



### *Energy Series No. 4...The Rise and fall of an Energy Giant...*

Yukos was born second into the new Russian oil industry of the early nineties. The company began with just one of West Siberia's major production associations, (Yuganskneftegaz)<sup>1</sup>. It acquired an obligatory downstream asset quickly, and made an early merger with Samaraneftegaz. The company was not very acquisitive<sup>2</sup>, adding only a medium-size west Siberian producer, Tomskneft.

Although it was founded as a private company, in April 1993, as was the case with most pre-1995 privatizations, the Russian government retained a majority interest in the company. Therefore, Yukos became one of the biggest prizes for the loans for shares scheme. In an auction on December 8, 1995, 45% of the company's shares were offered in exchange for a loan to the government, while another 33% of the stock was offered in a related investment tender. The asking price was 300\$ million for the two blocks.

Menatep Bank organized the auction of Yukos and although there was some competition from other oligarchs-unlike the vast majority of other auctions- Mikhail Khodorkovsky's offer trumped all others. He paid only 9\$ million more than the opening price on the block of 78% of Yuko's shares. At the time, Yukos had roughly 14bb of oil<sup>3</sup> which means that Khodorkovsky paid only 6 cents per barrel when the price per one barrel of Brent crude at the time of the auction was 17\$. Of course the most important machination regarding the auction concerning Yukos was that Menatep Bank belonged to Mikhail Khodorkovsky.

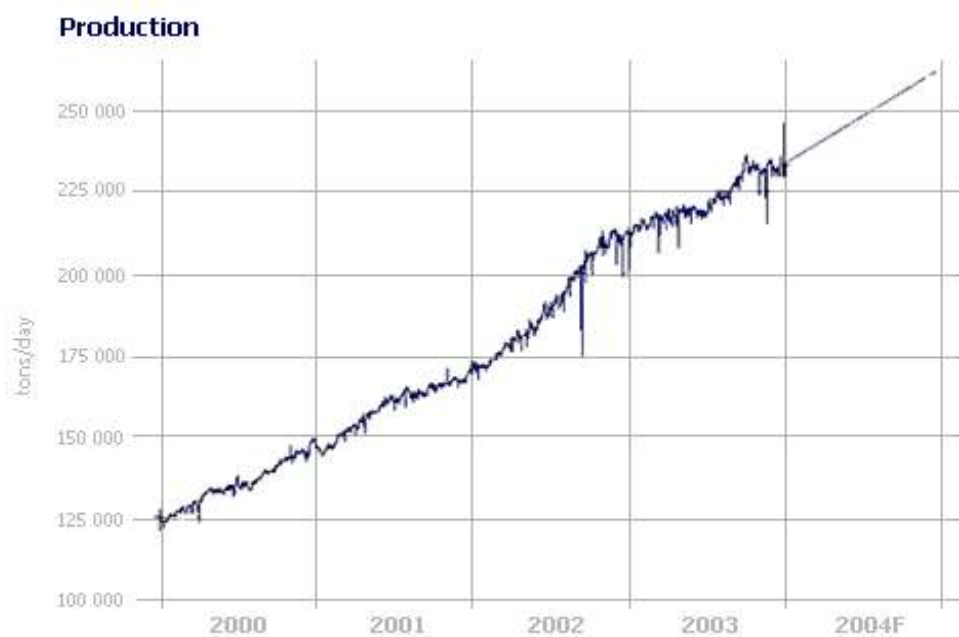
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<sup>1</sup> The specific field was the backbone of the Yukos production. It is positioned on the South bank of the Ob River.

<sup>2</sup> Especially in comparison with TNK and Rosneft which as we saw in the previous volume of the energy series was perhaps the most aggressive oil major regarding acquisitions.

<sup>3</sup> Market Intelligence Group, Russian Petroleum Investor. (1995), *Russian Petroleum Encyclopedia Upstream*. Vol. 1, p. 136.

From 1995 to 1998 production remained relatively stable (below 800,000b/d). However, the company was particularly well poised to exploit the rise in income that began in 1999. Its ace in the hole was a major discovery, the underdeveloped field Priobskoye. The area posed some technical difficulties but contained large quantities of recoverable oil. In 2000, driven by the initial increases at the field, Yuko's output began a sustained increase. It was on its way to become the countries largest oil producer, and in the next 3 years it was steadily at the first position of the Russian oil industry.<sup>4</sup>



Oil production was not the only sector where the company excelled. Yukos was the first oil major that reported financial results using (GAAP) in 2001. A year later it revealed the structure of its ownership while in 2003, its board contained roughly half Russian and half directors from outside Russia. A direct opposite from Lukoil for example which its board of owners was, and still is dominated by Russian shareholders. While the stain of the loans for shares perhaps never went away, during the first years of the new century, Yukos emerged from a shady corporate adolescence, publicly aspiring to become the Russian exemplar of sound, even progressive management.

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<sup>4</sup> The company almost doubled its production and peaked at 1, 6 million barrels per day in 2003.

Additionally, regarding technical measures used, the company's performance had risen across the board. Mainly through Priobskoye, Yukos reduced oil production costs and raised productivity. The company re-engineered some of the major and old West Siberian fields, while applied western techniques to all new major projects. Another vast difference between Yukos and Khodorkovsky's managerial style and other Oil majors which used Russian drilling techniques, neglected 'tired' wells and tried to earn top income without first investing. For example Lukoil and Rosneft in the vast majority of occasions never followed the western-style aggressive policy of Yukos regarding exploration, production, etc.

The company has focused on Russia, with foreign upstream involvement limited to a position in a low profile Kazakh exploration block. Downstream in 2002, Yukos acquired a major refinery in Lithuania and threw its weight behind a Russian consortium seeking to build a private pipeline from Western Siberia to Murmansk. The fact that this project could diminish Transneft's monopoly leverage highlights Khodorkovsky's strategy regarding the energy market, while it shows that by expanding further the company could harm the state interests.

From a western point of view Yukos had done it all right and the company's financial position became better every single year from 1999 onwards. Although there was some decline trends during 2002 and 2003 the major problems the company faced were legal and political problems.

### **The Yukos Affair<sup>5</sup>**

The Yukos affair is intertwined between two separate problems that surround the company and the man who sat atop its corporate structure-Mikhail Khodorkovsky. One source of trouble is clearly political. The second, which would probably not have arisen in the absence of the first, taps fast dealing during the loans for shares program. Together these two 'trend' engulfed and destroyed Russia's largest oil company.

The criminal indictments that Khodorkovsky and his partner Lebedev, face are actually the easier part of the affair to understand. Most of the charges boil down to actions taken by the Menatep bank in the 90's. The first set of charges has to do with Russia's largest fertilizer company Apatit.<sup>6</sup> The second set of charges has to do with tax evasion. The state claims that the two men used the corporation in order to create

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<sup>5</sup> We will only make a reference to this particularly complex case.

<sup>6</sup> Russian Petroleum Investor, (January 2004). *What Charges face Khodorkovsky?*, p. 12

personal tax dodges. Lebedev arrested in July 2003 and Khodorkovsky three months later while the government announced that except the charges, Yukos also owed to the state an additional 3.4\$ billion in tax from 2000.

The more complex part of the affair is not the detailed nature of their legal problems but why their actions got them into trouble. Yukos was not the only company that exploited the favorable climate of the 90's in order to expand and to avoid federal taxes. The answer lies to the way Khodorkovsky wanted to expand his political power and to challenge openly president Putin. More specifically Khodorkovsky personally and with the use of Yuko's philanthropy began to financially support Yabloko and the Union of Right Forces, things that were unacceptable to Putin and his entourage. In 2003 the attack against Kremlin continued however the reaction was swift and hard.

Khodorkovsky and Lebedev are in jail still and Yukos's assets were taken at the beginning by Rosneft and Gazprom. The state not only put behind bars one –maybe the brightest --of the oligarchs- but used Yukos in order to strengthen the state companies. Although in western eyes it seems disastrous to attack and cut down Russia's biggest energy major, this might not be the case. Putin, proved his word against the oligarchs. He used Yukos as a prime example, while in parallel proved that he was not afraid, their oligarchic clique. Also Yukos highlights the start of the policy of returning the energy crown jewels to the Kremlin, practically reversing the short-sighted policy of premier Yeltsin.

### **Yukos Now**

Yukos' fate - after its dispute with the Russian state in 2004, which led to the expropriation by the government of Yukos' main subsidiary, Yuganskneftegaz – has lately been raised to the surface again.

It has namely gone public that Rosneft, currently the second largest company in Russia in oil production, won on March 27<sup>th</sup> an auction, the first one in a series of auctions, including seven due to take place in April, that aim to liquidate \$22 billion-worth of bankrupt Yukos' assets. This specific auction was about 9.4% of Rosneft's shares owned by Yukos. Rosneft won the auction by bidding \$7.6 billion beating this way an offer from TNK - BP. Nonetheless, the price paid for the shares is estimated as 12% less of their current market value, since Rosneft paid \$900 million less than the value of an equivalent block of its shares in London Stock Exchange around the time of the auction in Moscow.

Rosneft was able to place this bid due to a \$22 billion loan that took from major western banks, as ABN Ambro, Barclays, BNP Paribas, Calyon, Citibank, Goldman Sachs, JPMorgan and Morgan Stanley – actually the largest loan a Russian company has ever received. Of that amount, \$9 billion went to a newly created subsidiary, RN-Razvitiye, for its bid to bring back the 9.4% stake in Rosneft.

Coincidentally, Rosneft was also the company that acquired a controlling 76.69% share in Yuganskneftegaz in 2004 after its expropriation by the government due to Yukos' back tax bill, and then sold it to the state for \$9.3 billion in order to settle its own tax debt. That auction for Yuganskneftegaz was actually marked by the victory of an unknown firm called Baikal Finance Group. It acquired Yuganskneftegaz for \$9.35 billion, far below its market value, estimated at the time to be \$14 billion to \$22 billion, but was bought by Rosneft a few days later. This sale was characterized as "the theft of the century". At today's energy prices, Yuganskneftegaz is actually worth far more, perhaps more than \$60 billion. This acquisition boosted Rosneft from a medium-sized oil company to the country's second-largest, after Lukoil.

This time again RN-Razvitiye was expected to win the bid, buying back the stake in Rosneft at a discount before selling it off at profit to a strategic investor within the year. Rosneft actually issued a statement saying it would use the acquired shares to swap for other assets in unspecified acquisitions it plans, either in Russia or abroad. In next auctions other Yukos' assets, five oil refineries, license to 2.3 billion barrels of oil reserves, 400,000 barrels of daily oil production, 20% of Gazprom Neft - the oil section of Gazprom – and two oil production units, Tomskneft and Samaraneftgaz, will go under the hammer. Rosneft has also placed an offer for the refineries, like Gazprom and foreign companies including Chevron have done.

There is a dispute between Yukos and the state concerning the estimation of the company's assets' value. Yukos owes the government \$26 billion in back taxes, and said its assets are worth more than \$22 billion - the bankruptcy court has estimated them so - and at least enough to pay off the debts.

Furthermore, the company alleges that tax claims against it are the Kremlin's revenge for the political activities of its former head Mikhail Khodorkovsky, who was arrested in 2003 and is now serving an eight-year jail term in Siberia for fraud and tax evasion. Khodorkovsky has made an appeal to the European Court of Human Rights. However, Russian authorities are rushing the auctions through before the appeal could be heard, which puts the legitimacy of the auctions in dispute.

Yukos' spokeswoman, Claire Davidson, likened the auctions to expropriation and theft, since the proceedings concerning the auctions have been arranged by Yukos' creditors, the largest of which are Rosneft and the Federal Tax Service chasing Yukos for \$17 billion. Moreover, the man appointed by the bankruptcy court to liquidate Yukos' assets, Edward Rebgun, has applied to join Rosneft's board of directors. One thing that is indeed peculiar about these government-organized auctions is that the organizers don't actually set the auction date until it has been agreed in the internal debate that is actually going to win it.

So, the outcome of the auction was virtually predetermined. Nonetheless, by Russian law, there must be at least two parties to an auction and until then there was only Rosneft. Trying to legitimize the seizure of Yukos, the state has sought the participation of international oil firms in the auctions.

It is said that TNK-BP, Rosneft's adversary in the auction, was likely pushed by the Kremlin to participate in the sale to lend it an air of legitimacy. In exchange, the British-Russian venture may have been promised a speedy resolution to the conflict over Kovytkta, its flagship project in the country. It is well known that TNK-BP has faced lots of problems in Russia, including threats by Natural Resources Ministry officials to revoke its operating license for Kovytkta by May if it fails to fulfill production quotas. TNK-BP of course denied any collusion with Rosneft. It said that it sought the Rosneft shares to deepen a strategic partnership with Rosneft and that there was a ceiling it wasn't going to go above. However, it is peculiar that the BP venture bowed out of the auction after only four minutes of bidding.

Criticism of the auctions' preordained quality is gaining traction outside Russia anyway. It is characteristic the California Public Employees' Retirement System, one of the largest investment funds in the world, was cautioned against investments in the Western companies - specifically BP and Chevron - that may take part in the auctions supporting this way illegal and unethical activity by the Russian government. Chevron has not announced a bid for Yukos' assets but has not contradicted statements that it sent a letter of intent late last year.

The only way to prove that the true price of the Yukos' assets had not been deflated to benefit Rosneft would be to hold an open, fully transparent auction. Instead of that, the bidding was shaped up as a repeat of the wildly rigged auctions in the 1990s that tycoons like Khodorkovsky himself used to buy up state property and put together companies like Yukos in exactly the sort of transactions Putin has rallied against.

Khodorkovsky's bank, Bank Menatep, bought Yukos for \$300 million in a 1996 auction, one of a series of so-called "loans-for-shares" auctions that were at the center of criticism of privatization in Russia in the 1990s. The organizers of the auctions have described the process as legal and fair, despite criticism. Edward Rebgun has said that the Yukos' assets would be sold for about 30% less than their appraised value because they were distressed, in part because of the constraints of a court-ordered timeline to liquidate the property, the outstanding tax claims and environmental complaints raised by the state.

Nonetheless, Yukos was once Russia's second-biggest Oil Company, pumping one in every five barrels the country produced. That explains well the state's wish to eliminate its presence in order to maximize the government's control on the Russian energy sector through Gazprom's monopoly. The state-controlled Rosneft has played a crucial role in this process. President Putin has after all made it clear that state-linked firms are to hold a 51% controlling stake in all major projects.

Rosneft and Gazprom are expected to be the biggest beneficiaries also in the next round of auctions. If Rosneft wins a bid for these assets, as expected, most of the former Yukos will be reunited under state control. The company is this way quickly muscling its way onto the world stage and expanding to compete with other state energy giants like Aramco of Saudi Arabia.

The auctions have been just another step in the concerted state process of gradual dismantlement of Yukos since the arrest of Khodorkovsky in 2003 for alleged corruption and tax evasion. Recently, two more former executives of Yukos have been sentenced to more than 10 years in prison each after being found guilty by a Moscow court of embezzlement and money-laundering. Vladimir Malakhovsky, ex-head of Yukos-owned Ratibor, and Vladimir Pereverzin, former deputy director of Yukos' foreign debt department, were prosecuted for buying oil at artificially low prices from Yukos' subsidiaries and then selling it on at higher prices, siphoning this way off \$13 billion. Both men condemned the verdicts as groundless. Furthermore, Yukos' most senior Russian executive, Vasili Aleksanyan, was recently arrested and accused of money laundering. A layer of the company, Svetlana Bakhmina, was also arrested in 2004 and accused of asset - stripping at the firm's Tomskneft subsidiary. She was sentenced to seven years in prison for stealing property worth \$300 million from Tomskneft.

Russian prosecutors have also launched a criminal investigation into ex-chief executive Steven Theede and three others - former chief financial officer Bruce Misamore, special adviser David Godfrey and Tim Osborne, from Yukos' shareholder Group Menatep - based outside Russia - accusing them of switching \$10billion in assets outside Russia. Specifically, Dutch-based subsidiary Yukos Finance - run by former Yukos' executives "exiled" from Russia - has sold a number of interests recently to help pay off creditors with financial claims against Yukos. It has raised about \$1.6billion from sales of shareholdings in Lithuanian and Slovakian energy businesses. Prosecutors say ex-Yukos bosses illegally transferred these assets to the subsidiary and their actions are tantamount to theft. Nonetheless, a Dutch court refused to grant Russian liquidators full control over Yukos' Dutch subsidiary. The four men denied any misconduct and said the investigation was only showing the unbelievable length to which the vendetta against Yukos and Group Menatep is being pursued.

Yukos had been hardly trying to stave off bankruptcy for three years, since it was hit with the tax bill causing a long court battle to begin. However, its creditors have voted overwhelmingly to ask a bankruptcy court to liquidate the beleaguered firm. The court agreed to the request in August 2006 after rejecting assurances from Yukos' management that it could remain in business and pay the \$17 billion it owes to its main creditors, Rosneft and Federal Tax Service, the ones that asked for the process of liquidation to begin.