

## **“Russian Energy Policy and its Challenge to Western Policy Makers”**

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### **Summary**

- The U.S. and the EU have too long ignored the Kremlin’s non-transparent and monopolistic energy policies, and its use of natural resources to exert political influence over the new democracies of Central and Eastern Europe.
- The responses of the EU and U.S. to Russian energy policies have been weak and uncoordinated and have had little or no effect on Kremlin behavior.
- The disruption of natural gas to Ukraine and Georgia in January 2006, of oil to Lithuania and Belarus in 2006, and of gas to Georgia again in January 2007 was only an intensification of Russia’s petro-politics that began as early as 1990.
- Studies document that there have been over 40 politically-motivated energy disruptions or threatened disruptions by Moscow in the past 17 years.
- Europe could be less concerned if Russia were rapidly moving in the direction of Western-style democracy. Unfortunately, Putin’s Russia has become more authoritarian, nationalistic and desirous of re-establishing its Soviet-era hold over its European and Central Asian neighbors.
- The U.S. and Europe’s tolerance of, or at most token opposition to, Russia’s coercive policies and non-transparent business practices have convinced the Kremlin that the West is either powerless or lacks the will to react because of its perceived need for Russia’s substantial resources.
- The reality, however, is that Russia is very much dependent on revenue from Europe’s energy markets and on Western financing and technology in the energy sector.
- President Putin effectively uses personal diplomacy with individual European leaders to achieve energy deals that benefit companies in individual countries (such as Germany, France and Italy), and these direct negotiations have deterred the European Union from carrying out a unified energy strategy.
- The lack of a coordinated and enforced European energy policy has allowed Moscow to block the implementation of the EU’s long-range plans to develop alternative gas pipelines from the giant Caspian fields to Europe and to maintain Russia’s monopoly control of Kazakh, Turkmen and Uzbek gas production.

- Recent bilateral Russian deals with Italy, Austria, Hungary, Bulgaria, Italy, Greece and Slovakia may have fatally undermined European plans to bring non-Russian controlled oil and gas to European markets.
- Levels of corruption in Central Europe may be increasing as a result of corrupt business practices of Russian connected energy companies. With world energy prices at record levels, the Kremlin has the resources to influence political and economic decisions in Europe, through targeted support for “friendly” political parties and key energy decision makers.
- There is no evidence that president-elect Medvedev, former Chairman of Gazprom’s Board of Directors, will force the company to adopt more transparent, business-oriented energy policies.
- EU energy policy will only be effective if Germany, France and Italy take an active part in implementing a coordinated EU energy strategy. The smaller EU member states, particularly those in East Central Europe, are not benefiting from the “soft security” that they expected from EU membership.
- The EU Council and Parliament should require member states to require the Commission’s Directorate General for Transportation and Energy to approve, or at a minimum hold open hearings regarding all agreements with Russia for new energy pipelines to Europe. There should be full and timely disclosure to DG TREN regarding any energy deal between a member and a non-member state.
- In keeping with Article 45 of the Energy Charter Treaty, all signatories, including Russia, should be required to carry out the treaty provisions in order to engage in energy business within the EU area. At a minimum, Russian energy companies should be prevented from securing a level of control over European companies that is greater than that allowed in Russia.
- Europe’s competition and anti-trust laws, particularly Article 82 of the EC Treaty, should be rigorously enforced in the event of energy agreements with foreign companies.
- The monopolies of Transneft and Gazprom should be held to the same competition laws that have been applied to other foreign companies (such as Microsoft) doing business within the EU.
- The enforcement of articles 45 and 82 would bring greater competition and transparency to the EU’s energy markets and would compel Russia to modify its most egregious energy marketing practices.
- Central European countries can improve their own security by increasing domestic energy storage, by boosting indigenous supplies of gas and oil by engaging in greater regional energy cooperation.
- Most important, however, is the need to reduce domestic corruption and to create a more welcoming and transparent environment for Western investors.

### **A Delayed Wake-up Call**

Gazprom’s disruptions of natural gas and oil to Central Europe in 2006/2007 increased awareness in Europe and the United States regarding Moscow’s success in using its energy resources as political leverage in Europe and to undermine the new

democracies that most recently emerged from decades of Kremlin control. Russia's recent sharp increases in natural gas prices to Ukraine, Georgia, Belarus, Bulgaria, Armenia and Moldova, and its control over key European gas pipeline systems, raise fresh concerns about Russia's foreign economic policies and the security implications for Europe. Russia's energy strategy also raises the stakes regarding America's own growing dependency on energy imports, and should lead the U.S. to question expectations that Russian supplies of gas and oil will contribute to America's energy security. Unfortunately, the U.S. and Western Europe have largely ignored this problem until recently, in part because the coercive nature of Russia's petro-politics has largely been confined to East Central Europe and Central Asia.

For many new EU member states such as Poland, Latvia, Lithuania, and for new democracies, like Ukraine, Georgia, and Moldova, Russian energy control is an old problem. Central European attempts to raise this issue in Western capitals have until recently been brushed aside. The rapid acceptance in 2005 by the EU Commission of the Russian-German undersea gas pipeline project was a serious mistake and highlighted Europe's inability to implement a common foreign and security policy. The concerns voiced by the Central Europeans should have raised the alarm bells in Brussels and in European capitals long before the Ukraine crises of early 2006.

The EU's support for the Nord Stream pipeline between Russian and Germany, and its ready acceptance of EU member state collaboration to construct the South Stream pipeline, both of which endanger the EU's policy of energy diversification, will only add to Russian influence over Europe's key economies.

The slow Western response has given Russian state companies time to stitch together additional bilateral deals with individual Western governments who are anxious to help their companies gain an investment foothold in Russian energy production. A re-examination of EU policy may be made more difficult by the curious fact that Russia plays an important role in the EU's own Energy Treaty Commission (ETC). This is the case, even though Moscow has refused to implement the Energy Charter, and particularly the draft Transit Protocol that is part of the Treaty. Russian implementation of this agreement would have resulted in greater competition within Russia's energy transportation sector. Under Article 45 of the Energy Charter, Russia was obliged to put the treaty into force at the time of signing, but has successfully convinced most Europeans that it was free to ignore the treaty unless it is ratified by the Duma. In spite of pressure from the EU to implement the Charter, Gazprom's Deputy CEO Alexander Medvedev has labeled it as a "stillborn document." Gazprom believes that its bargaining position now outweighs that of the West as a result of high world energy prices and political instability in producer countries in the Middle East, Africa and South America. In any case, the long-term political and security significance of the Putin Government's assertive energy policies warrants much closer study by Western governments, including the United States.

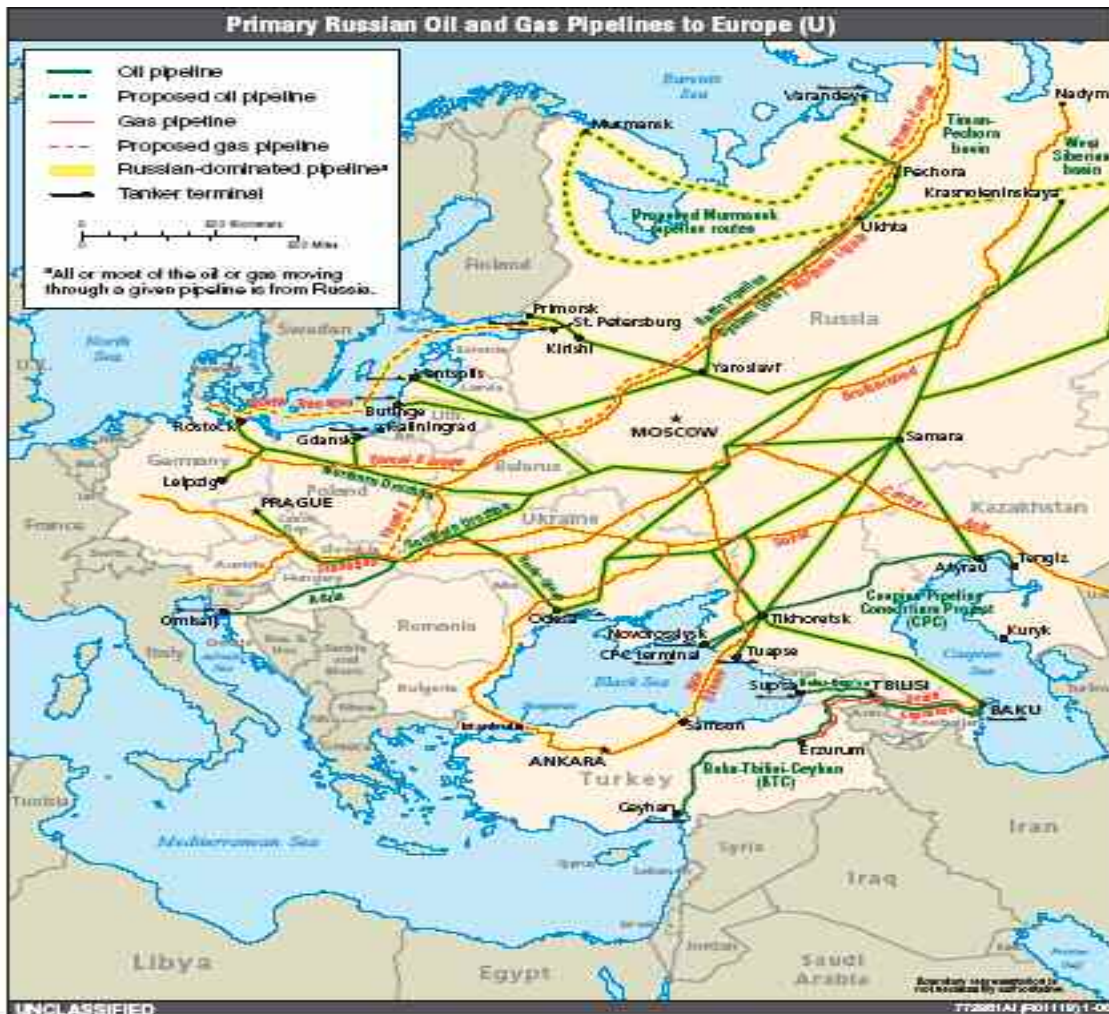
There is an unrealistic expectation in some circles in the U.S. that Russian natural gas supplies from the Russian Far East or from off-shore in the Barents Sea will fill the

gap created by declining U.S. and Canadian production and by political instability in Latin America, Nigeria and the Middle East. The reality is that Russian oil and gas exports are not growing at the pace they were just 3-4 years ago and companies such as Gazprom will have a difficult time fulfilling their existing gas delivery contracts with Europe. Investment in Russian exploration and development has declined from the level that existed before the systematic destruction of Yukos began in 2003 and the accelerated move to centralize control of almost all oil and gas resources under the current Kremlin Administration.

### **Pipeline Politics and Western Vulnerabilities**

The Putin Government has made it clear that it intends to use its energy export power to regain Russia's Cold War influence around the world, and particularly in Central Europe, the Caucasus and Central Asia. Some Russian economists, such as former Kremlin economic adviser, Andrei Illarionov, and former deputy energy minister, Vladimir Milov, have criticized their country's use of energy supplies as a weapon in its relations with other countries. They believe that it will distort Russia's own energy system and benefit those in power, rather than the country at large.

"Pipeline politics" by Moscow dates back to 1990, when it interrupted energy supplies to the Baltic States in a futile attempt to stifle their independence movement. The energy weapon was again used against the Baltic States in 1992, in retaliation for Baltic demands that Russia remove its remaining military forces from the region. In 1993 and 1994, Russia reduced gas supplies to Ukraine, in part, to force Kiev to pay for previous gas shipments, but also to pressure Ukraine into ceding more control to Russia over the Black Sea Fleet and over Ukraine's energy infrastructure. Even Belarus, and indirectly Poland and Lithuania, suffered supply disruptions in 2004 from the Kremlin's effort to take over Belarus' gas pipeline system. From 1998 to 2000, in an attempt to stop the sale of Lithuania's refinery, port facility, and pipeline to the Williams Company of Tulsa, Oklahoma, Transneft, Russia's monopoly transporter of piped oil, stopped the flow of crude oil to Lithuania nine times.



Russia's Gazprom, with the help of Germany's Ruhrgas, exercises control over the gas facilities and pipelines in the three Baltic States, where they also have monopoly control of the domestic gas markets in all three countries. Media outlets in the West have generally ignored Transneft's refusal to allow Kazakhstan to supply oil to Lithuania's Mazeikiai Refinery through the Russian pipeline system. In the autumn of 2006, Kazakhstan's oil company attempted to exercise its contractual right to ship crude oil to the Baltic coast, but was prevented from doing so by Transneft. Moscow attempted to stop any non-Russian company from taking over the Yukos ownership of Lithuania's facilities. Three years ago, Russia stopped all piped shipments of oil to Latvia in an effort to gain control over the oil port at Ventspils. Almost two years ago, Moscow blocked the shipment of all oil to Lithuania's Mazeikiai Refinery and the port at Butinge on the Baltic Sea, claiming that the pipeline "suffered a serious breakdown." This use of pipeline coercion in the Baltic States has not received enough attention in the West even though Latvia and Lithuania are EU and NATO members. The EU Commission's

response to pipeline disruptions has been slow and ineffective – when there has been a reaction.

The Russian pipeline monopolies of Gazprom (natural gas) and Transneft (oil) have been given free rides in terms of the open-market requirements of WTO and the EU's own Energy Charter. The EU's agreement with Russia on WTO in effect gave Moscow's increasingly monopolistic energy transportation and production firms carte blanche to avoid following accepted Western standards of transparency. The draft WTO agreement with the EU (not challenged by the U.S.) also allowed Russia to maintain a trade advantage in industrial goods by keeping its domestic energy prices considerably lower than world market prices.

### **German-Russian Energy Relations**

Russia stands to greatly increase its market share and its leverage in Germany and the rest of Europe through the construction of the expensive Baltic undersea Northern Europe gas pipeline (Nord Stream). An alternative construction of a parallel pipeline to the Yamal I line that runs through Poland would have been a much cheaper alternative (now estimated at over \$15.5 billion for Nord Stream vs \$2.8 billion for Yamal II). In addition, the enlargement of the Yamal line would have given both Central and Western European energy consumers greater political and economic security. The increased costs of Nord Stream will result in considerably higher energy prices for West European consumers as Russian and German companies try to recoup their investments.

No single country wields more influence in Moscow than does Germany. The trade and financial ties between Berlin and Moscow are important to the sustained development of both nations. Although many outside of Germany were disappointed with Chancellor Schroeder's consistent support for President Putin's domestic policies, everyone recognizes the value to European security of a close, constructive German-Russian relationship. Barring some dramatic policy change, Germany will continue to become more dependent on Russian gas imports (now over 44% of all the gas that Germany imports). This import dependence could well grow to 60% after the completion of all phases of the Nord Stream project.

### **Is the West Paying Attention?**

The EU has ignored the noncompetitive and political aspects of Russia's energy export policies, in part due to the desire Western energy firms to secure exploration and production rights in Russia. Although the EU recently initiated a more comprehensive study of the Community's energy security, the large countries of Europe continue to resist adhering to a common EU energy policy. Meanwhile, Russian companies are rapidly locking up non-transparent business deals with the Central Asian suppliers of Kazakhstan, Turkmenistan and Uzbekistan and with European consuming nations. Russian pipeline monopolies insure that Russia can buy energy cheap and sell it in Europe at a profit almost unmatched in world markets.

## **Europe as Hostage to Russian Energy**

The importance of good relations between Russia and the West, and particularly between Germany and Russia, cannot be underestimated. Nevertheless, it is a mistake to give Moscow the impression that the West needs Russian energy supplies more than Russia needs the oil and gas revenue that comes from the Western markets. Nor is it wise to let the Putin Government believe that its authoritarian domestic policies are acceptable as long as there is an expectation of increasing exports of Russia's energy resources. The West holds some powerful cards. Russia will not be able to develop its vast energy fields in Siberia, the Pacific Coast and in the Barents Sea before the middle of the next decade without Western capital and technology.

There are growing indications that Russia will be unable to meet its current European gas contracts unless foreign investors are offered significantly greater participation in exploration and development of Russia's new gas and oil fields. At present the opposite is happening, with Western companies' exploration and development rights being steadily and purposely reduced.

Russian gas exports to the West are already dependent on Gazprom's ability to monopolize and control gas exports from Turkmenistan, Kazakhstan and Uzbekistan. This Russian dependency on Central Asia will increase over the next 7-10 years, until there are substantial gas flows from the Yamal and Shtokman fields in the High North, and from new production on Sakhalin. In the past, Gazprom has neither had a reputation in the industry for innovation nor for productivity increases in exploration and development. With the company now under tighter control by the Kremlin, there are good reasons to question whether Gazprom and the increasingly powerful Rosneft will have the managerial skills, financing and technology necessary to meet Russia's export goals through increased domestic production.

There has been no coordinated push by either the EU or the U.S. to require that Russia open its energy market to foreign investors in the same way that Western companies and markets are open to Russian investors. Lukoil has been allowed to buy 100% of Getty Petroleum in the U.S., including 1,500 gas stations. U.S. energy companies can, according to Russian law, only own 49% of a Russian company, although in practice 20% ownership appears to be the ceiling set by the Kremlin. The West should be using its leverage to force Russia to play by the same transparent, competitive rules that guide business in the West. Western governments should not acquiesce to this uneven set of rules, but should demand full reciprocity with Russia in their investment policies. This would help promote the kind of investment that will increase, rather than decrease, economic reform and a more balanced growth in Russia itself. President Putin has compared the new Gazprom colossus to Norway's Statoil, but the latter has real domestic competition, its exports are divorced from foreign policy and it is a totally transparent company. Gazprom, with its interlocking ties to the Kremlin Administration and its gas pipeline monopoly, cannot be compared to any Western firm.



## **Intelligence Officers Making Energy Policy**

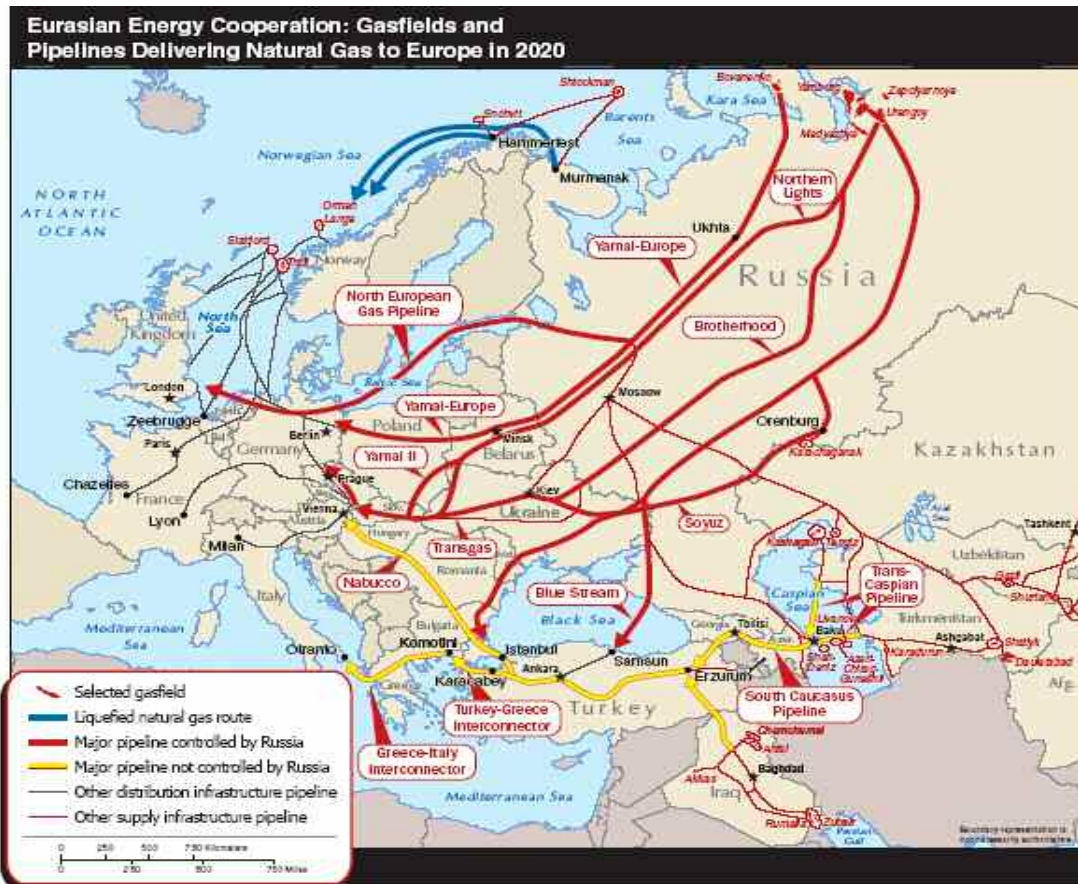
Former intelligence officers (siloviki) in the Putin administration and in Russia's energy companies have a strong role in determining national energy policy. The head of Rosneft is a former KGB associate of President Putin, and he helped engineer the breakup of Yukos and his company's seizure of the most valuable assets of Yukos. Former KGB and GRU officers sit on the boards of most of the country's major energy companies. In 1999, Moscow went so far as to send a former KGB/FSB officer as ambassador to Lithuania, in an attempt to provide behind-the-scenes support to Lukoil's negotiations with the Lithuanian Government and America's Williams Company. Before assuming the job in Vilnius, the ambassador had been the FSB's official liaison officer with Lukoil.

A few former intelligence officers are quite progressive in their views. The majority of this group, however, oppose weakening of the state through the growth of a transparent, independent private sector, and find it difficult to accept the idea of a win-win energy deal with a Western company. Granting majority control to a Western energy firm is viewed by most former Russian intelligence officers as a danger to Russia's national security interests. President Putin's use of Matthias Warnig, a former East German Stasi officer and now Dresdner Bank executive, to put together the financing and management of the Nord Stream pipeline system only added, perhaps unfairly, to suspicion that the project is more strategically than commercially motivated. Mr. Warnig, who was earlier proposed by Gazprom to sit on its board, is working directly under former Chancellor Schroeder in managing the Nord Stream gas pipeline project.

## **Ceding Too Much Control to Gazprom**

More scrutiny should be given by Western governments to the potential power of Gazprom to control the gas markets in Central Europe following the completion of the Baltic pipeline system in 2011-12. Under the German-Russian agreement, Gazprom will be able to buy significant shares in Germany's gas companies. Will this allow Gazprom to veto shipments of gas from Germany to Poland if the Poles have a dispute with Gazprom over price or availability and Russia decides to reduce or cut off the flow of gas? Could the increased power of Gazprom be used to stop liquid natural gas (LNG) receiving plants from being constructed in Poland, Latvia, or even in Germany? How much more political influence will Moscow have in Berlin as a result of Germany's growing energy dependency on Russia and of Gazprom's ownership stake in Ruhrgas?





Gazprom has recently reached non-transparent deals with Austria, Hungary, Slovakia and Bulgaria that will guarantee Russia's monopoly control of the gas and oil pipelines to Europe. These deals should be analyzed more closely by NATO for their security implications for Europe. NATO members have historically used the Alliance to examine issues that go beyond narrow questions of military defense.

Part of the Kremlin's present strategy is to rapidly increase prices to weak neighboring states in the hope that they will build up large debts, be unable to pay for the gas, and ultimately have to cede control over their domestic gas pipelines to Gazprom or Transneft to pay for the arrearages. This is what has happened in Belarus, Armenia and Moldova and is currently being threatened (again) in Ukraine.

### Ukraine Needs to Act to Strengthen its Own Hand

Ukraine's politicians, however, deserve much of the blame for the country's present situation. Kiev has allowed well-connected oligarchs to continue their control over gas deliveries from Russia and to control many of the country's domestic oil and gas fields. Even more damaging in the long run is the Ukrainian Government's lack of movement in developing fair and just conditions for both domestic and foreign energy investors. Here again, a few powerful individuals, most of them with close ties to Russia, have successfully kept out Western competitors. Ukraine could substantially reduce its

dependency on Russia through rapid reforms that would permit open tenders for energy exploration rights and a welcoming atmosphere for legitimate foreign energy investors. Seismic studies demonstrate that the country possesses considerable gas both on-shore, in the Black Sea and possibly in the Sea of Azov.

The country continues to exhibit little transparency in the entire energy market. Two thirds of Ukraine's refineries, processing three-fourths of the country's oil, are already owned by Russian companies. Almost 100% of the refined product that is exported is produced in Russian-owned companies. Ukraine's nuclear plants depend on Russian nuclear fuel rods. Former Russian Prime Minister Victor Chernomyrdin, who was also CEO of Gazprom, has for many years been Moscow's ambassador to Kiev. He has effectively promoted Russian near monopoly and has checkmated attempts by Western companies to gain a stronger foothold in Ukraine.

### **Time for the West to Lead on Energy Policy**

The EU should take the lead in building a more secure network of electricity inter-connectors between the countries of Western, Central and Eastern Europe. The EU could help marshal the international banks, such as the EBRD and EIB to take equity positions in the pipeline systems of Ukraine, Bulgaria, Moldova and Poland. This would help these countries modernize their pipelines. It would also provide a "neutral" party that could keep the pipelines from being controlled by non-transparent Russian companies and guarantee competition in gas and oil transportation. International financing for the proposed NABUCCO natural gas line from Azerbaijan would offer Central Europe much needed energy security, as would the building of the Odessa-Brody oil pipeline system.

The United States should re-examine its long-term energy relationship with Russia. Support for American investment in Russia's energy resources should not prevent us from demanding more transparent energy policies and a level playing field for foreign investors. We should expect a loosening of Russia's monopoly pipeline system and demand from Moscow that Central Asian energy producers be given direct access to Western markets. We are not being hostile toward Russia when we insist that there be reciprocity in Russian-European-U.S. energy relations. It would be foolish on our part not to want Russia to evolve into an economically successful democracy. Everyone would gain. Russians are going through a difficult period psychologically. Unfortunately, they are highly suspicious of America's motives in Central Europe and Central Asia and tend to believe that the U.S. and NATO are intent on "surrounding" Russia with hostile states; part of a grand scheme by the West to keep Russia weak economically and marginalized in international affairs. It is necessary for us to address these issues head on with our Russian colleagues, and at the same time work to counter Russian efforts to acquire psychological security by creating insecurity in Europe.

The world does Russia no favor by ignoring the monopoly and noncompetitive nature of this energy relationship. Meanwhile, neither the EU nor U.S. should allow Moscow to threaten the security of Europe, particularly the new democracies of Central

Europe through neglect or unwillingness to face down the new imperial mindset in the Kremlin. As Yuri Schmidt, the famous Russian human rights lawyer told audiences in Brussels, “Yes, Russia needs something from you. It needs your silence, and it is ready to pay you for it, too.” The January 1, 2006 wake-up call to the West was also an opportunity for those who want to see Russia build a modern, democratic state that is linked to Europe by mutually beneficial political and economic ties.

### **Policy Recommendations for the West**

Enforce the Energy Charter Treaty. According to Article 45 of the Treaty it went into effect when a state signed it (not ratified it), unless there was a specific declaration that it would “opt out” such as was done by Norway. Therefore, Russia already has a binding treaty obligation with the EU member states.

Enforce the Rome Treaty’s competition and anti-trust rules in cross-border deals between Transneft, Gazprom and individual European states.

Calculate the true cost to the European consumer of Russia’s pipeline monopoly of Central Asian supplies and of the very expensive Nord Stream pipeline.

Prevent member states from reaching individual deals with Russia that undercut the viability of EU plans to bring alternative supplies of energy to Europe.

Demand the right to immediately investigate disruptions of energy to the Baltic States, particularly when the disruption appears designed to force a member state to sell its facilities to Russia.

Provide more leadership in working with Central Asians to supply gas and oil directly to the EU, without the use of intermediaries.

Enforce a “level playing field” for European and Russian investors in the energy sector. The rules on both sides should be clear, transparent and enforceable.

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