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GAZPROM and LUKOIL: The Privatization of Giants[i]

LUKOIL
OIL COMPANY

OAO GAZPROM

I. INTRODUCTION

On a cold December day, Russian President Vladimir Putin was sitting in his office in the Kremlin, pondering the next step for Russian gas giant Gazprom. He scored an important gain in May 2001 by appointing Alexei Miller, a close friend and his deputy secretary for energy as CEO, thus reestablishing state control over the private company. Gazprom had been under scrutiny from some shareholders who alleged that its assets had been stripped and handed to closely related companies on the cheap. Putin hoped that Miller's appointment would put some order back in Gazprom's house. But six month later, the Kremlin was still dissatisfied with the way the company was being run, and Putin was faced with two choices: blame his old friend and replace him, or put forward a plan once and for all to reform Gazprom. Such a plan would have to deal specifically with two politically sensitive topics: the deregulation of local prices and the liberalization of Gazprom shares.

At the same time, Putin thought back over the history of Russia's other energy giant, Lukoil. The company was well on its way to becoming a global force, and it had the reputation as one of Russia's most transparent and legitimate investment opportunities. Lukoil had attracted significant interest from Western investors, and was nearly fully privatized. Furthermore, it had shown great progress over the previous years in key operating areas such as petroleum output, the percentage of wells that were operational, and the extent of drilling.

As Putin reflected over the similarities and differences between these two energy superpowers, he wondered how best to capitalize on each firm's competitive advantages, while taking into account the political realities of contemporary Russia.

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[i] *This case was written by Ziad R Raphael, Andrei Pivovarsky, Serge Todorovich, Joe Frasca and Nathan Monash under the supervision of Professor Paul Vaaler. It is prepared as the basis for class discussion rather than to illustrate effective or ineffective handling of an administrative or strategic situation*

II. INDUSTRY ANALYSIS

Modern Russia is one of the world's largest producers and leading exporters of energy resources. At its peak level in 1990, the Soviet Union (USSR) was the world's largest producer of crude oil with an output of 10.3 million barrels per day, compared to 7.3 million barrels in the US and 6.4 million barrels in Saudi Arabia.[1] However, this success cannot be attributed to the achievements of the post-Soviet Russian governments. The history of the modern Russian energy industry and its success, as well as its eternal problems, begins in the times of the former Soviet Union. The energy industry in the USSR was regarded as one of the top priorities of government, apart from the military and heavy industry. Since the establishment of the USSR, a clear delineation is seen in the development of the oil, gas, coal, and electricity sectors. The time lag between the start of development of these sectors was quite significant. Development of the electricity sector started in the early 1920s with the implementation of the Goelro plan, which aimed to complete the electrification of the USSR in 15 years. Nevertheless, development of the gas sector started relatively late; it was in the 1960s that the Soviet government launched a comprehensive program aimed at gas exploration and development of infrastructure. In 1960 the USSR started to build up the Unified Gas Supply System (UGSS), which today has no comparison in the world in terms of size and structure.[2] The development of the oil sector began with the czars of Russia well before the establishment of the USSR. Nevertheless, the sector was not fully utilized until the 1940s, when the USSR undertook significant efforts to achieve self-sufficiency.

Most of the gas and oil reserves of the USSR are located in the Russian Republic, which accounted for almost 95 percent of the Soviet-era oil production. After the break up of the USSR, Russia inherited a well-established energy infrastructure (though the route to Western Europe goes through Ukraine). Moreover, Russia possesses vast reserves of crude oil and natural gas (experts believe that both will be enough for the next 300 years).

With the collapse of the USSR, Russia had both the ingredients necessary to become the world's leading exporter of energy resources, as well as significant problems that have their roots in the former Soviet Union. These problems included the Soviet industry's high level of dependence on energy resources, its inefficient use of energy, and significant losses due to the transportation of resources. In addition, proceeds from the export of energy resources constitute a significant portion of Russian GDP. But, after the break up of the USSR, output from the energy industry suffered a severe decline due to the general economic decline in Russia (see Appendix 1).

Under the Soviet system the energy industry was split into four distinct sectors, all of which competed for greater governmental support. Modern Russia has retained this industry structure. As a result, the Russian energy industry is divided into the oil, gas, electricity, and coal sectors, and not one comprehensive industry. The gas sector is dominated (95 percent) by the state-owned Gazprom, while the primary player in the electricity sector is RAO ES Russia (Open Joint Stock Venture, United Energy Systems of Russia) governed by Anatoli Chubais. Minatom, a state-owned enterprise, controls all nuclear power plants in Russia. The Russian coal industry stands out as the most liberalized in Russia. After the collapse of the USSR, the Russian government outsourced the most unprofitable mines and privatized those that proved to be financially viable. At the other end of the spectrum, the oil industry is the least concentrated. Though there are 11 large players (including British Petroleum and Shell) in the Russian oil market, there is one dominant player: LUKoil. In general, the energy industry is highly concentrated, and has an Herfindahl-Hirschman Index (a measure of industry concentration with a maximum value of 10,000) of 3,591.[3] Concentration within all sectors except for coal is even higher (see Appendix 2).

III. GAZPROM

"Gazprom has a market value of $13.8 billion, tiny compared to ExxonMobil ($299 billion), Shell ($121 billion) or even Texaco ($38 billion). If Gazprom were optimistically valued at the same level as Exxon per barrel of hydrocarbon reserves, it would be worth $1.8 trillion, or 132 times the current market price. The government's stake would hence be worth $698 billion, or 4.6 times the entire Russian national debt"

William Browder, managing director of
Hermitage Capital, and a Gazprom investor[4]

Background: From State-Owned Enterprise to Private Firm

The present-day Russian joint stock company (RAO) Gazprom has its origins in a 1956 decision by the USSR Council of Ministers to set up a separate ministry for the gas industry -- Glavgaz -- in recognition of the emergence of natural gas as a viable energy source, independent of the oil industry.[5] Rapid growth in demand led to the establishment of numerous local, independent production enterprises and pipeline networks, nominally under the control of Glavgaz, to service demand. At the same time, export markets were developing. To ensure orderly, uninterrupted deliveries to both domestic and export markets, the Soviet Union in 1960 started to build up the Unified Gas Supply System (UGSS), which in its size and structure still has no comparison in the world.[6]

The UGSS is a technological complex ensuring continuous regulation and monitoring of the gas supply within a system covering the entire Soviet landmass. It extends from the well to the pipeline to the consumer. The UGSS has 210,000 km (126,000 miles) of trunklines, 376 compressor stations, more than 500 gas fields, 46 subsurface storage facilities for gas and six gas processing plants. [7]

In an attempt to bring more cohesion to the still rapidly growing industry, the Soviet government dissolved Glavgaz in 1988 and established Gazprom State Concern. Although owned by the state, Gazprom operated on a self-sufficient basis, without state participation in funding investment.[8] Initially, State Concern Gazprom brought some 90 enterprises, including state companies, production associations and research and production associations, under its umbrella. In March 1991, Soyuzgazexport Association -- the gas export organization -- and Zarubezhgaz Association -- an independent importer of equipment, materials and other products for the gas industry -- were converted into state-owned enterprises and became structural units of Gazprom.

Towards the end of 1991, Gazprom State Concern was corporatized and turned into an Interstate Joint Stock Company, in which the Russian Federation held over 85% of the stock, with Ukraine and Belarus, through which the main export pipelines run, holding the balance of the stock. However, the Antitrust Committee of the Russian Federation objected to the registration of the interstate company and, in May 1992, it was decided to reconstitute Gazprom, with the Russian Federation being the sole owner.[9]

Privatization

At the beginning of 1993, Joint-Stock Company (RAO) Gazprom was launched, with the intention of restructuring and privatization within three years.[10] A presidential decree gave the company official monopoly status, subject to strict regulation of domestic gas prices.[11]

The core of the RAO Gazprom consisted of those wholly-owned enterprises that were directly linked to the operation and development of the Unified Gas Supply System. Those included 23 gas producing and transportation enterprises; exporters and importers, such as Gazexport and Gazkomplektimpex; information management and communications firms; production supervision and control organizations; two major research and development (R&D) institutes; and various other organizations not linked directly to the Unified System. Many of those enterprises were turned into corporations, in which Gazprom presently holds controlling blocks of shares, while local privatizations were held for those enterprises not directly involved in the gas industry. [12]

RAO Gazprom's management structure is an extension of the form established when State Concern Gazprom was established in 1988. Gazprom's Charter gives the government of the Russian Federation an active role in corporate governance. Gazprom's top management body, the Council of Directors, consists of the company's Chairman and eight additional members, four of whom represent the following government agencies: Ministry of Finance, Ministry of the Economy, Ministry of Fuel and Energy, and Federal Commission for Securities and Fund Market.[13]

The actual privatization of Gazprom was handled differently than that of any other industry in Russia.[14] When the company's chief executive, Viktor Chernomydrin, was named Russia's prime minister in 1993, a management determined to keep ownership firmly within the Gazprom family was assured government compliance. According to Gazprom's articles of association, which were approved by Russia's parliament, the Duma, the state reserved a 40% stake in the company for at least three years, while up to 9% of the company was eligible for foreign ownership, the remaining 51% of Gazprom in theory going to Russia's domestic investors through voucher privatization. [15]

Gazprom's privatization, however, strayed from the course ratified by the Duma. In early 1994, 15% of Gazprom's shares were simply handed over to selected, unnamed employees or retired workers before any privatization auctions commenced.[16] By June of the same year, an additional 35% of Gazprom had been sold and traded at private, closed auctions in approximately 60 Russian gas-producing regions.[17]

In late 1994, Gazprom appointed the UK investment bank, Kleinwort Benson, to advise it on the sale of up to 9% of its stock to foreign investors. The work was assigned to the German branch of Kleinwort, suggesting that Gazprom wanted to hand-pick investors from foreign business circles where it already enjoyed close co-operation.[18] (Gazprom at the time had both transmission agreements and budding joint ventures with Wintershall Ergas and Ruhrgas.) By 1995, however, the sale of foreign Gazprom shares had stalled, and the earmarked 9% was transferred to Gazprom's management to hold in trust until such time as a foreign offering was held (see Appendix 5).

Legal and Regulatory Constraints

Gazprom is one of the world's largest natural monopolies, and as such, it is heavily regulated by the Russian government at the federal level. The most important of these regulatory constraints is entitled, "Regulatory Control of Gas and other Energy Sources' and relates to pricing.[19] It requires that domestic gas sales by Gazprom be made directly to end-users at a state-controlled, indexed price of 9 rubles per cubic meter, which is around 11% of the market price for gas on the world market[20], with exports prices to be determined by the world market.[21] The ruling, however, did grant Gazprom the right to control gas flows and to regulate gas production and delivery. [22] But, Russia is reportedly attempting to liberalize its gas industry by ending Gazprom's monopoly, while keeping regulations on the local price. In November 2000, the government ordered Gazprom to allow other companies to use up to 15% of its pipeline capacity.[23]

Another regulation forced Gazprom to take social concerns of its employees into consideration. In order to comply with the "Presidential Decree of 23 September 1992", which gives employees with over 10 years service in the gas industry in the far north or equivalent areas the right to be relocated to central regions of Russia, Gazprom implemented a program to move gas industry families to better accommodation and to build quality housing for its employees.[24] In further compliance with the government edict, the company developed an industry-wide program to optimize personnel location as well as rotate work management and systems to ensure the most effective employment of staff.

Early Business Strategy

RAO Gazprom's early business strategy was articulated within its corporate Charter and concerned both domestic and international issues.

Gazprom's top domestic priority was the refurbishment of existing UGSS facilities, as the company actively sought to improve the reliability of gas supplies and the economic efficiency of gas transmission.[25] Up to 37% of existing pipelines had been in service for up to 10 years, with a further 38% in service for between 10 and 20, the other 25% having been in service for more than 20 years. [26] The development and further enhancement of gas supplies would involve the timely upgrading and retrofitting of facilities, the replacement of obsolete equipment, the laying of new gaslines in some areas and providing new coatings for pipelines, among other requirements.[27] To this end, Gazprom established its High Technology Council, which in 1995 enlisted the assistance of the Italian firms Sham and Nuovo Pignone to evaluate the condition of pipelines and compressor stations in Russia, report their findings and submit upgrading proposals.[28]

Gazprom's domestic strategy also relied on the establishment of joint ventures in order to tackle expensive and technically complex gas projects within Russia. By far the most significant of Gazprom's early joint ventures was the company's 1994 agreement with Wintershall Ergas (WIEH) to build a new 4,100 km pipeline from the Yamal peninsula in Siberia to Western Europe. A first pipeline, with a capacity of 15bn to 20bn cm/y, would pass through Belarus and Poland to Frankfurt/Oder, all gas being marketed by WIEH.[29]

Later in 1994, Gazprom and Conoco International Petroleum started negotiations for a joint venture to produce petrochemicals for sale in Russia and internationally (see Appendix 6). The basic principle involved in the project was that common gasflows from the Senoman and Valanzhin horizons are separated to produce ethane-rich and methane-rich streams for supply to appropriate petrochemical facilities to be built by Conoco. In its finalized project-evaluation studies, Conoco showed the project to be attractive and worth special consideration.

Internationally, Gazprom focused almost exclusively on increasing gas exports to Europe. Gazprom CEO Rem Vyakhirev noted that, "Even on conservative estimates, European gas demand is predicted to increase by 200bn cm between 1994 and 2010…Gazprom has all the resources and facilities to meet a significant proportion of this additional European demand."[30] Gazprom sought to achieve large-scale European gas supply both delivered to border metering points and directly to consumers in importing countries. Direct supply to customers offered the potential for additional revenues to offset increasing production and transmission costs from remote supply sources such as Yamal. To this end, Gazprom created trading houses, public companies and joint ventures in a number of gas consuming countries, including Germany, Austria, France, Italy, Serbia, Slovenia, Poland, Greece, Finland and Hungary. [31] The sale of part of Russian gas supplies through these entities not only helped to secure materials and equipment needed by Gazprom, but served the important purpose of forging new links and relationships with foreign partners, based solely on the economic interests of the co-operating parties.[32]

Present Organizational structure (see Appendix 7)

Gazprom's complex organizational structure a vertically integrated company. Gazprom controls numerous "senior daughter" companies (Gazexport, Stroitransgaz, Gazprom-media) as well as "junior daughters" that are managed by the "senior daughters". Gazprom's portfolio includes hundreds of companies including such diverse industries as insurance, investment, banking, ship building, etc. The following companies constitute the core of Gazprom:

- **Gazexport** (managed by former CEO Rem Vyakhirev's, son Yuri) controls all Gazprom's exports of natural gas to the Western Europe;
- **Itera** controls Gazprom's exports to former Soviet republics and those countries that cannot pay cash, but settle their accounts through barter exchange;

- **Stroitranzgaz** is the exclusive contractor for all of Gazprom's construction projects. Its average annual revenues exceed $2 billion;
- **Gazprom-media** controls a Cyprus based entity (Leadville Investment Ltd.) that owns all media assets (NTV TV station, dozens of newspapers and magazines, etc.) of Gazprom. Gazprom-media is one of the driving horses of Gazprom's image and a source of political influence.

Gazprom itself owns controlling or minority stakes in three European banks and approximately 15 of the largest Russian banks. The largest of these is Gazprombank (#5 in Russia), which handles the vast majority of Gazprom's financial transactions as well as acts as its largest depository of Gazprom ADRs.

International Expansion in the Late 1990s

While one western fund manager noted that, "the further [Gazprom] moves from Russia's borders, the weaker its position,"[33] Gazprom continued to focus its business strategy internationally in the late nineties and early part of the 21st century. Because of highly regulated domestic prices and a favorable exports tax regime, Gazprom was able to sell exported gas at about 9 times the domestic rate, while continuing to pay domestic taxes.

CIS, Eastern Europe, Baltic and Balkan Countries

In 1998, the company sold more than 52 bcm of gas to the CIS and Baltic states. Although competition for customers is fierce in Eastern and Central Europe, Gazprom is able to fend off the multi-national giants, due in large part to the Urengoi-Pomari-Ujgorod pipeline, built by Glavgaz during the Soviet era. Unfortunately the pipeline extends only as far as Bulgaria.[34]

To compensate, Gazprom has plans for an ambitious and expensive project called "The Blue Stream", which includes construction of a gas pipeline from Russia to Turkey (see Appendix 8). A significant portion (392 km) will pass through the bottom of the Black Sea at depths of up to 2000 meters. Gazprom plans to deliver about 365 billion cubic meters of gas to Turkey in the next 25 years (approximately 15 % of total exports from Russia), with the company expected to reap annual revenues from this project estimated at $1billion[35].

Gazprom will undoubtedly face competition in this region, as a consortium of American companies have initiated a new construction project called the Trans-Caspian Pipeline (TCP), which thus far has excluded all Russian participation[36]. The pipeline will bypass Russia and be routed instead through Turkmenistan, Azerbaijan, Georgia and Turkey. If the project succeeds, and Gazprom delays in implementing the "The Blue Flow", Gazprom's interests and presence in this region will be compromised.

Central Asia

Gazprom's main competitor is Turkmenistan. Although it has large sources of natural gas, and a capacity of exporting about 100 billion cubic meters of gas per year, Turkmenistan because of its poor economic situation exports now only 10 billion.[37]

East Asia

Reports have emerged that Gazprom plans to develop the Kovitkinsk gas fields, the largest in Eastern Siberia which holds about 1.8 billion cubic meters of gas .The market for these resources will be China, and the gas would be transported through a new pipeline from East Siberia to China. [38]

Western Europe

Gazprom faces important competition from Norwegian gas suppliers in Western Europe. Its main European competitors are "Eurogas Inc.", "Royal Dutch Shell", and "ENI Group". [39]

Middle East

Gazprom is participating in a multinational project, named "Southern Pars", with France's "Total", Malaysia's "Petronas" and Iran's "Pars". This international project's objective is the development of a large gas field on the southwestern coast of Iran and the construction of chemical gas factories in the Iranian province of Bushir.[40]

Payment Problems

A major problem currently facing Gazprom is the collection of payments from its customers in Russia and the former Soviet states. In 1998, Russian consumers paid for only 28.5% of delivered gas. In 1999, more than 50% of gas delivered was not paid for. Ukraine tops the list of Russia's delinquent neighbors, owing more than $1 billion for delivered gas.[41] While the economic interdependence of Russia and its near abroad explain Gazprom's willingness to continue supplying its bankrupt neighbors, albeit at a far more modest rate than before, customer debts have reached such high levels that the situation has severely affected the company's ability to invest in new projects and facilities.[42]

Ownership and Management: The wheels fall off the horse

Since privatization in the mid-nineties, Gazprom has faced ownership and managerial problems which have cast a huge cloud over the company.

Ownership

"Who owns much of Gazprom is a secret"[43], but even the most uninformed are certain that insiders in the form of management, not employees, received a huge cut. As of 2000, the Russian government still owned 38%, while managers' official stake was around 35 %, most of it held by small group of individuals who received stakes in 1994 of 1% to 5% each. This leaves 25% in other hands. While some of that ownership can be traced, much of it is hidden, and believed to be held by Gazprom insiders.

In 1996, Gazprom finally allowed foreign participation through American Depository Receipt (ADRs) issues and limited nonresident holdings to 9% of Charter capital. Following Presidential decree #529, two classes of Gazprom shares were offered: local ones and ADRs.[44] Local shares are traded on four exchanges with over 90% of daily volume traded on the Moscow Stock exchange. A limited number of financial institutions are allowed to hold local Gazprom stock, the major institutional investor being Gazprombank, a fully-owned subsidiary of it parent.

Foreign investors are barred from buying Gazprom shares on the domestic Russian market and are forced to purchase ADRs on the New York Stock Exchange. ADRs trade at a price far above the price for domestic Gazprom shares (see Appendices 9 and 10). Gazprom's largest foreign shareholder is "Ruhrgas", which owns 4%. Other large foreign institutional investors are Brunswick and CS First Boston[45]

Many foreign investors have circumvented the "ring fence" between ADRs and Russian-only domestic shares by buying Gazprom shares through Russian fronts, or gray schemes. Analysts estimate that the foreign participation in Gazprom, including these schemes, is approximately 20% (see Appendix 11).

A working group is presently studying ways to liberalize Gazprom's share market. It will most probably recommend increasing actual foreign ownership to 20%, however, it is still unclear whether foreign entities will be restricted to purchasing ADRs or whether they will be allowed to access the lucrative local market.[46]

Management

In the years following privatization, minority shareholders complained that Gazprom's top management was stripping off company assets and selling them to each other at rock-bottom prices. Two telling stories emerged in the media, the Stroytranzgaz and the Itera scandals.

The Stroytranzgaz scandal

Before leaving his post as prime minister, Viktor Chernomyrdin, who reportedly owns $1 billion in Gazprom stock [47], handed a multi-million dollar federal contract to Moscow-based Stroytransgaz to lay gas pipelines in Russia's regions. Chernomydrin's son, Vitaly, was vice-president of the enterprise as well a 6% stakeholder, while Stroytransgaz itself was a satellite of Gazprom. The pipeline maker's list of shareholders, filed with Russia's Federal Securities Commission (FSC), includes not only Vitaly Chernomyrdin, but his brother, Andrei, and Tatyana Dedikova, the daughter of Gazprom's former chief executive, Rem Vyakhirev. The president of Stroytransgaz, Arngolt Bekker, is a Gazprom board member. In fact, Gazprom managers and their relatives own at least 60% of Stroytransgaz. It currently has $1.2 billion in orders on its books, over 80% placed by Gazprom. Perhaps the most lucrative gift of all, however, was the transfer to Stroytranzgaz of a 4.83% block of Gazprom shares.[48] Moreover, Gazprom charged only $2.5 million for these securities, which at the time had a market value of up to $80 million, according to Moscow brokerage United Financial Group. The FSC is currently probing asset transfers from Gazprom to Stroytransgaz, which may have violated laws barring insider trading. Stroytranzgaz says it is a transparent company with nothing to hide.[49]

Itera

Share purchases are at the heart of another allegation focusing on links between Gazprom and the Itera Group, a privately held company headquartered in Moscow. Over the last three years, Itera has shot up to become the world's fourth-largest holder of gas reserves, while Gazprom has remained No. 1. This has raised eyebrows because most of Itera's reserves have come from Gazprom.

Business Week obtained concrete evidence of links between Gazprom senior manager Viktor Bryanskikh, and Itera. Bryanskikh is a major shareholder of a corporation called Lanka Promkomplekt, which is registered at the same Moscow address as Itera, and is owned in part by companies with links to Itera. In February, 1999, Lanka also bought a chunk of Sibneftegaz, a Gazprom affiliate. Those shares eventually ended up under Itera's control.

The Sibneftegaz shares were also sold on the cheap. Sibneftegaz registered its shares in the 1999 sale at a value of $1.8 million, while independent analysts placed a valuation of $80 million on the shares. Fellow purchasers of the discounted stock were Gazprom senior manager Vyacheslav Kuznetsov, his spouse, and a company owned by the son and brother of Gazprom CEO Vyakhirev[50].

Another further charge leveled at Gazprom managers concerns the use of tax schemes in order to transfer assets to Itera. According to a recent report of the Audit Chamber, Gazprom paid 1998 and 1999 taxes to the Siberian regional administration of Yamal-Nenetsk in the form of gas, undervalued at $2 per thousand cubic meters. [51] The region, headed by an elected governor who also sat on Gazprom's board, sold the gas to Itera at the same low price. Itera, in turn, sold the gas on world markets for as high as $60 per thousand cubic meters. Itera garnered $1.8 billion in 1999 through such means. The Audit Chamber has passed its findings onto prosecutors for possible legal action. "Itera is such an egregious rip-off [of Gazprom shareholders], one blinks with disbelief," Moscow gas analyst Eric Kraus commented.[52] Gazprom management denied the allegations and hired PricewaterhouseCoopers to conduct an internal audit.

With Vladimir Putin's rise to President, the government of the Russian Federation took measures to restore confidence in Gazprom. Amid growing pressure from foreign investors and government officials for the company to be restructured[53], Putin refused to reappoint Rem Vyakhirev , who had held the post since 1992, as Gazprom CEO. In May 2001, Putin instead appointed a close personal ally, Alexei Miller, as Gazprom CEO, reasserting the state's grip over the company[54]. Foreign media praised the appointment. The Financial Times wrote that Miller's appointment was an "important step for economic reform and, potentially, foreign investment in Russia."[55] Shortly thereafter, the Russian state further reinforced its control over Gazprom when it won six of the 11 seats on the company's board of directors at the annual general meeting.[56]

The months following his appointment, however, showed Miller's incapacity to resolve Gazprom's managerial problems. The board of directors continued to refuse a request by minority shareholders to appoint a new independent auditor. PWC in its report had stopped short of admitting asset stripping by Itera, but highlighted a number of transactions whereby Gazprom had ceded stakes in gas fields to Itera on terms which had clearly resulted in Itera's commercial gain.[57] In addition, an ongoing battle between "Vyakhirevite" and "Millerite" managers has prevented the real changes needed to make Gazprom a fully transparent and public company.[58]

IV. LUKOIL

"If Gazprom was even valued at LUKoil's level it would go up to 7 times"

William Browder[59]

<u>Formation and Privatization</u>

With the disintegration of the Soviet Union in the early 1990s, the central government's control over the vast oil and natural gas reserves began to loosen. In 1992, local production associations started to take on administrative responsibilities and at the same time integrate vertically. Lukoil was one of the first of these consolidated organizations. Lukoil was established in the USSR in November of 1991 as a state-owned company that included three West-Siberian oil-extracting enterprises (Langepasneftegaz ("L"), Uraineftegaz ("U"), and Kogalymneftegaz ("K")) and four oil-and-chemical plants (two in Russia, one in Lithuania and one in Bashkiria; after the break up of the USSR the non-Russian plants were surrendered under pressure of the local governments).[60] The first deputy of Minister of Oil and Gas of the USSR was appointed the president of the company. Such entities clearly had the potential to use Russia's natural resources more efficiently, but there were concerns that Lukoil and other companies like it were merely reincarnations of the old communist system. Key factors working against these newly integrated companies were a lack of competition, an unconvertible ruble, a lack of transparency, and little understanding of risk.[61]

Soon after the creation of Lukoil, President Yeltsin issued a decree mandating the privatization of oil production, refining, and distribution. Though both the nationalist and communist political parties opposed the move, Yeltsin and his staff believed that only such a reorganization of the industry could reverse the trend of decreasing oil production. The industry had produced 11.4 million barrels per day (b/d) in 1988, but this figure fell to only 9.2 million b/d in 1991, and the decrease in production was expected to continue at a rate of 1.6 million b/d each year.[62] This worrisome trend was primarily due to the extremely poor state of Russian infrastructure: poor maintenance, leaks, mechanical failures, and technological limitations were all cited as causes. To rectify these weaknesses, analysts cited the need for an increased level of external investment.[63] Further pushing Yeltsin's hand toward privatization was the assistance package offered by the International Monetary Fund (IMF). Though the $24 billion dollar package was comprehensive in nature, one of the stipulations was that Russian oil prices be liberalized.[64]

Though there were many reasons to privatize these newly integrated companies, Yeltsin faced significant barriers. First and foremost, privatization would require the resolution of long-standing conflicts between the regional and central governments. Especially difficult issues centered on taxation and tariffs. Other key points to be addressed before full privatization included environmental regulation and an investment framework.[65] Finally, the central government faced a serious political dilemma. Though it clearly valued the hard currency the oil industry could provide, obtaining such funds would likely end the extremely low cost of oil products seen in the Russian marketplace. Citizens would likely resist any policy that would make their lives any more difficult.[66] A related problem was that Russian oil producers had little in the way of marketing and pricing experience, nor had they ever had to purchase their equipment at market value. This added a further level of complexity to Yeltsin's privatization plans.[67]

Under Yeltsin's decree, Lukoil was established as a vertically integrated holding company to be involved in the exploration, extraction, refining, and distribution phases of oil production. Upon this action, Lukoil was organized as a joint stock company, and the first stage of privatization was prepared.[68] According to the decree, 45% of Lukoil was to be owned by the central government for at least the following three years. Over the following two years, up to 40% of Lukoil could be sold to private citizens, with up to 15% going to foreigners through an auction.[69] Further, the decree mandated that Lukoil maintain a 51% stake in associations from which it had been created. Employees, managers, and the general public were also allowed to obtain shares of the constituent companies through vouchers, auctions, and preferential allocations.[70]

As a result of this first round of privatization, Credit Suisse First Boston obtained a 2.8% stake in Lukoil, offering some semblance of legitimacy to the process. Further, the state distributed vouchers to citizens and allowed them to bid for shares of newly privatized entities.[71] Through such a voucher auction, hundreds of thousands Russians were said to have invested up to three million vouchers in the company.[72]

Soon after completing this voucher stage of privatization, Lukoil continued on to a second phase. This phase, unlike the previous one, was undertaken with the expressed purpose of injecting capital into the company.[73] Under the terms of this stage, domestic investors would be offered 20.4% of registered capital, and the 15% reserved for foreign investors sold. The company hoped to raise upwards of $10 billion in the sale.

In order to make the company more attractive to potential investors, Lukoil undertook a far-reaching strategy. First, it sought to reverse the downward trend in oil production by improving wells and increasing exploration and development activities. Furthermore, the company undertook a campaign to revamp its old refineries in partnership with Western European companies, and to double the number of gas stations it operated within Russia.[74,75] Additionally, Lukoil made efforts to reform its accounting procedures by employing KPMG to review its books.[76] To further increase its profile, Lukoil also hoped to become the first Russian company to issue American Depository Receipts (ADRs) on the New York Stock Exchange, which would serve to increase its international liquidity.[77] As a final component of its strategy, the company announced its intention to purchase all outstanding "daughter" shares of its constituent associations, and therefore leave only shares of Lukoil the holding company on the market. The goal of this was to allow for cash to flow more efficiently through the enterprise. Nevertheless, it left many Russians with minority stakes in the subsidiaries vulnerable to the company.[78] It also prevented arbitrage opportunities that many investors profited from, since shares in the holding company were twice as much as the shares of its three component companies put together. By investing in each of the component companies separately, investors could get Lukoil at half the price.[79]

During the mid-1990's, the Russian oil industry saw itself as a product of a "poorly mastermined, evidently misguided, hardly transparent, and highly controversial process."[80] The biggest problem was the fact that the privatization was incomplete, leaving uncertainty as to how much state ownership was left. In late 1995, the Russian government instituted a "shares-for-loans" scheme aimed at improving the federal budget. Through this program, the shares of Russian oil companies owned by the federal government would be pledged against commercial loans offered by a small group of Russian financial institutions, with the shares themselves acting as collateral.[81] These shares were effectively auctioned off to parties that would take actual control over the companies. However, the government did not want to lose its control over these vital industries and President Yeltsin passed an executive decree extending federal ownership of the shares another 3 years. Therefore, the state remained deeply entrenched in the Russian oil sector during this period. Consequently, foreign investors were cautious about making investments in an industry whose property rights were not clearly defined.

Nevertheless, the holding banks did attempt to sell their shares, since the government was eventually forced to relinquish the shares (and control of many companies) to the Financial Industrial

Groups (FIGs) due to non-payment. The overwhelming majority of investors were "influential Russian financiers and tycoons who managed to buy control of the privatized oil majors due to accumulated cash resources and implicit government support."[82] The new owners began a program of substantial manpower cutoffs, shelving long-term investment programs, amputating marginal operations, and even terminating cooperation with foreign partners."[83] These processes caused a great deal of friction with the state, which began feeling that it may have gone too far with the privatization. In the case of Lukoil, a relatively small impact was felt, since only 5% of Lukoil shares were offered in the scheme.[84] Thus, control over the company remained out of the hands of the oligarchs even after the government had defaulted on its loans.[85]

Beyond the above-mentioned projects, a key component of Lukoil's strategy heading into the mid-1990s was its participation in the development of Caspian Sea oil reserves. Many observers see Lukoil as an "unofficial representative of the Russian state" in international oil negotiations.[86] In a move that confirmed this connection, the company was granted a 10% stake in an Azeri oil project after Russia argued that it must have a stake in the project.[87] The plan is to develop two fields containing an estimated 3 billion barrels of oil.[88] The company's involvement in the multilateral effort to extract oil from Azerbaijan has solidified its position among the most important of Russia's new corporations. Furthermore, this participation has increased interest in the company from foreign investors. Boosting its hope of entering global capital markets, Lukoil received permission from the SEC to begin filing preliminary technical documents in 1995.[89]

Due to the relative transparency of its operations and it international scope of operations, Lukoil was able to attract large foreign investors in the mid-1990s. Of these, ARCO was one of the most important. In 1995, ARCO purchased $250 million worth of convertible bonds, which could be converted into a 7.99% stake in Lukoil – the largest investment by an American firm in Russia up to that time.[90] In 1997, a joint venture with ARCO was finalized whose goal was to invest up to $5 billion in oil and gas project in the former Soviet Union.[91]

Lukoil today

Although the Russian oil industry has been called a "substantially privatized, cash-strapped, and quasi-market 'petroneurship',"[92]it, nonetheless, has made tremendous strides since the introduction of market economics and the end of centralized state planning. For Lukoil, the end of the 1990's marked the beginning of it becoming Russia's largest oil company. Of its many hallmarks, the fact that it owns reserves that are far larger than any of its western competitors is by itself impressive. Lukoil, by carefully navigating Russia's dysfunctional transition, has managed to be the first example of a successful Russian global corporation. It would be far-fetched to say that Lukoil has experienced such success based on its own merit. The fact is that Lukoil was the principal beneficiary of generous governmental decrees. As has been discussed, Prime Minister Viktor Chenomyrdin issued decrees granting Lukoil properties with estimated reserves of 1 million barrels per day in 1995. The decree was Lukoil's reward for opening up the industry to private sector investment and development.[93]

One of the reasons why Lukoil has succeeded is because of the quality (and connections, of course) of its management. Khartukov characterizes the major Russian oil companies as "oil-hierarchy sandwiches," with a "thin progressive bread around a thick conservative stuffing."[94] In other words, the top management of many of these companies is market-oriented and westernized, as are the young up and coming low-level managers. However, the middle-management retains Soviet-type administrators and retired ministerial bureaucrats. Nevertheless, Lukoil's management has been driven by one factor more than any other: growth. Lukoil has grown both internally and through a strategy of acquisition across the Russian oil market and beyond. It has acquired refineries in Eastern Europe, expanded production in Russia, and is exploring new fields in the Caspian Sea.[95] Some are critical of Lukoil's aggressive expansion. According to Florian Fenner of Brunswick Capital Management in Moscow, "[t]o be international is not a strategy unto itself" and that it may be better to concentrate on core business and core strengths.[96] For Lukoil's management, the goal is "to make Lukoil the world's largest oil company."[97]

According to Valery Graifer, the Chairman of the Board of Directors at Lukoil, "[t]he year 2000 was marked by Lukoil's most impressive production and financial performance ever recorded in its history."[98] Lukoil's principle financial results and operating indicators for the year 2000 are shown in Appendix 14.

As can be seen, the company did extraordinarily well. One of the most important indicators, earnings per share increased over 40 times since 1995, while dividend payments increased over 65 times.[99] In terms of operating indicators, crude oil production reached an all-time high of 77.7 million tonnes, while the volume of refining amounted to 32.2 million tonnes.[100]

As has been mentioned, a particular factor directly related to Lukoil's success is the business style of its management. Specifically, Lukoil is run much the same way as a western oil company. In its 2000 Annual Report, the Chairman of the Board of Lukoil reiterated the company's efforts to achieve effective corporate governance through transparency and disclosure.[101] Lukoil's new corporate governance code reflects the company's commitment to a) observing international standards for financial transparency and information disclosure; b) maintaining standards protecting shareholders' rights and guaranteeing them equal access to information; c) observing professional business ethics and integrating the best models of corporate governance practice into its activities; d) adhering to principles of fair competition; e) ensuring directors and officers meet their fiduciary duties; and f) ensuring environmental protection, labor benefits and safety, and active participation in educational and charitable programs.[102] The Chairman goes on to urge the nomination of independent directors to the Board, something that has not yet happened.[103]

The company still, according to its CEO Vagit Alekperov, has not reached perfection. The biggest problem is its capitalization, which is just 2.5 times higher than its net income.[104] In comparable companies it is as much as 10 times higher than net profits and 20 times higher in leading companies.[105] Nevertheless, the company is experiencing significant expansion and growth. A new oil and gas field was discovered in the Northern Caspian. Its acquisition of various smaller oil companies have proven successful, significantly contributing to Lukoil's economies of scale. In an unprecedented move into the North American market, Lukoil acquired the Getty Petroleum Marketing Company which sells petroleum products through 1,260 gasoline filling stations in 13 U.S. states.[106] The Caspian Pipeline Consortium, of which Lukoil is a part, completed a significant section of the pipeline, which will bring Caspian Sea oil to western market through Russia.[107] Considering where Lukoil started from, these achievements illustrate the tremendous success story Lukoil has become.

V. CONCLUSION

To conclude, both Gazprom and Lukoil began their existence in a similar fashion. They were essentially administrative components of the Soviet government, and later the Russian government. Through a process of commercialization, the foundations of these corporations were set. By going through privatization, these companies shared many similarities, though these also retained significant differences. These differences culminated in substantially different experiences facing these companies in their later development. Today, one, Lukoil, is on its way to becoming an established, well-managed, global corporation. Gazprom, however, is still confronting its privatization process, and in many ways, may have to start all over. Nonetheless, because of the vast quantity of its reserves, both companies will certainly become major players in the world energy market.

IV. STUDENT NOTE

Case Synopsis: The case of "Privatizing Giants: Gazprom and Lukoil" compares the very different privatization paths taken by Russia's two energy superpowers. Both formerly state owned enterprises, Gazprom and Lukoil today are profitable companies in their own right. The similarities between the two, however, end there. While the government of the Russian Federation continues to wield considerable influence over Gazprom (it holds a 38% stake in the company), private investors and market forces have had a much greater impact in shaping Lukoil's financial position and overall business strategy. This case fosters an important comparison between "privatized" state and publicly-owned enterprises within the context of the emerging Russian energy sector and economy as a whole. Furthermore, how each company responds to political, bureaucratic, economic and market oriented incentives, both domestically and on a global scale, elucidates key factors in the troubled transformation of the Russian enterprise.

1. Compare and contrast the privatizations of Gazprom and Lukoil. What were the objectives of each company? How did their strategies reflect their goals?
2. How well do the privatizations of these companied fit into the larger political and economic framework presented by Puffer et al in *The Russian Capitalist Experiment*?
3. How does the principal-agent relationship differ in Gazprom, where insiders maintain a large share of ownership, as compared to Lukoil where corporate governance is based on a more transparent, Western model? Is there a direct relationship between state ownership and state interference in corporate governance?
4. Looking at the bottom-line, both Gazprom and Lukoil are profitable. In the case of Gazprom, how do overarching social and political objectives cloud the goal of creating shareholder value?
5. Which privatization is more successful, Gazprom's or Lukoil's? Is the state as an owner necessarily a negative factor?

VI. TEACHING NOTE

A. Introduction

Sheila Puffer and her colleagues have proposed a framework to analyze the so-called "Russian capitalist experiment". This model divides the history of privatization in Russia into four distinct phases:

- **Commercialization** (late 1980s through 1992) – in this phase the Russian government attempted to reform the industrial sector in order to improve efficiency, though no attempt was made to transfer control over to the private sector

- **Privatization** (1993-1994) – during this phase, the Russian government transferred control of many state-owned companies to private citizens both through a system of voucher privatization and share auctions.

- **Nomenklatura** – (1994-1997) – over this period several powerful figures gained control over many of Russia's most important privatized firms. These men came to be known as the Oligarchs.

- **Statization** – (1998-present) – this final phase is characterized by increasing levels of state control over privatized firms, and is in great part a direct result of the Nomenklatura phase.

The teaching note that follows makes use of this structure to analyze the process of corporatization and privatization of Lukoil and Gazprom. The goal of this note is to elucidate the similarities and differences between the two paths of Russian energy privatization, one in which the government remains an important stakeholder (and shareholder), and the other in which Western market principles have taken hold within the Russian context. It is important to note that these two firms have very different goals – Lukoil seeks to maximize value for its shareholders, while Gazprom considers profit maximization within the larger geopolitical framework facing the Russian federation.

B. Analyzing the case

1. Commercialization

The Soviet and, later, the infant Russian government hoped that commercialization would reduce the inefficiency of state organizations and central planning by developing more flexible and rapid responses to changing market needs.[108] Commercialization was not meant to completely destroy state ownership, but merely prepare Russia for subsequent mass privatization by encouraging the beginnings of market-oriented economic activity.[109] The formation of cooperatives, joint ventures and private enterprises was legalized, while governments at the municipal, regional and state level continued to regularly and actively participate in strategic management and ownership.[110] Yeltsin's rise to power after the failed August 1991 coup greatly accelerated Russia's transfer to a market-oriented economy.[111] The newly-democratic leader freed prices from state control and decentralized the ordering and procurement of goods and services for the majority of state-owned industries.

a. Gazprom

Gazprom fits perfectly into the Soviet government's goals for the commercialization of its economy in the late eighties and early nineties. In an attempt to bring more cohesion to the still rapidly-growing industry, the Soviet government dissolved Glavgaz, its centrally-controlled and managed gas ministry, in 1988 and established Gazprom State Concern. Although still state-owned and managed by high-ranking Communist officials from Glavgaz, Gazprom operated on a self-sufficient basis, without state participation in funding or investment. In preparation for privatization and subsequent competition in global gas markets with multinational behemoths such as Royal Dutch Shell, State Concern Gazprom initially brought some 90 enterprises, including state companies, production associations and research and production associations, under its umbrella, while in 1991, Soyuzgazexport Association -- the gas export organization -- and Zarubezhgaz Association -- an independent importer of equipment, materials and other products for the gas industry -- were converted into state-owned enterprises and became structural units of Gazprom.

b. Lukoil

The commercialization stage of the Puffer et al model is characterized by policies aimed at increasing the efficiency of Soviet state-owned enterprises. This stage also represented the first attempt to open the Soviet economy since the Brezhnev years in the 1960s.[112] In terms of Lukoil, the mere creation of the company corresponds to this commercialization framework. Lukoil, as mentioned in the case, was created as a consolidated enterprise composed of associations and refineries. This structure, together with the early goal of attracting Western investors, had a large impact on the overall efficiency of Lukoil. Moreover, as one of the largest enterprises to be involved in the commercialization process, Lukoil accrued significant power, and was thus well positioned for the subsequent privatization phase. This corresponds to the general framework of the Puffer et al model.

2. *Privatization*

The process of privatization in Russia had ideological objectives and mixed results. While the idea, in theory, was to disassemble the mighty Soviet state in such a way that every Russian citizen had some ownership of the enterprises that were privatized, a communist-dominated parliament, prodded by enterprise managers, placed severe restrictions on the external domestic share ownership of many industries.[113] By the end of privatization's first stage, 70% of the shares of more than 19,000 enterprises were in the hands of enterprise workers and managers.[114] On the whole, management of these newly-privatized companies focused not on the maximization of profits, but on satisfying workers demands for job security and hoarding ownership shares in attempts to grow their personal wealth. Although a majority of formerly state-owned enterprises rested in private hands, 43% industrial production came from state-owned industry and an additional 40% came from enterprises where the state continued to own a significant share.[115] Overall, very little had changed in strategic management terms when the dust of privatization settled.

a. Gazprom

Gazprom's privatization followed a unique course in Russia, maintaining significant government influence, while implementing a profit-maximizing business strategy. Because of Gazprom's strategic importance to the economic future of Russia, the company was given an official monopoly over the gas industry, its domestic prices regulated to ensure service to the countries citizens and industry. The state reserved a 40% stake in the company and limited foreign ownership to 9%, although no foreign offering took place through 1994. Further ensuring state control, Gazprom's charter gave the government of the Russian Federation an active role in corporate governance, placing representatives from the Ministry of Finance, Ministry of the Economy, Ministry of Fuel and Energy, and Federal Commission for Securities on Gazprom's Council of Directors, the company's highest management body. That said, Gazprom enlisted the technical and financial assistance of foreign firms in an overhaul of its Unified Gas Supply System and plans to build the Yamal pipeline and domestic petrochemical plants. Internationally, Gazprom set out to significantly increase its gas exports to Europe, and, to that end, created trading houses, public companies and joint ventures in a number of European gas consuming countries.

Gazprom's privatization did share one similarity with Russian state-owned enterprises: severe ownership restrictions on its domestic shares. Unlike many industries in Russia, the Duma actually promoted and ratified the sale of 51% of Gazprom's shares through public voucher auctions. When the company's chief executive, Viktor Chernomydrin, was named Russia's prime minister in 1993, however, a management determined to keep ownership firmly within the Gazprom family was assured government compliance. In early 1994, 15% of Gazprom's shares were simply handed over to selected, unnamed employees before any privatization auctions commenced, while by June of the same year, an additional 35% of Gazprom had been sold and traded at private, closed auctions in approximately 60 Russian gas-producing regions.

b. Lukoil

The first round of privatization in Russia was through a system of vouchers. Though the goal was to give each Russian a stake in the privatizing firms, top managers and others with influence were able to obtain significant shares of Russia's most lucrative enterprises through secondary markets for the vouchers.[116] Lukoil's experience corresponds closely to this model, as the company did distribute many shares in exchange for vouchers, and several managers did manage to accumulate very large stakes in the company. Puffer et al, though, then go on to note that many firms involved in privatization remained vastly over-staffed and just as inefficient as they had been under the Soviet system. This was due to the fact that managers were not concerned with maximizing shareholder value, but rather with satisfying workers' demands and gaining increasing control over the enterprise.[117] This does not correspond well to the Lukoil experience. Though a few powerful managers did gain disproportionate control, foreign companies also took a stake in Lukoil soon after the initial privatization. As the company had a long-standing strategy to attract Westerners, it had an added burden of proving itself to be worthy of such investment. A final characteristic of the privatization stage of the Puffer framework is that the Russian state maintained a significant share of the "privatized" firms.[118] This closely follows the Lukoil experience as the central government initially held onto a 45% stake in the company. Nevertheless, this share was greatly reduced in subsequent stages.

3. Nomenklatura

Locatelli argues that the "the non-standard privatization "methods practiced in Central Europe, and the former soviet countries, specially the voucher system have led to a control by "insiders", that is by employees and managers, and the creation of a new kind of firm, a private enterprise controlled by insiders. This hybrid could be added to the already existing classifications of state-owned enterprise and private enterprise controlled by outsiders, which may be banks, institutional investors, foreign investors or individuals.[119]

The mixing of this kind of firm, with the self dealing that has characterized the privatization in Russia has not only failed to displace former directors of state owned enterprise but actually reinforced their control over corporate assets, leading many researchers to call corporate governance in Russia a modified form of "nomenklatura" management.[120] The nomenklatura stage of Russian privatization sees the state refrain from exercising its right as a shareholder, but rather cedes control to other insider majority shareholders. This results in a potential conflict between minority and majority shareholders, and often may lead to a decrease in efficiency. The result of the owners being managers in Russia is a lack of incentive they have to restructure the firm and maximize their value over the long run. Managers perceive their titles to firms as uncertain, and subject to expropriation, leading them in their short term horizons to expect the gain from increasing firms' value and share appreciation to be less than what they can obtain by stripping the company of its assets.[121]

a. Gazprom

Gazprom fits perfectly within Nomenklatura stage, during which self-dealing was a widespread phenomenon in Russia. During this period, Gazprom became controlled and managed by a few people. As an example, the Ex-Prime Minister Chernomyrdin is rumored to hold more than $1 billion of stock in Gazprom.[122] The Russian state, willingly or inadvertently helped in this trend with reports of a "trust agreement" between Gazprom and the Russian state.[123] According to this agreement, the state would delegate the management of its controlling block (38%) to the management, and will also give Gazprom a monopolistic position in regards to the gas exports, in return of Gazprom subsidizing the price of gas for local industry at 11% of the export price. Thus, insider control of Gazprom during the nomenklatura period has led to a to a conflict between the insiders and the minority shareholders, the problems of a lack of transparency, and limited foreign interest in participating in investments within Gazprom.

b. Lukoil

Lukoil, unlike Gazprom, never succumbed to the dire consequences of the Nomenklatura stage. The main reason for this was its fortunate position in the shares-for-loans scheme. As was discussed, Lukoil suffered a relatively small impact by the scheme since only 5% of its shares were pledged to the financial institutions controlled by the oligarchs. By keeping it outside the hands of the oligarchs, the state left it to its own devices, which meant that its gains or losses were strictly a result of its management. This is not to say that management operated independently of the Russian government. To the contrary, it managed to maintain excellent relations with key players, including various Prime Ministers, and used these contact to improve its position. In essence, by not being used as collateral in deals between the government and the financial oligarchs, Lukoil managed to become an oligarch in itself – an oil oligarch – and insulate itself from the costs of the nomenklatura stage. Unlike the oligarchs, however, Lukoil's mission, through its management, was to create a world-class Russian corporation.

4. Statization

Statization constitutes the last stage in the Puffer et al model. This stage sees the accumulation of power in the hands of government, restating de facto state control over privatized firms. This can be seen as the normal outcome of the Nomenklatura stage, where the increase self-dealing led to obvious state interference. This period would eventually see political turmoil, and more government involvement in economic decisions.

a. Gazprom

Gazprom also fits the characteristics of the Statization stage well. With its main characteristic, main state involvement in the economy, statization has a huge effect on Gazprom. During this period, the state took back effective control of the company, by choosing and appointing a CEO, controlling the board of director, launching investigations into Itera and Stroytransgaz, and setting the company's overall strategy. During this period, Gazprom is seen as being more a state-owned entity than a private firm. It seems the state has decided to de-privatize Gazprom for the time being and re-think the best options for the future, corporatization, full privatization, or even the break up of the company into different smaller players.

b. Lukoil

Again, Lukoil, unlike Gazprom, does not fit well into the statization stage. This is largely a result of its experiences during the nomenklatura period. Having insulated itself from nomenklatura involvement and developing into a relatively successful privatization story, Lukoil had no need for statization. The government made the wise move of leaving Lukoil alone and sharing in the benefits of its success.

C. Conclusion

As is demonstrated above, neither Gazprom nor Lukoil fits perfectly into the Puffer framework. In part, this can be attributed to the unique importance placed upon the energy sector in the Russian economy. Further, the corporate governance structure in these two companies differs from that seen in other privatized industries. The influence of Western financial practices in Lukoil, and the unique course of Gazprom's privatization diverge from the Puffer model. Nevertheless, important aspects of each stage inform the analysis of how these two firms fit into the overall process of Russian privatization.

Appendices

Table 1. *World Crude Oil Production*[a,ii]

	1970	1980	1990	1992	1993	1994	1995	1996
World	45,700	59,500	60,600	60,000	59,800	60,500	61,900	63,300
OPEC								
Algeria	976	1,020	794	772	747	750	764	818
Indonesia	855	1,576	1,289	1,346	1,327	1,319	1,498	1,392
Iran	3,831	1,662	3,252	3,455	3,671	3,585	3,612	3,668
Iraq	1,563	2,514	2,080	425	448	550	600	576
Kuwait[b]	2,983	1,661	1,235	1,050	1,870	2,000	2,007	2,048
Libya	3,321	1,830	1,374	1,493	1,361	1,380	1,390	1,393
Nigeria	1,090	2,058	1,811	1,902	1,905	1,883	1,890	2,246
Saudi Arabia[b]	3,789	9,903	6,414	8,308	8,087	8,000	8,074	8,080
United Arab Emirates	691	1,702	2,117	2,322	2,195	2,223	2,205	2,292
Venezuela	3,708	2,165	2,085	2,314	2,335	2,463	2,609	2,938
Other								
Canada	1,305	1,424	1,518	1,604	1,677	1,742	1,806	1,834
China	602	2,113	2,769	2,835	2,908	2,961	3,007	3,128
Kazakhstan[c]	NA	NA	515	515	460	405	415	460
Mexico	420	1,936	2,648	2,668	2,673	2,685	2,722	2,961
Norway	0	528	1,620	2,144	2,264	2,580	2,782	3,092
Russia[c]	**NA**	**NA**	**10,325**	**7,915**	**6,875**	**6,315**	**6,135**	**6,010**
United Kingdom	2	1,619	1,850	1,864	1,922	2,469	2,565	2,553
United States	9,648	8,597	7,355	7,171	6,847	6,662	6,560	6,465

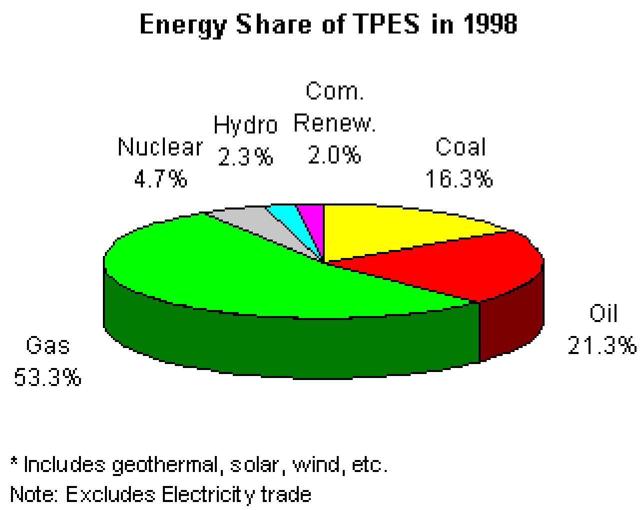
[a]Unless otherwise indicated, data are for crude oil and exclude natural gas liquids, shale oil, natural gasoline, and synthetic crude oil.

[b]Including about one-half of Neutral Zone production.

[c]Including natural gas liquids.

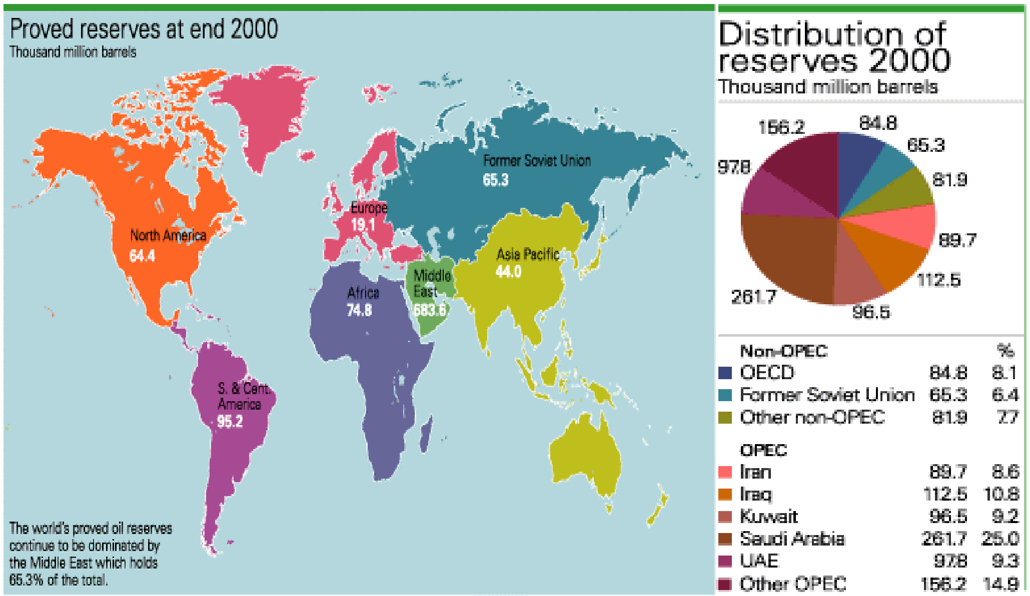
[ii] *Handbook of International Economic Statistics*, Table 22; available from http://www.cia.gov/cia/di/products/hies/

Appendix 2. *Shares of Different Energy Sectors, 1998*

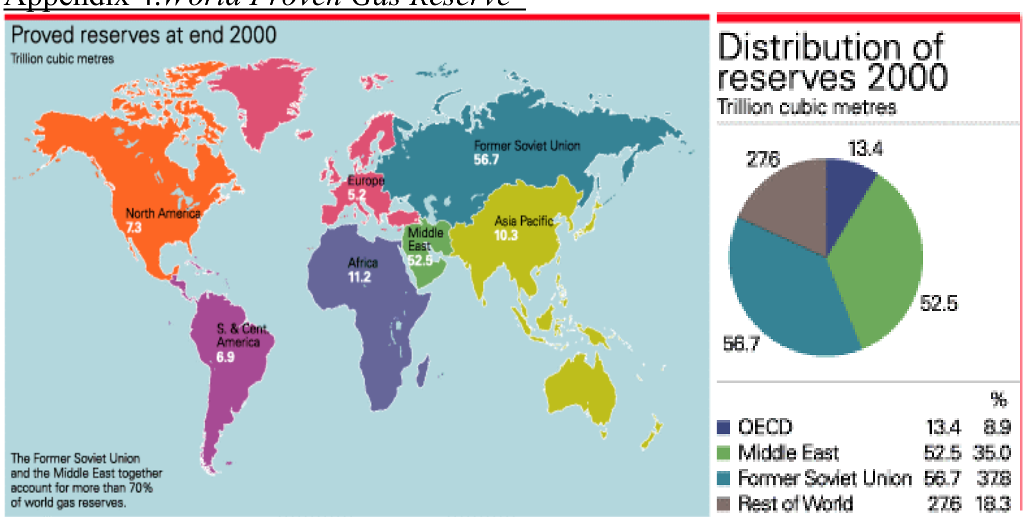


Source: Energy Strategy of Russia for the period ending 2020

Appendix 3. *World Proven Oil Reserve*[iii]

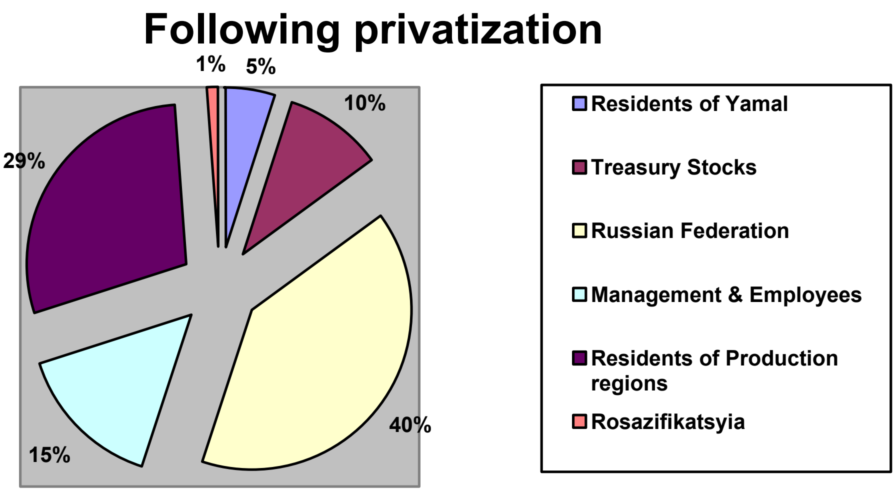


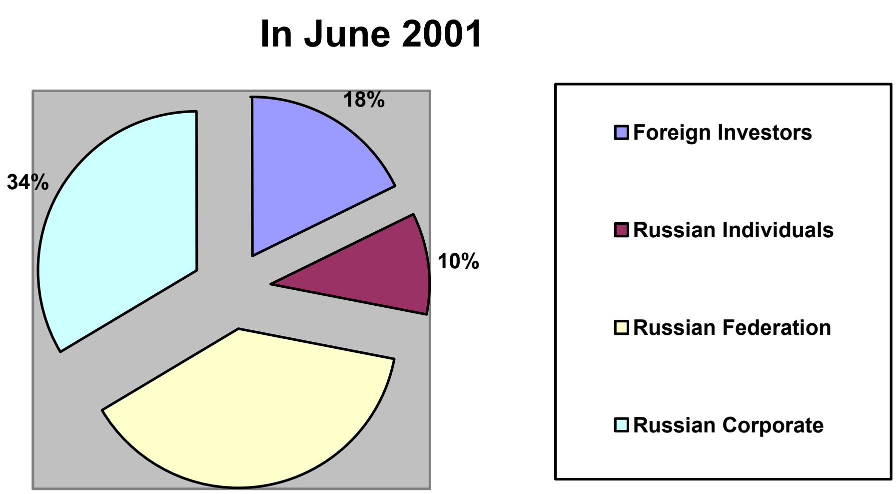
Appendix 4. *World Proven Gas Reserve*[iv]



[iii] BP Statistical review of World Energy 2001
[iv] Ibid

Appendix 5: *Gazprom Capital Structure: Following Privatization and in June 2001*[v]





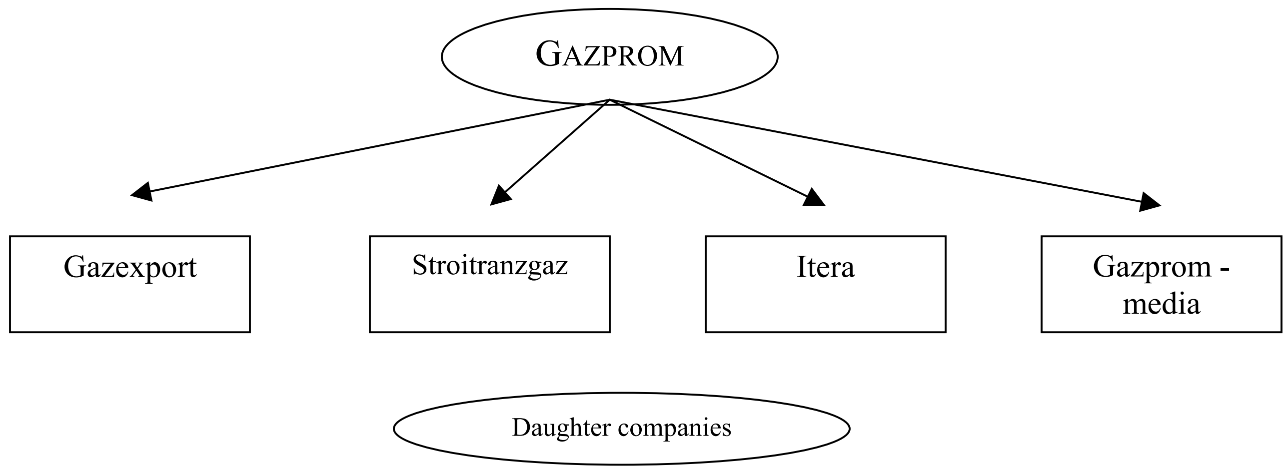
[v] Adapted by the authors from Alfa Bank estimates; available from Glaser Sergei, "Gazprom: The Option is Still Out of the Money: Alfa-Bank Equity Market. Accessed December 2, 2001. Available at www.alfa-bank.com.

Appendix 6: *Gazprom expansion through JV* [vi]

Country	Joint Venture	Stake %	Activities
Germany	Wingas	35.0	Gas transportation and storage
	Wintershall Erdgas Handelshaus (WIEH)	50.0	Gas trading company. Single trader of all the gas exported by Gazeksport until 2012.
	Zarubeûgas Erdgashandel	100	Gas trading
	Verbundnetz Gas (VNG)	5.3	Gas transportation and marketing
	Ditgaz	49.0	Gas trading
UK/ Belgium	Interconnector	10.0	Pipeline which connected Bacton (UK) with Zeebrugge (Belgium)
Poland	Gas Trading	35.0	Gas trading
	Europol Gaz	48.0	Gas transport
Italy	Volta	49.0	Gas trading and transport
	Promgaz	50.0	Gas trading and marketing
France	FRAgaz	50,0	Gas trading
Austria	GHW	50.0	Gas trading company
Serbia	Progress Gas Trading	50.0	Gas trading
Slovenia	Tagdem	7.6	Gas trading
Greece	Prometheus Gaz	50.0	Marketing and construction
Finland	Gasum Oy	25.0	Gas transportation and marketing
	North Transgas Oy	50.0	Construction of a pipeline beneath the Baltic Sea
Estonia	Eesti Gaas	30.6	Gas trading and transport
Latvia	Latvijas Gaze	25.0	Gas trading and transport
Bulgaria	Topenergo	100	Gas trading and transport
Romania	WIROM	25.0	Gas trading. The stake of Gazprom is hold by WIEH
Hungary	Panrusgas	50.0	Gas trading and transport
Turkey	Turusgaz	45.0	
Yugoslavia	JugoRosGaz	50.0	Gas trading and transport
Slovak Republic	Slovrusgaz		

[vi] Available from http://www.compiler.fi/tradestation/doingbusiness/businessfeatures/fditable1.html#Table%201.

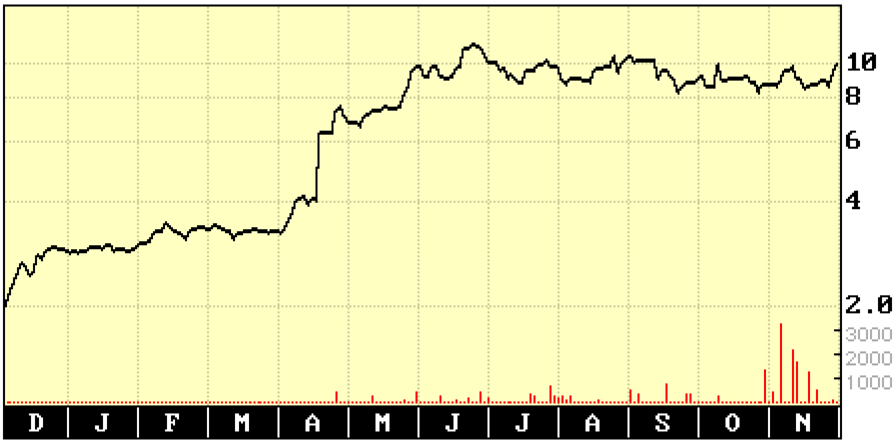
Appendix 7. *Simplified corporate structure of Gazprom.*



Appendix 8: *The Blue Flow Project*[vii]

[vii] Available from www.gazprom.ru

Appendix 9: *Gazprom ADR price chart for one year in $US*[viii]



Appendix 10: *Gazprom Local Stock Price in Russian Ruble*

viii *BusinessWeek*; available from http://host.businessweek.com/businessweek/TECHNICAL.html?Timespan=260&Symbol=OGZPF&Symbol=OGZPF

Appendix 11: *Top mutual fund holders of Gazprom's ADR*

Top Ten US Mutual Funds Holders of Gazprom's ADR[ix]

Institution	Shares Held	Filing date	Change	% Port	Turnover	Style	Inv. Type
Goldman Sachs Asset Management	448,700	09/01	-3,300	0.01	Mod	Core Growth	Investment Advisors
American Express Financial Advisors	268,837	09/01	268,837	0.00	Mod	Core Growth	Investment Advisors
Ohio State Teachers' Retirement System	202,300	09/01	202,300	0.01	Low	Core Value	Pension Funds
Teacher Retirement System of Texas	50,000	09/01	50,000	0.00	Low	GARP	Pension Funds
First Manhattan Capital Management	10,000	09/01	0	0.00	Low	GARP	Investment Advisors
Top 10 Holders Total Shares	**979,837**	**(100.00% of Total Value)**					
Total Shares	**979,837**						

Top Ten Non US Mutual Fund Holders of Gazprom's ADR[x]

Institution	Shares Held	Filing date	Change	% Port	Turnover	Style	Inv. Type
Danske Invest Osteuropa	648,237	04/01	67,410	13.36	High	_	Mutual Fund
Robur Rysslandsfonden	495,000	06/01	495,000	4.45	High	_	Mutual Fund
Capital International Emerging Markets Fund	410,560	12/00	-83,840	0.04	Mod	Emerg. Mkts.	Mutual Fund
KBC Equity Fund Eastern Europe	350,000	12/00	0	2.15	Mod	Emerg. Mkts.	Mutual Fund
Schroder International Select Emerging Europe	303,400	12/00	303,400	1.21		_	Mutual Fund
Sanpaolo International Equity Emging Mkts Europe	263,750	12/00	263,750	3.00		_	Mutual Fund
AXP Emerging Markets Fund	263,037	09/01	263,037	1.39	High	Emerg. Mkts.	Mutual Fund
General Management - Growth	260,000	12/00	0	0.28	High	_	Mutual Fund
Fleming Funds - Eastern European Fund	233,370	12/00	-175,000	0.15	Mod	Emerg. Mkts.	Mutual Fund
General Management - Neutral	212,000	12/00	0	0.11	Mod	_	Mutual Fund
Top 10 Holders Total Shares	**3,439,354**	**(69.91% of Total Value)**					
Total Shares	**4,920,011**						

[ix] Source JP Morgan, available from www.adr.com
[x] Ibid

Appendix 12: *Gazprom's Financial Data*[xi]

Annual Financials

Income Statement

All amounts in millions of US Dollars except per share amounts.

Income Statement	Dec 99	Dec 98	Dec 97
Revenue	12,113.2	6,732.3	23,299.8
Cost of Goods Sold	--	--	--
Gross Profit	--	--	--
Gross Profit Margin	--	--	--
SG&A Expense	--	--	--
Operating Income	847.4	--	--
Operating Margin	7.0%	--	--
Total Net Income	(2,882.6)	1,105.1	6,508.7
Net Profit Margin	--	16.4%	27.9%
Diluted EPS ($)	--	--	--
Balance Sheet	**Dec 99**	**Dec 98**	**Dec 97**
Cash	467.3	--	--
Net Receivables	7,993.2	--	--
Inventories	1,433.6	--	--
Total Current Assets	11,072.3	16,825.5	33,946.5
Total Assets	53,669.1	56,518.2	108,748.4
Short-Term Debt	3,095.9	--	--
Total Current Liabilities	11,242.0	10,802.4	26,477.8
Long-Term Debt	8,486.5	--	--
Total Liabilities	24,026.9	19,680.0	34,086.8
Total Equity	29,642.1	36,838.2	74,661.6
Shares Outstanding (mil.)	--	--	--

Historical Financials & Employees

Income Statement

Year	Revenue ($ mil.)	Net Income ($ mil.)	Net Profit Margin	Employees
Dec 99	12,113.2	(2,882.6)	--	298,000
Dec 98	6,732.3	1,105.1	16.4%	278,400
Dec 97	23,299.8	6,508.7	27.9%	362,200
Dec 96	20,779.9	1,682.2	8.1%	398,600
Dec 95	13,110.1	3,216.9	24.5%	375,000
Dec 94	24,444.2	1,782.2	7.3%	367,000

Debt ratio	22.3%
Return on equity	--
Cash ($ mil.)	467.3
Current ratio	0.98
Long-term debt ($ mil.)	8,486.

[xi] Hoovers Online, www.hoovers.com

Appendix 13: *Gazprom production growth and cash position in regards to other Russian Oil and Gas companies*[xii]

[xii] Available from http://www.capitalperspective.ru/september2001_october2001/bus_persp/

Appendix 14: *Lukoil's principle financial results and operating indicators for the year 1998-2000*[xiii]

Annual Financials

Income Statement All amounts in millions of US Dollars except per share amounts.	**Dec 00 (Prelim.)**	**Dec 99**	**Dec 98**
Revenue	14,219.9	9,752.0	3,960.2
Cost of Goods Sold	--	7,347.5	--
Gross Profit	--	2,404.5	--
Gross Profit Margin	--	24.7%	--
SG&A Expense	--	627.0	--
Operating Income	--	1,777.5	--
Operating Margin	--	18.2%	--
Total Net Income	3,378.1	1,119.7	5.7
Net Profit Margin	23.8%	11.5%	0.1%
Diluted EPS ($)	--	--	--

Balance Sheet	**Dec 00 (Prelim.)**	**Dec 99**	**Dec 98**
Cash	--	361.3	188.4
Net Receivables	--	2,161.2	--
Inventories	--	552.2	--
Total Current Assets	--	3,787.5	2,792.7
Total Assets	--	8,268.3	6,618.9
Short-Term Debt	--	276.9	--
Total Current Liabilities	--	2,845.1	2,613.0
Long-Term Debt	--	2,358.7	1,719.0
Total Liabilities	--	5,373.8	4,521.4
Total Equity	--	2,894.5	2,097.5
Shares Outstanding (mil.)	--	--	--

Historical Financials & Employees

Income Statement

Year	**Revenue ($ mil.)**	**Net Income ($ mil.)**	**Net Profit Margin**	**Employees**
Dec 99	9,752.0	1,119.7	11.5%	120,000
Dec 98	3,960.2	5.7	0.1%	90,000
Dec 97	9,002.9	303.3	3.4%	107,000
Dec 96	8,787.3	767.0	8.7%	94,236
Dec 95	6,711.0	545.5	8.1%	119,824
Dec 94	5,001.9	1,040.5	20.8%	82,900
Dec 93	5,341.3	2,165.4	40.5%	86,900

xiii Hoovers Online, www.hoovers.com

Appendix 15. *Gazprom managers (After Miller's appointment)*[xiv]

Chairman of the Supervisory Board: Dmitri Anatolevich Medvyedev
Chief Executive of the Management Board: Alexei Borisovich Miller
First Deputy Chief Executive of the Management Board: Pyotr Ivanovich Rodionov, age 50
Deputy Chairman of the Management Board: Irina Nikolaevna Bogatyreva
Deputy Chairman of the Management Board: Segey Konstantinovich Dubinin
Deputy Chairman of Procurement: Sergei Lukash
Head of Contract Development: Vladimir Ivanovich Rezunenko
Head of Deep Sea Drilling: Boris Alexandrovich Nikitin
Head of Finances: Mikhail Vadimovich Dokuchayev
Head of Financing: Aleksandr Nikolayevich Semenjaka
Head of Investment and Construction: Mikhail Axelrod
Head of Investments and Building: Yuri A. Goryainov
Head of Machine Building and Repair: Valentina Vladimirovich Pochinkin
Head of Oil and Gas Marketing: Vasiliy Tikhonovich Fadeyev
Head of Property Control: Aleksandr Ivanovich Zazakov
Head of Refining and Distribution: Vasiliy Podyuk
Head of Russian Federation Work: Victor Vasilyevich Ilyushin
Head of Underground Storage and Gas Usage: Bogdan Vladimirovich Budzulyak
Manager of Exports, Non-CIS, CIS, and Baltic Countries: Yuri Alexandrovich Komarov
Director of Information Policy Department: Alexander Dybal
Press Secretary of the Chief Executive: Natalia Selivanova

[xiv] Hoovers Online, www.hoovers.com

Appendix 16*: Lukoil managers*[xv]

Chairman: Valery Graifer
President and Director: Vagit Y. Alekperov
First VP and Director: Ravil U. Maganov
First VP and Director: Sergei P. Kukura
VP and Head of Capital Construction, Engineering, and Corporate Services: Serik Rakhmetov
VP and Head of Corporate Finances and Investments: Alexander K. Matytsin, age 39
VP and Head of Development and Securities: Leonid A. Fedoun
VP and Head of Financial Accounting and Control: Lubov Khoba
VP and Head of General Issues, Human Resources, and Transport: Anatoly A. Barkov
VP and Head of Geology and Exploration: Anatoly Novikov
VP and Head of Planning and Marketing: Anatoly G. Kozyrev
VP and Head of Marine and International Projects: Dzhevan K. Cheloyants
VP and Head of Petroleum Product Marketing: Vagit S. Sharifov
VP and Head of Oil Refining and Petrochemicals: Vladislav P. Bazhenov
VP and Head of Oil and Gas Supplies and Export of Products: Yury Storozhev
VP; General Director, LUKOIL Holding Service : Nikolay G. Chumak
VP; General Director, LUKOIL Trading House: Alexander S. Smirnov
VP; General Director, LUKOIL West Siberia: Vladimir I. Nekrasov
VP; President , LUKOIL Europe: Ralif R. Safin
President, LUKOIL Overseas: Andrei Kuziaev
Chief Accountant: Lilya Khisyametdinova
Secretary: Albert Galustov
Head of Legal Services: Ivan Maslyaev

Mergers and Acquisitions, Lukoil Europe: Sergei Popov

[xv] Hoovers Online, www.hoovers.com

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