



## **Transparency And Disclosure By Russian State-Owned Enterprises**

**Standard & Poor's Governance Services**

**Prepared for the Roundtable on Corporate Governance  
organized by the OECD in Moscow on June 3, 2005**

Julia Kochetygova  
Nick Popivshchy  
Oleg Shvyrkov  
Vladimir Todres  
Christine Liadskaya

**June 2005**

## **Transparency and Disclosure by Russian State-Owned Enterprises**

### **Executive Summary**

This survey of transparency and disclosure (T&D) by Russian state-owned companies by Standard & Poor's Governance Services was prepared at the request of the OECD Roundtable on Corporate Governance. According to the OECD Guidelines on Corporate Governance of SOEs, "the state should act as an informed and active owner and establish a clear and consistent ownership policy, ensuring that the governance of state-owned enterprises is carried out in a transparent and accountable manner" (Chapter III). Further, "large or listed SOEs should disclose financial and non financial information according to international best practices" (Chapter V). In stark contrast with these principles, the study revealed consistent differences in disclosure standards between the state-controlled and similarly sized public Russian companies. This is in line with the notion that transparency of state-controlled enterprises is hampered by the tendency of the Russian government and individual officials to use their influence on such companies to promote political or individual goals that often diverge from commercial motives and investor interests. High standards of transparency and disclosure, on the other hand, are a cornerstone in the foundation of good governance. They provide legitimate stakeholders--whether creditors, minority shareholders, taxpayers, or the general public--with the information they need to be able to begin to hold government decision-makers accountable for their actions.

Measured in a general sense, the companies included in the survey scored moderately on transparency, with an average aggregate score of 47% (disclosure of 47% of possible disclosure items). In contrast, the average score for the 10 largest Russian private, listed companies included in the Russian Transparency and Disclosure 2004 study, a similar survey by Standard & Poor's, is 52% (*see Russian Transparency and Disclosure 2004: Russian Transparency and Disclosure Survey 2004: Positive Trend Continues Despite Political Obstacles, published Oct. 13, 2004 on RatingsDirect, Standard & Poor's Web-based credit analysis system*). A comparison with state-owned industry peers in Western Europe and North America shows an even greater gap: the average score for that peer group is 63%, that is, 16 percentage points higher. The survey shows that the most transparent state-controlled companies are the ones that have listed stock, although having publicly traded debt can also contribute to transparency.

More significantly in Standard & Poor's view, a qualitative analysis of the firms studied shows that, in addition to differences in scope and detail of public reports, disclosure by state-controlled firms suffers from one-off lapses at critical junctures. Even if these events are relatively isolated, they have a major bearing on companies' strategies and performance. These lapses, which usually occur when significant stakeholder interests are at risk, undermine Russia's ability to attract capital at competitive rates, to build efficient and trusted institutions, and maximize its economic growth.

## Coverage

The study covers the 11 largest Russian companies from a variety of industries, in which the interest of the state (including that of regional authorities, and accounting for cross-ownerships and indirect influences), exceeds 50%. Five of these companies have their stock listed on Russian and/or foreign exchanges, and six do not have listed stock, but have publicly traded debt or preferred stock.

**Table 1. Companies Included in the Survey**

		Industry	State ownership (voting stock) (%)	Sales in 2003 (Mil. US\$)*	Market cap (Mil. US\$)¶	Listed common stock	Publicly traded debt or preferred stock
1	Gazprom	Oil & gas	38	26,719	65,026.0	Yes	Yes (Euro)
2	RZD	Railway	100	15,283	N/A	No	Yes
3	RAO UES	Utility	55	14,604	12,365.8	Yes	Yes
4	Tatneft	Oil & gas	33	4,639	3,490.9	Yes	Yes (Euro)
5	Svyazinvest (group)	Telecommunications	75	4,341	N/A	Yes§	Yes§
6	Transneft	Oil & gas	100	3,721	N/A	No	No
7	Rosneft	Oil & gas	100	3,641	N/A	No	Yes (Euro)
8	Alrosa	Mining	77	1,956	N/A	No	Yes (Euro)
9	Aeroflot	Airline	51	1,716	1,655.4	Yes	Yes
10	Sberbank	Banking	64	N/A	12,520.5	Yes	Yes (Euro)
11	VTB	Banking	100	N/A	N/A	No	Yes (Euro)

\*U.S. GAAP for Tatneft, IFRS for the rest.

¶As of May 26, 2005; source: Renaissance Capital.

§Key subsidiaries have listed stock and publicly traded debt.

N/A--Not applicable.

## Related Research by Standard & Poor's

The present study builds on and extends the earlier T&D research by Standard & Poor's Governance Services. Since 2002, Standard & Poor's has conducted annual surveys of T&D of the largest public Russian enterprises. Supported by the Moscow Interbank Currency Exchange (MICEX), the Russian Transparency & Disclosure Survey 2004 presented results on the disclosure practices by 50 Russian companies with listed equity and 10 closely held companies with listed bonds. Standard & Poor's has performed similar (although not identical) studies of T&D in the U.S. (2002), EU (2003), global emerging markets (2002), Southeast Asia (2003 and 2004), and Turkey (2005).

## Methodology

This survey primarily analyzes disclosure from an international investor's perspective. Therefore, it takes into account the availability of English-language information in addition to that which is provided in Russian. The checklist method consists of 105 items relating to:

## Transparency & Disclosure by Russian State-Owned Enterprises

- Ownership structure and shareholder rights,
- Financial and operational information, and
- Board and management structure and processes.

The complete list of items surveyed is presented in the Appendix.

As a part of the analysis, this study also presents a survey of T&D by 10 state-controlled industry-matched peers in the developed countries. This allows us to benchmark the disclosure practices of the Russian state-owned enterprises (SOEs) against those of their international peers, as well as the practices of similarly sized private Russian companies included in the last year's survey by Standard & Poor's.

Our analysis incorporates information included in annual reports, statutory filings, and Web-based disclosures published by May 13, 2004. Accordingly, we assessed the comprehensiveness of disclosure in each of these sources. As we did our analysis in May 2005, when most Russian companies have not yet published their 2004 annual reports and financial statements in accordance with International Financial Reporting Standards (IFRS) or U.S. GAAP, we could not account for the timeliness of annual disclosure within the scope of this study. For the same reason, we based our analysis on the information contained in annual reports and financial statements for 2003 based on the assumption--although not a certainty--that the 2004 disclosure will be at least at the same level.

### Key Findings

The analysis shows that government-controlled companies score moderately well on transparency, with an average score of 47% (*see table 2*). Gazprom, RAO UES, and Aeroflot appear on the top of list with overall scores of 63%, 59%, and 57%, respectively. All three companies provide financial statements in accordance with IFRS, and detailed operational information. Gazprom scored highest on nonfinancial and operational disclosure. In fact, the financial and operational disclosure by Gazprom and RAO UES (Gazprom's main domestic client) is linked to their monopoly positions, which make them subject to tight regulation by the authorities, including tariff setting. Their need, or potential need to attract debt and equity capital to fund modernization and investment, also creates pressure to meet the expectations of potential investors. Remaining weaknesses include limited availability of information in English and incomplete disclosure of executives and directors' compensation. While disclosure of such remuneration is also relatively limited at RAO UES, the utility company publishes minutes of board meetings on its Web site--a rare example of detailed disclosure of board process. The absence of an articulated dividend policy and limited disclosure on annual general meetings (AGMs), put negative pressure on the score of the Aeroflot. In addition, in its revenue structure, the flagship airline does not specify the size of the overflight fees that it receives from non-Russian airlines. The amount of these fees is important because they are a critical factor in the company's profitability, and other Russian airlines do not have a share in these fees.

Rosneft, RZD, and Tatneft came out at the bottom of the list, with overall scores of 43%, 28%, and 27%, respectively. Rosneft discloses virtually no information on its basic principles of corporate governance, including its Articles of Association and

dividend policy. The company does not file any statutory reports to Russian or foreign regulators that are public. RZD discloses little information on its governance mechanisms, moreover, the level of disclosure in the company's first statutory filing is below standard. In addition, IFRS statements by this company are not published in English. Tatneft has not yet presented its annual report, U.S. GAAP statements, and the 20-F filing for 2003, despite its NYSE listing. The company, which is an oil producer controlled by the government of the autonomous Republic of Tatarstan, saw its disclosure standards slip last year, after its auditor, Ernst & Young, questioned some transactions in its accounts leading to a delay in the publication of its U.S. GAAP financial statements. Tatneft, whose production has stagnated over the past five years while Russia's total oil output has risen by 50%, has also said it had overstated profits in 2001, 2002, and the first six months of 2003 because of another accounting mistake, and would need to publish corrected financial statements.

The three major areas of disclosure are summarized as blocks (*see table 2*). Block 2 (financial and operational information) is the strongest area of disclosure, with an average of 53%, while Gazprom, with a score of 72%, is the obvious leader. Block 1 (ownership structure and shareholder rights) scores lower on average, with 43%, which is surprising, given the relative ease of ownership and statutory rights disclosure for state-controlled companies. On this block, RAO UES scored highest among the 11 companies, with 54%. Block 3 (board and management structure and process) receives the lowest score of 39%, with Gazprom (56%) and Aeroflot (56%) being the strongest performers.

**Table 2. Scores on Russian SOEs**

		<b>Aggregate-SOEs 2005 (%)</b>	<b>Block 1 (%)</b>	<b>Block 2 (%)</b>	<b>Block 3 (%)</b>
1	Gazprom	63	50	72	56
2	RAO UES	59	54	64	55
3	Aeroflot	57	47	62	56
4	Alrosa	53	43	64	43
5	VTB	53	53	61	40
6	Svyazinvest (group)	51	43	58	45
7	Sberbank	47	44	49	46
8	Transneft	43	53	44	32
9	Rosneft	34	32	48	11
10	RZD	28	23	37	14
11	Tatneft	27	30	23	30
	<b>Average</b>	<b>47</b>	<b>43</b>	<b>53</b>	<b>39</b>

The average score for SOEs is comparable with the Russian Standard & Poor's Transparency Index 2004 based on the 50 largest public companies, which took the value of 46%. However, we believe that such a comparison is not the most meaningful, because many of these 50 firms are in fact much smaller in terms of sales than the SOEs in the present study, and have had less international exposure. Therefore, for the purpose of this study, we selected the 10 largest private firms, which we used as private domestic peers of the SOEs. These companies are: AvtoVAZ, LUKoil, MMK, Mobile TeleSystems (MTS), Norilsk Nickel, Severstal, Sibneft, Surgutneftegaz, TNK-BP, and VimpelCom. These firms are comparable in

size (defined as sales in 2003) to the studied SOEs. For instance, the aggregate sales by the 11 SOEs correspond to 18% of Russian GDP in 2003, while sales by the 10 private peers stood at 15% of GDP.

**Table 3. Average Scores on Private Russian Peers\***

	Aggregate score (%)	--Blocks (%)--			--Components (%)--					
		1	2	3	1	2	3	4	5	6
<b>T&amp;D 2004 average scores for 10 private peers</b>	52	46	59	46	44	50	59	63	57	24
<b>SOE average scores</b>	47	43	53	39	57	27	49	67	48	15

\*10 largest Russian private companies included in the T&D 2004 survey.

*Note: Component 1: Shareholder Capital. Component 2: Shareholder rights. Component 3: Financial information. Component 4: Operational/nonfinancial information. Component 5: Board and management information. Component 6: Board and management remuneration.*

Comparison with the private Russian peer companies shows that state-controlled enterprises are lagging behind in terms of transparency. Moreover, the presented comparison is a highly conservative one: If the same cut-off date were applied to both groups of companies--to account for timeliness of disclosure--we expect the difference would have been substantially wider. For instance, the scores on private companies in the Russian T&D 2004 study did not account for publications that took place after Aug. 13, 2004, (for example, late posting of 2003 financials), or improvements in online disclosure since that date. Further, certain methodological changes were introduced in the present study, such as inclusion of additional items addressing the disclosure on the influence of the state and associated risks. These changes could have negatively affected the comparability with the scope of T&D 2004, however, we expect these effects to be very minor.

With regards to breakdown by blocks, the gap is widest on the third block. This block comprises questions on the composition and practices of the governing bodies and remuneration of directors and officers.

Further breakdown by the six components in table 3 focused on more specific areas of disclosure, and provides more detail on specific areas of disclosure. For example, disclosure of ownership information is a much easier task for state-controlled enterprises--and a safer one in terms of exposure to political risks. In this sense, a higher level of ownership disclosure by SOEs (57% versus 44% on the first component) is predictable. At the same time, it is important to realize the limitations of such disclosure. While stakes held by the government in state-owned companies are usually quite clearly specified, personal interests of managers, and particularly, state officials in these, affiliated, and other firms are difficult to ascertain. Russian law demands that government functionaries and elected officials transfer all their assets to a blind trust until the completion of their state service. The absence of regulations regarding the establishment and the management of such trusts, as well as a narrow definition of affiliation in the Russian legislation and widespread intermediated ownership, makes it hard to track down officials' personal interests. Moreover, state officials only have to disclose their assets, transferred to trusts, in personal tax declarations and declarations to their supervisors, neither of which are published. This

lack of disclosure fuels speculation about the role of officials' personal interest in companies' decision-making.

The dramatically lower level of disclosure on shareholder rights (27% versus 50% on the second component) indicates that SOEs have systematic weaknesses in this area of disclosure. This also means that SOEs tend to provide very little information regarding how the government's goals and policies influence corporate decisions and operations, the decision-making process by the controlling governmental bodies, and mechanisms that could allow the minority shareholders to engage in a dialogue with representatives of the state. This weakness is a major one as it contradicts the core principles of transparency and accountability promoted in the OECD guidelines. The voting procedures for representatives of the state on companies' boards are of particular concern in this respect (*see The government's role in decision-making*).

Interestingly, SOEs score lower on financial information disclosure (49% versus 59% on the third component), but receive a slightly higher score on the nonfinancial/operational information (67% versus 63% on the fourth component). In fact, this result might reflect the attempts by SOEs to compensate for shortfalls in financial disclosure by providing extra detail on operations, which is common practice in Russia. Such compensation is, indeed, inadequate from an investor's perspective, particularly when disclosure on related-party transactions is incomplete. As indicated in the OECD guidelines, "abuse can occur through inappropriate related-party transactions, biased business decisions or changes in the capital structure favoring controlling shareholders" (Chapter III). While all SOEs in our study provide information on related-party transactions within the scope called for by IFRS/U.S. GAAP standards (Tatneft being a special case, see above), these standards typically do not include transactions with other government-controlled entities, and the information on transactions with indirect affiliates might be limited.

As noted above, both the information on composition of governing bodies, and the disclosure of remuneration of directors and executives is substantially weaker at SOEs than at their Russian peers (48% versus 57% and 15% versus 24%, on the fifth and sixth components, respectively). Most of the SOEs have not established an Audit Committee, a vital element of governance not only at private firms, but also at SOEs, as suggested by the OECD guidelines. Where such committees exist, the information on their composition and procedures is scant (for example, at Sberbank).

Table 4 shows the aggregate scores and component scores for the 10 non-Russian state-controlled companies included in the peer analysis.

**Table 4. Foreign SOE Peer Group**

		Country	Industry	State ownership (%)	Listed stock	Public debt	Aggregate (%)	--Block (%)--		
								1	2	3
1	Statoil	Norway	Oil & gas	71	Yes	Yes	82	83	91	66
2	Fortum	Finland	Utility	59	Yes	Yes	75	54	86	77
3	Telenor	Norway	Telecommunications	54	Yes	Yes	70	82	75	54

## Transparency & Disclosure by Russian State-Owned Enterprises

4	EDC	Canada	Banking	100	No	Yes	68	100	60	69
5	Vattenfall	Sweden	Utility	100	No	Yes	67	68	70	62
6	KfW	Germany	Banking	100	No	Yes	67	74	66	64
7	Finnair	Finland	Airline	65	Yes	Yes	64	71	58	68
8	Electricite de France	France	Utility	100	No	Yes	51	59	55	39
9	Gaz de France	France	Oil & gas	100	No	Yes	48	59	50	37
10	SNCF	France	Railway	100	No	Yes	42	67	51	17
	<b>Average</b>						<b>63</b>	<b>72</b>	<b>66</b>	<b>55</b>

As shown in table 4, the average transparency score for the non-Russian peers exceeds the average score for the Russian companies by 16 percentage points, with the widest gap on the first (29 points) and the third blocks (16 points), addressing information on ownership and shareholder rights, and disclosure on governing bodies, respectively. It is striking that the differences are particularly great in the areas of ownership information and shareholder rights, because SOEs typically disclose the interest of the state. In this respect, Gazprom and Tatneft are exceptions: While a complex system of cross-holdings exists with respect to ownership of Gazprom, obscure intermediary vehicles are used for the control by regional authorities in Tatneft. Apart from that, the large difference on the first block means that Russian state-controlled companies provide much less information on the existing private minority stakes than their foreign peers, and also disclose less information on governance mechanisms and shareholder rights. The difference is slightly smaller with respect to the second block, addressing the financial and operational disclosure, (13 points) although it is also substantial.

The breakdown presented in table 5 indicates that listed companies generally demonstrate a higher level of transparency than those having publicly traded debt only. In this sense, the impact of a listing on company's transparency is similar for the Russian SOEs and non-Russian peers. In fact, the gap is even wider for the non-Russian peers, despite higher levels of disclosure by both categories. This finding might reflect the greater effectiveness of regulatory requirements on disclosure that apply to listed companies in Western Europe and North America, as compared to those in Russia. We observed a similarly large difference in our Russian Transparency & Disclosure Survey 2004. In that study, 50 listed companies scored 17 points higher than nonlisted ones. However, the listed companies in that study were substantially larger, which has clearly contributed to the gap between the two groups.

**Table 5. Disclosure by Companies with Listed Stock versus Companies with Publicly Listed Debt**

(%)	Aggregate	--Block--			--Component--					
Russian SOEs		1	2	3	1	2	3	4	5	6
Listed stock*	51	45	55	48	50	39	50	71	59	19
Publicly traded debt only†	42	41	51	28	65	13	47	62	35	10
Non-Russian SOE peers										
Listed stock§	75	72	80	71	91	53	77	92	81	44
Publicly traded debt	57	71	59	48	94	46	53	76	52	38



## Transparency & Disclosure by Russian State-Owned Enterprises

<b>only**</b>										
<b>Russian private peers (all listed)</b>	52	46	59	46	44	50	59	63	57	24
<b>Listed companies in T&amp;D 2004</b>	46	46	47	46	48	46	41	61	56	24

\*Aeroflot, Gazprom, RAO UES, Sberbank, Tatneft, and Svyazinvest group.

¶VTB, Rosneft, RZD, Alrosa, and Transneft (has publicly traded preferred stock and, therefore, is clustered together with companies with publicly traded debt for the purposes of the analysis).

§Finnair, Statoil, Telenor, and Fortum;

\*\*KfW, SNCF, Vattenfall, Gaz de France, Electricite de France, and EDC.

Table 6 presents cumulative disclosure scores that are based on a slightly different approach, compared with the scores presented earlier: they do not account for comprehensiveness of information in each of the sources. For example, if a particular disclosure is made only on the Web site, but not in annual report or statutory filings, it is nevertheless considered complete, and the company received a maximum score on the respective item. This is different from our primary scoring methodology that accounts for level of disclosure in each of the sources (although the online disclosure has greater weight, reflecting its greater accessibility). Naturally, this less-stringent criterion leads to higher scores. In addition, the relative position of some companies changes slightly. RAO UES, for instance, comes out first, while Gazprom slips to second place. This reflects, primarily, the fact that RAO UES provides highly detailed online disclosure that is only partly replicated in its annual report and statutory filings, while Gazprom's disclosure is slightly less comprehensive, but relatively even in the three sources.

**Table 6. Cumulative Disclosure Scores\***

<b>Company</b>	<b>Aggregate (%)</b>	<b>Block 1 (%)</b>	<b>Block 2 (%)</b>	<b>Block 3 (%)</b>
RAO UES	81	74	91	71
Gazprom	75	65	86	63
Aeroflot	70	63	73	70
VTB	65	60	76	47
Alrosa	64	50	79	48
Svyazinvest (group)	63	56	68	58
Transneft	60	63	68	45
Sberbank	59	61	63	52
Rosneft	49	41	69	22
RZD	43	31	58	28
Tatneft	38	46	32	42
<b>Average</b>	<b>61</b>	<b>55</b>	<b>69</b>	<b>50</b>

\*Sources are not taken into account.

Table 7 shows that, as in the earlier analysis, when cumulative scoring is applied, the 11 Russian SOEs score lower than their non-Russian peers (by 4 percentage points), as well as than the Russian private peers (by 5 points). Apparently, the gap between Russian SOEs and their non-Russian peers becomes smaller with the cumulative scoring, while that with their Russian private peers remains the same. This is an interesting outcome, as it clearly indicates that for both the state-owned and private

Russian firms, the level of disclosure varies widely across sources--unlike that by the non-Russian peers. Thus, disclosure on the Web sites tends to be the most comprehensive, while annual reports are often less detailed, and statutory filings are the least informative, as they are typically viewed as a formality. This especially applies to the SOEs (*see table 8*).

**Table 7. Average Cumulative Disclosure Scores for the Russian Companies and Peers**

	Aggregate score (%)	--Block (%)--			--Component (%)--					
		1	2	3	1	2	3	4	5	6
<b>Russian SOEs</b>	61	55	69	50	71	39	65	84	61	20
<b>Non-Russian</b>	65	77	67	56	95	58	62	83	63	39
<b>Private Russian peers</b>	66	60	74	58	54	68	75	75	73	30

**Table 8. Sources of Disclosure**

	Annual report for the previous year (%)	Web site information (%)	Regulatory filings (%)
<b>SOEs</b>	39	59	29
<b>Non-Russian peers*</b>	63	65	57
<b>Russian private peers</b>	41	62	42

\*Excluding Finnair, SNCF, Vattenfall, Fortum, and EDC.

### Event-Driven Disclosure

Another important aspect of transparency is what is generally referred to as continuous disclosure, that is, companies' prompt and comprehensive disclosure of corporate actions, major events, and changing circumstances. This responsive type of disclosure is needed to ensure that all material news is communicated publicly, rather than selectively, and in full. According to OECD guidelines, SOEs should keep their shareholders duly informed in a timely and systematic fashion about material events (Chapter III).

The format of the T&D survey does not allow us to assess the quality of continuous disclosure, since it requires a case-by-case analysis of sporadic irregular events. In an effort to provide a meaningful subjective assessment, we studied a number of material events affecting Russian SOEs, where continuous disclosure would be expected.

We found that most government-controlled companies in Russia often do not provide fulsome one-off disclosures about material events, especially amid indications that Russian federal or regional authorities might be promoting political agendas through the actions of the firms. Several examples can be cited in this context.

*Rosneft*

One of the most striking examples is OAO Rosneft's purchase of Yuganskneftegaz (Yugansk) in December 2004. A former unit of OAO Yukos Oil Co. acquired and then sold by the government; it also was among the most controversial examples of the government's influence on company policy in the past year. Russia sold Yugansk for \$9.3 billion to dark-horse winner Baikal Finance Group, which was, three days later, acquired by Rosneft. The transaction demonstrated lack of timely disclosure by Rosneft in a number of respects, including the terms and sources of financing, as well as the decision-making and approval process regarding the purchase.

In January 2005, Rosneft announced it borrowed \$6 billion from China through Vnesheconombank against six years of oil deliveries, denying at the same time that the money was used to buy Yugansk.<sup>1</sup> The company, which is wholly owned by the state, has never disclosed any details of board discussions (if there were any) regarding the transaction itself and its financing, and the only Russian state official who admitted publicly he was familiar with the nature and the identity of the intermediary of the deal, Baikal Finance, was President Vladimir Putin himself.<sup>2</sup> Moreover, the acquisition of Yugansk has brought Rosneft's debt outstanding close to \$20 billion (including tax and other liabilities associated with Yugansk). In addition, Rosneft's near-term liquidity has been significantly weakened because of very large short-term maturities; the breach of covenants on financial debt; and the continuing default of Yugansk, now a material subsidiary of Rosneft, on the guarantee it had issued on Yukos' debt. (Standard & Poor's Ratings Services first put its 'B' rating on Rosneft on CreditWatch with developing implications reflecting Standard & Poor's view regarding its aggressive financial policy and high leverage, on one hand, and an alternative beneficial scenario from a creditors perspective, of a merger with higher rated Gazprom, on the other. Standard & Poor's lowered its rating on Rosneft to 'B-' and placed the rating on CreditWatch with negative implications after the government cancelled the merger with Gazprom; the rating remains on CreditWatch with negative implications primarily because of the tight near-term liquidity position.)

The scale and nature of the assets acquired by Rosneft, funded mostly by debt appears to create very high level of financial risk for the company. There are indications that the government might have used the company as a tool to establish a state-controlled champion in the nation's oil industry. This political rationale seems to have outweighed financial considerations. In Standard & Poor's view, the divergence of the interests and agendas of decision-makers from the interests of financial stakeholders--here mostly creditors--is a significant risk for those stakeholders.

#### *Vneshtorgbank*

It remains unclear whether Rosneft, which needed to quickly mobilize financing for the Yugansk purchase, needed to revert to raising bridge loans prior to raising the financing in China. Rosneft, as well as the two biggest state-controlled banks, Sberbank and Vneshtorgbank, has declined to comment on the issue when asked by the press and industry analysts. It should be noted that the reluctance of the parties to disclose information about the Yugansk financing could, in part, be related to the threat of litigation against parties facilitating the court-ordered auction of the former Yukos subsidiary by Yukos and its major shareholders.

Disclosure by Vneshtorgbank, which is wholly owned by the government, is also confusing when related-party dealings are concerned. The bank announced in March

2004 that it was increasing its cooperation with Rosneft and other state-controlled entities, including RAO UES, OAO RZD, AK Alrosa, and Rosenergoatom. The bank doesn't disclose its exposure to these borrowers (each of which dominates its respective industry). Vneshtorgbank reported that, in the fourth quarter of 2004, it agreed to accept Rosneft's guarantees for the obligations of the oil company's unit, Rosneft International Ltd., without disclosing the size, maturity, or other details on these obligations, nor the purpose of the borrowing.

#### *Transneft*

Yet another example of opacity relates to the possible relationship between the "Yukos affair" and delay of the government's decision on building an eastern Siberian oil pipeline--to be constructed, owned, and operated by state pipeline monopoly OAO Transneft. The consequences for Transneft are also unclear. After a three-year discussion on the most viable route for a new pipeline to take oil out of Russia and to a destination other than Europe, the government has settled on the route to the Pacific coast. The link, to cost at least \$6.5 billion (and as much as \$11.4 billion for the maximum capacity, according to company's estimates), would be twice as long and more than twice as expensive as a direct route to China, which was proposed and backed by Yukos. In addition, Russia has yet to explore crude reserves in eastern Siberia, which might affect the commercial viability of the Pacific route. There is no clarity on key commercial characteristics of the project, for example, expected tariffs, exact financing terms, payback, rate of return, potential impact on Transneft's financial profile in coming years, and so on.

Despite a wide discussion held by independent analysts in Russian business media, the government and Transneft have been discreet about the Siberian pipeline project, the comparative advantages and drawbacks of its various routes, its target performance indicators, sources of financing, and the decision-making process. Occasional remarks by state and Transneft officials have indicated that the government might have based its choice mostly on political grounds, such as Russia's relations with China and Japan and "the Yukos factor," rather than on purely commercial considerations.<sup>3</sup> According to the pipeline monopoly's CEO Semyon Vainshtok, Transneft will reduce its already modest dividends (of which the government is the biggest recipient) because of the cost of the Pacific pipeline.<sup>4</sup>

Focusing on the debate over the eastern Siberian pipeline, the government had shelved a project to build a pipeline to the Arctic Ocean to ship oil to the U.S. The government has returned to considering the Arctic project only recently, forcing Transneft to start preparing a feasibility study as a last-minute effort "in the afterburner mode," Mr. Vainshtok said.

#### *Aeroflot*

Aeroflot's bid to construct a new terminal on the land it rents near the Moscow Sheremetevo international airport is yet another vivid example of opaque decision-making. While Sheremetevo is wholly owned by the Russian government, which also owns a majority of Aeroflot, discussions about the allocation of the leadership role between the airline and the airport, the respective stakes in the newly created entity, and the choice of the project operator had been going on for more than two years. The tender for the project operator was finally launched in early 2004, and the tender commission under then Prime Minister Mikhail Kasyanov had initially announced

Alfa Group as the winner. However, that statement was subsequently reversed by Mr. Kasyanov's successor, current Prime Minister Mikhail Fradkov, almost immediately after he took office. The decision-making was then again stuck for another year, being affected, as are many other government decisions, by the reshuffle of duties and responsibilities within the government. The final allocation of the roles and stakes of the participants was determined only in March of this year, to become doubtful again in recent days as a result of a dispute between Aeroflot, Sberbank, and Vneshtorgbank.

### *RAO UES*

Another telling story is the pace of decision-making on the Russian electricity sector reform initiated and led by RAO UES. The government's work on reform, which is based on breaking up UES into competitive and monopoly players, had been stalled for most of 2004, until UES CEO Anatoly Chubais appealed to President Putin personally.<sup>5</sup> Without directives from the government, the UES board has been unable to move on the main issue of determining how to sell stakes in successor companies. Government officials continue making contradictory statements on whether only UES shares, or cash, or cash and shares together will be accepted as payment for the stakes. The lack of clarity on the issue has triggered a share plunge in most UES subsidiaries and has fueled volatility in parent company shares.

RAO UES is also known for a number of transactions that have neither been disclosed in a timely fashion, nor made in a transparent manner, such as settling the Soviet debt to the Czech Republic in 2001 and acquiring assets abroad. In the past two years, UES acquired generating assets and grids in Georgia, Armenia, and Ukraine. UES management believed that board approval for foreign acquisitions is unnecessary, because the general target to capture foreign markets already has been included in the "5+5" concept paper of 2003, which described prospects for the development of Russia's electricity industry through 2008. Decisions on these cases were coordinated with the government alone. UES has changed its approach only recently, bringing to its Board of Directors for discussion the issues of acquiring assets in Moldova and Kazakhstan, an agreement to complete a power station in Tajikistan, and a bid for two power stations in Bulgaria. Perhaps even more importantly, it is not clear who will own UES' foreign assets once UES itself is broken up and ceases to exist by 2007. UES officials have repeatedly declined to comment on the issue.

### *Tatneft*

In Tatneft, which generally lags behind all other Russian SOEs in our present review, continuous disclosure and disclosure of rationales for decisions is also remarkably weak. Tatneft itself admitted some of its loans in 1997 and 1998 were raised for the Tatarstan government, leading to Tatneft's default (with the debt subsequently restructured). Industry analysts have been left to speculate regarding whether some of Tatneft's borrowings since 2000 have been made for the Tatarstan government, rather than for corporate purposes. There is no evidence that some of Tatneft's major investment decisions, such as an unsuccessful bid to buy Turkey's oil refiner Tupras at \$650 million by its affiliate trader Efremov Kautchuk GmbH (although the affiliation was never disclosed by Tatneft), ever were considered by the company's board.

### *The government's role in decision-making*

The problem in the decision-making process in the largest Russian state-controlled entities, that form the “special list” is that in these companies all major decisions, before they are brought to the boards’ vote, need to be approved by the government, which has to issue the voting instructions to its representatives. Although obviously at odds with the concept of fiduciary duty articulated in the Russian Company Law (that is, a director bears personal responsibility to act in the interests of the company), such arrangements are legitimate in Russia: a series of government’s decrees, the latest being Regulations # 91-r and 738 issued in 2004, provide legal framework for such procedures. In fact, this inflexible, top-down approach by the government contradicts several principles of the OECD guidelines, including the principles that “SOE boards should exercise objective and independent judgment” and that “the state should let SOE boards carry out their responsibilities and limit its direct participation in these boards” (Chapter VI).

In many instances, decision-making by the government has been slow and opaque, becoming the subject of speculation by analysts and the media. Examples include the plan to merge Rosneft into Gazprom, about which the government continued to make conflicting statements for several months until May 2005, when the merger was abruptly canceled by a decision that was equally sudden for both Rosneft and Gazprom. Another example is the government’s unexplained move to waive the proposal expanding the rights of minorities at Svyazinvest in February 2005. According to several directors who represent the government on the boards of Russian SOEs, sometimes they head for board meetings having just received their voting instructions. The Russian market, when it comes to the largest SOEs and decisions related to them, is often driven by rumor, and some people might be trading on insider information, as there is no law against doing so in Russia at present.

### *Some international examples*

The peer analysis shows that cases of poor transparency, especially when it comes to questionable practices and decisions by SOEs, is not unique to Russia. In one of most illustrative cases, Norway-based Statoil’s CEO and board chairman were forced to resign in 2003 after they failed to disclose to directors a \$15 million contract with an oil consultant with ties to the son of Iran’s former president Hashemi Rafsanjani. The Norwegian government fined Statoil for entering into this contract to seek business in Iran, even though the police failed to find proof of bribery. In another example, the European Commission is forcing Gaz de France (GdF), France’s gas monopoly, to open access to its pipelines and to disclose information about pipeline capacity allocation to other gas companies, as required by European legislation on opening up the gas market. The commission called GdF’s tendency to block access and to withhold the information “an unacceptable level of non-compliance” with EU legislation. One notable difference, however, is that in the cited examples, the Norwegian government and the European Commission, respectively, called the companies to account for breaches of openness, whereas in Russia, the government itself often seems to be encouraging nontransparency.

We believe that these examples of event-driven lapses of disclosure illustrate the vulnerability of state-owned companies to opportunistic government decisions, driven by current political considerations rather than by sound business logic, especially given a lack of clarity regarding the government’s own goals and strategy.

## **Disclosure on Efficiency of SOEs by The Government**

According to the OECD guidelines, best government practices of managing SOEs should include detailed reporting on achieving the state objectives in this regard. The guidelines call on governments to provide to the public quantitative information on the state's portfolio, including such key indicators as its total value, turnover, profit, return on equity, equity/asset ratio, and dividends (Chapter V).

In Russia, such disclosure has been limited and, in fact, has deteriorated since President Putin reshuffled the government in the spring of 2004. The government only reports cumulative results of managing state property, disclosing total revenue from dividends on government-owned stakes, revenue from renting out federal property and land, profit of fully-owned government enterprises, and revenue from privatization, without operational details or financial indicators necessary to evaluate the effectiveness of state management.

Moreover, even the few figures disclosed are now reported only on an annual basis. For several years prior to the government reshuffle, the Property Ministry had reported these figures monthly. This practice was discontinued in April 2004, when the ministry was transformed into the Federal Agency for Managing Federal Property, supervised by the Ministry of Economy and Trade. The data for the full-year 2004 presented by the Economy Minister German Gref in a report to the government meeting, is available on the Economy Ministry's Web site as an addendum to the text of the report, but is quite difficult to find.

Russia's Audit Chamber, a parliament-controlled watchdog without executive powers, oversees budget expenditure and revenue and also is tasked to assure that state property is managed efficiently and expediently. The chamber, however, doesn't conduct any continuous monitoring on the issue, and, over the past two years, has mostly focused on reviewing privatizations of the early 1990s.

Without transparency, such an environment becomes a breeding ground for corruption. The fairness and predictability of rule of law are undermined, and poor governance and management practices in SOEs are likely to go unchecked and unchallenged. It is important to note that large SOEs influence the governance practices of a large number of private firms, as they set the standard that spills over to their business counterparts and peers. With less- than-transparent examples in sight, disclosure practices by private firms are likely to suffer.

---

<sup>1</sup> Press conferences by Finance Minister Alexei Kudrin and head of Russia's Energy Agency Sergey Oganessian on Feb.1, 2005, as reported by Reuters, Bloomberg, and Interfax.

<sup>2</sup> President Vladimir Putin's press conference in Germany on Dec. 21, 2004, as reported by Bloomberg and Vedomosti.

<sup>3</sup> See, for example, Bloomberg and Interfax reports on Industry and Energy Minister Viktor Khristenko's remarks after meeting Japanese Foreign Minister on Jan. 14, 2005.

<sup>4</sup> See Semyon Vainshtok's interview with Vedomosti on May 25, 2005.

<sup>5</sup> Anatoly Chubais' press briefing, Dec. 9, 2004.

## **Appendix: Criteria**

### **Criteria for the Transparency and Disclosure Survey**

#### **Block 1: Ownership Structure and Shareholder Rights**

##### **Component 1. Shareholder Capital**

Disclosure of:

1. The number and par value of issued and outstanding ordinary shares disclosed.
2. The number and par value of issued and outstanding other types of shares disclosed (preferred, nonvoting).
3. The number and par value of authorized, but unissued shares of all types disclosed.
4. The identity of the largest shareholder.
5. The identity of holders of all large stakes (blocking: > 25%; controlling: > 50%).
6. The identity of shareholders holding at least 25% of voting shares in total.
7. The identity of shareholders holding at least 50% of voting shares in total.
8. The identity of shareholders holding at least 75% of voting shares in total.
9. The number and identity of all shareholders each holding more than 10% of voting shares.
10. Shareholding in the company by individual senior managers.
11. Shareholding in the company by individual directors.
12. The description of share classes provided.
13. A review of shareholders by type.
14. The percentage of cross-ownership.

##### **Component 2. Shareholder rights**

Disclosure of:

15. The contents of any corporate governance charter or code of best practices.
16. Existence of code of business conduct and ethics.
17. Code of business conduct and ethics.
18. Details about the company's articles of association, such as changes.
19. Voting rights for each voting or nonvoting share.
20. The way that shareholders nominate directors to the board.
21. The way by which shareholders convene an extraordinary general meeting.
22. The procedure for initiating inquiries with the board.
23. The procedure for putting forward proposals at shareholders meetings.
24. A formalized dividend policy.
25. The existence of a review of last shareholder meetings.
26. Full general shareholder meeting minutes.
27. Calendar of important shareholders dates.

#### **Block 2: Financial and Operational Information**

##### **Component 3. Financial information**

Disclosure of:

28. The company's accounting policy.
29. The accounting standards it uses for its accounts.
30. Accounts according to local accounting standards.
31. Annual financial statements according to an internationally recognized accounting standard (such as IFRS/U.S. GAAP).
32. Notes to annual financial statements according to IFRS/U.S. GAAP.



33. Independent auditor's report with regard to annual financial statements according to IFRS/U.S. GAAP.
34. Unqualified (clean) audit opinion with regard to annual financial statements according to IFRS/U.S. GAAP.
35. Related-party transactions (RPTs): sales to/purchases from, payables to/receivables from related parties.
36. Indication whether such RPTs are made on an arm's-length/ non-arm's length terms.
37. Exact terms of RPTs.
38. Interim (quarterly or semiannual) financial statements according to an internationally recognized accounting standard (IFRS/U.S. GAAP).
39. Notes to such financial statements.
40. Whether these financial statements are audited or at least reviewed.
41. Transactions with government-controlled entities: sales to/purchases from, payables to/receivables from related parties.
42. Transactions with government-controlled entities: indication whether such transactions are made on an arm's-length/ non-arm's length terms.
43. Exact terms of transactions with government-controlled entities.
44. A basic earnings forecast of any kind.
45. A detailed earnings forecast.
46. Financial information on a quarterly basis.
47. Segment analysis (results broken down by business line).
48. Revenue structure (detailed breakdown).
49. Cost structure (high degree of detail).
50. The name of the company's auditing firm.
51. Whether the audit firm is a first-tier auditor
52. A reproduction of the auditors' report.
53. How much the company pays in audit fees to the auditor.
54. Disclosure of nonaudit fees paid to auditor.
55. Whether there are consolidated financial statements.
56. Methods of asset valuation.
57. Methods of fixed-asset depreciation.
58. A list of affiliates in which the company holds a minority stake.
59. The ownership structure of subsidiaries and affiliates.
60. A list or register of RPTs.
61. Description of functional relationships between key operating units within the group.
62. Policy with regard to the terms of intragroup transactions.
63. A list or register of group transactions.

#### **Component 4. Operational information**

Disclosure of:

64. Details of the kind of business the company engages in.
65. Details of the products or services the company produces or provides.
66. Output in physical terms.
67. Characteristics of fixed assets employed.
68. Efficiency indicators.
69. Industry-specific ratios.
70. A discussion of corporate strategy.
71. Discussion of government influence.

72. Any plans for investment in the coming years.
73. Detailed information about investment plans in the coming year.
74. An output forecast of any kind.
75. An overview of trends in its industry.
76. The company's market share for any or all of its businesses.

### **Block 3: Board and Management Structure and Process**

#### **Component 5. Board and management information**

Disclosure of:

77. The list of board members (names).
78. Details about directors other than name and title.
79. Details about the current employment and position of directors.
80. Details about the directors' previous employment and positions.
81. When each director joined the board.
82. Identification of the directors' arrangements with the company.
83. A named chairman listed.
84. Details about the chairman, other than name and title.
85. Details about role of the Board of Directors at the company.
86. A list of matters reserved for the board.
87. A list of board committees.
88. Names of all members of each existing committee.
89. Whether there are internal audit functions besides the Audit Committee.
90. Attendance record for board meetings.
91. A review of the last board meeting, such as minutes.
92. Detailed reviews of board meetings (including voting results).
93. The list of senior managers not on the Board of Directors.
94. The backgrounds of senior managers.
95. The nonfinancial details of the CEO's contract.
96. The number of shares held in other affiliated companies by managers.

#### **Component 6. Board and management remuneration**

Disclosure of:

97. Whether director training is provided.
98. The decision-making process for directors' pay.
99. The specifics of directors' pay, including the salary levels.
100. The form of directors' salaries, such as whether they are in cash or shares.
101. The specifics of pay for directors.
102. The decision-making process for determining managerial (not board) pay.
103. The specifics of managers' (not board) pay, such as salary levels and bonuses.
104. The form of managers' (not board) pay.
105. The specifics of performance-related pay for managers.