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Oil, carrots, and sticks: Russia's energy resources as a foreign policy tool

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ABSTRACT

This paper will explore the growth of Russia's energy leverage in recent years, a source of power which Russia has used both to reward its friends and punish its enemies. It will briefly trace the origins of this power in the integrated energy networks of the former USSR and Warsaw Pact. It will then examine recent cases of the use of 'oil power.' Both positive and negative linkage will be considered. Some states-such as Armenia, Belarus and the Ukraine under President Kuchma-have been favored with heavily subsidized energy. Others-such as Georgia, Moldova, the Baltic States and the Ukraine today-have been targeted by supply disruptions and punitive price increases. Russia's new 'petro-power' is of great importance today, and not just for its immediate neighbors: like other 'petro-states,' Russia is likely to gain ever more power as oil and gas become scarcer in the future.

1. Introduction and theory

In the past decade, Russia has increasingly moved back onto the world stage as an important actor. After a noticeable decline under Gobachev and Yeltsin, the Putin era saw a resurgence of Russian power. A key component of this power is Russia's ability to use its oil and gas reserves as foreign policy tools. If anything, the role of such policies has only increased under the new Russian President, Dimitri Medvedev. Before taking office he was the chair of the state gas monopoly, Gazprom, a key instrument of Moscow's 'petro-power.'

Recent examples of the role of this power have included both 'petro-carrots' (using oil and gas to reward allies) and 'petro-sticks' (using resources to punish states which defy the Kremlin). As this paper will show, states such as Georgia, the Ukraine and the Baltic States have been punished with supply interruptions and higher prices after their governments turned toward the West. Conversely, those who remained friendly to the Kremlin—such as Armenia, Belorussia, Ukraine before 2005, and the tiny statelets of Abkhazia, North Ossetia, and Trans-Dniestria—have been granted ample oil and gas at subsidized prices.

This paper will seek to analyze the nature and importance of Russia's current oil and gas power. First, in this section some relevant theories of economic linkage will be discussed. Second, the paper will briefly trace the emergence of Russia's current oil and gas influence. Finally, we will examine some concrete examples of recent Russian 'petro-carrots' and 'petro-sticks.' As we shall see, this form of Russian influence is increasingly important today, as part of the resurgence of 'petro-states' worldwide. Since oil and gas seem likely to remain scarce and expensive in the long run, the influence of these states will continue to grow. This will cause increasing problems for all oil-importing states, including our own.

Since the classic study by Hirschman (1945), theorists of economic influence have pointed to several factors which

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enable a state to successfully use its economic power against others (see for example D'Anieri, 1999: 48–56). First, it is very helpful for the initiating state to have a larger economy than the target state. This enables it to better survive any economic conflict. By this basic measure, Russia clearly has an advantage over its neighbors in the former Soviet Union and Eastern Europe. Second, it is helpful if the initiating state has a lower percentage of its trade with the target than the target does with it. For example, Germany has historically had only about 2% of its trade with Poland, yet this has often accounted for 30–40% of Poland's trade volume (Newnham, 2006:7). Clearly, Germany could easily impose a painful trade boycott on Poland, at very little cost to itself. Here again, Russia is in a similar position with most of its smaller, economically weak neighbors. Both of these conditions force the target state into what Keohane and Nye (1989) called "asymmetrical interdependence," or more simply, dependence.

Beyond these general criteria, though, are factors which relate directly to Russia's oil and gas power. First, oil and gas are products for which a substitute is very difficult to find. This is true for all oil and gas importing states, such as the U.S., but is especially true for Russia's energy trading partners. As we shall see, the former USSR deliberately linked both its own republics and its satellite states into a web of oil and gas dependency. All pipelines radiated out from Russia, and the housing, industry, and transport of the former Soviet bloc were built to run on Russian oil and gas. Oil, perhaps, can to some extent be brought in by ship from other countries (although port facilities may be inadequate or, as in Belarus, nonexistent). Gas, however, can generally only be shipped by pipeline, and thus all of Russia's neighbors have essentially no other source.[1] Such a monopoly position gives Russia huge market power over its customers.

However, while Russia's oil and gas may be vital for its partners, oil and gas *revenue* is vital for Russia. This potentially allows some countervailing pressure for Russia's customers, especially in times when oil and gas prices are low. Then, Russia may need to sell as much as they need to buy. As we shall see, this seemed to be the case in the Yeltsin years, with oil prices often at $20 per barrel or less. Partly as a result, the overall Russian economy was weak, which enhanced the bargaining power of its partners. Recently, however, with oil prices peaking at $147.27 per barrel in July 2008, the balance of power shifted decisively. With oil and gas this rare and valuable, Russia could easily find other buyers. Its natural gas flowed throughout Western Europe and could potentially reach other lucrative markets, such as China and Japan. Its oil could be shipped worldwide. Swimming in petro-profits, Russia could easily afford to impose embargoes on any individual country it chooses to target. While the economic downturn of 2008–2009 has moderated oil prices temporarily, the underlying situation remains.

In short, then, scholars of economic linkage can easily see why countries such as Ukraine, Belarus, and Georgia face such strong Russian 'petro-power.' This power rests on Russia's larger economy and its dominant position in the region's overall trade. It is greatly strengthened by the nature of the products involved. Oil and gas remain rare, valuable, and almost impossible to find a substitute for. We next turn to two other questions: how did this situation arise, and how has Russia tried to exploit it?

2. The growth of Russia's energy influence

The roots of today's Russian oil and gas influence date to the country's Soviet past. At that point, as we shall see, the Kremlin consciously began an effort to make Russian energy indispensable throughout both Eastern and Western Europe. By the 1970s, Soviet energy influence was a major headache for the West. This energy influence declined temporarily in the late 1980s and 1990s, due to low oil prices, the dislocations of the collapse of the USSR, and the privatization of many oil companies. However, Russia's ample resources and extensive network of pipelines ensured that its 'petro-power' was ready to re-emerge under President Putin.

During the 1950s and 60s the Soviet Union deepened its efforts to link itself to its Warsaw Pact allies economically. Under the Council for Mutual Economic Assistance (CMEA or COMECON), economic cooperation of all sorts was designed to complement the Soviet Bloc's military and ideological ties. While the CMEA had begun under Stalin, in 1949, in those years the Bloc members felt economically exploited.Khruschev, in contrast, hoped to build a 'socialist division of labor,' in which the USSR and its allies would all profit. At the same time, this web of mutual dependence would make it very difficult for any state to leave the group.

A key part of this emerging 'socialist division of labor' was the USSR's role as the dominant supplier of raw materials and energy to the rest of the Bloc (Kramer, 1985; Newnham, 1990). A pattern began then which continues today: Russia deliberately gave its allies oil and gas at highly subsidized prices—but only if they remained politically compliant (Marrese & Vanous, 1983). Loyal states which experienced political problems, such as Poland during the Solidarity period of 1980–81, were helped with even more generous subsidies. Meanwhile, critics of the Kremlin—such as Romania—were forced to rely on the much pricier world market for fuel.[2]

The reliance of Eastern Europe (and the rest of the USSR) on Russian oil and gas was only increased by these subsidies. Huge energy-hungry industries were built up, many of which (such as petrochemical plants) relied totally

[1] Natural gas can be liquefied and sent by ship, but this requires specialized facilities in both the sending and receiving state, and thus is still a relatively rare method. Also, it is possible in theory for gas from other states to be 'swapped' through Russia's pipelines. Thus, for example, in the relatively lax Yeltsin years Ukraine was allowed to purchase some gas from Kazakhstan. The Kazakhs sent the gas to Russia, which then sent the same amount on to Ukraine (Rutland, 1999: 166, 169). In theory, this allowed Kiev to benefit from competition—but only because Russia permitted the swap. It had no obligation to allow its pipelines to be used in this way.

[2] As Keller notes (1985: 35), in 1979 Hungary received 97% of its energy imports from the USSR, Bulgaria 92%, and East Germany 90%. Romania, in contrast, received only 16% of its imports from the Kremlin, having to buy the rest on the world market.

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on subsidized fuel. Average consumers, too, were accustomed to profligate energy use. For example, many apartments throughout the Soviet Bloc were built with no individual thermostats and no gas meters, encouraging waste. As we shall see, this legacy of dependence remains a powerful source of leverage for the Kremlin today.

Soon another important part of today's Russian energy influence was formed: the idea that the new East European pipelines would also allow large amounts of Soviet oil and gas to be exported to the capitalist west (Jentleson, 1986). This would earn Russia valuable hard currency, and would also serve as an important political tool, perhaps allowing Moscow to pry Western Europe away from American influence. Even in the early 1960s, U.S. leaders feared that the Druzhba [Friendship] oil pipeline, then under construction from Russia to East Germany, would allow the Soviets to gain influence in the West. Accordingly, the U.S. pressed West Germany and other suppliers to halt shipments of large diameter pipe and other equipment to Russia (Newnham, 2002: 132–136). The issue simmered for decades, with another major confrontation erupting under President Reagan, who pressed NATO to boycott the new natural gas pipelines which Russia was building to Western Europe (Jentleson, 1986). Nonetheless, the new links were completed, and have only deepened over the years.

The stage was set, then, for Russia to be able to use its energy power in two effective ways:first, by subsidizing its allies, and second, by selling to its enemies at full world market price, reaping rich profits. Either way, the Kremlin gained power. In retrospect, high oil prices appear to have been a major factor in the 1970s and early 1980s in bolstering Moscow's belief that it was winning the Cold War. As Gaddy noted in 2004 (348):

> [The present period] is not the first time that an oil windfall has shaped thinking in Russia. In the early 1970s the combination of vast new Siberian oil reserves coming on line and the price shocks due to the 1973 Arab-Israeli war provided what one historian has called the "greatest economic boom the Soviet Union ever experienced"[…] Abroad, the cash was earmarked for expanded subsidies to Eastern Europe and arms deliveries to new clients in more remote parts of the globe. By the beginning of the next decade, it would be used to pay for a costly war in Afghanistan.

Fortunately for the West, and for Russia's downtrodden East Bloc allies, the world market price for oil collapsed in 1986. Many experts, like the late economist and former Russian Prime Minister Yegor Gaidar, have argued that this played a major role in the rapid collapse of the USSR (Gaidar, 2007). Falling oil and gas revenue made it hard for Russia to afford the Cold War, helping to force a pullback from Afghanistan and other Third World ventures. The declining price of oil and gas forced Russia to prioritize its shipments to the wealthy West, cutting subsidized exports to Eastern Europe. This helped to destabilize the Soviet Bloc. Meanwhile, at home, falling oil and gas revenue hurt Russia's economy, putting another nail in the coffin of the Gorbachev government.

During the Yeltsin years, the slide in Russia's 'petro-power' continued. Several reasons can be cited for this. First, oil prices remained very low. Second, partly as a result, the overall Russian economy remained in free fall, increasing the government's desperation for hard currency exports. Third, these economic dislocations only helped to drive down oil and gas production, further reducing revenue. Finally, the privatization of Russian resources helped ensure that much of the limited 'petro-power' Russia retained would be exercised by businessmen, not politicians.

With a few brief exceptions—like a price spike at the time of the 1991 Gulf War—the world market price for oil remained below $20 per barrel from 1986 to 2000 (EIA, 2007b). The effect on Russia was dramatic. Such low prices further weakened the Russian economy, which was already staggering from the dramatic effects of Gorbachev and Yeltsin's moves toward the free market. It has been estimated that a $1 change in the world price of oil causes Russia's GDP to rise or fall about 0.35% (EIA, 2007a:1). Thus, the fall in oil prices in the 1980s—almost $30 per barrel–cost Russia about 10% of its GDP, a heavy blow. In addition to the falling oil price, output also plummeted. By the mid-1990s, oil production stood at 6 million barrels per day, about half of the Soviet-era peak (EIA, 2007a:2). Clearly, such a fall left Russia with much less 'petro-power.'

Overall, with the huge additional disruptions of the end of Communism, the Russian economy shrank by about 40% between 1991 and 1998. Not surprisingly, such a steep economic slide left the Russian government unable to pay its domestic expenses or its foreign debt. This steady financial decline struck at Russia's 'petro-power' in two ways. First, Moscow's desperate need for cash forced it to adopt a policy of "export at all costs." Even the modest income from customers such as Ukraine, receiving heavily subsidized oil and gas, was vital. Russian leaders worried that these states could simply refuse to pay, or that they could turn to alternate suppliers—especially if the Kremlin dared to raise prices. Russia's market share had to be defended. Even worse, Ukraine, Belarus, and the Baltic States stood astride Russia's lucrative export routes to the West. A move to shut down the export pipelines could have ruined Russia's weak credit rating and sent the ruble, already sliding daily, into a further tailspin. As the ruble collapse of summer 1998 showed, this was a real threat.

Second, the desperate need to close yawning budget gaps helped to force the Kremlin to privatize valuable state assets quickly, at fire sale prices—including oil and gas fields. As the Yeltsin years progressed, privatization steadily eroded state influence in the oil and gas sectors. Most oil resources were sold off, sometimes for pennies on the dollar. For example, Russian businessman Roman Abramovich was able to buy the oil firm Sibneft for about $100 million in 1995—and sell it for over 130 times more ($13.1 billion) ten years later (Kramer, 2005). By the late 1990s, oligarchs were able to gain control of oil fields without making any real payments; under the so-called 'loans for shares' program even short-term loans were enough to strip assets from the bankrupt Russian state. While foreign companies were not allowed to buy existing oil fields, they were permitted to secure majority control of potentially lucrative undeveloped fields.

By the end of the Yeltsin years the state retained control over only about ten percent of Russia's oil, hardly enough to

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control export policies. Plans were underway for even the last major state-owned oil company, Rosneft, to be sold to private owners. In fact, it was spared in 1998 only because private buyers rejected the cost to buy 75% of the firm, $2.1 billion, as far too high (Lane, 1999:35). Ironically, by 2006 Rosneft would be valued at about $80 billion, based on the $10.7 billion it received when a mere 15% of its shares were offered for sale (Rosneft, 2007). Q2

In the gas sector the Kremlin's role was stronger, but still weakened. Most natural gas production remained under Gazprom, the state-owned energy giant created just before the fall of the USSR. However, large shares of the company had been sold to domestic and foreign buyers, reducing the state's stake to about 38%. While the state retained influence, Gazprom's decisions were increasingly based on economic, not political calculations. Its usefulness as a tool of state leverage was declining. In the last years of the Yeltsin era, speculation was rampant that even Gazprom would be fully privatized, which would have virtually eliminated the Kremlin's energy power.

In the latter years of Yeltsin's rule many analysts concluded that not only did the Kremlin not control the oil and gas industry—in many ways, the industry controlled it. The leading oligarchs played a large role in Yeltsin's narrow reelection in 1996, gaining much influence. It seemed that even in foreign policy energy corporations played "a large, if not a dominant role" (Rutland, 1999:183). Fragmentation of the Kremlin's authority had reached a point where no clear decision-making procedure could be discerned at all. The contrast to today's forceful Russian state was stark.

3. Russia's 'Petro-Power' returns

Under President Putin Russia's energy influence reached unprecedented heights. Several factors have combined to produce this result. First, the world market for oil and gas greatly favored Russia and other producers in 2000–2008. These products became both valuable and rare, ideal preconditions for the use of any form of economic linkage, as noted in the theory section above. While prices have moderated in the current worldwide recession, a return to the era of 'cheap oil' in the 1990s is unlikely. Second, the Putin administration moved to take control of the country's oil and gas sector. This allowed Russia to harness its potential economic power for *state* purposes, a crucial condition which was largely lacking in the late Yeltsin years. Third, Russia moved aggressively to increase its control over oil and gas assets outside its borders, notably the pipelines which carry its products to the world. In sum, Russia is now much more free to use its oil and gas to either impose painful cost or offer lucrative benefits to states which it seeks to influence.

A key factor in the rise of Russia's 'energy power' was the state of the world market in oil and gas during Putin's reign. Supplies were tight worldwide, meaning that Russia's customers had few alternatives to buying from Moscow. States could not easily evade Moscow's energy sanctions or impose counter-sanctions. For example, the EU would have found it virtually impossible to boycott Russian oil or gas to express its distaste with Putin's foreign policy or his increasingly autocratic actions at home. Also, prices soared to record highs after Putin became President in 2000, with oil reaching almost $150 a barrel by mid-2008. This turnaround from the Yeltsin years allowed Russia to rake in massive profits from oil and gas sales. This in turn allowed the Kremlin to pay off Russia's foreign debts, which loomed so high under Yeltsin that they prevented Russia from fully using its petro-power, as was noted above. Today, while the recession has cut into Russia's financial reserves, it remains far more solvent than in the 1990s. If a country such as Belarus threatens to temporarily suspend Russian oil or gas shipments through its pipelines, Russia can shrug off the threat. It knows that it can afford a temporary drop in revenue, unlike in the Yeltsin years.

The tightness in world markets allowed Moscow to retain and expand its dominant market shares among its energy customers–and also to reel in new customers, such as China and Japan. For example, Belarus obtains essentially all of its natural gas from Russia—99%. The Baltic States depend on Moscow for about 89% of their gas supplies, Georgia for 88%, and Ukraine for 69%. Even some Western customers have similarly high levels of dependence, such as Austria (72%) and Greece (85%) (EIA, 2007c:6).

These underlying conditions—high prices, tight supplies, large market shares—all meet the preconditions noted in the theory section for the use of economic power. Yet another condition had been allowed to slip away in the Yeltsin years: state control of resources. As noted above, almost all of Russia's oil reserves were privatized in the Yeltsin years. Even mighty Gazprom was being considered for privatization. Under Putin this laissez-faire approach ended abruptly.

The prime example of this, of course, is the treatment of Yukos, considered by many to have been the best-run private oil firm in Russia. Mikhail Khodorkovsky, the founder of Yukos, was apparently targeted because he directly threatened Putin's control of the energy industry (Baker & Glasser, 2007: Chs. 14 and 17). Seemingly unaware of the looming danger, he was moving confidently forward in several areas which angered Putin. He was planning to acquire another large Russian oil company, Sibneft, thus taking a leading role in the oil sector. To finance such expansion, he was considering selling a large stake in Yukos to Western investors. And he was openly backing anti-Putin political forces in Russia itself. The result is well known: Khodorkovsky was arrested on what were widely regarded as bogus tax charges and eventually sentenced to eight years in a Siberian prison. More seriously, his firm wasdestroyed. The Russian government demanded higher and higher payments for 'back taxes,' and Yukos went bankrupt and was forced to sell its assets. In a farcical 'auction' held in December 2004 the largest share of Yukos' oil assets were transferred to the state-owned Rosneft.[3]

More quietly, the Kremlin then continued to consolidate its role in the oil sector. In late 2005, state-owned Gazprom purchased privately-owned Sibneft for $13.1 billion

[3] Rosneft bought the assets through a front, "Baikal Finance Group," which it formally took over three days later. The price was vastly understated–$9.35 billion for assets worth more than $60 billion (Meyers and Kramer, 2007).

(Kramer, 2005), eventually renaming its acquisition 'Gazprom Neft' [oil]. In this case, the sale was regarded as essentially voluntary, with a fair market price being paid. The owner, Roman Abramovich, was seen as having cleverly cashed out before the state raised pressure on him.

Yet tougher tactics remained possible, as the case of a smaller firm, Russneft, clearly shows. In the summer of 2007, its owner, the oligarch Mikhail Gutseriev, initially refused pressure to sell. The government swiftly responded with questionable tax allegations, like those used against Yukos. Gutseriev folded, selling to a Kremlin-approved buyer, aluminum magnate Oleg Deripska. Then he made the mistake of publicly denouncing the sale as unfair and forced. A warrant was issued for his arrest, but he had prudently left the country (Kramer, 2007).

Despite the growth of Rosneft and the creation of Gazprom Neft, about 60% of Russia's oil resources remain in private hands (Hashim, 2007:11). However, the remaining private firms have clearly understood Putin's message. All now back Putin and Medvedev in domestic politics and eagerly follow their line in foreign policy questions. This is the price of doing business in today's Russia.

As noted above, part of the reason for Putin's administration to target Yukos was fear of the firm's efforts to court foreign investors. Clearly, Moscow could not control the Russian oil sector if large, independent foreign firms either owned Russian energy companies or ran oil fields directly. Putin moved aggressively to try to squeeze foreign companies out of their majority holdings in the energy sector.

A prime example of Russia's new energy xenophobia was the treatment of thejoint venture known as Sakhalin-II, controlled by Shell, which had been created in the more flexible Yeltsin years. Huge political pressure was brought to bear on Shell in late 2006 (Kramer, 2006b). A key component of this was the assertion by the Russian environmental agency that the project could damage the environment. Given the dismal record of both Soviet and Russian oil exploration in this area—with their projects falling far below Western environmental standards—this claim was met with universal disbelief. Mysteriously, once the company agreed to sell majority control of its project to Gazprom at the end of 2006, the environmental objections vanished.

To defend its 'Petro-Power,' Russia strives to keep as many of its partners as possible in a state of energy dependence, a dependence which can be manipulated as Russia chooses. A key component of this strategy is the control of pipelines and other energy facilities in neighboring countries. Russia aims to control pipelines in Poland, Belarus, Ukraine and the Baltic states which take Russian oil and gas to other countries. If it cannot control these transit routes, it will try to bypass them, for example with the new Nord [North] Stream pipeline through the Baltic Sea, running directly from Russia to Germany. At the same time Moscow controls pipelines through its own territory which carry oil and gas from the Caspian and Central Asian countries, and works hard to ensure that these countries cannot find alternative export routes.

One of the tactics Russia has used to control pipeline routes is one mentioned above—the use of fabricated 'environmental' arguments. For example, a trans-Caspian pipeline has been proposed, which could allow Central Asian gas to reach the West via Azerbaijan and Georgia, bypassing Russia. Not surprisingly, the Russian environmental agency immediately denounced it as a looming threat to marine life. Oddly enough, the much longer Nord Stream trans-Baltic pipeline, which the Kremlin favors, was quickly approved by the same agency as posing no threat to the sea at all (Watchdog Okays, 2007).

4. 'Petro-carrots': oil and gas as economic incentives

In this section one side of Russia's energy power will be examined—its use as a form of 'positive linkage,' or incentives. As we shall see, oil and gas allow Russia to 'buy off' foreign companies and individuals. More importantly, the Kremlin can manipulate whole countries. As in the days of the Warsaw Pact, loyal allies are rewarded with ample amounts of subsidized energy, at great cost to Moscow. Today, of course, the recipients are different, since most of Central Europe has entered the EU and NATO and is no longer allied to the Kremlin. Thus, as we shall see, major recipients of petro-carrots have recently included the Ukraine (under President Kuchma), Belarus, and several small secessionist enclaves in Moldava and Georgia. While this aid has not always succeeded (notably in Ukraine), it has helped to keep pro-Kremlin leaders in power in Belarus, Abkhazia, South Ossetia, and the Trans-Dniestr region. This influence in what Moscow tellingly calls the 'near-abroad' is highly important, since it sustains Russia's ambitions to remain a major power.

Russian generosity to the Ukraine under President Leonid Kuchma was a clear case of using oil and gas pricing to favor a client state. Kuchma, who led the Ukraine from 1994 to 2005, was quite friendly to Russia, signing a "Treaty of Friendship, Cooperation and Partnership" with Moscow, designating Russian as an official language, and siding with Russia on many foreign policy issues.

Not surprisingly, these policies were rewarded by the Kremlin with subsidized oil and gas sales. Throughout Kuchma's time in office, Moscow kept gas prices frozen at about $50 per thousand cubic meters (TCM). In fact Kiev paid far less than even that, because much of the supply was simply given to Ukraine as 'transit fees' for gas being sent on to Western Europe. Also, Ukraine was allowed to fall far behind on even the limited payments it did owe, piling up a large debt to Russia. The political nature of these subsidies became only too clear after the pro-Western 'Orange Revolution' of 2004, when Kuchma was succeeded by Viktor Yuschenko. As we shall see in the next section, oil and gas 'carrots' suddenly became 'sticks' in Moscow's fight against Yuschenko.

Another prime example of a country favored by Russian oil and gas incentives is Belarus. Clearly, Russia was not rewarding Belarus for political or economic reforms; under the dictatorial President Lukashenko, Belarus has remained a Soviet-era remnant in the region. Yet Lukashenko has consistently backed Moscow in foreign policy, to the extent of pursuing for years the hope of creating a new federation with Russia. Thus the Kremlin has ensured the Belarus would be favored with extremely cheap gas. In 2006,

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Belarus paid only $47 per TCM, at the same time Russia was demanding $230—almost five times more–from the new pro-Western Ukrainian government (Vinocur, 2006).

The country's feeble, still largely state-run economy even has difficulty paying for the extremely discounted gas it receives. Until recently, Russia has been willing to overlook this. During the Yeltsin era, for example, Belarus was able to 'pay' its debts by such measures as giving up its claims on joint Soviet-era assets in Russia (1993) and giving up claims for "damage caused by Soviet troops in Belarus" (1996) (Lane, 1999: 168). Both of these claims were rather far-fetched, since Belarus had seized Soviet facilities on its own territory and damage from the Soviet-era military was hardly Yeltsin's responsibility alone.

Putin has gradually increased the pressure on Belarus to pay somewhat fairer prices for its energy, although the country is still subsidized. As seen in Table 1 below, Russia has increased prices for its allies, such as Belarus and Armenia, but has raised prices for more hostile states—such as Ukraine, Georgia and Moldova—by far more. Thus a 'price scissors' is created, which allows Moscow to benefit in two ways. First, it greatly increases its overall revenue, as all customers pay more. Second, the price differential allows it to punish its enemies and reward its friends at the same time. It is hard for Belarus to complain about having to pay $100 per TCM for its gas when Georgia is paying more than twice as much.

The massive price differentials and generous treatment of Belarussian debts have been instrumental in keeping the country afloat economically, and thus in keeping Lukashenko in power. The policy must therefore be scored as a significant success for Moscow. The West has long tried to sponsor opposition movements in Belarus, as in the 2006 presidential election when the 'Zubr' movement united behind the pro-Western candidate, Alexander Milinkevich. Yet Lukashenko's claim to have created "stability"—thanks in large part to low unemployment, subsidized food and energy—helped ensure that his opponent's support remained limited. He would likely have won reelection even without the paranoid police tactics and electoral cheating which he used to ensure overwhelming victory. Energy incentives helped to ensure that there would be no 'Orange Revolution' in Minsk.

In addition to the generous petro-subsidies offered to compliant neighbors like Belarus, Moscow has also cleverly used incentives to support several pro-Russian enclaves in less compliant states. Moldova, for example, has long been a thorn in Moscow's side, with its nationalistic policies alienating the Russian minority there. In response, Russia has supported the breakaway 'Trans-Dniestr Republic,' run by Russian-speakers. Like Belarus, it has preserved the symbols and style of the old USSR. Also like Belarus, this tiny 'republic' has been unable to pay for even its subsidized gas—yet Moscow has remained tolerant. By March 2007 the 'republic' had accumulated $1.3 billion in debt to Gazprom, which it announced it simply would not pay (Solovyov, 2007). Yet the gas kept flowing.

Table 1
Natural gas prices charged to Russian customers ($/TCM).

	2005	2006	2007	2008
Armenia	$56	$110	$110	$110
Belarus	$46	$46	$110	$125
Georgia	$63	$110	$235	$235
Moldova	$80	$110	$170	$190
Ukraine	$50	$95	$130	$160

Similarly, subsidized oil and gas has been provided to two breakaway regions of Georgia, a state which (as we shall see below) has been a major target of Russian oil and gas sanctions. South Ossetia and Abkhazia, both backed by Russian 'peacekeeping troops,' have carved out de facto independence from Georgia, and their defiance allows Moscow to increase military and political pressure on the Georgian leadership. Moscow has spent lavishly to support them. For example, Gazprom plans to spend about $600 million building new pipelines and gas infrastructure in South Ossetia (Lowe, 2007), a region with about 70,000 inhabitants. Clearly, this is a politically-motivated investment. All of these enclaves—the Trans-Dniestr Republic, Abkhazia, and South Ossetia—are impoverished, backward areas which could not survive economically without Moscow's help. The fact that all of them remain in existence, 16 years after the collapse of the USSR, must be credited in part to Moscow's 'petro-carrots.'

Another aspect of Russian oil and gas power is its potential use in 'bribing' individuals and corporations. By offering corporations shares in oil and gas fields, pipelines, and other projects, Russia can win influential allies abroad. In recent years Russia has been careful to keep majority control of such projects in its hands. Yet with energy prices sky-high, foreign firms seem willing to accept minority stakes—as Shell did when it was forced to cede control of the Sakhalin-II project.

Other Western companies have been just as vulnerable to the lure of investing in Russia's lucrative energy sector—on Russia's terms. Germany's energy partnership with Russia, for example, has deepened as German companies have signed on as minority shareholders in a number of deals. One of the 11 members of the Board of Directors of Gazprom itself is now Burckhard Bergmann, head of the German gas firm E.ON Ruhrgas AG (www.gazprom.com). His company and BASF each own a minority stake in Nord Stream AG, the Gazprom-controlled company which is to build a controversial pipeline under the Baltic Sea to bring Russian gas to Germany. Similarly, Gazprom recently signed a deal with Eni, the Italian energy giant, to build a "South Stream" pipeline, directed toward Italy and Austria (Dempsey, 2007). The EU had been striving to control such deals, uniting its members behind an 'Energy Charter' which would regulate the West European market and limit Russian dominance. Yet the lure of quick profit was too tempting. Most companies are well aware that if they do not accept Moscow's terms, their competitors will. This enhances Russian bargaining power.

Oil and gas profits can also be used to win over politically important individuals. Saddam Hussein was widely reported to have used this tactic after the first Gulf War, when his regime covertly gave oil export permits to individuals who were helping Hussein politically and economically. Such permits, allowing the export of steeply discounted oil, could then be resold to oil dealers at a large profit.

Some have seen similar implications in Russia's attempts to involve prominent Westerners in running state-controlled oil and gas companies. The most well-known case is that of Gerhard Schröder, which has been very controversial in Germany. The former German Chancellor had long favored close ties with Russia, specifically pushing hard for close energy ties. He played a key role in negotiating the controversial Nord Stream project. Over a month after his defeat in the September 2005 German election, in one of his last acts in office as a lame duck, Schröder approved a billion Euro German government loan guarantee for the project. Within days of his departure from office, Schröder was suddenly named Chairman of the Board of Nord Stream AG, the joint Russian-German company which is to build and operate the pipeline. The appointment led to widespread anger in Germany, where it was seen as a scandalous conflict of interest, and the EU launched an investigation into the loan guarantee deal (Buck and Benoit, 2006; Vinocur, 2006).

In the wake of this success, President Putin reportedly attempted to score another personnel coup in late 2005, offering the chairmanship of the state-owned Rosneft oil company to Donald Evans (Putin, 2005). Evans had left office only months before as U.S. Secretary of Commerce. He was well-known as one of President Bush's personal friends, having been close to him since they both lived in Midland, Texas, and serving as chair of his 2000 presidential campaign committee. Clearly, Moscow hoped that by hiring Evans Russia could influence the President. Perhaps sensing that the job offer would embarrass Bush, Evans eventually declined.

5. 'Petro-sticks': oil and gas as economic sanctions

In contrast to Russia's generous treatment of its political allies, those who oppose the Kremlin have faced economic punishment. This has included punitive price hikes and even oil and gas embargos. These tactics became obvious to the world at the start of 2006, when Russia cut off gas shipments to the Ukraine and Georgia. Ukraine faced another punitive gas cutoff at the start of 2009. The Baltic states have also been targeted. However, 'petro-sticks' have also been used in many more subtle ways, as we shall see, through measures such as punitive price increases and demands for debt payment. While these pressure tactics have not always brought immediate compliance with Moscow's wishes, they have had the dual effect of weakening Russia's opponents and setting an example *pour l'encouragement des autres.*

The Ukrainian case is one of the most well-known examples of Russian oil and gas sanctions. This is true not only because the Ukraine is an important state in its own right, but because cutting off Russian gas to that state can have a major impact on broader world markets. The main Russian gas pipeline to Western Europe runs through Ukraine, meaning that Kiev can easily react to any Russian supply cuts by reducing or stopping the flow to the rest of Europe. Under President Yeltsin this threat was enough to tie the Russians' hands, forcing them to compromise repeatedly with Kiev on gas supplies and pricing. As one author put it, voicing the common view in the late 1990s, any Russian threat to cut supplies was "not really credible," because Moscow needed the transit route as much as Kiev needed Russian gas (Rutland, 1999:168). Under Putin, this relatively benign policy ended—to the consternation of both the Ukrainians and Western Europe.

In late 2004 the Ukraine was convulsed by the dramatic dispute between presidential candidates Viktor Yanukovich and Viktor Yuschenko. Yanukovich, the designated successor of the incumbent president, Leonid Kuchma, was considered friendly to Moscow, and the Kremlin made its support for him clear (Yasmann, 2006). When Yanukovich was proclaimed the winner in a fraud-tainted vote in November 2004, Moscow rushed to accept his victory. The subsequent "Orange Revolution" by supporters of the pro-Western Yuschenko, which eventually succeeded in forcing a new election, was roundly condemned by Moscow. Yuschenko's victory in the second contest in late December seemed to push the Ukraine out of the Russian orbit. Even worse, he succeeded due to a popular uprising backed by the West. Such a "color revolution" (first seen in Serbia with the overthrow of Milosevic, then later in Georgia, Kirghizstan and Lebanon) seemed to Moscow to be a possible model for an uprising against Putin himself. As such, it could not be tolerated.

Accordingly, during the tense electoral campaign the Kremlin and its surrogates openly brandished the 'gas weapon.' As the leader of one pro-Moscow Ukrainian organization said, "what else but gas could convince the people of Ukraine that it's better to be a friend of Russia than the EU and NATO?" (Yasmann, 2006). It was made clear that a vote for Yuschenko was a vote for winters with no heat, shuttered factories, and economic collapse. After Yuschenko's final victory at the end of 2004 these threats began to be put into action.

Ukraine's 2005 gas contract with Gazprom had already been signed. But it soon became clear that after that the country would face a harsh price increase. Gazprom claimed, unconvincingly, that this was simply part of a natural increase to reach world market prices (WMP)—i.e., the prices paid by Western European states. Somehow, though, this need to increase the gas price had never been noticed under Kuchma, when prices held steady at about $50 per TCM for many years. Now, suddenly, Moscow demanded an almost five-fold increase to West European levels—about $235 per TCM. In addition, Gazprom suddenly demanded payment of Ukraine's accumulated debt for gas service. If successful, Gazprom's demands would have bankrupted Ukraine.

Matters came to a head at the end of 2005, when the annual gas contract expired and the two sides could not reach a new agreement. To the world's surprise, at the start of 2006 Gazprom quickly began to shut off the gas flow to the Ukraine. Even some commentators on Russian state-owned television were quite open in stating that "the gas cutoff is retribution for the Orange Revolution" (Yasmann, 2006). Moscow ignored Kiev's threats to retaliate by cutting the flow on to Western Europe. That region's supplies, too, fell greatly in the next two days, before normal shipments were restored on January 3.

In the end, the Kremlin did not achieve a complete victory. It was, however, able to force the Ukraine to agree

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to double the price it paid for gas, to about $100 per TCM.[4] This imposed a massive economic drain on the Yuschenko regime. The price also had the virtue of still being below the WMP, which would allow the Kremlin to easily justify future price increase. Yuschenko and the Ukraine were thus effectively held hostage, never knowing when the next economic blow would fall. And the price increase had a political effect; with rising economic discontent, President Yuschenko's party did less well than expected in the March 2006 parliamentary elections, stalling the progress of his Orange Revolution (Myers and Kramer, 2006).

Predictably, Russian meddling continued after 2006. Every action of President Yuschenko has been met with more threats of gas supply cuts, price increases, or new debt repayment demands. The pattern was the same in the fall 2007 parliamentary elections in Ukraine, which brought Yuschenko's ally Julia Timoshenko into power as Prime Minister. Again, the Kremlin tried to induce voters to favor her opponent, Yanukovich, with thinly veiled economic threats. When that failed, Gazprom again stepped in, cutting Ukraine's gas supplies in early 2008 in yet another dispute over debt repayment—which was widely seen as punishment for Timoshenko's victory (Harding, 2007). Finally, at the start of 2009 Gazprom again cut off gas shipments, again greatly reducing supplies sent to Western Europe for several days.

As the victories of Yuschenko and Timoshenko show, the Kremlin's pressure tactics do not always appear to work immediately. However, when Moscow is defied there is a price to pay; the Ukrainian economy has suffered a real drain thanks to Gazprom. As David Baldwin notes in his classic work Economic Statecraft, the success of sanctions cannot be measured only by whether they immediately bring political victory. One must also count the costs imposed as a success, since they weaken the opponent (Baldwin, 1985:132–133). Gazprom's price increases also have the added virtue of simultaneously strengthening the Kremlin—quite directly, since Gazprom is state-owned.[5] Additionally, the Ukraine's economic problems have imposed a political cost on Yuschenko and his pro-Western allies, weakening both political support and their ability to implement their campaign promises. Every Ukrainian hryvnia sent to Moscow for gas is one that cannot be spent on popular programs such as health, education or public works.

Furthermore, as noted above, the Kremlin successfully showed its resolved by ignoring Ukraine's efforts to disrupt gas flows to Western Europe. For years 'transit states' such as Ukraine, Belarus, and Poland had felt immune from Russian sanctions, believing that they could live without Russian gas better than Russia could live without West European hard currency from gas sales. But now rising oil and gas prices had enabled Moscow to pay off its debts and build up huge currency reserves, freeing it to use its resource leverage more aggressively. This is an important lesson for the future: when push comes to shove, the Kremlin will cut Western Europe's energy artery to achieve its political goals. This lesson has struck home in Western Europe, with leaders throughout the EU now following every energy dispute between Russia and its neighbors with obvious concern. The EU has been pushing Russia to accept an "Energy Charter," pledging to forswear politically-motivated embargoes, yet Moscow has steadfastly refused.[6] In the future, Ukraine's limited leverage as a transit state looks likely to decline further, as Russia finds alternative ways to reach its wealthy Western customers. As noted in the previous section, the new Nordstream pipeline will link Russia to Germany under the Baltic Sea and the South Stream route will cross the Black Sea to connect Russia directly to Bulgaria and thus to Southern Europe.

If anything, the position of other lands targeted by Russian 'petro-sticks' is even weaker than that of Ukraine. The Baltic States and Georgia, for example, are quite small, and thus cutting off their oil and gas costs Moscow almost nothing. These states also have less control over the transit of Russian oil and gas to other countries than does Kiev.[7] Accordingly, Russia has felt free to use its petro-power against them rather openly.

The Georgian case is similar to that of the Ukraine in that Russian sanctions were triggered by a 'color revolution'—the 'Rose Revolution' of November 2003, which overthrew President Shevardnadze and led to his replacement in early 2004 by Mikheil Saakashvili, supported by the West. As in the Ukrainian case, Russia soon began to threaten Georgia's gas supplies. In this case, though, the Kremlin seems to have resorted to more direct measures than a gradual reduction in gas pressure. On January 22, 2006, just days after the flow of gas to Ukraine was resumed, both gas pipelines to Georgia were suddenly severed by a series of carefully coordinated bomb blasts. At the same time, the electric lines supplying Georgia were also cut (Chivers, 2006). To this day the Kremlin denies any complicity in the affair, but many observers have their doubts.

Here again, while the Saakashvili government did not immediately fall or begin to follow Moscow's line, Georgia paid a heavy price. Moscow was able to force Georgia to agree to massive gas price hikes, from about $63 per TCM in

[4] In fact, the deal was even more beneficial to Moscow: the higher price was arrived at by mixing cheap gas from Central Asia, costing only about $65 per TCM, with gas bought from Gazprom at full world price, about $230 TCM (EIA, 2007c:6).

[5] This is a notable contrast to most forms of economic sanctions, which impose costs on both the target and the sender. For example, President Carter's grain embargo against the USSR, imposed after it invaded Afghanistan in 1979, was very unpopular in the U.S. While it hurt Moscow somewhat, it seemed to hurt struggling American farmers more. Thus the embargo was hastily revoked by the incoming Reagan administration, despite Reagan's fierce anti-communism.

[6] Historically speaking Russia's position is very ironic. During the Cold War the USSR was targeted by Western embargoes, such as multilateral technology sanctions, which hurt it greatly. From the first days of the Soviet state Moscow tried to persuade Western states to sign agreements prohibiting embargoes. For example, an important factor in the Rapallo agreement between Germany and Russia in the 1920s was Germany's agreement to renounce embargoes (Newnham, 2002:80). Now, it seems, the shoe is on the other foot, and it is Western nations which must ask Russia to renounce the economic weapon.

[7] Georgia can cut off Russian gas shipments to Armenia, an ally of Russia, which gives it some potential leverage. And some Russian oil is shipped to the West through Baltic ports, although Russia has greatly reduced this amount.

2005 to $110 in 2006 (see Table 1). Finally, in 2007, Georgia became the first ex-Soviet state to pay full WMP for its gas—$235 per TCM. When added to other Russian sanctions—such as refusing to buy Georgian wine and produce on 'health and safety' grounds and expelling thousands of Georgian guest workers as 'illegal immigrants'—the damage to Georgia's economy has been considerable. The weak economy has in turn put Saakashvili on the defensive politically. In November, 2007, in the face of widespread protests, he was forced to declare a temporary state of emergency, which simultaneously weakened his regime and undercut his democratic credentials. As noted above, Georgia has been further weakened by Russia's generous subsidies to the breakaway regions of South Ossetia and Abkhazia, which could not survive without Russian support.

Another interesting case of Russian 'petro-power' is the sanctions against the Baltic States, which have long angered Moscow with their pro-Western orientation. Russia now seems willing to use its resources to punish these states for any kind of economic or political defiance, no matter how small. In July 2006, for example, Russia shut down the oil pipeline which supplied the Mazeikiai refinery in Lithuania. This installation is crucial to the region, since it supplies the rest of the Baltic states. It is also the largest source of revenue for the Lithuanian government. Formally Russia blamed an "oil leak" for the shutdown, a leak which it claimed would somehow take up to two years to repair (Kramer, 2006a). Interestingly, this technical problem appeared only after Lithuania had agreed to sell the refinery to a Polish company, PKN Orlen, rather than accepting rival Russian offers. Fortunately Lithuania was able to retool the refinery to run on oil delivered by sea. However, shortly afterward the facility was hit by a major fire, whose origin remains unexplained.

Political defiance, too, is now speedily answered by the Kremlin. In May 2007 Estonia took a small but symbolic step. It decided to move an old Soviet war memorial from the center of its capital, Tallinn, to a more remote park. Both Moscow and the local Russian minority saw this as a slap in the face to the Red Army, whose troops had liberated Estonia from the Nazis. Many Estonians clearly saw the 'liberation' more as a new enslavement. The dispute quickly escalated, and Russia announced that oil shipments to Estonia, normally delivered by rail, would unfortunately be stopped—allegedly due to "maintenance work" (Halpin, 2007). In the end, the embargo lasted only two weeks, but was quite costly, since all freight shipments were stopped, which affected coal and many other products as well. Russia's economic actions were accompanied by attacks on Estonia's embassy in Moscow and by a new tactic—a cyber-assault on a variety of Estonian websites.

The Baltic cases were a shock to the West. Unlike Ukraine and Georgia, Estonia and Lithuania are members of both NATO and the EU, so Russia's economic sanctions against them were a slap at both organizations. The thin fig leaf of "technical problems" was convincing to no one.

In all, it is clear that in recent years Russia has begun to use its 'petro-power' with new confidence. It openly rewards its friends and punishes its enemies, with carefully calibrated tactics which escalate from threats to price increases to outright embargos. As shown in this section, these tactics may not always 'work' immediately, in the sense of bringing political compliance. But they always inflict costs on Moscow's opponents, both economically and in increased political instability. And as Baldwin reminds us, if economic sanctions "increase a target country's cost of noncompliance" they are having an important effect (Baldwin, 1985:132).

6. Conclusion

As this paper has shown, Russia's 'petro-power' has become an increasingly clear threat to all the states which buy Russian oil and gas. This is obviously especially true for the small, poor, highly dependent states of what Russians call the 'near-abroad'—the former Soviet states. As we have seen, Russia has used its influence both to reward its friends and punish its enemies, seeking to regain its influence over the region. It has shown it can be successful, and even when it is not it can impose high costs on those who dare to defy it.

Yet the impact of Russia's actions extends far beyond Russia's immediate neighbors. For example, Western Europe now has great cause for concern. Although it is less dependent on Russia than the former Soviet states, Moscow's willingness to ruthlessly use its 'petro-power' has led to much worry among EU states—and, as we have seen, to increasing efforts to persuade Russia to sign an Energy Charter restraining its influence. Other countries, such as the U.S., also have reason to be concerned about Russia's oil wealth. While the U.S. does not depend directly on Russian oil and gas, it has many allies that do. Russia also exerts some influence on global prices, especially in today's unsettled, nervous 'seller's market.' It has recently tried to enhance this leverage by creating an organization of natural gas exporters, modeled on OPEC. Any decision by Moscow to limit production would immediately cause world prices to jump.

Finally, the U.S. and others around the world are also concerned about another facet of Russia's 'petro-power': the huge war chest of oil and gas revenue that Moscow has accumulated. By early 2008 Russia held over $157 billion in its 'Stabilization Fund,' one of a number of 'sovereign wealth funds' which have emerged in recent years worldwide (Kramer, 2008). Disturbingly, these sovereign wealth funds are often held by countries which are undemocratic and have limited commitment to free markets. Also, more and more, countries with regional or worldwide geopolitical ambitions control large wealth funds. For example, Russia, Venezuela and Iran rank among the top wealth fund holders (Truman, 2007:3). And this new wealth is clearly based on oil and gas; of the 19 top fund states in 2007, at least 13 had wealth based mainly on that source (Ibid., and author's calculations).

In short, the surging price of oil and gas has driven a fundamental reallocation of global wealth. This can be seen in the fact that oil exporting states had a collective balance of payments surplus of $88 billion in 2002 and $571 billion in 2006, an increase of almost five times in only four years (Andersen, Fick, & Hansen, 2007:50). Despite the current decline in oil prices, projections for the longer-term future are even more sobering. A recent report projected

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that sovereign wealth funds could expand from $2.5 trillion in 2007 to $27.7 trillion in 2022 (Sesit, 2007). Thus, as the world warily watches the rise of politically ambitious 'petro-states' like Russia, there is reason for concern. And all countries, not just Estonia or Belarus, should be aware of the cynic's version of the golden rule: "He who has the gold makes the rules."

Q3

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