechanism of rent sharing — a form of corruption — are ignorant of what is going on. They are involved in

a form of what Gregory Grossman in the context of the Soviet economy described as the "loot chain." At the bottom of the chain were a diverse group of individuals who shared some of the loot without necessarily being aware of where their income came from. Most did not see themselves as beneficiaries of corruption at all. On the contrary, they saw themselves as honest, hardworking people who deserved what they got. Today's "rent chain" operates in the same way.

46. Moreover, an anti-corruption campaign is itself likely to be incorporated into the protection racket. Consider this: to operate a business in Russia, you're forced to pay protection. If you do, you break the law. You are guilty of corruption. Your only recourse to avoid prosecution is to pay off the right people, to participate in another protection racket. It's a classic Catch-22.

Will This System Last?

47. Although Russia faces many challenges and pitfalls on the path to long-term sustainable economic development, its short and medium-term performance will continue to depend mainly on the volume of oil and gas rents and how they are used. If we therefore want to know whether the system I have described — Putin's system — can outlive his term in office, we must ask two questions: (1) will world oil prices allow the rents to continue; and if so, (2) can a successor continue to manage the rents as well as Putin has done so far?

48. Let us look first at the oil price. A price of around $60 a barrel or above for 2008 and beyond would provide Russia with a strong flow of rents. But then we must turn to the second question: how well can a successor manage the rents? One way to examine that is to recall my statement about Putin's three great accomplishments: (1) he centralized collection of the rent; (2) he centralized use of the rents for strategic state purposes; and (3) he managed the tensions inherent in the rent sharing process itself. Of the three, the first is the most robust. Centralized rent collection — essentially, the formal system of tax administration and enforcement — has been institutionalized and should therefore endure. As for the use of the rents, Putin defined the priorities well. A successor is likely to stick with them. It is the third task, that of managing the rent sharing process, that is the difficult one. A successor must understand Putin's concept of "Russia, Inc.," subscribe to it, and be capable of putting it into practice. He cannot allow rent sharing to devolve into personal enrichment to the detriment of state interests. A fratricidal rivalry among the elites could threaten use of the rents for state interests. Here is where corruption is relevant. The bad corruption — venality — can take over. If that happens, Russia will not be nearly as stable as it now appears to be.

[Word count: 4,107]

MR. TIM OSBORNE
DIRECTOR, GML, LTD.

TESTIMONY BEFORE THE HOUSE FINANCIAL SERVICES SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY, TRADE, AND TECHNOLOGY

"U.S.-RUSSIA ECONOMIC RELATIONSHIP: IMPLICATION OF THE YUKOS AFFAIR"

October 17, 2007

INTRODUCTION

I wish to thank Subcommittee Chairman Gutierrez and Ranking Member Paul for convening this hearing today. I respectfully request that my full written statement be entered as part of the record.

My name is Tim Osborne and I am a Director of GML, Ltd. ("GML"), formerly known as Group Menatep, Ltd. GML is a diversified financial holding company, established in 1997, and it at one time owned strategic stakes in a number of Russian companies, including YUKOS Oil Company ("Yukos"), as well as a number of financial portfolio investments on stock markets in Russia and internationally. It is incorporated and existing in accordance with the laws of Gibraltar. GML is the majority shareholder in Yukos, holding approximately 51 percent of Yukos equity capital through wholly owned subsidiaries. Yukos was the largest privately owned energy company in Russia prior to its expropriation by the Russian Government.

The directors of GML are responsible for stewardship of the company in keeping with recognized standards of transparency and corporate governance and, more recently, in protecting the company's remaining assets. These market principles embraced by GML and its leadership are unfortunately not the norm in the Russian marketplace. American investors, as well as investors worldwide, should be alarmed at the lack of investor protection and corporate governance in Russia.

Let me be clear, the Yukos case is about the improper and illegal persecution and seizure of legitimate individual corporate and private assets for the political and financial benefit of the Russian state.

The past four years have seen a veritable onslaught against GML, its holdings, and its shareholders by Russian authorities, against the backdrop of a profound retreat in democratic developments in Russia. This includes the abandonment of the rule of law, collapse of an independent judiciary as well as a breakdown of corporate governance, investor protections and business transparency.

Beyond the obvious problems faced by the direct targets of the Russian authorities, American minority shareholders in Yukos have lost $6 billion. The Russian government has made clear that the expropriation of their investment is acceptable and permissible collateral damage.

The impact of these events on American investors is dire, and will continue to be going forward if it goes unchecked. It's a tragic irony that I am testifying virtually on the four year anniversary of the arrest and imprisonment of Mikhail Khodorkovsky, a

founding shareholder of GML and the senior executive of Yukos, and his business partner, Platon Lebedev.

I would like to call your attention to four universal principles held dear to free and open markets worldwide, which as illustrated by the conduct of the Russian Government towards Yukos and GML, are being set aside in Russia to the detriment of investors and financial stakeholders in the U.S. and abroad. They are:

- Transparency in capital markets;
- Maximizing shareholder value;
- Protecting investors; and
- Adherence to the rule of law.

TRANSPARENCY IN THE CAPITAL MARKETS

Free, open and transparent capital markets are an essential element of the freedom required for buyers and sellers in any marketplace to trade with confidence. The better the information, the more efficient the market. Public disclosure of all material information is a basic ingredient of an efficient market. It is what separates investing from roulette - and if Russia restricts the flow of information about publicly owned companies, American investors will be playing Russian roulette with their financial future.

Unfortunately, this is what is happening in Russia today. Russia has large companies that interest investors around the world, but many of them are owned, in whole or in part, by the government . And if all that investors can buy is a minority share in such a government controlled enterprise, and if critical information about the controlling shareholder and ultimate parent is restricted by that very government, a key component of a genuine market is missing. Not only that, but a key component of investor protection is missing as well.

Yukos was the first Russian company comprehensively to adopt Western standards of corporate governance, transparency and shareholder rights including the preparation of consolidated financial statements in compliance with U.S. generally accepted accounting principles (GAAP). Yukos hired leading American consultants, such McKinsey & Company and Pricewaterhouse Coopers (PwC), to advise senior management. In addition, Yukos advanced the hiring of experienced professional corporate managers and the election of independent members of the board of directors.

In 2001, Yukos American Depository Receipts (ADRs) began trading over the counter in the U.S. market and by 2003 U.S. investors, including state pension funds and individuals, held approximately 15% of the shares in Yukos. Moreover, in 2003, Yukos was preparing to go public in the United States. Preliminary submissions had been made to the SEC, and under Mr. Khodorkovsky's leadership, Yukos was prepared to accept the stringent reporting, disclosure, and internal control requirements under the Sarbanes-Oxley Act of 2002. These requirements are recognized to be the broadest investor

protections in the world, and a company engaged in misconduct does not voluntarily expose itself to such scrutiny.

Nothing better illustrates a lack of transparency than the statements of the Russian authorities surrounding the government's so-called tax enforcement campaign against Yukos. Since the beginning of the tax enforcement campaign, the Russian Government has repeatedly stated that its objectives were simply the even-handed execution of Russian law. On numerous occasions, the Russian Government stated it had no intention of destroying or bankrupting Yukos, and that the state had no plan to re-nationalize Yukos' assets and resources. The Russian Government publicized that it was receptive to a negotiated settlement of the tax issues.

Contrarily, the Russian Government refused to discuss or negotiate a settlement. They froze Yukos' assets, eliminating Yukos' cash resources to pay taxes. With Yukos under siege, the Russian Government initiated actions with several banks to push Yukos into bankruptcy. As a final blow, the Russian Government organized the process to ensure that most of Yukos' major assets were transferred to Russian state-owned enterprises.

A few simple numbers provide the context for the absurdity of the Russian authorities' tax claims. Yukos had already paid $15 billion in taxes for the period of 2000 through 2003, on total gross income for that period of $29 billion. Thus, the taxes paid amounted to approximately 52% of gross income. Beyond that amount, the Russian authorities alleged that Yukos owed an additional U.S. $27 billion for that period, bringing Yukos' total tax liability for the period to over U.S. $42 billion, greater than 100% of the company's gross income. This is not taxation. This is confiscation.

The Russian authorities' false charges and misleading information, including the government's true motive to eliminate Yukos as a competitor for Russian state-owned enterprises, obstruct the transparency that investors and efficient markets demand.

MAXIMIZING SHAREHOLDER VALUE

Another essential ingredient of a genuinely free market is marketplace actors who make decisions based on economic motives of profit and loss. This assures that the market will perform its most critical function — allocating resources efficiently across the economy. But governments act for reasons of national interest, which — while important — can be very different. So by pursuing political and strategic concerns instead of purely economic motives, government owned companies can distort the proper functioning of markets. Shareholders will naturally wonder whether actions are taken because of an economic rationale or because of political calculations.

Conversely, if a company is owned by shareholders, and not by the government, then the normal workings of shareholder democracy will ensure that the business is run in their economic interest. It is a powerful check against corporate management becoming

complacent or — much worse — corrupt. Private shareholders insisting on their economic rights is the best way to establish corporate accountability and efficiency.

In the United States and other Western markets, majority shareholders are not allowed to act without a rational business purpose to maximize value for all shareholders, including minority shareholders. American securities law embraces a set of rights and investor protections for all shareholders in order to protect their financial interests.

However, in Russia today, a majority state-owned enterprise is often compelled to act in furtherance of the Kremlin's political and strategic objectives. For example, Rosneft, the Russian state-owned oil giant, entered the capital markets in 2006 through the sale of global depository receipts on a London Exchange, which are sold over the counter to American investors. Rosneft's prospectus of July 2006 quite literally states, "the Russian Government, whose interests may not coincide with those of other shareholders, controls Rosneft and may cause Rosneft to engage in business practices that do not maximize shareholder value."

In addition to the setting aside of shareholder interests in Russian publicly owned companies, the Russian authorities may take action against a corporate manager who doesn't act in the best interests of the Russian Government's political and economic objectives. As a Director of GML, I have personally endured a series of threatening actions by the Russian authorities in retaliation for exercising my fiduciary duties to maximize shareholder value.

In response to my efforts to protect GML holdings, including Yukos assets, the Russian authorities have launched a criminal investigation directed at me and three former senior Yukos executives who are U.S. citizens. Actions by the Russian authorities to bully and intimidate me for acting in accordance with my fiduciary duties undermines the interests and rights of U.S. investors in Yukos. You can be assured that I will not be deterred in this regard.

In today's Russia, the pressures on business to champion the Russian Government's interests, above all others, is immense and quite real. PwC served as Yukos' auditor for the period 1995 through 2004. PwC had always stood by the accuracy and reliability of Yukos' financial statements. However, beginning in the latter part of 2006, the Russian Government initiated a campaign against PwC in order to discredit its work for Yukos. In particular, the Russian authorities initiated actions to invalidate the prior Yukos auditing contracts, terminate longstanding auditing relationships with other Russian companies, and questioned the future licensing of PwC as an auditor in Russia. The authorities also charged PwC with tax evasion and accused PwC of assisting Yukos in tax evasion. This was an attempt by the Russian authorities to intimidate PwC and relent in its defense of Yukos' audits.

Sadly, the Russian authorities were successful. Notwithstanding its unequivocal statements as late as December 2006, in a press release issued in June of 2007, PwC withdrew all audit opinions for Yukos. Subsequently, it appears that PwC has received more favorable treatment in the Russian courts and in its dealings with Russian

authorities and state-owned enterprise clients. Moreover, PwC's license to practice as an auditor in Russia has been renewed.

PROTECTING INVESTORS

The issue of protecting the interests of American investors, particularly individual investors, is an important principle of our free market economic system, regardless of whether the protection is for investments in the U.S. domestic market or overseas markets. U.S. shareholders, investors, institutional investors, consumers and others must be protected as Russia is an emerging market where U.S. investment will occur more and more often. It is therefore increasingly important to minimize the risk to U.S. citizens. Russia is a growing segment of the U.S. and global economies and there must be a rule of law that will support investment in Russia and the protection of U.S. investor rights. How will fund managers address their responsibility to shareholders when Russian companies such as Rosneft openly state that the interests of shareholders may be a secondary priority?

The protection of U.S. investor rights is the central issue in the 2005 civil lawsuit filed by several American shareholders of Yukos ADRs. The holders of Yukos ADRs lost approximately $6 billion, several of whom filed suit against the Russian government and Russian oil companies on the basis that investors were protected by U.S. securities laws. The claim against state-owned energy firms, Gazprom and Rosneft, among others, stated that the defendants violated U.S. securities laws by "falsely assuring" publicly that the Russian government would not renationalize Yukos. This example clearly demonstrates how U.S. investors are at risk.

Another example that highlights the present anxiety and importance of protecting U.S. investors in the Russian market is recent action by the California Public Employees' Retirement System ("CalPERS"). CalPERS, which provides pension fund, healthcare and other retirement services for approximately 1.5 million California public employees, is the largest pension fund in the United States. At the behest of California's State Comptroller, CalPERS was asked to review its investments in Chevron and BP over concerns about the potential purchase of expropriated Yukos assets in state auctions and related litigation. In the end, none of the companies had participated in an auction of Yukos assets.

ADHERENCE TO THE RULE OF LAW

There is a very important role for government in ensuring free, open, and efficient markets. The rule of law is a necessary ingredient. A share in a company is a property right, and it must be enforceable in law. So, we need honest, independent courts and a tough, independent regulator. But, when the courts are responsive to political pressure, and the regulator and the regulated are one and the same, there is an inherent conflict of interest. The role for government is tough, independent, and neutral policeman — not player and referee at once.

Respect for the rule of law in Russia is a principle in jeopardy. A perfect example is the manipulation of the Russian courts by Russian authorities in furtherance of their campaign against GML and Yukos. Each time the Russian authorities' allegations have come before an independent court outside of Russia, the court has found the allegations to be substantively deficient, or politically motivated.

For example, on August 13, 2007, the Swiss Federal Supreme Court recorded its finding as to the existence of political motivation of the Russian authorities. The Court concluded the factual record clearly established that the criminal proceedings against Mr. Khodorkovsky and others related to Yukos was orchestrated by the powers that be in Russia for political reasons. The Court rejected the Russian Government's request for mutual assistance. Courts in London and the Government of Lithuania have reached the same conclusion and denied extradition requests for ex-Yukos executives who fled to London.

In the United States, we find another example. A Federal District Court dismissed securities claims against Yukos, its management and GML for misrepresentations concerning Yukos' tax compliance filed by three Yukos shareholders as a class action based on charges filed in Russia. A key basis for the dismissal was that plaintiffs failed to allege sufficient facts to demonstrate that Yukos, et al., violated Russian tax laws or knew or should have known that the company's tax strategy was illegal.

Another area where Russia is failing to adhere to the rule of law is international treaties. GML has filed a claim under the Energy Charter Treaty ("ECT"), a 51 nation agreement to establish a regime for energy disputes. Although the Russian government signed the treaty and is therefore bound by its provisions, Russia has failed to honor its commitment. Under the ECT, GML is seeking compensation for the Russian Government's unlawful seizure of Yukos in a $29 billion (minimum) arbitration, the largest commercial arbitration in history.

Finally, it is important to remember the human dimension of the Yukos affair and the impact it has had on everyone associated with the company, most notably Mikhail Khodorkovsky and Platon Lebedev, but including former Yukos employees, defense lawyers and managers of the Yukos assets, who have all been subjected to varying degrees of abuse and harassment.

All of these events beg the crucial question: From an American investor perspective, how could you have confidence in your ability to enforce your property right in a Russian publicly owned company without an independent judiciary to serve as arbiter of your claim?

CONCLUSION

The Yukos affair is a dark cloud hanging over the ability of American investors to invest in Russia with confidence. It is important to remember that Yukos is not alone –

the protection of company and investor rights is a concern for other entities operating in Russia. All you have to do is read the papers to see stories about how the law is being selectively applied to foreign and domestic firms in Russia.

I believe there must be a change of course in Russia with significant economic and political reforms, such that American investors can become confident that their rights and interests will be protected according to internationally recognized standards of corporate governance, business transparency and the rule of law. Unfortunately, Russia is heading in the wrong direction, as I can personally attest. The Russian authorities continuing attacks on Yukos and GML is a case study in the potential dangers and perils for companies and investors trying to navigate in Russia today.

Thank you again for convening this important hearing and I welcome your questions.

October 17, 2007

Testimony of David Satter
Research Fellow, Hoover Institution,
Stanford University, Senior Fellow, Hudson Institute
U.S. House of Representatives,
Committee on Financial Services, Subcommittee on Domestic and
International Monetary Policy, Trade and Technology
U.S. – Russia Economic Relationship: Implications of the Yukos Affair"

The Yukos affair represented a turning point for post-soviet Russia. Ever since acceding to the presidency, Vladimir Putin has worked to concentrate power in his hands and in those of the clan of former KGB officers who are his close supporters. He has eliminated federalism in violation of the Russian constitution, subordinated the legislative branch of government and the courts and imposed control over national television and the press.

With the arrest of the head of Yukos, Mikhail Khodorkovsky, however, he also acted to assure that the nation's oligarchs would support only political candidates backed by the regime. His goal was to place the nation's wealth in the service of his own political faction, choking off political opposition and completing the transformation of Russia into a controlled society with a permanent political leadership.

Khodorkovsky would hardly qualify as an international cause celebre if his arrest were an isolated incident, unrelated to the political struggles within Russia. Like the other Russian oligarchs, he amassed a fortune in the Yeltsin years on the strength of insider information and corrupt ties. There is no better example of how this worked than the methods through which he obtained the controlling packet of shares in the Yukos Oil Company, which controlled 2 per cent of the world's oil reserves. Khodorkovsky's bank, Menatep, was put in charge of the auction of the Yukos shares. It then acted to eliminate all competitive bidding and Khodorkovsky purchased the company for $159 million, $9 million above the starting price. In 2003, the value of Yukos was estimated at $15 billion.

Unlike the other oligarchs, however, Khodorkovsky understood that the Russian rules of bandit capitalism were unacceptable internationally and he took steps to transform Yukos into a modern Western corporation, declaring his income and introducing Western standards of accounting and corporate governance. He also began to exercise the rights of a Western businessman, including the right to finance opposition political parties.

In the end, it was this that sealed his fate. The Russian bureaucracy depends on businessmen's violations of the law, in particular tax avoidance, in order to facilitate a steady flow of bribes and to assure that they live in fear and so are amenable to political control. Khodorkovsky had broken with that system and his example had to be suppressed for the system to survive.

In August, the Swiss Supreme Court rejected a request for legal assistance from the Russian authorities in the Yukos case on the grounds that the case was politically motivated. According to the decision, the case against Yukos had "a political and discriminatory character… underlined by the infringement of human rights and of the right to defense."

Nonetheless, the Yukos affairs casts a long shadow over Russian economic and political life. The post-Yukos system uses economic relations for political purposes and obliges Russians and Westerners that seek profitable economic relations in Russia to pay a price in political principles and self respect.

In the post-Yukos system, no individual doing business in Russia is completely secure. Khodorkovsky was not only Russia's richest citizen. He was also the head of its most enlightened company. It was a measure of Yukos's success that on the eve of Khodorkovsky's arrest, the company was on the brink of attracting as much as $25 billion in foreign investment from Exxon-Mobil for a 40 per cent stake in the company. Given the rise in oil prices, Yukos could not have gone bankrupt for purely economic reasons. Even after losing Yuganskneftegaz, its principal production unit, Yukos made good on a tax bill of $23 billion by the end of 2005. The company's remaining units included oil fields capable of pumping 500,000 barrels a day of crude and Russia's biggest refinery. According to the terms of one restructuring plan, Yukos promised to liquidate $18.2 billion in outstanding debts within 18 months. But the creditors rejected all offers and chose to dismantle the company, demonstrating that special interests were determined to destroy Yukos and distribute its assets among themselves. In the end, the principal beneficiaries were state run energy concerns run by Putin's closest cronies.

The aftermath of the Yukos case also makes it highly unlikely that Putin and his cronies will ever willingly surrender power. Yuganskneftegaz was sold to a previously unknown Baikal Finance Group at about half its likely real value. The state oil company Rosneft then purchased Baikal Finance. Yukos had filed for bankruptcy in Texas and won an American injunction barring Gazprom and its Western financiers from participating in the auction. It was apparently out of a desire to avoid legal complications that the Baikal Finance Group emerged to bid for Yuganskneftegaz. The sale, in fact, duplicated the tactics used by Yeltsin era oligarchs during privatization. It was also illegal because in tax settlement cases, non-core assets must be disposed of first. Yuganskneftegaz was the core of Yukos.

Under these circumstances, any transfer of power is risky for the present Russian leadership. Those who organized the illegal dismembering of Yukos could be subject to the same treatment that they imposed. This is an important reason why fair elections in Russia are unlikely to occur. In this, the Russian authorities can only be gratified by the Western reaction. The success of Rosneft's London IPO suggests that the bulk of Western investors are not interested in the ethical and legal issues presented by the destruction of Yukos and the treatment of the Yukos investors.

Finally, the aftermath of the Yukos case convinced the Russian leadership that they can use coercive tactics with foreigners freely. Royal Dutch Shell ceded control of the Sakhalin-2 oil and gas project to Gazprom under conditions in which it was widely believed to have been shortchanged by $5 billion after the Russian government threatened Shell with the termination of operating licenses over alleged environmental violations. The Western attitude is so supine that Shell president Jeroen van der Veer actually thanked Putin when the ordeal was over in December, 2006. The Russians also cut off supplies to the Mazeikiu Nafta refinery in Lithuania. The refinery was the biggest Yukos asset outside of Russia and it was sold to a Polish company

despite efforts by the Russian government to acquire it. After that, the company began to experience problems with oil supplies. Finally, a Russian pipeline official informed them that they might never get supplies and there was nothing anyone could do about it.

Russia has cut off gas supplies to Ukraine and used the threat of a cutoff to get a higher price from Belarus in the middle of winter while continuing to use discriminatory pricing in the case of other customers in accordance with political allegiance. Turkey receives 75 per cent of its gas from Russia and, under these circumstances, is acutely aware of the need not to offend Russia. Russian officials have openly stated that Hungary's energy dependence on Russia precludes an "anti-Russian foreign policy."

Under these circumstances, it is important for the United States to develop a strategy for countering attempts by Russia to ignore the law and use economic relationships as a means of imposing political conformity. The U.S. was instrumental in the extension of membership in the G-7, which became the G-8 even though Russia's internal practices did not conform with that organization's principles. Similarly, Russia is a candidate for membership in the WTO and consideration is being given to rescinding the Jackson-Vanik amendment. All of these steps are inconsistent with Russia's present practices. Accordingly, Russia should be removed from the G-8 and action on WTO membership and the Jackson-Vanik amendment should be postponed until such time as it is justified by Russia's actions.

Western companies should seek to act cooperatively in the face of Russian pressure and violation of contracts and not allow themselves to be played off against each other to the ultimate detriment of everyone. There should be a means to investigate attempts by the Russian authorities to pressure Western companies to give up their contractual rights as well as measures to support affected Western companies in the event of abuses. At the same time, the U.S. and the European Union should develop a strategy to prevent Russia from using energy as a political weapon, including measures to protect against the consequences of any abrupt and politically motivated cutoff of supplies, coupled with the establishment of standards of transparency, competition and reciprocity.

Finally, the U.S. should be very wary of attempts by Russian companies to acquire U.S. assets with strategic significance both in light of the fact that Russia is determined to prevent such acquisition when it comes to their own strategic assets and because, in the aftermath of the Yukos case, no Russian company can be regarded as truly independent of the Russian state.

Responses to Questions for the Hearing Record
on behalf of Mr. Tim Osborne (Director, GML Ltd.)

U.S. House Committee on Financial Services
Subcommittee on Domestic and International Monetary Policy,
Trade and Technology
Hearing entitled:
"U.S. - Russia Economic Relationship: Implications of the Yukos Affair"
October 17, 2007
For witness: Mr. Tim Osborne (Director, GML Ltd.)

1. **It is my understanding that you, and others affiliated with Yukos and GML, have been harassed and intimidated by the Russian authorities for properly carrying out your fiduciary duty to protect shareholders.**

   Moreover, you were quoted about a year ago in the Times of London saying that the Kremlin would prefer GML receive nothing from their investment in Yukos, and Russian authorities are trying to make your life as miserable as possible.

   Can you comment?

Thank you for your question, Congressman Roskam. I am grateful for your interest in this matter.

In my written testimony, I have outlined at some length the corporate cases brought against key assets of Yukos Oil Company ("Yukos") and GML. However, it would be misleading to look at this solely as a corporate matter. As I have suggested earlier, this case originated in politics. With the passage of time, and in part a function of the absence of any accountability, it has grown to include greed. As such, it has a sharp and disturbing human dimension that has caused those involved with Yukos and GML to personally suffer.

The vendetta brought by the Russian authorities against many people involved with Yukos and GML has included a wide range of criminal proceedings that are, like the tax charges, expressions of political motivations rather than law. For this reason, I appreciate the opportunity to discuss the actions taken by the Russian government against myself and key individuals.

I personally continue to be the target of actions by the Russian authorities designed to bully, intimidate, and harass me in order to stop me from carrying out my duties as a director of GML, including defending Yukos shareholders' property rights and assets. Additionally, the Russian authorities are motivated to retaliate against me for exercising my responsibilities, as the elected shareholder representative in Yukos' involuntary and contrived Russian bankruptcy proceeding,

to protect the remaining assets and property rights belonging to Yukos shareholders worldwide. The Russian state would like to punish me for fulfilling my fiduciary duties.

The Russian authorities' efforts to harass and intimidate me are part of a global campaign by the Russian Government to utilize requests for extradition, property freezing orders, and search and seizure of documents to attack individuals associated with GML and Yukos who endeavor to fulfill their fiduciary duties to protect the rights of shareholders, including American citizens. Every time these requests have been considered by courts outside Russia, including the European Court of Human Rights and Switzerland's Supreme Court, the courts have rejected their validity because politically-appointed Russian prosecutors and judges have disregarded internationally recognized prohibitions on the use of these conventions for political purposes.

Unfortunately, the Russian government is willing and able to use its authority to intimidate and harass individuals like me for standing on the side of shareholders, when their goals do not align with the political and economic interests of the Russian state. Since mid-2006, the Russian Government has shown a renewed determination to misuse the decaying legal framework in Russia to pursue its political and economic vendetta against GML and Yukos.

For instance, in an obvious act of retaliation, the Russian General Prosecutor's Office (GPO) launched a criminal investigation of me and three former senior Yukos executives, who are U.S. citizens, immediately after a Dutch court ruled in 2006, at our request, the proceeds from selling Yukos' foreign assets should remain under the control of the Dutch court and not be allowed simply to go to Russian creditors. As you may expect, the Russian creditors were primarily the taxing authorities and the state owned oil company, Rosneft. This Dutch court victory came shortly after a similar victory in a New York court. These investigations falsely allege criminal misappropriation, unlawful enrichment, and money laundering in connection with the legitimate restructuring of the legal ownership of Yukos' Netherlands-owned assets.

I actually learned of the investigation of me through a notice posted on the GPO's website. I have not yet received any direct communication from the GPO however, despite official protests by the British Foreign and Commonwealth Office, the Law Society of England, and three letters by my counsel. My counsel sent those three letters directly to the GPO informing that I am willing to be interviewed in London by Russian investigators about any suspicions they may have. None of our letters has received a reply.

The Russian authorities launched these investigations against me and the former Yukos executives because we dared to fight to protect the rights and interests of Yukos shareholders in the Dutch court, which would not recognize the Yukos bankruptcy proceeding in Russia since it had been challenged in the European Court of Human Rights. The timing and circumstances of the investigations demonstrate clearly the Russian state's motivation to take action against me, in addition to action against GML, for the sole purpose of intimidation and as a vendetta. The Russian government's illegitimate ulterior motives are further highlighted by the fact I did not become a GML director until March 31, 2004, well after the Yukos/Khodorkovsky affair began. Prior to this time, I had no substantial business involvement with Yukos, GML or Mr. Khodorkovsky, and I was not a director of the relevant Netherlands entity at the time the complained of events occurred (although I am now).

These are not merely my conclusions. Rather, they are shared by essentially every independent legal authority and outside observer. In October, a Dutch court ruled the Russian sale of assets

held by Yukos Finance, the Dutch subsidiary of Yukos, was illegal on grounds that a Russian bankruptcy proceeding against Yukos was invalid under Dutch law. In its ruling of October 31, 2007, the Dutch court attacked the Russian bankruptcy action against Yukos. The court concluded, "Yukos Oil has been deprived of a fair trial in the determination of the amount of taxes it owed to the Russian state". In addition, in the last two years courts in England, Switzerland and Lithuania have held that the Russian prosecution of Yukos and those related to it were politically motivated, and the European Court of Human Rights has held that Mr. Khodorkovsky's co-defendant, and previous GML director Platon Lebedev's due process rights were violated.

As the Russian state's bully tactics against me have proceeded, I have been advised by the British Foreign and Commonwealth Office to restrict my travel. Police have advised me to increase my home and personal protection. Unfortunately, such recommendations have become the norm because of a growing list of unexplained tragedies that have mysteriously befallen those who have stood up to the Kremlin.

My predecessor on the Board of Directors for GML, Stephen Curtis, was killed in a helicopter crash in 2004. The direct cause of the crash was never determined. To say the least, it prompted great anxiety for my family and I. While the sum total of all these events makes every day filled with apprehension to varying degrees, I am resolved to continue on with my responsibilities and duties.

Thank you again for you question, and I express my gratitude for your Committee's interest in the human dimension of the Yukos affair. I trust that we will work together to protect Yukos investors, particularly American investors, and ensure that my personal hardships in defending Yukos investors are not in vein.

2. It is my understanding that GML has filed a claim against the Russian Federation under the Energy Charter Treaty, seeking compensation for Yukos assets expropriated by the Russian government.

Can you explain the suit?

Thank you for your question, Congressman Lucas. I am grateful for your interest in this matter.

GML has filed a claim against the Russian Federation pursuant to the Energy Charter Treaty ("ECT"). This action is being pursued by GML Limited's wholly owned subsidiaries Yukos Universal Limited ("Yukos Universal") and Hulley Enterprises Limited ("Hulley") who have a controlling shareholding in Yukos Oil Company ("Yukos").

The ECT seeks to ensure that investors in the energy industry resident in signatory states are protected from having their investment made worthless by the actions of a government of another signatory state (such as expropriation of assets).

The campaign which has been waged against Yukos through the arrests of its senior management, the disproportionate tax reassessments, the seizure and expropriation of Yukos' major operational subsidiary Yuganskneftegaz has led to the bankruptcy and liquidation of Yukos. Yukos Universal and Hulley's substantial investment in Yukos is now worth nothing.

As such, arbitration proceedings under the ECT pursuant to the rules of the United Nations Commission on International Trade Law were commenced against the government of the Russian Federation on February 3, 2005 following service of a Notice of Arbitration and Statement of Claim upon the Russian embassy in Paris and the Kremlin in Moscow. The amount claimed by Yukos Universal and Hulley in total is for not less than US$ 28.3 billion (subject to further adjustment after forensic accounting input) in addition to costs and fees.

A few weeks ago, an Amsterdam, Netherlands, Court ruled the Russian tax case was conducted in violation of Yukos' due process rights under the European Convention, of which Russia has agreed to comply. Although not binding on the Tribunal hearing the ECT claim, this ruling is instructive of how an independent judiciary will adjudge our claim.

Thank you again for you question, and I express my gratitude for your Committee's interest in the Yukos affair, and the consequences for shareholders in America and abroad.

3. In your testimony, you stated that U.S. investors lost over $6 billion in the confiscation of Yukos, and they are seeking compensation for Yukos assets expropriated by the Russian government.

Can you further explain this?

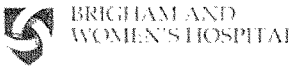
Thank you for your question, Congressman Marchant. I am grateful for your interest in this matter.

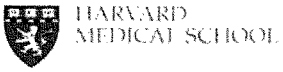
As I stated in my written testimony, the issue of protecting the interests of investors, particularly individual investors, is an important principle of the American free market economic system, regardless of whether the protection is for investments in the U.S. domestic market or overseas markets. U.S. shareholders, investors, institutional investors, consumers and others must be protected as Russia is an emerging market where U.S. investment will occur more and more often. Without a venue to address the unlawful confiscation of shareholder property rights, this principle falls apart.

While GML has pursued legal action stemming from the Yukos affair in foreign courts and venues, American shareholders of Yukos have moved to redress the massive theft and confiscation of their property rights in Yukos within the U.S. courts. Because one of the U.S. shareholders of Yukos is best situated to inform you of their efforts, and the importance for the Committee, I refer you to a letter written to me by Dr. P.D. Allen, M.D., of Massachusetts, which I have enclosed with my answer (Exhibit 1).

Dr. Allen's letter is an excellent explanation of the cause of US investors in Yukos, but more importantly, it shows a real need for your Committee to take an active role in addressing the root causes of Yukos affair, and exploring ways to find relief for these harmed investors.

Thank you again for your question, and I express my gratitude for your Committee's interest in the Yukos affair. I look forward to the working with the Committee in the days ahead.





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Professor Anesthesia

December 18, 2007

Mr. Tim Osborne
Wiggin Osborne Fullerlove
52 Jermyn Street
London SW1Y 6LX
ENGLAND

Re: **U.S. Investor Efforts to Hold the Russian Federation Accountable for the Expropriation of Yukos Oil Company**

Dear Mr. Osborne:

This is in your response to your inquiry about the status of our efforts as U.S. investors to obtain relief in U.S. courts and hold the Russian Federation accountable for the expropriation of Yukos Oil Company. The bottom line is that we have been unable to get the U.S. courts to hear our claims, because the judge in our case ruled that she did not have jurisdiction over the Russian Federation and the other defendants.

Judge Kollar-Kotelly of the U.S. District Court for the District of Columbia handed down her decision on November 26, 2007. Although she noted that our allegations against Russia "tell a troubling story," she concluded that U.S. courts did not have jurisdiction to "reach the merits of Plaintiffs' claims." This is a truly disappointing outcome. We were not even able to present our arguments about how Russia and the other defendants have violated U.S. securities laws and international law. Instead, the judge threw our case out on a procedural issue. It is now clear that we have no remedy in the U.S. courts.

Our lawsuit charged that Russia and several enterprises owned by the Russian government, including the state oil company Rosneft, violated international law by expropriating Yukos without compensation. We also alleged violations of U.S. racketeering and securities laws. Specifically, we made two principal claims: (i) through the freezing of the shares of Yukos's majority owners, unjustified tax levies, and the sham auction of Yukos's principal asset to a state-owned company, Russia effectively re-nationalized Yukos, and did so without paying any compensation to its owners; and (ii) as part of that scheme, the defendants made misrepresentations directed at the U.S. and global securities markets, falsely assuring the investing public in violation of U.S. securities laws that the Kremlin did not intend to re-nationalize Yukos.

I and other American investors purchased shares in Yukos on the U.S. over-the-counter market – in part relying on statements by President Putin and others that the Kremlin would not re-nationalize Yukos – only to see the value of our investments dwindle to nothing. In addition to the investors who were involved in our lawsuit, my understanding is that there are thousands more U.S. investors who lost money as a result of Russia's illegal re-nationalization of Yukos, including institutional investors and public pension funds in 19 states. The estimated loss to U.S. investors is approximately $6 billion.

Before closing, I might also say a word about our group of investors who tried, and failed, to hold Russia accountable in U.S. court. I think this is important, because Russia's attack on Yukos affected many average Americans. Our group of investors includes current and former professors, teachers, bankers, civil servants, accountants, and a retired utility foreman. Three of us have served in the Marines. Most of us invested a portion of our retirement money in Yukos ADRs, and many of us are currently retired. For example, one of us, a retired banker and ex-Marine, lost over $700,000 just prior to his retirement as a result of the Yukos takeover. We are from many states, including California, Colorado, Florida, Georgia, Illinois, Massachusetts, Minnesota, Nevada, New Jersey, New York, Tennessee, Texas, Washington, and Wisconsin.

The judge's dismissal of our case is most disappointing. Unlike investors in other countries, we have no investment treaty to rely upon, and we are therefore in the hands of the U.S. courts. The U.S. court's refusal to assert jurisdiction over Russia left not just us, but all American investors in Russia, with no remedy at all. There also is no possibility of seeking justice in the Kremlin-controlled Russian courts. It is outrageous that the Russian government could confiscate the property of Americans and then not be held accountable for its actions.

In closing, I would like to thank you for your continued efforts to bring attention to the plight of the minority shareholders in Yukos, even at great personal risk of retaliation by the Russians. It takes courage, and that courage is appreciated.

Sincerely,

P. D. Allen, M.D., Ph.D.
Professor of Anesthesia