



## Security Implications of Russian Energy Policies

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### Key Points

- The recent 'gas war' between Ukraine and Russia does not reflect a policy change in Moscow. Russia has used its energy power in an attempt to influence the foreign and security policies of its neighbours since 1990.
- The European Union and the United States have been slow to recognise that the energy policies of the Kremlin are a danger to Europe and particularly to the independence of the Central Europeans. These policies are also not in the long-term interest of Russia itself.
- The West should pressure Russia to adhere to the Energy Charter and to World Trade Organisation principles by making its energy policies and actions more transparent and based on competitive business practices.
- Ukraine should respond to Russian pressure by developing a crash programme of energy efficiency and by increasing domestic production of gas and oil by creating a welcoming and transparent environment for foreign investors.

Russia's tough stance towards Ukraine on natural gas prices was viewed by many in Europe and the United States as raising new issues concerning Russia's foreign economic policies and growing European and US dependency on energy imports. For many new EU member states and for countries such as Ukraine, Georgia, and Moldova, however, this is an old problem. Central European attempts to flag the issue in Western capitals have until now been brushed aside. The rapid approval by the EU Commission of the Russian-German undersea gas pipeline project was a mistake. The concerns of the Central Europeans should have been examined in more detail. Western governments would also be wise to analyse more closely the political and security implications of Russia's energy policies.

### Ukraine Has Not Been the Only Target of Russia's Energy Weapon

There is much more at stake for Europe than its own energy supplies. Moscow's increasing control of the energy infrastructure and markets in Central Europe has long-term implications for the security, and not only energy security, of all of Europe. The comments of former Kremlin economic adviser, Andrei Illarionov, citing Russia's increasing tendency to use energy as a weapon in its relations with other countries, should act as a wake-up call to Western governments, and particularly the EU.<sup>4</sup> They can no longer afford to be complacent regarding Russia's willingness to use its considerable energy resources for political blackmail, a situation that dates back to 1990, when Moscow cut energy supplies to the Baltic States in a futile attempt to stifle the 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 supplies, but also to pressure Ukraine into ceding more control to Russia over the Black Sea Fleet and over Ukraine's

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<sup>4</sup> "Russia: Putin's ex-aide says he quits because he could no longer speak out", BBC Monitoring, 30 December 2005.

energy infrastructure.<sup>5</sup> Even Belarus, and indirectly Poland and Lithuania, suffered supply disruptions in 2004 from the Kremlin's politically motivated attempt to take over Belarus' gas pipeline system. As recently as 1998–2000, in an attempt to stop the sale of Lithuania's refinery, port facility and pipeline to a US company, Transneft stopped the flow of oil to Lithuania nine times. None of these examples of Moscow's use oil and gas shipments to strong-arm its neighbours resulted in complaints from Brussels or Washington.

*Consumption of Russian oil and gas in selected Central and East European countries*

	Share of Russian crude oil as a percentage of total crude oil consumed (%)	Share of Russian gas as percentage of total gas consumed (%)
Germany	31 (2003)	38 (2003)
Poland	91 (2002)	58 (2001)
Ukraine	61 (2003)	39 (2001)
Lithuania	90 (2004)	100 (2002)
Latvia	n.a.	88 (2002)
Estonia	n.a.	100 (2002)
Belarus	75 (2004)	94 (2002)

### The EU Has for Too Long Ignored Non-transparent Energy Policies

Why has the EU, particularly the large gas importers like Germany, the Netherlands and France, ignored the lack of transparency and competition in Russia's energy sector? The Russian pipeline monopolies of Gazprom (natural gas) and Transneft (oil) have been given free rides in terms of the open-market requirements of the WTO and the EU's own Energy Charter. The EU's bilateral agreement with Russia on its accession to the WTO in effect gave Moscow's increasingly monopolistic pipeline and production companies *carte blanche*. Russia will be able to increase its market power and its political leverage in Europe through the construction of the expensive undersea Baltic pipeline system. The construction of the Yamal II pipeline would have been a much cheaper alternative and would have given both Central and Western European consumers greater energy security.<sup>6</sup>

The West ignored Gazprom's takeover, with Ruhrgas' help, of domestic gas facilities and markets in all three Baltic States. It disregarded Transneft's

<sup>5</sup> Paul J. D'Anieri, *Economic Interdependence in Ukrainian-Russian Relations*, Albany, NY: State University of New York Press, 1999, p. 78.

<sup>6</sup> "Poland Wants Expanded Yamal-Europe Pipe", *Russia & CIS Oil and Gas Weekly*, 1 December 2005.

recent announcement to Kazakhstan that it would not be allowed to supply oil to Lithuania's Mazeikai Refinery through the Russian pipeline system, even though Astana has the legal right to do so.<sup>7</sup> Russia has stopped all piped shipments of oil to Latvia for the past two years in an effort to gain control over the oil port at Ventspils. And now, Moscow is again attempting to keep non-Russian companies from buying Lithuania's Mazeikai Nafta Refinery and the port at Butinge. Should not this use of raw energy power be a subject for discussion within the EU Commission and between the Commission and other importing countries such as the United States and Japan?

### The West Does Have Leverage with Russia

It is a mistake for governments in the West to believe that they need Russian energy supplies more than Russia needs the oil and gas revenue that comes from Western markets. Russia does not have the capital or technology to develop its vast energy fields without assistance from the West. There has been no inclination by either the EU or the United States to use their considerable leverage to force Russia to play by transparent, competitive rules that guide business in the West. The pipeline monopolies of Transneft and Gazprom are contrary to the Energy Charter signed by the EU and Russia. Where is the pressure on Russia to ratify and implement the Charter?<sup>8</sup> Following the destruction of Yukos, Russian officials declared that private companies would not be allowed to build pipelines in the country.<sup>9</sup> Yukos had planned to build, with other private Russian energy companies, pipelines to China and to supply Europe through an oil line to Murmansk.

### Former Spies Making Energy Policy

Russian energy policy is increasingly being formulated by former intelligence officers (*siloviki*) in the Putin administration and in Russia's energy companies. The head of Rosneft and a former KGB associate of President Vladimir Putin helped engineer the break-up of Yukos and his company's seizure of the most valuable assets of Yukos.<sup>10</sup> Former KGB and GRU [Glavnoye Razvedovatel'noye Upravlenie] officers

<sup>7</sup> Valeria Korchagina, "Kazakhstan Fume over Lithuanian Oil Deal", *Moscow Times*, 21 November 2005.

<sup>8</sup> <http://europa.eu.int/scadplus/leg/en/lvb/l27028.htm>, last updated 13.08.2001.

<sup>9</sup> "Putin may allow private companies to build pipelines in Russia", Prime-Tass, 29 April 2004.

<sup>10</sup> Alexei Polukhin, "1.1 The Gas Secrets Non-disclosure Agreement", *Novaya Gazeta*, No. 94, 15 December 2005, p. 3.

sit on the boards of almost all the country's major energy companies. In 1999, Moscow even sent out a former KGB/FSB [Federal'naya Sluzhba Bezopasnosti] officer as ambassador to Lithuania, in an attempt to provide behind-the-scenes support to Lukoil's negotiating position. Before assuming the job, the ambassador had been the FSB's official liaison officer with Lukoil. The *siloviki* generally oppose any weakening of the state through the growth of a transparent private sector. Putin's use of a former East German Stasi officer to direct the financing of the undersea Baltic pipeline system only added perhaps unfairly to the suspicion that the project is more politically than commercially motivated.<sup>11</sup> The actions of the intelligence sector have only set back Russia's own development as a democracy and as a market economy from providing long-term benefits to Russia's own population.

### Ceding Too Much Control to Gazprom

For too long, Europe's energy relationship with Russia has been directed by only a few member states. The role of former German Chancellor Gerhard Schroeder in giving President Putin a pass in the areas of democracy and competition are well documented. But the United States has also been more eager to secure energy supplies from Russia than to pressure the Kremlin into reforming its economy. The EU and the United States have for too long ignored the non-competitive and political aspects of Russia's energy export policies. This is due in part to competition by Western companies for exploration and production rights in Russia. How much thought has been given to the potential power of Gazprom to control the gas markets in Central Europe following the completion of the Baltic pipeline system? 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? 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? If the EU decides to implement its long-awaited requirement for member states to have more gas storage, will this be possible now that the EU has blessed the Baltic pipeline system designed to bypass Poland and the Baltic States? What about Russian purchases of gas from Turkmenistan, Uzbekistan and Kazakhstan that are clearly designed to deny the West the ability to buy

directly or at prices negotiated between producer and consumer, rather than working through Gazprom?<sup>12</sup> Are these moves by the Kremlin compatible with WTO membership? It is hard to imagine that they are.

Gazprom is now attempting to pressure Bulgaria into breaking a binding agreement on gas price and availability that is in force until 2010.<sup>13</sup> A test for the EU will be whether it backs up this soon-to-be member state with political support. So far, there is no sign that Brussels will intervene. Perhaps Bulgaria, as a member of NATO, should put the issue of energy security on the agenda of the North Atlantic Council, which concerns itself with issues that go far beyond the narrow one of military inviolability. Of course, other member states will have to step forward in the Council and support a policy discussion of the issues surrounding Russia's aggressive energy policies. Poland, the Baltic States, and Romania might be so inclined.

### EUROPE'S GAS PIPELINE NETWORK



Source: Inogate (EU oil and gas transport co-operation programme) via BBC News.

### No Big Winners in the 'Gas War'

That brings us to the Russia-Ukraine 'gas war' that was allegedly resolved to the satisfaction of both sides on January 4. Russia's political agenda in using gas prices to punish the pro-Western Yushchenko government is clear from statements made by Russian supporters of Gazprom's hard line and from remarks by Russia's few remaining reformers. Few people familiar with political and economic relations between Russia and Ukraine believe that this agreement will last very long.<sup>14</sup> Moscow's

<sup>11</sup> Sally Bogle, "Gazprom, E.ON, BASF Begin Construction Work on NEGP, May Offer 9% to New Investor", *World Markets Analysis*, World Markets Research Centre, 12 December 2005.

<sup>12</sup> "Gazprom Established Control Over All Gas Resources of Three Asian Republics", *The Russian Oil and Gas Report*, 14 November 2005.

<sup>13</sup> "Bulgaria Refuses to Review Gas Contract with Russia's Gazprom", *Agence France Presse*, 6 January 2006.

<sup>14</sup> Fred Weir, "Russia-Ukraine Gas Standoff", *Christian Science Monitor*, 3 January 2006.

requirement that all gas to Ukraine be contracted through the non-transparent company RosUkrEnerg, the direct successor to the even less-transparent EuralTransGas, raises questions about the reliability of future European gas supplies that originate in Central Asia. In light of past actions, no one should have been surprised by Moscow's tough approach to Kiev. One can make a good case that Russia should move towards charging market prices to importing countries. And, an equally good case can be made that it is in the long-term interest of Ukraine and other importers to move in the direction of paying world prices. Once market prices are reached, Moscow's political leverage will decrease. A four-fold overnight increase in price from \$50 to \$230 per 1,000 cubic meters, however, is not justified, particularly in light of the 2004 agreement between the Kuchma government and Gazprom, which locked prices in until 2010.<sup>15</sup>

More important, however, is that no one knows what the real market price of Russian gas and oil would be if a transparent situation existed within Russia's exporting companies. If Russian consumers were forced to pay prices that were significantly more than one-tenth of what Moscow claims to be the world market price, domestic demand would drop and additional Russian oil and gas would be placed on the international market. Does the \$47 per 1,000 cubic meters charged to Belarus have any relationship to the market, or does the Kremlin consider it an 'internal price'? These are all questions that need greater discussion in both Brussels and Washington.

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

Ukraine's politicians, however, deserve some of the blame for the present situation. Kiev has allowed corrupt oligarchs to continue their control over gas deliveries from Russia. More damaging in the long run is the Yushchenko government's lack of movement in developing a level playing field for domestic and foreign energy investors. Here again, a few powerful individuals, most with close ties to Russia, have successfully kept out Western competitors. Ukraine could substantially reduce its dependency on Russia through rapid reforms that permit open tenders for exploration rights and by adopting a welcoming atmosphere for legitimate foreign energy investors. Seismic studies demonstrate that the country possesses considerable gas – both on-shore and in the Black Sea. The present

government in Kiev, however, inherited a difficult situation from the Kuchma administration. Two-thirds of the refineries processing three-fourths of the country's oil are in the hands of Russian companies.<sup>16</sup> Almost 100% of the refined product that is exported is produced in Russian-owned companies. All of Ukraine's nuclear plants depend on Russian nuclear fuel rods. Victor Chernomyrdin, the former CEO of Gazprom, as Moscow's ambassador to Kiev, has been very effective at promoting Russian energy interests and at keeping out potential Western competitors.

Instead, the cosy relationship between Russian and Ukrainian energy interests persists, even after the New Year's Day reduction of gas supplies. Talk by the Yushchenko government over the past year about diversifying imports and stopping corruption in the energy sector has resulted in little follow-through.<sup>17</sup> Few economists see the Odessa-Brody oil pipeline project or the NABUCCO gas pipeline project, which would go from Iran/Azerbaijan through Turkey to Austria, as realistic alternatives in the short or medium term. A more serious and immediate solution would be for the Yekhanurov government to embark on a crash programme to improve energy efficiency and to open the country's oil and gas fields to Western investors. Unfortunately, Ukraine's forthcoming parliamentary elections in March have resulted in a high degree of paralysis on the part of the country's decision-makers.

### **The West Needs to Act as Well**

The West, including the EU and the United States, needs to quickly rethink its energy and non-energy policies with Russia. The two cannot be separated. The world does Russia no favour by ignoring the monopoly and uncompetitive nature of this energy relationship. The West does have the economic and political leverage to force Russia to become more transparent and commercial in its foreign energy policies. It cannot 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.

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<sup>15</sup> Daniel Kurdelchuk, Olexander Malinovsky and Inna Novak, "A European Approach to Ukraine's Gas Dilemma: Road map to solve the dilemma", *Mirror-Weekly*, International Social Political Weekly, No. 49 (577), 17-23 December 2005.

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<sup>16</sup> "Ukrainian Oil Specialist Against Building of More Oil Refineries", ITAR-TASS, 20 May 2005

<sup>17</sup> "Ukrainian president outlines challenges at public forum", BBC Monitoring Kiev Unit, 28 November 2005.

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