

# DEMOCRACY IN RETREAT IN RUSSIA

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## HEARING

BEFORE THE

### COMMITTEE ON FOREIGN RELATIONS UNITED STATES SENATE

ONE HUNDRED NINETH CONGRESS

FIRST SESSION

—————  
FEBRUARY 17, 2005  
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Printed for the use of the Committee on Foreign Relations



Available via the World Wide Web: <http://www.access.gpo.gov/congress/senate>

U.S. GOVERNMENT PRINTING OFFICE

22-751 PDF

WASHINGTON : 2005

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## **DEMOCRACY IN RETREAT IN RUSSIA**

**THURSDAY, FEBRUARY 17, 2005**

U.S. SENATE,  
COMMITTEE ON FOREIGN RELATIONS,  
*Washington, DC.*

The committee met, pursuant to notice, at 9:34 a.m., in room SD-419, Dirksen Senate Office Building, Hon. Richard G. Lugar, chairman of the committee, presiding.

Present: Senators Lugar, Sununu, Martinez, Biden, Sarbanes, and Obama.

### **OPENING STATEMENT OF HON. RICHARD G. LUGAR, U.S. SENATOR FROM INDIANA**

The CHAIRMAN. This hearing of the Senate Foreign Relations Committee is called to order.

In his Inaugural Address, President Bush stated that, quote, "It is the policy of the United States to seek and support the growth of democratic movements and institutions in every nation and culture, with the ultimate goal of ending tyranny in our world," end of quote.

I agree with the President. Democracy must be at the core of United States foreign policy and diplomacy. Our country must be prepared to play a leadership role in ensuring that democracy and basic freedoms are promoted and preserved around the world.

The states of the former Soviet Union present a special challenge to the advancement of democracy. Some states, such as Latvia, Lithuania, and Estonia, have solidified democracy, and used this foundation to establish strong economic security links to Europe, including membership in NATO. Elsewhere, the people of Ukraine and Georgia have struggled and sacrificed for democracy. Those efforts have paid off with new governments based on democratic principles and the rule of law.

But these encouraging signs are not universal. Belarus is the last remaining dictatorship in Europe, a virtual police state. The countries of Central Asia are controlled by strongmen, and the effective and consistent application of democracy, the rule of law, and human rights remain, in some cases a distant goal.

The biggest concern in the region for democracy advocates, however, is Russia. Despite elections and the experience of post-Soviet personal freedoms by the Russian people, the fate of democracy in Russia is perhaps more ambiguous now than at any time since the collapse of the Communist system. Russia is a vitally important country with which the United States must have a constructive relationship. Those who would discount Russia's relevance to United

States national security in a post-cold-war world are seriously mistaken, in my judgment. The interests of our two countries intersect in countless areas. Russia can be a critical partner in the war on terrorism, in preventing nuclear nonproliferation, in meeting world energy needs, in organizing international responses to emergencies, and in maintaining economic vibrancy in both Europe and Asia.

With the adoption and maintenance of strong democratic institutions, Russia would develop from an occasional partner of the United States into a close friend. The benefits of such a relationship, for both countries, would be enormous.

However, the United States/Russian relationship cannot develop in positive directions while basic freedoms are being violated in Russia. This is not just a policy of the U.S. Government. When a country does not respect the rule of law, private businesses around the world impose market-driven consequences on that country. Investment and other economic links that would help Russia diversify its economy and improve its trading relationships are far less likely to appear if foreign companies cannot count on a fair and consistent business climate and legal system.

The Russian people have suffered from suicide bombings and terrorist attacks, including the tragedies at the Moscow theater and the elementary school at Beslan. Russia is fighting to overcome terrorist threats that pose grave risks to citizens on its own soil. In this struggle, we identify with the people of Russia, and we pray for their safety. But even as we understand the complex choices facing the Russian Government, we can attest that these horrible events should not be used to justify the rolling back of democracy. This is a self-defeating strategy that will weaken, and not strengthen, Russian society.

In recent months, the Kremlin has taken action to stifle public dissent and political opposition. Rival political parties have been suppressed; the election of regional governors was canceled; and most of the media has been brought under state control. This pattern of behavior has spilled into the Russian Government's handling of the economy. The campaign against Yukos and Mikhail Khodorkovsky reached a new low, on December 28, when one of President Putin's senior economic advisors criticized the forced sale of Yukos' main oil-producing unit and its purchase by a state-owned company as, quote, "the scam of the year," end of quote. This honesty resulted in the official being stripped of most of his responsibilities by the Kremlin.

Outside of Russia, the Kremlin has attempted, unsuccessfully, to alter the outcome of the election in Ukraine, and has provided overt support to the breakaway regions, specifically Abkhazia, in Georgia. Russian backing remains a critical component in President Lukashenko's hold on power in Belarus and in efforts by governments in Central Asia to rebuff democratic advancements. These anti-democratic actions do not make Russia safer, because they contribute to regional instability.

The West's next opportunity to reinforce democratic values is in Moldova next month. Moldova's path toward democracy has been marked by free and fair multiparty elections. We must be vigilant to ensure that the people of that country have the freedom to choose their leaders.

As the United States encourages democracy in the former Soviet Union, we must maintain the foreign policy tools that support this effort. The administration's fiscal year 2006 request for the foreign-affairs account is an especially good one. But one area that should be revisited, in my judgment, is its 13-percent cut in the funding for the Freedom Support Act, which underwrites democracy programs in the former Soviet Union. With so much at stake in Russia, this is not the time to diminish our funding in this area.

Next week, our President, President Bush, will meet with President Putin in Bratislava. The discussion may focus on the proliferation of weapons of mass destruction and the global war on terrorism. There is much to discuss in these areas, including the identification of additional weapons sites in Russia in need of security upgrades and Russia's resistant posture toward granting liability protections to United States contractors working on the Plutonium Disposition Program.

In addition to these important subjects, President Bush must make democracy, human rights, and the rule of law priorities of the discussion. The United States must continue to press Russia to adopt a free and fair political and judicial system. Only then will the United States/Russian relationship reach its full potential.

To examine the threats to democracy and the rule of law in Russia, we are joined today by Mr. Steven Theede, the chief executive officer of Yukos, and Mr. Tim Osborne, director of Group Menatep. We appreciate their appearance, especially given that hearings in the Yukos court case, including claims against the Russian Government, are still continuing in Houston today.

On our second panel, we are pleased to welcome Stephen Nix of the International Republican Institute, Nelson Ledsky of the National Democratic Institute, Anders Aslund of the Carnegie Endowment for International Peace, and Bruce Jackson of the Project on Transitional Democracies.

Gentlemen, we thank all of you for joining us today. We look forward to your insights.

Let me mention that my colleague, the distinguished ranking member of the committee, may not be with us for a period of time, or perhaps throughout the entire hearing, because a bankruptcy bill, which he initiated 8 years ago as the original cosponsor, is suddenly being marked up this morning in the Judiciary Committee. That will necessarily require his presence, and we understand that. That bankruptcy markup was unknown when this hearing was scheduled. He deeply regrets that he will not be present to, at least, hear the initial testimony, but we know that he will participate if he possibly can.

Let me, at this point, call upon you, gentlemen, in the order that I have introduced you, for your opening statements. Perhaps you can summarize in roughly a 10-minute period of time. The Chair will not be that rigorous with time restrictions. We're here for your information, not to restrict the amount that you have to say—but let me just say, at the outset, that your full statements will be made part of the record in their completion.

Mr. Theede.

**STATEMENT OF STEVEN THEEDE, CHIEF EXECUTIVE  
OFFICER, YUKOS OIL COMPANY, MOSCOW, RUSSIA**

Mr. THEEDE. Well, thank you very much, Mr. Chairman.

My name is Steve Theede, and I am chief executive officer at Yukos Oil Company. And I do very much appreciate the opportunity to be here today, so thank you for the invitation.

I will be brief, and have submitted a more full copy of—and statement for the record.

There is much at stake in how the Yukos situation is resolved: The supply and price of global oil, the safety and welfare of Yukos employees and communities, the future of economic development and rule of law within Russia, and the relationship of the Russian Federation with the United States and other nations.

The United States has a direct interest in the resolution of the Yukos situation. Beyond the important political or strategic concerns, there are the vital issues of global energy and economic security. There are the rights of more than 60,000 individual and institutional investors, many of them Americans, who express their faith in Yukos and their faith in Russia by investing in the company and in the country.

Investors, whether they are American or not, must have confidence that investments made in the international marketplace will be protected and that the rule of law, not politics or greed, will dictate the actions of government.

I've spent more than 30 years working in the international oil and gas business, engaging successfully in different legal and political systems around the world. And I moved to Moscow, and I joined Yukos about 18 months ago because I believed that, within the global oil business, no country had more potential than Russia, and no company had more promise than Yukos.

In less than a decade, as a privatized company, Yukos had become Russia's most stable and reliable oil producer and among the most efficient and fastest growing producers in the world. As an innovator, a taxpayer, and an employer, Yukos had become the true Russian success story and Russia's most progressive, transparent, and successful oil company.

Were there risks in the Russian business environment? Of course there were. But less than 2 years ago, the risks seemed more commercial than political. I heard and believed President Putin's message of an independent judiciary, of private ownership, of more protection for investors, of participation by international companies to help tap Russia's vast reserves.

But those high expectations at the start only deepen the feelings of disappointment and betrayal today. We've seen, Mr. Chairman, a ruthless and unprecedented campaign by the Russian Government against Yukos, carried out by way of dubious and discriminatory taxes, illegal expropriation of property, arrests, and individual intimidation. A modern, globally respected company has been dismantled by a series of carefully timed and politically motivated attacks by the Russian Government. The market value of Yukos has plummeted from \$40 billion to \$2 billion in less than 6 months.

As a litmus test for future investors, the Yukos experience certainly is not encouraging. The rules have clearly changed. For reasons known only inside the Russian Government, it has—seems to



have reversed its commitment to privatization and chosen instead to increase the role of the state. As a result, the whims of those in power have replaced the guarantees of due process, adherence to the rule of law, and protections for the rights of shareholders and property owners.

Sitting here today, secure in the rule of law, it's hard to imagine the human tragedy that is still unfolding in Russia today. The former leadership of Yukos sits in a Russian jail. Most troubling to me personally, many loyal and outstanding Yukos employees, people whom I have worked side by side with over the last year and a half, find themselves subject to intimidation by the government and threats by its agents. I fear for those good people and the uncertain future that they face in a country that they love just as we love our own.

The economic tragedy continues to unfold. It represents the dismantling of a potentially great oil company, and one of Russia's largest taxpayers, through a systematic and deliberate government campaign to bankrupt Yukos.

First, government officials instructed tax authorities to make a tax case against Yukos. The tax claims are a contrivance without merit or precedent. They are based on a selective and retroactive application of Russian tax laws, and on fines and penalties that are unconstitutional. They totaled the incredible sum of \$27½ billion.

I have a chart that I would like to submit that, in essence, shows the total tax bill that has been assessed against the company. And those are the red bars. That is the total of taxes paid at—during the current years that they were due, plus the additional penalties that have been assessed—taxes and penalties that have been assessed against the company as a result of this most recent attack. And that's compared to the gross revenues of the company. Total gross revenues of the company, which is shown in the blue chart.

And we're showing this just to give you an idea how outlandish these tax claims are, because, consider, in 2002, the total taxes, both invented and otherwise, along with fees, fines, and penalties assessed against Yukos, totaled 111 percent of the company's gross revenue. There is no business or economic logic that explains how a company can be assessed more in taxes than it collects in revenue.

As their next step, the Russian court and bailiff sought to collect the total amount, more than \$27 billion, before our legal appeals were even exhausted.

In addition, while demanding immediate payment, they simultaneously froze all Yukos assets and bank accounts; in effect, leaving the company unable to properly function.

The government's resolution to this contrived situation was to declare that, because Yukos could not pay its fictitious taxes, the bailiffs would have to seize Yuganskneftegaz, our most valuable asset, which produces about a million barrels a day, and sell it at auction to satisfy these tax charges. Drained of cash and unable to sell assets, we were left with limited means to invest in operations, pay salaries, meet expenses, or pay taxes that we allegedly owed—owed.

The so-called auction was a sham in which Yuganskneftegaz, which accounted for roughly 60 percent of our total production ca-

pability, was sold for less than half its appraised value. Not surprisingly, the buyer was an unheard-of company, created just 2 days earlier and of no certain address, that sold its prize almost immediately to Rosneft, a 100-percent completely state-owned and controlled company whose new chairman also continues in his position as a senior government official.

Despite the government's unsupportable claims, Yukos acted in a responsible way. Even while challenging the tax claims through all available legal, political, and diplomatic channels, as a matter of good faith and as a signal of our interest in finding a reasonable resolution, we began to pay some of the taxes. But it quickly became clear that this was not really about taxes, but, rather, an orchestrated effort to wrest control of the company and its assets.

As the Moscow Times summarized it on January 14, 2005, "State-controlled banks helped a state-controlled oil company purchase a controlling stake in Yugans, which was being sold by the state for tax debts owed to, and defined by, the state."

The legality of these actions has apparently stirred debate even within top ranks of the Russian Government. Just last week, Andrei Illarionov, a long—a close and long-term economic advisor to the Russian President said, Yuganskneftegaz should be returned to Yukos. He said there are certain common human commandments, such as, "Thou shalt not steal." Not surprisingly, by speaking truth to power, this once-influential advisor has reportedly been stripped of many of his duties.

When Americans ask, "Why should we care about this?" I could give you a number of reasons, but I'll focus on the reasons that I know best, and that's energy. As the world's largest oil consumer, clearly America's energy security and the strength of its economy depend, in good measure, on the stability and reliability of global oil supplies. Yukos had the potential to add significantly to the stability of the supply coming from Russia, making its dismantling an important economic blow.

The numbers are quite impressive. Operating with the efficiencies and incentives of a publicly traded company utilizing world-class technology and expertise, the annual production of Yukos grew by 300 percent from 2000 to 2003. At the same time, Russia's overall production grew just 30 percent.

Before the government campaign began, in 2004, Yukos had become the largest producer of crude oil in Russia and the largest exporter of crude oil from Russia. Slightly less than 20 percent of all crude oil produced in Russia came from Yukos and its subsidiaries.

The production growth is rapidly decelerating. Production growth rate has now fallen 4 straight months in Russia. The International Energy Agency cut its forecast of Russian oil output growth this year to 3.8 percent, citing higher taxes and a worsening regulatory climate. The treatment of Yukos and the increasing state control of oil production, in general, are the critical contributing factors. State control is increasing, even as production growth is decreasing.

Just last week, the Russian Federation announced a ban on United States and other foreign-owned companies from bidding for new permits to develop several large oil fields. This will further discourage needed investment capital and expertise.

Ronald Nash, Chief Strategist at Renaissance Capital, which is a Moscow-based investment bank, called the ban a dramatic step down the road of state intervention which Russia has been following for some time. The ban could dissuade foreign companies from investing in Russia.

The eyes of not just this body, today, but also the world are on Russia as it attempts to gain full membership in the global economic community. Russia may be tearing up its own rule book, but it cannot be allowed to tear up the international rule book.

Would-be investors might well be wary of doing business in a country where international norms and the rule of law can be so easily violated, and where property and shareholder rights cannot be guaranteed. As long as that system exists, Yukos will not be the last company to find its rights violated and its assets seized by the Russian authorities.

I appreciate this chance to take part in the hearing today, Mr. Chairman, and I also thank you for unanimous—thank the committee for unanimously passing a strong resolution of disapproval against the actions of the Russian Government. I hope this strong show of resolve will inspire similar protests by the full Senate, the House, the President, and Americans, in and out of government.

Thank you very much.

[The prepared statement of Mr. Theede follows:]

PREPARED STATEMENT OF STEVEN THEEDE, CHIEF EXECUTIVE OFFICER, YUKOS OIL COMPANY, MOSCOW, RUSSIA

#### INTRODUCTION

Yukos is one of the largest multinational oil companies in the world. The company had a market capitalization of \$40 billion before the Russian Federation engaged in a ruthless and unprecedented campaign of dubious and discriminatory taxes, illegal expropriation of property, arrests and intimidations. The attack by the Russian Federation against Yukos violates Russia's foreign investment laws, which provide for international arbitration of investment disputes, as well as Russia's obligations under its treaties and international law.

There is much at stake in how this situation is resolved: The security, reliability and price of global oil supplies; the safety and welfare of Yukos' employees and communities; the future of economic development and rule of law within Russia; and the relationship of the Russian Federation with the United States and other nations.

The United States has a direct interest in the resolution of the Yukos situation. Beyond the important political or strategic concerns, there are the vital issues of our nation's energy and economic security. There are the rights of more than 60,000 individual and institutional investors, many of them Americans, who expressed their faith in Yukos by investing in the company.

Today, the market value of Yukos has plummeted from \$40 billion to \$2 billion because of the Russian government's campaign of persecution and intimidation against Yukos and its officials.

The Russian government has carried out a ruthless and unprecedented campaign against Yukos by way of dubious and discriminatory taxes, illegal expropriation of property, arrests and intimidation. For reasons known only inside the Kremlin, Russia has decided to reverse its commitment to privatization and chosen instead to increase the role of the state. It has made an equally unfortunate choice to ignore the Western-style reformist laws it passed over the past several years when those laws conflict with the interests of the Kremlin. As a result, there are no guarantees of due process, no adherence to the rule of law, and no protections for the rights of shareholders or property owners.

#### BACKGROUND

Following the collapse of the Soviet Union in the early 1990s, the Russian Federation's oil industry consisted of hundreds of stand-alone state-owned entities. The

vast majority of these were inefficiently run, unprofitable and overstaffed. They survived only through continued state support. In 1993, the Russian government set out to restructure the nation's oil and gas sector. Through privatization, the government hoped to make the Russian oil and gas sector viable in a global market and, above all, attract much needed direct foreign investment into the country.

Yukos was founded by the Russian government on April 15, 1993 through the integration of state-owned producing, refining and distribution entities. Although it had become a separate legal entity, the newly created Yukos remained entirely state owned. It remained that way until December 1995 when the Russian government sold its stake in Yukos to a group of Russian investors. Thus, through a series of tenders and auctions held in 1995 and 1996, Yukos essentially became Russia's first fully privatized oil company.

#### RUSSIAN SUCCESS STORY

Despite the arrival of private investors, Yukos continued to experience a sharp decline in production output and mounting salary arrears, and faced the technical bankruptcy of its main production unit, Yuganskneftegaz or YNG. Its debts to the Russian government had grown to more than \$3.5 billion. In May 1996, Mikhail Khordokovsky stepped in as Chairman of Yukos' Executive Board, bringing with him a dynamic, professional management team. The task of this team was clear: Transform the company into a multinational enterprise managed in accordance with the highest international standards of operational efficiency, transparency and corporate governance. Over the next eight years, Yukos was successfully transformed into a viable, vertically integrated, transnational oil company competing with the biggest oil industry players in the world.

The company repaid all debts owed to Russian federal and regional governments, and increased its production capacity by reinvesting its profits in drilling, capital construction and new oil field development. Further, realizing that attaining Yukos' goal of becoming a successful international energy player would require substantial foreign investment, Yukos embarked on an ambitious program to transform the company's corporate culture into that of a fully transparent, Western-style corporation. For example, Yukos became the first Russian company to switch to international accounting standards, and the first Russian-based multinational to disclose its management and ownership structure to the public.

The company's annual production output grew by 17 percent in 2001 and by 19 percent in 2002. By 2002, Yukos accounted for approximately 18 percent of Russia's total oil production, producing an average of 1.4 million barrels a day. Before the government launched its deliberate campaign to destroy the company, Yukos and its subsidiaries were the largest producers of crude oil in Russia and the largest exporters of crude oil from Russia. Together they produced slightly less than 20 percent of all the crude oil produced in Russia, and refined and marketed slightly less than 20 percent of the refined products in Russia. This made Yukos one of the largest oil and gas companies in the world.

In December 2002, Standard & Poor's rated Yukos "BB with stable outlook," and in January 2003, Moody's Investor Service assigned the company a rating of "Ba2." At the time, these were the highest long-term and foreign currency issuer ratings for any privately-held Russian multinational. Khodorkovsky himself won the 2002 "Entrepreneur of the Year" prize, awarded annually by Russia's leading business daily *Vedomosti*, published jointly by the *Financial Times* and the *Wall Street Journal*. The same year, the Russian government named Yukos the "Best Company for Compensation and Social Payments Programs," as well as for the "Implementation of Social Programs at Enterprises and Organizations." By 2003, Yukos had signed major joint venture and strategic affiance agreements with international companies such as Total, Schlumberger, and Microsoft. In fact, the company's success was so internationally celebrated that, in 2003, ExxonMobil expressed its interest in acquiring between 40 and 50 percent of Yukos for an estimated \$25 billion—a transaction that would have been the single largest direct foreign investment in Russian history.

Not surprisingly, since 1998, the value of Yukos' shares increased more than tenfold, including a growth of 250 percent in 2001 alone. By all accounts, Yukos was the signature success story of the new Russian Federation. By October 2003, the market capitalization of Yukos' worldwide stock was estimated at more than \$30 billion. As late as April 2004, Yukos' market capitalization was estimated at more than \$40 billion. United States investors owned interests in Yukos that were worth approximately \$4 billion in October 2003, when the Russian authorities began their persecution of Yukos' chief executive officer.

American investors (and investors from around the world) bought their interest in Yukos in the good faith belief that their investment would not be expropriated. Russia, recognizing the importance of the rule of law to international investors, adopted the Russian Foreign Investment Law which states in its preamble that it is, "aimed at . . . ensuring stable terms for operations of foreign investors and compliance of the legal order of foreign investment with the standards of the international law."

A company that had been formed from the decaying remnants of the Soviet era had become a standard bearer for the new, pro-foreign investment Russian Federation. Within a mere eight months, however, between April and December 2004, this transparent, globally-respected multinational corporation, worth an estimated \$40 billion, was subjected to a series of carefully timed and politically motivated attacks by the Russian government, ultimately forcing it to seek bankruptcy protection in the United States on December 14, 2004.

#### KHODORKOVSKY ARRESTED

During 2002 and early 2003, Mikhail Khodorkovsky reportedly became concerned the country's upcoming general election would result in a two-thirds pro-government majority in the Russian Parliament ("Duma"). He began to contribute openly to major opposition parties, but reportedly refused requests to finance United Russia, the current governing party. He became an outspoken critic of the alleged endemic corruption in the Russian administration and advocated for progressive legislative reforms. Due to his close ties with Western business and political leaders, his words were resonating outside of Russia and his reputation growing.

In mid-2003, an election year in Russia, the Kremlin reacted. Platon Lebedev, Chairman of Menatep Limited, Yukos' largest shareholder, was arrested in July 2003 on charges of fraud and tax evasion, and Vasily Shakhnovsky, a member of Yukos' Management Board, was charged with tax evasion. In July 2003, the Russian Government raided Yukos' offices where it went through computer records for approximately 17 hours. And on October 25, 2003, Mikhail Khordokovsky was arrested at gunpoint by government agents and jailed on charges of tax evasion, theft of state property, and fraud. He remains jailed to this day. In addition, many loyal and outstanding Yukos employees have found themselves subject to intimidation by the government and threats by its agents. The Government continues to arrest Yukos' managers, intimidate its employees through illegal searches of their homes conducted by masked, armed forces, confiscate personal property of the company and its officers, and jail or threaten other company employees on trumped up criminal charges. In a recent example of this repugnant methodology, Svetlana Bakhmina, a young Deputy General Counsel of Yukos and the mother of two young children, was arrested late at night at her home in Moscow on charges relating to her legal work at Yukos. She remains incarcerated.

Despite the political activism of its largest individual shareholder, however, Yukos itself was never involved in Khordorkovsky's political activities. All his contributions to opposition parties, for example, were made from his personal funds and not from corporate accounts. Nevertheless, hand-in-hand with its criminal investigations, the government also apparently perceived that it had to move against Khordokovsky by targeting Yukos, the single most concentrated source of his wealth. In December 2003, a few weeks after Khordokovsky's arrest, the Ministry of Taxation conducted a perfunctory two-week "special" audit of Yukos' books. In April 2004, the government slapped a \$3.4 billion audit report on Yukos, which it claimed Yukos owed in respect of the 2000 fiscal year. The Russian government's moves against Khordokovsky's wealth, through tax assessments against Yukos, have been numerous since then, clearly retaliatory and have involved the systematic repudiation of the rule of law.

#### THE TAX ASSESSMENTS

Following the first assessment against Yukos, the government levied additional tax assessments against Yukos and certain of its subsidiaries. Including massive penalties, fines and interest, these assessments eventually totaled approximately \$27.5 billion. They were based on government audits of Yukos' books, which had already been audited by PricewaterhouseCoopers, formally audited and confirmed as correct by Russian tax authorities, and made as transparent as possible as part of the company's corporate philosophy. Further, in light of the fact that Yukos was one of Russia's largest taxpayers, it was in constant communication with the regional Russian tax authorities, which had approved all of Yukos' previous filings following similar audits. Yukos has always maintained that the company, like many other companies in Russia, used legal and government-approved tax reduction provisions.

Allegations that Yukos had acted illegally could only be made under a selective and retroactive reinterpretation of Russian tax law that could not reasonably have been anticipated when the transactions took place.

In addition, the amount of the taxes has been swelled by usurious default interest, penalties, and fines. This exponential rate of increase jeopardized Yukos' ability to conduct business and decimated its net equity. In a blatant example, tax assessments for 2001 and 2002 have been in excess of 100 percent of Yukos' annual consolidated gross revenue; for 2003 the assessments have been in excess of 80 percent of Yukos' consolidated gross annual revenue. Indeed, the assessments levied against Yukos for 2001 were in excess of four times the consolidated gross industry average taxes; for 2002, in excess of 3½ times the industry average; and for 2003, in excess of 2½ times the industry average.

#### KREMLIN MOVES TO BANKRUPT YUKOS

Despite the government's insupportable tax claims, Yukos acted in a responsible manner. Even while challenging the tax claims through all available legal, political and diplomatic channels, as a matter of good faith and as a signal of our interest in finding a reasonable resolution, Yukos began to pay some of the taxes. But it became clear this was not really about taxes. It was about an illegal and politically motivated campaign to expropriate valuable oil assets and return them to the close control of the government. Having ignored any number of settlement proposals by Yukos, or other reasonable proposals to pay the entire amount of the tax assessments over time, the Russian government instead intensified its collection efforts against Yukos by utilizing the full apparatus of the state.

On April 15, 2004, the government obtained an injunction forbidding the disposal, encumbering or other dealing with any of the assets of the company. On June 30, 2004, a further freezing order forbade any disposals of assets while at the same time requiring an additional tax payment of more than \$3.4 billion to be made within 5 working days on pain of a penalty surcharge of 7 percent of the total debt (\$241 million).

Because of the injunction and the freezing order, the company was prohibited from making that additional tax payment. Its formal application on July 2, 2004, that sufficient assets to meet the liability should be released for that purpose was rejected. The surcharge was duly applied. The government's ultimate resolution to this contrived situation was to declare that because Yukos could not pay its fictitious taxes, the bailiffs would have to seize Yuganskneftegas, the company's most valuable asset, and sell it at auction to satisfy the tax charges.

On August 31, 2004 the bank accounts of Yuganskneftegas were frozen and on September 9, 2004, following a further additional tax assessment of \$2.7 billion, thirteen further freezing orders were imposed on Yukos' bank accounts forbidding all transactions. As a result, the company had no access to cash to reinvest in their operations, operate their businesses, disburse company expenses, pay salaries to employees, satisfy any amounts levied under the tax assessments, and most importantly, pay current taxes. In essence, by forcing the company to operate with no money, the Russian government left Yukos incapacitated and unable to function.

Having rendered Yukos cash-flow insolvent, the Russian government through its bailiffs conducted an auction of Yuganskneftegas on December 19, 2004, allegedly to raise money to pay a portion of Yukos' tax bill. In violation of a restraining order from a U.S. Bankruptcy Court, the auction proceeded as scheduled, with the assets being sold for half their appraised value. The buyer in this sham auction was an unheard-of company of no certain address that sold its prize almost immediately to Rosneft, a front for the Kremlin, whose chairman had led the attack on Yukos in the first place.

By forcing down the value of YNG stock at the auction, the subsequent set-off against Yukos' tax bill still left a significant tax liability, potentially putting other assets in jeopardy. At the Russian government's request, Dresdner Kleinwort Wasserstein valued the shares of YNG in preparation for the auction. It gave a valuation of between \$15-\$18 billion. Despite that valuation by an independent bank, the Russian government set the auction to start at significantly under \$9 billion, less than half the valued amount.

In recent comments, Andrei Illarionov, a close and long-term economic adviser to the Russian president, said Yuganskneftegas should be returned to Yukos. "There are certain common human commandments," Mr. Illarionov said. "Such as 'thou shalt not steal.'" Not surprisingly, this once influential adviser has reportedly been stripped of many of his duties following his comments.

The Kremlin's deliberate campaign against Yukos has serious implications for the United States. Americans should be concerned about a Russian government still

willing to unleash its agents in a ruthless campaign against companies or individuals. Likewise, we should be wary of a retreat from democratic values in Russia and a seeming level of instability, especially given Russia's strategic location and nuclear capability.

As the world's largest oil consumer, America's energy security—and by extension its economic security—depends on the stability and reliability of global oil supplies. Yukos had made significant investment in technology, equipment and talented staff, and was playing a growing role in stabilizing world supplies.

Today, industry analysts note that the Russian government is tightening its grip on the energy sector. Christopher Weafer, chief strategist for Alfa Bank, said this move "is not unexpected and is part of the government's efforts to exercise greater control over the energy sector." Just last week, the Russian Federation announced a ban on U.S. and other foreign-owned companies from bidding for new permits to develop several large oil fields. This action will further slow the growth of Russian oil production by discouraging needed investment capital and expertise.

Roland Nash, chief strategist for Renaissance Capital, a Moscow-based investment bank, called the ban "a dramatic step down the road of state intervention, which Russia has been following for some time." Mr. Nash concluded: "The ban could dissuade foreign companies from investing in Russia."

As the Wall Street Journal reported recently, slowing growth in Russian oil production has helped drive up world oil prices. Production has fallen for four straight months. The International Energy Agency cut its forecast of Russian oil output growth this year to 3.8 percent, citing higher taxes and a worsening regulatory climate. These circumstances run counter to the energy and economic security of the United States.

#### UNCERTAIN FUTURE

In July 1999 the Russian Federation adopted the Russian Foreign Investment Law in order to attract and encourage foreign investment on its territory. According to its preamble: "This Federal Law determines the basic guarantees of foreign investors' rights to the investments, and to the income and profits obtained from such investments, and the terms of business activities of foreign investors in the Russian Federation." The legislation's preamble declares its purposes to be: "Attracting foreign material and financial resources, advanced engineering and technologies, managerial experience and efficient application thereof in the economy of the Russian Federation, and ensuring that the legal regime of foreign investments is in compliance with the norms of international law and the international practice of investment co-operation."

The Yukos matter puts the eyes of the world squarely on the Russian Federation to judge whether it is living up to that commitment. Yukos is protected by the investment guarantees set forth in the Russian Foreign Investment Law because foreign investors own at least 10 percent of Yukos' capital stock and because Yukos reinvests its income and profits in oil production and related activities on the territory of the Russian Federation.

By any measure, the Russian government tax claim is not in keeping with international norms or even Russian law. It was imposed without substantive due process by retroactive application of substantive law that was different from what had been applied to Yukos in the past and different from what was applied to other similar companies. It involved an interpretation of law that could not reasonably have been anticipated. It was also imposed without procedural due process involving a fair opportunity to be heard, in many cases imposing taxes for prior years in which the Russian government had previously said no more tax was due.

This has resulted in a discriminatory taxation of Yukos as compared to other oil and gas companies operating in Russia, many of which are not foreign-owned corporations, and at \$27.5 billion, it was so grotesquely large that it equaled between 80 to 111 percent of Yukos' U.S. GAAP consolidated gross revenues (before expenses are taken into account) for the years 2001, 2002 and 2003, and about 70 percent in 2000.

The inequitable and illegal actions surrounding these extraordinary tax claims substantially impaired Yukos' ability to pay its more than \$1.5 billion of debt to over 150 legitimate lenders and trade creditors, and caused the value of Yukos' common stock, owned by over 60,000 shareholders, to plummet from over \$40 billion to less than \$2 billion.

These actions also focus attention on Russia as it attempts to gain full membership in the global economic community. Would-be investors might well be wary of doing business in a country where international norms and the rule of law can be so easily violated, and where property and shareholder rights cannot be guaranteed.

The Kremlin may feel it has license to tear up the Russian rule book, but international rules are another matter. The rights of international investors can only be protected in a legal system that is fair and unbiased, not one where the Russian government picks winners and losers before it ever decides to hear the case. As long as that system exists, Yukos will not be the last company to find its rights violated and its assets seized by the Kremlin.

The actions of the Russian government have bankrupted a company that once seemed destined to serve as a model for Russia's economic future. The European Union has condemned the actions against Yukos as a politically motivated, coordinated attack by the Russian government designed to regain control of strategic economic assets. The Senate Foreign Relations Committee has also added its influential voice through a resolution of disapproval which the Committee passed on a unanimous vote.

Sadly, the Russian people will bear much of the burden as well. At its peak, Yukos employed more than 100,000 people, paid billions of dollars in taxes and invested generously in local communities. A modern, globally-respected company has been dismantled by a series of carefully timed and politically motivated attacks by the Russian government. As a litmus test for future investors, adherence to the rule of law and compliance with international norms, the Yukos experience is not encouraging.

The CHAIRMAN. Thank you very much, Mr. Theede.  
Mr. Osborne, would you proceed, please?

**STATEMENT OF TIMOTHY OSBORNE, MEMBER, BOARD OF DIRECTORS, GROUP MENATEP, UNITED KINGDOM**

Mr. OSBORNE. Thank you, Chairman Lugar, for inviting me to the hearing today. I've already submitted formal remarks, but I'd like to offer a brief summary.

My name is Timothy Osborne. I have practiced as an attorney in the United Kingdom for over 25 years, specializing in international tax issues and corporate governance. I am a member of the Independent Board of Directors of Group Menatep. Group Menatep is a diversified international financial holding company established in 1997 by Mikhail Khodorkovsky, Platon Lebedev, and others.

I've experienced firsthand Russia's approach to the rule of law and to property rights. Group Menatep, its founders, and its main asset, Yukos Oil Company, have been the subject of a coordinated and relentless onslaught by the Russian authorities.

Group Menatep is the majority owner of Yukos Oil Company, holding approximately 51 percent of the Yukos equity capital. In addition, Group Menatep placed a separate 10 percent of the Yukos shares in a trust, the Veterans Petroleum Trust, which provides retirement benefits for Yukos workers in the remote oil fields in Siberia.

I was appointed as one of the three members of the board, in March 2004, to manage the company in keeping with Western standards of corporate governance. More recently, I've been primarily involved in trying to protect the company and its assets.

The attacks on Group Menatep and its founders are an integral part of an orchestrated and sustained campaign by the Russian authorities, and need to be explained in the context of what is happening in Russia.

The Council of Europe Parliamentary Assembly, known as PACE, appointed Sabine Leutheusser-Schnarrenberger, a member of the Bundestag, a former German Justice Minister, to examine the nature of the cases launched by the Russian authorities against Yukos and its former executives. Her report, which was based on an extensive legal analysis of the facts surrounding the case, was



adopted by the plenary session of PACE on January 25 of this year. The report found that the prosecutions went beyond the mere pursuit of justice to include such elements as to weaken an outspoken political opponent, intimidate other wealthy individuals, and regain control of strategic economic assets.

I would like, Mr. Chairman, that this report be entered into the record.

The CHAIRMAN. It will be entered in full.

Mr. OSBORNE. Mr. Chairman, I'd like to summarize briefly the attacks against Group Menatep that began in 2003.

The Russian authorities have used the pretext of unpaid taxes to justify their attacks on Yukos and Group Menatep's founders, despite the fact that they had all retained the highest quality financial advisors. Prior to the assault undertaken by the Russian authorities, Yukos has been widely praised for its financial openness. It was audited by PricewaterhouseCoopers according to U.S. GAAP standards. Neither PricewaterhouseCoopers nor the Russian tax authorities raised any questions of additional taxes when the books were closed and taxes paid for the years in question. No suggestion of tax evasion was made at any time until the current onslaught began.

Rather than evading taxes, Yukos was the third-largest payer of taxes in Russia during this period, and it paid taxes at or above the industry average, amounting to billions of dollars.

The attitude of the Russian authorities to Yukos changed completely in the wake of their dispute with Mr. Khodorkovsky. Suddenly, massive amounts became due, in some years amounting to over 100 percent of the gross revenue of the company for that year, as just explained by Mr. Theede.

Having improperly levied abusive taxes on Yukos, the Russian authorities then froze Yukos assets, and, in August 2004, seized its subsidiary, Yuganskneftegaz. Yuganskneftegaz had been valued by Western bankers appointed by the Russian Government as worth between \$15 and \$18 billion. Yuganskneftegaz represented 60 percent of Yukos oil production and was, until its seizure, the core asset of the company.

By freezing assets and seizing Yuganskneftegaz, the Russian authorities essentially assured Yukos' inability to pay the disputed outstanding tax bills. They then proceeded to put Yuganskneftegaz to auction, arranged to have a sole state-controlled bidder, who bought Yuganskneftegaz for less than 50 percent of its true value.

However, it would be misleading to look at this solely as a corporate matter. This case originates in politics. What began as a vendetta brought by the Russian authorities against Mr. Khodorkovsky and his colleagues has now expanded to include intimidation and harassment of employees at all levels of Yukos.

Two examples. The wife and children of one of Yukos' outside counsel was recently detained at the airport in Moscow for hours on alleged drug offenses. No drugs were found, no charges were made, and, ultimately, they were let go. Another example is the female employee in the Yukos legal department who was arrested, leaving her young children unattended, and has, in effect, been held hostage in custody to encourage the return to Russia of her boss.

What is Group Menatep doing about this? Initially, we made every possible good-faith effort to resolve the conflict in an amicable and reasonable fashion. We retained former Canadian Prime Minister Jean Chretien. He met with President Putin in July 2004 and followed this with a number of telephone calls and letters. President Putin committed to review proposals to resolve the tax and other legal issues then outstanding. Separately, Yukos, I understand, has made over 50 different settlement approaches to the Russian Government. No response has been received to any of these approaches.

Given the complete lack of response, we concluded, toward the end of 2004, that the Russian Government's aim was the expropriation of Yukos. We consider that any final hopes that the Yukos affair could be settled reasonably and in a legal fashion were crushed last December, when the government ordered the sale at auction of Yukanskneftegaz, the core asset. As mentioned above, the auction was little short of a farce.

On November the 2nd, Group Menatep delivered notification to the Russian Federation requiring them to enter into the discussions required under the 1994 Energy Charter Treaty. The Russian Federation totally ignored this request. Consequently, on February 9 of this year, at the end of the 3-month standstill period, Group Menatep filed its notes of arbitration, statement of claim against the Russian Federation for the losses caused. The claim seeks compensation for approximately \$28 billion.

Our objective in doing this is to protect Group Menatep's remaining assets, to seek compensation for the losses of all Yukos shareholders, and demonstrate to the world that Yukos, Group Menatep, and its founders have been the victims of an illegal, politically motivated campaign designed to expropriate and renationalize Yukos, with total disregard for the rights of all shareholders, the rule of law, and generally accepted principles of international law.

Mr. Chairman, let me just touch briefly on the impact of the Russian Government's actions on the United States.

The United States has minority shareholders in Yukos, including state pension funds, such as that of Ohio. They've been directly and negatively impacted by the Russian authorities' flagrant disregard for the rule of law and individual property rights, with losses to United States shareholders estimated in the billions of dollars.

The Yukos affair has broad implications for the global investment community in which U.S. citizens are heavily represented. Group Menatep and all international investors have an interest in open and free markets where the investments are protected by legal systems adhering to the rule of law.

The risk of loss should be based on market forces and business performance, not on arbitrary governmental actions. Moreover, as Mr. Theede has describe, the repercussions for the U.S. energy security are serious. We now have a situation where decisions are being made based on Russian foreign-policy objectives and internal politics, not markets.

I'm not an expert on foreign policy, and would not presume to make recommendations on United States policy toward Russia; however, it is widely acknowledged by foreign-policy experts that the attacks on Group Menatep, Yukos, and Menatep's founders are

selective and politically motivated. It's increasingly clear, moreover, that this is a part of a concerted effort to reclaim state control over a major element of Russia's energy sector, for strategic reasons.

Since the collapse of the Soviet Union, the central goals of the United States have been the promotion of democracy, the rule of law, and free markets. All of these have been threatened by what is taking place.

The upcoming summit meeting of Presidents Bush and Putin will provide another opportunity for the United States to raise these concerns, and we will be watching to see that the United States is still trying to advance and protect these commitments.

Given the current ominous trends in Russia, I note that many experts have called into question Russia's accession to the WTO, its participation in the Group of Eight, and, in particular, the appropriateness of its hosting the G8 meeting in 2006. These are a rules-based organization and a grouping of the world's leading democracies, respectively. I wonder whether the Russian Federation is currently a suitable candidate for either.

Mr. Chairman, hearings such as these send an important signal to the Kremlin that the United States is closely watching its actions and is vitally concerned about the rule of law, as well as property rights and human rights, in Russia.

I thank you for the opportunity to testify here today. Once again, I'm grateful for the interest and attention this matter is receiving.

[The prepared statement and related material of Mr. Osborne follows:]

PREPARED STATEMENT OF TIMOTHY OSBORNE, MEMBER, BOARD OF DIRECTORS,  
GROUP MENATEP, UNITED KINGDOM

INTRODUCTION

I wish to thank Chairman Lugar and Senator Biden for convening this hearing today. The past 18 months has seen a veritable onslaught against Group Menatep, its holdings and its shareholders by the authorities in Russia, against the backdrop of an apparent retreat in democratic development in Russia. I am grateful to you, Mr. Chairman and Senator Biden, along with your colleagues in the Senate, for your early recognition of the serious nature of these events in the Resolutions that were introduced in the previous session of Congress.

My name is Tim Osborne and I am a member of the independent Board of Directors of Group Menatep. My fellow Board members and I were appointed in March 2004 to conduct the day to day operations for the company following the detainment of Director Platon Lebedev in July 2003 and then the still-unexplained death of Mr. Stephen Curtis, appointed as his successor, in a helicopter accident in the spring of 2004.

Group Menatep is a diversified financial holding company, established in 1997 by Mikhail Khodorkovsky, Platon Lebedev and others, and it owns strategic stakes in a number of Russian companies, including YUKOS, as well as a number of financial portfolio investments on stock markets in Russia and internationally. It is incorporated and existing in accordance with the laws of Gibraltar. Group Menatep is the majority owner of Yukos Oil Company, holding approximately 51 percent of Yukos equity capital through wholly owned subsidiaries.

As a member of the Group Menatep Board of Directors, I am responsible for stewardship of the company in keeping with recognized standards of transparency and corporate governance and, more recently, in protecting the company's remaining assets. I do not represent Yukos Oil Company or the individuals mentioned above, however, the attacks on Group Menatep holdings and its founders are an integral part of an orchestrated and sustained campaign against the company by the Russian authorities and therefore need to be explained in the context of what is happening in Russia.

I hope at some stage there will be an opportunity for a hearing on the nature of these charges and the conduct of the criminal cases against these individuals. For-

eign policy experts, government officials, financial analysts, the defense attorneys and independent human rights groups agree that the trials, like the charges against Yukos, are politically motivated and that they have been riddled with violations of due process and human rights. I will submit for the record along with my written testimony some of their statements and reports.

#### THE ATTACKS AGAINST GROUP MENATEP

##### *The Tax Issues*

While some Russian companies' accounting practices may remain insufficient for the standards of international investment markets, Group Menatep adopted a different approach. It chose to hire top quality financial professionals and auditors for its companies, including Yukos, putting into place internal controls sufficient to meet the highest standards of market economies. Prior to the assault undertaken by the Russian authorities, Yukos had been widely praised for its financial openness and the maintaining of its accounts in accordance with Western accounting practices. While its competitors included firms whose accounts remained less than transparent, it was Yukos, the company that had opened its books to the world, which was selected for prosecution. The fact that Yukos keeps open books meant that it was audited by both outside accounting firms and the Russian government, neither of which raised any issues of tax evasion when the books were closed out and taxes paid for the relevant years.

The assessment by the Russian authorities that Yukos had paid all of its taxes changed completely in the wake of the political dispute between the Russian authorities and the leadership of Group Menatep. Suddenly, massive amounts became due, in some years amounting to more than 100 percent of the gross revenue of a company for that year. The Russian authorities only raised tax evasion allegations after they had already initiated their political crackdown on Group Menatep's shareholders. The tax charges against Yukos both tracked, and followed in parallel, the events in the trials of these executives. Thus, as the trial against these executives heated up, the initial charge for US \$3.5 billion in back taxes quickly ballooned to over US \$27 billion.

A few simple numbers provide the context for the absurdity of the Russian authorities' assessments. Yukos has already paid \$15 billion in taxes for the period 2000 through 2003, on total gross income for that period of \$29 billion. Thus, the taxes paid amount to approximately 52 percent of gross income. Beyond that amount, the Russian authorities allege that Yukos owes an additional US \$27 billion for that period, bringing Yukos' total tax liability for the period to over US \$42 billion, or nearly 145 percent of the company's gross income. Let us call a spade a spade. This is not taxation. This is confiscation.

The crux of the Russian government's allegation is that Yukos evaded taxes through the illegal use of tax havens in the years 2000 through 2003. Beyond the fact that Yukos paid taxes at a level equivalent to or in excess of, on a percentage basis, every one of its competitors in the Russian energy business, there is a fundamental problem with the Russian government's legal case against Yukos. The fundamental problem is that the structures used by Yukos to limit its taxes were lawful under Russian law at the time that Yukos employed them. Russian authorities first had to change the tax law and then apply these changes retroactively in order to even allege tax evasion. Notably, Yukos competitors in the oil and gas field also employed these same tax structures and yet no significant charges of tax evasion have been brought against these companies.

One need not be a Russian legal expert to judge that the actions of Russian authorities are improper. Not only is Russia imposing tax laws retroactively, it is singling out and punishing one company for actions that were industry norms.

The retroactive application of tax law and the selective prosecution by Russian authorities of Yukos are two objective indicators of the abusive nature of these cases. But there are many other objective facts that show that the Russian tax assessments were improper. Prior to the levy of any of these additional taxes against Yukos, the company was already the third largest taxpayer in Russia. Indeed, its tax-to-revenue ratio ranged between 30 to 32 percent during that time and during this period, Yukos paid more in taxes during this period than the industry average. In fact, if one was to add the amount of taxes Yukos originally paid in these years to the amount of taxes that the Russian government alleges that Yukos evaded, the Yukos tax payments would represent 175 to 244 percent of the industry average. These figures do not include the further fines, penalties or interest that the Russian government has added to the tax bill. If such things as fines, penalties and interest payments are included, the amount that the Russian government has asked Yukos

to pay represents approximately 267 to 402 percent (depending on the year) of the industry average for taxes paid during this period.

Let us examine a single year of taxes assessed by the authorities—2002. On November 1, 2004, the Tax Ministry assessed Yukos an additional US \$10 billion in back taxes and penalties for the year 2002. According to these new allegations Yukos was expected to pay a total of US \$7.9 billion in taxes for 2002. This US \$7.9 billion does not include penalties, fees and interest and therefore represents what the Tax Ministry alleges Yukos should have paid in taxes in 2002. US \$7.9 billion represents 70 percent of the total revenues earned in 2002 and approximately 115 percent of the company's gross income for the year. If penalties, fees and interest are included, the total tax bill for 2002 represents 111 percent of total revenue earned by Yukos for the year 2002 and 184 percent of gross income for the year.

The Russian tax authorities chose not to provide Yukos any opportunity to address these charges prior to the issuance of tax bills. Their demands for back taxes were immediately rubber stamped by the Russia courts. There was absolutely no effort on the part of the tax authorities and the courts to negotiate any schedule for repayment.

The behavior by the Russian authorities in this case demonstrates how, when abused, the power to tax is indeed the power to destroy. To provide you with just some of the highlights of the abuses:

- On July 2, 2004, the Russian Tax Ministry issued a claim against Yukos for US \$3.3 billion in back taxes for the year 2001. This US \$3.3 billion was in addition to a tax bill of US \$3.5 billion that the Russian Tax Ministry had issued the previous December in connection with taxes for the year 2000. On the same day, court bailiffs freeze Yukos bank accounts and notify the company that it must pay a 2003 tax bill of US \$3.4 billion within five days.
- On September 3, 2004 the Tax Ministry presents Yukos with a new US \$4.1 billion tax bill for 2001 and announces that the company has only one day to pay.
- On September 8, 2004 Russian government officials begin to collect on a Yukos tax bill from 2001, immediately confiscating US \$2.7 billion from Yukos bank accounts.

These disproportionate tax claims against Yukos have been accompanied by the government's freezing of Yukos assets, making payment impossible. These improper actions by Russian authorities were then followed by the forced sale of Yuganskneftegas in December 2004 in an auction in which a false veneer of formal process was used to cover what was actually an illegal expropriation.

#### *Russia's Illegal Expropriation of Yuganskneftegas*

Having improperly levied abusive taxes on Group Menatep's main holding, Yukos, Russian authorities then seized Yukos subsidiary Yuganskneftegas in August 2004. Yuganskneftegas had been valued by Western bankers as worth between US \$15–\$18 billion. It represents 60 percent of Yukos oil production and was, until its seizure, the heart of the company. By seizing Yuganskneftegas, the Russian authorities essentially assured Yukos' inability to pay any of the outstanding tax bills. They then proceeded to put Yuganskneftegas to auction, arranged to have a sole friendly bidder, and to have the company bought up by a state-controlled firm.

In an attempt to preserve shareholder value in the face of these improper actions by Russian authorities, Yukos declared bankruptcy in a federal bankruptcy court in Houston on December 15, 2004, which under traditional bankruptcy law rules would halt the auction. The Russian authorities chose to proceed regardless, auctioning off Yuganskneftegas on December 19, 2004, in violation of a December 16th Temporary Restraining Order ("TRO") issued by the United States Bankruptcy Court for the Southern District of Texas.<sup>1</sup> One Russian firm, Gazprom, participated in the bidding despite the express prohibition of the same by the TRO.

As noted above, Yuganskneftegas has been valued at between US \$15–\$18 billion and yet the Russian government auctioned it off for only US \$9.4 billion. The winner of the auction for Yuganskneftegas was an absolutely unknown company by the name of Baikal Finance Group. Baikal Finance Group had no apparent means of financing the purchase. It was obviously operating as a front company for the state-owned company Rosneft in this sale. Some have speculated that the reason for the use of the front company was an effort to shield Rosneft from any legal liability stemming from, amongst other things, the fact that the auction was in violation of the federal judge's stay order. What is absolutely certain is that Baikal itself was not a legitimate bidder.

<sup>1</sup>In *Re Yukos Oil Company*, Case No. 04–47742–H3–11 (S.D. Tex., December 16, 2004).

When research on the Baikal was conducted, nothing could be discovered regarding who owned Baikal or where its financing had come from. The company had no previous operations, no capital, and no known shareholders. The only information available on the company was that it shared an address with a tiny grocery store in the small Russian provincial town of Tver. Three days after the auction, Baikal Finance was “sold” to Rosneft, although public information as to who was paid what for this \$15 billion to \$18 billion asset remains scanty. Press accounts suggest that Rosneft received a loan of some \$6 billion from a consortium of Chinese banks which paid that sum to the Russian government in order for Rosneft to “buy” Yuganskneftegas. The foreign policy implications of this sale are underlined by the recent disclosure that the Chinese helped fund Rosneft’s acquisition of Yuganskneftegas.<sup>2</sup> The Chinese banks were reportedly acting on behalf of the Chinese and Russian governments. Following the acquisition, Rosneft now controls 16 percent of Russia’s total crude oil output.<sup>3</sup>

In summary, this was no auction in any normal sense, but an extraordinarily unethical, illicit and cynical expropriation of private sector assets by the Russian authorities. Group Menatep continues to contest the illicit proceedings relating to the sale of Yuganskneftegas, in Russia and in courts around the world. As Mr. Theede discussed, Yukos is serving notice under the U.S. bankruptcy law that the December 19 sale in contravention of the Bankruptcy Court’s order was illegal and that it will seek to recover from those involved in the sale.

There has been widespread condemnation of the forced sale of Yuganskneftegas, internationally and within Russia itself, including explicit recognition of its political nature. Most telling is the criticism of the sale from within the Russian government itself. Andrei Illarionov, then the most senior economic adviser to Russian President Vladimir Putin, described the sale as “the swindle of the year.”<sup>4</sup> Shortly after he voiced his criticism of the sale, Illarionov was stripped of most of his responsibilities.<sup>5</sup> Even Russian Economic Minister German Gref, a close associate of President Putin, referred to the sale as “unjustified.”<sup>6</sup> Criticism outside of Russia has also been pointed. As summarized in one foreign press report: “The Yugansk auction was the culmination of a Kremlin campaign to crush Yukos’ politically ambitious principal owner, Mikhail Khodorkovsky, and seize control of strategic sectors of the economy sold off in the chaotic privatizations of the 1990s.”<sup>7</sup>

#### *Actions Against Individuals*

I have discussed at some length the corporate cases brought against key assets of Group Menatep. However, it would be misleading to look at this solely as a corporate matter. As I have suggested earlier, this case originated in politics. The vendetta brought by the Russian authorities against essentially every person involved with Group Menatep has included a wide range of criminal proceedings that are, like the tax charges, expressions of politics rather than law. For this reason, I feel it is necessary to discuss the actions taken by the Russian government against key individuals. While I do not represent these individuals, I have followed their plights closely because they are so intertwined with the fate of Group Menatep.

The most notorious of these is the prosecution of Mikhail Khodorkovsky and Platon Lebedev. Khodorkovsky was until recently the CEO of Yukos and Lebedev was director of Group Menatep. My understanding is that all of the charges against Khodorkovsky and Lebedev are what one would consider “white collar” crimes and that there is no compelling state interest in their continued imprisonment during their trials. Despite the fact that they pose no threat to society and in spite of Lebedev’s reported poor state of health, these two men remain in a Russian prison.

I have tried to understand the charges against Khodorkovsky and Lebedev but there appears to be little rhyme or reason to the government’s case. The case against these two focuses on the privatisation of a fertilizer company by the name of Apatit. However, this privatisation took place in 1994 and the allegations surrounding this transaction would seem to be issues of contract law, not criminal law. Nine years passed from the privatisation sale to the arrest of Khodorkovsky and Lebedev. During those nine years, three separate civil suits were concluded with regards to this privatisation, focusing on breach of contract issues, with no criminal issues being raised. They resulted in a signed settlement agreement between a

<sup>2</sup> China Had Role in Yukos Split-Up, BBC News, February 2, 2005.

<sup>3</sup> Putin Backs State Grab for Yukos, BBC News, December 23, 2004.

<sup>4</sup> Minister Hits Out at Yukos Sale, BBC News, January 11, 2005.

<sup>5</sup> Id.

<sup>6</sup> Id.

<sup>7</sup> Richard Ayton and Andrew Hurst, State seizes Yukos’ core oil unit, The Age, December 24, 2004.

Group Menatep company, Volna, and the Russian Federal Property Fund that seemingly brought an end to what has now become referred to as the “Apatit affair.”

Remarkably, not only was the Russian government a signatory to the settlement agreement, but the Prosecutor General Vladimir Ustinov, in a letter to President Putin in April 2003, stated that there were no legal reasons for initiating an investigation into the Apatit affair. Throughout all three of these proceedings and the nine years that passed from the time of the transaction and the arrest of Lebedev and Khodorkovsky, no allegations of any criminal behavior were made against these two. Furthermore, although the Russian Federation has since moved to set aside the civil settlement, it has never returned the \$16 million paid by Group Menatep as part of the settlement. I can only imagine that no allegations of criminal behavior were made in the civil proceedings because there was no evidence of any criminal behavior.

Khodorkovsky and Lebedev are the highest profile Yukos and Group Menatep executives, but the Russian government has targeted many more and has shown no sign of stopping in its persecution of anyone who is willing to defend Yukos or Khodorkovsky and Lebedev. In fact, some are being detained in an effort to build cases against Yukos and Menatep executives. Alexei Pichugin, a retired FSB major, was the first target in the Russian authorities’ assault on Yukos. Pichugin worked in the department of economic and financial security at Yukos during 1998. In May 2003, Russian authorities used the disappearance of his close friends, Sergei and Olga Gorin, as a pretext to grill Pichugin on internal financial matters at Yukos. He was charged on June 26, 2003 with the double murder of the Gorins, and later in August 2003 with three additional attempted murders (Victor Kolesov, Olga Kostina and Evgeni Rybin) from 1998. The initial trial began in October 2004 but ended in a mistrial in December. According to many observers, the jury was dismissed after it became apparent to the court that they would not return a guilty verdict. A second trial began in January of this year with a new jury.

In Pichugin’s trial, the authorities’ entire case has rested on testimony from a convicted serial murderer and child abuser, Igor Korovnikov (“Korovnikov”). Korovnikov is currently serving a life sentence in the FSB-run Lefortovo Detention Center for eight murders committed between October 1998 and February 1999, and for the sexual assault of five young girls. While little is known of the actual testimony of Korovnikov because all of the proceedings have been held in secret, it is important to note that Korovnikov was imprisoned at the time some of these alleged crimes were committed and Korovnikov’s “evidence” surfaced only after he was moved in 2003 by the authorities from Ogenny Island, a penal colony for life-sentence prisoners renowned for its harsh regime, to Lefortovo prison.

Beyond prosecutors putting on testimony from Korovnikov which the original jury evidently found insufficient, and the state’s ending the proceedings in order to avoid Pichugin’s acquittal, outside experts assessing the proceedings have found that the authorities violated international human rights and due process standards in conduct of Pichugin’s trial. Russian authorities classified the case as top secret, trying it in private. Portions of Pichugin’s case files have been classified by the government. Pichugin was denied opportunities for confidential communication with his lawyers, and the judge in his case once gave Pichugin’s counsel just days to review 35 volumes of documents. Pichugin’s lawyers had limited access to his case files and were forced to sign “state secret” nondisclosure agreements that would give them a 10-year prison sentence should they disclose the files.

The Parliamentary Assembly of the Council of Europe (“PACE”) has resolved that the unjustified restrictions on public access to court proceedings and the fact that, “in particular, all proceedings against Pichugin have been held in camera even though only a small portion of the case file has been classified as secret” are among the “most serious corroborated shortcomings” of the Yukos related prosecutions.<sup>8</sup>

Notably, the Pichugin case is merely one, if egregious, example of a pattern of abuses by Russian authorities, which have undertaken these legal cases in a coordinated legal assault on people with ties to Khodorkovsky and Yukos. These abuses include the arrests of Svetlana Bakhmina and Elena Agronovskaya. Ms. Bakhmina worked in the Yukos legal department. Ms. Agronovskaya was a Yukos outside counsel. Both were expected to testify for the defense in the Khodorkovsky and Lebedev trials. They also include the issuance of arrest warrants in January 2005 for other associates of Khodorkovsky and Lebedev, including Mikhail Brudno (“Brudno”), Vladimir Dubov (“Dubov”), Alexander Gorbachev, Vladislav Kartashov, Alexei Spirichev, and Irma Chernikova, after Brudno and Dubov were invited to the U.S. to discuss the Yukos affair with members of Congress.

<sup>8</sup>Europe Parliamentary Assembly, Circumstances Surrounding the Arrest and Prosecution of Leading Yukos Executives, Res. No. 1418 at ¶ 8 (January 25, 2005) (Exhibit 2).

*Independent Judicial Review*

Each time the allegations by the Russian Federation have come before an independent court outside of Russia, the Court has found the allegations were substantively deficient:

In August of 2003, Defendant Russian Federation secretly submitted requests for mutual legal assistance to the Attorney General of Switzerland requesting the seizure of business documents related to, inter alia, Group Menatep, its subsidiaries, Khodorkovsky, Lebedev, Yukos, and Yukos-related trading companies. Subsequently in March 2004, Defendant Russian Federation sought the freeze of numerous bank accounts in Switzerland in the name of the same entities and individuals, and the Swiss Attorney General froze accounts holding approximately \$4.9 billion dollars. On June 8, 2004, the Swiss Federal Supreme Court directed the Swiss Attorney General to release several of the accounts subject to orders ripe for review and held that “the [Russian] request and its amendments do not contain any fact enabling determination, even minimally, of the cause, nature and scope of such extensive damages, which would be of a nature to justify the ordering of the contested freeze.” *Pecunia Universal Ltd. v. The Office of the Attorney General of Switzerland*, No. 1A.86/2004/col at 6 (Tribunal Fédéral June 8, 2004). The Court went on to assess a 5,000 Swiss Franc penalty on the Swiss Attorney General. *Id.*

Prior to implementing the Swiss Supreme Court’s ruling, the Swiss Attorney General contacted Defendant Russian Federation representatives and asked whether it had any additional evidence to warrant the freeze of the accounts. Defendant Russian Federation’s representatives did not offer such evidence and accounts containing approximately \$4.7 billion dollars were released.

In 2003, the Russian Federation also requested the Attorney General of Liechtenstein seize records located in Liechtenstein and relating to Khodorkovsky and Group Menatep’s alleged illegal activity. Menatep and Khodorkovsky objected and Liechtenstein’s highest court denied the request and held (i) that there were no facts presented underlying the alleged criminal offenses against Khodorkovsky and Lebedev, (ii) that “the suspicion arises that the alleged tax offenses do not even exist . . . and the other alleged crimes are mere allegations without substance,” and (iii) that the request by the Russian government was a “fishing expedition” and to grant the seizure request would amount to a violation of International Law. Case No. 12 RS.2003.255—ON 25 at 6 (Fürstliches Obergericht April 25, 2004).

*Political and Economic Motivations for Legal Cases*

One does not have to specialize in human rights issues to see that in these cases Russian authorities are not abiding by international standards relating to rule of law, but are instead approaching these cases politically. These proceedings exhibit a “Red Queen” approach to justice: “verdict first—evidence later.” These are not merely my conclusions, they are shared by essentially every outside observer. As the Parliamentary Assembly of the Council of Europe has recently found following an extensive fact-finding by a senior Rapporteur,

The circumstances of the arrest and prosecution of leading Yukos executives suggest that the interest of the State’s action in these cases goes beyond the mere pursuit of criminal justice, to include such elements as to weaken an outspoken political opponent, to intimidate other wealthy individuals and to regain control of strategic economic assets.<sup>9</sup>

Similar conclusions were reached late last year by the U.S.-based human rights organization, Freedom House. On December 20, 2004, Freedom House downgraded Russia’s status to “Not Free,” in its annual survey of global freedom. Russia was the only country to register a negative category change in 2004, moving from Partly Free to Not Free. In making the designation, Freedom House Executive Director Jennifer Windsor stated that “Russia’s step backwards into the ‘Not Free’ category is the culmination of a growing trend under President Vladimir Putin to concentrate political authority, harass and intimidate the media, and politicize the country’s law-enforcement system.” Freedom House described the arrest of Khodorkovsky as the event that “signaled the increasing politicization of the legal system,” and concluded that “the arrests and investigations in 2003 of Mikhail Khodorkovsky, the Yukos energy company, and the Menatep Group reinforced perceptions that the rule

<sup>9</sup>Europe Parliamentary Assembly, *Circumstances Surrounding the Arrest and Prosecution of Leading Yukos Executives*, Res. No. 1418 at ¶ 14 (January 25, 2005) (Appended hereto as Exhibit 2).



of law is subordinated to political considerations and the judiciary is not independent of the president and his inner circle.”<sup>10</sup>

The abnormal nature of the arrest and prosecution of Khodorkovsky, Lebedev and others affiliated with Yukos, as well as the treatment of other business leaders not affiliated with Yukos which has been held in violation of international law,<sup>11</sup> reflect the Russian authorities’ political motivations in prosecuting the Yukos-related defendants. But it is also worth looking at the processes of the trials themselves, because they raise the question of whether the founders of Menatep are in essence now political prisoners in Russia. As I appreciate it, the U.S. government is required by the Congress to make such human rights judgment on an annual basis, looking country-by-country. Last year, while expressing concern about the political nature of these cases, the U.S. State Department did not make a finding that Khodorkovsky, Lebedev and Pichugin were political prisoners. However, the facts that have emerged over the past twelve months, combined with what preceded them, may provide a basis for the U.S. government to give further consideration to that question.

Separately from the personal cases, there is the issue of the handling of Yukos by Russian authorities, its tax cases, and the forced auction of Yukos’ most important energy subsidiary, Yuganskneftegas, for a fraction of its actual value by Russian authorities to a shell company. This shell company in turn sold the subsidiary back to a state-owned enterprise, though there is no record that any payments were actually made in the purchases. Thus, the Russian government levied false taxes against Yukos, not lawfully due the government, as a strategy to steal its prime assets. These proceedings, too, were a sham, fundamentally unjust, and reflecting not just improper political motivations, but improper commercial ones as well, as I will discuss further later in this testimony.

#### *The Question of Political Imprisonment*

I wish to address here the question of the political imprisonment of Khodorkovsky, Lebedev, and Pichugin as part of the vendetta engaged in by Russian authorities against Group Menatep.

I understand that the State Department examines the existence of political prisoners in its Annual Country Reports on Human Rights Practices, usually without elaboration on the standard applied in making judgments about the existence of political prisoners in a country.<sup>12</sup> I have been advised that in 1992, in response to congressional concerns expressed about human rights conditions in Turkey, Assistant Secretary of State for Legislative Affairs Janet Mullins wrote a letter to the Chairman of the Subcommittee on Europe and the Middle East of the Committee on Foreign Affairs explaining the Department’s review and opinion on the situation or existence of political prisoners in Turkey. Ms. Mullins explained:

Our working definition of political prisoner is broadly inclusive. To summarize, it includes persons who are incarcerated without charges, or on charges for offenses commonly held to be matters of belief or for membership in a religious social, racial or national group. This definition extends our concern to persons prosecuted even under ostensibly internationally acceptable law when the charges are trumped up, or trial unfair. Our definition includes those convicted of politically motivated acts where the punishment is unduly harsh because of the person’s race, religion, nationality or social group.<sup>13</sup>

I have been advised that the U.S. continues to apply this working definition in assessing persons as foreign political prisoners.<sup>14</sup> Under this working definition, the trumped-up charges against Khodorkovsky, Lebedev and others affiliated with Yukos, the unfair nature of their trials, the political motivation of the authorities in the conduct of these cases, and the circumstances of their arrests, detention and trials, would appear to provide grounds for an assessment in the upcoming 2004 Report on Human Rights Practices in Russia that Khodorkovsky, Lebedev, and Pichugin are being held as political prisoners.

<sup>10</sup><http://www.freedomhouse.org/research/freeworld/2004/countryratings/russia.htm>.

<sup>11</sup> See e.g., *Gusinsky v. Russia*, Eur. Ct. H.R., April 29, 2004, all European Court of Human Rights cases cited are available at <http://www.echr.coe.int>.

<sup>12</sup> U.S. Department of State, Country Reports on Human Rights Practices: China (2003), available at <http://www.state.gov/g/drl/rls/hrrpt/2003/27768.htm>.

<sup>13</sup> 138 Cong. Rec. E2747 (September 22, 1992) (extension of remarks of Hon. Lee H. Hamilton on Human Rights in Turkey).

<sup>14</sup> Telephone interview with Peter Su, Office of Legislative Affairs, U.S. Department of State on January 27, 2005.

I understand that Congress may also request a report from the State Department that addresses the specific situation of these individuals. The more detailed criteria adopted by the Parliamentary Assembly of the Council of Europe (PACE) for identifying political prisoners, discussed below, may provide a useful analytical framework for U.S. government officials and members of the Senate to consider the question of whether these persons are political prisoners from the perspective of U.S. law.

PACE has adopted a series of objective criteria developed by a group of experts to define “political prisoners.”<sup>15</sup> According to PACE:

A person deprived of his or her personal liberty is to be regarded as a political prisoner:

- If the detention has been imposed in violation of one of the fundamental guarantees set out in the European Convention on Human Rights and its Protocols (“ECHR”), in particular freedom of thought, conscience and religion, freedom of expression and information, freedom of assembly and association;
- If the detention has been imposed for purely political reasons without connection to any offense;
- If, for political motives, the length of the detention or its conditions are clearly out of proportion to the offense the person has been found guilty of or is suspected of;
- If, for political motives, he or she is detained in a discriminatory manner as compared to other persons; or,
- If the detention is the result of proceedings which were clearly unfair and this appears to be connected with political motives of the authorities.<sup>16</sup>

In the cases of Khodorkovsky, Lebedev and others affiliated with Yukos and Group Menatep, all of whom are accused of non-political crimes, e.g., tax evasion, the last three criteria are the most strongly indicative of the status of these defendants as political prisoners. Each of the criteria is discussed further below.

#### *Detention Disproportionate to Offense Charged*

Under the third criterion, Khodorkovsky, Lebedev and others affiliated with Yukos and Group Menatep Limited should be held to be political prisoners because the manner in which Khodorkovsky and Lebedev were arrested, as well as their continued detention and treatment, are disproportionate to the non-violent economic crimes with which they are charged. Russia’s prolonged arbitrary detention of these individuals is a violation of international law, and, particularly with respect to Khodorkovsky, has been declared by PACE as a corroborated and serious shortcoming of the Russian proceedings.<sup>17</sup>

The European Court of Human Rights (“ECHR”) has described the prohibition on arbitrary detention contained in the European Convention of Human Rights to require release once detention ceases to be reasonable, and has ruled that the judicial officer before whom the arrested person appears must review the circumstances mitigating for or against detention, to decide by reference to legal criteria whether there are reasons to justify detention, and to order release if there are no such reasons.<sup>18</sup> Furthermore, according to the ECHR, “continued detention can be justified in a given case only if there are specific indications of a genuine requirement of public interest which, notwithstanding the presumption of innocence, outweigh the rule of respect for individual liberty laid down in Article 5 of the Convention. . . .”<sup>19</sup> The same prohibition against arbitrary detention is contained in the Universal Declaration of Human Rights (“Universal Declaration”)<sup>20</sup> and the International Covenant on Civil and Political Rights (“ICCPR”)<sup>21</sup> Even under Russian criminal law, I understand, pretrial detention is supposed to be exceptional, and is only sanctioned if it is impossible to find alternative means to guarantee appearance at trial.<sup>22</sup>

<sup>15</sup>Europe Parliamentary Assembly, Resolution 1359: Political Prisoners in Azerbaijan (January 27, 2004).

<sup>16</sup>Europe Parliamentary Assembly, Committee on Legal Affairs and Human Rights, Political Prisoners in Azerbaijan, Doc. No. 9826, App. 1 (June 6, 2003).

<sup>17</sup>Europe Parliamentary Assembly, Circumstances Surrounding the Arrest and Prosecution of Leading Yukos Executives, Res. No. 1418 at ¶ 8 (January 25, 2005) (Appended hereto as Exhibit 2).

<sup>18</sup>*Aquilina v. Malta*, Eur. Ct. H.R., April 29, 1999, ¶ 47.

<sup>19</sup>*Kalashnikov v. Russia*, Eur. Ct. H.R., July 15, 2002, ¶ 114; see also *L.A. v. France*, Eur. Ct. H.R., September 23, 1998, ¶ 102.

<sup>20</sup>G.A. Res. 217A, U.N. Doc. A/810, at art. 9 (1948) (hereinafter Universal Declaration).

<sup>21</sup>International Covenant on Civil and Political Rights, 999 U.N.T.S. 171, at art. 9(1) (1967) (hereinafter “ICCPR”).

<sup>22</sup>Russian Code, Article 108 (“[t]aking into custody as a measure of restriction shall be applied by the court towards the suspect or the accused of committing crimes, for which the criminal

In five hearings dealing with Lebedev's detention (July 3, August 28, October 28, and December 23, 2003, and June 23, 2004) and four hearings respecting Khodorkovsky's detention (October 25 and December 23, 2003, and March 19 and June 23, 2004), the court determined, and appellate courts upheld, that the defendants should continue to be detained.

These determinations were defective because they failed to address whether less extreme measures than detention could balance the defendants' rights to pretrial release against the interests of the judicial system as Russian, international, and U.S. law require. Khodorkovsky and Lebedev have been charged only with economic crimes and there has been no allegation of continuing crimes, yet they are being treated as posing serious threats to society and have now been in prison for 15 months and 19 months respectively.

#### *Discrimination in Detention and Prosecution*

Similarly, application of the second criterion suggests Khodorkovsky and Lebedev are political prisoners. Independent observers have described the Russian case against Yukos and its former executives as "a case of highly selective law enforcement," and have added that the prosecutors and the courts are "highly politicized."<sup>23</sup> Based on the investigation of its Rapporteur, PACE has resolved that these defendants have been, "in violation of the principle of equality before the law—arbitrarily singled out by the authorities."<sup>24</sup>

The crimes with which they are charged, to the extent that the charges are even cognizable, relate to the privatization of state-owned assets, tax evasion, and fraud. Khodorkovsky and Lebedev are being prosecuted for these alleged offenses while other individuals who engaged in similar alleged conduct have been left unscathed. As PACE has noted, "the allegedly abusive practices used by Yukos to minimize taxes were also used by other oil and resource companies operating in the Russian Federation which have not been subject to a similar tax reassessment, or its forced execution, and whose leading executives have not been criminally prosecuted."<sup>25</sup>

#### *Unfair Proceedings*

Lastly, application of the third criterion supports a finding that Khodorkovsky, Lebedev, Pichugin and others affiliated with Yukos and Group Menatep are political prisoners because the proceedings are devoid of fairness and have not been held before an open, independent, and impartial tribunal, with defendants enjoying unrestricted rights to counsel.

The Universal Declaration provides, "[e]veryone is entitled in full equality to a fair and public hearing by an independent and impartial tribunal, in the determination of his rights and obligations and any criminal charge against him."<sup>26</sup> It further provides, "[e]veryone charged with a penal offence has the right to be presumed innocent until proved guilty according to law in a public trial at which he has had all the guarantees necessary for his defense."<sup>27</sup> The ICCPR and the European Convention provide for the same rights.<sup>28</sup>

In the proceedings against Khodorkovsky and Lebedev, the Russian authorities' restriction of public access to pre-trial proceedings, interference with defense lawyers, and the manner in which evidence is presented against the accused, have been declared by PACE as corroborated and serious shortcomings of the Russian proceedings.<sup>29</sup>

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court envisages the punishment in the form of the deprivation of freedom for a term of over two years, *if it is impossible to apply a different, milder measure of restriction.*" (emphasis added)).

<sup>23</sup> Organization for Economic Cooperation and Development, Economic Survey Russian Federation 2004, available at [http://www.oecd.org/document/62/0,2340,en\\_2649\\_201185\\_32474302\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/62/0,2340,en_2649_201185_32474302_1_1_1_1,00.html).

<sup>24</sup> Europe Parliamentary Assembly, Circumstances Surrounding the Arrest and Prosecution of Leading Yukos Executives, Res. No. 1418 at ¶ 9 (January 25, 2005) (Appended hereto as Exhibit 2).

<sup>25</sup> *Id.* at ¶ 10.

<sup>26</sup> Universal Declaration, at Art. 10.

<sup>27</sup> Universal Declaration, at Art. 11(1).

<sup>28</sup> European Convention at Art. 6.

<sup>29</sup> Europe Parliamentary Assembly, Circumstances Surrounding the Arrest and Prosecution of Leading Yukos Executives, Res. No. 1418 at ¶ 8 (January 25, 2005) (Appended hereto as Exhibit 2).

*Right to an Independent Tribunal*

Most of the pre-trial detention hearings of the Yukos defendants were held in the Basmany Court in Moscow, whose judges are regarded by many independent observers as taking instructions from the Kremlin.<sup>30</sup>

The U.S. State Department has found that the Russian judiciary is “seriously impaired by a shortage of resources and corruption, and still subject to influence from other branches of Government.”<sup>31</sup> There is substantial question over whether the courts will independently hear the cases against Khodorkovsky, Lebedev and their colleagues. The performance of the courts in the repeated denial of bail for the defendants, the refusal to allow an independent medical evaluation of Lebedev (who was in the hospital at the time of his arrest and is believed to suffer from hepatitis and other illnesses), and the fact that the same judge was assigned the Khodorkovsky and Lebedev cases (which were initially separate trials), as well as other facts, call into question the independence of the court that will try these defendants.

*Right to Open and Public Proceedings*

PACE has declared the “unjustified restrictions on the publicity of certain court proceedings” involving Khodorkovsky, Lebedev and others affiliated with Yukos and Group Menatep as a serious violation by Russian authorities of applicable human rights standards.<sup>32</sup>

As discussed above, the pretrial hearings against Khodorkovsky and Lebedev took place in closed sessions of the Basmany Court, and sometimes even defense attorneys were excluded. Meanwhile, Pichugin’s entire trial has been held *in camera* and most of the evidence in the case has been classified.

*Denial of the Assistance of Counsel*

Restrictions on the ability of the lawyers for Khodorkovsky, Lebedev and others affiliated with Yukos and Group Menatep Limited to meet with their clients, denial of access of Lebedev’s lawyers to the court room during a hearing, and the search and seizure of documents from a lawyer’s office have been declared by PACE as examples of additional serious shortcomings in the proceedings against the defendants.<sup>33</sup>

Attorneys for Yukos have had their offices searched and files seized and, Svetlana Bakhmina, deputy general counsel of Yukos, has been arrested. Just this month the British Law Society and the International Bar Association called upon Russian authorities to release Ms. Bakhmina.

*Russian Motivations*

As my testimony has now outlined, the tax charges against Yukos and the criminal cases against Khodorkovsky and Lebedev brought by Russian authorities are not about the pursuit of justice or the tracking down of a corporate scofflaw. These actions of the Russian government are about something quite different. They are means to an end, and that end is the solidification of power by the persons currently in charge of the Russian government through the elimination of economic and political competition.

It is easier to see this when one focuses on what Group Menatep was trying to accomplish in its approach to business. In a nutshell, it was an approach in which the company treated its assets as belonging to its shareholders, not to any government, individual, or grouping, including management. Given this focus, Group Menatep had to be both transparent and extremely competitive. Its major energy asset, Yukos, competed directly against major state-owned energy companies, such as the oil company Rosneft, the pipeline company Transneft, and the gas company Gazprom. Yukos became an effective and aggressive competitor to state owned companies, and was on its way to becoming a partner with non-Russian oil firms. The

<sup>30</sup> Anna Neistat (Director of the Moscow office of Human Rights Watch), Russia: Yukos Trial Begins Amidst Rights Rollback (on the trials of Mikhail Khodorkovsky and Platon Lebedev, “if it’s anything like most trials in Russia it is unlikely to showcase the judiciary’s independence. More likely, defense arguments will be downplayed, most of its motions overturned, and the outcome will have little to do with the hearing and a lot with executive will”), available at <http://www.hrw.org/english/docs/2004/06/16/russia8852.htm>.

<sup>31</sup> U.S. Department of State, Country Reports on Human Rights Practices: Russia at Introduction (February 25, 2004), available at <http://www.state.gov/g/drl/rls/hrrpt/2003/27861.htm>.

<sup>32</sup> Europe Parliamentary Assembly, Circumstances Surrounding the Arrest and Prosecution of Leading Yukos Executives, Res. No. 1418 at ¶ 8(vi) (January 25, 2005) (Appended hereto as Exhibit 2); but see *Lebedev v. Russia*, Eur. Ct. H.R., Application No. 4493/04 (November 25, 2004).

<sup>33</sup> Europe Parliamentary Assembly, Circumstances Surrounding the Arrest and Prosecution of Leading Yukos Executives, Res. No. 1418 at ¶ 8 (January 25, 2005) (Appended hereto as Exhibit 2).

vision of a substantial Western presence in the Russian oil industry deeply disturbed the Russian government. In fact, the actions against Khodorkovsky, Lebedev, and their associates derailed the proposed acquisition of Sibneft by Yukos and scuttled the purchase of a substantial block of Yukos stock by a major U.S. oil company. In addition, Yukos' production and distribution decisions, based on market forces, have often clashed with the dictates of the Russian state as it attempts to control access to its energy resources to curry international favor or to punish countries that had fallen from grace with the current Russian authorities.

Because Yukos was focusing on meeting its obligations to its international shareholders, regardless of their location, Yukos had a number of serious disputes with the oil company Rosneft, the only Russian domestic oil company wholly-owned by the Russian state. Yukos' relations with Rosneft deteriorated significantly in 2002 and 2003, and Rosneft appears to have played an important role in the initiation of the persecution of the Yukos officials. As I have already mentioned, it was Rosneft that ended up acquiring Yuganskneftegas when it absorbed Baikal Finance Group, the front company that had purchased Yuganskneftegas.

Yukos had also clashed with Transneft, the wholly state-owned pipeline company responsible for the distribution of 93 percent of all oil produced in Russia. The Russian government's control of Transneft has enabled it to maintain control, through quotas and other mechanisms, of oil distribution both domestically and internationally, and to collect taxes and fees on oil production, transport and export. The Russian government has used the distribution channels of oil and gas as a strong foreign policy tool, particularly in its dealings with its neighbors in the former Soviet Union and Eastern Bloc countries. Ukraine gets most of its energy from Russia and the Russian government provides discounted sales of oil and gas to the central Asian republics as a means of maintaining influence in these countries. Therefore, when Yukos challenged Transneft proposed plans for pipelines, it was in fact challenging a vital aspect of Russian foreign policy. For example, after the Russian authorities rejected a proposal for a pipeline to Murmansk, intended to facilitate oil exports to the West, Khodorkovsky announced his intent for Yukos to privately finance and construct the line.

The most significant conflict between Transneft and Yukos had been over the construction of pipelines to China and Japan. While Yukos had been championing a proposed pipeline to China, Transneft had for many years stated its intention to build a much longer pipeline from Eastern Siberia to a Pacific export point to serve the Pacific Rim market. Both China and Japan actively lobbied the Russian government over the pipeline route and it appears that in the end, both countries got at least a part of what they wanted. It was recently announced that the pipeline will stretch to the Pacific, bypassing China. However, Rosneft, using the assets of Yuganskneftegas, recently signed a long-term oil supply agreement with the Chinese. The Japanese and Chinese have returned the favors bestowed upon them by the Russian government with pledges of financing for the development of Russia's energy sector.

The largest company in Russia is the state controlled gas giant, Gazprom. Gazprom has viewed Yukos as a threat to its gas monopoly and also wants to break into the oil business. Yukos is perceived as a threat to Gazprom because of its ability to produce gas cheaper than Gazprom and also because Yukos was exploring the idea of building a pipeline to the Arctic Ocean where its gas could be liquefied at a terminal and exported to Europe. Such a project would place Yukos in competition with Gazprom in the sale of gas to Europe and allow Yukos to completely bypass Gazprom's pipelines.

While I have outlined above the economic and geopolitical motivations of the Russian government in targeting Yukos, it is important to note that just because the Russian government has been successful in hobbling Yukos, this does not mean that the government is finished in its quest to gain control of Russian oil fields and pipelines. This is clearly seen in last week's declaration by the Russian government that only companies that are majority owned by Russians will be allowed to participate in tenders for oil and mineral rights. As the state's control over the Russian oil industry grows, decisions in the industry will become less and less about market forces and, instead, will be increasingly driven by Russia's international policy aspirations.

The Russian authorities have also been motivated to move against Yukos in its attempt to silence political opponents of the current regime. The Russian authorities considered Khodorkovsky, Lebedev and their colleagues to be ideological and political opponents. Khodorkovsky was seen as a potential future political threat to the current government due to his economic support of liberal candidates for the Duma and the Presidency. As chairman of Yukos, he engineered reforms that brought transparency, corporate governance, Western management and global investments.

By contrast, the current Administration favors increased state control of the economy and the subordination of political and economic institutions to the will of the executive. The arrest of Lebedev was seen as a warning to Khodorkovsky to step down and/or flee Russia as had other persecuted oligarchs. Instead of heeding this warning, Khodorkovsky continued to openly criticize the Russian authorities and, despite many opportunities to do so, refused to go into exile.

Prior to his arrest and incarceration, Khodorkovsky was an active critic of Russia's current President and funded opposition parties, including the Union of Rightist Forces (SPS) and Yabloko. In addition, Khodorkovsky had many allies in the Duma and it was rumored that he was in favor of limiting the power of the Russian presidency by moving the country towards a parliamentary democracy.<sup>34</sup> He was also widely believed to have political aspirations himself, including the Russian presidency. Khodorkovsky's role in opposition politics was expressly cited in the U.S. State Department's 2003 Human Rights Report which stated that "[o]pposition parties, particularly those receiving funding from some so-called oligarchs, were seriously hampered by the investigation and arrest of Yukos President Mikhail Khodorkovsky, a step widely believed to have been prompted, at least in part, by the considerable financial support he provided to opposition groups."<sup>35</sup>

While it is hard to determine whether the Russian government has gone after Lebedev and Khodorkovsky to get at the assets of Yukos, or if the campaign against Yukos was an attempt to weaken Khodorkovsky, the end result is that the government has used its ongoing investigation of Yukos as leverage against Lebedev and Khodorkovsky in their criminal proceedings. The tax case against Yukos has never been about the reclamation of taxes, but instead has been a naked attempt to destroy Group Menatep, its shareholders, and Yukos, thereby eliminating a major source of support for Khodorkovsky and also renationalizing strategic assets.

These cases are part of a continuing pattern of the consolidation of power by the Kremlin. The Kremlin now controls the press, and to a great degree, the Russian energy sector.

#### GROUP MENATEP RESPONSE

The Board of Group Menatep has made every possible good faith effort to reach an amicable settlement with the Russian authorities. To that end, we asked the former Prime Minister of Canada, Jean Chretien, to act as an intermediary in opening discussions with the Russian government. Prime Minister Chretien met with President Putin in the Kremlin on July 5th of last year. Also present at the meeting was Alexei Miller, president of Gazprom. Over lunch, the President agreed that his government would review in good faith any proposals by Yukos to resolve the tax and other legal issues then outstanding. Prime Minister Chretien had numerous subsequent telephone conversations with President Putin and wrote him several letters. More than 50 proposals to resolve the outstanding claims against Yukos were sent, some of them directly to President Putin's office. All of these efforts yielded no response from the Russian government. After several months, we could only conclude that the Government's campaign against the company had nothing to do with legitimate tax collection or fair minded prosecution of alleged financial crimes, and instead serves the Government's political ends, which were, and remain, the expropriation of Yukos and the destruction of Group Menatep and its shareholders.

Any hopes that the Yukos affair would be settled in a reasonable and legal fashion were finally crushed last December, when the Government ordered the sale of Yuganskneftegaz, Yukos' largest and most valuable oil production arm, as detailed above. None of the money realized by the sale will go to Yukos or its shareholders. Ostensibly it will be used to repay the inflated tax arrears and arbitrary penalties which the Russian Government imposed on Yukos to justify the sale in the first place. Indeed, every effort to appeal the tax assessments and other proceedings against Yukos in the Russian courts has been summarily denied except one, when a brave judge did rule against a particularly egregious government decision; in that one case, the judge was quickly dismissed and his ruling overturned.

As a result, on February 9 of this year, Group Menatep proceeded to file a claim against the Russian Federation under the terms of the 1994 Energy Charter Treaty. Group Menatep's claims are based on the Russian Federation's failure to protect the company's investments in Russia, and specifically the expropriation of Yuganskneftegaz. The claims seek compensation of approximately US \$28.3 billion.

<sup>34</sup> Dr. Martha Brill Olcott, *The Energy Dimension in Russian Global Strategy*, Vladimir Putin and the Geopolitics of Oil, The James A. Baker III Institute for Public Policy, October 2004.

<sup>35</sup> U.S. Department of State, *Country Reports on Human Rights Practices: Russia* at § 3 (February 25, 2004), available at <http://www.state.gov/g/drl/rls/hrrpt/2003/27861.htm>.

Under the terms of the Treaty, breaches by the Russian Federation of its international obligations entitle the Claimants to the payment of prompt, adequate and effective compensation. Under Article 26 of the Energy Charter Treaty, disputes can be referred to international arbitration if they are not settled amicably between the disputing parties within 3 months of a notification of claim. The Claimants delivered original notifications to the Russian Federation on November 2, 2004. Since then, the Russian Federation has totally ignored the notifications and has failed to settle amicably the dispute.

Group Menatep will pursue the ECT claim and all other available legal remedies in jurisdictions around the globe, using all means at our disposal. Our objective is to protect the company's remaining assets, seek compensation for the losses Group Menatep has incurred in the Russian Federation and demonstrate to the world that Yukos, Group Menatep and its shareholders have been the victims of an illegal, politically motivated campaign by the Russian Government outside the bounds of accepted international norms, behavior and custom.

#### IMPACT ON THE U.S.

The detrimental impact of the "Yukos affair" has been widely reported in the media, as have its repercussions for Russia's relations with the West. Not only have U.S. shareholders—including public pension funds—been directly and negatively impacted, but the actions of the Russian authorities show a flagrant disregard for rule of law, as the circumstances around the auction of Yuganskneftegas clearly demonstrate. Along with my remarks, I am submitting for the record today a handful of media reports on the Yuganskneftegaz auction that refer to the "farcical" nature of the Russian authorities' conduct (Financial Times, December 20, 2004). As a majority owner in Yukos, Group Menatep has seen the value of its stake plummet.

In my role as a Director of Group Menatep, I have duties and obligations to the company. Investors rely on the integrity of the company itself and on its public filings with securities regulators. But they also rely on the political and legal systems in the countries in which such companies operate, for if rule of law is not followed and property rights are not protected in a country, the whole international system for attracting and protecting foreign investment breaks down.

The U.S. has been a leader in the development of this international system, and has worked to bring Russia into it through economic agreements designed to protect investors from such risks as expropriation of their assets by state authorities. These include the United States' Treaty with the Russian Federation Concerning the Encouragement and Reciprocal Protection of Investment which expressly is designed to protect American investors from such risks in Russia, and which provides as follows in relevant part:

Investments shall not be expropriated or nationalized either directly or indirectly through measures tantamount to expropriation or nationalization ("expropriation") except for a public purpose; in a nondiscriminatory manner; upon payment of prompt, adequate and effective compensation; and in accordance with due process of law and the general principles of [non-discriminatory] treatment. . . .<sup>36</sup>

Despite Russia's signing this treaty in Washington on June 17, 1992, the treaty did not go before the Russian Duma for serious consideration of its ratification under Russian law until 2003, and it has yet to be ratified.

This treaty is clearly intended to protect U.S. investments in Russia including securities of a Russian company held by U.S. nationals. By our estimates, approximately 15 percent of Yukos' shares are owned by U.S. nationals. Accordingly, regardless whether the Duma has ratified the treaty, Russia's expropriation and nationalization of Yukos would appear to constitute a failure by Russian authorities to comply with the treaty obligation that Russian representatives undertook in 1992.<sup>37</sup> These actions have directly harmed U.S. nationals whose interests were protected in theory by that treaty.

I do not know whether the U.S. government is concerned about this apparent violation by Russia of its duties to the U.S. under the Bilateral Investment Treaty or the fact that Russia has failed to ratify this treaty after nearly 15 years. While the issue of whether private individuals have remedies available to them under the treaty notwithstanding its ratification status in Russia is currently being studied,

<sup>36</sup>Treaty with the Russian Federation Concerning the Encouragement and Reciprocal Protection of Investment, TIAS 11471, at Art. III(1); Treaty Doc. 102-33 (June 17, 1992).

<sup>37</sup>I note that under article 18 of the Vienna Convention on the Law of Treaties, May 23, 1969, 1155 U.N.T.S. 331, a State is obliged to refrain from acts which would defeat the object and purpose of a treaty it has signed pending ratification.

it is clear that if the U.S. concludes that Russia is not living up to its responsibilities under the Treaty, or that Russia is not even taking seriously the practice of treaty making, it has a number of remedies available to it. These could include deferring decisions to grant Russia additional economic privileges, given its apparent inability or unwillingness to abide by one of the most basic provisions of a bilateral investment treaty—the prohibition on expropriation without compensation.

Mr. Khodorkovsky was a leading proponent for Russia's integration into world markets, and particularly for closer ties with the U.S. and the West, another factor mentioned as a possible catalyst for his arrest. This sends a chilling signal to Russia's business leaders and discourages the sort of open and collaborative economic relationship that would be of mutual benefit to the U.S. and Russia.

As Mr. Theede explained, energy security is another critical factor in the "Yukos affair." The Russian Government's desire to renationalize energy assets held by Yukos was, in my personal view, an important motivating factor for the attacks on Group Menatep. Whereas under Mr. Khodorkovsky's leadership, Yukos was exploring new ways of cooperating with the U.S., including the diversification of Russian export markets through the construction of pipelines to supply both the east and west coasts of the United States, we now have a situation whereby these decisions will be made based on Russian foreign policy objectives and internal politics, not markets. Indeed, just this past week, the Russian Government announced that only majority owned Russian oil firms will be allowed to bid on exploration contracts later this year—an announcement rightly seen as extremely worrisome by major news media and Western analysts alike.

#### U.S. REACTION

As I have previously mentioned, I am not an expert in foreign policy and would not presume to make recommendations on United States policy towards Russia. However, it is widely acknowledged by such experts that the attacks on Group Menatep and its leadership are selective and politically motivated. It is increasingly clear, moreover, that the "Yukos affair" is not a one-off occurrence, but rather forms part of a concerted effort to reclaim state control over Russia's energy sector for both strategic reasons and personal enrichment. It may be that the United States government finds expropriations, unfair arrests, prosecutions and trials, and consolidation of key sectors in Russia's economy under state control to have national security implications. It is obvious that U.S. interests will continue to be dramatically affected until the Yukos "affair" is resolved in a manner consistent with international standards and rule of law.

A wide array of commentary points to the negative impact this matter is having on capital flight out of Russia, foreign investment into Russia and U.S.-Russia energy cooperation. U.S. minority shareholders in Yukos have also lost a great deal of money, among them public pension funds such as the State of Ohio.

Hearings such as these send an important signal to the Kremlin that the U.S. is closely watching its actions and is vitally concerned about rule of law, as well as property and human rights in Russia.

The upcoming Summit meeting of Presidents Bush and Putin will provide another opportunity for the United States to raise these concerns, and I would hope you will urge President Bush to send a strong signal when he meets with President Putin next week.

Given the current ominous trends in Russia, I note that many experts have called into question Russia's accession to the WTO, its participation in the Group of Eight, and in particular its hosting of the G8 meeting in 2006. As rules based organizations and a grouping of the world's leading democracies respectively, my personal experience has provided a stark example as to why the Russian Federation is not currently a suitable candidate for either.

I thank you for the opportunity to testify here today, and once again, am grateful for the interest and attention this matter is receiving.



## REPORT OF THE COUNCIL OF EUROPE PARLIAMENTARY ASSEMBLY

The Circumstances Surrounding the Arrest and Prosecution of Leading Yukos Executives

Doc 10368 Addendum, 24 January 2005

Addendum to Report: Committee on Legal Affairs and Human Rights. Rapporteur: Mrs. Sabine Leutheusser-Schnarrenberger, Germany, Liberal, Democratic and Reformers Group

## A. INTRODUCTION

1. Following the adoption of the report in the Committee for Legal Affairs and Human Rights on 25 November 2004, a number of events have prompted me to present the following additional information to the Assembly.

## B. REPLY OF THE FEDERAL TAX SERVICE

*i. Comparative tax burdens on Yukos and its competitors*

2. On 5 January 2005, the Rapporteur received a reply to the questions I had asked the head of the Federal Tax Service, Mr. Serdyukov, following my visit to Moscow in September.

3. As regards the requested official figures on the comparative tax burden for oil producing companies, the reply was evasive.

4. The question on Yukos' tax burden before and after the reassessments was not answered because of the confidentiality of such information; I was encouraged to obtain the information from the taxpayer itself, i.e. from Yukos.

5. I had already received this information from Yukos' CEO Steven Theede and the CFO, Bruce Misamore, during my visit to Moscow in September. My question to the Federal Tax Service was intended to cross-check the information provided by Yukos, in line with my quest for utmost fairness and objectivity. I take it that if the information provided by Yukos, which I published in the Explanatory Memorandum with the proviso that confirmation by the Federal Tax Service was still outstanding, were false, Mr. Serdyukov would have said so in his reply.

6. I must therefore assume that the total tax burden for Yukos, including the retroactive reassessments, is indeed about triple that of its Russian competitors and that the total tax burden for 2002 exceeds Yukos' turnover for that year.

*ii. Temporary reprieve for taxpayers threatened by financial difficulties*

7. The reply to my question regarding the legal possibility of temporary reprieve for taxpayers threatened by financial difficulties following tax reassessments is clear: The law does not allow for any such reprieve if procedures for criminal tax evasion have been instituted.

8. While the answer is quite clear, the categorical exclusion of any payment facilities to avoid bankruptcy for the sole reason of the opening of criminal proceedings raises legal issues concerning the principles of proportionality and the presumption of innocence (Article 6 paragraph 2 of the ECHR).

*iii. Treatment of other Russian oil companies having used the same tax minimisation schemes*

9. In reply to my question, whether other Russian oil companies, and if so which ones, had been subjected to similar reassessments and their executives criminally prosecuted, given that we had been told that other oil and resource companies had used the same tax minimisation schemes, I was given detailed legal explanations, underpinned by copies of judgments of different Russian and CIS courts, according to which agreements between local and regional authorities granting individual taxpayers privileges with regard to federal taxes are, legally, invalid.

10. The question of the legality, in tax law, of the tax minimisation schemes used by Yukos, as well as many other resource extraction companies between 2000 and 2002, was neither the subject of my question, nor even of my report. The reply mentions some other companies whose agreements with local authorities have been declared unlawful. But the core of my question—whether Yukos' competitors and their leading executives have been subjected to the same excessive enforcement measures and even criminal prosecutions, has not been addressed.

11. I must therefore conclude that Yukos and its leading executives have indeed been "arbitrarily singled out by the authorities," as it is said in paragraph 9 of the draft resolution.

C. NEW DEVELOPMENTS AND FURTHER INFORMATION RELATING TO “THE CIRCUMSTANCES SURROUNDING THE ARREST AND PROSECUTION OF LEADING YUKOS EXECUTIVES”

*i. Sale of Yugansneftegaz*

12. What was still not certain at the time the Committee on Legal Affairs and Human Rights adopted the report—i.e. that Yukos’ principal asset, its oil-producing subsidiary Yugansneftegaz, would be sold off below market value to players closely linked to the Kremlin, has meanwhile turned into actual fact: On 19 December 2004, “Baikal Finance Group,” registered under an address in Twer in central Russia, which houses a fast-food joint (“Café London”), a mobile phone shop and the liquor store “Dionis,” successfully bought Yugansneftegaz for € 7 bn, i.e. less than half of the “fair value” estimated *inter alia* by Dresdner Kleinwort Wasserstein at an auction in which other potential bidders, including from abroad, were discreetly “discouraged” from participating. Reportedly, the detour via Baikal Finance Group and Rosneft, the State-owned oil company to whom the original buyers are said to have transferred Yugansneftegaz, had become necessary after Gazprom and international banks supporting Gazprom’s expected bid had been discouraged from acting overtly as buyers by an injunction pronounced by a Texan court a few days before the auction pronounced at the request of Yukos. At the end of the day, Yugansneftegaz has been effectively renationalised.

13. The auction and the proceedings leading up to it have been widely criticised internationally, for example by the spokesperson of the U.S. State Department, who highlighted the lack of transparency and independence of the courts leading to a loss of confidence of foreign investors, and by the Finnish Minister for Foreign Affairs, Erkki Tuomioja, who said that the renationalisation of Yukos was not the right way to promote foreign investment in Russia. Kremlin economic advisor Illarionov and Economic Affairs Minister German Gref also criticised the handling of the Yukos affair and the sell-off Yugansneftegaz, recalling that the State had proved to be an “inefficient” owner of key industrial assets. Mr. Illarionov was reportedly recently demoted and lost his function as the Russian “sherpa” for the G8 economic summit process.

*ii. European Court of Human Rights asking for explanations from the Russian authorities*

14. On 14 December 2004, the Court, which had granted the Yukos case priority in July 2004, asked the Russian authorities for explanation on six substantive points arising from the company’s April 2004 application. The questions concern, *inter alia*, the fairness of the hearings before the competent Russian courts, and issues related to the deprivation of property (Article 1 of Protocol 1 ECHR), and to the principle of *nullum crimen, nulla poena sine lege* (Article 7 of the ECHR).

*iii. New developments in the court proceedings—allegations of increased pressures on lawyers and witnesses*

15. On 12 January 2005, Mr. Khodorkovsky—who has rarely taken the floor in the courtroom until now—made a statement bitterly accusing the State organs of having destroyed the very riches that they say they want him to return. Citing numerous procedural violations by the prosecution tolerated by the court, he said that he lost all faith in the authorities’ objectivity. In the interest of the country, society and the prosecution and courts themselves, he called for a truly independent judiciary. Prosecutor Shokhin replied via Interfax that Mr. Khodorkovsky, in order to avoid punishment, just tried to blacken those who perform their duty.

16. On 14 January 2005, it was announced that new criminal charges for money laundering (article 174 part 1 of the Russian Criminal Code, i.e. legalisation of proceeds of crime) would be brought against Mr. Khodorkovsky and Mr. Lebedev.

17. On 18 January 2005, Mr. Robert Amsterdam, international legal counsel for Mr. Khodorkovsky and Mr. Lebedev, sent me a written statement with fresh allegations of increased pressures on lawyers working on the Yukos case and witnesses of the defense.

RESOLUTION 1418 (2004)

1. The Parliamentary Assembly, reaffirming its commitment to the Rule of Law as one of the Council of Europe’s core values, is concerned by the shortcomings of the Judicial process in the Russian Federation revealed by the cases of several former Yukos executives.

2. The rule of law requires the impartial and objective functioning of the courts and of the prosecutors’ offices, free from undue influences from other branches of

government and the strict respect of procedural provisions guaranteeing the rights of the accused.

3. The Rule of Law includes the equality of all before the law, regardless of wealth or power.

4. The right to a fair trial, as protected by Article 6 of the European Convention on Human Rights (ECHR), includes the right to a fair and public hearing by an independent and impartial tribunal established by law, the presumption of innocence and adequate time and facilities for the preparation of the defence. A fair trial requires respect of the rights of the defence, the privileged lawyer-client relationship and the equality of arms between defence and prosecution.

5. The public character of judicial proceedings, as guaranteed by Article 6 of the ECHR, is an important element of a fair trial, in the interests of the accused, but also of the public at large and its confidence in the correct functioning of the judiciary.

6. The Assembly stresses the importance of the independence of the judiciary and of the independent status of judges in particular and regrets that legislative reforms introduced in the Russian Federation in December 2001 and March 2002 have not protected judges better from undue influence from the executive and have even made them more vulnerable. Recent studies and highly publicised cases have shown that the courts are still highly susceptible to undue influences. The Assembly is particularly worried about new proposals to increase further the influence of the President's administration over the judges' qualification commission.

7. Facts pointing to serious procedural violations committed by different law enforcement agencies against Mr. Khodorkovsky, Mr. Lebedev and Mr. Pichugin, former leading Yukos executives, have been corroborated during fact-finding visits whilst some allegations appear to have been exaggerated by the defence team. On balance, the findings put into question the fairness, impartiality and objectivity of the authorities which appear to have acted excessively in disregard of fundamental rights of the defence guaranteed by the Russian Criminal Procedure Code and by the ECHR.

8. The most serious corroborated shortcomings include the following:

i. Despite specific requests of the defence lawyers, tests were not carried out in good time that could have established whether or not Mr. Pichugin had been injected with psychotropic drugs; Mr. Pichugin was also held in the "Lefortovo" prison that is not subject to the usual controls of the Ministry of Justice and remains under the direct authority of the Federal Security Service (FSB), contrary to a specific commitment the Russian Federation undertook when joining the Council of Europe;

ii. Shortcomings in medical attention to Mr. Lebedev in prison: In the face of serious concern about Mr. Lebedev's deteriorating state of health, the prison authorities have so far refused to allow an examination of Mr. Lebedev by independent doctors, despite repeated requests;

iii. Delays in obtaining the prosecutor's permission have prevented the lawyers from entering into contact with their clients during a particularly critical time after their arrests, making it more difficult for them to organise their defence; a legislative reform abolishing the requirement of a prior permission from the prosecutor's office for a lawyer to visit his or her client in prison has not been applied in practice, at least not in the cases of the former Yukos executives;

iv. Denial of access of Mr. Lebedev's defence lawyers to the courtroom during the hearing deciding on his pre-trial detention;

v. Search and seizure of documents in the defence lawyers' offices, summons of lawyers for questioning on their clients' cases and alleged eavesdropping against defence lawyers: The prosecution must not be allowed to circumvent the lawyer-client privilege by a simple play on case file numbers, especially when the cases are as closely related to one another as the criminal cases against MM. Khodorkovsky, Lebedev and Pichugin and the tax cases against Yukos and its subsidiaries;

vi. Unjustified restrictions on the publicity of certain court proceedings: Members of the public have had extremely limited access to certain hearings that were announced as public whilst other hearings were or are being held *in camera* in the first place. In particular, all proceedings against Mr. Pichugin have been held *in camera* even though only a small portion of the case file has been classified as secret; his lawyers have been placed under strict instructions not to discuss the proceedings in public, even the reasons of the final judgment may be kept secret;

vii. Denial of bail (in particular regarding Mr. Khodorkovsky): Mr. Khodorkovsky was placed in pre-trial detention several months after Mr.

Lebedev's arrest on very similar grounds, an arrest that media reports interpreted as a "warning" to Mr. Khodorkovsky. Mr. Khodorkovsky's conduct showed that there was no risk of absconding or of interfering with evidence. After the completion of the pretrial investigation, Mr. Khodorkovsky and Mr. Lebedev were kept in custody which raises additional issues in light of the judgments of the European Court of Human Rights in the cases of *Kalashnikov v. Russia* and *Letellier v. France*. Also, following a recent legislative reform, persons accused of nonviolent "economic crimes," such as those allegedly committed by Mr. Khodorkovsky, are generally not placed in pre-trial detention;

viii. Other unfair features of the trials against Mr. Khodorkovsky, Mr. Lebedev and Mr. Pichugin: The court systematically allows the prosecutor to read out the minutes of the pre-trial interrogation of witnesses and to put pressure on the witness in the courtroom to simply confirm those minutes. This undermines the effectiveness of the right of the defence to question witnesses of the prosecution, whose pre-trial interrogation they are generally not able to attend. The defence lawyers are also not allowed to exchange written notes with the accused in the pre-trial detention centre and in the courtroom. They can only exchange notes after the court has first read them.

9. The Assembly notes that the circumstances surrounding the arrest and prosecution of the leading Yukos executives strongly suggest that they are a clear case of non-conformity with the Rule of Law and that these executives were—in violation of the principle of equality before the law—arbitrarily singled out by the authorities.

10. In particular, the allegedly abusive practices used by Yukos to minimise taxes were also used by other oil and resource companies operating in the Russian Federation which have not been subjected to a similar tax reassessment, or its forced execution, and whose leading executives have not been criminally prosecuted. Whilst the law was changed in 2004 and the alleged "loophole" thus closed, the incriminated acts date back to 2000 and retrospective prosecution started in 2003.

11. Intimidating action by different law enforcement agencies against Yukos and its business partners and other institutions linked to Mr. Khodorkovsky and his associates and the careful preparation of this action in terms of public relations, taken together, give a picture of a coordinated attack by the State.

12. The criminal charges laid against persons who made use of the possibilities offered by the law as it stood at the time of the incriminated acts, following a retroactive change of the tax law, raises serious issues pertaining to the principle of *nullum crimen, nulla poena sine lege* laid down in Article 7 of the ECHR and also to the right to the protection of property laid down in Article 1 of the First Protocol to the ECHR.

13. The circumstances of the sale by auction of Yuganskneftegaz to "Baikal Finance Group" and the swift take-over of the latter by State-owned Rosneft raises additional issues related to the protection of property (ECHR First Protocol Article 1). This concerns both the circumstances of the auction itself, leading to a price far below fair market value, and the way Yukos was forced to sell off its principle asset, by way of trumped-up tax reassessments leading to a total tax burden far exceeding that of Yukos' competitors, and for 2002, even exceeding Yukos' total revenue for that year.

14. In view of paragraphs 8–12 above, the Assembly considers that the circumstances of the arrest and prosecution of leading Yukos executives suggest that the interest of the State's action in these cases goes beyond the mere pursuit of criminal justice, to include such elements as to weaken an outspoken political opponent, to intimidate other wealthy individuals and to regain control of strategic economic assets.

15. The Assembly recognises the right, and even the duty, of the law enforcement bodies to bring to justice the perpetrators of criminal offences. It also recognises the legitimate right of the elected political leadership to pursue its political objectives, including in the economic sphere. However, it strongly objects to the use of law enforcement procedures for such purposes. In this context, reference is made to the judgment of 19 May 2004 of the European Court of Human Rights in the *Gusinskiy* case in which the Court found that the detention in remand of N-TV founder Gusinskiy violated Article 5 of the ECHR because it had established that the applicant's prosecution had been used to intimidate him into selling off his stake in N-TV to Gazprom.

16. The Assembly therefore, in general terms,

i. Calls upon the Russian authorities to vigorously pursue and implement reform of the legal and judicial system and of law enforcement agencies with a view to strengthening the Rule of Law and the protection of human rights and

to continue co-operating with the Council of Europe, in the framework of ongoing programmes;

ii. Encourages the courts to assert their independence vis-a-vis the executive authorities in assessing the guilt or innocence of all accused persons, applying the law in conformity with the European Convention on Human Rights;

iii. Invites the authorities in charge of pre-trial detention centres to ensure that lawyers' access to their clients in detention is no longer subjected to any conditions not prescribed by law, notably to prior authorisation or recommendation by the public prosecutor, and to provide the conditions for the effective exercise of the defence rights of the persons in their custody, including the respect of the privileged relationship between lawyers and their clients;

iv. Urges the competent authorities to ensure that all pre-trial detention centres, including Lefortovo isolation centre in Moscow, be subject to supervision by the Ministry of Justice, in line with earlier commitments by the Russian Federation.

17. As regards more specifically the cases of the former leading Yukos executives, the Assembly:

i. Requests the executive, authorities of the Russian Federation to guarantee the full independence of the judicial proceedings against leading Yukos executives from any attempt to influence them and to take measures to stop any such attempt;

ii. Requests the public prosecutors to carry out their work in these proceedings in a professional, impartial and objective manner, respecting the letter and the spirit of the procedural protections for the accused laid down in the Russian Criminal Procedure Code and the European Convention on Human Rights and the principles set out in Recommendation (2000)19 of the Committee of Ministers on the role of public prosecution in the criminal justice system;

iii. Calls upon the courts to ensure effective public access to the hearings in the proceedings against the leading Yukos executives;

iv. Urges the competent authorities to ensure in particular that only those parts of the trial against Mr. Pichugin remain closed to public scrutiny which are directly linked to information for which there is a legitimate need for secrecy, taking account the importance attached to the principle of open court hearings by the European Convention on Human Rights;

v. Urges the competent authorities to allow immediately an independent medical assessment of Mr. Lebedev's state of health.

#### RECOMMENDATION 1692 (2005)

1. The Parliamentary Assembly, referring to its Resolution 1418 (2005), recommends that the Committee of Ministers in general terms:

i. Continue offering to the Russian Federation the Council of Europe's co-operation in preparing and implementing reforms of the legal and judicial system and of law enforcement agencies, aimed in particular at further strengthening the effective independence and transparency of the courts and of their proceedings, particularly as regards the distribution of cases among judges of a given court (principle of the judge determined by law);

ii. Evaluate the extent to which progress has been achieved under past and current assistance and co-operation programmes carried out in these fields of judicial reform, and to inform the Assembly of the results of this evaluation and of any adaptations that may turn out to be necessary in order to achieve better results;

iii. Urge the Russian Federation to ensure that all pre-trial detention centres, including Lefortovo isolation centre in Moscow, be submitted to supervision by the Ministry of Justice, in line with earlier commitments and be open to visits by representatives of the Parliamentary Assembly as requested.

2. Concerning more specifically the cases of the leading Yukos executives, the Parliamentary Assembly recommends that the Committee of Ministers:

i. Remind the Russian authorities of the importance it attaches to the principle of open court hearings and ask them to ensure that exceptions to this principle in the Pichugin case are limited to the strict minimum, in accordance with Article 6 § 1 of the European Convention on Human Rights;

ii. Remind the Russian authorities of the importance it attaches to the principle that detention on remand shall be an exceptional measure and ensure that this principle is also applied in the case of Mr. Khodorkovsky;

iii. Urge the Russian authorities to immediately allow an independent medical assessment of Mr. Lebedev's state of health.

The CHAIRMAN. Thank you very much, Mr. Osborne. We appreciate the testimony of both of you gentlemen.

We've been joined by the distinguished ranking member of the committee, Senator Biden. Do you have an initial word of greeting to—

Senator BIDEN. Just a welcome. I apologize for not being here, and I'll withhold an opening statement. I'm anxious for us to move on.

Thank you, gentlemen.

The CHAIRMAN. Very well. We'll proceed with a round of questions. We'll start at 8 minutes, and I'll commence the questioning.

Many have suggested taking a long view of Yukos. The privatization of assets moving from the time of the Soviet Union to a time of private ownership brought about some successes. And Yukos was clearly one of these. But many critics have said the disbursal of the shares of stock was unusual and, in some cases, led to certain persons or groups accumulating great wealth. And, however they may have obtained it, some cynics point out that some of the wealth may have been accumulated in strange ways, but, in the event that it was, those who were managing the wealth ought to presume to stay in business, as opposed to politics. These cynics have argued that if you've decided to take what might be thought as ill-gotten gains, however well developed subsequently, into the political arena, you could expect consequences.

Such has been a rationalization for the fate of the chairman of Yukos, for example. But, as you pointed out, Mr. Osborne, this has now proceeded down through the rank and file of the company, not simply the leadership, whatever may have been the political struggle of that variety. And it's led other observers of Russia to point out that even though we have, as a country—that is, the United States—from the time that Bob Strauss went to Russia as an Ambassador—advocated the rule of law, banking reform, proper titling of property, all sorts of procedures that would make Russia, in quotes, “a normal country” for investment by Europeans. The Europeans are close by, but obviously they have an interest in the United States. This advice has been taken rather haltingly, in bits and pieces, and not without a great deal of development, even to the present.

Now, in the past, some have pointed out, Russia suffered because of this. The amount of investment going into Russia was substantially less, for example, than that going into China. And Russians have complained to some of us on this committee, and others, that they have been unfairly dealt with. Our response was often that the rules of the game made such investment much more precarious. Some people in the energy business decided to take those risks, because the opportunities were enormous and the long-term situation might have been different. But, nevertheless, the amount of investment was always somewhat deficient.

Now, for the moment, Russia, unlike during the times of Boris Yeltsin, for example, is flush with cash, in terms of its overall budget. The leverage for advice seems to have diminished very substantially. As a matter of fact, many Russians in the government resent any critiques. They perhaps resent the fact that we're reviewing this situation today. They might argue that this is Russian

business; as a matter of fact, they don't need our help, they don't need our investment. And, in fact, steps have been taken in Russia recently to forestall investment by other countries, indicating hostility, as a matter of fact, to that sort of intervention.

Now, it's in this context that we have this hearing. I want to get some idea, leaving aside Russian interests that might have been involved, were there United States stockholders who lost money? Were there people from other countries who lost money? In other words, what has been the impact, in your judgment, either one of you, upon our country, upon other countries, leaving aside whether this is good business for Russia? In my opening statement, I have opined that I don't think it's very good business for Russia. It's rather shortsighted, to say the least. These good times come and go. But, at the same time, leaving aside that editorial comment, what are the implications for our business or for the world economy?

Mr. OSBORNE. Mr. Chairman, if I could make a couple of comments first, I'll let Mr. Theede talk about the numbers, because I think he's got them much more at his fingertips than I have. But I think, on the accusations about the acquisition of Yukos, I don't think that, although there's resentment, there's ever been an accusation that anything illegal was done on the acquisition of Yukos by Mr. Khodorkovsky and his colleagues at the time. They acted in accordance with the law of the time. And I think, in any country, you can look back, and laws develop. I think, also——

Senator BIDEN. Generous.

Mr. OSBORNE [continuing]. I think that there are also, if there was resentment and the feeling that that was acquired cheaply, that there are legitimate ways that governments use to rectify those matters. In the UK, there was a view that Mrs. Thatcher had sold off some of the state assets rather cheaply and we had wind-fall taxes. People complained about them, but they seemed to resolve the situation. This has just turned into a vendetta against Mr. Khodorkovsky and the others.

And, you know, they forget that also what Mr. Khodorkovsky was doing was developing a very open Western-style-run company, which was very profitable. And that was really the resentment.

Mr. THEEDE. Well, I could add a couple of things to that. I think, first of all, I have been very impressed with what Mr. Khodorkovsky and his colleagues did, in terms of improving the performance of the company that they did buy at the time of privatization. And, through the process of improvement, they not only focused on efficiency of production and all the fundamental things, but they also focused on corporate governance and transparency, and really, in many ways, became a poster-child, I think, for Russia, in terms of corporate reform and becoming a model of what is possible; and, as part that, also encouraged a number of Western investors to invest in Yukos.

The CHAIRMAN. Just on that point, Mr. Theede, is there any supposition that President Putin recognizes this? In other words, one accusation is that President Putin is a governance-type, comes from a KGB background. He's a bureaucrat, not an economist, not a venture capitalist. I ask this, because obviously a very severe judgment

has been made to invade this entire process, one that appeared to be wealth-producing, all for other reasons.

Mr. THEEDE. Yes. Well, I've refrained from personalizing the actions against the—

The CHAIRMAN. Yes.

Mr. THEEDE [continuing]. Company over the last year, but I will say that approximately 20 percent of the company today is owned by Western investors, and about half of those, or 10 percent of the company, owned by Americans. The attack on the company seems to have taken place without regard to those international investors.

The CHAIRMAN. I thank you.

Senator Biden.

Senator BIDEN. Thank you.

Gentlemen, let me follow up on that point. And you've answered my question. Twenty percent of Yukos is owned by foreign investors. Is that correct? Is that what you said?

Mr. THEEDE. Twenty percent of the company is owned by ADR holders, yes.

Senator BIDEN. Okay. I mean, engage in conjecture for me. You may have done this before I came in. If you did, I'll withhold, and I'll move to something else. What do you think the motivation for the action was? Was it the fact that there was this transparent company growing here, and that was a threat? Or what do you think the motive was?

Mr. THEEDE. My personal opinion is, there is just no question that it's politically motivated.

Senator BIDEN. But a lot of things are politically motivated. It could be politically motivated, in the sense that they did not want to have a Western-style corporation emerging that is transparent. It may be politically motivated because they viewed Khodorkovsky as a direct threat to Putin's political security.

Mr. THEEDE. I believe it had its—has its roots in the fact that Mr. Khodorkovsky posed an opposition threat and an alternative point of view of Russia's future.

Senator BIDEN. I guess what I'm trying to say is that it's an important distinction. There is, understandably, all kinds of conjecture as to why and what individual or multiple reasons prompted this action. And if one is—as I understood the Chairman—a growing resentment of Western investment, period, "We don't need anybody's help," a sort of a xenophobic feeling about Russian resources and assets, that's one thing. If it is a political vendetta—put it another way, assume that Yukos had been a political ally of Putin. I expect, from your answer, that you think this would not have happened, notwithstanding the fact it had all these other markings of a progressive, open, Western-style corporate governance.

Mr. THEEDE. That is correct, Senator Biden. I believe it has its roots in political differences of opinion.

Senator BIDEN. Gotcha.

Mr. THEEDE. And my observation has been that—I think that the government has been quite concerned about the impact that their actions against Yukos are having, in terms of investment climate for Russia. And—

Senator BIDEN. That was my next question. Talk to me more about that. There has still been much less than the investment in



China, and much less than the investment in Turkey, for example. But there's still been—what was it, \$10 billion or thereabouts, invested? Would that be on track as to what would have occurred, in your view, anyway? Or do you think, had this action not been taken by Putin, that there would have been significantly more activity and investment?

Mr. THEEDE. Well, I—that's getting a bit out of my area. But I would answer your question in this way. Having worked in international companies for 32 years, and knowing how corporations, in general, make investment decisions, all companies assign certain political and economic risks to their investment opportunities. And, to a large extent, those risks are based on—are related to country risk.

Senator BIDEN. Right.

Mr. THEEDE. And my view is that international investors have most likely increased the country risk associated with investing in Russia as a result of the Yukos situation.

Senator BIDEN. Mr. Osborne, do you want to comment on that?

Mr. OSBORNE. Yes. Could I go back to your previous question—

Senator BIDEN. Surely.

Mr. OSBORNE [continuing]. About why the confrontation with Mr. Khodorkovsky? I think it's rooted in Yukos' success. I think the fact that Yukos was a significantly more profitable, more efficient company than the state-owned comparisons, the fact that Mr. Khodorkovsky was not backward in pointing that out. He was confrontational. He believed that there was a democracy occurring and that he was entitled to support opposition parties. But I think, at the end, the root of the problems was his success.

Senator BIDEN. Well, again—this may be a distinction without a difference—what I'm trying to get at here is that it tells us one thing about Putin and his leadership and where he wants to take the country. If the motivation was the comparative success and failure—state-run company, corporate Western-style-run company, one failing, one succeeding, or one succeeding much more than the other—that's one thing. Assume that he had decided that the way to deal with Putin was not to be outspoken. Assume that he more accurately read the situation and said that, "There is no democracy like I think"—like he thought there may have been. And assume he had decided to do what would not be unknown in any country, that his best interest was to align himself with Mr. Putin. Is it your assertion that the success of the company still would have led to its being undermined by Putin?

Mr. OSBORNE. I think that it's my belief, that there was a decision that they wanted to take back into state ownership large parts of the energy sector. And what got Yukos to being first choice was its success—

Senator BIDEN. Gotcha.

Mr. OSBORNE [continuing]. And the fact that it was entering into active discussions with Western petroleum companies to come in and joint-venture with it.

Senator BIDEN. I see. Last question—Mr. Chairman, my time is—I only have a minute left—to either of you. Is there any indication that Putin understands, comprehends, or is worried about the future investment prospects that he needs, in terms of the Russian

economy, to attract dollars or euros, and that he is in any way reaching out to cherry-pick by making assurances, private assurances, or to court such investment in either the oil sector or any other sector? Is there any evidence of that?

Mr. OSBORNE. Not as far as I can see. I haven't seen any.

Mr. THEEDE. Well, I think that I have seen some of that. I think that there have been a number of comments made by Kremlin officials trying to characterize the Yukos situation as being Yukos-specific. And once the Yukos situation is finally resolved, whatever that might look like, then Russia will go back to—on track, on plan. And, of course, my position is—has consistently been that if the systems are in place that allow this to happen to Yukos, then it can certainly happen again in the future.

Senator BIDEN. Thank you very much.

The CHAIRMAN. Thank you, Senator Biden.

Senator Sununu.

Senator SUNUNU. Mr. Theede, I think you mentioned the number of 60,000 investors, and an answer to Senator Biden's question indicated that 20 percent of the company is foreign-owned. How many investors, roughly, does that translate to? How many foreign investors are there in the company?

Mr. THEEDE. Basically, that's the 60,000. The balance—

Senator SUNUNU. And that includes individuals and institutions?

Mr. THEEDE. Yes, it does.

Senator SUNUNU. But a pretty significant number.

Mr. THEEDE. Yes.

Senator SUNUNU. It's not in the dozens, it's in the thousands.

Mr. THEEDE. Yes.

Senator SUNUNU. And, Mr. Osborne, could you describe a little bit—or try to characterize a little bit more specifically the reaction of foreign capital markets to the confiscation? Have we seen a fall in the share prices of other ADRs? Have there been increases in interest rates or risk premiums associated with investments in Russia? Has there been any attempt to try to characterize the reaction of the capital markets?

Mr. OSBORNE. That's not a subject that I feel particularly competent to talk about, but I think there has certainly been a flight of capital out of Russia. I think the government's own statistics show that there's been multibillion dollars of capital leaving Russia. And, I think that the only energy-sector investments that have been made from abroad into Russia have been made with state-owned enterprises, with presumably fairly well-regulated agreements before they've gone in there.

So I'm conscious that I haven't answered your question, but I don't have that information. I can obtain it and make sure it's put on the record.

Senator SUNUNU. Anything you want to add, Mr. Theede?

Mr. THEEDE. Well, I'm—as Mr. Osborne said, I don't have the facts at my fingertips, but I think if you look at the performance of the Russian stock index for 2004, compared to international indices, it has not performed as well. And, to a large extent, that's due to Yukos' share price plunging from \$16 to less than a dollar, and Yukos had been a significant part of the—of that exchange—measures.

Senator SUNUNU. I think it's clear that the members of this committee condemn this kind of private property confiscation. You've heard the chairman talk about the importance of the rule of law. You know, democracy is not just a question of having a vote or an election, but it consists of having institutions that apply the law equally, judicial institutions that are—that have integrity. All of those things are important, are supported by the members of this committee. But aside from our—or condemning the action or speaking out against this, or trying to characterize the negative outcome, what other appropriate response would you like to see from the international community?

Mr. THEEDE. Well, I—for me, it's fairly simple. I think that there should be an expectation that Russia lives up to its international commitments and it follows the law.

Senator SUNUNU. That's an expectation, though. I mean, I'm looking for specific—sort of, a recommendation or a course of action that you think would lead to that outcome. For example, WTO is obviously something of great interest to the Russian Federation. I think some people might argue that accession to the WTO might provide a mechanism through which great incentive is created for applying the law appropriately for establishing and maintaining these institutions. Other people might argue effectively the opposite: No; participation in WTO, because of its value, should not be granted until there's a more consistent track record. Do you have an opinion?

Mr. OSBORNE. I think you've accurately set out the alternative views. And, I think, what one's got to do is balance that with history and see where—what Russia has done with other similar organizations. And, in particular, look at the way it's treated the decisions of the European Court of Human Rights, where it's ignored them; and, therefore, one might conclude that it would accede to the WTO based on promises, going forward, and then not feel obliged by them. So I think my view—and I am totally unqualified to express the view—is that they—one should be sure that they have reached the level playing field before they are allowed on to play.

Senator SUNUNU. Given your personal experience, which does qualify you to express your view, and probably does make your view fairly well informed—given your personal experience with this situation and the—your sort of personal experience with the actions and statements of Mr. Putin, what do you think he will respond to most effectively, or most directly, in this situation? And, I mean, for example—and this may not be the only answer—the President is meeting—President Bush is meeting with President Putin later this month, I believe, on the 24th. Do you think this is an issue that can be dealt with effectively on a personal level, or do you think that the European community or WTO or a wider circle of global actors needs to be brought into play?

Mr. OSBORNE. Well, I'm sure that if President Bush was to let it be known to President Putin that he thought that this sort of behavior was reprehensible, then that would go a very long way. If that can be coupled with similar comments from other world leaders in the G8, then that's got to strengthen the message. And the impression that I have—and it's a personal impression—is that

President Putin wants to be seen on that level playing field with the other world leaders, and they've got to explain to him what it takes to get there.

Senator SUNUNU. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Sununu.

Senator Obama.

Senator OBAMA. Thank you, Mr. Chairman. I'll be very brief.

I just want to pick up on Senator Sununu's line of questioning, and just get some impression, in terms of what the U.S. Government's role in sorting this through has been, and whether you think that there are additional steps that the U.S. Government, whether at the consular level or through other mechanisms, should have been doing, that has not happened. Because, obviously, although we're disturbed by what's—the story that's been described, at a certain point our task is to see what kind of impact we can have on U.S. foreign policy over the long term.

So, I'm wondering how has our government responded, and what steps you think we might have taken differently, or additional steps we need to take in the future.

Mr. OSBORNE. I'm very conscious of not being a citizen and it being wrong for me to express views of—like this. And—but, I think, my view is that all of the Western leaders and the Western governments have got to emphasize the importance of the rule of law, and that that is fundamental, and the short-term gains about oil or energy or anything else must come secondary to getting the rule of law applied in all countries, including Russia.

Mr. THEEDE. Well, in answer to the first part of your question, there's been really tremendous cooperation and support and, I think, open channels of communication with United States Government officials at a number of levels, from the Embassy in Moscow to Washington and so forth. And, you know, I've been very pleased with the concern that's been shown.

In the end, that has not, I don't think, had an impact on the outcome of the situation to date, but certainly there has been a very strong interest in what Yukos' future might hold and what's happening to Yukos.

My personal experience, having worked in Russia for a relatively short period of time, a year and a half, is—and I found out this—I learned this the hard way—is that standard—I want to—I'll call it diplomatic, but we use it in business, too—but standard diplomatic language doesn't always make its point in Russian culture. And I found that, for me to be effective, I had to have a strong position, and I had to state it clearly, and I had to—and that was whether I was agreeing with an individual I was working with, or whether I was disagreeing. But, either way, they respected the fact that I had a strong position and I was clearly outlining that position.

Senator OBAMA. Okay.

Thank you, Mr. Chairman. That's really the only question I had.

The CHAIRMAN. Well, thank you very much, Senator Obama.

Let me just initiate a final question or two by saying that your point, Mr. Theede, is, you found, as a businessman in Russia in the last 18 months, the need to state a strong position. And let me just

say, I think we have tried, in our questions, to be probing and philosophical and to find the nuances of this. In my own judgment, in this particular case, I believe the President of Russia, President Putin, made a monumental blunder. It was a blunder, not only in terms of breach to the rule of law, but, if you were simply to look at it in economic terms, in substituting an inefficient state-run corporation for something that was doing very well, and had international backing. It's a loser any way you look at it.

Now, you can say, well, President Putin knew what he was doing. He saw a rival out there, and he was going to suppress that rivalry, taking a look at the maintenance of his regime as the important aspect. So perhaps, in that line of thinking, he would say, "I've been successful. I have my rival in jail. He's bottled up. And it ought to be a lesson for anybody else who happens to think about this."

Now, you know, as we recite all this, I'm reminded of a meeting of a number of Members of the Senate and the House, not long ago, talking about this subject. And one of the Members said, "Now, I don't want to be considered isolationist and nativist and what have you. We're all international. But why do we care about Russia? What difference does it make?" In other words, this Member, not just to play the devil's advocate, was saying that if President Putin wants to get into a squabble and jail his opponents and go for inefficiencies and downgrade the Russian state—after all, Russia has the economy about the size of Belgium, that's what we're looking at here, and it may diminish lower than Belgium by the time they're finished—why should we care?

Now, some of us, on the other hand—and I'm one of these, admittedly—would say, well, we do care about Russia, for a good number of reasons. We've cared about Russia for a long time, about the people of the country, about its culture, about its future, about its relationship with us. This can be a remarkable situation, of relationship and friendship, and we ought to work at this. And some of us would say, in fact, most of the work is occurring just at that level, with the two Presidents, President Putin and President Bush.

Now, how do we enrich the fabric of this discussion? Most of our other international relationships have many, many other players, people like yourself, in business, people in all sorts of cultural realms, lots of students. Now, we have a good bit of this, but it's diminished over the course of time.

In our hearing with Secretary Rice, yesterday, I mentioned the Freedom Support Act budget. It's to diminish by about 13 percent, and that's not the first time it's diminished. There was an enthusiasm at the beginning, as '91 and '92 came and so forth, and that's diminished a whole lot.

Well, there are the farm groups going through Russia, quite apart from the cultural groups. Some of this still occurs, but much less than it should. And, reciprocally, our visa problems pose a lot of difficulty for Russians—not just visas for students, but also for others—so that the intersection there, in our war against terrorism, what have you, has had its toll. And we have to examine those things.

I very much appreciate both of you being very forthcoming about the business aspects of this. You have been reticent to speculate

into the political realm, to take the position that President Bush might or might not take when he meets in Bratislava with the Russian President. But my own view is that there is, at even the level of President Putin and the Foreign Minister and the Defense Minister and people with whom some of us have had some contact, a real desire for better outcomes. I think it's very important that we keep pressing that possibility, even, as you say, sometimes making strong statements, making our position well known. It would be a mistake to be ambiguous in this case, in my judgment, if you care about Russia and about the relationship. I have said to my congressional colleagues, "If you don't care, then, as a matter of fact, you just let things run." And they will run badly, not just for Russians, but for others who are in the periphery of the Russian state and for others with whom they come in contact. And that, I think, will be ultimately tragic—if we are not observant, if we are indifferent.

Let me ask if either of you have any final thoughts. And if not, we'll press on with our next panel. Do you have a final summary, Mr. Theede or Mr. Osborne?

Mr. THEEDE. No, sir; I have nothing to add from what's been said.

The CHAIRMAN. Thank you.

Mr. OSBORNE. I think just to take up the points that were made by your colleagues about: What can the world do? I really think that one thing it can do is make a condition of access to the WTO the cessation of these politically motivated attacks. Whether they will or not, I don't know. But that's my only final thought.

Thank you very much.

The CHAIRMAN. Well, I think you make a very good point. I think some skeptics would say that, given the course of affairs, Russia is so far from WTO membership. It's not really clear it's heavily motivated to want to be in the WTO if, in fact, current activities are an indicator. But perhaps there is leverage here. We've asked you what are the levers? Some Russians tell me, "This is not a lever, this is simply patronizing, on your point. You believe in the WTO. And, in a way, it might be interesting for us, but it is hardly essential." Perhaps President Bush will discover that President Putin has much more interest in the WTO and issues of that ilk than has been apparent. And, if so, then perhaps we will have more to talk about.

Well, we thank both of you for your testimony.

The Chair would like to call now a distinguished panel that would include Dr. Anders Aslund, the Director of Russian and Eurasian Program of the Carnegie Endowment, Mr. Bruce Jackson, President of the Project on Transitional Democracies, Mr. Stephen Nix, Regional Program Director for Eurasia, and the Honorable Nelson Ledsky, Regional Program Director for Eurasia, at the National Democratic Institute.

Welcome, gentlemen. We very much appreciate your coming to the hearing this morning.

And let me say at the outset, as I mentioned with our previous witnesses, your statements will be published in full in the record. You need not ask for that to occur. And to the extent that you are able to summarize those statements, that would be appreciated.

I'll ask you to testify in the order that I introduced you. That would be, first of all, Dr. Aslund, then Mr. Jackson, then Mr. Nix, and, finally, Mr. Ledsky.

Dr. Aslund.

**STATEMENT OF DR. ANDERS ASLUND, DIRECTOR, RUSSIAN AND EURASIAN PROGRAM, CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE, WASHINGTON, DC**

Dr. ASLUND. Mr. Chairman, thank you very much. I would like to thank you for this opportunity to speak on an important topic.

Russia is something that I care very much about. I've studied Russia for more than 30 years. And I don't think that the developments that we have seen in Russia, particularly in the last year or so, have been very fortunate.

But my major argument is that Mr. Putin has chosen authoritarianism. This choice of his is not strengthening, but weakening the Russian state. And, therefore, there is, as you mentioned at the beginning, unfortunately less that the United States today can do together with Russia.

During his first 4-year term, President Putin was highly successful. The country enjoyed political and economic stability and great economic growth. He did also carry out reforms on a broad front—judiciary reform and tax reform, but also many others. He succeeded in his policymaking, because he balanced two groups—on the one hand, the old oligarchs from the Yeltsin era; on the other hand, his KGB people from St. Petersburg—but left a small group of liberals with inordinate influence as arbiters.

He managed enigmatically to be everything to all voters, and, indeed, was elected President with 71 percent of the votes cast in an election that was deemed free, but not fair, by the OSCE. But after that we have seen that since he consolidated power, he has done what he really wanted to do. And the choice is not very encouraging. I think that we should focus upon four major policy failures in the year past. They reflect the inadequacy of the new system that President Putin has built so meticulously.

The first policy failure, indeed, was the Yukos affair. The arrest of Mikhail Khodorkovsky meant that Mr. Putin eliminated the oligarchs as a political force. That meant that only a small group of KGB officers really sat on top of state power in Russia and at the same time, as we have heard, the lawless confiscation of Yukos rendered his excellent tax reform and the substantial judicial reform little but jokes.

The second scandal was the hostage drama at the school in Beslan in Northern Ossetia. The scandal was that the government didn't do anything. In the end, on the third day, it was the locals who stormed the school, and the result was, of course, a maximum blood bath. This was simply state distortion. Russians accept a lot, but not that the state does nothing.

The third big policy mistake was the massive intervention—by Mr. Putin personally—in the Ukrainian Presidential election. There he proved himself poorly informed, antidemocratic, anti-Western, and ineffective. You can say that in one stroke he managed to unite the United States and the European Union, which is

quite an achievement, but he did so against himself, and he left much of his prior realist foreign policy in tatters.

A fourth big policy drama has been the recent reform of the social benefits, which has simply been bungled, which makes it look like an action directed against the poor in the midst of Russia's oil boom.

All these four policy mistakes illustrate the systemic shortfalls of President Putin's new regime.

First of all, Mr. Putin is too jealous of power to share it with anybody, even with his Prime Minister. This leads to an excessive centralization of power which has virtually paralyzed his government.

Second, President Putin is now increasingly representing only a narrow circle of KGB officers from St. Petersburg. You can't manage a country for long with such a narrow power base. And, naturally, his personal popularity is now falling fast.

Third, by strangling independent information, President Putin allows himself to be increasingly disinformed by his own bureaucracy.

Fourth, checks and balances have been minimized, which means that the quality of decisionmaking gets worse, as we saw in the social benefit reform.

And, fifth, as his regime has changed, so has its interests. The dominant interest now is of the small circle of KGB officers who sit on the top of the state administration and on top of the state enterprises. This is the most antireformist interest that you can imagine. Therefore, there are no reforms coming forward.

So my point here is that Putin's rule is not only authoritarian, but it's dysfunctional. It is too rigid and too centralized to handle crises, and crises always happen. Rather than addressing any of these problems, President Putin just stubbornly continues further in the same direction of further centralization.

My suggestion here, without developing it further, is that such a regime can hardly be very stable.

What does this then mean for United States/Russia relationship?

First of all, no illusion can be harbored any longer about shared values between the United States and Russia. President Putin does not believe in freedom and democracy, which he has well shown, contrary to prior statements of his.

Second, the consequences of these differences in values are most evident in the newly independent states in Eurasia. We are likely to see more standoffs, as we have just seen in Ukraine, where President Putin supports authoritarian rulers, while the United States, of course, must stand on the side of democracy.

Third, much of the bilateral talks between the United States and Russia have been devoted to development of Russian energy. As we have just heard, of course, all these policy changes in the last year or so, around the Yukos affair, hamper that.

Fourth, as you mentioned in your introductory words, Russia's redeeming feature in recent years has been that it has been seen as a firm and capable ally of the United States in the war on international terrorism and on nonproliferation. Alas, major terrorist acts in Russia, both in Moscow and North Caucasus, suggest that Russia might not be very effective in doing so, even at home.



So, let me conclude, Mr. Chairman. It should be emphasized that the United States and Russia still have common interests in the nonproliferation of arms of mass destruction and many regional conflicts around the world, and they should be further pursued. But, I think that it's time to talk to Russia with a firm public voice.

We have to see, as the final point, that President Putin's unfortunate choice of an authoritarian regime has reduced both the efficacy of a Russian state and the shared interests of the United States and Russia.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Aslund follows:]

PREPARED STATEMENT OF ANDERS ASLUND, DIRECTOR, RUSSIAN AND EURASIAN PROGRAM, CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE, WASHINGTON, DC

Mr. Chairman, I would like to thank you for this opportunity to speak on the important topic of the retreat of democracy in Russia. Russia in the 1990s was not a full democracy, but it was a much freer society than Russia today, while its economy has developed very positively since then. The retreat of democracy in Russia is nothing that has been forced upon President Vladimir Putin but an intentional result of his. Therefore, I shall discuss how his regime has evolved. In particular, I shall focus on major events of the last year and what they tell us about the nature of Mr. Putin's regime. Finally, I shall discuss the potential impact of the changes in Russia on the future of the U.S.-Russia relationship.

*The Evolution of President Putin's Regime*

Overtly, Russia's President Vladimir Putin appears to have undergone a remarkable transformation between his first and second term. By and large, he was highly successful during his first term. The country enjoyed political and economic stability, and the economy grew by a solid annual average of 6.5 percent. The country carried out reforms on a broad front.

It appeared as if President Putin was steered by four major aims:

1. Political control;
2. High economic growth of 7–8 percent a year attained through market economic reforms;
3. Rule of law through judicial reform; and
4. Realist foreign policy enhancing Russia's international standing at little cost. During his first term, President Putin was highly successful in achieving these goals.

Yet, the black marks were by no means absent. Putin had risen to power on a ruthless war in Chechnya, and his first term saw ever worse terrorist attacks, against which his government stood helpless. Another negative was a steady reduction of democratic freedom of rights. Independent media were reined in or taken over. Frequent regional elections were increasingly tampered with. State power was ever more centralized to the President.

There was an obvious contradiction between President Putin's first goal of political control and his other objectives, but his concentration of political power was so gradual that the contradiction was not all too striking. In fact, policymaking from 2000 till 2003 was conditioned on a balance of power between the Yeltsin-era big businessmen and Putin's rising friends from the KGB in St. Petersburg. As a result, a small group of liberal reformers, such as Minister of Economy German Gref and Minister of Finance Alexei Kudrin, tended to exert inordinate influence, although they had no independent power base. An avid reader of opinion polls, President Putin tried enigmatically to be everything to all voters. The outcome was an excellent and comprehensive reform wave, improving the economy and the judicial system. In particular, a new tax code was adopted, introducing a flat personal income tax of 13 percent, and the new Land Code sanctified private ownership of land.

Thanks to his many policy successes, President Putin became genuinely very popular. He exploited his attainments to reinforce his personal power, and in the parliamentary elections in December 2003 his United Russia party won a majority of two-thirds of the seats. President Putin won the Presidential elections in March 2004 with no less than 71 percent of the votes cast in elections that were deemed free but not fair by the Organization for Security and Cooperation in Europe (OSCE). After having been a bit of everything to everybody, he had now consolidated his power to do what he really wanted to do.

*Four Monumental Failures*

The last year has seen four monumental policy failures by the Putin regime. They reflect the inadequacy of the new system President Putin has built so meticulously. The first big policy failure was the Yukos affair. On October 25, 2003, Mikhail Khodorkovsky, the richest man in Russia and Chief Executive Officer of Yukos Oil Company, was arrested. The motives of his arrest appear to have been two. First, President Putin wanted to further enhance his political control, by arresting the richest oligarch. Second, various interests around Mr. Putin aspired to seize Yukos assets. The immediate effect was that Mr. Putin's political system changed. The balance between oligarchs and KGB officers ceased instantly, because the other oligarchs heeded the warning and largely withdrew from political activities. Rather than being the arbiter between two powerful groups and thus representing the population at large, Putin instantly became the representative only of a small group of KGB officers from St. Petersburg, minimizing his power base.

Yukos appears to have utilized loopholes in the tax legislation, but biased tax authorities and courts have levied an incredible total of \$28 billion in additional taxes and penalties on the company, forcing it into bankruptcy. Thus, Russia's progressive tax reform has been rendered a joke. The judiciary has delivered the judgments that the Kremlin has required, effectively jeopardizing also the substantial judiciary reform. The Yukos affair has been long and sordid. At each turn, the worst possible option has been chosen by the authorities. In the end, President Putin has let Yukos be confiscated through arbitrary taxation and kangaroo courts. Characteristically, Mr. Putin has not made any concession whatsoever at any stage.

The second scandal was the hostage drama in Beslan. On September 1, 2004, a group of terrorists seized a school in Beslan in Northern Ossetia in Russian Northern Caucasus. Russia's foremost special forces were sent to Beslan, but they were given neither ammunition nor body armor, battle plans or operative command. At no time was the school cordoned off. The Chairman of the Federal Security Service (FSB) and the Minister of Interior arrived in Beslan soon after the siege started, but they just hid, doing nothing in public. The two regional governors concerned refused to go there and did nothing. In fact, nobody from the government did anything. Putin and his government just ignored the Beslan crisis apart from minimizing news coverage, and the rare official statements were just gross lies. On the third day, local Ossetians had had it. They stormed the school themselves with their own guns and killed several special troops in the process. No less than 330 hostages were killed.

It is difficult to imagine a worse government performance. Law enforcement failed the population. It possessed no relevant intelligence. Policemen accepted bribes to let the terrorists through. Mr. Putin, however, has refused to accept any criticism of law enforcement. He sacked none of the culprits, only the editor in chief of the private newspaper *Izvestiya* because of his accurate reporting. He has done nothing against the rampant corruption and incompetence of the FSB, his alma mater. To reconsider his failed Chechnya policy does not appear to be in question. Rather than giving governors more authority, he immediately demanded to appoint them. Instead of seeking a cure, he persists in aggravating his policies that contributed to the problem in the first place, showing inordinate stubbornness.

The third big policy mistake in the last year was the Russian involvement in the Ukrainian presidential elections. According to information that I have received from the Yushchenko campaign, President Putin promised Russian enterprise financing of no less than \$300 million for Prime Minister Viktor Yanukovich's campaign. Russian TV, widely viewed in Ukraine, campaigned for Yanukovich and slandered the democratic candidate Viktor Yushchenko. Dozens of Russian political advisors descended on Ukraine, campaigning for Yanukovich. In the last month of the election campaign, President Putin himself went twice to Ukraine to campaign for Yanukovich. President Putin's preference for Yanukovich is rather odd. Yanukovich had served two prison sentences for violent crimes. He represented the largest oligarchic clan in Ukraine, while Mr. Putin had been combating the oligarchs in Russia. It was Yushchenko who had allowed Russian companies to buy big assets in Ukraine, while Yanukovich had opposed such purchases. Mr. Putin's choice only made sense as an action against democracy and against the West.

In Ukraine, Mr. Putin proved himself, poorly informed, anti-democratic, anti-Western and ineffective. In one stroke, he managed to unite the United States and the European Union, but against himself, leaving much of his realist foreign policy in tatters. Strangely, it does not appear as if the Kremlin has learned anything from its spectacular failure in Ukraine. It appears as if the conclusion drawn is that Moscow should have acted earlier and even more heavy-handedly. On the one hand, this is depressing from an intellectual point of view, and it means that anti-Americanism is likely to increase in the Kremlin. On the other hand, it is rather reassuring, be-

cause it means that Moscow will be as ineffective stemming democratization in other countries in Eurasia. Russia's policy is too inadequate to pose any serious threat of neo-imperialism in the region, even if Putin's regime certainly has proven its bad intentions in Ukraine.

A fourth big policy drama has been the recent reform of the social benefits. Russia has a multitude of old social benefits that are primarily targeted on the privileged, and many of the benefits on the books are never paid out. It would make sense to sort this system out, to target benefits on those in true need, while unjustified benefits that could never be afforded were taken off the books. However, everything was done wrongly. The reform was presented as the monetization of benefits in kind, while many were just abolished. Full compensation was promised for the actual benefits in kind, but it appears that only about one-third of them were actually compensated for. Proper calculations were not undertaken, and the federal and regional governments did not agree on who should pay for what. Although the benefit reforms affected about 40 million people, they were not properly explained. To add insult to injury, the 35,000 highest officials, including Mr. Putin, had their salaries quintupled at the same time, and none of their very substantial benefits in kind was taken away. The social benefit reform seemed outright anti-poor, and this occurred in the midst of Russia's oil boom and a huge budget surplus. This was just politically inept, and spontaneous popular protests against the reform and Putin himself erupted throughout the country. They have been spearheaded by pensioners and are still continuing.

#### *The Nature of Putin's Current Regime*

There are many other policy mistakes to record, but the reason why I have discussed these four policy mistakes in such detail is that they are probably the biggest and show that they are not accidental but systemic. Therefore, there are reasons to believe that they will be repeated. Alas, President Putin's very success in his consolidation of power may lead to his future fall. He was so fortunate during his first term because he recognized the limitations to his power. Now, he seems to think himself free of constraints, but no politician is that lucky. He has not only changed policies, but the very structure of the Russian government.

First of all, Mr. Putin is too jealous of power to delegate. In the last year, President Putin has unwisely concentrated far more power in his hands than he can manage. He has replaced his strong chief of staff and prime minister he had during his first term with men famous for never making any decisions. One reason for this extreme overcentralization is that Mr. Putin does not trust anybody. Rather than creating a strong vertical command, he has paralyzed his own government because, although he is a micromanager, Putin takes his time and is not very decisive. In effect, he has transformed himself from a strategic policymaker, tilting the balance at the conclusion of a decision, to a fireman running around fighting with all bush fires. A critical shortcoming of this rigid centralized system is its inability to handle crises, as was so obvious in the Beslan school hostage drama, but crises are common in Russia.

Second, by playing KGB officers and oligarchs against one another, Putin managed to represent the whole people and be everything to everybody. Now, he is increasingly representing only a narrow circle of KGB officers from St. Petersburg. The Russian elite is overwhelmingly against Mr. Putin, but they dare not oppose him openly as yet. President Putin could have won in free and fair elections, but he chose not to. As a result, his legitimacy depends on little but his personal popularity, which is falling fast. According to the Russian Public Opinion Foundation, 65 percent would have voted for Mr. Putin in presidential elections in March last year. Ten months later this number had fallen to 42 percent, that is, a drop of over one-third in ten months.

Third, by strangling independent information, President Putin allows himself to be increasingly disinformed by his own bureaucracy. Being a true secret policeman, Mr. Putin is preoccupied with secrecy, and he seems to rely more on intelligence from his old circle of KGB men from St. Petersburg than on real information.

Fourth, checks and balances have been minimized. By depriving the parliament, the council of ministers and the regional governors of much of their power, President Putin has emptied the formal institutions of any real content. Instead, he is busy setting up informal advisory institutions, such as the State Council and the Public Chamber, which are of little or no consequence. Ironically, the last Russian leader to do so was Mikhail Gorbachev from the summer of 1988. Therefore, no institution can lend legitimacy to Mr. Putin if he starts faltering. He could have won a free and fair election in March 2004, but he chose not to, so he does not enjoy that legitimacy either.

Fifth, as the regime has changed, so have its interests. The dominant interest is that of Mr. Putin's KGB friends, who dominate the state administration and now also the big state enterprises. The state administration and the remaining large state enterprises should be focuses of reform, but reforms cannot go against their ruling interests, and nobody expects any further significant reforms. Even during Putin's first term, the share of public expenditure devoted to state administration, law enforcement and military have steadily increased at the expense of social expenditures.

Sixth, politicians in power usually ration their public statements to be able to maintain a fair degree of deniability. President Putin, however, evidently does not want anybody to speak for him but acts as the only authoritative spokesman of his government. This leads to his overexposure, the decline of his enigma, and his dwindling authority, since his words are not always substantiated by actions. Again, the thought goes to Mikhail Gorbachev, who made ever more frequent and long television speeches toward the end of his reign.

Seventh, many political leaders manage to maintain their credibility and authority by blaming top aides and sacking them repeatedly. For instance, Belarus' President Alexander Lukashenko is a master in that art. So far, however, Mr. Putin has been very reluctant to undertake personnel changes, and he has missed repeated occasions to sack obvious culprits, notably in the Beslan hostage drama. Obviously, this is a means that he has at his disposal, but strikingly he has not even demoted any of his many KGB loyalists from St. Petersburg as yet.

Admittedly, the Putin regime has skillfully manipulated elite, media and civil society, but you can only manipulate that much before you lose credibility and authority, and that threshold has probably been crossed during the protests against the social benefit reform this January. The point is that Mr. Putin's rule is not only authoritarian but dysfunctional. It is too rigid and centralized to handle crises, which always occur. Rather than addressing any actual problem, Putin just pursues his personal authoritarian agenda further. This centralized police state appears to be interested in little but its own economic and political power. It is difficult to escape the impression that Putin is more concerned about pampering his KGB men than fighting terrorism. Since liberal economic reforms harm their interests, they have been abandoned. This regime can hardly be very stable, and our future study should be devoted to how this regime is likely to crumble.

Russia's problem today is not the economy, which is doing very well with a growth of 7 percent last year. The standard of living is rising even faster. But we have just seen a popular revolution in neighboring Ukraine, although that economy grew by 12.4 percent last year, and real incomes almost twice as fast. Most regime changes in post-communist countries, democratic or not, are driven by popular discontent with corruption. For a long time, in Russia such concerns have been directed against the oligarchs, but it is now all too obvious that the oligarchs no longer dominate Russia, whereas Putin's KGB men do. At the same time, opinion polls are showing that popular demands for freedom and democracy are on the rise again. In the Ukrainian Orange Revolution, the two dominant demands were for democracy and freedom, and Ukraine was reminiscent of Russia with its mild authoritarianism.

#### *Potential Impact on the Future of the U.S.-Russia Relationship*

Russia's regime has changed significantly in the course of the last five years. Under President Boris Yeltsin, it was a somewhat flawed democracy, but it was still a rather free society. This is no longer the case. Naturally, such a change must have consequences for the U.S.-Russia relationship.

First, no illusion can persist any longer about any shared values between the United States and Russia beyond those of certain realism in foreign policy. Even publicly, the Kremlin is abandoning its talk about the oxymoron "managed democracy," instead talking more accurately about mild authoritarianism. The repeated policy disasters in the last year show that Russia has not benefited, but suffered, from this rising authoritarianism.

Second, the consequences of the differences in values are most evident in the newly-independent states in Eurasia. Today, most of these countries are considered not free or authoritarian by the authoritative Freedom House. The natural American attitude is of course to support democracy, but, as events in Ukraine have shown so well, President Putin's natural policy is to stand up for the old authoritarian rulers against democracy. As people in other countries in the region are about to rise against their dictators, this conflict between Russia and the United States is likely to be repeated. The United States must stand firmly on the side of democracy.

Third, for years, much of bilateral talks between the United States and Russia have been devoted to development of Russian energy. Unfortunately, little has come

of these many talks, and the recent developments in Russia have seriously limited the future opportunities. The reinforced state oil pipeline monopoly in Russia means that private pipelines are no longer an option. In particular, that has seriously delayed the construction of an oil pipeline to Murmansk, which could have supplied the United States with Russian oil. A recent decision to prohibit companies that are not predominantly Russian-owned to bid for licenses for new deposits of Russian resources has further limited the possibilities for American companies in Russia. The Yukos affair shows how much the legal and tax climate has been aggravated even for Russian energy companies.

Fourth, Russia's redeeming feature in recent years has been that it has been seen as a firm and capable ally of the United States in the war on international terrorism. Alas, repeated major terrorist acts in Russia, both in Moscow and North Caucasus, suggest that Russia is not very effective in this task even at home.

The overall conclusion is that President Putin's unfortunate choice to build a mildly authoritarian regime has reduced both the efficacy of the Russian state and the shared interests of the United States and Russia. This testimony has focused on the problems arising from Russia's domestic change, but this does not mean that the United States should turn its back on Russia. After all, Mr. Putin's authoritarianism is relatively mild by international comparison, and its international threat appears limited. The United States and Russia still have common interests in the non-proliferation of arms of mass destruction and many regional conflicts around the world. The United States has an interest in strengthening the modern and progressive forces in Russia through further exchanges of people and trade. Notably, Russia's accession to the WTO should be welcomed as a progressive step.

The CHAIRMAN. Thank you very much, Dr. Aslund.  
Mr. Jackson.

**STATEMENT OF BRUCE P. JACKSON, PRESIDENT, PROJECT ON  
TRANSITIONAL DEMOCRACIES, WASHINGTON, DC**

Mr. JACKSON. Thank you, Mr. Chairman.

Perhaps I could just focus my summary on the interpretation of what has gone on in Russia, what it means to its neighbors, and what it means to us, since, I think, there is no disagreement about the facts of the case. Judging from your opening statement, the facts are well known.

Beginning with Mikhail Khodorkovsky's arrest in 2003, it was a watershed event in democracy in Russia, where Putin moved from the concept of a managed democracy to something more sinister, and marked the beginning of a profound crackdown, a comprehensive crackdown, against all the foundations of democracy in Russia, not simply Yukos.

We know now, from looking at the Orange Revolution in Ukraine and the Rose Revolution in Georgia, that there are six pre-conditions for democratic change: An effective civic society, independent political parties, an opposition in parliament, the beginnings of a business community, an independent media, and some control over the military and security system by civilians.

It seems to me that what President Putin evidently decided was to destroy these foundations of democracy in Russia, and to discourage their development in countries around Russia. And that is precisely what has occurred.

In May 2004, Putin attacked the NGO sector and accused them of being foreign agents, effectively silencing the NGO sector. Human Rights Watch reports that opposition parties have either been decimated or eliminated altogether beginning from the elections in December 2003. United Russia now controls two-thirds of the Duma, so all legislation that Mr. Putin wants goes through, in-

cluding constitutional change, which allowed the elimination of the regional governors.

The destruction of Yukos speaks for itself. This is precisely what Mr. Putin wished to accomplish, and largely, many of us think, because he viewed Mr. Khodorkovsky as a political rival to him in the 2008 elections, which I think was likely, at the time.

All television and radio stations are now under state control. And most ominously, the rise of the KGB as the political class in Russia. Russian sociologists estimate that 70 percent of all Russian officials—regional officials are KGB agents, and that the KGB has increased their presence in the Russian bureaucracy by 300 percent since the time of Mr. Gorbachev. This is why, in the aggregate, the Freedom House has downgraded Russia to the “Not Free” status, where it now sits with Belarus, North Korea, and Saudi Arabia.

Thus, I do not think it is accurate to say that democracy is in retreat in Russia. Democracy has been assassinated in Russia. And it was deliberate.

Now, my second point is, as Andrei Sakharov wrote, “A country that does not respect the rights of its own people will not respect the rights of its neighbors.” So it’s not simply an undemocratic regime in Russia; it’s an antidemocratic Russia abroad. And what are the consequences and the manifestations of an anti-democratic state in Eurasia?

I think it is interesting to look at the doctrinal writings in Russia right now by one Mr. Pavlovsky, who is quite close to Mr. Putin. He says, “One should be aware that, at least, until the end of President Putin’s tenure, and probably until the end of the Presidency of his successors, Russian foreign-policy priority will be to turn Russia into a 21st century world power.” This is all about power.

And, basically, the growing view is, to achieve this status, Russia must be undemocratic at home in order to consolidate the power of the state, and it must be antidemocratic abroad in order to block the entry of political competitors—such as the NATO, the European Union—into the states around Russia. And this is what justifies their actions. They have actually formally introduced the concept of preemptive counterrevolution; where democracy looks like it may flourish or there’s proclivities, that they will intervene.

And if we look through their conduct in nearby states, just to tick off a few—since you are well aware of their actions in Georgia, I won’t draw on that at length—but the attempt to eliminate the OSCE monitoring of the borders between the North Caucasus and the South Caucasus—the only explanation is to allow military and paramilitary intervention in the affairs of a weaker democratic state.

And since, in Moldova, as you know, since the 2003—Russia has been sponsoring a criminal enterprise in Transdnistria, which is basically one of the largest arms exporters in Eurasia, despite the fact that it has—doesn’t even have a border with Moldova.

In Ukraine, their intervention there was profound. Analysts like Dr. Aslund have estimated that in excess of \$300 million was spent to basically rig the outcome in favor of Mr. Yanukovich and possible—and many Western diplomats in Kiev believe that the assassination attempts that were repeatedly directed against President

Yushchenko originated from Russia, certainly from criminal interests in Russia, and quite possibly intelligence interests.

Turning, finally, to their policy toward Belarus, this is a regime that sponsors the dictatorship in Belarus. Again, in their own words, "Russia will clearly distinguish between certain characteristics of a political regime in a neighboring country and its observance of allied commitments. Belarus is a model ally." This is their conclusion. Frankly, that the last dictatorship in Europe is the closest ally of the Putin government, if this fact were not a tragedy, it would be laughable. But this is essentially what we're dealing with.

It seems to me that the argument that we—our partnership with Russia is bearing fruit does not stand any scrutiny. They are not supporting us in weapons—in an effort to limit the proliferation of arms, nor are they cooperating in any manner in the war on terror. In fact, Putin flew, personally, to Kazakhstan to tell President Nazarbayev to pull his troops out of Iraq. And if this is a partner in the war on terror, I'm—I just don't understand the term any longer.

Now, it seems to me, turning to the implications of: What can we expect from a regime like this?—it seems to me that there's six quick conclusions.

One, Russia will actively contest the growth of democratic governments along its western border with Europe, throughout the Black Sea and Caucasus region, and in Central Asia. As part of blocking the movement of democracy, they will block the resolution of frozen conflicts. So we cannot expect any movement there.

Second, Russia will obstruct the development of effective multilateral institutions and their operations, not limited to the OSCE, also NATO's Partnership for Peace, and I would expect this year you'll see them try to restrict funds from United Nations peacekeepers in the region. Russian will increasingly engage in paramilitary and criminal activities beyond its borders.

But President Putin's goal of a 21st century empire will inevitably cause him to seize, extort, or otherwise secure the oil and gas reserves of the Caspian and Central Asia as a source of state funds. This is not limited to Yukos. They're talking about the entire strategic—what they call the strategic resources of the state. They want it all.

Fifth, it seems to me that the policies of Russia and the conduct of President Putin are growing increasingly eccentric. References to "castrating journalists" is sort of a humorous aside, it's not the characteristics of a democratic leader. So we are not dealing with a benevolent autocracy; we are dealing with a violent and vulgar "thuggery."

And, sixth, this plan, as you observed in your remarks, sir, cannot possibly work. It will ultimately take the Russian people to financial and political destruction. And the second fall of Russian power could be far more catastrophic to world politics than the fall of the Soviet Union in 1989. So we have a serious challenge to policy, as to: How do we manage them and get them to turn back from this dangerous path that they've embarked upon?

It seems to me—and this has come up in earlier testimony, and I think Dr. Aslund again covered it—there are four things we have to do.

The exemption that President Putin seems to enjoy from public criticism simply must end. If we can criticize Saudi Arabia and Egypt for undemocratic activities, we can certainly call what's happening in Russia by its true name. And among other names, Mikhail Khodorkovsky is a political prisoner. That's all—that's just, flat and simple, what it is.

Second, we must move to suspend Russian access to these privileged institutions of the West which they are trying to undermine at the same time. Not only WTO. The G7, Jackson-Vanik should stay in place, and, across the board, access to the institutions of the West must be limited until behavior conforms with standards.

Third, we need to talk—engage our European allies, who have firsthand experience with Russian power and know exactly what they are seeing. We have to coordinate with them, much in the way, under your leadership, we've tried to begin to coordinate a policy on Belarus. There has to be a common policy toward the failure of democracy in Russia, and that can only be worked out with our European allies.

And, finally, Natan Sharansky talks about the concept of moral clarity. I think that that is closely related to the concept of strategic clarity. We simply must tell Mr. Putin directly what is unacceptable behavior and where the red lines are. Crossing borders into Ukraine to steal the Kerch channel, insisting that Georgia sign a framework agreement limiting their sovereignty in perpetuity, those things have to be ruled out of bounds, and we have to be clear and up front about that.

I think that the time to begin that is obviously next Thursday, in Bratislava. And President Bush really—we are all looking for Mr. Bush to draw the red lines at that summit, which is critical.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Jackson follows:]

PREPARED STATEMENT OF BRUCE P. JACKSON, PRESIDENT, PROJECT ON  
TRANSITIONAL DEMOCRACIES, WASHINGTON, DC

Mr. Chairman, Members of the Committee, thank you for the opportunity to testify before you on the rapid deterioration of democracy in Russia over the past 24 months, the cause of this deterioration, and the significant dangers Russian policy now poses for the United States, its European allies and friends, and for the future prospects of democracy in the Euro-Atlantic. I would like to discuss three major questions:

- (1) What are the necessary institutional requirements for a successor state of the former Soviet Union to succeed in a transition to democracy? And how have these institutions, which would be essential for a democratizing Russia, fared in President Putin's Russia?
- (2) What policy is President Putin pursuing towards democracy in Russia and towards the prospect of positive democratic change in Russia's neighbors?
- (3) Has Russia become hostile to both the democratic values and the institutions of the West? And, if so, what should be done about it?

I

In retrospect, we now recognize that the arrest of Mikhail Khodorkovsky on October 25, 2003 by heavily armed, special forces troops was the watershed event in the deterioration of democracy in Russia. Prior to this arrest, the soft suppression of democratic forces appeared to some as a manifestation of Moscow's historic political insecurity and an understandable effort to "manage" democracy and ameliorate the



excesses of, and societal stress from, the Yeltsin era. Subsequent to October 2003, it became apparent that what President Putin had undertaken was a comprehensive crackdown on each and every perceived rival to state power and the re-imposition of the traditional Russian state, autocratic at home and imperial abroad.

However, if we focus only on the animus President Putin has towards Mr. Khodorkovskiy and the resultant “show trials” of Yukos executives, we risk missing the breadth of the crackdown on democratic forces and risk failing to see the logic of authoritarian and possibly even dictatorial power behind the events in Russia over the past two years.

Let me contrast the situation in Russia with the positive developments in Georgia during the Rose Revolution in November 2003 and in Ukraine during the Orange Revolution of December 2004. Democratic leaders in CIS countries and outside analysts have paid considerable attention to the attributes of Georgian and Ukrainian society that allowed their respective transitions to peacefully sweep away autocratic regimes despite their total control of the hard power of the security services and military forces.<sup>1</sup>

While the encouragement of Western democracies and the prospect of membership in such important institutions as the European Union and NATO have been important factors in the thinking of reformers in CIS countries, the preconditions of democratic change in the former Soviet Union appear to be:

- (1) An extensive civic society comprised of multiple NGO's where pluralism can develop;
- (2) Independent political parties which can contest elections;
- (3) An opposition bloc in Parliament which can offer alternative policies and serve as a training ground for future governance;
- (4) The beginnings of a business community which can financially support an opposition as a counterweight to the regime's use of government resources and corrupt business allies;
- (5) An independent media with the capability to distribute printed materials and with access to at least one independent television station; and
- (6) Civilian control of the military and security services adequate to ensure that armed force will not be used to suppress civil dissent.

Regrettably, Mr. Putin and the former KGB officers who surround him, the so-called “Siloviki,” conducted an analysis of the preconditions of democratic change, similar to the one I have just outlined, but reached a radically different conclusion. Rather than support and encourage these positive developments in post-conflict and post-Soviet states, President Putin evidently resolved to destroy the foundations of democracy in Russia and actively to discourage their development in countries neighboring Russia and beyond. And this is precisely what he has done.

(1) In May 2004, Putin formalized the attack on the civil sector in his state-of-the-nation address by accusing NGO's of working for foreign interests and against the interests of Russia and its citizens. Coupled with the conviction of academics Igor Sutyagin and Valentin Danilov on fabricated charges of espionage, the NGO sector in Russia has been effectively silenced.<sup>2</sup>

(2) Human Rights Watch reports that “opposition parties have been either decimated or eliminated altogether, partially as a result of the deeply flawed elections of December 2003.”<sup>3</sup>

(3) By 2004, United Russia, Putin's party in the Duma, controlled two-thirds of all seats and enough votes to enact legislation of any kind and to change the constitution to suit the President. On December 12, 2004, Putin was thus able to sign into law a bill ending the election of regional governors and giving the President the right to appoint Governors, thereby eliminating the possibility of any parliamentary or regional opposition.

(4) The destruction of Yukos and the seizure of its assets marked the beginning of the destruction of the business class, but do not fully convey the scale of re-nationalization. The Kremlin has made no secret that Russia claims all oil and gas reserves in the former Soviet Union as well as ownership of the pipelines which transit the territory of the former Soviet Union. The outflow of investment from Russia over the past year and a half confirms that the business base which could support alternative political views inside Russia is shrinking rapidly. The elimination of a politically active business community was precisely what President Putin

<sup>1</sup> See Dr. Irma Krasovskaya, “The Georgian and Ukrainian Revolutions: Implications for Central Eurasia (Belarus)” presented at the Nixon Center Seminar, chaired by Dr. Zeyno Baran, January 26, 2005 (forthcoming.)

<sup>2</sup> See among others the reporting of Masha Lipman, Carnegie Endowment for International Peace, Moscow.

<sup>3</sup> See Human Rights Watch, Russia Country Summary, January 2005.

intended to bring about by the arrest and subsequent show trial of Mikhail Khodorkovsky.

(5) Of all the areas where the Russian Government has suppressed the possibility of democracy, it has been most comprehensive and ruthless in its attack on independent media. All significant television and radio stations are now under state control. The editor-in-chief of *Izvestia* was fired for attempting to cover the tragic terrorist attack on the school children of Beslan, and two journalists attempting to travel to Beslan appear to have been drugged by security services. The state of journalism in Russia is so precarious that Amnesty International has just reported that security services are targeting independent journalists for harassment, disappearances and killing.<sup>4</sup> It should surprise no one that the distinguished Committee to Protect Journalists lists Russia as one of the World's Worst Places To Be a Journalist in its annual survey.<sup>5</sup>

(6) Among the most alarming of recent developments, however, is the return of the KGB to power in the Presidential Administration. According to Olga Kryshatanovskaya, a leading Russian sociologist, former KGB officers are regaining power at every level of government and now account for 70 percent of regional government leaders. Other analysts state that the number of former secret police in Putin's government is 300 percent greater than the number in the Gorbachev government. In this situation, there is a high probability that military and security services would be used to suppress civil dissent and, indeed, are already being used to this effect.

As a consequence of the systematic suppression of the basic foundations of a democratic society, on December 20, 2004, Freedom House downgraded Russia to the category of "Not Free" which Russia now shares with Belarus, North Korea and Saudi Arabia, among other undemocratic regimes.<sup>6</sup> Indeed, the majority of informed opinion on both sides of the Atlantic had reached that same conclusion much earlier and I have included their collective assessment as an annex to this testimony.<sup>7</sup> What I wish to add today to the near-unanimous view that Russia has become an autocratic state is my belief that the destruction of democracy in Russia was a premeditated and calculated act of state power, ordered by President Putin, and executed by a class of KGB-trained officials assembled for this purpose.

If the conditions which supported democratic change and reform in Georgia and Ukraine are any guide, President Putin has orchestrated a sustained and methodical campaign to eliminate not only democratic forces in civil and political life, but also the possibility of such forces arising again in the future. I do not think that it is accurate to say that democracy is in retreat in Russia. Democracy has been assassinated in Russia.

## II

Nobel Peace Prize Laureate Andrei Sakharov wrote, "A country that does not respect the rights of its own people will not respect the rights of its neighbors," and this is an admonition to hold in mind when assessing the overall direction of Putin's policies.<sup>8</sup> Rather than simply label Russia as an autocracy or as a borderline dictatorship, it is probably more accurate and useful for this Committee to regard Russia as an "anti-democratic state" locked in what its leadership imagines is a competition with the West for control of the "post-Soviet space."<sup>9</sup>

President Putin's initial argument for "managed democracy" rested on his belief that the sometimes unpredictable quality of liberal democracy could weaken the security of the Russian state unless it were subject to a substantial degree of state control. Whether or not he actually believed this, he quickly advanced to a more militant conviction that independent political parties, NGO's and journalists, by questioning the wisdom of his policy towards Chechnya, were effectively allies of terrorism. It is a short walk from the authoritarian view that domestic freedom must be curtailed in wartime to the dictatorial conclusion that all opposition and dissent is treasonous. By 2004, President Putin had arrived at the dictatorial conclusion.

<sup>4</sup>Amnesty International Press Release, "Russian Federation: Human Rights Group Threatened By Security Forces," January 20, 2005.

<sup>5</sup>The Committee to Protect Journalists, Annual Survey of the World's Worst Places To Be a Journalist, May 2, 2004.

<sup>6</sup>Freedom House, "Russia Downgraded to Not Free," December 20, 2004.

<sup>7</sup>An Open Letter to the Heads of State and Government of NATO and the European Union, September 23, 2004.

<sup>8</sup>Quoted in Natan Sharansky, "The Case for Democracy: The Power of Freedom to Overcome Tyranny and Terror" Public Affairs, 2004, pg. 3.

<sup>9</sup>Vladimir Socor, "Kremlin Redefining Policy in 'Post-Soviet Space,'" Jamestown Foundation, February 8, 2005.

Despite the fact that Moscow has killed upwards of 100,000 Chechens in the last decade and is estimated to be “disappearing” approximately 400 Chechen civilians annually, curiously, the war on terror does not figure prominently in Russian doctrinal statements. To the contrary, the casualties in the North Caucasus seem to be regarded as a cost associated with a larger strategic objective. As Kremlin consultant Gleb Pavlovsky explained on February 3, 2005, “One should be aware that, at least until the end of President Putin’s tenure and probably until the end of the presidency of his immediate successors, Russia’s foreign policy priority will be to turn Russia into a 21st century world power.”<sup>10</sup>

To put it bluntly, the growing view in Putin’s inner circle is that in order to regain the status of a world power in the 21st century, Russia must be undemocratic at home (in order to consolidate the power of the state) and it must be anti-democratic in its “near abroad” (in order to block the entry of perceived political competitors, such as the European Union or NATO, invited into post-Soviet space by new democracies). The war on terror is not central to this calculation and is little more than something to discuss with credulous Americans from time to time.

Again, the statements of Gleb Pavlovsky confirm understandable suspicions about Russian intentions. Shortly after the election of Victor Yushchenko as President of Ukraine, Pavlovsky urged the Kremlin to adopt a policy of “pre-emptive counter-revolution” towards any neighbor of Russia which manifested politically dangerous democratic proclivities.<sup>11</sup> Another of the so-called “polit-technologists” Sergei Markov, who also advises President Putin, has called for the formation of a Russian organization to counter the National Endowment for Democracy, whose purpose would be to prevent European and American NGO’s from reaching democratic movements anywhere in the Commonwealth of Independent States, in other words in post-Soviet space. (There is, of course, not the slightest reference to countering militant fundamentalism or Islamic terrorist cells in any of this.)

With this framework, it might be useful to review the recent interventions of Russia in the internal affairs of its neighbors:

Since the Rose Revolution in Georgia in late 2003, the Government of President Misha Saakashvili has been under constant pressure and occasional threat from Russia. In August 2004, Russia blocked the reinforcement of the OSCE peace-keeping mission to South Ossetia to facilitate its movement of military equipment and criminal traffic through the Roki tunnel into the zone of conflict. In that same month, Russian-backed South Ossetian paramilitary forces began to distribute AK-47’s widely among the South Ossetian populace, adding to the danger of inter-ethnic conflict. In return for this type of Russian “protection,” the OSCE estimates that the “government” of South Ossetia sends \$50m per year to the mafia-KGB bosses in St. Petersburg.

In December 2004 Russia vetoed the continuation of the OSCE-led border monitoring operation which polices the mountain passes along Georgia’s borders with Ingushetiya, Chechnya and Dagestan in the North Caucasus. Most observers believe the removal of international monitors is intended to allow Russia complete freedom to conduct military and paramilitary operations inside Georgia under the pretext of chasing terrorists. Russia has continued to hand out Russian passports to secessionists in Abkhazia and South Ossetia, and, despite its multiple international commitments to withdraw its military forces from Soviet-era bases in Georgia, continues to occupy and reinforce these bases. In a word, Putin’s policy towards Georgia is indistinguishable from the 19th century policies of Czarist Russia towards the easily intimidated states of the South Caucasus.

In Moldova, since December 2003 when the Russian negotiators proposed in the infamous Kozak Memorandum to legalize the permanent stationing of Russian troops in Transdnistria, Russia has worked tirelessly to exacerbate tensions between Transdnistria and Chisinau and to prevent the demilitarization of Transdnistria. As a result, Russia has been able to keep Moldovan leadership sufficiently weak, divided, and corrupt so as to be incapable of enacting the reforms necessary for democratization. Transdnistria remains exclusively a criminal enterprise under Moscow’s protection and the largest export hub of illicit arms traffic in the Black Sea region. And remember, Russia shares no border with Moldova, a fact which adds to the imperial character of Russian intervention.

In Ukraine, the massive scale of Russian interference and President Putin’s personal involvement in the recent fraudulent presidential elections is well-known. Most analysts believe that the Kremlin spent in excess of \$300m and countless hours of state television time in the attempt to rig the election for Victor Yanukovich. What may be less well known to this Committee is that explosives used

<sup>10</sup> Socor, *op. cit.*

<sup>11</sup> Dr. Ivan Krastev, Center for Liberal Studies, Sofia, Bulgaria. (Interview with author.)

in the botched assassination attempt on Victor Yushchenko and the dioxin poison that almost succeeded in killing him both almost certainly came from Russia. Western diplomats and numerous Ukrainian officials in Kiev say privately that the investigation into these repeated assassination attempts is expected to lead to Russian organized crime and, ultimately, will be traced to Russian intelligence services. There is mounting evidence that the murder of political opposition figures in neighboring countries is seen by some factions of the Russian security services, such as the GRU, as being a legitimate tool of statecraft, as it was in the dark years of the Soviet Union.

With regard to Belarus, President Putin's government has been an accomplice with Alexander Lukashenko in the construction and maintenance of what has been often called "the last dictatorship in Europe." This unholy alliance has brutalized and impoverished the people of Belarus and is distinguished only by the degree of Russian cynicism which motivated it. Here again, I cannot improve on the words of Putin-advisor Gleb Pavlovsky:

We are totally satisfied with the level of our relations with Belarus. Russia will clearly distinguish between certain characteristics of a political regime in a neighboring country and its observance of allied commitments. Belarus is a model ally.<sup>12</sup>

Think about this for a moment. The last dictatorship in Europe is the closest ally of the Putin Government. If this fact were not a tragedy, it would be laughable.

These are only illustrations of the growing belligerence of Russia's near abroad policy. A more comprehensive treatment would include the threatening manner the Kremlin uses in discussions with the Baltic states on commercial transit and Russian-speaking minorities; the seizure of the waterway (the Kerch Channel) connecting the Black Sea and the Sea of Azov from Ukraine; the demands on concessionary energy rights from Kazakhstan; not to mention the extermination of 100,000 Chechens. There is little doubt that President Putin believes that 19th century mercantilism and militarism are appropriate tactics for a 21st century Russian leader.

In all fairness, there are some U.S. Government officials who believe that, although Russia's internal conditions are disappointing even deplorable, the benefits of a U.S.-Russian partnership in the war on terror, energy export issues, and the effort to counter the proliferation of weapons outweigh these concerns. This is at least an argument for the case advanced by Russian apologists. Unfortunately, there is no evidence that Russia is helping with the war on terror, the world energy supply, or on weapons proliferation beyond what the Russian government would do anyway in its own national interest. Indeed, the evidence available points to the opposite conclusion.

Not only is President Putin deliberately working to create weak and vulnerable states on Russia's borders which will serve as a breeding ground for future criminals and terrorists, he is actively trying to undermine American interests in building a democratic Iraq. In January 2005, President Putin visited President Nazarbayev in Kazakhstan and ordered him to pull the Kazak troops out of Iraq. When President Nazarbayev refused, Putin cut short his visit and returned to Moscow.

Promises to increase Russian energy production and exports remain unmet. Russia's most capable and modern energy company was re-nationalized and its resources taken over by some of its least efficient producers. Russia not only refuses to support Western anti-proliferation efforts in Iran, but it has been and continues to be a critical foreign supplier to Tehran's weapons programs.

In 2004, Russia blocked a NATO naval mission which would have provided surveillance in the Black Sea of weapons traffic and potential terrorist attack. I have already outlined the Kremlin's campaign to push OSCE peacekeepers and border monitors out of the former Soviet space, which will soon be followed by efforts to curtail U.N. missions in places such as Abkhazia. The overall effect of our "partnership" with Russia appears to have rendered the citizens of a dozen independent countries more vulnerable to terrorism and organized crime, while allowing the Russian military to remain the largest source of proliferated arms in the world. This hardly seems fair value for the compromise of American principles which this partnership obviously entails.

<sup>12</sup>Socor. op. cit.

Given the reversal of democratic trends in Moscow and the appearance of a threatening Russia in Eurasian politics, what are the implications for U.S. foreign policy? It seems to me that we are forced to six conclusions:

(1) Russia will actively contest the growth of democratic governments along its Western border with Europe, throughout the Black Sea and Caucasus region, and in Central Asia. President Putin intends to block the resolution of the frozen conflicts from Transdnistria to South Ossetia to Nagorno-Karabakh and to maintain the Soviet-era military bases which serve as occupying forces and prolong these conflicts. The instability this policy will cause in the governments throughout the post-Soviet space will be a long-term threat to the interests of Europe and the United States in stabilizing and democratizing this region.

(2) Russia will obstruct the development of effective multi-lateral institutions and their operations, such as the OSCE and NATO Partnership for Peace, anywhere in what Putin perceives as Russia's historical sphere of influence, thereby isolating Russia's neighbors from the structures of international dialogue, conflict resolution, and cooperation.

(3) Russia will increasingly engage in paramilitary and criminal activities beyond its borders, both as an instrument of state policy and as a function of simple greed. Thus, the United States should expect the persistence of arms traffic to embargoed states and the irresponsible proliferation of small arms (as in South Ossetia) as well as a higher incidence of both politically and criminally motivated bombings and murders (as in the recent car bombing in Gori, Georgia and the repeated attempts on Victor Yushchenko's life).

(4) President Putin's goal of a 21st century empire will inevitably cause him to seize, extort or otherwise secure the oil and gas reserves of the Caspian and Central Asia as a source of funds for state power. Indeed, the seizure of Yukos and the network of pipelines were the first two steps in a larger plan to control the resources of Central Asia. Setting aside the negative impact these developments will have on world energy prices, our allies in Europe will become increasingly dependent on an oil monopoly controlled by the Russian security services for its growing energy needs. Without doubt, this oil and gas will come with a political price.

(5) The policies of Russia and the conduct of President Putin are growing increasingly eccentric and seem to be motivated more by an angry romanticism, than by a rational calculation of national interest. Mr. Putin's insistence in an interview with Russia journalists at the time that there were no casualties in the slaughter in the Nord-Ost Theater is revealing. Mr. Putin was only conscious of casualties among the Russian security services; the lives of civilians did not figure in his calculus. As everyone knows, the unpredictable and uncalculated use of power in international politics is highly dangerous. In a word, we are not dealing with a benevolent autocracy; we are now dealing with a violent and vulgar "thuggery."

(6) And, finally, President Putin's plan cannot possibly work. Both strategically and economically, Russia cannot support itself as a world power and cannot feed its people with an economy run by the Kremlin. Thus, if these trends are not reversed, Mr. Putin will bring about the second collapse of Moscow which may well be far more dangerous and violent than the collapse of the Soviet empire in 1989. It was precisely this outcome, the return to empire and the resultant collapse, that U.S. policy has been trying to avert since the fall of the Berlin Wall. As Secretary of State Condoleezza Rice advised presciently some years ago, a critical challenge for U.S. policy will be "to manage the decline of Soviet power." So far, we are not meeting this challenge.

It seems to me that there are four policy steps that the United States should take in response to the threat posed by an anti-democratic Russia. First, we have to end the exemption from public criticism that President Putin's administration seems to enjoy. There has been almost no testimony on this critical issue before this Committee by senior Administration officials for the last two years. This silence is not in our interests and conveys a false impression of permissiveness to the Kremlin. If Saudi Arabia and Egypt are no longer immune from legitimate criticism of their undemocratic practices, so too must Russian practices be subject to public censure by U.S. policymakers.

Second, as Senator John McCain has called for, the United States must end the policy of advancing access to the inner councils of democratic institutions (the G7, NATO, and the White House) as long as Mr. Putin continues to abuse human and political rights at home and attempts to undermine democratic institutions abroad. If the conduct of Mr. Putin is free from penalty, he will undoubtedly continue to pursue policies counter to the interests of the community of democracies.

Third, the United States should work with our partners in NATO and the European Union to develop common strategies to deal with the death of democracy inside Russia and with its imperial interventions abroad. The recent enlargements of the EU and NATO added many European countries with first-hand knowledge of what it means to be an object of Russia's predatory policies. For Czechs, Slovaks, Poles, Balts and others, Russian imperialism is not an abstraction. We can and must expend the political capital to develop a common Western approach that promotes democracy inside and alongside the Russian Federation.

Finally, Natan Sharansky reminds us that "moral clarity" is the essential quality of a successful democracy in its foreign policy. As a nation, we have been far from morally clear about the political prisoners in Russia and the human rights abuses throughout the North Caucasus, to name two of the most egregious examples.

Closely related to the lack of moral clarity is the absence of "strategic clarity." We simply have not informed Russia where the "red lines" are in their treatment of vulnerable new democracies and what the consequences are for Russia in pushing beyond what used to be called "the rules of the game." This Committee can play a very significant role in urging the Administration and communicating directly to Moscow, quite specifically, that the continuation of the arrests, seizures, murders and threats I have described will result in the suspension of commerce with and access to the United States.

A stern and public rebuke to Mr. Putin may cause Russia to rethink the self-destructive path on which it has embarked and serve to protect the long-term democratic prospects and future prosperity of Russia and its neighbors. It would also send a message of hope to embattled democrats inside Russia and the beleaguered democracies on its borders. Let us hope that President Bush delivers this message to Mr. Putin next week in Bratislava.

Thank you, Mr. Chairman.

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AN OPEN LETTER TO THE HEADS OF STATE AND GOVERNMENT OF NATO AND THE EUROPEAN UNION, SEPTEMBER 23, 2004

As citizens of the Euro-Atlantic community of democracies, we wish to express our sympathy and solidarity with the people of the Russian Federation in their struggle against terrorism. The mass murderers who seized School No. 1 in Beslan committed a heinous act of terrorism for which there can be no rationale or excuse. While other mass murderers have killed children and unarmed civilians, the calculated targeting of so many innocent children is an unprecedented act of barbarism that violates the values and norms of our community and which all civilized nations must condemn.

At the same time, we are deeply concerned that these tragic events are being used to further undermine democracy in Russia. Russia's democratic institutions have always been weak and fragile. Since becoming President in January 2000, Vladimir Putin has made them even weaker. He has systematically undercut the freedom and independence of the press, destroyed the checks and balances in the Russian federal system, arbitrarily imprisoned both real and imagined political rivals, removed legitimate candidates from electoral ballots, harassed and arrested NGO leaders, and weakened Russia's political parties. In the wake of the horrific crime in Beslan, President Putin has announced plans to further centralize power and to push through measures that will take Russia a step closer to authoritarian regime.

We are also worried about the deteriorating conduct of Russia in its foreign relations. President Putin's foreign policy is increasingly marked by a threatening attitude towards Russia's neighbors and Europe's energy security, the return of rhetoric of militarism and empire, and by a refusal to comply with Russia's international treaty obligations. In all aspects of Russian political life, the instruments of state power appear to be being rebuilt and the dominance of the security services to grow. We believe that this conduct cannot be accepted as the foundation of a true partnership between Russia and the democracies of NATO and the European Union.

These moves are only the latest evidence that the present Russian leadership is breaking away from the core democratic values of the Euro-Atlantic community. All too often in the past, the West has remained silent and restrained its criticism in the belief that President Putin's steps in the wrong direction were temporary and the hope that Russia would soon return to a democratic and pro-Western path. Western leaders continue to embrace President Putin in the face of growing evidence that the country is moving in the wrong direction and that his strategy for fighting terrorism is producing less and less freedom. We firmly believe dictatorship will not and cannot be the answer to Russia's problems and the very real threats it faces.

The leaders of the West must recognize that our current strategy towards Russia is failing. Our policies have failed to contribute to the democratic Russia we wished for and the people of this great country deserve after all the suffering they have endured. It is time for us to rethink how and to what extent we engage with Putin's Russia and to put ourselves unambiguously on the side of democratic forces in Russia. At this critical time in history when the West is pushing for democratic change around the world, including in the broader Middle East, it is imperative that we do not look the other way in assessing Moscow's behaviour or create a double standard for democracy in the countries which lie to Europe's East. We must speak the truth about what is happening in Russia. We owe it to the victims of Beslan and the tens of thousands of Russian democrats who are still fighting to preserve democracy and human freedom in their country.

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 Mr. Kenneth Weinstein

The CHAIRMAN. Thank you very much, Mr. Jackson.  
 Mr. Nix.

**STATEMENT OF STEPHEN NIX, REGIONAL PROGRAM DIRECTOR FOR EURASIA, INTERNATIONAL REPUBLICAN INSTITUTE, WASHINGTON, DC**

Mr. NIX. First of all, thank you, Mr. Chairman, for this opportunity to appear before you today. I will try to be brief on a very important and lengthy topic.

Mr. Chairman, the Russian Federation today is a country in which the rights of citizens to participate in government through free and fair elections, independent media, and civic activism are being severely curtailed. As my esteemed colleagues here have noted, the list of democratic rollbacks implemented by the Putin administration is as long as it is egregious: Complete control over national media, ongoing attempts to control the course and results of elections by changing the electoral system, the arbitrary arrest and prosecution of business leaders and the triumph of state-run monopolies over the rule of law, and the absence of checks and balances within the decisionmaking process. Mr. Putin has periodically introduced terms in which to couch these alarming trends: Dictatorship of the law, managed democracy. My friends and colleagues in Russia, however, are now using a new term to describe these events: Bureaucratic dictatorship.

The watershed event of Russia's creeping authoritarianism was the election of December 2003, when Russian prodemocratic parties



failed to garner sufficient support to remain a faction in the Russian National Parliament. The fourth invocation of the Russian State Duma, with 360 out of 450 seats occupied by Unified Russia, is, therefore, now dominated by a single progovernment party. With no national parliamentary presence and no real access to mass media, prodemocratic parties have fallen into a crisis of identity at the national level, marked by a lack of leadership, organization, and consistent ideology.

Mr. Chairman, if the prodemocratic forces are absorbed in a crisis of identity, the Russian public is engulfed in a crisis of faith in the political party system. A nationwide poll conducted by the Levada Center last month indicated that nearly 50 percent of the population feel that political parties play either absolutely no role, or just a very minor one, in the daily life of Russia. Only 7.2 percent feel that political parties play a major role. In contrast, nearly 50 percent of those polled believe that the FSB plays either an important, or a very important, role. I think you'll agree with me, Mr. Chairman, that these statistics are very alarming.

The Kremlin, meanwhile, has moved further to undermine the crippled national opposition movement. With only a shadow of an opposition, the Duma has devolved into little more than a rubber stamp for legislation. With the help of a loyal state Duma, the Kremlin has taken steps to eliminate single-mandate districts, increase the threshold required to enter Parliament from 5 percent to 7 percent, and to outlaw the formation of electoral blocs in future national parliamentary elections. This divide-and-conquer approach, Mr. Chairman, is intended solely to force democratic parties to campaign against one another for pro-reform votes. By splitting the vote this way, the Kremlin all but guarantees that the democratic opposition will once again be shut out of Parliament.

In order to stifle grassroots democratic movements, the Kremlin has moved to prohibit the creation of regional political parties and the emergence of new parties by artificially inflating registration requirements, raising obligatory party membership, and applying direct pressure on party members. On January 31, Russia's Ministry of Justice again delayed the registration of a new democratic party, *Novye Pravye*, or "New Right," saying that it needs more time to review the case.

Despite all of these things, Mr. Chairman, the political pendulum is not swinging in only one direction in Russia. Russia's first year of a return to a single-party state has also proved to be a year of setbacks for the Putin administration. The economy is faltering, Russia's strong-arm tactics in the "near abroad," as has been noted previously, have failed, and Putin's "vertical of power" has proved unable to protect Russian citizens from acts of terrorism. Recent public-opinion data shows falling approval numbers for the Prime Minister, his government, and even President Putin himself.

We are now witnessing as Russians take to the streets throughout the country to protest social reforms. On January 29, thousands of St. Petersburg citizens marched against Kremlin policies, including pensioners, World War II veterans, and students.

Mr. Chairman, these actions by the Russian people are heartening to me, as it proves what I believed all along, that apathy is not, in fact, endemic in the Russian population, and that the Rus-

sian public does not—does believe that the government must be accountable to the people. Russia remains, despite the setbacks, fertile ground for democracy. And I make this assertion based, not only on dramatic images of street protests and public demonstrations, but on more subtle ongoing developments.

The truth is, a lot is happening at the regional level. During regional legislative elections over the last year, regional opposition parties have doubled and even tripled the support the national party received in the 2003 national elections. Many have accomplished this with little support from national leadership or, indeed, international assistance. In fact, regional opposition parties have been able to accomplish what the national parties could not; namely, form coalitions and work together.

At the same time, civil activists and political leaders at the regional level are coming together to counteract what they rightfully see as the skewed monopoly progovernment forces have on public discourse.

Mr. Chairman, the Russian Federation today is a country at critical crossroads. Despite the results of the 2003 elections, despite the crisis of Russia's democratic opposition, despite the Russian public's lack of faith in political party processes, and despite the Putin administration's concerted efforts to achieve an absolute grip on power, Russian democracy is not a lost cause. Russian citizens have been bombarded with Mr. Putin's attempts to discredit democratic ideals and movements, including the government and media. And yet, the Levada poll, I cited earlier, indicates that at least 10 percent of Russians are still willing to vote for a democratic party; enough to enter the state Duma, even if the Kremlin's attempts to raise the threshold does succeed.

The United States, and the international community as a whole, must provide whatever support we can to these defenders of Russian democracy in the regions. Without them, Russia's future is bleak.

We must support Russia's democratic community in their efforts to unite behind common goals and ideals. Only by building real, effective coalitions with like-minded partners can the democratic movements provide a viable alternative to the proponents of the Kremlin status quo. This process has already begun, to a certain extent, as evidenced by the electoral gains that I mentioned earlier.

We must also engage and encourage young people to be involved in representative government as civil-society activists, candidates, or party members. The talent and idealism of Russia's youth cannot be allowed to waste away. Initiatives as simple as community service projects can help to underscore the ways in which a participatory democracy can address the concerns of Russia's young people.

Finally, we must engage Russia's leadership in such a way that it recognizes the dangerous line it is walking. President Putin must come to understand that his authoritarian policies are bad for Russia and are leading to a systemic crisis in every sector—economic development, foreign policy, and civil society. Only by opening up Russia to a range of opinions and healthy debate will Russia truly thrive. The current climate of oppression will lead only to stagnation.

Mr. Chairman, we, in the United States, applauded in the early 1990s, as the Russian people threw off the yoke of oppression, and watched with hope as they began to create a society dedicated to democracy, a free and open economy, and adherence to the rule of law. And we, in the United States, have watched with profound sadness as these hard-fought achievements and sacrifices have been cast aside by an increasingly authoritarian regime. This is not a government that the Russian people deserve. This is not a government that the Russian people should tolerate.

I say this because I firmly believe that our friends, the Russian people, are capable of creating a democracy that offers them the stability, the prosperity, and the freedom that they so richly deserve.

Again, thank you, Mr. Chairman, for this opportunity.

[The prepared statement of Mr. Nix follows:]

PREPARED STATEMENT OF STEPHEN NIX, REGIONAL PROGRAM DIRECTOR FOR  
EURASIA, INTERNATIONAL REPUBLICAN INSTITUTE, WASHINGTON, DC

Mr. Chairman, first of all, thank you for the opportunity to testify here before you today. I would like to request that my statement be submitted to the record. This hearing is in itself testimony to the crucial importance of the issue of deepening authoritarian tendencies in the Russian Federation.

The Russian Federation today is a country in which the rights of citizens to participate in government through free and fair elections, independent media, and civic activism are being severely curtailed. As my esteemed colleagues here have noted, the list of democratic rollbacks implemented by the Putin Administration is as long as it is egregious: The complete control over national media outlets by the state; ongoing attempts to control the course and results of elections by changing the electoral system; the arbitrary arrest and prosecution of business leaders and the triumph of state-run monopolies over rule of law; and the absence of checks and balances within the decision-making process. Mr. Putin has periodically introduced terms in which to couch these alarming trends—"dictatorship of the law," and "managed democracy." My friends and colleagues in Russia, however, are now using a new term: Bureaucratic dictatorship.

The watershed event of Russia's creeping authoritarianism was the election of December 2003, when Russian pro-democratic parties failed to garner sufficient support to remain a faction in the Russian national parliament. The fourth invocation of the Russian State Duma, with 360 of 450 seats occupied by Unified Russia, is therefore now dominated by a single, pro-government party. With no national parliamentary presence and no real access to mass media, pro-democratic parties have fallen into a crisis of identity at the national level, marked by a lack of leadership, organization, and consistent ideology.

If the pro-democratic forces are absorbed in a crisis of identity, the Russian public is engulfed in a crisis of faith in the political party system. A nationwide poll conducted by the Levada Center late last month indicated that nearly 50 percent of the population feel that political parties play either absolutely no role, or just a very minor one, in the life of Russia. Only 7.2 percent feel that the political parties play a major role. In contrast, nearly 50 percent of those polled believed that the FSB, the KGB successor, plays either an important or very important role. I think you will agree that these statistics are extremely troubling.

The Kremlin, meanwhile, has moved to further undermine the crippled national opposition movement. With only a shadow of an opposition, the Duma has devolved into little more than a rubber stamp for initiatives put forward by the Kremlin to strengthen its almost absolute grip on power. With the help of a blindly loyal State Duma, the Kremlin has eliminated single mandate districts, increased the threshold required to enter parliament from 5 percent to 7 percent, and outlawed the formation of electoral blocs in future national parliamentary elections. This "divide and conquer" approach is intended to force democratic parties to campaign against each other for pro-reform votes. By splitting the vote in this way, the Kremlin all but guarantees that the democratic opposition will once again be shut out of parliament. In order to survive, these parties have no choice but to merge into a single organization, a task which is fraught with political, legal, and bureaucratic challenges.

In order to stifle grassroots democratic movements, the Kremlin has moved to prohibit the creation of regional political parties and the emergence of new parties by artificially inflating registration requirements, raising obligatory party membership, and applying direct pressure on party members. Just last Monday (January 31), Russia's Ministry of Justice, violating the spirit, if not the letter, of the law, again delayed the registration of a new democratic party—Novye Pravye, or the New Right,<sup>1</sup> saying that it needs more time to review their case.

Despite the foregoing, Mr. Chairman, the political pendulum is not swinging in only one direction. Russia's first year of a return to a single party state has also proved to be a year of unequivocal setbacks for the Putin Administration. The economy is faltering, Russia's strong-arm tactics in its "near abroad" have failed, and Putin's "vertical of power" has proved unable to protect Russian citizens from heinous acts of terrorism. Recent public opinion data shows falling approval numbers for the Prime Minister, his Government, and even President Putin himself.

We are now witnessing as Russians take to the streets throughout the country to protest what they feel to be the Kremlin's failure to fulfill basic social responsibilities to the public. On February 6, 2,000 people in Petrozavodsk took part in a protest to demonstrate against Kremlin-initiated reform of pension benefits. On the same day, a number of youth groups, including Youth SPS, Youth Yabloko, and "Idushie bez Putina" ("Walking Without Putin"), organized a protest in Moscow against the presidential appointment of governors and the strengthened "vertical of power."

On January 29, thousands in St. Petersburg marched against Kremlin policies, including pensioners, World War II veterans, and students. The protest was organized by the "St. Petersburg Civic Resistance" movement, which consists of opposition parties, movements, and NGOs, including Yabloko, KPRF, Social Democrats, League of Women Voters, Committee of Soldiers' Mothers, St. Petersburg Democratic Assembly, and Walking Without Putin.

On January 29, Yabloko organized a protest in more than 30 cities and regions throughout Russia to protest against benefits legislation and the actions of Unified Russia, who voted for benefit monetization legislation, housing reform, auto insurance reform, the abolition of gubernatorial elections, and changes to the military draft law.

Families of the Beslan school hostage victims have blocked a central highway in the region in an attempt to voice their frustration with the Administration's response to the horrific tragedy that took place there last September 1.

The response of the Putin Administration to these protests has been remarkable only in its complete failure to adequately address the concerns being aired by citizens. The Beslan families have been rebuked by a key Kremlin aide for their attempts to demand accountability from regional leadership. The Kremlin has also attempted to wholly discredit the massive protest movement against pension reforms by labeling organizers as provocateurs and radical opportunists. Organizers were targeted for arrest, especially young people. However, some participants have alleged that elderly pensioners were arrested, and even beaten. Not until after the voice of the people became overwhelming did the government respond, if only to point fingers at a promise half-hearted revision of the reforms.

Mr. Chairman, these actions by the Russian people are heartening to me, as it proves what I have believed all along—that apathy is not, in fact, endemic in the Russian population, and that the Russian public does believe that the government must be accountable to its people. Russia remains fertile ground for democracy. I make this assertion based not only on dramatic images of street protests and public demonstrations, but on more subtle, ongoing developments.

The truth is that while Putin rushes to eliminate democratic voices at the national level, democracy shows signs of re-invigoration at the regional level. During regional legislative elections over the last year, regional opposition parties have doubled and even tripled the support the national party received in 2003. Many have accomplished this with little support from national leadership, or indeed, international assistance.

<sup>1</sup>Novye Pravye submitted registration papers on November 22, 2004. According to the law on political parties (June 21, 2001), their registration must be decided on within one month. The party believes that the law gives the government one month to review the case and come up with either a positive or a negative answer. However, a loophole in the law allows the government to drag its heels on the process indefinitely. Point 4 of Article 15 states that the government has one month to make a decision "upon verification of correspondence of documents, necessary for registration . . . , to the requirements of the federal law." The government can claim that it is still "verifying documents" and win the case in court on a technicality.

In fact, regional opposition parties have been able to accomplish what the national leadership could not last year; namely, form coalitions with other like-minded parties and candidates to present a unified opposition choice on the ballot. A united bloc of Yabloko and SPS received 8 percent in elections for the Arkhangelsk Oblast regional legislature. During elections in Kurgan, SPS received 10.4 percent. In the Republic of Ingushetiya (which borders Chechnya), Yabloko reached 10.8 percent. And most recently in Taimyr, Yabloko cooperated with the Party of Life to take 22 percent of the vote.

At the same time, civil activists and political leaders at the regional level are coming together to counteract what they rightfully see as the skewed monopoly pro-government forces have on public discourse. Hundreds of thousands of human rights and political party activists continue their work in the regions regardless of pressure applied on them by the FSB and the Kremlin. IRI has worked with a number of these activists and the organizations they represent. Using innovative means to reach out to the public, they communicate their messages through forums, press releases, internet sites, newsletters, rallies, and even leaflet campaigns. They are fighting to make sure that dissenting voices, no matter how small, are heard.

On December 12, Russia's Constitution Day, more than 1,200 representatives of Russian civic groups, political parties, and media from all over the country came to Moscow to take part in the "All-Russia Civic Forum." These advocates of democracy came to say "no" to Kremlin policies and to develop a democratic agenda for their country. The Civil Resistance movement in St. Petersburg brought together opposition parties, movements, and civic groups to stand up for media freedoms, picketing local television stations to protest censorship on TV, and allow the voice of democratic Russia to be heard.

Mr. Chairman, the Russian Federation today is a country at a critical crossroads. Despite the results of the 2003 elections, despite the crisis of Russia's democratic opposition, despite the Russian public's lack of faith in political party processes, and despite the Putin Administration's concerted efforts to achieve an absolute grip on power, Russian democracy is not a lost cause. Russian citizens have been bombarded with Mr. Putin's attempts to discredit democratic ideals and movements through any means available, including the government and the media. And yet, the Levada poll I cited earlier also indicates that 10 percent of Russians are still willing to vote for a democratic party—enough to enter the State Duma even if the Kremlin's attempt to raise the threshold succeeds.

I firmly believe that the real strength and indeed, the future of pro-democracy forces lies in the regions and among Russia's younger generations, who must not, and will not, tolerate a return to dictatorship.

The United States, and the international community as a whole, must provide whatever support we can to these defenders of Russian democracy. Without them, Russia's future is bleak.

I believe that we must act now to help Russians re-establish their faith in a democratic system. We must work to assist democratic political parties to regain legitimacy in the eyes of their constituents by focusing on their development at the grassroots level. Targeting promising activists, civil organizations, and political movements at the local level, we can provide training and support to help them more effectively represent the needs of their communities. In addition, we can assist these activists in crafting messages and platforms that demonstrate to their constituents that someone is paying attention to their interests.

We must support Russia's democratic community in their efforts to unite behind common goals and ideals. Only by building real, effective coalitions with like-minded partners can the democratic movement provide a viable alternative to proponents of the Kremlin status quo, or supporters of nationalist radicals. This process has already begun, to a certain extent, as evidenced by electoral gains made by democratic coalitions in the regions I mentioned earlier. Although Russia's democratic opposition parties may not have a clear national party head, national leadership can benefit from the momentum growing at the regional level and learn from the successful examples of their colleagues in the regions. Initiatives like Committee 2008, a group of pro-democracy advocates and leaders who are working together to find common ground for a diverse group of political parties, civil society organizations, and individual activists, are an important step towards this goal.

We must also encourage young people to re-engage in representative government as civil society activists, candidates, or party members. The talent and idealism of Russia's youth cannot be allowed to waste away to apathy and disenfranchisement. Initiatives as simple as community service projects can help to underscore the ways in which participatory democracy can address the concerns of Russia's young people much more effectively than radical nationalism, or rote acceptance of pro-government ideology.

Finally, we must engage Russia's leadership in such a way that it recognizes the dangerous line it is walking. President Putin must come to understand that his authoritarian policies are bad for Russia, and are leading to a systemic crisis in every sector—economic development, foreign policy, and civil society. Only by opening up Russia to a range of opinions and healthy debate will Russia truly thrive. The current climate of oppression will lead only to stagnation.

We in the United States applauded in the early 1990's as the Russian people threw off the yoke of oppression, and watched with hope as they began to create a society dedicated to the ideals of democracy, a free and open economy, and adherence to the rule of law. And we in the United States have watched with profound sadness as these hard-fought achievements and sacrifices have been cast aside by an increasingly authoritarian regime. This is not a government that the Russian people deserve. This is not a government that the Russian people should tolerate. I say this because I firmly believe that our friends, the Russian people, are capable of creating a democracy that offers them the stability, the prosperity, and the freedom they so richly deserve.

Thank you.

The CHAIRMAN. Well, thank you very much, Mr. Nix, for your testimony.

I apologize for my abrupt departure for a few minutes, but I would simply indicate, because I think this will be of interest to all of you, that I was on the telephone with Ambassador John Negroponte. He has been nominated to be our Director of National Intelligence. We congratulate him. He assures me, as he has assured all of you, that he will go back to Iraq. He will work through the formation of the government that is currently in process there, and, much as he tried to do with his work with the United Nations as he underwent the confirmation process for Ambassador to Iraq, he will do a similar role for our country now during another transition period.

Let me ask now for you, Mr. Ledsky, to give your testimony. We appreciate your coming.

**STATEMENT OF HON. NELSON LEDSKY, REGIONAL PROGRAM  
DIRECTOR FOR EURASIA, NATIONAL DEMOCRATIC INSTITUTE,  
WASHINGTON, DC**

Ambassador LEDSKY. Thanks, Senator Lugar.

I don't want to repeat what my colleagues have said. Each has made a—what I think—a very excellent presentation of the problems in Russia, and there is no point in going over them again.

I want to start off by thanking you, Senator Lugar and Senator Sarbanes, for the work you've done on democratic development over the years all around Europe and the world. It's been my pleasure to work with both of you—for more than 20 years now, I know what role each of you has played in the furtherance of democratic development in the Ukraine and Georgia, and, I think, it wholly appropriate that the committee turn its attention now to Russia. This is a country which, frankly, deserves to be at the top of everybody's list. It has not been at the top of any of our lists over the last 4 or 5 years.

I speak today as the Director of the National Democratic Institute's programs in the former Soviet Union. I share with my colleague, Steve Nix, the difficult task of being an operating non-governmental organization in Russia. So we speak as people who are on the ground, who are facing the difficulties day by day that have befallen Russian citizens, Russian political parties, Russian civic society. And it's in that sense that I would like to be heard.

We've prepared a statement, and you can read it, but I'd just like to emphasize two or three points.

First, we've had an office in Moscow since 1992, and we've been operating with whatever political parties want to talk to us and work with us over the course of the last 13 years. And, literally, we have trained and worked and consulted and talked to thousands of people in Russia. And it is these people who want us there, who need us there, who are not giving up the struggle, even as the current situation is as described by Anders and Bruce.

Second, we have been working with civil society in Russia. We've been seeking, since the mid '90s, to work with a series of organizations that can monitor elections effectively. And within the last 3 or 4 years, we've brought together a coalition of groups into what is called the VOICE coalition, "Golos" in Russian. This group monitored the 2003–2004 elections, issued a report, had a press conference, explained the deficiencies of that electoral process, received absolutely no publicity in the Russian press, and very limited publicity in the United States. But they did outline the very specific failures that occurred in the elections of December 2003 and March 2004. And it is from those failed elections that a Duma has been installed which represents only a single group, that decisions have been taken to stop the election of governors in the regions, to realter the judiciary so that there is less rule of law today than there was 2 years ago, or 5 years ago. So the trend is all downward, and it's been particularly downward in the last year or two, since those elections of 2003 and 2004.

I would like to point out one thing in particular that Bruce mentioned, and that is the attack that the Russians have made at the Organization of Security and Cooperation in Europe, the Russian assault on that organization's ability to do monitoring around the former Soviet Union and in Europe. The Russians want to put the emphasis on economic factors, move it away from human rights and the rule of law and monitoring.

So the Russian attitude, over the last year, has not only grown worse at home, it has grown worse in its effect on overseas activities.

I think it's also important to say, rather flatly, that the democratic gains that were made in the early '90s have all but been erased. The trend is clearly in the wrong direction. But there are, as Steve points out, not only pockets of independence and liberalism in the country, but areas of the country where NDI and IRI have tried to work, where there clearly are organizations that are beginning to grow. And, I think, it's that very growth which the Kremlin is now attacking, by eliminating the possibility of elections and free expression in the regions.

So—both Bruce and Steve and I—want to keep working in the regions. It's become increasingly difficult given the application of what the Russians call law to actually operate outside Moscow and to build groups outside Moscow. It's difficult to bring people from the regions outside of Moscow, because the name of each individual trained or consulted must be reported to the Russian police. And if we buy a railroad ticket or a lunch for somebody, that must be declared as income by that individual. So people are naturally frightened from coming to see us or being seen by us.

There are two very hopeful signs, which I want to highlight.

The first is that, last December a Civic Congress was organized in Moscow, and it brought together 1,500 political and civic activists who asserted their determination to promote peaceful political reform. It sought to foster cooperation between the liberal reform parties that have been in existence in Russia for the last 10 years and to bring civic organizations of all kind together into a united congress. And they set forth an agenda for the future, and they set in motion an organization which will continue to meet in Moscow and in the regions over the course of the next 2 or 3 years. And we believe that that congress, and efforts which has begun earlier this year, need to be supported and encouraged and helped.

Second, the civic organization, VOICE, which we have helped found, has now some 23 chapters across Russia. They are seeking to grow, with the help of USMD, to some 40 or 45 organizations across the country so that they will be in a position to monitor whatever elections are allowed in the future, including the parliamentary elections of 2007 and the Presidential elections of 2008. We believe that that organization must be encouraged, strengthened, and supported.

I end by simply saying that international engagement with Russia is important and must be maintained. We need your help. We need the support of the Congress. We need the support of every individual Senator and Representative if we are to be effective in Russia, to convince the Russians that they are moving in the wrong direction and that what lies ahead, if they move in the current direction, are all the dangers that Bruce has outlined. There is another path, we want to work with the Russians along that path, we want to help support democratic development. I would urge you to help support organizations like mine and the hundreds of other nongovernmental organizations that are trying to function in Russia today.

[The prepared statement of Ambassador Ledsky follows:]

PREPARED STATEMENT OF NELSON LEDSKY, REGIONAL PROGRAM DIRECTOR FOR EURASIA, NATIONAL DEMOCRATIC INSTITUTE, WASHINGTON, DC

On behalf of the National Democratic Institute (NDI), I would like to thank the Committee for this opportunity to discuss the current political situation in Russia. I would especially like to recognize and thank Senators Lugar and Biden for their leadership and support for promoting democracy worldwide.

NDI has followed democratic development and civil society in Russia since the early 1990s. The Institute has maintained a field office in Moscow since 1992, from which it has provided assistance to a broad spectrum of political parties that exist in Russia. NDI had sought to help these parties strengthen their structures and assist them in advocating for their priorities at both the federal and local level. NDI has provided training and consulted with thousands of individuals on long term party organization. Our objective has not been to promote a particular ideology or electoral outcome, but to support development of a genuine multiparty system that allows for divergent viewpoints.

The same objective holds true for our activities with civil society groups. Here we have sought to assist the organizational development of nonpartisan groups that can monitor the conduct of elections and promote popular political participation at the national and local levels. We have been able to assist these groups over the past decade, and since 1999 have supported the efforts of a cross-regional association of civic groups called The Voice Association for the Defense of Voters' Rights (VOICE). VOICE, or Golos in Russian, has become Russia's leading nonpartisan election monitoring organization. It has 23 affiliates with programs covering two-thirds of the country's population.



The political environment in Russia has grown progressively more difficult over the past two years, particularly since the December 2003 parliamentary elections and the March 2004 presidential election. Both contests failed to meet Russia's commitment as an OSCE member. The VOICE Association identified widespread vote tabulation irregularities and uncovered numerous accounts of voter coercion. VOICE noted that: Municipal workers were ordered to vote, sometimes for one particular candidate; members of the military were told to report the time they voted; students were threatened with losing housing if they did not vote; and voter lists were being manipulated to ensure a high turnout. VOICE documented an unexplainable decrease in the voter rolls of two million individuals between December 7, 2003 and March 14, 2004. All possible avenues, from media, to security services, to electoral commissions, appear to have been used to ensure a large margin of victory for the incumbent president, and a large voter turnout figure.

As a consequence of these elections, United Russia and other pro-government parties now hold a two-thirds majority in the State Duma, while two of the reform-oriented parties, Yabloko and the Union of Right Forces (SPS), have lost all their representation in the legislature. With little access to the media, constant attacks by the national news channels, and their financial support significantly affected by the government's investigation of their primary supporters, these parties are now clearly disadvantaged in the Russian political environment.

As 2004 drew to a close, the Russian administration successfully eliminated elections for regional governors, consolidated its control over the judiciary by putting high court appointments under Kremlin control, increased the legal hurdles faced by non-Kremlin-aligned political parties attempting to take part in upcoming elections, and limited the rights of citizens to hold mass demonstrations.

Through various pieces of legislation, the Russian government has also made it increasingly more difficult for international NGOs to provide support to their Russian partners. Since last year, NDI has faced ongoing investigations by both regional and national Russian authorities.

Russia is also presently taking forceful initiatives to undercut the contributions of the OSCE to help promote democratic processes in Russia and in other countries in the Commonwealth of Independent States (CIS), by charging that there is an overemphasis on the so-called "human dimension" of the OSCE, which concentrates on human rights and democracy, and by accusing unjustly the OSCE's Office for Democratic Institutions and Human Rights (ODIHR) of politically biased assessments of elections in Russia and the CIS. Russia's criticisms and threats to pull back from the OSCE and its institutions jeopardize international election monitoring, as well as the role of international assistance organizations and the activities of domestic democratic reformers.

The democratic gains that characterized Russian politics in the 1990s have largely been overturned, and there are no guarantees that current trends will be reversed any time soon. The parliamentary and presidential elections scheduled for 2007 and 2008 could provide opportunities for greater political engagement by civic and political groups. It is equally possible, however, that the 2007 and 2008 elections will be scripted to ensure a continuity or even amplification of current tendencies. The challenge for parties and civic organizations, therefore, is to rebuild and reconnect at local, regional and national levels and to take advantage of any political openings.

There are clearly pockets of independence in Russia. Last December, The Civic Congress, a meeting of 1,500 political and civic activists publicly asserted their determination to promote peaceful political reform. It sought to foster cooperation among political parties, civic groups and members of the media and business communities as a counterweight to anti-democratic trends. The Congress was remarkable in the Russian context because it brought together diverse groups that had not previously associated with one another. Also, it appeared to be a rejection of the resignation and complacency that have gripped many democratic reformers over the past several years. The Congress released a declaration on proposed joint actions and established leadership bodies to oversee its follow-on activities.

In addition, organizations like The VOICE Association have grown steadily in size and coverage, providing a counterweight to those who may seek to manipulate the electoral process. The Association is hoping to expand its local branches from 23 to 40 in time to observe upcoming local elections as well as the 2007 and 2008 national elections. VOICE's growing presence year-round would give them a unique perspective, and their ability to remain involved in the electoral process between elections provides small but potentially significant opportunities to engage citizens in the political process and help deter electoral misconduct.

International engagement in the furtherance of Russian democracy remains critically important. Russian democrats depend upon assistance and require the contin-

ued attention of world opinion makers. The international community should concentrate its support on those seeking to build democratic institutions and processes in Russia and should counter initiatives that make it more difficult for organizations like NDI, the OSCE and others to provide assistance. NDI remains optimistic about the prospects over the long run for Russian democracy and intends to remain committed to this cause.

The CHAIRMAN. Thank you very much, Mr. Ledsky.

Indeed, there is strong support for the Democratic Institute and the Republican Institute, not only in Russia, but all over the world, as you pursue, with their umbrella agency, the National Endowment for Democracy, some remarkable goals.

I want to call now on Senator Sarbanes to commence the questioning.

Senator SARBANES. Well, Mr. Chairman, thank you very much. And I apologize, because I'm going to have to leave very quickly for another hearing. But I did want to come and hear this panel, and I want to thank all of the members of the panel for their very helpful contributions.

I particularly want to note the contributions that Ambassador Ledsky has made over the years, first in the government and then in his service with the National Democratic Institute. He's made a significant difference in many policy areas, and I just want to underscore that here this morning.

Ambassador LEDSKY. Thank you.

Senator SARBANES. I want to put one question to the panel, to which I hope each of you will respond.

The first time Mr. Bush met with Mr. Putin, he said, "I looked the man in the eye. I was able to get a sense of his soul." I think you recall that comment. Now, he's meeting with President Putin in Bratislava 1 week from today. I'd be interested in knowing which items you think the President should have on his agenda to present to Putin. What should he say to Putin?

In fact, as you answer the question, imagine that we were to take the transcript of what you say and send it down to those who are preparing the President for the trip, and say, "At this hearing, we asked these four experts which issues they thought you should raise, and here's a suggested set of talking points for your meeting with President Putin."

Mr. Nix, why don't we start with you, and we'll just go right across the panel?

Mr. NIX. Yes, Senator; thank you.

Well, I'll tell you what the International Republican Institute would propose to the President of the United States in the course of this meeting, and that is—we've already prepared a letter, a draft letter, for President Bush, which we hope that our colleagues at the National Democratic Institute will sign, as well as the president of the National Endowment for Democracy. In essence, what we would ask in this letter, sir, is that the President repeat his desire, and the United States desire, for Russia to reaffirm commitments to democratic principles such as we have listed: The rule of law, free and fair elections, a market economy, all of the things that have been discussed here today. And in addition to those principles, what we would ask the Russian Government, and what we think that the President of the United States might ask, is that Russia work with the United States to help two newly-emerging

democracies—that is, Georgia and Ukraine. And, we think, it's very important that Russia be involved. And we think that Russia could play a pivotal role in helping these newly developed democracies if they work with the United States in doing so.

Ambassador LEDSKY. I have nothing to add to what Steve has suggested. It is true that the nongovernmental organization community is preparing a letter for the President, and we all hope to endorse it.

Dr. ASLUND. Thank you, Mr. Sarbanes, for the question.

Since nobody has quoted President Bush's last major statement on President Putin, I thought I should quote it, from the 27th of September, 2003. "I admire President Putin's vision of building democracy and freedom and the rule of law in Russia." That is what should be clearly and firmly denied. Such a statement should not be left on the record. I think that President Bush has a moral right of publicly revoking that statement when he meets President Putin.

I think that the most important thing is to speak clearly and loudly, as both Stephen Nix and Nelson Ledsky suggested here, continue engaging in the practical issues. Of course, the United States and Russia have common interests that should be pursued, as we have discussed, but the United States cannot stay quiet when Russia is violating its legal commitment to various international conventions that it has ratified.

Thank you.

Mr. JACKSON. Thank you, sir, for letting me—giving me enough time to try to think of what I'm going to say to your question. [Laughter.]

I'm diplomatically challenged, at the best of times, and this is such an easy target to go after some statements which, I think, we all regret, you know, as Americans, to basically countenance or basically say that we do not see what's happening in Russia.

I think there are three points that one would make to President Bush. There has been a profound and negative change in the conditions in Russia, in terms of democracy, but there has been no detectable change in United States policy toward Russia. That seems to be a disconnect that I would also—would hope that this committee would look into in the course of this year.

The second point is, moral clarity, which figured prominently in the inaugural speech, is not something you do in private conversations; it's something you do in public, and when the whole world is watching. The whole world will be watching Bratislava. And, I think, Anders is absolutely right, we need to loudly say what we stand for as a nation.

And the third point is, every single NGO has downgraded Russia over the last year and a half. They are now among the worst places, and the most dangerous places, in the world to be a journalist. How come there has been no downgrade by the governments of the Western world in this same period, when every part of civic society is reporting this?

So those would be the three questions I would pose to the White House.

Senator SARBANES. Yeah. Could I sharpen the question just a moment? But what should President Bush, in a more specific way,

push President Putin to do? What is it, exactly, we want Putin to do? I mean, how do you transpose respect for the rule of law into specifics, given what Russia has done? What changes did the Russians make that they should reverse, whether by law or by practice?

Mr. JACKSON. Could I take a shot, sir?

I think President Putin deeply—about the only thing he does value is reputation and status. This achievement of great power status is key to who he is. And, I think, you basically can say, “We will not endorse that.” You can begin by having the President say, “We’re not going to this celebration in May,” of the, sort of, Stalinist legacy of Russia. You could say, “There isn’t going to be a G8 Summit in Moscow next year, under these conditions. And we are going to basically limit your access into the democratic institutions of the world while you continue to maintain this antidemocratic conduct.”

Senator SARBANES. Anyone else want to add to that?

Mr. NIX. I would encourage the rollback of some of the recently pronounced, and some enacted, constitutional reforms and legal reforms, such as the appointment of governors, as opposed to their direct election, and also this change to a total partyless system, which is designed to root out any opposition that remains in the Duma, a number of legal changes that relate to electoral processes that could be rolled back to show, and to demonstrate, support for true multiparty competitive system.

Senator SARBANES. What about the courts? What could they do to move to an independent judiciary?

Mr. NIX. I’m an attorney, sir, and I would be happy to try to answer that question, because I’ve worked in the area of rule of law, as well.

It’s a tremendous challenge. If you talk to people in the rayon level and the oblast level, there is no independent judiciary, there is no enforcement of contracts. In fact, I noted recently that Boris Nemtsov, a very active Union of Right Forces party leader, has been appointed an advisor to newly elected President Kuchma of Ukraine. And the reason for that—I’m sorry—Victor Yushchenko—newly elected President Yushchenko of Ukraine—and the basic reason for that appointment is that there are a number of Russian businesses that now want to invest in Ukraine, because they see a newly elected democratic government that will respect the rule of law, and they see an independent court system, or, at least, the possibility and the prospect of one, that will enforce contracts. So you see this move, that Russian businessmen now actually view Ukraine as a better investment than their own country. And, I think, the root problem is that the President has to undertake some reforms within the courts of general jurisdiction in Russia to enhance the independence of the judiciary. It has to come from the executive branch.

Senator SARBANES. Thank you very much, Mr. Chairman. I appreciate your courtesy.

The CHAIRMAN. Well, thank you very much, Senator Sarbanes.

Dr. Aslund, you may have some information about this issue, and this is why I raise the question with you. In July 2004, Paul Khlebnikov, editor of Forbes Russia, was shot and killed outside

his apartment. The Russian Government has pledged to fully investigate the murder, and suspects are reportedly in custody. The United States has offered assistance, but, to date, our help has not been accepted. Can you bring us up to date on the status of this investigation? What are the implications on United States/Russian relations arising from this?

Dr. ASLUND. I knew Paul Khlebnikov, and he was, of course, a very knowledgeable journalist. In particular, he knew a lot about Russian business, since he was composing this list of the 100 richest people in Russia. By composing such a list, probably he knew so much about various business deeds that the suspicions can go in any direction.

What the authorities are now suggesting is that he was murdered because of a book that he wrote about—"Conversations with a Barbarian," which is about a conversation with one of the Chechen terrorists, and if I remember rightly, there were three Chechens who are in custody accused of his murder. For an outsider, it's impossible to know. Threads can draw in very different directions. And, of course, we do not have the highest regard for the Russian law enforcement system in these cases.

Thank you.

The CHAIRMAN. What is likely to occur with regard to this case? Will it finally just simply pass away without further action, or is there likely to be some resolution, in whatever the Russian legal system may be?

Dr. ASLUND. We can see, in similar cases, if we take the murder of Galina Starovoitova, long time has passed, certain people accused and, indeed, arrested; albeit, to my knowledge, no judgment has been passed. The judgments are often passed several years after the event, or don't really take place. So it's very much in limbo, or somebody else might know more.

The CHAIRMAN. During the panel, mention has been made about Georgia and Ukraine. Let me take up the Georgian situation for a moment.

The end of the OSCE monitoring—that is, Europeans on the border of Georgia, noting comings and goings—terminated at the beginning of the year. You've suggested that this is not by coincidence. The Russians really did not like that monitoring to proceed.

Now, during a visit that I had with President Saakashvili of Georgia recently, the point that he made through me to our government was to press the importance for the United States to visit with Europeans about coming back to the border, and that this, in fact, is in the interest of Georgia, but also in the interest of Russia.

There are allegations from time to time of so-called Chechen terrorists coming across the Georgian border into the Pankisi Gorge. There is ambiguity as to what Russian responsibilities are, in terms of chasing and capturing them or so forth. But certainly, there is on the part of the Georgians, the feeling that clearly the Pankisi Gorge is inside territory of Georgia and that this would be a violation of the sovereignty of the country. That ambiguity continues, and the need to sort things out is important. So that is a major point.

A second one, and perhaps even more profound, is a general fear on the part of Georgians, not just the President of the country, that

Russia is suggesting that Abkhazia ought to be an independent state, that a vital part of the territory of Georgia ought to become an independent state. This is of interest to Russia, as a foreign-policy problem. The beginnings of negotiations between Russia and Georgia about this have not been fruitful, and many do not expect they will be, so long as there is a general feeling of a potential split-off of parts of the territory of the country.

Now, under those circumstances, the Georgians, of necessity, look to us—that is, the United States. They hope Europeans might be involved, particularly in the case of the monitoring. They suspect that Europeans should be involved, because of Georgia's interest in NATO, and its interest ultimately in the EU. Admittedly that is a stretch, in terms of the requirements of the EU and the very small economy that Georgia has now and the large leaps that would be required to come into this. Can any of you on the panel offer, at least, some thoughts about whether these are your perceptions, in terms of their requests of us, and, likewise, the nature of our response? How vigorous should the United States be with regard to the monitoring of the borders of the country and the fact that Abkhazia and South Ossetia—another issue that continues in abeyance there—are parts of Georgia, and that the territorial integrity of Georgia as a fledgling democracy are important to us? Does anyone have a comment on that issue?

Yes, Mr. Jackson.

Ambassador LEDSKY. I have several—

The CHAIRMAN. Mr. Ledsky.

Ambassador LEDSKY [continuing]. Comments. And Bruce does, too, I'm sure.

First of all, I think the United States has a very important stake in the success of the Georgian Government and the success of the experiment that is now going on in Tbilisi. It's very much in the interest of the United States that that effort succeed and that that government be successful in reforming the state and putting it on a viable basis.

I think there are three or four major problems that government has. The first is one you haven't mentioned, and that is the continued presence of Russian troops on Georgian soil.

The CHAIRMAN. The bases.

Ambassador LEDSKY. The bases. The Russian bases in Georgia. And I do think, here, the Georgian Government has received, and should continue to receive, support from the United States in this area.

The second is the question of South Ossetia. I think that and the Abkhazia situation are somewhat different. But, I think, the idea of a U.N. force or a multilateral force of some kind on those two borders is very important, and we—I see no reason why the U.S. Government shouldn't support that kind of idea.

The CHAIRMAN. Mr. Jackson.

Mr. JACKSON. I completely agree with what Mr. Ledsky has laid out, but let me add a couple of other factors.

One, I go the Pankisi Gorge every—virtually every time I visit Georgia, and there are no Chechen terrorists. I mean, there is a significant social problem up there, but this is a pretense, the no-

tion that there are Chechens attacking Russia from Pankisi. It's just flat not true.

It seems to me we have to look at this in context. The reason that there is increasing pressure from the Kremlin on this new government is because of its democratic image. This was the source of the Rose Revolution, this was a Presidency that had succeeded in unifying the country, first in Ajaria, and it tabled a peace plan, a very progressive peace plan, for South Ossetia. This was threatening. So Russia wants to keep them on the defensive, either undermining the democracy in Georgia or subordinating it to Moscow's geostrategic interests.

They did this in three manners:

In August, they blocked the OSCE from expanding its presence in South Ossetia and to keep the rocky tunnel, a transshipment point, open to essentially military and paramilitary goods.

Second, they refused to withdraw their bases and are now gridlocking that and forcing—trying to force Georgia to limit its rights by—they say that their Istanbul commitments to withdraw no longer pertain, and they are asking onerous provisions to continue discussions.

And, finally, they want the international peacekeepers out, to leave them a free hand, and they want, not only in the border monitoring, but they also want Russia to say, in all peacekeeping operations, Russia will be the only referee, that the international community won't be allowed to be present.

So this is a pattern of activity, and Pankisi Gorge is only a pretext.

The CHAIRMAN. Well, let me just follow along this idea. When I visited in Ukraine in August, authorities of the government with whom I visited made the point—informally, but very firmly—that there would be no Rose Revolution in Ukraine as their elections approached. They had noticed what had occurred in Georgia, and it did not meet their approval. And as chapter and verse of this, they pointed out that, in fact, the mayoral election in Ukraine had been firmly dealt with earlier in the year. By “firmly dealt with,” they meant that it included international observers being thrown down the stairs of the city hall and other violent activities, such as suppression of the ballots and the declaration that the government candidate was the winner. So, at least, the authorities were indicating that the stage of democracy in Ukraine was fairly well contained in this vivid incident, and that they would not countenance the type of public demonstrations and other activities that characterized the Rose Revolution in Georgia.

Now, that was August. This is now February, not too long after. But I also, at that time, visited with the Presidential candidate of the opposition. He is now the President of the country. He was a dashing figure, 50 years of age, looked like he was 35, from Hollywood vintage. But he already was commenting that he thought his automobiles were being run off the road by various authority figures. Obviously, his messages were being suppressed on television in Ukraine, except for Channel 5. And, therefore, there were already difficulties. This was long before the poisoning occurred and other situations that were vividly to change his life and the life of the country.

Now, I mention all this because, you know, we're about to come up to an election in Moldova, which has not been widely commented on by the world, as a whole, but is of great interest to each of you gentlemen, as close observers of the situation.

What can we anticipate in Moldova? And what, for instance, are the organizations that you represent, Mr. Nix and Mr. Ledsky, planning to do in Moldova? Do you know of other activities that will illuminate that situation for everyone?

Would you start, Mr. Nix?

Mr. NIX. Yes; thank you, Senator.

Yes; both IRI and NDI maintain a presence in Moldova, and we've been working very, very hard with—again, with all the parties, including the Communist Party, which is, as you know, in control of both the executive and legislative branches of that country.

In terms of the election, the elections have been troubled in the past, but certainly the threat of fraud at the level that we knew was a certainty in Ukraine doesn't appear to exist in Moldova. Again, we think that there are going to be problems with the count and with the election administration at a certain level, but not nearly the level that we knew would take place in Ukraine. We do not, therefore, have funding for the large numbers of international observers that you saw when you traveled to Ukraine.

And, in terms of the outcome, it's difficult to assess. There is a united opposition. Again, they face some of the same problems that Russian political parties face and Ukrainian political parties face; that is, no access to media whatsoever, and oppression from the government, and the use of administrative resources to further the aims and goals of the party in power.

In terms of an actual result, I mean, our polls show that the opposition will do fairly well in this election. Whether they will do well enough to achieve a majority in parliament remains to be seen.

That would be my take on Moldova.

The CHAIRMAN. Mr. Ledsky.

Ambassador LEDSKY. We have been working together with the International Republican Institute in Moldova for about 2 years now. We have cooperated, we've been working with the same parties, including the Communist Party, including the government party. Our representative in Kishinev had a meeting only 2 weeks ago, I think, with the President of the Republic, President Voronin, and we discussed very carefully the problems that were arising with respect to the elections.

Those elections are on March 6th. We have not only worked with all of the lists that are running in the election, but we have come to work now, over the last few months, with a monitoring—domestic monitoring organization, which is being funded by the Europeans and by the Eurasia Foundation. And, we think, there will be a decent and effective monitoring operation at the Moldovan elections. We'll be doing a parallel vote tabulation, as we did in the Ukraine and as we did in Georgia.

So I don't know what the results of this election will be, but I, myself, agree with Steve that the level of fraud and mismanagement will be sufficiently—well, it will be down from the last election.



The CHAIRMAN. Yes, Mr. Jackson.

Mr. JACKSON. Could I just add to that? I think, clearly, the Orange Revolution in Ukraine unsettled or caught Moscow off balance so that they did not prepare the kind of political intervention in Moldova. It is, however, true that consultants paid by the Kremlin came down—the same people that were arranging Yanukovich's election appeared in Moldova in September and October. They set up meetings in Moscow in November, and with Kuchma. And then after their defeat, in December, they don't appear to have renewed their activity in Moldova. It will take them some time to regroup. But they have been able to take polling places that would have been open to international scrutiny and move them into Transdnistria, so there will be a certain amount of votes coming in from Transdnistria that we can't see.

The CHAIRMAN. Those will be beyond observation.

Mr. JACKSON. I don't see how you get anybody in there.

The CHAIRMAN. Well, let me follow through with the broader point that each of you have made in various ways. The Rose Revolution certainly was unexpected. The Orange Revolution may have been expected, in a way. There certainly was some sophisticated organization by persons in Ukraine who were prepared to protest, as they did, although the degree of support, the longevity of all that, maybe, could not have been predicted, nor the circumstances that were involved in that. But clearly—and you stated this at the beginning, Mr. Jackson—the Russian situation presently is one of wishing to block resolution of frozen conflicts elsewhere, or to place, under the penumbra of Russia, surrounding situations where there appear to be conflicts or elections or opportunities of this sort. That has not worked in the case of Georgia, thus far, although you've all noted now that there are still Russians in military bases. Abkhazia and South Ossetia, undecided; foreign observers at the border, vanished.

Our President, as he visited with President Putin, and in his Inaugural Address, has made some very strong statements with regard to democracy and the universality of these principles. He does so, obviously, with humanitarian concern for each of the individual persons, sacred persons, in the affected countries, but also, in terms of the interests of our country, that we are safer if other countries have democracies and if there is this dialog with other democracies. That is a prominent part of foreign policy that he sees for this country, the ethics of what we are doing.

In Russia, some reforms that were meant to have a more efficient social-service economy have not been administered very well, if they were something that should have been in play to begin with; namely, the cash payments, as opposed to payments-in-kind, as people rode buses or received other services. The idea is that this will be rationalized now, and some order brought out of the chaos at a time when Russia was cash poor and did not have the ability to deal with these situations.

Some would say that Russia still is cash poor outside of Moscow and St. Petersburg and some other places. And this is a part of the problem of administering the new social programs. They would say that it's not surprising that the elderly or pensioners or so forth would rise up and say, "We liked the old system, as a matter of

fact. We wanted to catch the bus and we don't want to pay the bus fare. We want to move ahead as we used to. So it's all right for you social economists to have rationalized how all this is going to work, but it doesn't really work very well for us."

Thus, the unthinkable has been occurring, and that is, demonstrations, larger and larger groups of people bobbing up in various parts of the country. President Putin, perhaps surprised by this, has sent out persons to try to help fix the situation, but these do not appear to have been very adept people. There just is not a social administration in Russia that handles these things very well, quite apart from maybe formulating the policy to begin with in a Duma that was not very democratically based, in which the dialog was perhaps somewhat truncated by the nature of the elections that you have talked about.

Now, some have also commented, "Not to worry. Regardless of whether there are some elderly people out there in the streets demonstrating, and their problems may be fixed, or not, this is not the Rose Revolution, this is not the Orange Revolution, and it is not the forerunner of any revolution." On the other hand, others have suggested that the inspiration of Georgia and Ukraine could take hold with some people in Russia who wonder why they might not have a great deal more freedom, as is being enjoyed in the periphery. And some then, darkly, have suggested, before you get into wishing what you think ought to occur here, it's not really at all clear what would be the successor regime to this situation. Are the forerunners for democracy, the potential for institution-building aspects, at hand, that could bring a change?

This is blue-sky thinking, way down the trail, but I mention in the same breath that many dismissed the Rose Revolution, dismissed the potential for the Orange Revolution. Maybe some feel that, after all, given the way the world works, the Rose Revolution might be ultimately suppressed by Russia, and we might see a different turn. Likewise, Ukraine may have a heady moment now, but, after all, they live in a dangerous neighborhood.

Which way are things going to turn? Are they going to move more toward the Rose/Orange direction or toward the suppression of dissent, with a penumbra over the whole situation?

Yes; Dr. Aslund.

Dr. ASLUND. Thank you, Senator.

I very much think like you about this question. First, on the social-benefit reform. It was as bungled as it could be. Part of the benefits were supposed to be taken away because they had never been paid out. They were just taken off the books. But it was called monetization. Then the calculations were wrongly done. Probably only one-third of the actual benefits were compensated for. The federal government pushed this to the regional governors, who didn't want to pay. Therefore, it was ever more complicated. Just in case, it was not explained to the population, and 35,000 top officials in Russia, including President Putin, at the same time got a quintupling of their salaries, and they kept all their benefits in kind. So this was just a massive affront to the population.

So the poor are losing the benefits, when the country is booming. And—

The CHAIRMAN. Well, that's a very good statement—I'm going to stop you for a moment—that the poor saw two-thirds of their benefits vanish in this so-called reform of monetization, but 35,000 officials in Russia, including President Putin, saw their salaries quintuple, did you say, at this same juncture?

Dr. ASLUND. Yeah. And, indeed, you don't even get away with it with a—in a mildly authoritarian state. So these protests were clearly spontaneous, and they were massive, and they were outside of the main centers. This reminds me very much of what happened in Poland in August 1980, when solidarity was founded. And we saw how that ended.

So, indeed, I think that this shows that President Putin's power has passed the peak. You can't make four such big mistakes in one year without suffering. And, I think, that what this shows is really how dysfunctional this mild authoritarian rule is. But we also see that it's not organizations that pick it up, but it's spontaneous protests, which make this more difficult to predict. Therefore, it doesn't quite look like the Orange Revolution where Our Ukraine had one-quarter of the seats in Parliament since the last parliamentary elections.

So I would say that this was the beginning of the end, and we are already seeing more liberalism right now in the Russian media, simply because the safety valve needs to be used, or because the Kremlin can't control it quite as much as we thought.

Thank you.

The CHAIRMAN. Mr. Jackson.

Mr. JACKSON. I completely agree with your point, that the—we don't quite understand how big the Orange and Rose Revolutions were in Eurasia. I think they were—those twin events were the most important geopolitical change in Eurasia certainly since the fall of the Berlin Wall, and we're still seeing the aftereffects. It's not just in Belarus and Moldova, where their effects are obvious, but throughout Central Asia, all the way to China. The concept of this democratic change is changing the way people think about the world. And, frankly, the words of President Bush, in his inaugural, were part of that message, that freedom and democracy were possibilities, where I don't think they were viewed as such before.

But for the people and the youth of these countries, these are messages of freedom and hope, but for the regimes in Moscow, in Minsk, and in Turkmenistan, this was tantamount to a declaration of war. This threatens, you know, their privileged positions, their monopoly of state power, their monopoly of resources, and they view it as such.

Democratic change is profoundly threatening to these oligarchies and elites and security services who basically persist by their monopolization of power. This means sharing power. I think it is not a structural question, though: Will it—will these—Kiev and Tbilisi succeed or will they fail? I think that is deeply to be affected by people here—yourself, sir, your committee—funding IRI and NDI to give them the resources to support democracy. This is a competition.

The CHAIRMAN. Mr. Jackson, just on that point—these are sort of strong words—if the speech that the President gave out around the steps is a declaration of war, as perceived by the regime in

Turkmenistan, for example, or Belarus, do you suppose President Bush saw that in what he had to say? In other words, he is now proceeding to visit with President Putin. He has declared, really, what our ethos is, in pretty strong terms. It is awfully difficult to square how you find the words, say, of 2 years ago, the evaluation of President Putin, with this today, especially if it strikes President Putin as strongly as you're suggesting. Might President Putin conclude that, in general, our President is talking about eternal verities, that there is a timeframe in which all good things happen—in other words, that this is not necessarily a current or urgent problem, but rather, one down the trail that we all hope will occur? What is your judgment as to the reaction out there to these words, on the part of President Putin, quite apart from the authorities in Turkmenistan?

Mr. JACKSON. I think what the President was talking about in the inaugural is nothing more than basic American values, "This is what our country believes. This is what our allies believe. This is what we mean when we talk about democracy. This is a community of shared values." And, I think, the President correctly and eloquently summarized those values. There is a claim, I think, all Americans share that democracy is universal, that all peoples should have equal access to those freedoms, and that's the central foundation belief—political belief of the West. I think it is very uncomfortable for regimes that basically are reactionary in nature and that much prefer the policies of the 19th century, the militarism and mercantilism and unchecked nationalism that characterized that century. We do not stand for that. And I—it is only disappointing that Putin and others find themselves so distant from those values. And, frankly, that's their problem, not our problem.

The CHAIRMAN. Mr. Nix, do you have a comment about this?

Mr. NIX. Senator, I'd like to address your comments about the effects of the Orange and Rose—

The CHAIRMAN. Yes.

Mr. NIX [continuing]. Revolutions. And I'd like to make two points. First of all, it no doubt had a profound effect on democratic movements, not only in Russia, but the rest of the former Soviet Union. Political parties, opposition movements, are reinvigorated. They see that it could happen. And so, that has given them a sense—as has been noted previously, a sense of hope and confidence that it could be.

Conversely, it's had another effect, in terms of the governments of those countries—again, not just in Russia, but in Central Asia, Belarus, and other countries where IRI and NDI work. The governments in those countries have acted very swiftly, in terms of disrupting the political parties' operations, trying to disrupt and prevent IRI from—NDI—from providing technical assistance and training. In a very short time, operationally, we have felt the brunt of these government crackdowns, as have the political parties that we work with.

So it's had a tremendously positive effect on these political party movements. At the same time, it has made it much more difficult for these political parties to operate, and has made it increasingly

difficult for IRI and NDI to continue to provide the type of assistance that we do.

And I'd like to sum up by connecting up to your opening statement, sir, when you noted the proposed cutbacks in FSA funding. I firmly believe that this is not the time to cut back. This is the time to accelerate and to expand on our support to these democratic movements. The time is right, based not only on the Georgian and Ukrainian experience, but other things that we see out in the regions that should be supported.

The CHAIRMAN. Mr. Ledsky.

Ambassador LEDSKY. I have just a small footnote. How Mr. Putin, and how the other autocrats around the former Soviet Union, view the President's statement, I don't know. I suspect they think it is pure rhetoric and it doesn't have to be paid much attention to. I hope they're wrong, if that is their judgment.

My own feeling is that we won't know, exactly, and we won't be able to have much direct effect on their behavior—that is, the autocrats' behavior. What is critically important—and I go back to the point I made earlier—is that the experiment in democracy, which the Georgians and the Ukrainians have now undertaken, succeeds and that American assistance to those governments is critical at this juncture—that is, 2005.

We have already seen in Georgia that the USAID mission of the United States Embassy looks upon organizations like ours as already having achieved its objective, and that there is now the chance to move to some other country or some other project. Because the Georgian revolution is complete, democracy has been established, organizations such as ours are no longer needed. That is the most tragic mistake that could be made by the U.S. Government and U.S. agencies in 2005.

And I would urge you to, whatever you do to the Freedom Support Act, in terms of percentages, that sufficient money be devoted to Georgia and the Ukraine, because the examples of those two countries are what the President Putins of the world will be looking at, not the declarations by politicians or bureaucrats, like myself.

The CHAIRMAN. Well, I think that's very sound advice. And let me just say, I was pleased that, in the request for the supplemental appropriation bill, the President has asked for \$60 million for Ukraine. Now, as a part of that effort, really over and above outside altogether of our situation, the Millennium Challenge group in Georgia is impressive, and it would appear that this may be an avenue for some support, but it's very modest, given the amounts of money that are involved in Millennium Challenge all together. But the fact is that Georgia is working those problems quickly and successfully.

But I just pick up your general point. There has been a tendency on the part of the Congress, maybe even society as a whole—hopefully, never NDI and IRI—to finish off an election and move on.

Ambassador LEDSKY. Right.

The CHAIRMAN. Many of us feel that this was a tendency in Latin America, during the 1980s, during which a great number of you and Members of the Congress were involved in El Salvador, Guatemala, Honduras and Nicaragua. Many of these governments have

continued to do well, although some are having their problems. This committee has found, throughout Latin America, a good number of precarious situations and a relative paucity of interest.

It is so important right now to make certain that, in Georgia and Ukraine, just to name the two that you have mentioned, these are success stories. That may require a commitment on our part that has not yet been rationalized, perhaps, as fully and programmatically as needed. That is one purpose of our hearing today; to bring these thoughts to the fore, as a memo to all of us, including during our visits with our administration.

There is more work to be done. Today we have talked about Yukos as a case that is important. This panel has a broad interest in the relationship with Russia. I think that it has been important to illuminate it, and hopefully we may do so again.

I thank each one of you for your contributions, your testimony, and your forthcoming responses.

The hearing is adjourned.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

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#### ADDITIONAL MATERIAL RECEIVED FOR THE RECORD

##### PREPARED STATEMENT RECEIVED FROM MIKHAIL KHODORKOVSKY

1. I regret profoundly that my personal political position and public activity have served as an excuse for the illegal expropriation of property from all YUKOS shareholders, organized by a group of corrupt officials and businessmen working in their own interest.

2. I have never belonged to any party. However, I always believed and continue to believe that it is my right as an individual and citizen to support various political forces financially no matter what the current government may feel about them.

3. In supporting various political forces, I did everything possible to promote the establishment and strengthening of system-forming institutions within the Russian state and of civil society in Russia.

4. Over the course of the seven years that my colleagues and I managed the YUKOS companies, we achieved a state of total transparency of the corporation and openness in its business dealings. In protecting shareholder rights, we tried to keep corrupt bureaucrats from meddling in YUKOS affairs. This made the corrupt bureaucracy decide to wreak vengeance on me, my partners and colleagues.

5. I frequently spoke out in public—at the State Duma, at sessions of the cabinet of the Russian Federation, at meetings of business people with the president of Russia—in favor of legislation that would completely and precisely spell out the rules for the formation of the business milieu in Russia, including the mutual obligations of state and business. I felt and still feel that the bureaucracy must be stripped of its right to interpret laws arbitrarily and of its ability to substitute decisions by officials for legislation.

I spoke out, in particular, for a stable and transparent tax system, as well as for equality of access for all oil producers to the state-owned main pipelines and for the construction of a private infrastructure for transporting energy, which would have substantially intensified and improved the energy and fuel sector of Russia.

6. I gave lectures to many audiences in Russia and abroad on the need for the democratic development of the Russian Federation, on the prospects for free-market reforms and the development of an open economy in my country, and on the social responsibility of business. I also wrote articles on the paths of development for my country in numerous authoritative Russian and foreign publications.

7. I had expected my public activity to lead to pressure on myself, but I did not imagine that the pressure would turn into the total destruction and plunder of YUKOS and the illegal persecution of numerous shareholders and staff, as well as their relatives, even young children.

8. Despite the fact that I no longer have major holdings, I continue to support—to the extent of my abilities from my prison cell—various social, human rights and charitable initiatives, both through Open Russia, the NGO I founded, and in other ways. I maintain that there is a need for a real separation of powers in Russia, the

creation of an effective system for protecting human rights, and the guarantee of independent mass media in my country. I intend to support Russian science, culture, and the right of Russians to freedom of religion.

My fellow countrymen strive for freedom and they deserve it. The liberal economic reforms of the 1990s were not always well-considered and they turned out to be excessively painful for millions of Russians. But the reforms have not turned my people away from the desire to live in a free and just society where social harmony prevails. Today, in my restricted circumstances, and in the future, I firmly intend to fight for freedom and justice in Russia together with my nation, a nation of which I am an inalienable part.

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RESPONSE FROM STEVEN THEEDE TO QUESTIONS SUBMITTED BY SENATOR CHUCK HAGEL

*Question 1.* Could you describe the Yukos Oil presence in the United States? Does Yukos Oil have offices in the United States? Number of U.S. Shareholders? Status of share trading in the United States?

[NOTE.—An answer to this question was not available at the time of printing.]

*Question 2.* Could you provide an overview of the charges before Mr. Khodorkovsky? Are these individual charges or charges against the company of Yukos? With the actions taken against Mr. Khodorkovsky and Yukos, are there laws that have been alleged to have been broken by the Russian government or Russian court system relative to this case?

Answer. Counsel for Mikhail Khodorkovsky and Platon Lebedev have prepared the following brief statement and explanation regarding the substantive criminal charges filed against these two businessmen and the primary defenses to the charges and the procedural due process violations of Russian law that have occurred throughout the trial. On behalf of our clients, counsel thanks the Senate Foreign Relations Committee for the opportunity to submit this summary into the hearing record. It is impossible to address every pertinent detail that demonstrates why the charges are devoid of merit and rather represent a manipulation of the Russian criminal justice system to further the ulterior motives, both political and economic, of those in the Russian government. In addition, we outline the procedural violations that have occurred during the trial in order to further demonstrate why any conviction Messrs. Khodorkovsky and Lebedev should be given no currency.

As a threshold matter, the Committee should understand that all of the legal defects and due process violations described below are based upon the application of Russian law, either as established in the Russian Constitution and the substantive and procedural Criminal Codes or under International laws expressly adopted by and incorporated into Russian law. The defense does not seek to exonerate Messrs. Khodorkovsky and Lebedev by changing the applicable law, but rather by attempting to secure the application of existing Russian law pursuant to the Rule of Law.

The assessment that these cases are political in origin has now been made by every independent court or government body to review this matter. In January 2005, the Council of Europe endorsed the findings of its Human Rights Rapporteur, Sabine Leutheusser-Schnarrenberger, who summarized her assessment that these prosecutions were based on politics, not criminal justice, with the following sentence:

I have come to my own conclusion, namely that the presence of an interest of the State that exceeds its normal interest in criminal justice being done and includes such elements as: to weaken an outspoken political opponent, to intimidate other wealthy individuals, and to regain control over “strategic” economic assets—can hardly be denied.<sup>1</sup>

On Friday, March 15, 2005, the Bow Street Magistrates’ Court in London ruled that two former executives of Yukos should not be extradited to Russia on the basis that the prosecution of Mr. Khodorkovsky was politically motivated and that no one associated with him or Yukos could receive a fair trial in Moscow. *Between the Government of the Russian Federation v. Dmitry Maruyev and Natalia Chernysheva*. In 2004, Courts in Liechtenstein and Switzerland have rejected Russia’s requests for international legal assistance in their purported criminal investigations and prosecutions of Messrs. Khodorkovsky and Lebedev. Liechtenstein Superior Court for

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<sup>1</sup>Europe Parliamentary Assembly, Committee on Legal Affairs and Human Rights, Circumstances Surrounding the Arrest and Prosecution of Leading Yukos Executives, Doc. No. 10368, Explanatory Memorandum at ¶ 57 (November 29, 2004 (text adopted by Parliamentary assembly on January 25, 2005) (Appended hereto as Exhibit 1).

Civil Cases No. 12 RS. 2003.255; *Pecunia Universal Ltd. v. The Office of the Attorney General of Switzerland*, Federal Supreme Court of Switzerland, 1A.86/2004, Decree of June 8, 2004.

I. ANALYSIS OF THE CRIMINAL CHARGES ALLEGED AGAINST MESSRS. KHODORKOVSKY AND LEBEDEV

The Procuracy's case against Messrs. Khodorkovsky and Lebedev is rooted in what is, at best, a baseless mischaracterization and, at worst, a calculated lie: That these men are not business leaders, but kingpins of organized crime characterized in the allegations as the "Group." In other words, the Procuracy alleges that Group Menatep Limited ("GML") and other corporate structures are not legitimate business entities, but components of a criminal enterprise.<sup>2</sup>

The Procuracy's motive for alleging the putative crimes were committed by an organized group in order to secure a procedural and political advantage:

- Imputing to and Holding Defendants Criminally Liable for the Alleged Acts of Others in the So Called "Organized Group";
- Extending the Statute of Limitations Periods for the Charged Offenses;
- Materially Increasing Penalties and Tightening Security Measures Such as Imposition of the Pre-Trial Detention; and
- Providing a Pretext for the Violation of the Defendants' Fundamental Human Rights.

Furthermore, the allegation allows the Procuracy to stigmatize these men and the companies they built, thereby destroying their reputation and establishing a thin veneer of legitimacy to a politically and economically-motivated prosecution.

The Procuracy alleges that Messrs. Khodorkovsky and Lebedev, their coshareholders and partners in Group Menatep, along with unidentified others, conspired and acted as an organized group to commit these crimes, and created Group Menatep as a vehicle to coordinate a network of "false corporations" to carry out and conceal the unlawful objectives of the organized group. The Procuracy fails to demonstrate scienter—criminal intent—in support of its contention that Group Menatep and its various holdings were structured for the purpose of conducting criminal activities. The Procuracy does not do so because it cannot; Messrs. Khodorkovsky and Lebedev and Group Menatep were associated for the lawful purpose of engaging in legitimate business activities.

The Procuracy's effort to cast Group Menatep as a criminal organization is not credible in view of the extraordinary efforts of Messrs. Khodorkovsky and Lebedev to introduce transparency and accepted Western business practices to the Russia's often murky business world. In particular, GML has subjected itself, and the enterprises in which it has interests, to heightened standards of transparency and corporate governance, and has undergone rigorous audits by respected accounting firms such as Ernst & Young (GML) and PricewaterhouseCoopers (PWC) (Yukos). In addition, although not a public company, in 2002 and 2003 GML publicly disclosed its audited financial statements, including on its website—[www.groupmenatep.com](http://www.groupmenatep.com). These actions refute their designation as a group of criminal racketeers. Criminals do not publish their structure or finances on the internet.

Analysis of the law concerning organized criminal groups demonstrates its inapplicability here. The commentary to the Russian Criminal Code defines an organized group as "comprise[d] of two or more individuals who have joined efforts in order to commit one or several crimes. This variety of complicity is characterized by professionalism and stability." Complicity refers to the agreement by the members of the organized group to engage in one or more criminal acts prior to their actually taking steps to implement any criminal objective. The stability component requires the existence of "permanent ties between the member of the organized group and [choice] of particular methods of activity involved in the preparation and perpetration of their crimes. Stability of an organized group, therefore, requires prior agreement and a degree of organization."

This definition of "organized group" simply does not comport with the true facts here. First and foremost, the Procuracy makes no credible allegation, let alone offers any evidence, of scienter—criminal intent—or criminal agreement to support an assertion of complicity. That several persons or corporations, conduct business together does not, without more, make them criminal co-conspirators. For example, GML is a legal entity organized for the lawful purposes of overseeing the business

<sup>2</sup>For ease of reference, the term Group Menatep will be used herein to include various corporate entities that existed at different times relevant to the Procuracy's allegations in which Defendants were associated, i.e., shareholders, officers and directors at, including, but not limited to, Bank "Menatep," ZAO "Rosprom," OAO NK "Yukos," and GML).



interests of its various holdings. The Procuracy's mere assertion that entities with connections to Group Menatep ranging from merely holding accounts at Bank Menatep to having been founded by Bank Menatep employees does not provide any basis for allegations of criminal complicity, i.e., there is no basis for the leap from the existence of a banker-client relationship to the allegation of criminal collusion.

Here, however, the Procuracy alleges that virtually anyone associated with Group Menatep as far back as 1990, whether or not named as a defendant, are members of the organized group. More is required to criminalize these legally formed corporate entities and those persons associated with them. The Procuracy cannot simply provide a list of persons and entities and, without more, transform their legitimate association for the lawful purpose of conducting business into a criminal organized group. The Liechtenstein Court cited this particular flaw in the Russian criminal allegations as part of its basis for denying Russia's request for mutual assistance. Both the Liechtenstein Superior Court and the Swiss Supreme Court found that the Russians had failed to identify a discernable link between the lawfully organized entities and the alleged illegal conduct. Stripped of this omnibus allegation, the substantive deficiencies of the charges in the individual episodes become even more apparent.

*Episode I—Khodorkovsky and Lebedev committed no crimes in connection with the privatization of Apatit*<sup>3</sup>

The Procuracy has alleged three forms of fraudulent conduct in connection with the 1994 acquisition of 20 percent of the stock in a Russian company named Apatit: (1) defendants conspired to create shell companies secretly controlled by Bank Menatep to bid on the shares, including the winner, Volna; (2) at the time it bid, defendants had no intention of complying with the terms of the bid, specifically an Investment Plan for the infusion of capital into the company; and (3) defendants submitted false documents to the Murmansk Region Property Fund as part of the bidding process. There is no legal or factual basis for the Procuracy's leveling these criminal fraud charges. Under the Russian Criminal Code (and United States criminal law), a fraud conviction requires establishing a specific intent to defraud—scienter, malicious intent, or mens rea—at the time of the initial act. Here there is no, and can be no, evidence of any requisite malicious intent on the part of Messrs. Khodorkovsky and Lebedev. The evidence is to the contrary, all material information related to Bank Menatep's role in supporting bidders in the privatization tender was fully disclosed to the Russian government during the bidding process. Furthermore, Volna, through Bank Menatep, invested significant capital into Apatit, thus, substantially performed its obligations under the Stock Purchase Agreement and eliminating any possible finding of contemporaneous intent not to comply with the Investment Plan. Finally, the alleged conduct did not result in any harm to Apatit and so cannot support any fraud charges. As the prosecution's own witnesses testified during the trial, at the time of the tender Apatit was on the verge of bankruptcy, but as a direct result of Volna and Bank Menatep's infusion of capital and introduction of enhanced management, e.g., proposed revisions to the Investment Plan, and the implementation of revised payment practices and marketing and sales structures, Apatit became, and remains, a prosperous company.

*Episode II—Misappropriation of corporate opportunities*

The Russian Authorities allege that between 1995–2002, Messrs. Khodorkovsky and Lebedev breached their fiduciary duty to Apatit by selling concentrate ("Apatit product") at reduced prices through transactions wherein "shell" entities under their control, purchased Apatit product at reduced prices (e.g., \$40 per ton), resold it at higher market prices (e.g., \$63.50 per ton), and retained the price differential. To reach this fanciful position, the Procuracy disregards fundamental economic propositions, business realities, and the facts.

What the Procuracy casts as criminal conduct is the commonly used business practice of downstream sales. The realities of the early years of privatization provide needed context here. After privatization, Apatit lost the benefit of the government's trading and distribution infrastructure as well as the government's financing and credit-backed sales. The newly privatized Apatit, as with the rest of Russian industry, lacked cash for the supplies and salaries necessary to continue production. As a result, it was forced to barter its product at a discounted price in exchange for

<sup>3</sup>In addition to the allegation of fraud in regard to privatization of Apatit, the Procuracy filed fraud charges in connection with the privatization of the Research Institute for Fertilizers and Insecto-Fungicides ("RIFIF") in 1995. The issues with respect to RIFIF largely mirror those of Apatit's privatization, discussed in Episode I, *infra*, and in the interest of brevity are not addressed here.

needed inventory. One of the first changes implemented by the new shareholders was, through the infusion of capital, the termination of swap sales and the creation of a trading structure whereby Apatit sold its product to a distribution company at a profit. The downstream structure—approved by its Board of Directors, including a representative of the Russian Government allowed Apatit to stabilize cash flow, develop meaningful budgets, guarantee sales, effectively plan production volumes, minimize and optimize its tax liabilities, and avoid the risks and additional costs with respect to the downstream sales. In the short term, it allowed the company to avoid involuntary bankruptcy proceedings and, thus, was essential to Apatit's survival and expansion and in the best interests of its shareholders.

*Episode III—Yukos tax minimization structures complied with corporate tax laws*

The Procuracy has alleged that defendants caused Yukos to systematically evade taxes through the use of “affiliated entities” registered in the restricted access jurisdiction of Lesnoy, Nizhneturinsky District, Sverdlovsk Region (“Lesnoy”). Such restricted access jurisdictions, carried over from the Soviet-era, were remade into legislatively created internal tax havens known as ZATOs. These special administrative territories were governed by federal law, pursuant to which all taxes collected within a ZATO's territory were retained for its own budget. ZATO's were authorized to provide tax benefits, principally reductions of effective rates, within its region at its own budgetary expense. The entities receiving these tax benefits, in turn, were required to transfer to a percentage of their tax savings to extra-budgetary funds of the ZATO. The ZATO's (“ZATOs”) came to be viewed as a “loophole” in the tax system, and “loopholes” by definition are legal and utilizing one is definitely not criminal.

It is beyond dispute that during the period covered by the criminal charges, these were lawful vehicles for tax minimization, and the conduct the Procuracy challenges cannot constitute a criminal, or even civil, tax violation. These operating companies were legal entities, which complied with the applicable requirements, and their presence in ZATOs was a lawful, and for the ZATO's, a beneficial tax practice.

The Procuracy alleges the illegal plan allegedly occurred in two phases; first the “affiliated entities” prepaid their tax obligations with promissory notes as opposed to cash, and, after overpaying and improperly negotiating tax reductions with the ZATOs, secured tax refunds without having paid on the original notes. In connection with phase one, the Procuracy alleges that, for the tax years 1999 and 2000, Khodorkovsky and Lebedev caused Yukos to register four “affiliated entities” in a ZATO to secure illegal tax reductions. The Procuracy claims that this scheme resulted in an underpayment of taxes of \$601,814,702.19 by these entities which then also illegally received cash refunds causing the Federal budget losses totaling RUR 407,120,540.28 (\$14,084,782.92).

The Procuracy's case fails for the following reasons:

- The ZATO registered entities qualified for tax benefits negotiated with the finance administration in Lesnoy. Each of the entities served as a trading company that provided downstream services to Yukos by marketing and reselling crude oil to third party purchasers or arranging for the crude oil to be processed into refined petroleum products. The ZATO-registered entities' tax payments and subsequent claims for tax deductions were disclosed and audited. The Federal Tax Authorities conducted regular audits for compliance with the requirements of the ZATO law and, other than the calculation of certain specific payments, never challenged the structure.
- The use of promissory notes was a legal and accepted business practice. Prior to January 1, 1999, it was permissible to make tax payments in non-monetary form. In fact, payment with promissory notes was a widely used business practice in the years prior to 1999 until the Russian Duma changed the law. Despite this change, the tax authorities continued to accept tax payments in non-monetary form until the end of 1999. During the trial the defense presented, or attempted to present the testimony and reports of several Russian experts regarding the legality of the payment of taxes with promissory notes during this period, as well as a letter from the Russian Tax Ministry grandfathering the right to use promissory notes for the year 2000.
- The ZATOs received payments on the promissory notes with interest. During the trial at least one representative of a ZATO testified how the local administration received payment and utilized the funds from the promissory notes. The defense also submitted a letter from the Lesnoy Finance Ministry identifying numerous tax payers who utilized promissory notes and the receipt of the applicable payments.
- There is no proof of specific intent, i.e., that the defendants violated the tax laws “willfully.” Messrs. Khodorkovsky and Lebedev are not accountants or tax

lawyers and the government offers no evidence that they developed the tax strategy at issue. To the contrary, the tax strategy Yukos utilized was implemented in good faith and in reliance upon the advice of counsel and accounting experts, generated after the full disclosure of all pertinent facts. This reasonable, good faith reliance defeats the requisite element of intent to violate the law.

*Episode IV—Alleged personal criminal tax evasion*

The Procuracy also has leveled charges of personal tax evasion against Khodorkovsky and Lebedev, alleging that they unlawfully evaded taxes by submitting false tax declarations claiming certain income as private entrepreneurial revenues rather than as salary. Once again, the Procuracy distorts the facts in order to transform what was no more than the use of a lawful, permissible and widely employed tax minimization regime into criminal tax evasion. At the time, Russian law provided that a private entrepreneur could elect to make a fixed advance tax payment in exchange for a license, which constituted full satisfaction of taxes on earnings derived from the licensed, entrepreneurial services. Such licenses encouraged entrepreneurship by providing incentives in the form of a simplified and fixed advance tax payment for individuals engaged in providing services as independent contractors.

Following then existing law, Messrs. Khodorkovsky and Lebedev applied to and were approved by their local taxing authority for licensing as private entrepreneurs. Both men paid their annual fee for such license status, and in all other respects acted in compliance with the law, and were in good standing as private entrepreneurs.

*Episode V—Yukos funds were legally invested in Media Most Corporation*

The Procuracy alleges that Mr. Khodorkovsky engaged in a scheme to funnel money from Yukos Oil Company to Vladimir Gusinsky and in doing so caused the “organized group, illegally and gratuitously [to] remove[] and put into the hands of V.A. Gusinsky” monies belonging to Yukos and its shareholders, therefore committing a crime of misappropriation under Article 160(3)(a) and (b). The Procuracy’s allegations against Mr. Khodorkovsky focus on two series of transactions which occurred between 1999 and 2000 involving the purchase of certain commercial paper issued by Media Most. These transactions were neither illegal nor gratuitous and were fully disclosed and approved by Yukos’ Board of Directors.

By that time, Media Most was the dominant private media outlet in Russia, and an increasingly vocal critic of the government administration. The Procuracy retaliated with a series of raids of Media Most’s headquarters followed by Mr. Gusinsky’s arrest on charges of fraud and embezzlement and the company’s forced bankruptcy. The European Court of Human Rights (“ECHR”) last year held the Russian government, inter alia, had used the criminal justice system not to enforce the law but to further its economic priorities. Case of *Gusinskiy v. Russia*, App. No. 70276/01 (Eur. Ct. H.R. May 19, 2004). It concluded that the Russian government’s attack on Media Most and Mr. Gusinsky constituted extortion, with the criminal justice system implementing the scheme.

The first set of transactions involve three loans by Yukos to Media Most whereby Yukos agreed to loan RUR 635,450,000 and received as a collateral four promissory notes from Media Most with a nominal value of \$25 million. By April 28, 2000, Yukos had redeemed the notes and received in excess of their full nominal value. Yukos then reinvested the full amount in four promissory notes, issued by MetaMedia, a Media Most related entity, with a nominal value of \$25 million. Despite the 2000 events which led Media Most into a forced bankruptcy proceedings, Yukos managed to recover the full value of its investments by April 19, 2002.

Similarly, the second set of transactions involve a purchase of Most-Bank promissory notes by two entities, “Grace” and “Mitra,” for RUR 1,014,434,620 and also were commercially reasonable at the time. Subsequently, as a result of the Government’s persecution of Mr. Gusinsky and his businesses, the notes were written off. Yukos reported the write off on its consolidated financial statements for 2000 and 2001 as prepared by PricewaterhouseCoopers pursuant to generally accepted accounting practices (“GAAP”). To the extent that Yukos shareholders suffered any loss, it was the result of the Procuracy’s attack on Media Most and Mr. Gusinsky and not because of any illegal conduct by Mr. Khodorkovsky.

II. VIOLATIONS OF DUE PROCESS IN THE PROSECUTION OF MESSRS. KHODORKOVSKY AND LEBEDEV

Much has been written about the due process abuses committed by the Russian Procuracy during the investigation and prior to the trial, e.g., the illegal search of

defense counsel and the improper pretrial detention of Messrs. Khodorkovsky and Lebedev and the litany of violations will not be repeated here. Predictably, the due process abuses did not end with the commencement of the trial. The trial is replete with instances where the court violated the criminal procedure code. Moreover, the Procuracy and the defense have not been treated equally by the court. For example, the defense has been provided with less time to present their case and the overwhelming majority of defendants' motions and requests to court are denied. The court repeatedly has made thinly-reasoned decisions that simply parroted the Procuracy's self-serving and unsubstantiated assertions and completely ignored the Procuracy's violations of Russian law and the defense's arguments.<sup>4</sup>

Specifically, the Court, both upon the request of the Procuracy and sua sponte, has interfered with defense counsel and the manner in which evidence is present against the accused, have all been declared by PACE as corroborated and serious shortcomings of the Russian proceedings.<sup>5</sup> The list of other violations include:

- Impermissible introduction of evidence by the Procuracy:
  - Evidence obtained through illegal searches and seizure, and
  - Unauthenticated documents;
- Defendants denied the opportunity to introduce exculpatory evidence, including key expert reports;
- Restriction on scope of direct questions of defense witnesses and of defense cross examination of prosecution witnesses;
- Defendants denied requests to subpoena prosecution key expert witnesses;
- Harassment and improper influencing of witnesses:
  - Continued investigation and interrogation of trial witnesses;
  - Threats of searches, arrests and prosecution;
  - Improper questioning during trial concerning witnesses' personal life and work unrelated to the case;
- The Court's making motions on behalf of the Procuracy;
- The Court questioning witnesses on behalf of the Procuracy;
- Denial of effective assistance of counsel in the form of:
  - Interference with access;
  - Interference with confidential communications;
  - Harassment of defense counsel;
- Failure to disclose exculpatory evidence.

#### CONCLUSION

The above is a mere thumbnail sketch of the total perversion of the Russian criminal justice system in the Khodorkovsky/Yukos Affair. It requires far greater detail to demonstrate all of the complexities and nuances of the abuses that have occurred during the past 18 months. Counsel is available to provide additional information for use in further investigation of the matter.

*Question 3.* International energy policy is important to the Senate Foreign Relations Committee and in particular to the Subcommittee on International Economic Policy, which I chair. Please elaborate on the role that Yukos played in the overall energy market. What was the international market for Yukos? Did Yukos, for example, play a significant role in oil supplies to some of the large energy buyers such as the Europe Union or China. Was Yukos a supplier of U.S. resources?

[NOTE.—An answer to this question was not available at the time of printing.]



<sup>4</sup>Id.

<sup>5</sup>Europe Parliamentary Assembly, Circumstances Surrounding the Arrest and Prosecution of Leading Yukos Executives, Res. No. 1418 at ¶ \* (January 25, 2005).