

## Russia's Energy Policy: Security Dimensions and Russia's Reliability as an Energy Supplier

The conflict between Russia and Ukraine over natural gas prices and transit reached its peak during the winter of 2005-2006, which subsequently led to Russia cutting gas supplies – an action that affected most of Western Europe. In the midst of the conflict, Russia took over the Chairmanship of the G8. Ironically, energy security was declared as the top priority for the G8.

When Russia's military capability fell after 1991, it moved its attention to non-military security tools. In the process, Russia came to realise the strategic potential of its hydrocarbon resources. It is therefore of utmost importance to grasp Russia's role as a strategic player in the international energy sphere, to identify potential risks and opportunities and to assess the issue of energy security. A key question is whether Russia, from a security political point of view, can be seen as a reliable energy supplier.

The objective of this study is hence to elucidate Russia's role as a strategic energy supplier by analysing its energy policy from a security political perspective while the aim is to assess the question of whether Russia is a reliable supplier of energy. This is done by focusing on Russia's resource base, its perceptions, its domestic market management, the state's control of the energy sector, Russia's foreign energy relations and its energy levers.

The conc

clusion is that Russia's political reliability as an energy supplier depends on the time perspective, the receiver and the context. Further usage of the energy levers will likely be aimed at the former Soviet states, but Europe may well be affected. Beyond doubts, Russia's coercive energy policy should be understood in a long-term geopolitical and strategic context under which political, economic and market drivers coexist. Russia has strategic priorities to keep its influence over the CIS and its energy policy is one of the means used for this reason.

The international competition for Russia's resources is a future key factor. As a result, frictions may arise both between Russia and consumers, and between various consumers. The negative trends in combination with Russia's structural instability and unpredictability in policy underscore that the magnitude of uncertainties concerning Russia's development are much higher than it first seems.



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Robert L. Larsson

# **Russia's Energy Policy:**

Security Dimensions and Russia's

Reliability as an Energy Supplier

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<b>Abstract</b> <p>The objective of this study is to elucidate Russia's role as a strategic energy supplier by analysing its energy policy from a security political perspective while the aim is to assess the question of whether Russia is a reliable supplier of energy. This is done by focusing on Russia's resource base, its perceptions, domestic market management, the state's control of the energy sector, Russia's foreign energy relations and its energy levers.</p> <p>The conclusions are that Russia's political reliability as an energy supplier depends on the time perspective, the receiver and the context. Further usage of the energy levers will likely be aimed at the former Soviet states, but Europe may well be affected. Beyond doubts, Russia's coercive energy policy should be understood in a long-term geopolitical and strategic context under which political, economic and market drivers coexist. Russia has strategic priorities to keep its influence over the CIS and its energy policy is one of the means used for this reason.</p> <p>The international competition for Russia's resources is a future key factor. As a result, frictions may arise both between Russia and consumers, and between various consumers. The negative democratic trends in combination with Russia's structural instability and unpredictability in policy underscore that the magnitude of uncertainties concerning Russia's development are much higher than it first seems.</p>		
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<b>Sammanfattning</b> <p>Målet med föreliggande studie är att belysa Rysslands roll som strategisk energileverantör genom att analysera dess energipolitik i ett säkerhetspolitiskt perspektiv. Syftet är att utröna huruvida Ryssland är en pålitlig energileverantör. Detta har gjorts genom att fokusera på Rysslands resursbas, dess perceptioner, inhemska marknadsstyrning, statens kontroll över energisektorn samt Rysslands utrikes energirelationer och energipolitiska hävstänger.</p> <p>Slutsatsen är att Rysslands pålitlighet som energileverantör beror på tidsperspektivet, avnämaren och kontexten. Ytterligare användning av energi som påtryckningsmedel kommer troligen att drabba de foma sovjetstaterna, men Europa kan även påverkas. Rysslands hårdföra politik skall utom tvivel förstås i ett långsiktigt geopolitiskt och strategiskt perspektiv under vilket politiska-, ekonomiska- och marknadsaspekter rymms. Ryssland har strategiska prioriteringar att behålla inflytandet över OSS och energipolitiken är ett medel för detta ändamål.</p> <p>Den internationella konkurrensen kring Rysslands resurser är en framtida nyckelfråga. En konsekvens är att friktioner kan uppstå såväl mellan Ryssland och konsumenter som konsumenterna sinsemellan. Dagens negativa demokratiska trender i kombination med Rysslands strukturella instabilitet och oförutsägbarhet understryker att nivån på osäkerheten kring rysk utveckling är större än den först verkar.</p>		
<b>Nyckelord</b> Ryssland, Putin, säkerhet, säkerhetspolitik, energi, energisäkerhet, påtryckningsmedel, råvaror, rörledning, olja, gas, OSS, EU, Ukraina, Vitryssland, Georgien, Moldavien, Baltikum, Kaspiska regionen, Kina		
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# Foreword

This study has been conducted at the Division for Defence Analysis at the Swedish Defence Research Agency (FOI) and has been carried out within the project for study of Energy as a Global Security Issue, headed by Ambassador Ingolf Kiesow and since 2005 by John Rydqvist. The project has during several years covered security dimensions of Eurasian affairs, in particular energy.<sup>1</sup> The great powers of Asia has naturally been in focus and China's energy needs and related security implications have for example been assessed both from a demand perspective<sup>2</sup> and from the Chinese national security perspective.<sup>3</sup>

Research for the study has also been carried out with support from the project on Russia's Foreign, Defence, and Security Policy (RUFSP) under the auspices of Jan Leijonhielm, Head of Bureau. One of the core tasks for the project is to address Russia's military capability in a ten-year perspective, in a series of major biannual reports, by assessing military factors against the backdrop of the general development and the Russian civil society.<sup>4</sup> Non-military security dimensions have also been analysed in separate reports<sup>5</sup> and Russia's strategic commodities, from a supply-perspective, was the theme of a major report in 2004.<sup>6</sup> The objective of

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<sup>1</sup> Kiesow, Ingolf (2003), *Energy in Asia: an Outline of Some Strategic Energy Issues in Asia*, Stockholm: Swedish Defence Research Agency (FOI), FOI-R--0739--SE.

<sup>2</sup> Sandklef, Kristina (2004), *Energy in China: Coping with Increased Demand*, Stockholm: The Swedish Defence Research Agency (FOI), FOI-R--1435--SE.

<sup>3</sup> Kiesow, Ingolf (2004), *China's Quest for Energy: Impact upon Foreign and Security Policy*, Stockholm: The Swedish Defence Research Agency (FOI), FOI--1371--SE.

<sup>4</sup> Leijonhielm, Jan, *et al.* (2005c), *Rysk militär förmåga i ett tioårsperspektiv - problem och trender 2005 [Russian Military Capability in a Ten-Year Perspective - Problems and Trends 2005]*, Stockholm: Swedish Defence Research Agency (FOI), June 2005, User Report. FOI-R--1662-SE. The report is in Swedish but an extensive English summary is found in Leijonhielm, Jan, *et al.* (2005a), *Russian Military Capability in a Ten-Year Perspective - Problems and Trends 2005: Summary and Conclusions from a Study for the Swedish Ministry of Defence*, Stockholm: The Swedish Defence Research Agency (FOI), June 2005, Memo 1396.

<sup>5</sup> Sjölund, Martin (2002), *Ekonomisk säkerhet-till vilket pris? En studie av den ryska synen på ekonomisk säkerhet [Economic Security - To What a Price? A Study of the Russian View of Economic Security]*, Stockholm: Swedish Defence Research Agency (FOI), FOI-R--0409--SE, and Svensson, Charlotte (2003), *Ekonomi och säkerhet i de baltiska staterna: en studie av relationen mellan säkerhetstänkande och ekonomiska beroenden [Economy and Security in the Baltic States: A Study of the Relation between Security Thinking and Economic Dependence]*, Stockholm: Swedish Defence Research Agency (FOI), FOI-R--0895--95.

<sup>6</sup> Leijonhielm, Jan and Larsson, Robert L. (2004), *Russia's Strategic Commodities: Energy and Metals as Security Levers*, Stockholm: Swedish Defence Research Agency (FOI), FOI-R--1346--SE.

that report was to shed light on Russia's situation concerning crude oil, natural gas, aluminium, nickel and palladium. It briefly covered the tangled web of political and economic issues and the roles played by these strategic commodities. It relied on quantitative data and focus was on the role played by these commodities on the world markets.

This report, in contrast, refrains from reiterating time-series data and mainly opts for a qualitative approach without, other than in brief terms, looking at the resource base. Greater emphasis is instead put on Russia's intentions, capabilities, reliability and connected security issues. By this, it tries to connect several dimensions and present them as a coherent report.

The study has been jointly commissioned by the Swedish Foreign Ministry and the Defence Ministry, and in line with FOI's quality assessment regulations it was reviewed at a seminar headed by Robert Dalsjö. I am indebted to Dr Johannes Malminen, an expert on economic security at FOI, who at the seminar acted as opponent concerning the methodology, approach, structure and arguments of the report. He gave constructive criticism on how to improve the report, of which many have been incorporated. I am also highly indebted to Michael Fredholm, an expert on Russian energy and developments in Eurasia, at Stockholm University. He closely scrutinised the report and with great patience commented on assumptions, facts and analysis. His corrections and feedback greatly contributed to my endeavours to find the correct balance of the report. I am also grateful for the valuable support received from colleagues; especially Ingolf Kiesow, Jan Leijonhielm, Ingmar Oldberg, Caro Vendil Pallin, Jan T. Knoph, Jakob Hedenskog and Wilhelm Unge who have endured my lengthy manuscripts and provided me with the best research atmosphere. Rinat Greenberg has kindly corrected my worst linguistic errors. Needless to say, any remaining errors, omissions, misinterpretations or any other transgressions are naturally mine, and mine alone.

## Main Conclusions

- Russia's political reliability as an energy supplier depends on the time perspective, the receiver and the context. By and large, Russia is a reliable supplier in such that most of its energy exports has reached (and will reach) its destination. This does not mean, however, that energy flows necessarily will be spared from interruptions or political and economic frictions.
- The risk for supply interruptions aimed at the states of the Former Soviet Union (FSU) is present today. Depending on bilateral relations and the present context, the risk for partial and/or short-duration cut-offs is high, especially against Belarus, Ukraine, Moldova and Georgia. In the short-run, the risk for total and/or permanent cut-offs is low for all these states. In the long run, risks are difficult to estimate, but cannot be overlooked.
- The risk for supply interruptions aimed at non-FSU Europe is presently very low. There is, however, a high risk for non-FSU Europe to be affected by interruptions aimed at any of the FSU states. Russia appears to perceive certain European states as affordable collateral damage.
- Preceded by a severe political crisis, the risk for partial and/or short-duration cut-offs aimed at non-FSU Europe increases. In that case, it would likely be aimed at a specific importer rather than at a group of states (such as the EU). Risks in the long-run perspective are difficult to estimate. Anything can happen. If a total and/or permanent cut in supply to Europe would materialise, it would have to be preceded by a serious degeneration of relations in combination with a developed technical ability for Russia to export energy elsewhere.
- The barriers (Russia's needs for exports revenues, transit dependence and risks of destroyed reputation etc.) against short and partial supply interruptions and coercive policy are weak.

They are only safeguards against long duration cut-offs or against important customers.

- If Russia were to develop in a democratic direction and show genuine commitment to market reforms, the threshold would increase. It would also increase if Russia would ratify and follow the EU Energy Charter. It would also have to pay less attention to its strategic ambitions and adhere to the European tradition of embracing true interdependence.
- Presently, there is a risk for experiencing coercive policy, 'annoying behaviour', 'technical problems', 'contractual disputes', 'discriminatory price policy' or similar problems aimed at reaching geopolitical, political, or economic goals for almost all receivers of Russian energy. The risk is higher for the FSU as Russia's priorities and leverage are strongest there. Russia will likely not strive to use the energy lever for the sake of it, but it will by all means strive for a strengthened capability. By all means, it would be prepared to use it if it deems so necessary.
- Since 1991, the energy lever has been used for putting political or economic pressure on Estonia, Latvia, Lithuania, Ukraine, Belarus, Moldova, Georgia that subsequently affected most of Europe. The number of incidents, i.e. cut-offs, take-overs, coercive price policy, blackmail or threats, is over fifty in total (of which about forty are cut-offs). Incidents appear to be equally divided on the Yeltsin and Putin eras, but the number of cut-offs have decreased by half during Putin.
- The immediate reasons for Russia's coercive policy appear to be to coerce political concession in ongoing negotiations, commandeer infrastructure take-over, and execute economically favourable deals or to make political statements. There are economic underpinnings in the majority of the cases and Russian demands for payments of debts are legitimate. However, there are also political underpinnings in more than half of the incidents, and in a few cases explicit political demands are evident.

- Market actions are the norm for most non-coercive activities and Russia attempts to be a reliable trade partner. Being a reliable energy supplier gives Russia international respect and is something that Russia feels it deserves as a great power. Marketisation will likely deepen, possibly also within areas that have been politically sensitive. The Kremlin will certainly keep its grip over certain pivots and ensure that it has the capability to correct or punish unwanted actions.
- Analysts who solely use the market aspect as an explanatory factor to all activities tend to be incorrect. They isolate market aspects from geopolitics and often have a narrow definition of energy security. There is also a risk that the new EU members will be disregarded when the security of supply to Western Europe is discussed. Acknowledging the priorities of new EU members would serve Europe's security architecture.
- Beyond doubts, Russia's coercive energy policy should be understood in a long-term geopolitical and strategic context under which political, economic and market drivers coexist. Russia has strategic priorities to keep its influence over the CIS and its energy policy is one of the means used for this reason. The strategic underpinning explains why 'marketisation' essentially only occurs when it is politically suitable and against politically suitable objects and for politically suitable reasons. When it is not politically approved of, marketisation rarely occurs.
- Ensuring national security is the fundamental task of Russia's energy policy. Russia utilises its energy policy to create growth, extend influence, avert geopolitical and macroeconomic threats and to reduce the risk of being blackmailed. Russia's policy predominately harmonises with stated intentions and there are some grounds in the Russian fears of becoming dependent on others (for economic and political reasons).

- The Russian leadership has moreover 'securitised' the energy issues, which from a Russian point of view legitimises the use of exceptional means to tackle perceived problems and threats. As a result, policies are coerced and if they fail (or are not implemented), frustration grows and renewed coercive attempts are made. This encompasses both its domestic and foreign energy policy and partly explains why marketisation and increased authoritarianism occur.
- The use of exceptional means (coercive policy, nationalisation, central planning, politicised policies etc.) is made possible as power over the energy sector is continuously being concentrated to the Kremlin and its loyal appointees in the corporate sector and within state structures. Formal powers have also been given to the security services, for example the FSB.
- The Kremlin's influence is larger than it appears, as subtle and informal means are used to control the energy sector. Self-censorship and politically fine-tuned market action by the energy corporations underpins the markets' responsiveness. The state and the energy companies often act in tune in strategic matters.
- Putin is creating a culture of a politically correct market economy. The result of the Kremlin's policy is an ostensibly functional market that covers democratic deficits and a high degree of central planning. A goal appears to be a market that acts in line with the Kremlin's agenda, but where the 'need' for the Kremlin's explicit interference is diminishing.
- The power concentration and Putin's 'vertical of power' have created a mirage of stability. Unpredictability however exists both at a structural level and in policy that results in conflicting trends that undermine the political and economic stability. This in combination with Russia's perceptions, intentions, capabilities, track record, lack of democracy, and (lack of) rule of law aggravates the problems of dependence on Russian energy.

- Russia's unsustainable policy on exploitation of energy carriers has led to a circumstance where Russia might have to cut down on energy exports, especially on oil, even in the short term. This has implications as the international competition for Russia's resources has commenced and is likely to increase gradually.
- Russia has not yet been able to create the infrastructural prerequisites for obtaining full flexibility in the geographic directions of energy exports. Once necessary infrastructure projects materialise or available amounts of energy for exports decreases, Russia will be able to take political considerations when selecting receivers of energy carriers. This would apply also for exports of liquefied natural gas.
- As a result of international competition for Russian resources, frictions may arise both between Russia and consumers, and between various consumers. The international competition for energy largely takes place in Russia and the CIS and is of utmost importance. Herein lays the grand politics that affects all market-based priorities.
- Despite the aforementioned problems and risks, developments have hitherto been far from a worst-case scenario. The negative political and democratic trends in combination with Russia's structural instability and unpredictability in policy however underscore that the magnitude of uncertainties are much higher than it first appears.

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## 1 Introduction

The conflict between Russia and Ukraine over natural gas prices and transit reached its peak during the winter of 2005-2006, which subsequently led to Russia cutting gas supplies – an action that affected most of Western Europe. In the midst of the conflict, Russia took over the Chairmanship of the G8. Ironically, energy security is the top priority during the Chairmanship – President Vladimir Putin has declared.<sup>7</sup>

Meanwhile, the common energy strategy of the European Union is only in the making. Several EU-members have opted for bilateral policies towards exporters of energy; trying to tackle augmenting energy demands at a time when global hydrocarbon resources slowly but steadily are being depleted. As traditional consumers of oil cannot be expected to decrease their energy needs at the same time as growing economies increase their energy consumptions many-fold, Russia's position on the international energy markets becomes increasingly important. Russia has thus stepped forward as a viable and alternative supplier to the volatile Middle East – not only for Europe, but also for the US, China, India and Japan that compete for access to Russia's hydrocarbons.

By being wedged between competing net consumers of energy, Russia has come to realise the strategic potential of its hydrocarbon resources. When Russia's military capability fell after 1991, it therefore moved its attention to non-military security tools – energy being one among many. Thus, energy must bear some of the burden of Russia's security policy – internally and externally. It is therefore of utmost importance to grasp Russia's role as a strategic player in the international energy sphere, to identify potential risks and opportunities and to assess the issue of energy security.

There are at least three interrelated concepts that are critical in order to undertake such a task. The first concept, 'energy safety', concerns the

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<sup>7</sup> Ostrovsky, Andrew (2005b), 'The New Oligarchs? Winners and Losers in the Kremlin's Grab for Oil Wealth', *The Financial Times*, 7 November 2005, p. 13.

physical safety of issues such as critical infrastructure and transports, regardless where the threat comes from.

The second concept is 'security of supply'. The core issue here is whether the end user (broadly speaking) receives energy from the exporter. Threats to energy supply can, among other things, relate to domestic system risks or have geological, political, economic or physical roots, for example problems on the market or natural disasters. Problems could also be connected to the risks of inappropriate investments, technical failures, terrorism and strife in the importing state.<sup>8</sup> The magnitude of the threats to supply varies over space and time. Most often, technical failures or extraordinary weather conditions pose the toughest challenges to security of supply.

In a security policy context, however, the most important threats are those that stem from antagonistic actors. Threats can have political or economic underpinnings, for example if energy supplies are deliberately cut in order to coerce political concessions. This leads to the third concept – 'energy security'. It encompasses all security political aspects of energy policy and energy relations. 'Energy security' is thus a wide concept and the terms 'security of supply' and 'energy safety' are subordinated to it. Some analysts tend to use the term 'energy security' when they mean 'security of supply', which can be somewhat confusing. By this, it may appear as they have a wider scope than what they actually do.<sup>9</sup> A narrow approach fundamentally misses security issues connected to management of the energy sector, energy relations and issues of sensitivity, vulnerability and dependence.

When it comes to Russia, Roland Götz, a prominent energy analyst at the Institute for International and Security Affairs in Germany, argues that from a political point of view, Russia has been a reliable energy supplier for 30 years. Any hint of turning the tap would discredit it as a supplier,

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<sup>8</sup> Owen, Anthony D. (2004), 'Oil Supply Insecurity: Control versus Damage Costs', *Energy Policy*, Vol. 32, p. 1880.

<sup>9</sup> See Stern, Jonathan (2005), 'European Gas Supply and Security Issues', *European Dependence on Russian Energy*, Network on Oil and Gas (NOG), Stockholm, 13 September 2005.

he states.<sup>10</sup> Jonathan Stern, the Director of Gas Research at the Oxford Institute for Energy Studies agrees and says that security analysts have an obsession with the risks connected to energy dependence. Empirical evidence of this being a problem is lacking, he argues. He further claims that disruptions usually come from technical accidents rather than political events.<sup>11</sup>

It is indeed true that Russia has been a rather reliable supplier of energy to Western Europe, even during the peaks of the Cold War. It is also true that disruptions are usually caused by technical failures or accidents. Despite being excellent in many ways, analyses by Stern among others fall short in three ways. First of all, they mainly focus on security of supply, not on other security political aspects of energy relations. Second, they tend to neglect problems of new EU members or the Newly Independent States while showing concern only for states in Western Europe. Finally, they often fail to incorporate the issues of political perceptions and geopolitical context unless they speak about the problems of unreliable transit states.

The showdown of the Russian-Ukrainian gas conflict 2005/2006, as one of several cases, shows that it would be irresponsible to refrain from assessing the reliability of Russia as an energy supplier from a higher perspective. One reason is that from the perspectives of the now independent states of the former Soviet Union (FSU), Russia has been anything but a reliable supplier during the last 15 years. In addition, even if accidents are more common than politically motivated supply interruptions, problems cannot be overlooked, as they need to be tackled once they occur. One reason is that the security dimensions reach farther than the issue of securing the imminent consumption needs of the West. Problems, risks and threats do exist.

A common definition of a threat is something negative that might happen in the future (in this case from antagonistic actors). When an actor's intention exists along with a capacity to realise the threat, it

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<sup>10</sup> Benoit, Bertrand and Thornhill, John (2005), 'Fear That Gas Supply Gives Russia Too Much Power over Europe', *The Financial Times*, 12 January 2005, p. 2.

<sup>11</sup> Ibid., p. 2. and Stern 'European Gas Supply and Security Issues'.

becomes an issue of priority. This poses a risk that can be seen as a function of the consequences of what might happen and the probability for it to happen. In short, if the consequences are serious and/or the probability is high, there is a high-level risk.<sup>12</sup> Naturally, the function must also consider factors such as uncertainties, history and the present context. If these factors aggravate the problems, the risk rises. It is therefore the basic assumption of this report that Russia's energy policy and its reliability as energy supplier must be seen in the light of Russia's general development, as it connects to issues such as democracy, foreign policy, economy, its military situation and the geopolitical setting.

Security does not only relate to the actual threats, but also to how they are perceived by various actors (as actions are taken upon both perceptions and realities). In the light of mounting global needs, and subsequent competition for Russian resources, it therefore becomes vital to understand what Russia's intentions are, how it views its energy exports and its natural resources. What are the perceptions of officials and policy makers, and what kind of strategic priorities does Russia have? In addition, it becomes crucial to assess the strength of Russia's energy levers, should Russia choose to use them. To what extent can political visions and decisions within the fuel and energy complex (the TEK) be implemented and how large is the manageability, manoeuvrability, adaptability and responsiveness of the sector? If reliability is seen as a subjective measurement of the risks connected to security of supply (that stems from political decisions in a broad meaning), can Russia, from a security political point of view, be seen as a reliable energy supplier? For who, when and why?

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<sup>12</sup> Sjöstedt, Gunnar and Furustig, Hans (2000), *Strategisk omvärldsanalys [Strategic World Analysis]* (Lund: Studentlitteratur), pp 26-28.

### Objective and Aim

The *objective* of this study is to elucidate Russia's role as a strategic energy supplier by analysing its energy policy from a security political perspective.

The *aim* is to assess the question of whether Russia is a reliable supplier of energy.

### Approach, Method and Structure

An analysis of Russian energy can be approached from a geological standpoint by an assessment of the geological potential and geographic location of Russia's resources. Moreover, it can be approached from a business/economic standpoint by looking at financial opportunities or its impact on world market prices. The over-arching perspective of this report, however, is a security political one. In order to elucidate Russia's role as a strategic energy supplier, a set of interrelated research questions must be addressed.

- Why, to what extent and to who are Russia's energy resources important?
- What are Russia's perceptions, intentions and position to its commodities, exports and energy relations?
- What are the Kremlin's capabilities and how are they used when it comes to managing the domestic market?
- How large is the Kremlin's control of the energy sector?
- What is Russia's foreign energy policy?
- What is Russia's track record in terms of reliability and usage of the energy levers?
- What are the objectives, drivers, trends, patterns, outcomes and ways of using the energy levers?
- What and how strong are the barriers against further usage of the energy levers?

Given the differences in character of these questions, one cannot find a common denominator for approaching all questions in the same way. Hence, the method for tackling the problem is to keep the security-political perspective as a framework while altering the approach to the

various research questions in each chapter. As this study is aimed at experts, officials, policy makers and security analysts alike, any explicit theoretical references or discussions are however kept to a minimum.<sup>13</sup>

By and large, the research questions are covered in separate chapters, even if cross-references exist. A reader wishing to read only parts of the report is advised to read the conclusions in the beginning of the report in combination with the last two chapters. The beginning and end of each chapter also contain summaries and conclusions.

Chapter two, 'Russia's Resource Base', addresses the questions: why, to what extent and to who are Russia's energy resources important, by providing a pure descriptive background to Russia's TEK. It provides a market overview and relies on statistical data that is put in some comparison to other major energy producers and exporters. The importance of the sector to Russia and to world markets is also mentioned. In order to provide a timeframe of Russia's importance as an energy exporter, a few key points of the sustainability of the sector are outlined.

Chapter three, 'Russia's Energy Perceptions', approaches the question of what Russia's perceptions, intentions and position to its commodities, exports and energy relations are. This is accomplished by looking at what has been stated or written on the topic, for example by Putin or the official energy strategy. It is not a full discourse analysis, but an attempt is made to discern how the Russian leadership (explicitly) perceives energy and commodity issues in order to understand pursued policy and assess to what extent declared intentions harmonise with pursued policy (as shown in chapter six).

Chapter four, 'Domestic Market Management', assesses the question of what the Kremlin's capabilities are and how they have been used when it comes to managing the domestic market. This is initially made by a survey of some of the tools that can be used when managing the market. The Yukos and Khodorkovsky affair serves as an example of how the

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<sup>13</sup> This is also the reason why some of the rich empirical findings have been provided in great detail, although its importance for the greater argument sometimes is rather modest.

Kremlin acts in the domestic energy sector and what the consequences can be, both for domestic and foreign entities.

Chapter five, 'State Control of the Energy Sector', approaches the question concerning how strong the Kremlin's powers over the energy sector are by mapping the enmeshment of state structures and private enterprises within the Russian energy sector. It is reasonable to assume that the responsiveness to political decisions is higher if the elite in a broad understanding has connections or loyalties to the highest political level. It would thus provide an indication of the Kremlin's political ability to manage the energy sector and ensure that the implementation process (this includes expressed intentions as well as taken decisions) is carried out.

It must be stressed that when the terms 'Kremlin' or 'Moscow' are used as subjects, it refers to the presidency and the presidential administration while 'the President' or 'Putin' are used when the actual person is meant. When the official policy line or the whole state apparatus is referred to, the word 'state' is used. The term 'government' in most cases refers to the cabinet. The terms 'governmental', 'state structures' or 'state bodies' are used interchangeably for state institutions.

Chapter six, 'Russia's Foreign Energy Relations' addresses the questions of what Russia's foreign energy policy looks like and what Russia's track record in terms of reliability and usage of the energy levers is. It consists of a survey of Russia's energy relations with a number of actors in which Russia's capabilities, intentions and strategic priorities can be seen. Pipeline projects, infrastructure issues, trade and the nature of the relations are touched upon. It however lies outside the scope of this study to detail the perceptions, policies and level of dependence and vulnerability of all receivers of Russian energy. The cases of Russia's usage of its energy levers are further analysed in the next chapter.

Chapter seven, 'Russia's Energy Levers Scrutinised', puts the main thrust on what the objectives, drivers, trends, pattern, outcome and way of using the energy levers are. In addition, it addresses the question of what and how strong the barriers against further usage of the energy

levers are. The barriers partly reduce the problems experienced by supply interruptions and possibly provide inertia to hostile intentions.

The energy levers can be seen as foreign policy tools. The researcher Janusz Bugajski has listed fourteen of Russia's foreign policy tools and 'energy controls' is one of them, which is connected to issues such as diplomatic pressure and economic leverage.<sup>14</sup> In Bugajski's words, it belongs to Russia's 'foreign policy arsenal'. By that, he indicates that they are weapons of some kind. In the energy debate, the terms 'energy weapon', 'energy tool' or just 'method' are used intermittently and it can be put into question what the difference between an 'energy tool' and an 'energy weapon' really is.

Strictly speaking, a tool becomes a weapon or a lever when it is used as one. Tools like tariffs, taxes, decrees or supply interruptions can thus be 'ordinary tools' for managing the energy sector, but they can also be used as weapons aimed at reaching specific purposes beyond sector management. This report will use the term 'energy tool' in all cases when referring to the method or capability *per se*. When it comes to usage of energy tools against domestic or foreign entities, the term 'energy weapon' or 'energy lever' will be utilised. The two latter terms thus include all tools used for this purpose, not only supply interruptions, even if this is the most serious case. The tools can be used separately or combined. It is the belief in this report that such activities exist, but to what extent and whether this remains a security risk is up to debate.

If a company acts on its own behalf, it can also be questioned whether the energy tools can be seen as weapons or levers in the interest of the state. Yet, it is virtually impossible by using open sources to trace any evidence of Kremlin ordering a firm to take a certain course of action. Therefore, this report attempts to shed light on the connections between the Kremlin and the energy enterprises and look at their priorities and strategic projects to see if they act in tune or not. The basic argument is that if the state enjoys a strong grip over the Russian energy sector, any

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<sup>14</sup> Bugajski, Janusz (2004), *Cold Peace: Russia's New Imperialism* (Washington D.C.: Praeger/Center for Strategic and International Studies), pp. 29-47.

strategic project or coercive policy against foreign entities must at least be tolerated by the Kremlin.

Chapter eight presents 'Conclusions and Prospects for the Future'. These are not sorted by the research questions listed above (as these are connected to several dimensions). Instead, they are sorted by a few key topics such as domestic trends, strategic priorities, intentions, capabilities, usage of the energy levers, consequences of usage of the energy levers and finally, the main question on Russia's reliability as an energy supplier. It can thus be seen as a subsidiary aim of the report to take future risks into consideration. The risks are thus appraised by a combination of what might happen, the probability for it to happen along with current trends, Russia's track record, uncertainties, and the present context.

By employing a method that encompasses several approaches, the study risks becoming an anthology rather than a unified analysis. It is still the belief here that should Russia's energy policy be understood and its reliability assessed with some accuracy, it is not only advantageous – but even pivotal to take a broad approach that includes several perspectives.

By and large, cases and issues have been selected on the criteria that they are related to the topics of either intentions or capabilities. By its nature, the study takes the role of being something of a criminography of the Russian energy policy, and it must be stressed that it is not a purpose of the report to target the numerous business opportunities that indeed exist in Russia today. Neither is it the purpose to compare Russia's situation and policy to other international energy actors.

### **A Note on Material and Sources**

This report relies on a variety of sources, such as statistical data, company web sites, official documents, statements, news wires, newspaper/online articles, academic journals and analytical reports. As events unfold quickly in the energy markets, most of the sources selected have been published after 2003. With a few exceptions (for example the

Russian-Ukrainian gas row in 2006), this report only takes into account material published until the end of 2005.<sup>15</sup>

Since most of the questions in this report are on issues of energy, security and/or political economy, these types of sources have been prioritised (i.e. the Financial Times, RosBusinessConsulting, Energy Policy or security reports with regional focus). Concerning statistics, most of the data has come from either the International Energy Agency (IEA) or BP (that derives its data from the 'Oil and Gas Journal'). These data are, at best, informed estimations and some of the numerous uncertainties are listed in Appendix II.

When it comes to bias of sources, it is worth underlining is that most newspapers utilised are rather liberal (the Financial Times, Kommersant, the Economist, the Moscow News). The most biased views have often been omitted, for both the Russian and international sources, unless they stem from policymakers (as their views have the greatest bearing on pursued policy). This exception is thus not related to the bias of the media, but rather to the cited persons.

Similar to this report, several western think tanks (and subsequently their reports) have an 'energy consumer biases. One example is the influential Washington-based Center for Strategic and International Studies (CSIS) that has produced a report on a similar topic.<sup>16</sup> It labels Russia's energy policy as one of 'neo-imperialism' and its recommendations include that the US must take a much tougher policy line on Russia. What makes the report interesting is that the author has conducted over 100 interviews with officials, businesspeople and politicians in Russia, Poland and the former Soviet Union. Given the politically sensitive nature of the topic, many chose to be anonymous. Despite this, and the fact that the report has an American bias (as it contains policy recommendations for US energy relations with Russia), it

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<sup>15</sup> The sources in the footnotes are written in full the first time they are mentioned while subsequent citations only include author and title.

<sup>16</sup> Smith, Keith C. (2004), *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, Washington D.C.: Center for Strategic and International Studies (CSIS), December 2004.

is well worth taking the information into consideration, but a reader should be aware of this when valuing its ideas and comments.

Another case is the Baker Institute at Rice University in Houston that has produced a series of reports on Russia's energy strategy, which this report relies on.<sup>17</sup> The reports are sponsored by a great range of energy corporations (Halliburton, Shell and BP just to mention a few) but it is less judgemental than the report from CSIS.

The bias in official documents, such as Russia's Energy Strategy to the year 2020,<sup>18</sup> is apparent. It can nonetheless be stated that there are many uncertainties, as transparency concerning the energy sector is missing, both at the corporate level and at state level. This may relate to the data on resources, but also to the structural management of the sector. Information on the role of the Federal Security Service (FSB) in economic security management is, for example, a secret. In fairness to Russia, it can be stated that many corporate websites are better and more informative than similar ones in other countries.<sup>19</sup>

Furthermore, this study occasionally refers to some rather dubious Russian websites, such as 'Kompromat' (compromising material) and 'Skandaly' (Scandals). Purportedly, each issue of the magazine Kompromat (and subsequently also its website) is dedicated to reporting that is promoted by the highest bidder at that given time. It has been involved in court processes versus Yukos for distributing defamatory material (in both form and content). It did not comply with court rulings. Articles are, however, most often reposted from other serious newspapers and websites (such as Izvestia or Nezavisimaya Gazeta).

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<sup>17</sup> For example Jaffe, Amy Myers and Soligo, Ronald (2004b), 'Re-evaluating U.S. Strategic Priorities in the Caspian Region: Balancing Energy Resource Initiatives with Terrorism Containment', *The Energy Dimension in Russian Global Strategy* (Houston: The James A. Baker III Institute for Public Policy of Rice University).

<sup>18</sup> Ministry of Industry and Energy (2003), 'Energeticheskaya Strategiya Rossii na period do 2020 goda [Russia's Energy Strategy until the Year 2020], Uvershdena no 1234-r, 28 August, 2003.' *Ministerstvo promyshlennosti i energetiki Rossii*, Published: Last accessed: 7 February 2005, Internet: <http://www.mte.gov.ru/docs/32/189.html>.

<sup>19</sup> Arnott, Robert (2004), 'National Oil Company Websites as Primary Sources of Oil and Gas Information', *The Journal of Energy Literature*, Vol. X, No. 1, p. 25f.

Possibly, this makes them somewhat more reliable than they first appear to be, but one should be cautious not to draw any firm conclusions from this material. This report has been unable to verify what they have put forward in this context, but it has nonetheless included the information as plausible and an indication of the murkier sides of the energy sphere that little is being published about.

Finally, Vladimir Milov is frequently cited as his views are not only insightful and well grounded, but are also expected to have a certain impact in the Russian debate. He was a member of the Federal Energy Commission and was later appointed Deputy Minister of Energy in Russia with responsibility to develop Russia's national energy strategy. In 2003, he founded the Institute of Energy Policy (*Institut Energeticheskoi Politiki*), which he since then heads. Although formally independent, he is still consulted by the government for developing laws on issues related to oil and gas, for example the new law on subsoil resources. He is also a member of the Strategy and Reform Committee under the Board of Directors of UES Russia. From an economic point of view, he can be viewed as an outspoken liberal, often criticising Russia's official policy. This dual character makes it somewhat difficult to evaluate his loyalty and his agenda, for example if he speaks as a representative of his own independent institute or as consultant to the Russian government. The former appears most plausible.

## 2 Russia's Resource Base

**Questions:** Why, to what extent and for who are Russia's energy resources important?

**Approach:** The chapter provides a descriptive background and overview of Russia's fuel and energy complex (TEK) since 1991.

**Main findings:** Reform of the TEK is ongoing. It moves slowly and will improve slightly in the short term. The TEK is yet to be the foundation for Russia's economic growth for the foreseeable future. However, Russia's approach is highly unsustainable and the economy rests on a skew and shaky foundation.

Russia's proven reserves of natural gas underscores that Russia will remain the world's supreme supplier. Russia will scarcely keep pace with Saudi Arabia in either oil production or exports. There is a clear risk that Russia's oil export levels will decrease strongly even in the short-term perspective.

In a security perspective, the sustainability and power of the TEK is consequently strong and for all practical purposes, it can be assumed that Russia's role as an energy supplier will be strengthened as demand elsewhere increases.

### Overview of Russia's Energy Sector

The relative shares of the total primary energy supply (TPES) in Russia have been constant since the early 1990s. Figures on energy production from IEA in 2002 shows that in 1999, (if electricity produced from thermal plants are excluded), natural gas made up about 52 per cent, oil and oil products 21 per cent, coal 18 per cent, nuclear 5 per cent and hydro 2 per cent, while the rest was combustible renewables.<sup>20</sup> Concerning energy consumption, approximately equal shares (around 33 per cent) went to the industrial and the residential sectors respectively. Transport took a 20 per cent share and the rest went to other sectors (i.e.

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<sup>20</sup> IEA (2002b), *Russia Energy Survey 2002*, Paris: The International Energy Agency (IEA), p. 49.

agriculture and commercial services).<sup>21</sup> The breakdown of each energy carrier naturally differs.

### *The Electricity Sector*

The electricity sector in Russia has been plagued by the Soviet heritage, which is both rigid and inefficient. There are reform plans and the state-run sector is slowly being restructured. Production, sales and maintenance are supposed to be opened up for competition. Transportation, distribution and control over supplies are meant to remain under state control.<sup>22</sup> Most of the sector is in poor shape and some analysts claim that reform will not make a difference. At least \$US50 billion is needed for reform according to one estimate.<sup>23</sup> The IEA on the other hand estimates that investment needs, especially after 2010, amount to over \$US380 billion.<sup>24</sup>

The IEA sees some prospects of success, but there are numerous obstacles. For example, reform does not appear to include a sufficient independent regulatory framework and there are clear risks of the state being rule-maker, regulator and participant at the same time. Another risk is that Gazprom is moving into the electricity market. As it is the key supplier of gas to thermal plants, it could well cross-subsidise its own plants and by that impede the emerging competition on the market.<sup>25</sup> In November 2005, Chubais stated that the reform plans were delayed,

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<sup>21</sup> Ibid., p. 50.

<sup>22</sup> RosBusinessConsulting (2005c), 'Electricity Reforms Look Good on Paper', *RosBusinessConsulting*, Published: 30 May 2005, Last accessed: 30 May 2005, Internet: <http://www.rbcnews.com/komment/komment.shtml>.

<sup>23</sup> Piani, Gianguido (2005), 'Saving Russian Energy from Reform', *The Moscow Times*, Published: 30 May 2005, Last accessed: 30 May 2005, Internet: <http://www.moscowtimes.ru/stories/2005/05/30/006.html>.

<sup>24</sup> IEA (2005), *Russian Electricity Reform: Emerging Challenges and Opportunities*, Paris: The International Energy Agency (IEA), p. 15.

<sup>25</sup> Ibid., p. 19f.

even if progress is made.<sup>26</sup> The state of affairs at UES is such that electricity supply cannot be guaranteed, not even to Moscow.<sup>27</sup>

Russia is the fourth largest producer of electricity in the world, but it is also a great consumer. Therefore, its exports are only a few percentages of its production. However, given its large size, its *de facto* output is substantial. Apart from bilateral cooperation (which is vast), Russia by RAO UES also takes part in multilateral cooperation forms. One example is Baltrel (the Baltic Ring Electricity Co-operation Committee) where Sweden (by Svenska Kraftnät and Vattenfall) is represented. It aims to create a common electricity market around the Baltic Sea,<sup>28</sup> while another is the Union for the Co-ordination of Transmission of Electricity (UCTE) that deals with the European electricity grid.<sup>29</sup>

In the last couple of years, there have been numerous blackouts in Russia. Several of them have been due to non-payments (as the power companies are sanctioned to carry out) but most are due to technical problems with the system. One blackout that received a great deal of attention was in Moscow in the spring of 2005 when between 1.5 and 2 million people were affected and UES claims it cannot ensure power if the temperature drops to 25 degrees below zero for more than three days.<sup>30</sup>

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<sup>26</sup> RosBusinessConsulting (2005d), 'Energy Reform Delayed', *RosBusinessConsulting*, Published: 29 November 2005, Last accessed: 30 November 2005, Internet: <http://www.rbcnews.com/free/20051129175936.shtml>.

<sup>27</sup> RosBusinessConsulting (2005), 'UES Threatens Moscow with Power Cut', *RosBusinessConsulting*, Published: 1 December 2005, Last accessed: 1 December 2005, Internet: <http://www.rbcnews.com/komment/komment.shtml>.

<sup>28</sup> Baltrel (2005), 'Baltrel', *The Baltic Ring Electricity Co-operation Committee (Baltrel)*, Published: N/A, Last accessed: 25 July 2005, Internet: [http://www.baltrel.org/default\\_Baltrel.htm](http://www.baltrel.org/default_Baltrel.htm).

<sup>29</sup> UCTE (2005), 'UCTE Keeps the Lights on!' *Union for the Co-ordination of Transmission of Electricity (UCTE)*, Published: N/A, Last accessed: 25 July 2005, Internet: [http://www.ucte.org/aboutus/mission/e\\_default.asp](http://www.ucte.org/aboutus/mission/e_default.asp).

<sup>30</sup> RosBusinessConsulting 'UES Threatens Moscow with Power Cut'.

### *The Nuclear and Coal Sectors*

The significance of the nuclear sector in Russia is relatively small, but it is believed to take a greater role in future power generation, according to the official energy strategy.<sup>31</sup> The state is in full control of the sector and the Ministry of Atomic Energy (Rosatom) controls Rosenergoatom that governs Russia's ten nuclear power plants<sup>32</sup> (except the independently operated Leningrad nuclear power plant).<sup>33</sup> Also the nuclear sector is to be reformed, but not as dramatically as the electricity or gas sectors (as there is no privatisation or restructuring to speak about). Instead, the focus is on investments and increasing output.<sup>34</sup> It is likely that momentum will be gained under 2006 under the auspices of Sergei Kriyenko, who under 2005 was appointed new head of Rosenergoatom.<sup>35</sup>

Coal is still of great importance to Russia, despite the environmental implications it bears along. Russia's resources of coal are the second largest in the world. Akin to nuclear power, it will increase in relative importance as Russia has set out to save the natural gas for impending generations. This process is nonetheless slow. The market is largely privatised, but several of the market operators are state owned or state controlled. Unlike oil, gas and electricity, it is of little or no use as a security lever on other states, partly due to the nature of coal and partly due to their relatively low level of dependence and vulnerability.<sup>36</sup>

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<sup>31</sup> Ministry of Industry and Energy 'Energeticheskaya Strategiya Rossii na period do 2020 goda [Russia's Energy Strategy until the Year 2020], Utvershdena no 1234-r, 28 August, 2003.'

<sup>32</sup> See further Rosenergoatom (2005), 'Operation Utility - "Rosenergoatom"', *Rosenergoatom*, Published: N/A, Last accessed: 25 July 2005, Internet: <http://eng.rosatom.ru/?razdel=20>.

<sup>33</sup> Fredholm, Michael (2005), *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, Swindon: Conflict Studies Research Center, September 2005, 05/41, p. 5.

<sup>34</sup> IEA *Russia Energy Survey 2002*, p. 171ff.

<sup>35</sup> RosBusinessConsulting (2005a), 'Analysts Split on Atomic Energy Chief Appointment', *RosBusinessConsulting*, Published: 18 November 2005, Last accessed: 18 November 2005, Internet: <http://www.rbcnews.com/komment/komment.shtml>.

<sup>36</sup> IEA *Russia Energy Survey 2002*, p. 149ff.

### *The Natural Gas and Oil Sectors*

The starting point for the modern oil sector in Russia was 1992 when existing producers and refineries were united in Rosneftegas, an association evolving from the Ministry of Oil Industry. By presidential decree, the members of the association were transformed into joint stock companies. The capital was split into 25 per cent preferred shares and 75 per cent ordinary shares. The 51 per cent of the ordinary shares (thus 38 per cent of the total share capital) were to be kept in federal ownership for three years. The remaining parts were distributed to personnel and managers and sold at auctions.<sup>37</sup>

Since then, things have changed. The first restructuring of the Russian oil industry after 1991 created ten vertically integrated companies (VICs) (Lukoil, Yukos, Surgutneftegaz, TNK, Tatneft, Sibneft, Slavneft, Rosneft, Bashneft and Sidanco), of which the four former were the largest. In addition, there were approximately 135 foreign investment merger companies, 45 independent companies in addition to subsidiaries or small firms. Today there are many more.

It can be stated that of the ones that today operate independently,<sup>38</sup> the most prominent one is the Tyumen Neftyanaya Kompaniya (TNK) that was founded in 1995 as state-owned company. Between 1997 and 1999, the Alfa Group and Access/Renova Group took control. In 2003, it merged with BP that now holds 50 per cent. This was the largest foreign investment in Russia and it was strongly advocated by Putin. It has set into motion a course of increasing its gas operations and this has resulted in confrontations with the *de facto* gas monopoly Gazprom. In 2005, TNK-BP fell under scrutiny by the authorities and the Russian state with allegations that TNK-BP was evading over one billion dollars (US) in tax.

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<sup>37</sup> Poussenkova, Nina (2004), 'From Rigs to Riches: Oilmen vs. Financiers in the Russian Oil Sector', *The Energy Dimension in Russian Global Strategy* (Houston: The James A. Baker III Institute for Public Policy of Rice University), p. 1.

<sup>38</sup> Note that often the term 'independent' is used by analysts even if a majority of the company is owned by a state-controlled company such as Gazprom, for example Stern, Jonathan P. (2005), *The Future of Russian Gas and Gazprom* (Oxford: The Oxford University Press/The Oxford Institute for Energy Studies), p. 19.

Given the claims against Yukos, the question was if history would repeat itself.<sup>39</sup>

Another firm is Sibneft, which was created by a decree by Yeltsin in 1995. It took Noyabrskneftegas (production), together with Noyabrskneftegasgeophysica (exploration) and Omsknefteprodukt (marketing) to create a new company in 1996. Sibneft and Yukos planned to merge in 2003 but these plans were quickly thwarted. In July 2005, Putin gave his public approval of Gazprom acquiring Sibneft.<sup>40</sup> In September of the same year, Gazprom declared that both parties had agreed to the deal. This highly prestigious deal secured Gazprom's place as the fifth largest oil producer in Russia. Several more, although smaller, mergers are under way.

Yukos, for a long time the premier firm, was formed in 1993 by a governmental decree. It long consisted of the production unit Yuganskneftegaz and the refining concern Kuibyshevnefteorgsintez. During its existence, it has made tremendous progress and moved from being a small, poorly run, company to the largest oil producer in Russia, thereby breaking new ground by adopting Western-style audit methodology and increasing transparency within the company. As seen below, this development came to a blatant halt in 2003 when the Yukos affair was launched. In general, the oil sector is deregulated and market principles most often prevail, at least in non-strategic matters. The relative strength of the largest firms is seen in Table 1.

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<sup>39</sup> Gorst, Isabel and Boxell, James (2005), 'Putin Tells BP Chief Venture Has his Support', *The Financial Times*, 23-24 April 2005.

<sup>40</sup> RosBusinessConsulting (2005), 'Gazprom to Buy Sibneft, with Putin's Approval', *RosBusinessConsulting*, Published: 12 July 2005, Last accessed: 12 July 2005, Internet: <http://www.rbcnews.com/komment/komment.shtml>.

**Table 1: Production of Crude Oil by Russia's Major Oil Firms**

Firm	2003 in b/d
Yukos	1,630,000
Lukoil	1,589,014
TNK-BP	1,239,836
Surgutneftegaz	1,088,000

**Source:** Russian Petroleum Investor, cited in Koyama, Ken (2004), 'Reorganization of Russian Petroleum Industry and its Effect on Business Strategy', *The Energy Dimension in Russian Global Strategy* (Houston: The James A. Baker III Institute for Public Policy of Rice University, pp. 9-12.

With a few exceptions, the Kremlin cannot dictate all actions for the private oil companies. If Russia wishes to use any firm as a foreign policy lever, the pre-eminent mode is to turn to Transneft. The state-run Transneft is the company that takes care of crude oil transport by pipeline (while Transnefteprodukt operates pipeline transport for petroleum products).<sup>41</sup> In short, the Kremlin controls the oil tap.

In contrast to the oil sector, the gas sector is state-run by Gazprom and its subsidiaries. No valid competitors exist, as small independent producers must cooperate with Gazprom to obtain access to the pipeline transport. Gazprom controls almost 90 per cent of Russia's gas and is the largest gas company in the world.<sup>42</sup> Jonathan Stern argues that the marketisation of the gas sector began in 2002 as then gas deliveries started to be profitable and non-paying customers could expect to get disconnected.<sup>43</sup> Presently, the Kremlin is in control of the domestic gas sector and gas exports (and much of the gas sectors in neighbouring countries where Gazprom or its subsidiaries are located). The gas sector largely works like a centrally planned Soviet market where Gazprom takes the role of the Ministry of Gas.

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<sup>41</sup> Koyama, Ken (2004), 'Reorganization of Russian Petroleum Industry and its Effect on Business Strategy', *The Energy Dimension in Russian Global Strategy* (Houston: The James A. Baker III Institute for Public Policy of Rice University), p. 4.

<sup>42</sup> Ahrend, Rudiger and Tompson, William (2004), *Russia's Gas Sector: The Endless Wait for Reform?*, Paris: Organisation for Economic Co-operation and Development (OECD), Economic Department, 17 September 2004, Economics Department Working Papers 402 (ECO/WKP (2004)(25), p. 5.

<sup>43</sup> Stern *The Future of Russian Gas and Gazprom*, p. 59.

### Russia's Oil in Comparison

Russia's oil production declined dramatically during the early 1990s, as the collapse of the Soviet Union resulted in both decreased ability to produce and a decreased demand. Since 1998, however, production has steadily risen and has almost regained its former strength. The situation concerning consumption is lagging severely behind. Industrial demand has been as slow as the industrial recovery. This has nonetheless provided a surplus of oil that Russia exports. Export levels have hence followed production levels and for long been have on the rise.<sup>44</sup>

Table 2 illustrates that Russia is one of the worlds foremost oil producers. In fact, it has at times produced more oil than Saudi Arabia. There is not another producer that has close to the levels of Russia or Saudi Arabia.

<b>Table 2: Main Producers of Crude Oil 2003</b>									
Country:	Proved reserves:		Production:			Exports:		Consumption:	
	In bmt	In %	In mmt	In%	R/P ratio	In mmt	In %	In mmt	In %
Saudi Arabia	36.1	22.9	474.8	12.8	73.3	354.7	21.3	67.0	1.8
Russian Federation	9.5	6.0	421.4	11.4	22.2	154.7	9.3	124.7	3.4
USA	4.4	2.7	341.1	9.2	11.3	n.a.	n.a.	914.3	25.1
Iran	18.0	11.4	190.1	5.1	92.9	113.6	6.8	54.0	1.5
Mexico	2.3	1.4	188.8	5.1	11.6	97.5	5.8	82.6	2.3
China	3.2	2.1	169.3	4.6	19.1	n.a.	n.a.	275.2	7.6
Venezuela	0.2	0.1	153.4	4.2	24.8	128.5	7.7	23.9	0.7
Norway	1.4	0.9	153.0	4.1	8.5	148.0	8.9	9.6	0.3
Canada	2.3	1.5	141.9	3.8	15.5	n.a.	n.a.	96.4	2.6
Great Britain	0.6	0.4	105.6	2.9	5.4	n.a.	n.a.	76.8	2.1

**Source:** BP (2004), *Statistical Review of World Energy - June 2004*, London: BP. For exports: BP (2002), *BP Statistical Review of World Energy - June 2003*, London: BP and RosBusinessConsulting (from Svenska Petroleum Institutet), Internet: <http://www.spi.se>, Last accessed: 1 February 2005.

**N.B.** List sorted by size of production. Exports figures are from 2002. Bmt=billion metric tons. Mmt=million metric tons. % = per cent of world total. n.a.=not available/not applicable. For explanations of uncertainties, proved reserves or P/R = see comments in connection to Table 15: Comparative Classification of Oil Reserves, p. 303.

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<sup>44</sup> Only figures for 2003 are showed here and no quantitative comparisons between various estimations are made, for trend and more data, see Leijonhielm and Larsson *Russia's Strategic Commodities: Energy and Metals as Security Levers*, p. 32.

As the US oil reserves are being depleted and the country today consumes its produced oil, it has no supply leverage on the world market despite its size in production. It is similarly discernible in Russia as compared to Saudi Arabia. Russia consumes twice the amount of oil consumed by Saudi Arabia and thus has less room for exports. The most notable thing is the gap in reserves. Despite the fact that Russia occasionally produces more oil than Saudi Arabia does, it is noticeable that the sustainability of Russia's production is much smaller than Saudi Arabia's. The reserves/production ratio (eg. how many years that it will be able to produce oil given today's knowledge, production volumes and known reserves) is more that three times better for Saudi Arabia than for Russia.<sup>45</sup> Saudi Arabia's spare capacity is however more restrained today than it has been in the past. Nevertheless, in the long run Russia will hardly be able to keep pace with Saudi Arabia.

### **Russia's Natural Gas in Comparison**

Since 1990, production of natural gas in Russia has also declined, but far less than oil production. Little by little, it is on the rise again. Thus far, consumption shows few signs of increasing, but appears to have stabilised (at fairly low levels). Natural gas exports, on the contrary, have almost doubled since 1990.<sup>46</sup>

Table 3 above illustrates that Russia is the world's premier producer of natural gas, closely followed by the US and Canada respectively. Unlike the situation for oil, Russia consumes a higher proportion of its production, but is nonetheless the most important exporter of natural gas in the world. The reserves/production ratio on top of Russia's proven reserves underscores that Russia will remain the supreme supplier of natural gas.

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<sup>45</sup> This is a frequently used but far from optimal measurement on sustainability and it should not be taken at face value.

<sup>46</sup> Leijonhielm and Larsson *Russia's Strategic Commodities: Energy and Metals as Security Levers*, p. 55.

## Russia's Energy Policy

**Table 3: Main Producers of Natural Gas 2003**

Country:	Proved reserves:		Production:			Exports:		Consumption:	
	In trcm	In %	In bcm	In%	R/P ratio	In bcm	In %	In bcm	In %
Russian Federation	47.00	26.7	578.6	22.1	81.2	131.77	29.0	405.8	15.7
USA	5.23	3.0	549.5	21.0	9.5	16.82	3.7	629.8	24.3
Canada	1.66	0.9	180.5	6.9	9.2	98.60	21.7	87.4	3.4
Great Britain	0.63	0.4	102.7	3.9	6.1	15.20	3.3	95.3	3.7
Algeria	4.52	2.6	82.8	3.2	54.6	33.08	7.3	21.4	0.8
Iran	26.69	15.2	79.9	3.0	100+	3.52	0.8	80.4	3.1
Norway	2.46	1.4	73.4	2.8	33.5	68.37	15.0	4.3	0.2
Indonesia	2.56	1.5	72.6	2.8	35.2	3.74	0.8	35.6	1.4
Saudi Arabia	6.68	3.8	61.0	2.3	100+	n.a.	n.a.	61.0	2.4
Netherlands	1.67	0.9	58.3	2.2	28.6	42.17	9.3	39.3	1.5

**Source:** BP (2004), *Statistical Review of World Energy - June 2004*, London: BP.

**N.B.** List sorted by size of production. Trcm=trillion cubic metres. Bcm=billion cubic metres. % = per cent of world total. N.a.= not available/not applicable. For comment on uncertainties, proved reserves and P/R = see comments in connection to Table 15: Comparative Classification of Oil Reserves, page 303.

### Economic Importance of the Energy Sector for Russia

Russia is extremely dependent on the commodity and energy sectors for its economic growth. The problem is acknowledged by the authorities, for example by Mikhail Kasyanov in January 2004 when he as then Prime Minister stated that “[i]n spite of numerous changes in the Russian economy, Russia is still too dependent on primarily commodity exports”.<sup>47</sup> Energy carriers (oil, gas, coal etc.) together account for approximately 55 per cent of the value of Russia’s exports. In terms of GDP growth, commodity exports account for more than 2 percentage points (of a 7 per cent growth in 2003), according to official statistics. The oil and gas sectors (not only exports), has contributed to GDP by 7-8 per cent between 2001 and 2004.<sup>48</sup>

Furthermore, Sergei Oganessian, Head of the Russian Federal Energy Agency in 2005 stated (probably referring to figures for 2003) that the TEK makes up 28 per cent of GDP, 30 per cent of the industrial output,

<sup>47</sup> New Europe (2004), 'Russia Still Dependent on Primary Commodity Exports', *New Europe*, 25-31 January 2004, p. 36.

<sup>48</sup> Leijonhielm and Larsson *Russia's Strategic Commodities: Energy and Metals as Security Levers*, p. 27.

54 per cent of the federal budget and 45 per cent of Russia's currency reserves.<sup>49</sup> The currency reserve on 1 October amounted to US\$159.6 billions<sup>50</sup> (compared to only US\$136 billions in the spring of 2005).<sup>51</sup> The trade surplus reached US\$80.1 billion after a 48.8 per cent increase during the first half of the year.<sup>52</sup>

Statistics in general, and these figures in particular, can be debated and are connected with great uncertainties, not the least how the GDP is calculated and what it actually measures (17 other uncertainties concerning energy are listed in appendix one). It may yet be so that the Russian economy rests on the energy sector even beyond what official figures show. For example, up until 2003 many Russian firms exploited juridical loopholes to avoid taxation of energy, usually by so-called 'transfer pricing'. This method, in short, consists of a way of transferring profits from the industrial sector to the trading sector by selling the product cheaply to a trading company that is located in an 'internal offshore' (i.e. the Russian regions of Mordovia, Kalmykia and Chukotka). The receiving company is also owned by the producing company (and sometimes just exists on paper). The trading company can thereafter resell the product, in this case oil, without paying taxes for it. Hence, the money never reaches the state budget. Consequently, the sector's share of GDP growth was underestimated according to the calculations made by the World Bank. The oil and gas industry's share of GDP are estimated to be approximately 20 per cent instead of 8 per cent.

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<sup>49</sup> RIA Novosti (2005c), 'Russia's Energy Sector: Priorities Remain', *RIA Novosti*, Published: 2 February 2005, Last accessed: 15 February 2005, Internet: [http://en.rian.ru/rian/index.cfm?prd\\_id=160&msg\\_id=5370918&startrow=1&date=2005-02-02&do\\_alert=0](http://en.rian.ru/rian/index.cfm?prd_id=160&msg_id=5370918&startrow=1&date=2005-02-02&do_alert=0).

<sup>50</sup> RIA Novosti (2005d), 'Russia's Gold and Foreign Currency Reserves on October 1', *RIA Novosti*, Published: 7 October 2005, Last accessed: 19 October 2005, Internet: <http://en.rian.ru/russia/20051007/41630748.html>.

<sup>51</sup> Pravda.ru (2005), 'Russian Immense Currency Reserves Pose Competition for Asian States', *Pravda.ru*, Published: 18 March 2005, Last accessed: 19 October 2005, Internet: [http://english.pravda.ru/main/18/89/358/15130\\_reserves.html](http://english.pravda.ru/main/18/89/358/15130_reserves.html).

<sup>52</sup> RosBusinessConsulting (2005□), 'Russia's Trade Surplus', *RosBusinessConsulting*, Published: 17 October 2005, Last accessed: 18 October 2005, Internet: [http://top.rbc.ru/english/index.shtml?/news/english/2005/10/17/17173340\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/news/english/2005/10/17/17173340_bod.shtml).

Adjustments in early 2004 have however limited the use of this method.<sup>53</sup>

The large export revenues from oil and gas mentioned above are deposited in a large stabilisation fund, which in 2004 amounted to \$US34 billion. Finance Minister Kudrin expected the fund to grow even more in 2005 and reach a level of \$US53 billion.<sup>54</sup> Economic analyses of Russia's development show that Russia's dependence on natural resources, as engines of growth will continue.<sup>55</sup> Given the fact that of Russia's 100 largest companies, 75 per cent are within the oil or gas sector,<sup>56</sup> it is apparent that the importance of the sector will prevail.

However, if prices on crude oil were to decrease, the incitements for focusing on refined products would increase even further than today. High oil prices thus impede on sector reform at the same time, as revenues for exports are needed to conduct reform. Russia's state budget is balanced on an oil price of some \$US20-26/barrel Brent oil. In 2005 the price on Brent oil (Russian oil of the 'Urals quality' is at least \$US1-1.5/barrel cheaper) reached levels of over \$US70/barrel. As a consequence, Russian revenues were substantial and analyses by Goldman Sachs suggest that there is a risk for a so-called super-cycle where such prices become 'normal' and occasional spikes can drive up the price to \$US100/barrel for Brent oil. Other analyses point in the other direction and underscore that the high prices of the 1970-80's did not become permanent.<sup>57</sup> This report does not try to appraise these figures, but high prices appear more plausible than low.

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<sup>53</sup> World Bank (2004), *Russian Economic Report - February 2004*, Washington D.C.: The World Bank.

<sup>54</sup> Munter, Päivi (2005), 'Oil Money Provides Wealth of Problems for Buoyant Rouble', *The Financial Times*, Companies and Markets, 27 April 2005, p. 30.

<sup>55</sup> Brunstad, Bjørn, *et al.* (2004), *Big Oil Playground, Russian Bear Preserve or European Periphery?* (Delft: Eburon/ECON), p 57ff.

<sup>56</sup> Vahtra, Peeter (2004), *Russian Oil Sector Today and Tomorrow: The Implications of the Case of OAO Yukos*, Turku: Turku School of Economics and Business Administration/Pan-European Institute, 2/2004, p. 9.

<sup>57</sup> Morrison, Kevin and Brown-Humes, Christopher (2005), 'On the Climb: A Natural Resources Boom is Unweathering both Profits and Perils', *Financial Times*, 11 April 2005, p. 13.

Problems of capital flight nevertheless remain and usage of offshore firms and bank accounts used for tax evasion are common. For example, Cyprus is, by far, the largest foreign investor in Russia. The Alfa Bank estimates that the total amount of offshore capital from Russia is \$US300 billion, which in fact is almost 50 per cent of Russia's GDP.<sup>58</sup> One measure to tackle this problem was mentioned in Putin's address to the Federal Assembly in April 2005 when he indicated that there might be a tax amnesty for offshore capital.<sup>59</sup> According to the Alfa Bank, such a move might bring back some 10-20 per cent of capital located offshore.<sup>60</sup> Developments in late 2005 and early 2006 suggest that Russia is slowly experiencing a net-inflow of capital.

Russia's reliance on raw material, in general, and specifically hydrocarbons, also demonstrate that there is a risk of what is called a 'resource curse' (or resource burden), which bring along risks of long-term problems in terms of trade, revenue volatility, 'Dutch disease', crowding out effects, increasing the role of the state and other socio-cultural and political impacts.<sup>61</sup> Indeed Russia runs this risk, but it is hard to assess to what degree. One solution is to leave resources unexploited, while other alternatives include diversification of the economy, stabilisation by oil funds, stricter investment policy or political reforms to carry out the corrective politics.<sup>62</sup> Leaving resources in the ground is not an option in Russia. Given a high degree of awareness of the problems, the other suggestions are taken into consideration, but little progress is being made even if an oil fund now is in place.

### **Sustainability of Russia's Role as Energy Supplier**

The sustainability of Russia's energy sector and extraction of hydrocarbon resources has been questioned on the basis of the reserve figures show in Table 2 and Table 3. Estimates of reserves are connected

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<sup>58</sup> Munter 'Oil Money Provides Wealth of Problems for Buoyant Rouble', p. 30.

<sup>59</sup> President of Russia (2005), 'Annual Address to the Federal Assembly', *President of Russia*, Published: 25 April 2005, Last accessed: 26 April 2005, Internet: [http://www.kremlin.ru/eng/text/speeches/2005/04/25/2031\\_type70029\\_87086.shtml](http://www.kremlin.ru/eng/text/speeches/2005/04/25/2031_type70029_87086.shtml).

<sup>60</sup> Munter 'Oil Money Provides Wealth of Problems for Buoyant Rouble', p. 30.

<sup>61</sup> Stevens, Paul (2003), 'Resource Impact: Curse or Blessing? A Literature Survey', *Center for Energy, Petroleum and Minerals Law Policy (CEPMLP) Internet Journal*, Vol. 13, No. 14, p. 3.

<sup>62</sup> *Ibid.*, pp. 18-22.

to great uncertainty. Unlike the Western practice, Russia has had the tradition of assessing reserves on the grounds of what is technically possible to extract – not what is economically feasible. As this is not a geological discussion, only a few examples from the wider debate should be mentioned as they have importance for global energy supply.<sup>63</sup>

### *Sustainability of Reserves*

First and foremost, Russia's reserves of oil and especially gas are vast, especially in relation to nearly every other producer. This secures Russia's place as a key supplier of energy from a geological standpoint. Given the analyses on global hydrocarbon reserves by the Association for the Study of Peak Oil (ASPO), it stands to reason that Russia's resources will not save the world from depletion.<sup>64</sup> Geological evidence suggests that even if new fields are found (and all unconventional hydrocarbon liquids (UHL, i.e. oil sand, shale oil, tar sand) are taken into account, also Russia's reserves will have but a marginal role. According to ASPO Russia's production peaked in the 1980's and the current boost will peak around 2010.<sup>65</sup>

There is yet a debate between economists and geologists/geophysicists, on what the impact from depletion would be. Economists argue that when prices rise, it is economically feasible to invest and to take new and previously too costly fields into operation. In addition, new exploration efforts are made. When new fields are found and results from investments are seen (some ten years later), supply levels increase and prices drop. The risk of depletion is therefore continually postponed and the prices of 2005 will not remain they argue.<sup>66</sup>

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<sup>63</sup> Worth noting is that also Western or Middle-Eastern states exaggerate data on reserves.

<sup>64</sup> See especially the Hirsch-report, which was one of the most important peak oil reports during 2005: Hirsch, Robert L., *et al.* (2005), *Peaking of World Oil Production: Impacts, Mitigation and Risk Management*, SAIC, February 2005.

<sup>65</sup> ASPO (2005), 'The General Depletion Picture', *ASPO Newsletter*, No. 2, April 2005, and arguments in Aleklett, Kjell (2005), 'Radetzki berättar bara halva sanningen [Radetzki is only Telling Half of the Truth]', *Svenska Dagbladet*, Published: 14 July 2005, Last accessed: 25 July 2005, Internet: [http://www.svd.se/dynamiskt/brannpunkt/did\\_10121897.asp](http://www.svd.se/dynamiskt/brannpunkt/did_10121897.asp).

<sup>66</sup> Radetzki, Marian (2005), 'Priset på olja halverat 2010 [Price on Oil Will be Half as Much in 2010]', *Svenska Dagbladet*, Published: 12 July 2005, Last accessed: 25 July 2005, Internet: [http://www.svd.se/dynamiskt/brannpunkt/did\\_10110577.asp](http://www.svd.se/dynamiskt/brannpunkt/did_10110577.asp).

As mentioned, ways of assessing reserves varies greatly. The International Energy Agency (IEA) estimates that Russia's 'Proven reserves' (see Table 15: Comparative Classification of Oil Reserves) of oil amounts to approximately 60 billion barrels, (Russia's says 90 billions). By a conservative estimate, using US standards, the oil would last for 26 years given the current pace. A less conservative estimation states 32-38 years. If UHL is taken into consideration, Russia is considered to have some 300 billion barrels, which would last several hundred years.<sup>67</sup> However, UHL is costly to extract, has less energy content and is not environmentally friendly.

In addition, even if Russia and the Former Soviet Union (FSU) has been the engine of non-OPEC, growth drops sharply according to IEA figures. It also means that Russian oil production is projected to slow down, domestic consumption would slowly increase and thus net exports would gradually fall. In short, there will be an increasing dependence on OPEC even if Russia will remain a key supplier.<sup>68</sup>

### *Sustainability of Production*

In regards to the energy industry, Russia is currently 'enforcing' increased production. Few new fields are engaged into the operation. The lion's share of extracted oil and gas comes from fields prospected already in the Soviet era. This approach is short-sighted in nature and not sustainable.<sup>69</sup> Russia clearly opts for short-term gains rather than long-term stability and sustainability. It takes advantage of high prices with reasoning according to Bobo Lo that the turbulent years of the 1990s taught the Russian elite that one should make profit when it can be made – therefore no long-term vision or strategy is sought after.<sup>70</sup> An

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<sup>67</sup> Ivanov, Vladimir I. (2004a), 'Russia and Regional Energy Links in Northeast Asia', *The Energy Dimension in Russian Global Strategy* (Houston: The James A. Baker III Institute for Public Policy of Rice University), p. 10.

<sup>68</sup> Murray, Isabel (2005), 'Russian Energy and European Dependence', *"New" Security Threats in Eurasia: Implications for the Euro-Atlantic Space*, International Energy Agency (IEA), Stockholm, 19-20 May 2005.

<sup>69</sup> Ebel, Robert E. (2004), 'Russian Reserves and Oil Potential', *Russian Oil and OPEC's Policies*, Carlton Tower, London, 15 March 2004, p. 4.

<sup>70</sup> Lo, Bobo (2003), *Vladimir Putin and the Evolution of Russian Foreign Policy* (London: Blackwell/Royal Institute of International Affairs), p. 62.

implication is that Russia does not have any surplus production capacity that can be used for tackling fluctuations in the oil market. It has also reduced its political and economic levers.

According to Russia's Energy Strategy, prognoses of future oil production are dependent on the scenario applied. An optimistic scenario suggests that by 2010, Russia would produce 9.8 million b/d of crude oil of which 5.6 million b/d would go to export. A moderate scenario points to 8.9 million b/d and 5.6 million b/d for exports. These levels could be kept until 2020 it states.<sup>71</sup>

Yukos' prognosis, in contrast, states that Russian oil production will peak around 2010 while exceeding 10 million b/d until 2015 when a slow decline starts and reaches just below 10 million b/d in 2020. Yukos also states that the fields in Timan Pechora, West Siberia and Volga Ural will peak in 2010 and the fields in Eastern Siberia and Russian shelf will grow (and that all growth is to come from new fields).<sup>72</sup> The Minister of Natural Resources, Yuri Trutnev, shares the view over Western Siberia but says that it will be the most important region until 2020.<sup>73</sup> That production in general will decline in 2010 is confirmed by Anatoli Ledovskikh, chief of the Federal Agency for the Use of Natural Resources.<sup>74</sup> This could still be seen as optimistic views and some say that the average daily output of oil peaked already in September 2004.<sup>75</sup>

It must also be underscored that if Russia is serious about trying to double its GDP in ten years time, additional production of energy is

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<sup>71</sup> Ministry of Industry and Energy 'Energeticheskaya Strategiya Rossii na period do 2020 goda [Russia's Energy Strategy until the Year 2020], Utvershdena no 1234-r, 28 August, 2003'.

<sup>72</sup> Ebel 'Russian Reserves and Oil Potential', p. 6

<sup>73</sup> Prime-Tass (2004), 'The Ministry of Nature Warns about Probable Decline in Crude Oil Production Volume in Western Siberia', *Prime-TASS (Reposted at Transneft)*, Published: 12 October 2004, Last accessed: 21 March 2005, Internet:

<http://www.transneft.ru/press/Default.asp?LANG=EN&ATYPE=9&PG=0&ID=6765>.

<sup>74</sup> RIA Novosti (2005b), 'Russian Oil Production to Shrink Since 2010, Warn Experts', *RIA Novosti*, Published: 6 April 2005, Last accessed: 18 April 2005, Internet:

[http://en.rian.ru/rian/index.cfm?prd\\_id=160&msg\\_id=5492129&startrow=1&date=2005-04-06&do\\_alert=0](http://en.rian.ru/rian/index.cfm?prd_id=160&msg_id=5492129&startrow=1&date=2005-04-06&do_alert=0).

<sup>75</sup> Milov, Vladimir (2005b), *Russian Energy Sector and its International Implication*, Moscow: Institute of Energy Policy, 30 March 2005, Discussion Paper , p. 13.

essential. Energy analyst Vladimir Milov suggests that Russia needs 130-230 million metric tonnes (mmt)/year extra production of crude oil for this. The solution is to increase production or cut down on exports.<sup>76</sup> A review by major oil companies reveals that much of the Russian potential to supply more oil to international markets depend on a few factors, namely low domestic price and high international price that put pressure on the will to export, and a long-term successful removal of export route bottlenecks, for example towards Asia/Pacific, but also Barents sea (Murmansk) and routes by the Black Sea that bypasses the Bosphorus.<sup>77</sup>

In terms of gas exports, one of the reasons for gas production not rising is the general inability of Gazprom to create growth and negligence to invest in the up-stream sector (extraction) as it mostly is interested in pipeline issues. Milov argues that this may even prove to create a gas deficit in the future.<sup>78</sup> This is illustrated by the table below.

<b>Table 4: Russia's Projected Gas Balance as for 2010</b>		
	2004	2010
Gazprom gas production (Optimistic case, without introduction of Yamal gas field)	545	550
Gas exports by Gazprom (Europe, Turkey, CIS, not including Asian exports)	191	312 (incl. 200 Europe and Turkey, 112 CIS)
Gas produced by Gazprom and available for domestic supplies	354	268
Domestic gas demand in Russia (with annual growth rate 4.3% as was true for 2002-2004)	423	545
Deficit	69	307
Supplies of Turkmen gas (optimistic)		70
Supplies of Kazakh gas		15
Current volume of gas production by Russian independent gas producers		90
Total deficit (in bcm)		132
<b>Source:</b> Milov, Vladimir (2005b), <i>Russian Energy Sector and its International Implication</i> , Moscow: Institute of Energy Policy, 30 March 2005, Discussion Paper, p. 12, on the basis of: BP, Lukoil, Oxford Institute for Energy Studies, Institute of Energy Policy.		

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<sup>76</sup> Ibid., p. 3.

<sup>77</sup> Gordon, Richard G. (2004), 'Russian Oil Futures', *The Energy Dimension in Russian Global Strategy* (Houston: The James A. Baker III Institute for Public Policy of Rice University), pp. 3-5.

<sup>78</sup> Milov *Russian Energy Sector and its International Implication*, p. 11f.

### *Sustainability of Exploration*

Since 1991, there have been few fields or discoveries in exploration. Exploration has decreased in intensity, but there are some unexplored areas in the arctic and on the continental shelf. Some say that these may contain up to 4 billion barrels of oil.<sup>79</sup> Whether high oil prices will facilitate processes of exploration is questionable, partly because there is not such a tendency and partly because new discoveries usually stem from new technology rather than new efforts during times of high prices.<sup>80</sup>

Also for gas, the major fields, such as Urengoi, Yamburg, Medvezhe and Orenburg in East Siberia and Volga-Ural regions, were found and peaked in production many years ago. Zapolyarnoye is currently the most important field that is in its early stages of operation. These are so-called 'super giant fields'. This indicates that that they have (had) more than one trillion cubic meters of reserves while 'giant fields' hold between 0.5 and one trillion cubic metres, the field on the Yamal peninsula and Timan-Pechora in West Siberia being two. In total, Russia has 11 super giant fields and at least 13 giant fields.<sup>81</sup> Ray Leonard (of the company Yukos) states that Russia has the necessary geological potential for new findings, even more than is recognised today, but improving the investment climate and promoting rule of law is yet most important.<sup>82</sup>

### *Sustainability of Investments*

Figures of investment needs differ substantially between all analyses that have been taken into account in this report. No attempts are made to appraise them, but some will be mentioned to provide an idea of the needs as seen by some key actors. The IEA estimates that the whole gas industry needs about \$US164-171 billion until 2020 and that the oil

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<sup>79</sup> Stinemetz, Douglas (2003), 'Russian Oil Sector Rebound under Full Swing', *Oil and Gas Journal*, No. N/A, 2 June, p. 22.

<sup>80</sup> Ivanov, Vladimir I. (2004b), *Russian Energy Strategy 2020: Balancing Europe with the Asia-Pacific Region*, Niigata City: Economic Research Institute for Northeast Asia (ERINA), 2 February 2005,

<sup>81</sup> Bakhtiari, Samsam A. M. (2003), 'Russia's Gas Production, Exports Future Hinges on Dramatic Changes at Gazprom', *Oil and Gas Journal*, No. N/A, 10 March 2003, p. 21f.

<sup>82</sup> Ebel 'Russian Reserves and Oil Potential', p. 5.

industry needs \$US157-197 in the same period.<sup>83</sup> The Minister for Economic Development claims that when it comes to pipelines, investments today are only 29 per cent of the needs for maintenances.<sup>84</sup> Figures from the Ministry of Natural Resources show that in East Siberia \$US20 billion is needed the next 45 years just to support production aimed at filling just one single pipeline to the east coast.<sup>85</sup> Other figures show that Gazprom alone needs \$US 100 billion of investments.<sup>86</sup> One core problem concerning the investment rate is that companies such as Gazprom have vast and costly infrastructure while at the same time there are price limits that it has been forced to keep within. It has thus been difficult to obtain necessary capital.<sup>87</sup>

The problems of investments and attracting foreign capital are found within the whole sector, both for so-called greenfield (new developments) and brownfield (acquisitions of existing production) investments.<sup>88</sup> No matter which estimate or analysis is most accurate – it is clear that the whole TEK is plagued by chronic underinvestment. In the long run, this will have an impact on Russia's ability to supply energy to world markets as a gradually a greater share must be used towards domestic consumption.

The structural problems of the energy market hinder development also in new fields, such as Liquefied Natural Gas (LNG). Development of this sector would allow Russia to export gas by tanker and not only pipelines. New markets would thus emerge. Yet, so far Russia has little infrastructure for LNG, and few projects that will have a great impact.<sup>89</sup> Sakhalin 2 is one of the major projects and it is a privately financed

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<sup>83</sup> IEA (2002a), *Energeticheskaya Politika Rossii: obzor 2002*, Paris: The International Energy Agency (IEA), p. 41.

<sup>84</sup> Ahrend and Tompson *Russia's Gas Sector: The Endless Wait for Reform?*, p. 15.

<sup>85</sup> Bloomberg (2005), 'East Siberian Oil Fields Need \$ 20bn Investment', *Bloomberg (Reposted at Alexander's Gas and Oil Connections)*, Published: 10 February 2005, Last accessed: 3, Internet: <http://www.gasandoil.com/>.

<sup>86</sup> Arvedlund, Erin E. and Mouawad, Jad (2005), 'Breakup of Yukos Hits Output in Russia', *The International Herald Tribune*, 22 February 2005, p. 8.

<sup>87</sup> Stern *The Future of Russian Gas and Gazprom*, p. 202.

<sup>88</sup> Victor, David G. and Victor, Nadejda M (2003), 'Axis of Oil?' *Foreign Affairs*, Vol. 82, No. 2, p. 55.

<sup>89</sup> Arvedlund and Mouawad 'Breakup of Yukos Hits Output in Russia', p. 8.

project. Several terminals are yet being built. Despite its many advantages, Gazprom has been slow in taking on LNG projects. In comparison, LNG demand grew by 12 per cent in 2003 (compared to gas demand that only grew 2.2 per cent). The EU, which is an important customer, opts for increased usage of LNG.<sup>90</sup> The main rationale for this is that it provides flexibility and largely reduces the issue of supply security to a question of money since the LNG market is more like a spot market for gas than what pipeline carried gas is. The LNG boom is also explained by the fact that the costs have decreased at the same time as capacity has increased.

### *Sustainability of Consumption*

Usage and extraction of hydrocarbons in Russia are also inefficient and wasteful of energy. One of the most important reasons is that gas was used free of charge during Soviet times, and it is still considered to be too cheap by the authorities and analysts alike. Natural gas currently accounts for 55 per cent of Russia's primary needs and 80 per cent of its power generation.<sup>91</sup> The problem is so serious that Igor Bashmakov, the Executive Director of the Centre for Effective Energy Use, in 2004 stated that there is a risk that Russia even may have to stop its energy exports. The rationale being that the oil and gas might have to be used for domestic consumption. One problem, according to him, is that Russia does not have a state policy for increased efficiency, nor believes in market regulation.<sup>92</sup> This may not be entirely true, but as an example of Russia's inefficiency, it can be stated that, according to World Bank in 2003, Russia (like Kazakhstan and Ukraine) is consuming 0.5 kg of oil equivalents per dollar of GDP by PPP. This should be compared to only 0.1-0.2 kg for industrialised and emerging economies.<sup>93</sup>

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<sup>90</sup> Milov *Russian Energy Sector and its International Implication*, p. 6.

<sup>91</sup> Bakhtiari 'Russia's Gas Production, Exports Future Hinges on Dramatic Changes at Gazprom', p. 21.

<sup>92</sup> RosBusinessConsulting (2004), 'Russia Might Stop Energy Exports by 2010', *RosBusinessConsulting (Reposted at Alexander's Gas and Oil Connections)*, Published: 22 December 2004, Last accessed: 25, Internet: <http://www.gasandoil.com>.

<sup>93</sup> Milov *Russian Energy Sector and its International Implication*, p. 1f.

### What is Special about Russia?

Generally speaking, an energy sector has some special characteristics. Philip Andrews-Speed has even argued that the energy sectors in most countries are different from other sectors. He illustrates that:<sup>94</sup>

- Primary energy resources are owned by the state;
- Most governments retain considerable influence over the nation's energy sector through various combinations of policy, regulation, ownership or investment;
- Energy is a vital input to any modern economy, and security of energy supply is a concern for most governments;
- An increasing number of countries are becoming progressively more dependent on a small number of international suppliers of oil, gas and coal;
- The energy sector remains dominated by large-scale, capital-intensive projects with long-lead times, and by a relatively small number of national and multinational companies with the experience and skills to carry out such projects;
- The financing of such projects is increasingly becoming an international activity requiring complex legal documentation to satisfy the lender;
- The long-distance transportation of energy by pipeline or by wire is a natural monopoly which gives disproportionate power to the commercial operator, to the supplier of the energy and to any transit state; thus such transportation infrastructure is commonly governed by an international treaty;
- The energy sector is a major contributor to local, national, regional and global pollution;
- Nuclear energy is dependent on technology related to nuclear weapons.

Even if this list is created from a general standpoint, this report underscores that the list well characterises clearly the Russian TEK essentially in every aspect. Andrews-Speed further argues that due to this special nature, there are special needs for a long-term commitment

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<sup>94</sup> Andrews-Speed, Philip (2003), 'Energy Security in East Asia: A European View', *Symposium on Pacific Energy Cooperation*, Tokyo, 12-13 February 2003, p. 7.

between states and companies, preferably by having legal agreements and permanent institutions.<sup>95</sup> Currently, international agreements where Russia is involved are closed on bilateral bases and so far, wider forms of cooperation are still in the cradle. There are exceptions, and possibly, also a comprehensive gas trade regime can be developed between Russia and the EU. Russia has been eager to create something like a gas-OPEC, but the idea has not yet materialised.<sup>96</sup> Apart from multilateral infrastructure projects, Russia has also been involved in foreign energy sectors.

The point is thus that Russia, on the whole, does not stand out as a particularly different case. As is indicated in this report, transparency is sometimes better and sometimes worse than others (in international comparisons). This is similar to for usage of the energy lever, coercive energy policy, state monopoly and political instability. This is one of the reasons why there is such an oil bonanza in Russia despite the numerous problematic issues that this report underscores. The uncertainties that give room to question Russia's economic and political stability and investment climate are exactly what makes it possible to take existing opportunities.

If foreign companies are aware of the informal rules, political boundaries and modus operandi of actors on the Russian market – there is nothing that states that short-term gains cannot be reached. It becomes problematic when business interests and risk-taking occasionally stands in contrast to state priorities. It is therefore paramount to grasp, understand and tackle the problems, frictions and uncertainties that exist if an importing state wants to have the upper hand in its dealings with Moscow. This is especially important when it comes to energy security and foreign policy, not only when looking at the security of supply.

### **Summary and Conclusions**

The relative shares of total primary energy supply in Russia have remained the same since the beginning of the 1990s. The electricity sector in Russia is rigid and inefficient but it is slowly being reformed.

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<sup>95</sup> Ibid., p. 7.

<sup>96</sup> Stern *The Future of Russian Gas and Gazprom*, p. 141.

Production, sales and maintenance of electricity are thought to be opened up for competition, while transportation, distribution and control over supplies are meant to remain under state control. Similar plans exist for the gas sector although those may not be realised. The coal (privatised but state controlled) and nuclear sectors (state run) are slowly being consolidated. Coal and nuclear energy will take greater roles in Russian consumption in the future.

Russia will remain a strong supplier of oil, but will scarcely be able to keep up pace with Saudi Arabia in either production or exports. Russia is currently enforcing increased production in an unsustainable way where long-term strategies have had to stand back for short-run profits. The production has already peaked, according to most analysts. Russia has not (or is unlikely to) develop any surplus production capacity. Exploration has decreased in intensity, although there are some unexplored areas.

Russia's position concerning natural gas is much stronger. Despite inefficiency and waste, produced amounts are substantial. The reserves/production ratio (eg. how many years that the reserves will last given the same level of production and economic terms) on top of Russia's proven reserves of natural gas underscore that Russia will remain the world's supreme supplier.

Russia is exceptionally dependent on its commodity sectors for economic growth. Reliance on raw material in general and hydrocarbons specifically aggravates the risk for a 'resource burden'. The entire TEK is plagued by chronic underinvestment. In the long run, this will have an impact on Russia's ability to produce and supply energy. There is a strong risk that Russia's ability to export oil will decrease strongly also in the short run. Russia may want to take a greater share of its oil for domestic consumption, thus limiting exports.

Russia is well aware of existing problems. In comparison to other producers of oil and gas, Russia's situation does not stand out as particularly different. Things in Russia are changing quickly and great

uncertainties exist. The connection to Europe nonetheless makes it pivotal for European consumers to handle upcoming frictions.

In short, Russia will remain a key supplier of both oil and gas even if net-importers could possibly face an increase in dependence on oil from OPEC. In a security perspective, the importance of Russia's energy sector can be seen as so large, that it can be assumed that Russia's role as an energy supplier will be strengthened as demand increases elsewhere.

### 3 Russia's Energy Perceptions

**Question:** What are Russia's perceptions, intentions and position to its commodities, exports and energy relations?

**Approach:** The chapter approaches the question by looking at what has been stated or written on the topic (in contrast to chapter seven that mainly focus on events), in order to see how Putin and the Russian leadership perceives energy and commodity issues.

**Main findings:** Ensuring national security is the fundamental task of the energy policy and Russia will use its energy policy to avert geopolitical and macroeconomic threats, in addition to the risk of being blackmailed. Russia is prepared to put economic pressure on the CIS countries and there appears to be a common understanding that Russian ownership abroad is likely to decrease the risk of anti-Russian policy lines. At the same time, Russia strives to be a reliable trade partner. Energy is also linked to economic security and is aimed at promoting growth, extending influence and ensuring independence. Any integration into international structures should not threaten Russia's independence.

Domestically, Putin is not against private property, but private companies cannot take control from the state (as the state speaks for the Russian people). He sees the ceding of assets in the 1990s as a mistake that must be reversed. A mixed system where some property is state owned and some is private is best for Russia according to Putin. Harmony in words and deeds largely exists, with a few exceptions.

#### **Russia's Perception of Energy and Security**

A starting point for assessing Russia's notion of security is in its concepts and doctrines. The most fundamental concept is the Security Concept. It can be seen as a blueprint that outlines Russia's place in the international community and the priorities of the Russian Federation as it "defines the most important directions of the state policy of the Russian

Federation".<sup>97</sup> It provides a window into Russia's over-arching goals and its national interest. It is approved of by the President and it derived benefit from the status of a decree. Concerning the general national interest, it states that:

*Russia's national interests are the combined and balanced interests of the individual, society and the state in economic, domestic political, social, international, informational, military, border, ecological security. They are long-term in nature and define the main goals and strategic and short-term goals of the state's domestic and foreign policy. The national interests are secured by institutions of state authority, which may also act in coordination with public organizations operating on the basis of the constitution and legislation of the Russian Federation.*<sup>98</sup>

When it comes to energy specifically, it is briefly mentioned in an environmental context, for example:

*The threat of a deteriorating environmental situation in the country and depletion of natural resources depends directly on the state of the economy and society's willingness to appreciate the global nature and importance of these issues. For Russia this threat is especially great because of the domination [sic] position in industry of the fuel and energy sector, inadequate legislation for environmental protection, lack or limited use of energy-saving technologies, and low environmental awareness.*<sup>99</sup>

Even if the importance of energy is mentioned in relation to environmental sustainability, it stands clear that its importance for the industrial sector is emphasised. Given Russia's development and the Energy Strategy, it can be assumed that future security concepts will put more stress on energy security and possibly it will be awarded higher status than, for example, information security.

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<sup>97</sup> Security Council (2000), 'Kontseptsiiia Natsionalnoi Bezopanosti Rossiiskoi Federatsii [National Security Concept of the Russian Federation], otvershdna, Ukazom Prezidenta, Rossiiskoi Federatsii, ot 17 dekabria 1997 g. no 1300, (v redaktsii Ukaza Prezidenta, Rossiiskoi Federatsii, ot 10 ianvaria 2000 g. no 24)', *Sovieta Bezopanosti Rossiiskaya Federatsiya*, Published: Last accessed: 3 February 2005, Internet: <http://www.scrf.gov.ru/Documents/Decree/2000/24-1.html> and <http://www.russiaeurope.mid.ru/RussiaEurope/russiastrat2000.html> (English).

<sup>98</sup> Ibid.

<sup>99</sup> Ibid.

During Soviet times, the importance of the pipeline network and natural resources for the Military-Industrial Complex was paramount.<sup>100</sup> Some even argue that the importance of the TEK can be traced even further. In Russia's opinion, it has always been a land of resources, and this helped to thwart both Napoleon's and Sweden's ambitions to conquer Russia.<sup>101</sup> Energy is also a short cut for Russia in its international relations and attempts to be treated with respect.<sup>102</sup> This aspect is one of the most important reasons why energy exports are politically important to Moscow and why it will abstain from unnecessary utilisation of the energy levers.

Energy security is closely linked to economic security. An assessment of various policy documents reveals that Russia holds three things of special importance, namely: promoting economic growth, extending Russia's international influence, and ensuring Russia's economic independence. Russia perceives economic growth as a means to realise its national interests by improving living conditions for the citizens or creating opportunity for further industrial development. This is the responsibility both for the state and for private actors. Attracting investments is on the agenda, but not at any cost. The Russian state and corporations must have the strongest foothold on the market. Industrial products are seen as more advantageous to export than commodities, as revenues from industrial output are more stable and have greater margins than revenues from the commodity sector.<sup>103</sup> In this case, Russia has nonetheless failed in going from words to deeds.

In addition, Russia has an ambition to extend its economic reach for political reasons. It strives to deepen its economic-institutional influence and increase its industrial exports, most notably within the arms sphere

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<sup>100</sup> Ulfing, Lars (2004), *Rysk krigskonst [Russian Art of War]* (Stockholm: The Swedish Defence Collage), p. 214.

<sup>101</sup> Medvedev, Sergei (2003), *Rethinking the National Interest: Putin's Turn in Russian Foreign Policy*, Garmisch-Partenkirchen: The George C. Marshall Center/European Center for Security Studies, The Marshall Center Papers 6, pp. 31-34.

<sup>102</sup> Monaghan, Andrew (2005), *Russian Oil and EU Energy Security*, Swindon: Conflict Studies Research Centre, November 2005, 05/65, p. 2.

<sup>103</sup> Sjölund *Ekonomisk säkerhet-till vilket pris? En studie av den ryska synen på ekonomisk säkerhet [Economic Security - To What a Price? A Study of the Russian View of Economic Security]*, pp. 26-29.

(as Russia sees a correlation between arms exports and political influence).<sup>104</sup> It prefers a situation where it may conduct policy without interference from other actors. Economic independence is prioritised. This concept was further underlined when Lavrov at a closed session in the Federation Council declared that Russia is prepared to exert economic pressure against the CIS states.<sup>105</sup>

In Russia's view, it is required that the state take responsibility for sectors that are considered of special importance in terms of self-sufficiency. The commodity sector is one such example.<sup>106</sup> This does not mean that all actions have an immediate security rationale, even if it is a main goal of the policy as such. Putin and the leadership are aware of the need to have the finances in order. This report has indicated that very little has happened in terms of either integration or investments, but the needs are often stressed. According to the Minister of Industry and Energy, being competitive is a key goal for Russia's industrial policy, and this is supposed to come from wider integration, investment regimes and taking part in globalisation.<sup>107</sup> Russia however appears to have its doubt about globalisation.<sup>108</sup>

### **Putin's View of Energy and Commodities**

Putin held a low profile during his first term in office, letting Kasyanov handle the economic policy. During his second term, there is a clear restoration of state control over energy industries.<sup>109</sup> Putin has gradually

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<sup>104</sup> Ibid., pp. 34-37.

<sup>105</sup> Ozerov, Victor (2005), 'Neloyalniye ostanutsya bez nefi i gaza [Disloyalty Will Remain without Oil and Gas]', *Nezavisimaya Gazeta*, Published: 13 October 2005, Last accessed: 17 October 2005, Internet: [http://www.ng.ru/printed/politics/2005-10-13/1\\_notloyal.html](http://www.ng.ru/printed/politics/2005-10-13/1_notloyal.html).

<sup>106</sup> Sjölund *Ekonomisk säkerhet-till vilket pris? En studie av den ryska synen på ekonomisk säkerhet [Economic Security - To What a Price? A Study of the Russian View of Economic Security]*, p. 40f.

<sup>107</sup> Ministry of Industry and Energy (2005c), 'Glavnaya tsel nashei prolyshlennoi politiki - eto dostizhenie rossiei viskogo urovnya natsionalnoi konkurentosobnosti [The Main Goal of our Industrial Policy is for Russia to Achieve a High Level of National Competitiveness]', *Ministerstvo promyshlennosti i energetiki Rossii*, Published: 24 October 2005, Last accessed: 31 October 2005, Internet: <http://www.minprom.gov.ru/activity/auto/appearance/9>.

<sup>108</sup> Larsson, Robert L. (2005b), 'Ryssland lider av globaliseringsångest [Russia Suffers from Globalisation Agony]', *Framsyn*, No. 5, p. 31ff.

<sup>109</sup> Milov *Russian Energy Sector and its International Implication*, p. 7.

begun to concentrate much of the state powers to the post of the President and the presidential administration.

It is generally believed that when it comes to foreign ownership within the energy sector, Putin has a 'psychological barrier' of a maximum share of foreign ownership, at least according to Vladimir Milov. He states that Putin believes that foreign enterprises should not be allowed to own a larger share than 20 per cent of a Russian energy company. As an example, it can be stated that when Yukos and Khodorkovsky in 2003 tried to sell a 25 per cent-share of YukosSibneft to ExxonMobile, Putin blocked the deal as it was market driven and beyond his control, Milov argues.<sup>110</sup> By looking at Russia's policies on foreign direct investments in 2005, it is clear that a maximum ownership share defined in legal terms is 49 per cent. If Putin has a tougher stand on natural resources than current legislation, which indeed is likely, a 20 per cent 'psychological barrier' is plausible.<sup>111</sup> This signifies that while there are no formal laws against acquisitions up to 49 per cent, there are risks that other regulations or red tape are used to prevent unwanted foreigners from taking over Russian assets or operating in Russia.

Martha Brill Olcott and Harley Balzar are both prominent researchers on Russia who have assessed Putin's perception of commodities and this section will raise a few of their points. Olcott claims that Putin does not believe that privatisation is what is best for diversifying Russia's economy and generating revenue. Putin does not rely on global forces to provide economic opportunities. A premature globalisation means hardship for Russian citizens in his opinion.<sup>112</sup> He is stated to understand the importance of protecting private property, but private companies cannot take control from the state, as the state speaks for the Russian people.<sup>113</sup>

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<sup>110</sup> Milov, Vladimir (2005a), 'Problemi energeticheskoi politiki Rossii [Problems of Russia's Energy Policy]', *Moskovskii Tsentri Karnegi*, Moscow, 1 February 2005.

<sup>111</sup> Olcott, Martha Brill (2004), 'Vladimir Putin and the Geopolitics of Oil', *The Energy Dimension in Russian Global Strategy* (Houston: The James A. Baker III Institute for Public Policy of Rice University), p. 3.

<sup>112</sup> *Ibid.*, p. 16.

<sup>113</sup> *Ibid.*, p. 3.

Allegedly, Putin in the late 1990s published a PhD dissertation (*Kandidat Nauk*) at St. Petersburg's State Mining Institute, titled "Mineral Raw Materials in the Strategy of Development of the Russian Economy". Since then, the Mining Institute has become a prominent body in Russian energy affairs. Most of the German energy leaders that visit St. Petersburg stop by at the institute. Its rector, Vladimir Litvinenko, is a member of the Energy Commission and is also believed to have taken part in drafting Russia's Energy Strategy.<sup>114</sup>

The topic of the thesis was 'developing economies', and how to introduce Western management style into Russia's raw material sector. He later published an abstract on his findings.<sup>115</sup> Harley Balzer has provided the research community with a translation of the abstract, which he published in 'Problems of Post-Communism'<sup>116</sup> and commented on in 'Post-Soviet Affairs'.<sup>117</sup> Balzer notes that Putin possibly thought that some academic credentials would boost his career when he left Sobchak's office in the aftermath of the lost election in 1996 and this was why he decided to write a dissertation.<sup>118</sup>

The thesis itself is not publicly available, as reporters who tried to get hold of it in 1999 soon experienced. Balzer believes that there is a possibility that Putin had access to information through the KGB/FSB that made some of the material sensitive. The abstract was however not classified before Putin was inaugurated as prime minister and when it

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<sup>114</sup> Kupchinsky, Roman (2006a), 'Russia. Putin's Former Colleagues Make Up Today's Energy Team', *RFE/RL*, Published: 15 February 2006, Last accessed: 21 February 2006, Internet: <http://www.rferl.org/featuresarticle/2006/02/09bec758-1028-4efc-a5ee-c6e1d5083755.html>.

<sup>115</sup> Putin, Vladimir Vladimirovich (1999a), *Mineralno-syrevye resursy v strategii razvitiya Rossiiskoi ekonomiki* [*Mineral Raw Materials in the Strategy for Development of the Russian Economy*], St Petersburg: State Mining Institute, January 1999, *Zapiski Gornogo Instituta* [Notes of the Mining Institute] 144 (1999). A copy of the cover and the conclusions in original is found at Polit.ru (2005), 'Dissertatsiya Vladimira Putina: otkyda vzyalsya skandal [Vladimir Putin's Dissertation: Where Does the Scandal Come From]', *Polit.ru*, Published: 14 December 2005, Last accessed: 14 December 2005, Internet: <http://www.polit.ru/analytics/2005/12/13/lopatnikov.html>.

<sup>116</sup> Balzer, Harley (2006), 'Valdimir Putin's Academic Writings and Natural Resource Policy', *Problems of Post-Communism*, Vol. 53, No. 1.

<sup>117</sup> Balzer, Harley (2005), 'The Putin Thesis and Russian Energy Policy', *Post-Soviet Affairs*, Vol. 21, No. 3.

<sup>118</sup> Balzer 'Valdimir Putin's Academic Writings and Natural Resource Policy'.

subsequently was classified, Balzer interprets it as 'bureaucratic caution'. It therefore took some time before the rector of the Mining Institute granted permission to translate the article for 'Problems of Post-Communism'.<sup>119</sup>

When Olcott analysed the abstract she, as Balzer, noted that it is unlikely that Putin himself has written the thesis as he at the time was a senior official, making moves to become a national player. Writing in the name of the leader was a common Soviet practice. But as Olcott says, even if it was written by someone else, Putin must have authorised it and thus approves of it.<sup>120</sup> It is therefore an indication of his views (or possibly how he wants to be understood). Balzer points to facts suggesting that Aleksei Kudrin and his team were behind at least some of the details of Putin's thesis. This would mean that there is little difference in how the liberals and the siloviki see energy policy.<sup>121</sup>

Balzer further points out that Putin's views probably have changed over time, but that it still may yield some insights in terms of his policy preferences. At a conference in September 2005, Putin admitted that there was some correlation between the thesis and pursued policy, (upon having got a question on the influence of the thesis).<sup>122</sup> Apparently, on several occasions Putin has mentioned a thesis that he did not complete, but refrained from elaborating on the thesis that he actually did defend. The defence of the thesis was however stated to be excellent according to the official opponent, Mikhail Medvedkov.<sup>123</sup>

Judging from this, Putin believes that the natural resource base guarantees Russia's international position and ensures positive economic development. The state should set priorities in the oil industry and state planning must be the core of resources management. Even if natural resources are important, Russia cannot only be an exporter of raw materials but must develop processing industries in order to promote the

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<sup>119</sup> Ibid.

<sup>120</sup> Olcott 'Vladimir Putin and the Geopolitics of Oil', p. 16f.

<sup>121</sup> Balzer 'The Putin Thesis and Russian Energy Policy', p. 215.

<sup>122</sup> Ibid., p. 215.

<sup>123</sup> Ibid., p. 215.

standard of living for Russian citizens and make Russia a leading economic power. This requires that the state and 'large financial-industrial corporations' together can compete with Western corporations.<sup>124</sup> This demonstrates that he is aware of the needs of diversifying the sector, but at the same time, little has been done in this respect. If large financial-industrial corporations, (referring to VICs, such as Gazprom), are to lead the way, it might be problematic to combine conversion towards processed products and a rigid state-controlled structure.

The state must, according to Putin, work at making these large corporations competitive by using market means, regulating development and providing assistance to the development of the mineral processing sector. Putin says that he will strengthen and increase the number of vertically integrated companies in the oil and gas sector.<sup>125</sup> As these words were written before 1999, many new VICs are unlikely to come after 2006 even if they could (the company Russneft is an example of a VIC created as late as 2002).

Putin also states that it becomes gradually more difficult to bring large financial revenues to the state budget in the near future. Therefore, he supports the idea of state-sponsored foreign investments, but Russia should not give up its powers.

*The Russian mineral raw material complex plays an important role in all aspects of the state's vital functions...The development of the raw materials sector helps form a strong industrial base which is capable of satisfying the needs of both industry and agriculture; it makes an important contribution to the income of the country as its products remain the basic source of foreign currency.*<sup>126</sup>

Putin states that the sector is important for entire towns and regions. It largely contributes to the GDP of the country and in the restructuring of

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<sup>124</sup> Putin, Vladimir Vladimirovich (1999b), *Mineralno-syrevye resursy v strategii razvitiya Rossiiskoi ekonomiki* [Mineral Raw Materials in the Strategy for Development of the Russian Economy], St Petersburg: State Mining Institute, January 1999, Zapiski Gornogo Instituta [Notes of the Mining Institute] translated by Harley Balzer in Problems of Post-Communism, vol. 53, no 1, 2006. 144 (1999).

<sup>125</sup> Olcott 'Vladimir Putin and the Geopolitics of Oil', p. 17.

<sup>126</sup> Ibid., p. 18.

the national economy; hence it plays a strategic role. It also constitutes the basis for the country's military strength and provides social stability in addition to facilitating integration processes between countries.<sup>127</sup> There must be a fusion of state and private sectors according to the thesis. When VICs are created, they should be assisted by the state, and firms should be made capable of competing with foreign corporations on an equal basis.<sup>128</sup> As a payback, these VICs are supposed to promote processed industry products, promote exports, provide minerals and to develop the resource base. Naturally, they are to operate within a framework provided by the state. If they do, they may keep their assets. It is clear that Putin sees the ceding of assets in the 1990s as a mistake that must be reversed. Olcott in this context emphasises that it is not ownership that is most important and points to the words:<sup>129</sup>

*The state has the right to regulate the process of the acquisition and the use of natural resources, and particularly mineral resources, independent of on whose property they are located; in this regard the state acts in the interest of society as a whole, as well as in the interests of private owners whose interest conflict and who need the help of the state organs of power to achieve a compromise.*<sup>130</sup>

*At the beginning of market reforms in Russia, the state let go of the nation's natural resources, to a breakdown in the geological sector that had been formed over the course of many decades, as well as a number of other negative consequences. The pro-market euphoria of the first years of economic reform has gradually given way to a more considered approach, an approach which assumes the possibility of and recognizes the need for the regulating influence of the state on the economy as a whole and on those developing natural resources in particular. There are many examples of effective state involvement in long-term projects for developing natural resources found in countries with developed market economies.*<sup>131</sup>

These words are much in line with what Putin has stated before in terms of expressed state strategy. In fact, most of what the abstract of the thesis underlines is in harmony with the energy strategy and pursued policy.

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<sup>127</sup> Putin *Mineralno-syrevye resursy v strategii razvitiya Rossiiskoi ekonomiki* [*Mineral Raw Materials in the Strategy for Development of the Russian Economy*],

<sup>128</sup> Olcott 'Vladimir Putin and the Geopolitics of Oil', p. 18.

<sup>129</sup> Ibid., p. 19.

<sup>130</sup> Ibid., p. 19.

<sup>131</sup> Ibid., p. 19f.

He also states on the topic of the strategic goals of state policy in the energy sector that it is "aimed at furthering the geopolitical interests and maintaining the national security of Russia".<sup>132</sup>

Olcott also notes that Putin blames private ownership for the collapse of the sector (presumably after 1991). He dislikes the Western management-style that "some oligarchs introduced" (one example is Yukos). There is no threat of further re-nationalisation Olcott argues.<sup>133</sup> Putin also ensured in 2006 that these threats are exaggerated, but few observers are convinced.

Putin nonetheless advocates the 'modifying' of legal structures, for example tax and licensing structures. A mixed system is best for Russia he says, where property is state owned and only some is private. State regulation should give private investors legal guarantees and financial credit support and insurances against natural disasters. The state will also provide infrastructure and information to support development of the sector.<sup>134</sup> In retrospect, this view harmonises with what has happened in Russia since 1999. Putin also sees some strategic tasks for the state when it comes to management and regulation of the natural resources sector. A few things must be done.

*--- completing the changeover to a rational combination of administrative and economic [i.e. market driven] means in the state regulation of natural resources*

*--- creating an efficient system of state organs of management in the area of natural resources, that includes the clear delineation of their functions and base of coordination*

*--- developing a legal basis for stimulating innovation and investment in the production, consumption and protection of natural resources*

*--- optimizing the volumes and increasing the diversification of sources of investment in the production, consumption and protection of natural resources*

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<sup>132</sup> Putin *Mineralno-syrevye resursy v strategii razvitiya Rossijskoi ekonomiki [Mineral Raw Materials in the Strategy for Development of the Russian Economy]*,

<sup>133</sup> Olcott 'Vladimir Putin and the Geopolitics of Oil', p. 20.

<sup>134</sup> Ibid., p. 20.

--- *developing state regulation of export-import operations in the sphere of natural resources*

--- *ensuring the delineation of rights and functions of both the federal organs and of the subjects of the Russian Federation in the area of natural resources*

--- *implementing state support for scientific research [in these areas], creating the conditions for the balanced use of natural resources as the basic factor in the country's stable development*

--- *accounting for regional features in the use of natural resources to improve the functioning of the Russian economy as a whole*<sup>135</sup>

Putin is speaking about delineating state ownership of natural resources by a system of taxation and licensing rights together with sanctions against those who break the law.<sup>136</sup> Olcott suggests that this is a partial explanation for the timing of the Yukos affair. Russia by 2003 had done enough reform in the legal sphere to hold companies accountable.<sup>137</sup> It is doubtful whether this correlation is very strong, given the complexity of the affair. But Putin further underscores that:

*Even in developed countries, market mechanisms do not provide solutions to strategic tasks of resource use, protecting nature, and sustainable economic security[...].*<sup>138</sup>

Olcott argues that although Putin is in favour of private property, the understanding of private property is different from the understanding held by the oligarchs. Putin states that one must expand the list of resources that can be developed on a fee basis and in due time, a unified system of normative and legal guarantees will be developed. One aspect of this delineation can be made in a centre-periphery context. Olcott sees the reform of appointing (instead of elections of) governors in this light.<sup>139</sup> Another aspect is the abolition of the dual-key. As late as in the address to the Federal Assembly in spring 2005, Putin stated:

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<sup>135</sup> Ibid., p. 21.

<sup>136</sup> Ibid., p. 21.

<sup>137</sup> Ibid., p. 22f.

<sup>138</sup> Putin *Mineralno-syrevye resursy v strategii razvitiya Rossiiskoi ekonomiki* [*Mineral Raw Materials in the Strategy for Development of the Russian Economy*].

<sup>139</sup> Olcott 'Vladimir Putin and the Geopolitics of Oil', p. 22f.

*In my opinion a third important task is to pursue vigorous policy in promoting liberalization in private enterprise. I'd like to focus on measures to stabilize civil law relations and to achieve a dramatic increase in opportunities for free enterprise and capital investment.<sup>140</sup>*

*The fiscal agencies must not close their eyes to legal violations. But we should find ways for back taxes from previous years to be repaid in the interests of the state without destroying the economy and pushing business into a corner. The tax agencies must not "terrorize" business by returning to the same problem again and again. They should work rhythmically, promptly reacting to violations but spotlighting above all inspections of the current period.<sup>141</sup>*

In Putin's notion, there appears to be a balance between state interference and market-driven actions. He acknowledges the need for private initiative but there are over-arching issues relating to security and the national interest that overshadows everything else. This was shown at the Economic Forum in St. Petersburg in June 2005 when he stated that: "[...] excessive state interference in the economy could impede the country's business development. But infrastructure and the defense sector should remain under state control."<sup>142</sup> On 29 April 2004, he stated, "At the moment I consider that there are no grounds for the state to give up its control over pipeline transportation. But this does not hinder private investment, which will be welcomed."<sup>143</sup>

In some ways, Putin's support for liberalisation is merely lip service. While occasionally indicating that liberalisation and marketisation is sought after, his hardline opinions are stronger. At a press conference in February 2006, Putin compared Russia with Norway where "the oil-and-gas sector is completely monopolized by the state". Pavel Baev correctly underscore that there is great differences between the two cases. Norway has two competing firms while Gazprom is in full control. And, as Baev states, there have been:

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<sup>140</sup> President of Russia 'Annual Address to the Federal Assembly'.

<sup>141</sup> Ibid.

<sup>142</sup> RosBusinessConsulting (2005z), 'Putin Disappointed by Slow Economic Advance', *RosBusinessConsulting*, Published: 15 June 2005, Last accessed: 15 June 2005, Internet: [http://top.rbc.ru/english/index.shtml?/news/english/2005/06/14/14164811\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/news/english/2005/06/14/14164811_bod.shtml).

<sup>143</sup> Cited in Fredholm *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, p. 9.

*[...] efforts in Norway aimed at securing the independence of Statoil and Norsk Hydro in running their business and also at making sure that the decision-making in the Ministry of Oil and Energy is not unduly influenced by the particular interests of these companies.<sup>144</sup>*

It has also been argued that Russia's relatively flexible stand on the Caspian region, its commercial interests, EU cooperation and aspiration for WTO membership are proofs of a new mindset. This idea is, however, a misconception according to Bobo Lo who argues that these are just new means for pursuing state interest (more pragmatically). In Russia's view, only with a strong economic base can Russia be a global player.

When Putin outlines his view on how to reach the strategic goals, he states that the first stage must be directed at solving a few problems (see below). These suggestions are currently slowly being handled by the Putin administration.

*[...]perfecting legislation pertaining to natural resources, including strengthening administrative and criminal responsibility for violations; deepening and improving the economic mechanism for resource exploitation; clarifying and correcting the system of licensing and regulations in the sphere of resource exploitation; working out a mechanism for auditing; expanding the list of types of natural resources exploited for a for-fee basis; creating a functioning mechanism to financially support programs and measures for renewal and protection of natural resources; forming criteria and requirements for delimiting state and other types of natural resource property; and similarly creating a federal reserve of valuable minerals and other types of natural wealth etc.<sup>145</sup>*

### **Bureaucratic Rivalry**

Putin's view on energy and natural resources is not shared by all members of the government and state structures. There appears to be interdepartmental competition. Basically, several camps can be seen, but they can be grouped into two main clusters that are found within the presidential administration and the government when it comes to the

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<sup>144</sup> Baev, Pavel (3006), 'Putin, Gazprom, and "The Other Norwegian Company"', *Eurasia Daily Monitor*, Vol. 3, No. 25.

<sup>145</sup> Putin *Mineralno-syrevye resursy v strategii razvitiya Rossiiskoi ekonomiki* [Mineral Raw Materials in the Strategy for Development of the Russian Economy].

vision of economic and energy policy. One is, like Putin, pro increased state control, while the other holds a somewhat more liberal view. Below a few examples relating to economic issues and the Yukos affair are provided.

### *The Clash within the Presidential Administration and Government*

The camp advocating increased state control can be referred to as the 'hardliners', 'siloviki faction', *derzhavniki* (promoters of Russia as a great power), nationalists or the 'statists'. There are no distinct borders between the groups neither in theory nor in reality. The siloviki are however usually referring to the group of people with a background in the defence and security structures while the term 'hardliners' usually refers to their position towards state control. Most of the siloviki are nonetheless hardliners.

Vladimir Trutnev, the Minister of Natural Resources, shares many of the concerns held by Putin and has promised to revoke licences from those firms that do not develop the reserves that they have the concession right of.<sup>146</sup> Trutnev aims to reduce this problem both by administrative and economic methods, courts actions, and by imposing tax on reserves.<sup>147</sup>

Prime Minister Mikhail Fradkov, who replaced the liberal Mikhail Kasyanov, also stands on Putin's side and argues in favour of increased state control of the sector. According to Kryshtanovskaya and other analysts, the hardliner faction is informally led by Igor Sechin, the deputy head of the presidential administration. As the section on Gazprom and Rosneft shows, he and Rosneft (that he also is on the board of) have been outspoken supporters of strong state control. In the words of *Kommersant* "[i]t is generally believed that in Vladimir Putin's opinion, Mr. Sechin's administrative influence is at least as great as that of his official boss".<sup>148</sup> Sechin does not have any experience in the energy business, but has worked as an interpreter (in French and Portuguese) in

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<sup>146</sup> WPS (2004), *The Russian Oil and Gas Report*, Moscow: WPS Monitoring Agency, (Sample).

<sup>147</sup> Ögütçü, Mehmet (2002), 'Attracting Foreign Direct Investment for Russia's Modernization: Battling Against the Odds', *OECD-Russia Investment Roundtable*, St Petersburg, 19 June 2002, p. 5.

<sup>148</sup> Sapozhnikov, Petr and Butrin, Dmitry (2004), 'Damage Control', *Kommersant*, Published: 4 October 2004, Last accessed: 28 July 2005, Internet: <http://www.kommersant.com/page.asp?id=511585>.

Africa for the KGB. He has been a loyal aide of Putin's since 1991 and is considered to be the architect behind the Yukos affair. Reportedly, he has held a grudge against Khodorkovsky for many years and was especially upset when Khodorkovsky implied that Rosneft was a corrupt scheme aimed to benefit powerful insiders, him being one of them.<sup>149</sup>

Viktor Ivanov (aide) and Sergei Ivanov (Minister of Defence) are other hardliners that Putin listens to, even if they are not directly involved in the energy sector. In addition, many Duma deputies have a conservative view. They do not trust foreign intervention on the Russian market and claim that they will 'rob Russia'.<sup>150</sup> The hardliner camp thus has great support in the Duma, which paves the way for strong decisions.

Dmitry Medvedev, until recently the deputy head of the presidential administration, is stated to head the liberal fraction. Sergei Shtogrin, the Deputy Chair of the Duma Budget Committee has also argued heavily against Trutnev's proposals of revoking licences.<sup>151</sup> Andrei Denisov, Russia's Deputy Minister of Foreign Affairs, has fought for the idea that Russia should have a liberalised domestic energy market where companies can compete. In contrast to Putin, he argues for "protection of the legitimate interests of foreign economic operations in the Russian market".<sup>152</sup> German Gref, the Economy Minister, has openly criticised state involvement in the energy sector. As an example, he has stated that the company Rosneft should be privatised.<sup>153</sup> Gref was quoted by the Financial Times saying, "In principle, I don't think that enlarging natural

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<sup>149</sup> Baker, Peter (2004), 'Putin Finding Power in the Pump', *The Washington Post (Reposted at Energy Bulletin)*, Published: 11 August 2005, Last accessed: 28 July 2005, Internet: <http://www.energybulletin.net/1598.html>. It is also interesting to note that the Prosecutor General's, Vladimir Ustinov's, son in 2004 married Sechin's daughter.

<sup>150</sup> Ögütcü 'Attracting Foreign Direct Investment for Russia's Modernization: Battling Against the Odds', p. 5.

<sup>151</sup> WPS *The Russian Oil and Gas Report*,

<sup>152</sup> Denisov, Andrei (2004), 'How the MFA Promotes Russian Business Interests Abroad', *International Affairs (Moscow)*, Vol. 50, No. 4, p. 68.

<sup>153</sup> Ostrovsky, Andrew (2005c), 'Russian Minister Attacks Energy Nationalisation', *The Financial Times*, 12 January 2005, p. 1.

monopolies is a good idea. But in this case, the aim [of liberalising the market in Gazprom shares], is so noble that it justifies the means."<sup>154</sup>

Putin's economic advisor, Andrei Illarionov, also belonged to the liberal camp and it was significant when he became advisor.<sup>155</sup> He has not been fond of pursued policies and has even called the sale of Yuganskneftegaz the "scam of the year" (see chapter four).<sup>156</sup> Igor Ivanov (ex-Foreign Minister) and Anatoly Chubais (RAO UES) also belong to the liberal group.<sup>157</sup> Others are Alexander Zhukov, the Deputy Prime Minister, and Alexei Kudrin the Finance Minister.<sup>158</sup> Also, Igor Shuvalov, an aide to Putin, was against the selling Yuganskneftegaz and argued that if it was to happen, it must be transparent and only take place if Yukos was unable to pay. The Deputy Minister of Energy, Ivan Matyurov, has stated that he believed that foreigners could take part in the auction of Yuganskneftegaz.<sup>159</sup>

Despite the fact that several key figures are liberals, most analysts agree that Putin relies on the hardliners to a greater extent than on the liberals. As *The Economist* notes on the topic of economy, Gref is basically marginalised.<sup>160</sup> This goes for many in the administration. For sure, Sechin and Sergei Ivanov have Putin's ear.

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<sup>154</sup> Ostrovsky, Andrew (2005a), 'Chief Executive Has a Vision for Gazprom: Alexei Miller tells Arkady Ostrovsky about his Global Ambitions', *The Financial Times*, FT Special Report: Russia, 5 April 2005, p. 6.

<sup>155</sup> Kravchenko, Yekaterina (2001), "'The Liberal Madman": Over the Indecisive Premier', *Business in Russia*, No. 116, May-June 2001, p. 13ff.

<sup>156</sup> Ostrovsky 'Russian Minister Attacks Energy Nationalisation', p. 1.

<sup>157</sup> Allison, Roy (2004), 'Strategic Reassertion in Russia's Central Asia Policy', *International Affairs*, Vol. 80, No. 2, p. 280.

<sup>158</sup> Buckley, Neil (2005b), 'Free Market Advocate: German Gref, the Economy Minister, talks to Neil Buckley', *The Financial Times*, FT Special Report: Russia, 5 April 2005, p. 2.

<sup>159</sup> RIA Novosti (2004), "'It Is Not Good" to Sell Yuganskneftegaz, Says Russian Presidential Aide', *RIA Novosti (Reposted at Johnson's Russia List)*, Published: 28 October 2005, Last accessed: 14 April 2005, Internet: <http://www.cdi.org/russia/johnson/8431-11.cfm>.

<sup>160</sup> *Economist* (2005a), 'The Kremlin Repents, Maybe', *The Economist*, No. N/A, 9 April 2005, p. 23.

Olga Kryshtanovskaya has argued that Putin appears to be comfortable with this split within the government and administration.<sup>161</sup> It provides a rich input of opinions and arguments and Putin may weigh the pros and cons of suggested decisions. He has replaced several liberals with hardliners (Kasyanov/Fradkov for example) but not to the extent that he could have (if he really wanted to). Another gain is that the administration can take several policy lines at once. Even if this brings about other problems, mixed signals might be sought after.

It is up for debate in terms of whether Putin is actually pleased. It is not in his nature as a leader to dismiss employees on a regular basis in the same way as Yeltsin did. He prefers continuity. When he dismisses staff, he does it in a rather humble fashion. Putin is probably not keen on having this apparent split, but as long as he manages to balance the groups properly, he appears to prefer to keep it this way instead of creating instability by dismissals. In some ways, it can be seen as a weakness, but it is also a pragmatic approach. President Mikhail Saakashvili in Georgia has taken the opposite approach and basically only has loyalty as the foundation of his cabinet, which has resulted in incoherence, instability and loss of momentum.<sup>162</sup>

### *Interdepartmental Competition*

There are elements of competition and interdepartmental clashes between governmental bodies, for example, when it comes to deciding on issues related to the oil pipeline from Russia's Far East to the Pacific Coast or when the Ministry of Natural Resources decided on abolishing the dual key against the will of other bodies.<sup>163</sup> The processes appear to be about protecting one's own turf. It is thus not based on diametrically opposed views on how best to serve the national interest. As these kinds of decision-making procedures and negotiations are far from transparent and opinions not always explicitly state, an analysis of the process will

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<sup>161</sup> Buckley, Neil (2005e), 'Worries About Concentration of Power', *The Financial Times*, FT Special Report: Russia, 5 April 2005, p. 4.

<sup>162</sup> Larsson, Robert L. (2005a), 'Georgia's Cabinet Carousel: What Goes Around Comes Around', *Central Asia-Caucasus Analyst*, Vol. 6, No. 1.

<sup>163</sup> Fortescue, Stephen (2003), 'The State Versus the Resource Sector: Resource Rent Issues in Russia', *International Political Science Association XIX World Congress*, Durban, South Africa, 30 June 2003, p. 11.

have embedded uncertainties. Given the secretive and non-transparent situation, in combination with the endemic problems with corruption, shadow economy and informal links it is not too bold to assume that it happens to a much wider extent than has been shown here.

When various state structures oppose each other (or third party actors), they usually do it by using the formal bureaucratic procedures such as coordination agreements (*soglasovanie*) or other forms of red tape. Judging from this it is virtually impossible to find conclusive evidence of competition, but the larger pattern suggests that it exists and that the centre of power, i.e. the presidential administration, is not strong enough fully to coerce a specific outcome at every level.

### **A Note on the Russian Energy Strategy from 2003**

“Russia’s Energy Strategy”<sup>164</sup> is a 118-page document that outlines priorities and forecasts for Russia’s energy sector until the year 2020. It replaced earlier versions from 1995 and 2000. The document is divided into ten chapters, namely:

- 1) The goals and priorities of Russia’s energy strategy until the year 2020.
- 2) Problems and major factors of the development of the fuel and energy complex.
- 3) Major tendencies and prognoses of the development perspectives of the Russian economy.
- 4) State energy policy.
- 5) Prospects of demand for Russian energy resources.
- 6) Prospects of development of the fuel and energy complex.
- 7) Regional features of the development of the energy sector.
- 8) Science, technology and innovation policy within the fuel and energy complex.
- 9) Interaction of the fuel and energy complex and the adjacent industry.

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<sup>164</sup> Ministry of Industry and Energy 'Energeticheskaya Strategiiia Rossii na period do 2020 goda [Russia's Energy Strategy until the Year 2020], Utvershdjena no 1234-r, 28 August, 2003.' When the actual document is referred to, it is capitalised, while in all other cases the meaning is basically Russia’s long-term energy policy.

- 10) Expected results and realisation of the system of the energy strategy.

As Michael Fredholm notes, the language of the Energy Strategy is military in its style and character. It speaks about struggle, influence, goals and strategy and when prominent actors, such as Semyon Vainshtok, speak about these issues, it is common to cite military theorists.<sup>165</sup> This can be interpreted as an indication of how energy is perceived and how the processes in the sector develop.

It should nonetheless be read with care. As all official documents of this kind, it is first and foremost a political document. It only shows what it wants to show. Its key role is to be both a statement of the current situation and a manifest of Russia's intentions. In addition, there are forecasts of different kinds, for example production volumes. This has several implications.

First, presented data can be questioned on several grounds. Even if it is not forged, the methodology with which it is compiled differs from western practice. A list of such issues is found in appendix one. Data presented can be regarded as being more exact than it really is (for example by having decimal figures). Statistical data will therefore be awarded a subsidiary role in this report.

Second, forecasts and estimates of reserves are highly politicised and may serve the purpose of trying to attract investments or just follows the Soviet practise of bragging over achievements. Although this does not appear to be the major aspect. Forecasts change quickly and should not be seen as predictions. As an example, the strategy document from 2002 pointed in other directions of gas and oil production than the current one does.

Third, even if the document is detailed in some parts, it is rather vague in others, eg. what the connections are between the state and companies, a topic that often causes concern among foreign observers, should be

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<sup>165</sup> Fredholm *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, p. 3.

like. Naturally, many issues are left out and any hidden agenda must be sought after outside official documents.

Finally, the point of having a strategy document is to provide some sort of stability by providing a hint of intentions that result in greater predictability. The energy strategy cannot be fully compared to the Security Concept in this aspect. The Security Concept ranks above the Energy Strategy and has less detail as it focuses on threats, priorities and goals. However, if one looks beyond the data and forecasts of the Energy Strategy, many of Russia's intentions can be viewed.

When a military doctrine or concept is analysed, it is usually done by comparing the document to empirical evidence in order to confirm what has been stated. By that, intentions and capabilities can be understood. It is similar for an energy strategy. Hence, if certain aspects concerning the intentions stated in the Energy Strategy are compared to information and data found elsewhere. Hence, the security policy aspects of the strategy is more important than the reserves and market forecasts and it must be emphasised that Russia sees its energy sector both as an offensive security policy tool and a bulwark against foreign threats. It also explicitly states "ensuring national security - that is the fundamental task of the energy policy".<sup>166</sup>

Independence is key to Russia. The strategy therefore states that Russia will use its energy policy to avert geopolitical and macroeconomic threats. Russia should not be pressured or object to economic or energy blackmail. As the same time, the strategy emphasises that Russia should be a reliable trade partner.<sup>167</sup> This is a difficult balancing act.

### **Summary and Conclusions**

The importance of the industrial sector is emphasised in the security concept and it can be assumed that future security concepts and doctrines will put more stress on energy security. Energy is closely linked to security and is aimed at promoting economic growth,

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<sup>166</sup> Ministry of Industry and Energy 'Energeticheskaya Strategiiia Rossii na period do 2020 goda [Russia's Energy Strategy until the Year 2020], Utvershdjena no 1234-r, 28 August, 2003.', p. 17.

<sup>167</sup> Ibid., p. 18f.

extending Russia's international influence, and ensuring Russia's economic independence. Energy should extend Russia's economic reach and influence for security reasons, as Russia prefers a situation where it may conduct policy without interference from other actors. The energy strategy states that ensuring national security is the fundamental task of the energy policy. Russia will thus use its energy policy to avert geopolitical and macroeconomic threats in addition to risks of being blackmailed. At the same time, Russia strives to be a reliable trade partner. This intention is true and contradicting behaviour stems from the perception that there are embedded risks of being dependent or integrated. Russia wants to play by the rules but feels that its national security requires it to put limits on the extent of which it can give up independence. Any integration into international structures will thus only go to a point where Russia's independence is not threatened.

Putin is not against private property but private companies cannot take control from the state as the state speaks for the Russian people. The ceding of assets in the 1990s was a mistake that must be reversed. A mixed system where some property is state owned and some is private is best for Russia.

Putin's hard-line view on economic security and energy is not shared by all members of the government or administration. The hardliners include Trutnev, Fradkov, Sechin, Sergei Ivanov and Viktor Ivanov while the liberal soft-liners include Gref, Illarionov (while in office) and Kudrin. This liberal group has much less impact on policymaking. The aggregated Russian perception can thus be stated to be that of Putin, the hardliners and the Energy Strategy. There is a strong harmony between words and deeds. The thesis that Putin allegedly has written on raw materials could be seen as a blueprint for the energy strategy and the policy that is pursued today.

The clash in view on energy and security also reaches into the company boardrooms of The Kremlin-loyal firms (i.e. Gazprom and Rosneft). Putin is probably not comfortable with this split, but feels that stability is prioritised (unlike the actions taken by Yeltsin). It is beyond doubt that the hardliners, especially Sechin and Sergei Ivanov have Putin's ear and

decisions usually fall out their way. Interdepartmental and intradepartmental clashes also exist but appear to be about protecting the one's own turf rather than different views on national interest. Actions are typically taken by using the formal bureaucratic procedures, even if other ways exist.

## 4 Domestic Market Management

**Question:** What are Kremlin's capabilities and how are they utilised in terms of managing the domestic energy sector?

**Approach:** A descriptive survey of some of the tools that can be used when managing the energy sector is made in the chapter. The case of the Yukos and the Khodorkovsky affair serve as examples for further discussion and analysis.

**Main findings:** The state's toolkit is strong and the Kremlin has taken several steps to keep a firm grip on the sector. Largely, marketisation will continue and there will likely be a process of demarcation of areas where either liberalisation or enhanced state control will emerge. Appearingly, regulation concerning strategic core areas will be less liberal, but more apparent.

The Khodorkovsky affair has been about him, his background, political ambitions and unwillingness to submit to the president, while the Yukos affair was about transferring powers and assets to the state. Both affairs connect to Putin's struggle against the oligarchs and attempts to strengthen his and the Kremlin's control over Russia at large. Several negative consequences followed. These types of problems is diminutive compared to the civil unrest that is found elsewhere. The affairs entrenched some of the Kremlin's strategic priorities and the long-term impacts on Russia's reputation as an energy exporter will clearly minute. Other companies do run the risk of sharing Yukos' fate, but the threshold for actions of the same magnitude is rather high.

### Tools for Managing the Market

This section is aimed at outlining a few issues in a rapidly changing energy sector and highlights a few problems facing the actor in the energy market. Given rapid changes, exact data on tariffs, etc., should not be taken as fixed.<sup>168</sup>

#### *Pipeline Ownership*

By controlling the entire oil and gas pipeline (and electricity) grid, the state has a strong lever in controlling energy flows. Transneft has by and large been working at full capacity during the last years and has had problems with bottlenecks.<sup>169</sup> Few additional domestic pipelines are planned and Transneft's murky financial situation gives room to question the feasibility of undertaking any major project. It is accurate that a number of local pipelines are partly privately owned, but companies that are controlled by the state in turn, own parts of these pipelines. One privately owned trunk pipeline is the CPC Pipeline between Kazakhstan and Novorossiysk,<sup>170</sup> but several new ones are unlikely in the foreseeable future and new laws would presumably have to be adopted. Foreign firms thus have no opportunity of attaining access to the pipeline grid without approval from the Russian state. Similarly, this is the situation in the gas grid that is handled by Gazprom.

This is not something that only affects foreigners. Also small domestic producers of natural gas are forced to sell their gas to Gazprom to lower prices than offered by the local customers.<sup>171</sup> In an international context, access to spare capacity is a key issue. Russia has not yet ratified the

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<sup>168</sup> For a good overview of the business climate for foreign investors, see PriceWaterhouseCoopers (2005), *Doing Business in the Russian Federation 2005* (Moscow: PriceWaterhouseCoopers) and concerning the gas market, Stern's book is a good introduction, Stern *The Future of Russian Gas and Gazprom*.

<sup>169</sup> Railway transport has also taken, during the last couple of years, a greater share of energy exports. EIA (2005), 'Russia: Country Analysis Brief', *Energy Information Agency (EIA)*, Published: February 2005, Last accessed: 15 December 2005, Internet: <http://www.eia.doe.gov/emeu/cabs/russia.html>.

<sup>170</sup> Fredholm *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, p. 30.

<sup>171</sup> Shmal, Gennady (2005), 'Gas Prices Must See a Gradual Increase', *Moscow News*, 30 November - 6 December, p. 4. See also the section on Gazprom in the chapter of the Kremlin and the TEK in addition to the chapter Russia's Energy Relations.

Energy Charter Treaty that tackles the problem, while all of the Central Asian states have. As long as Russia does not ratify it, it becomes more difficult for other producers to deliver energy to Europe. This reluctance may prove to be a boomerang if the Central Asian states find it easier to export its gas southwards and eastwards instead of through Russia.

### *Oil Exports Quotas*

There is an export quota for Russian oil. A maximum share of 38 per cent of extracted oil for each company may be exported by pipeline. Permission to export is specified by the Governmental Commission for Oil and Gas Pipeline Use and is based on the actual supply of the previous quarter. Basically, access is raised for those companies that are above targets and lowered for those that are below.<sup>172</sup> One of the purposes of this quota is to prevent all oil from being exported (especially at times of high international prices) and securing access for domestic consumers. Oil companies thus have limitations to what they can do with extracted oil. In reality, it is not a substantial problem as only Yukos has been close to exporting 38 per cent. Even if it becomes a problem for some companies, there are several unofficial ways to tackle the problem, such as by railway transport and illegally/legally selling oil to companies that in turn export it.

### *Problem with Tenders*

The way of handling tenders is continuously changing and often disturbs foreign firms. They are often rigged in one way or another in favour of state controlled firms. For example, Sevneft won the tender for the Gamburtseva oil deposit in Timan-Pechora. It won by paying a price of \$US7 million (as determined by the Ministry of Natural Resources and the Nenets Committee – the local administration). Allegedly, there had been US offers of about \$US100 million, but a Russian company was given priority.<sup>173</sup> Russian concession rights have also had an ostensible 'dual key' that refers to agreements that both federal and regional authorities must grant. A committee headed by Dmitry Kozak (now Putin's appointee in the South Federal District) suggested that the dual

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<sup>172</sup> Vahtra *Russian Oil Sector Today and Tomorrow: The Implications of the Case of OAO Yukos*, p. 30.

<sup>173</sup> Fortescue 'The State Versus the Resource Sector: Resource Rent Issues in Russia', p. 1.

key would be removed and it subsequently was.<sup>174</sup> The result is that the region that is concerned by the concession chiefly loses its power to affect the outcome and additional powers are transferred to Moscow.

### *Secrecy and Lack of Transparency*

If greater transparency is seen as a way of attracting foreign capital, it is problematic that Yukos, which spearheaded the development towards greater transparency and Western-style methods of auditing, has been trodden. Lack of transparency is often pointed out as a problem for foreign firms. This is indeed a problem for investors that seek information on assets. While the transparency around certain metals, such as palladium, have increased somewhat,<sup>175</sup> the opposite has occurred for hydrocarbons since Putin on 11 November 2003 approved of changes to the law "On State Secrets". The consequence was that data on reserves, methods, locations, extraction amounts, production and consumption of fossil fuels were made state secret.<sup>176</sup>

Detailed maps have traditionally been secret in Russia, and particularly for those that concern strategic resources: It is problematic for the foreign oil companies, as drilling for oil requires maps of resolution higher than 1:2500.<sup>177</sup> As a result, even The Kremlin-sanctioned foreign operators, such as TNK-BP, have enormous problems in obtaining usable maps. One case demonstrates that maps received from the authorities had details on latitudes and longitudes removed and the grid diverged from the true north. This type of secrecy is promoted by the FSB even if free online satellite imaging software makes it possible to look at the exact location. Foreign business executives partly interpret this as a way for the state to tackle unemployment since numerous cartographers must be employed by the foreign firms. It is also a way for the security structures to keep influence over society and, allegedly, they try to pressure foreign

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<sup>174</sup> Ibid., p. 5f.

<sup>175</sup> Leijonhielm and Larsson *Russia's Strategic Commodities: Energy and Metals as Security Levers*, pp. 98-101.

<sup>176</sup> Fredholm *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, p. 6.

<sup>177</sup> Panov, Andrei, *et al.* (2005), 'The FSB Hides the Details: Foreigners Forbidden to Examine Russia Too Closely', *Vedomosti (Reposted at Johnson's Russia List)*, Published: 24 October 2005, Last accessed: 24 October 2005, Internet: <http://www.cdi.se/russia/johnson>.

firms to replace its foreign managers with Russians, as they are more “beholden to pressure”.<sup>178</sup> The FSB has especially targeted TNK-BP as many of its subsidiaries are headed by foreigners and several operations have been suspended.<sup>179</sup>

Yet, it can be stated that the level of transparency in Russia is still greater than in most OPEC states<sup>180</sup> and the government cannot bear the full responsibility for the over-all level of closure. Several of the leading companies in the Russian energy market are not too keen on openness and corporate transparency. Transneft in 2002 took a decision to become less transparent and refrained from issuing a full financial report. Part of the explanation is that Transneft together with Transnefteprodukt and Gazprom were included on the list of ‘Strategic Enterprises and Strategic Joint Stock Companies’. This list was not made public in full, but as Michael Fredholm has noted, in 1998 other companies, such as Lukoil, Sibur, Slavneft and UES appeared on the list. It is not unlikely that these companies are among the over 1000 enterprises that later appeared on the list.<sup>181</sup>

As a part of the liberalisation, Gazprom has tried to improve its financial transparency within several areas since 2003,<sup>182</sup> but the core issues of connections to the state, ownership of subsidiaries, and links to state bodies are yet to be improved. Without this knowledge, it is impossible for investors and analysts to know whether a company has sufficient financial backing or if there are conflicts of interests. The problems are overwhelming in the closely connected banking sector. Standard and Poor's has assessed the Russian banks' level of transparency and found that the 30 most transparent firms are refraining from disclosing about 84

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<sup>178</sup> Kramer, Andrew E. (2005), 'In Russia, Lots of Latitude in Getting a Good Map', *The International Herald Tribune*, 1 December 2005.

<sup>179</sup> Panov, *et al.* 'The FSB Hides the Details: Foreigners Forbidden to Examine Russia Too Closely'.

<sup>180</sup> Morse, Edward L. and Richard, James (2002), 'The Battle for Energy Dominance', *Foreign Affairs*, Vol. 81, No. 2, p. 30.

<sup>181</sup> Fredholm *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, p. 6, and endnote 66 on p. 40.

<sup>182</sup> Oxford Analytica (2003), 'Gazprom Improves its Financial Transparency', *Oxford Analytica*, Published: 17 November 2003, Last accessed: 2 December 2005, Internet: <http://www.oxan.com>.

percent of their capital. The state-run Vneshtorgbank is apparently the worst in this sense.<sup>183</sup>

### *Licensing and the Law on Subsoil Resources*

Mainly all subsoil resources belong to the state. Companies wishing to explore and extract seek and are given licences to extract the resources (that they subsequently are allowed to keep and sell) according to the law "On Subsoil Resources" (*Zakon o nedrakh*).<sup>184</sup> If certain conditions are not met, for example that the deposits are not developed, the licence can be revoked. In the first half of 2001, this happened 37 times and another 42 licence holders were put on notice.<sup>185</sup> In the spring of 2005, it was yet announced that 40 new fields would be open for exploration and possibly another 30 in East Siberia.<sup>186</sup> The problem lies in that licensing has been used in a political context against non-state loyal firms. One example is that Slavneft's licence was about to be revoked, but as soon as Rosneft bought Slavneft, the revoking procedure was abolished.<sup>187</sup> Whether there were legitimate reasons for this or not is difficult to say. Even Lukoil has been threatened by the Natural Resources Minister that the licences that once had been given might be revoked unless Lukoil started extraction in three months time.<sup>188</sup> This is one example of the duality of the Russian energy market. Lukoil can be seen as a pro-Kremlin company, but it does not mean that it has a *carte blanche* to do what it wants.

In 2004, a law on licences was introduced. The new method of issuing licences was meant to introduce civil legislation principles, i.e. contracts between the government and investors that are expected to promote

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<sup>183</sup> Kochetygova, Yulia, *et al.* (2005), *Issledovanie informatsionnoi prozrachnosti rossiiskikh bankov: nedostatochno effektivnaya praktika raskritiya informatsii* [*Transparency and Disclosure by Russian Banks: Disclosure Practices of Russian Banks Currently Dismal*], Moscow: Standard and Poor's, 25 October 2005.

<sup>184</sup> Valdez, Marla, *et al.* (2005), 'Comparative Mineral Law of the Russian Federation and Central Asian Republics', *Centre for Energy, Petroleum and Mineral Law and Policy (CEPMLP) Internet Journal*, Vol. 15, No. 2.

<sup>185</sup> Fortescue 'The State Versus the Resource Sector: Resource Rent Issues in Russia', p. 9.

<sup>186</sup> Bloomberg 'East Siberian Oil Fields Need \$ 20bn Investment'.

<sup>187</sup> Fortescue 'The State Versus the Resource Sector: Resource Rent Issues in Russia', p. 9.

<sup>188</sup> Moscow Times (2005), 'News in Brief', *The Moscow Times*, 26 January - 1 February 2005, p. 9.

'marketisation'. The new law would not have any impact on ongoing operations (but was only meant to cover new relationships and undistributed resources). The share of undisturbed deposits is however low (8 per cent for oil and 12 per cent for gas).<sup>189</sup> Essentially, resources are to remain state assets until sold. Mining and production companies were being granted concessions by the state on the basis of costs and added profit margin. Production companies have not met it with great enthusiasm as it is seen to give additional powers to the authorities.<sup>190</sup> What is most important with this new law is that there is a limit of foreign ownership (see below).

### *Privatisation Programmes*

In general, Putin has stated that several existing enterprises will be privatised. He has also asked Prime Minister Mikhail Fradkov to consider amendments to (Article 181) the Russian Civil Code and submit the bill to the State Duma for approval. According to Putin, 3,000 joint-stock companies and 8,000 state-owned concerns would be privatised in the future. "Natural monopolies and the banking sector will also be affected by privatization", he states.<sup>191</sup> In the spring of 2005, the Duma considered a draft law 'On Trunk Pipelines' that stipulated a maximum 20 per cent quota of foreign ownership. Putin's party United Russia was prepared to support it and the Kremlin was also reportedly positive about it.<sup>192</sup>

In spite of what has been stated above and in the following chapter, these are most likely honest intentions, but it is doubtful whether the privatisation within the strategic sectors will be far-reaching. In all probability, the state keeps its grip on the pivots that ensures full control of energy flows and subsoil resources. This can be interpreted as a manner of attracting investments while at the same time maintaining state control.

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<sup>189</sup> Milov *Russian Energy Sector and its International Implication*, p. 13.

<sup>190</sup> Vahtra *Russian Oil Sector Today and Tomorrow: The Implications of the Case of OAO Yukos*, p. 29.

<sup>191</sup> RosBusinessConsulting (2005 |), 'Putin: Russia Gears up for More Privatization', *RosBusinessConsulting*, Published: 11 April 2005, Last accessed: 14 April 2005, Internet: [http://top.rbc.ru/english/index.shtml?/news/english/2005/04/11/11123138\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/news/english/2005/04/11/11123138_bod.shtml).

<sup>192</sup> Milov *Russian Energy Sector and its International Implication*, p. 14.

### *Gas Prices*

Gas prices vary strongly between consumers, as they are dependent on negotiated contracts. In 2004, the domestic price was \$US28/thousand cubic meters (tcm). That price has also been given to Belarus and a few other CIS states at times of friendly relations.<sup>193</sup> These figures are currently changing. Ukraine, for example, was told to pay \$US230/tcm to Gazprom and further discussion of the foreign dimensions is found in chapter six. Price discrimination is to some extent related to the distance or bulk discounts, but may also have political foundations.

The gas price has been an issue of concern when it comes to the needs of the domestic sector and the international dimension.<sup>194</sup> Russia entering the European and Asian LNG market (which is not plausible in the short-term perspective) will have a strong impact on LNG prices.<sup>195</sup> Gas prices are also a main topic in the ongoing WTO negotiations. One condition for WTO accession has been that Russia must raise domestic prices (already in 2006) to at least \$US40-41/tcm and to \$US59-64/tcm by 2010.<sup>196</sup> The rise has started. Domestic prices are hence expected to increase by 14 per cent in 2006, according to governmental officials, and domestic sales would then start to be profitable. Also, electricity and railway transport would get higher fees.<sup>197</sup> The agreement in May 2004 with EU on WTO increase of gas prices has taken a small step,<sup>198</sup> but it is still smaller than what the outline in the energy strategy suggests.<sup>199</sup> The plan is that industrial users will be the first to be subject to the higher prices.

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<sup>193</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 13.

<sup>194</sup> For an excellent summary of gas prices, see Stern *The Future of Russian Gas and Gazprom*, p. 43ff.

<sup>195</sup> Hartley, Peter R. (2004), 'Russian Natural Gas Supply: Some Implications for Japan', *The Energy Dimension in Russian Global Strategy* (Houston: The James A. Baker III Institute for Public Policy of Rice University), p. 29.

<sup>196</sup> Milov *Russian Energy Sector and its International Implication*, p. 4.

<sup>197</sup> RosBusinessConsulting (2005g), 'Gas Prices May Grow 14 Percent Next Year', *RosBusinessConsulting*, Published: 15 June 2005, Last accessed: 16 June 2005, Internet: <http://www.rbcnews.com/free/20050615195146.shtml>.

<sup>198</sup> Ahrend and Tompson *Russia's Gas Sector: The Endless Wait for Reform?*, p. 10.

<sup>199</sup> Ministry of Industry and Energy 'Energeticheskaya Strategiya Rossii na period do 2020 goda [Russia's Energy Strategy until the Year 2020], Utvershdjena no 1234-r, 28 August, 2003.', p. 32.

Higher gas prices are by many in Russia seen as a prerequisite for a modernisation of the sector. Higher prices would increase efficiency and reduce the current waste. This would also indicate that larger amounts of gas could be exported and pay for further investments. At the same time, Gazprom does not want to sell gas domestically as it loses money from it. The state is supposed to secure domestic supply by regulating exports – this is how Gazprom's monopoly has been justified.<sup>200</sup> There are thus opposing ideas of what to do with the market. Even the energy strategy states that socially important actors must be guaranteed energy, but an increasing proportion of domestic customers can be expected to have to pay for its gas (and electricity). Presumably only the most important entities, such as strategically important military consumers or socially unstable regions, will be exempted from payment demands or cut-offs. This protective shield held by the Russian state is not appreciated by energy companies and conflicting agendas are present. Gazprom, for example, already by 1998 started to use cut-offs to domestic customers that did not pay their bill (the number of incidents rose from 50 in 1997 to 2,230 in 1998).<sup>201</sup>

### *Oil Prices*

Russian oil prices follow international oil prices to some extent, but have lower quality and are somewhat cheaper. In 2004, the wellhead price in Russia was \$US11/barrel with a domestic price of about 25 per cent of the average international price depending on quality.<sup>202</sup> The price on Russian crude oil that is exported is \$US1-2 less than international prices. There are at least two types of subsidies embedded in the energy price. One is seen as a regional subsidy dating back to 1997 and it is based on the distance to the wellhead. The second is a strong subsidy on gas to households as they pay less than industries do.<sup>203</sup> Prices are mostly set by the international market, but in the fall of 2005, Prime

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<sup>200</sup> Ahrend and Tompson *Russia's Gas Sector: The Endless Wait for Reform?*, p. 20.

<sup>201</sup> Stern *The Future of Russian Gas and Gazprom*, p. 49.

<sup>202</sup> For a longer comment on prices and its determinant factors, see: Ahrend and Tompson *Russia's Gas Sector: The Endless Wait for Reform?*, p. 23ff.

<sup>203</sup> *Ibid.*, p. 9.

Minister Fradkov stated that the prices on fuel oil might be regulated in order to handle the problem in the Far East for the upcoming winter.<sup>204</sup>

The international energy debate has since 9/11 covered the topic of a purported 'terrorism premium', an additional cost to each barrel of oil that can be explained by the higher level of insecurity stemming from terrorism. This is a question of control costs versus damage costs. From a US point of view it can be seen as the marginal external cost of maintaining military capability for safeguarding access to Persian Gulf oil exports (i.e. an implied subsidy of \$US 0.35-1.05/gallon of petroleum equivalents.<sup>205</sup> The existence and explanation is debatable, but no matter the case – it is beneficial for Russia as oil prices rise, while the risks for terrorist attacks against infrastructure in Russia are very small, (if certain parts of the Northern Caucasus are excluded).

The so-called 'Asian premium', the extra cost for each barrel that certain Asian states must pay for oil imports from the Gulf, is about \$US1.5/barrel above world market prices<sup>206</sup> and has had a 13 year average of approximately \$US1.02/barrel. Most analysts agree that it increases over time, is not temporary, and that it has a negative impact on, for example, China's competitive power as it in principle transfers \$US5-10 billion per year to producing countries.<sup>207</sup> The explanation for its existence has been that the conditions for it exist, and that Saudi Arabia has decided to take advantage of it. Some analyses suggest that neither Russia nor any non-Middle East oil producer has the strength to abolish Saudi Arabia's possibility to apply it.<sup>208</sup> Russian exports do have an effect on world market prices and to some extent also on the Saudi

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<sup>204</sup> RosBusinessConsulting (2005y), 'PM: Government May Regulate Fuel Oil Prices', *RosBusinessConsulting*, Published: 8 November 2005, Last accessed: 8 November 2005, Internet: [http://top.rbc.ru/english/index.shtml?/news/english/2005/11/08/08092327\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/news/english/2005/11/08/08092327_bod.shtml).

<sup>205</sup> Owen 'Oil Supply Insecurity: Control versus Damage Costs', p. 1881.

<sup>206</sup> Umbach, Frank (2004a), 'Europe's Energy Non-Policy', *Internationale Politik (Transatlantic edition)*, No. 4.

<sup>207</sup> Ogawa, Yoshiki (2004), 'The Asian Premium and Oil and Gas Supply from Russia', *The Energy Dimension in Russian Global Strategy* (Houston: The James A. Baker III Institute for Public Policy of Rice University), p. 1f.

<sup>208</sup> Jaffe, Amy Myers and Soligo, Ronald (2004a), 'The Future of Saudi Price Discrimination: The Effect on Russian Production', *The Energy Dimension in Russian Global Strategy* (Houston: The James A. Baker III Institute for Public Policy of Rice University), p. 26.

price discrimination. If it is to have an impact in the coming years, higher Russian oil production is necessary, according to most analyses.<sup>209</sup> This is one explanation why closely integrated infrastructure, joint ownership and long-term supply contracts are very advantageous for China in its relations with Russia (and other oil producers). It is also a reason why other net-consumers must be prepared to compete for access to resources by the same means as China and India.

### *Taxes, Duties and Tariffs*

There are several taxes on energy in Russia.<sup>210</sup> In February 2004, the Government raised the tax on production of oil (due to high oil prices) when it started to calculate it as an estimate of roubles per ton multiplied with a coefficient for world market prices (which proportionally gives a high domestic price).<sup>211</sup> In actual money, the tax has been between US\$30 and 35 per ton.<sup>212</sup> The Ministry of Energy also suggested in 2004 with regard to depleted fields, far away from pipelines and that produce modest amounts, that the producers should pay lower tax than elsewhere.<sup>213</sup> The result would be \$US6 billion superfluous in tax income for the state (as it would result in increased production worth of \$US7.5 billion and a lower profit of only \$US1.5 billion). The problem is that it punishes efficient companies. According to a Troika Dialog analyst, this would drop the margins for companies by 11-12 per cent. Yukos, which together with Sibneft have been one of the most efficient firms, has lobbied for a flat tax.<sup>214</sup> Every second month Russia's export duties are re-calculated on the basis of Russian oil and the world market. In June 2005, the duties reached a new level at \$US102.6 per ton,<sup>215</sup> but were

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<sup>209</sup> Ibid., p. 16.

<sup>210</sup> For a longer comment on Russian energy taxes, see: Olcott 'Vladimir Putin and the Geopolitics of Oil', p. 25, and Stern *The Future of Russian Gas and Gazprom*, p. 56.

<sup>211</sup> RIA Novosti 'Russia's Energy Sector: Priorities Remain'.

<sup>212</sup> Vahtra *Russian Oil Sector Today and Tomorrow: The Implications of the Case of OAO Yukos*, p. 23f.

<sup>213</sup> Ibid., p. 23f.

<sup>214</sup> Ibid., p. 24.

<sup>215</sup> RosBusinessConsulting (2005}), 'Russia Introduces Record Oil Export Duty Today', *RosBusinessConsulting*, Published: 1 June 2005, Last accessed: 1 June 2005, Internet: <http://www.rbcnews.com/free/20050601095726.shtml>.

expected to rise to some \$US136 per ton.<sup>216</sup> By August 2005 the duty had risen to a record high \$US140,<sup>217</sup> and is constantly changing.

Most energy companies have utilised various 'internal offshore-regions' (i.e. Mordovia, Kalmykia and Chukotka) in order to dodge profit tax. This possibility was nonetheless thwarted by the government after a new law on capital flight, a new VAT-regime and some custom innovations to promote refined products were introduced after 2003.<sup>218</sup> Thanks to these internal offshore, Yukos, Sibneft and TNK-BP report to have paid only 13-15 per cent in 2002 (as compared to the standard rate of 24 per cent at the time).<sup>219</sup> Putin's view is that a 50-50 percent split of excess oil profit between government and companies is reasonable. Some analysts claim that 12 per cent in profit tax is necessary for getting capital to stay.<sup>220</sup> There are more problems concerning taxes than this in Russia and even Arkady Dvorkovich, Putin's aide and head of the expert department of the presidential administration, agrees that some of the taxes are a burden.<sup>221</sup> The plan is, according to Prime Minister Fradkov to cut the VAT from 18 percent to 13 (previously it was 20 per cent) and the rationale would be to boost growth.<sup>222</sup>

Much of the complaints from Russian companies relate to tariffs and duties on energy exports. Andrei Sharonov, the First Deputy Minister of the Economic Development and Trade Ministry, claims that one of the

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<sup>216</sup> RosBusinessConsulting (2005x), 'Oil Exports Duties to Hit New Record High', *RosBusinessConsulting*, Published: 29 April 2005, Last accessed: 2 May 2005, Internet: <http://www.rbcnews.com/free/20050429164036.shtml>.

<sup>217</sup> RosBusinessConsulting (2005~), 'Russia Raises Export Duties on Oil Products', *RosBusinessConsulting*, Published: 26 July 2005, Last accessed: 27 July 2005, Internet: [http://top.rbc.ru/english/index.shtml?/news/english/2005/07/26/26180158\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/news/english/2005/07/26/26180158_bod.shtml).

<sup>218</sup> Barges, Inessa (2004), 'State Takes Offensive: Analysis - Russia Prepares to Strip Oil Companies of their Super-profits', *Russian Petroleum Investor (World Trade Executive)*, Last accessed: 15 February 2005, Internet: <http://www.wtexec.com/RPIStateOffensive.html>.

<sup>219</sup> Vahtra *Russian Oil Sector Today and Tomorrow: The Implications of the Case of OAO Yukos*, p. 23.

<sup>220</sup> *Ibid.*, p. 24.

<sup>221</sup> Moscow News (2004), 'Putin's Aide Opposes Further Tax Increases in Russian Oil Sector', *Moscow News (Reposted at Alexander's Gas and Oil Connections)*, Published: 25 November 2004, Last accessed: 23, Internet: <http://www.gasandoil.com>.

<sup>222</sup> Ministry of Trade and Economic Development (2005b), 'Russian Cabinet Considers Slashing VAT Rate', Published: 10 February 2005, Internet: <http://www.gasandoil.com>.

problems of calculating a reasonable gas transmission tariff rate is the non-transparency of gas transmission costs.<sup>223</sup> Hence, he puts the blame on Gazprom. When it comes to oil tariffs, they have been decided by the now abolished Federal Energy Commission (FEK) and were meant to:

*[...] cover for the economically feasible expenses, formation of planned net profit necessary for the production program implementation, and payment of taxes in accordance with Russian legislation.*<sup>224</sup>

Transneft states that its tariffs are not connected to oil prices, but instead to electricity prices (as that is about 17 per cent of its expenses) and of metal prices, and calls for annual changes in order to smooth inflation.<sup>225</sup> It is worth underlining that even if the price for oil paid by foreign customers follows world market prices, Russia can use tariffs for price differentiation in the same way as it does for gas. For example, there are lower tariffs for CIS states than for other customers. On the border to Odesa in Ukraine, tariffs are for examples 1.3 times lower than for Western customers, 2.2 times lower at the Western borders, 2.1 times lower in Latvia and 3 times lower to Lithuania.<sup>226</sup> Thus, prices and tariffs can be utilised as both carrots and sticks in Russia's foreign relations.

### *Further Obstacles for Foreign Investors*

The Russian state has recaptured its influence in several areas and set strong limitations on what foreign firms can do. The Minister of Natural resources even stated in February 2005 that foreign firms should not be allowed to bid for natural resources projects of any type.<sup>227</sup> In April 2005, he stated that there are some possibilities for foreign firms in little explored locations, but the closely located deposits Russia wants to

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<sup>223</sup> Reznik, Irina (2004), 'Miller Led Gazprom's Restructuring', *Vedomosti (Reposted at Gazprom)*, Published: 16 March 2005, Last accessed: 21 March 2005, Internet: <http://www.gazprom.com/eng/articles/article11003.shtml>.

<sup>224</sup> Transneft (2005b), 'Tariffs', *Transneft*, Published: N/A, Last accessed: 21 March 2005, Internet: [http://www.transneft.ru/Tariffs/Tariffs\\_en.asp](http://www.transneft.ru/Tariffs/Tariffs_en.asp).

<sup>225</sup> Koptubenk, Dmitriy (2004), 'Government Should Say if the Country Needs the Eastern Pipeline', *RosBusinessConsulting (Reposted at Transneft)*, Published: 14 December 2004, Last accessed: 21 March 2005, Internet: <http://www.transneft.ru/press/Default.asp?LANG=EN&ATYPE=9&PG=0&ID=7345>.

<sup>226</sup> Transneft 'Tariffs'.

<sup>227</sup> Stratfor (2005), *Global Market Brief, 14 February 2005*, Stratfor.

keep.<sup>228</sup> He also stated that in 2005, 250 new licence auctions would be held and that 90 per cent would be open to foreigners.<sup>229</sup> This appears a generous prospect, but it is possible that foreigners will only be invited for the less attractive deposits. The US has not been keen on the new law and President Bush has even urged Russia to clarify the bill.<sup>230</sup>

The new law on subsoil resources forbids foreigners to own more than 49 per cent of Russian energy companies. 49 per cent is considered to be enough for most actors, as slightly smaller actors such as Tatneft or Bashneft are not really affected.<sup>231</sup> Others, such as TNK-BP, see it as a problem.<sup>232</sup> Laws are however not necessary to keep foreigners away. This is shown by an incident in 2002 when Slavneft was to be privatised, the Chinese National Petroleum Company was "strongly advised" by Russia not to take part in the auction (and never did).<sup>233</sup>

Exxon-Mobil has offered to buy a 38 per cent share of Yukos, but this was thwarted by Putin at the same time as Exxon-Mobile's explorations rights for the project Sakhalin III was taken away.<sup>234</sup> Consequently, Exxon-Mobile considers itself to have been cheated by the Russian authorities. As Sakhalin is a remote location and very hard to explore due to the harsh climate, there is no logic in the Russian actions and statements, it claims.<sup>235</sup> In September 2004, Trutnev further warned that further licence withdrawals might come about for the Kovytko area. Licences granted earlier could be given to Gazprom/Rosneft instead of to foreigners.<sup>236</sup>

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<sup>228</sup> Ostrovsky, Andrew and Gorst, Isabel (2005), 'TNK-BP Chief Attacks Russia's Uncertain Investment Climate', *The Financial Times*, 13 April 2005, p. 4.

<sup>229</sup> Pustilnik, Marina (2005a), 'Making the Wrong Excuses', *Moscow News*, 23 February - 1 March 2005, p. 8.

<sup>230</sup> Moscow News (2005f), 'US Asks Russia to Clarify Bill Limiting Foreign Access to Oil and Gas Deposits', *Moscow News*, Published: 25 October 2005, Last accessed: 27 October 2005, Internet: <http://www.mosnews.com/news/2005/10/25/kremlinmineral.shtml>.

<sup>231</sup> Olcott 'Vladimir Putin and the Geopolitics of Oil', p. 25.

<sup>232</sup> Grizodubova, Tina (2005a), 'Foreigners Banned from Developing Russia's Rich Natural Resources', *Moscow News*, 16-22 February 2005, p. 9.

<sup>233</sup> Milov *Russian Energy Sector and its International Implication*, p. 14.

<sup>234</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 51.

<sup>235</sup> Ostrovsky and Gorst 'TNK-BP Chief Attacks Russia's Uncertain Investment Climate', p. 4.

<sup>236</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 51.

The TNK-BP merger is essentially the only large merger that has been successful (as it had Putin's approval) but from Russia's point of view, it is problematic as it gave foreign executives access to information on Russia's reserves, which are state secrets.<sup>237</sup> At the same time as the new law on foreign ownership was adopted, TNK-BP faced massive tax charges. Robert Dudley, the chief executive, stated that the "significance of this [tax claim] goes far beyond our company".<sup>238</sup> He also bemoans about the conditions for foreign firms in Russia. It is hard to bring in foreign managers and hard to navigate or start operations.<sup>239</sup>

According to Yuri Trutnev's, the Minister of Natural Resources, statement on 10 February 2005, foreign firms or consortia (that are more than 50 per cent foreign owned) should hence not be allowed to bid for natural resources projects of any type. This idea has been, according to inside sources of the Ministry for Natural Resources, planned for at least a year and the perception is that foreigners are stealing Russia's minerals.<sup>240</sup> On 18 October 2005, Trutnev explained that the Mineral Resources Agency would compile a new list on 'strategic reserves'.

The criteria for the new list are three-fold. Firstly, it depends on content. Oil, gas, uranium, diamonds and pure quartz are a few examples of strategic materials. The second criterion concerns the size of the reserves. This means that only deposits over 150 million tons of oil, or 1 trillion cubic meters of gas, would be included (offshore deposits excluded). Finally, the geographic location would be a criterion, which means that deposits in the "defence sector" will be seen as strategic if the "interest and security of the country" is affected.<sup>241</sup>

The new list would only cover deposits that are now unallocated, or if a contractor gives up the concession right. When experts have commented

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<sup>237</sup> WPS *The Russian Oil and Gas Report*.

<sup>238</sup> Ostrovsky and Gorst 'TNK-BP Chief Attacks Russia's Uncertain Investment Climate', p. 4.

<sup>239</sup> *Ibid.*, p. 4.

<sup>240</sup> Stratfor *Global Market Brief*, 14 February 2005.

<sup>241</sup> RosBusinessConsulting (2005e), 'Foreigners Welcomed to Russia's Oil Sector', *RosBusinessConsulting*, Published: 20 October 2005, Last accessed: 20 October 2005, Internet: <http://www.rbcnews.com/komment/komment.shtml>.

on the proposed bill, they have noted that if the second criterion refers to 'proven reserves' there are no such deposits. Possibly, there would be some in Eastern Siberia or located offshore. The rationale of the initiative, which is among Russia's more liberal bills, is found in the insight that Russia is plagued by chronic under-investments.<sup>242</sup> It was finally adopted on 1 November 2005 together with the bill on foreign ownership.

The US has often stated that it is worried over the investment climate in Russia. US Ambassador Alexander Vershbow claimed that real investments projects the last three years in the US-Russian energy dialogue could be counted on the fingers of one hand.<sup>243</sup> Since the US Jackson-Vanik provision of 1974<sup>244</sup> links US-Russian trade to Russia's human rights accord, Russia is not seen as a free market economy by the US and President Bush has called for the Congress to lift it, but this had not been made.<sup>245</sup>

The question lies in whether these limitations and problems actually have an impact. Valery Nesterov at the Troika Dialog believes that regulating influx on money is not a problem,<sup>246</sup> but others think that it is a message to foreigners. France's Total and ConocoPhillips have stated that they would 'consider' planned investments in Russia.<sup>247</sup> 'Consider' is a suitable word in this context as a withdrawal from the market is unlikely for all foreign firms. The prospects of profits are too high to leave unexplored. Possibly, foreign firms become more cautious of which companies they choose to interact with. Lukoil announced in July 2005 that it would conduct further joint ventures with ConocoPhillips over the Naryanmarneftegazoil field in the Timan-Pechora region. Lukoil would have a 70 per cent share while ConocoPhillips would hold

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<sup>242</sup> Ibid.

<sup>243</sup> Ostrovsky and Gorst 'TNK-BP Chief Attacks Russia's Uncertain Investment Climate', p. 4.

<sup>244</sup> White House (2001), 'Jackson-Vanik and Russia Fact Sheet', *The White House*, Published: 13 November 2001, Last accessed: 1 July 2005, Internet: <http://www.whitehouse.gov/news/releases/2001/11/20011113-16.html>.

<sup>245</sup> Kirchgaessner, Stephanie (2005), 'Putin's Critics Call on Bush to get Tougher', *Financial Times*, A, 18 February 2005, p. 2.

<sup>246</sup> Grizodubova 'Foreigners Banned from Developing Russia's Rich Natural Resources', p. 9.

<sup>247</sup> Pustilnik 'Making the Wrong Excuses', p. 8.

a 30 per cent share. It is meant to be managed proportionally to these shares.<sup>248</sup>

At the end of 2005, however, a leap forward was taken by Russia in terms of liberalising the shares of Gazprom. Earlier, domestic trade mostly took place at the small stock exchange in St. Petersburg and foreigners were only allowed to buy Gazprom derivatives (depository receipts based on shares) abroad. There was also a law stating that foreigners could own a maximum quota of 20% of Gazprom's authorized capital. This is changing. Shares may now be traded on the RTS and MICEX stock exchanges and there will be no restrictions to foreign ownership.<sup>249</sup> The reason why the restrictions were imposed was that the state wanted to have control over Gazprom. This reason is still valid, but since it was imposed, the state has increased its direct ownership from 38 to 51 per cent. Control over Gazprom thus remains in the Kremlin's hands.<sup>250</sup>

### *Investment Regimes are Standing Idle*

As this report illustrates, foreign investors in the Russian TEK are met with many obstacles, unpredictable changes of the regulatory framework and politicised decisions aimed at promoting national interest at the expense of the emerging market economy. In order to attract foreign investment in politically unstable environments, two models have been employed internationally for providing long-term stability, namely by contractual agreements such as a licence/concessions-based system usually called 'tax/royalty agreements' (TRA) or by the 'production sharing agreements' (PSA).

A TRA regime is founded in the idea of giving a producer the right to extract oil for which it pays a licence fee, royalty and tax (usually defined as a percentage of gross revenues). The state basically dictates all financial terms and the producer has to accept the contract. This model is

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<sup>248</sup> RosBusinessConsulting (2005r), 'Lukoil and ConocoPhillips Set up Joint Venture', *RosBusinessConsulting*, Published: 1 July 2005, Last accessed: 4 July 2005, Internet: <http://www.rbcnews.com/free/20050701175811.shtml>.

<sup>249</sup> Blokhin, Alexander (2005), 'Foreigners to Get Access to Gazprom Shares', *Moscow News*, 30 November - 6 December, p. 4.

<sup>250</sup> *Ibid.*, p. 4.

often utilised in industrialised countries as the contract, in reality, makes expropriation possible. It is therefore unsuitable for the foreign investor in countries where the risk of expropriation can materialise.<sup>251</sup> From what has been stated, this would apply to Russia and the regime has not been seen as suitable for Russia.

The general idea of PSAs is that the state keeps the ownership of the resources, but transfers the rights of a certain share of the production to the foreign producer in return for work and services provided by the investor. The regime is subject to civil law and both parties must agree on any contractual changes. PSA regimes are often utilised by developing countries that recently have opened up for foreign investors in the energy sector.<sup>252</sup> The risk, from the investor's point of view, is the risk of 'renegotiations' once investments are made. These renegotiations often fall within areas where the law is weak.<sup>253</sup> Despite this risk, analyses suggest that if the factors of adaptability, immunisation against legal and political risks and budgetary effects were jointly considered, PSAs would be best for the Russian market.<sup>254</sup>

Russia has not, however, utilised the existing PSA regime except for a few projects at Kharyaga and Sakhalin,<sup>255</sup> and there has been an aversion towards the regime. Russia has instead modified the agreements by putting limitations on the numbers of deposits that can be extracted under a PSA agreement. This limit has been 30 per cent of the Russian reserves.<sup>256</sup> Apart from being a political statement, the limitation is pointless, since the law on PSAs was adopted in 1995, no agreements have been made. Ongoing projects were all initiated before the law was adopted.<sup>257</sup> The regime is not dead yet. A new law on PSA has been

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<sup>251</sup> Ziener, Gert (2001), 'The Russian Oil Sector: Finally Ready for Investors?' *Russian Economic Trends*, Vol. 10, No. 3/4, pp. 38-41.

<sup>252</sup> Ibid., pp. 38-41.

<sup>253</sup> Victor and Victor 'Axis of Oil?', p. 57.

<sup>254</sup> Ziener 'The Russian Oil Sector: Finally Ready for Investors?', pp. 41-43.

<sup>255</sup> Oil and Gas Journal (2003), 'Russian Oil M&A Action Surges with Mixed Outlook', *Oil and Gas Journal*, No. N/A, 5 May 2003, p. 38.

<sup>256</sup> Ziener 'The Russian Oil Sector: Finally Ready for Investors?', p. 43.

<sup>257</sup> Energimyndigheten (2003), *Den ryska oljan: nuläge och framtidsmöjligheter [The Russian Oil: Current State and Possibilities for the Future]*, Stockholm: Energimyndigheten, p. 40.

adopted which states that PSA will only exist if there are no regular regime auctions. Possibly this will relate to the other Sakhalin projects (no. 2, 4, 5, 6 and beyond) and analyses suggest that they might be won by Rosneft/Gazprom.<sup>258</sup>

The PSA regime has not been very popular among domestic energy companies for a number of reasons. Yukos was for example behind much of the lobbying campaign that discredited the PSA regime,<sup>259</sup> apparently to prevent unwanted foreign competition (TNK-BP on the other hand thinks it could also benefit them).<sup>260</sup> Another reason why domestic firms work against the regime is its transparency. It prevents them from murky deals, shielded from insight.<sup>261</sup> Nothing points to an increasing usage of PSAs and some analysts claim that mergers and acquisitions will be the way for foreign companies to start operating on the Russian market.<sup>262</sup> However, as stated above, there are serious limitations to what is possible to achieve in mergers as well. Even if TNK-BP is the only major successful merger, small acquisitions and joint ventures exist.

### **Regional Rascals**

Centre-periphery relations have always been problematic for Russian leaders. Russia's size is explanation enough for the problems of responsiveness. Regional or local leaders conducting foreign, security or top-level energy policy without approval from Moscow are problematic for Putin to handle. The problem is further exacerbated when, like in Taymyr, the head of the main industry, Norilsk Nickel, becomes governor and by that entrenches a position of power that is difficult to affect from Moscow. It is in this light that some, but not all, of Putin's actions must be seen. Centralisation is in many ways a poor solution, but it explains why Putin has withdrawn some of the local rights to

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<sup>258</sup> Milov *Russian Energy Sector and its International Implication*, p. 19.

<sup>259</sup> *Ibid.*, p. 19.

<sup>260</sup> Olcott 'Vladimir Putin and the Geopolitics of Oil', p. 8.

<sup>261</sup> Victor and Victor 'Axis of Oil?', p. 56.

<sup>262</sup> Fletcher, Sam (2003), 'Mergers, not PSAs, Key to Russian Investment', *Oil and Gas Journal*, 2 June 2003, p. 31.

autonomy. It was not because Putin was obsessed with power, but because this is his blunt way of regaining some control.

In the oil sector, even small empires have been formed, for example in Bashkortostan. There the level of nepotism took large proportions in the early 2000s as the son of the regional president Ural Rakhimov, was appointed Vice-President of the Bashneftekhim oil company. Azat Kurmanaev, a relative of the president's wife became head of Bashkreditbank, while the president's wife was appointed to a senior position in the regional Ministry of Foreign Relations and Trade. The local monopolies dealing with transportation, timber and fuel were further nationalised.<sup>263</sup>

### **The Case of Yukos and the Khodorkovsky Affair**

The Yukos affair will serve as an example of what can happen in the Russian energy market and what the consequences can be. The launching of the affair took place between June and October 2003 when Mikhail Khodorkovsky, the CEO of Yukos, and Platon Lebedev of the Gibraltar-based group Menatep, which owns 61.01 per cent of Yukos through the companies Yukos Universal (Isle of Man) and its subsidiary Hulley Enterprises (Cyprus), were arrested.<sup>264</sup>

The backdrop of the affair can be seen in two parallel processes. The first concerns Putin's struggle against the oligarchs who grew powerful under the reign of Yeltsin. Two of the most powerful oligarchs, who mainly operated within the media sphere, Boris Berezovsky and Vladimir Gusinsky were forced to leave Russia and his media empire, Media-Most, was during the process given to Gazprom. Khodorkovsky, Vladimir Potanin and Roman Abramovich were for long the most powerful oligarchs and, silently, ferocious foes of the Kremlin (even if they supported Yeltsin back in 1996 and Abramovich's relations to Putin are rather good). Allegedly, Putin and some of the oligarchs made a deal in 2000. The bottom line was that as long as the oligarchs did not interfere in politics and in addition started to pay tax – much of the

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<sup>263</sup> Kryshatanovskaya, Olga and White, Stephen (2005), 'The Rise of the Russian Business Elite', *Communist and Post-Communist Studies*, No. 38, p. 304.

<sup>264</sup> Vahtra *Russian Oil Sector Today and Tomorrow: The Implications of the Case of OAO Yukos*, p. 19.

misdeeds of the 1990s would be 'forgotten', or at least not mentioned.<sup>265</sup> Evidence of this is naturally difficult to provide, but judging from what has happened since, the allegation appears to have some ground.

Putin had no need for support from the oligarchs, but instead had to ensure that they would not oppose the president, which they surely had the financial means to do. In the year 2000, the economic power of Russia's 25 richest men exceeded that of the Russian state.<sup>266</sup> The second process concerns Putin's endeavours to strengthen his and the Kremlin's control over Russia at large. This includes both thwarting political opponent's ambitions to challenge Putin and bringing back the energy sector into the Kremlin's reach.

### *Allegations*

In short, charges were made at 12 individuals, including conspiracy, stealing of state property fraud and tax evasion (of \$US3.27 billion in 2000).<sup>267</sup> According to Yukos, this figure was based on the inclusion of revenues of several independent companies that actually had reported these sums to the authorities. Despite this, the tax burden amounted to 85 per cent of revenues in 2000.<sup>268</sup> And, according to Khodorkovsky, Yukos by that had to pay more tax than it got in gross profit.<sup>269</sup> That Khodorkovsky would dispute the figures is yet expected. Andrei Machanski, at Brunswick UBS Investment Bank, has however scrutinised the figures and found that Yukos between 1998 and 2002 evaded \$US2.055 billion in profit tax that together with penalties and fines would amount to \$US3.523 billion. This was not the only tax Yukos evaded, Machanski states.<sup>270</sup>

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<sup>265</sup> Olcott 'Vladimir Putin and the Geopolitics of Oil', p. 6.

<sup>266</sup> Ibid., p. 6.

<sup>267</sup> Vahtra, Peeter and Liuhto, Kari (2004), *Russian Corporations Abroad: Seeking Profit, Leverage or Refuge?*, Turku: Turku School of Economics and Business Administration/Pan-European Institute, p. 21.

<sup>268</sup> Ibid., p. 20.

<sup>269</sup> Khodorkovsky, Mikhail (2005), 'Property and Freedom', *Russia in Global Affairs*, Vol. 3, No. 1, p. 109.

<sup>270</sup> Barges 'State Takes Offensive: Analysis - Russia Prepares to Strip Oil Companies of their Super-profits'.

There were also allegations stemming from the privatisation of the apatite fertiliser company owned by the company Menatep. Menatep was the company that later took over Yukos from the Russian state in the notorious 'loans for shares program' under Yeltsin. In 2002, the shareholders of Menatep were Khodorkovsky (9.5 per cent) Nevzlin (8 per cent) Platon Lebedev (7 per cent), Vladimir Dublov (7 per cent) Mikhail Brudno (7 per cent) Vasily Shakhnovsky (4.5 per cent), while the remaining 50 per cent were held in a trust.<sup>271</sup> During the court process, these charges were nevertheless dropped due to the prescription period.<sup>272</sup>

### *The Counter-strike*

Yukos was understandingly sceptical to the allegations and accused the authorities in the way they pursued the investigations. For example, the deputy head of the legal department of Yukos, Svetlana Bakhmin, was arrested (supposedly) only in order for the prosecutors to get hold of Dmitry Golobolov, the chief lawyer of Yukos.<sup>273</sup> Several analysts have further underscored that many aspects of the trial violate European Convention of Human Rights (that Russia is a signatory of).<sup>274</sup> Lebedev in this context stated that he is preparing to appear both for the Supreme Court of Russia and for the European Court.<sup>275</sup> There are however justifications to assume that everyone of the accused in the Yukos affair has tried to politicise the trial to the greatest extent possible. Amplifying the political connotations is a prerequisite for successfully bringing the case to the European Court for Human Rights and it also facilitates domestic and international lobbying for Yukos and the defenders in the trial.

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<sup>271</sup> Olcott 'Vladimir Putin and the Geopolitics of Oil', p. 11.

<sup>272</sup> Arutunyan, Anna (2005), 'Khodorkovsky Sentenced to 9 Years in Prison', *Moscow News*, 1-7 June 2005, p. 2.

<sup>273</sup> Buckley, Neil (2005c), 'Russia's Leading Oligarch Faces Judgement Day in Yukos Affair', *The Financial Times*, 27 April 2005, p. 2.

<sup>274</sup> Interfax (2004b), 'More Russians Think Khodorkovsky Trial is Objective - Poll', *Interfax* (Reposted at Johnson's Russia List), Published: 21 July 2004, Last accessed: 14 April 2005, Internet: <http://www.cdi.org/russia/johnson/8301-5.cfm>.

<sup>275</sup> RosBusinessConsulting (2005t), 'Menatep Chief to Appeal to European Court of Human Rights', *RosBusinessConsulting*, Published: 17 June 2005, Last accessed: 20 June 2005, Internet: <http://www.rbcnews.com/free/20050617181548.shtml>.

The joust between the state and the market also took place outside the courtroom with the aim to win the hearts and minds of the domestic and international community. Yukos' campaign was in parts very successful and one poll indicates that 40-50 per cent of the respondents stated that they did not believe that Khodorkovsky would get a fair trial.<sup>276</sup> At the same time, people in Russia did consider the oligarchs as gangsters that stole their and Russia's assets, especially in the 'loans for shares' program of the 1990s. The authorities, therefore, had great support in its actions against the oligarchs.

On one occasion, Khodorkovsky supposedly gave his view on the situation in an article in the newspaper *Vedomosti* (that also appears in the journal "Russia in Global Affairs"). The article was rather humble and reconciliatory in its tone. Yet it claimed that the trial "is a politically and commercially motivated attack by one business (represented by governmental officials) at another business."<sup>277</sup> However, he also indicated that he does not aim to take revenge on the state when saying "Relax, guys, I am not going to play the Count of Monte Cristo."<sup>278</sup> Instead, he put focus on the selective application of law, retroactive introduction and use of legal norms. This, according to the article, results in reduced trust for the government and the new arbitration courts.<sup>279</sup> The Deputy Justice Minister Yury Kalinin claims that Khodorkovsky has denied that he wrote the article and states that Khodorkovsky could not possibly have written the article as it should have undergone censorship by the administration of the Matrosskaya Tishina prison.<sup>280</sup> Khodorkovsky is yet known to have smuggled out many letters that were subsequently published.

### *The Sentence*

The sentence was to come on 27 April 2005 but was postponed a few days prior to the announcement. Rumour had it that one of the judges

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<sup>276</sup> Interfax 'More Russians Think Khodorkovsky Trial is Objective - Poll'.

<sup>277</sup> Khodorkovsky 'Property and Freedom', p. 111.

<sup>278</sup> Ibid., p. 113.

<sup>279</sup> Ibid., p. 107.

<sup>280</sup> Interfax (2004a), 'Khodorkovsky Denies Writing Liberalism Article', *Interfax (Reposted at Johnson's Russia List)*, Published: 6 April 2004, Last accessed: 14 April 2005, Internet: <http://www.cdi.org/russia/johnson/8153-1.cfm>.

was ill.<sup>281</sup> However, given the preparation of the celebration in memory of the victory in the Great Patriotic War, taking place on the 9 May,<sup>282</sup> there are reasons to believe that the sentence was postponed in order to avoid distractions during the celebrations.

One day before the sentence was to be announced; Khodorkovsky's lawyers also stated that they expected a sentence of 10 years in prison camp.<sup>283</sup> As expected, the court found Lebedev and Khodorkovsky guilty on all seven charges on 16 of May.<sup>284</sup> They were both sentenced to nine years in a prison camp. Andrei Krainov was given a five year suspended sentence since "he had cooperated with investigators".<sup>285</sup> On 22 September 2005, the Moscow court overruled Khodorkovsky's appeal and the sentence won legal force. One of the crimes had yet been prescribed and the sentence was thus lowered to eight years for Khodorkovsky. He would as a consequence be sent to the Chita region in Siberia, near Mongolia and China.<sup>286</sup>

### **Consequences of the Affair**

The Yukos-affair induces along implications far beyond the domestic political and economic scene. Drawing on observations made by Russian and foreign press, at least seventeen direct or indirect consequences can be seen.

First and foremost, Putin split Yukos. Parallel to the court process, Putin decided that Yukos should be split and that its main production unit,

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<sup>281</sup> Buckley 'Russia's Leading Oligarch Faces Judgement Day in Yukos Affair', p. 2.

<sup>282</sup> Ugodnikov, Konstantin (2005), 'Yuganskii emirat [The Emirate of Yugansk]', *Itogi*, No. 20, 17 May 2005, p. 36f.

<sup>283</sup> Kniivilä, Kalle (2005), 'Mannen som blev för mäktig för Putin [The Man Who Became too Powerful for Putin]', *Sydsvenska dagbladet*, Published: 23 April 2005, Last accessed: 25 April 2005, Internet: <http://w1.sydsvenskan.se//Article.jsp?article=10117130&imagerlist=9&textlist=10..>

<sup>284</sup> Buckley, Neil, *et al.* (2005), 'Rise and Fall of Russia's Financial Faust', *The Financial Times*, 17 May 2005, p. 4.

<sup>285</sup> Arutunyan 'Khodorkovsky Sentenced to 9 Years in Prison'.

<sup>286</sup> Lepina, Marina (2005), 'Mikhaila Khodorkoskogo perebrosili na uran [Mikhail Khodorkovsky Sent to Uran]', *Kommersant*, Published: 20 October 2005, Last accessed: 20 October 2005, Internet: <http://www.kommersant.ru/doc.html?docId=619388>.

Yuganskneftegaz, was to be sold at an auction.<sup>287</sup> Gazprom quickly set out for Yuganskneftegaz.<sup>288</sup> The auction for Yuganskneftegaz was however won on 19 December by a newly created and until then unknown company called the Baikal Finance Group. As the company that won was a shell-company, the whole auction was quickly questioned by participants and observers alike. However, Putin himself guaranteed that there was not a problem, as he knew who was behind Baikal Finance Group. As it turned out, two of the owners were Igor Minibayev and Valentina Komarova. They both worked for the Kremlin-loyal Surgutneftegaz that according to some sources has connections to Putin himself.<sup>289</sup> It is remarkable that on 22 December, the Baikal Finance group sold Yuganskneftegaz to Rosneft.<sup>290</sup> According to other sources, Rosneft (with the assistance of the St. Petersburg-based Meshprombank) assisted the government in the actions against Yukos.<sup>291</sup> In an analysis by Jamestown, it was stated that:

*Kommersant in its December 29 edition quoted an unidentified Gazprom official as saying that the \$1.7 billion deposit Baikal had made in order to participate in the auction had been provided by Russia's fourth-largest oil company, Surgutneftegaz, which is stated to have warm relations with the Kremlin. According to Kommersant, Rosneft sold Gazprom a 70% stake in one of its affiliates, Sevmorneftegaz, for \$1.7 billion so that the gas giant can repay Surgutneftegaz's loan.*<sup>292</sup>

Yukos, in the wake of the auction, lodged an appeal to Moscow's Arbitration Court for the sale of Yuganskneftegaz and sought 324 billion roubles for caused damages. A case was later filed against Rosneft,

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<sup>287</sup> Arvedlund, Erin E. (2005), 'Tough Week for Yukos', *The International Herald Tribune*, 11 April 2005, p. 11.

<sup>288</sup> Arvedlund and Mouawad 'Breakup of Yukos Hits Output in Russia', p. 8.

<sup>289</sup> Kirillov, Denis and Vaysberg, Valerii (2004), 'Svoi sredi chuzhikh, chuzhoy sredi svoikh: o prezidenta est ne tolko novoye pravitelstvo, no i starie druzya po neftyanomi biznesi [One Among Others, Others Among One: the President Has Not Only a New Government, but Also Old Friends Within the Oil Business]', *Russkiy Fokus (Reposted at Kompromat)*, Published: Last accessed: 8 February 2005, Internet: <http://www.kompromat.ru/main/putin/druzya.htm>.

<sup>290</sup> Grizodubova, Tina (2005b), 'Gazprom, Rosneft Approaches Unnecessary Merger', *The Moscow Times*, 26 January -1 February 2005, p. 9.

<sup>291</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 24.

<sup>292</sup> Gurin, Charles (2005), 'The Heart of Yukos is Nationalized', *Eurasia Daily Monitor*, Vol. 2, No. 1.

Gazprom, Gazpromneft, Baikal Finance Group, the Ministry of Finance and as third parties the main Moscow Department of the Ministry of Justice, Yuganskneftegaz and the Federal Antimonopoly Service.<sup>293</sup> As a result, one of the most important oil production companies in Russia was transferred from a relatively independent company to state-controlled Rosneft.

Second, the structure of Yukos, also beyond the loss of Yuganskneftegaz, might be affected. There has long been speculations whether Yukos' other production units, Samaraneftgaz and Tomskneft, will remain within Yukos or if they are standing in line for another phase of *de facto* expropriation. This would mean that three out of seven subsidiary companies dealing with exploration and extraction are taken from Yukos.<sup>294</sup> It has been argued that the production volumes of these two companies are relatively small. Samaraneftgaz, for example, only produces 250,000 b/d and Tomskneft 320,000 (figures from 2003).<sup>295</sup> Together they produce more than 50 per cent of what Yuganskneftegaz did during the same period (1,000,000 b/d).<sup>296</sup> Given the consequences (as listed here) stemming from the split – it would be unwise to neglect the risk of further splits.

Third, planned mergers will not materialise. One planned merger was for example between Yukos and Sibneft. There were many reasons for this being stalled (for example that Sibneft demanded a different managerial and corporate structure that Yukos had),<sup>297</sup> but the Yukos affair was the final blow and while Putin had promoted the TNK-BP merger, the situation with Yukos and Sibneft was far from embraced by the Kremlin. Another more important issue was Yukos' plan to have either Chevron or ExxonMobil buy a 25 per cent (plus one share)

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<sup>293</sup> RosBusinessConsulting (2005,,), 'Yukos Appeals Yugansk Auction', *RosBusinessConsulting*, Published: 31 May 2005, Last accessed: 1 June 2005, Internet: [http://top.rbc.ru/english/index.shtml?/news/english/2005/05/31/31180824\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/news/english/2005/05/31/31180824_bod.shtml).

<sup>294</sup> Orekhin, Pyotr, *et al.* (2005), 'Kto sleduyoschii [Who's Next]', *Nezavisimaya Gazeta*, 16 March 2005, p. 6.

<sup>295</sup> Koyama 'Reorganization of Russian Petroleum Industry and its Effect on Business Strategy', p. 9.

<sup>296</sup> *Ibid.*, p. 9.

<sup>297</sup> Vahtra and Liuhto *Russian Corporations Abroad: Seeking Profit, Leverage or Refuge?*, p. 20.

blocking stake in the combined Yukos-Sibneft.<sup>298</sup> Naturally, these plans are unlikely to materialise under current circumstances. Instead, Sibneft was targeted by Gazprom in the wake of the stalled Gazprom-Rosneft merger.

Fourth, a new management board was appointed in the spring of 2005. When the prominent profiles were jailed, the board had to be modified and consequently received a new composition. It is difficult to see what difference this makes, but surely, the composition would have been different. It is not far-fetched to assume that the current composition is less radical in its stand on the Kremlin than the previous was. In the least, it does not have as great political ambitions.

Fifth, there has been a huge loss in oil production and exports for Yukos, which also affects tax collection and Russia's general economic growth. However, according to the head of the Federal Energy Agency Sergei Oganessian, the losses stemming from Rosneft's take-over of Yuganskneftegaz does not exceed 5 per cent in terms of monthly output (since the losses can be explained by the cyclical winter decline).<sup>299</sup> This contrasted Illarionov's opinion. He, who was an aide in economic affairs to the President, has made statements that the Yukos-affair has resulted in three per cent lower growth than Russia otherwise would have had. This is a tremendous loss if it is true; however, there is little validity to support this statement.

In addition, having a presidential aide that implicitly argues against the president's policy is truly remarkable. Illarionov is known for his adherence to liberal economic policy and his views were not left unopposed. Sechin, also an aide to Putin, went against Illarionov's statements, as he is widely believed to be one of the architects behind the affair. In the aftermath of the criticism of the Yukos-affair and how it was handled, Illarionov was relieved from his duties as representative to G8. The rationale for this has not been made public. It is a fact, nonetheless,

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<sup>298</sup> Belton, Catherine (2005a), 'Khodorkovsky's High Stakes Gamble', *The Moscow Times*, Published: 16 May 2005, Last accessed: 17 May 2005, Internet: <http://www.moscowtimes.ru/stories/2005/05/16/001.html>.

<sup>299</sup> RIA Novosti 'Russia's Energy Sector: Priorities Remain'.

that as a result of the lost of Yuganskneftegaz, Yukos fell from being the premier producer by 1.7 million barrels per day in 2004 to only producing 600,000-700,000 barrels per day in spring 2005.<sup>300</sup>

Sixth, market consequences followed the Yukos-affair. The company Lenaneftegaz (which is controlled by Yukos), for example, had received a licence for oil extraction in Talakan. This is one of the largest fields in Siberia that in the process was withdrawn from Yukos by the authorities (and given to the Kremlin-friendly company Surgutneftegaz).<sup>301</sup>

Seventh, Khodorkovsky's political agenda never came about. It was no secret that Khodorkovsky supported a number of political parties and organisations, most notably the liberal Yabloko and the Union of Right Forces (SPS). He also tried to buy seats in the Duma, presumably in order to affect new tax legislation. This was not approved of by the Kremlin and there have been continuous speculations whether Putin would take action. Khodorkovsky was believed to pave the way for running for President or at least change the political opinion against Putin (even if his exact political agenda or ambitions were not outspoken). Whatever they were – thwarted they became.

Putin's actions against Yukos and Khodorkovsky did not take place totally without popular support. In July 2005, a group of 50 well-known celebrities ranging from astronauts and Olympic champions to directors and politicians signed an open letter in support of the government against Khodorkovsky. Their main argument was that the major corporations should not be allowed to work above the law. What is interesting about the letter is that most of the signatories have close links to Putin's party, United Russia. Khodorkovsky is heavily criticised in the letter, as were those who had opposed the process. *Moscow Times*, among other papers, noted that the usage of open letters in support of the state was a common feature of the great terror of the 1930s.<sup>302</sup> Even if

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<sup>300</sup> Arvedlund 'Tough Week for Yukos', p. 11.

<sup>301</sup> Vahtra *Russian Oil Sector Today and Tomorrow: The Implications of the Case of OAO Yukos*, p. 21.

<sup>302</sup> Gessen, Masha (2005), 'Open Letters, Closed Minds', *The Moscow Times*, Published: 1 July 2005, Last accessed: 11 July 2005, Internet:  
<http://www.themoscowtimes.com/stories/2005/07/01/006.html>.

many people shared the views expressed in the letter, it should not be seen as an act of popular support, but instead as a part in the competition of loyalty. This process took place about the same time as when Khodorkovsky declared that he would run for the Duma fill-in election. When the sentence won legal force, this would no longer be possible.<sup>303</sup>

Eighth, there were financial consequences for Yukos. As expected, Yukos' shares were affected. Having been at levels above \$US14 in the spring 2004, the shares fell and landed on \$US1 in the spring 2005.<sup>304</sup> Blaming the whole fall on the affair might be moot – but it definitely had a great impact, especially as Yuganskneftegaz, a core asset, was removed from the company.

Ninth, the Russian stock exchange (RTS) index was affected. Allegedly, the RTS index dropped by 10 per cent when Alexei Pichugin<sup>305</sup> and Lebedev were arrested, and it dropped another 10 per cent when Khodorkovsky was arrested. When the official statements were made – it dropped further by 15 per cent.<sup>306</sup> Kakha Bendukidze, then Director General of the United Machinery Group (and now Minister of Economy in Georgia), was one of the few supporters of Khodorkovsky. He claims that because of the Yukos affair, the capitalisation of the Russian stock market was reduced by \$US10 billion.<sup>307</sup>

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<sup>303</sup> Gazeta.ru (2005), 'Khodorkovsky the Parliamentarian', *Gazeta.ru (Reposted at Moscow News)*, Published: 26 August 2005, Last accessed: 29 August 2005, Internet: [www.mosnews.com/column/2005/08/26/khodorkovsky.shtml](http://www.mosnews.com/column/2005/08/26/khodorkovsky.shtml).

<sup>304</sup> Orekhin, *et al.* 'Kto sleduyoschii [Who's Next]', p. 6.

<sup>305</sup> Alexei Pichugin was in 1998 Head of Yukos Department for Economic and Financial Security. He was in 2003 charged for murder. According to the website of his lobby campaign this was his reason in him not wanting to give out higher ranking people within Yukos. See Pichugin Trial (2005), 'The Case Against Alexei Pichugin', *The Pichugin Trial*, Published: N/A, Last accessed: 27 July 2005, Internet: <http://www.pichuginontrial.com/trial.cfm>.

<sup>306</sup> Delyagin, Mikhail (2005), *The Yukos Case as a Mirror on the "Dictatorship of Squalor"*, Moscow: Institute for Globalization Issues.

<sup>307</sup> Izotov, Arkady (2003), 'What are Russia's Losses Because of the Yukos Scandal?' *Pravda.ru*, Published: 18 September 2003, Last accessed: 16 June 2005, Internet: [http://english.pravda.ru/main/18/89/355/10922\\_yukos.html](http://english.pravda.ru/main/18/89/355/10922_yukos.html).

Tenth, there are also suggestions that Russian businesspeople became increasingly inclined to transfer company revenues out of the country.<sup>308</sup> This is a fairly logical response if the political leadership has a market approach characterised by ambiguity.

Eleventh, the affair also had some impact on the capital flows. One analyst argues that, *ceteris paribus*, Russia's net inflow of capital during the first half of 2003 (which amounted to \$US4 billion) was replaced by a \$US5.9 billion outflow in the second half of 2003 - solely as a consequence of the affair.<sup>309</sup>

Twelfth, there was a 'strategic pause' in investment decision-making in Russia, especially in the up-stream sector. In the long run, this may have consequences in terms of production losses.<sup>310</sup> It is naturally difficult to estimate exactly how large the impact is, but according to German Gref investments in production dropped by 20 per cent.<sup>311</sup> This view is shared by Khodorkovsky and his lawyers often put forward this consequence.<sup>312</sup> Considering the rather strong lobby campaign for Yukos, it is unwise to take these kinds of statements at face value and others argue that the affair did not have any impact as a restraining factor. Instead, some argue, it should be seen as a domestic political issue that can be disregarded from an investor's point of view.<sup>313</sup> This point of view is supported by the fact that the amount of investments for 2006 is estimated to reach new high levels of over \$US100 billion<sup>314</sup> even if this amount includes Russian capital from Cyprus - the largest investor in Russia.

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<sup>308</sup> Delyagin *The Yukos Case as a Mirror on the "Dictatorship of Squalor"*.

<sup>309</sup> Ibid.

<sup>310</sup> Milov *Russian Energy Sector and its International Implication*, p. 12.

<sup>311</sup> Delyagin *The Yukos Case as a Mirror on the "Dictatorship of Squalor"*.

<sup>312</sup> RosBusinessConsulting (2005o), 'Khodorkovsky's Lawyer Warns Against Cutback in Foreign Investments', *RosBusinessConsulting*, Published: 16 May 2005, Last accessed: 17 May 2005, Internet: <http://www.rbcnews.com/free/2005016115744.shtml>.

<sup>313</sup> Borisov, Alexander (2004), 'Investment in Russia and the Yukos Affair', *International Affairs (Moscow)*, Vol. 50, No. 2, p. 79f.

<sup>314</sup> Sudakov, Dmitry (2005), 'Foreign Investments in Russian Economy to Reach \$100 Billion Next Year', *Pravda.ru*, Published: 17 June 2005, Last accessed: 17 June 2005, Internet: [http://english.pravda.ru/main/18/89/358/15643\\_investment.html](http://english.pravda.ru/main/18/89/358/15643_investment.html).

Thirteenth, Yukos has been infamous for its aversion towards the PSA-regime. Thus, Yukos' spearheading of the anti-PSA-campaign came to a halt as a result of the affair.<sup>315</sup> However, this has little importance today, as PSA as a means to attract foreign investors is dead in Russia.

Fourteenth, there were many international consequences at the micro level. As a result of the Yukos-affair the share price of the Yukos-owned and Lithuanian-based oil refinery Mažeikių Nafta dropped by almost 23 per cent.<sup>316</sup> Lukoil offered to buy Yukos' shares (50 per cent) of Mažeikių, but in April 2005, the offer was declined.<sup>317</sup> Hungary's oil and gas group (MOL) also cancelled its deal with Yukos when Yukos delivering capabilities was thwarted. Instead, MOL switched to Lukoil for Russian oil.<sup>318</sup> Yukos' possibilities to deepen its engagement at the port of Ventspils in Latvia were also thwarted. TNK-BP emerged as an option. At the time, this was controversial since any deliveries to Ventspils had to go by Transneft's pipelines (and that would compete with shipments from the port of Primorsk or by rail).<sup>319</sup>

In June 2005, Lukoil announced that it intended to acquire a 66 per cent share of the company Geoilbent and filed an application with the Federal Antimonopoly Service.<sup>320</sup> This would strengthen Lukoil's position vis-à-vis Yukos as Geoilbent is owned by a Cyprus-based subsidiary of Yukos. It must be remembered that about this time, Russia was also withdrawing from negotiations with ConocoPhillips.<sup>321</sup> Thus, most of Yukos operations had crumbled while companies, such as Lukoil, that stands close to the Kremlin has had a field day and continues to cooperate.

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<sup>315</sup> Milov *Russian Energy Sector and its International Implication*, p. 19.

<sup>316</sup> Zashv, Peter (2004), *Russian Investments in Lithuania: Politics, Business, Corporate Culture*, Turku: Pan-European Institute/Turku School of Economics and Business Administration, 10/2004, p. 16.

<sup>317</sup> Arvedlund 'Tough Week for Yukos', p. 11.

<sup>318</sup> Dorman, Oleg (2005c), 'Oil Companies Rush in to Take Yukos' Place as Top Explorer', *The Moscow News*, 26 January - 1 February 2005, p. 8.

<sup>319</sup> Vahtra *Russian Oil Sector Today and Tomorrow: The Implications of the Case of OAO Yukos*, p. 22.

<sup>320</sup> RosBusinessConsulting (2005s), 'Lukoil Ready to Acquire Geoilbent from Yukos', *RosBusinessConsulting*, Published: 15 June 2005, Last accessed: 15 June 2005, Internet: <http://www.rbcnews.com/free/20050614160650.shtml>.

<sup>321</sup> Vahtra *Russian Oil Sector Today and Tomorrow: The Implications of the Case of OAO Yukos*, p. 32.

Fifteenth, the relations to the US were affected. Yukos, under supervision of Khodorkovsky, fought for a new pipeline that would run from West Siberia to the port of Murmansk aiming to expand oil shipping to the US. This idea however collapsed as soon as Khodorkovsky was imprisoned.<sup>322</sup> Transneft has nonetheless taken the role of pushing for this idea. The US has criticised Russia severely for the Yukos affair. Putin responded to these allegations and referred to them as parts of 'America's imperial ambitions'. In due time, greater oil deliveries to the US may be realised, but it is highly unlikely that Yukos will head such a development.

Sixteenth, Yukos was barred from delivering oil to Mažeikių. This is notable as Yukos actually held a majority stake in the Lithuanian refinery. The Lithuanian government has indicated that it believes that Yukos' tax problems might be a fact of nuisance. Instead, it would like to take over the refinery and letting Lukoil and a few other firms take care of oil supply.<sup>323</sup> Reliability of supply is a valid argument, but it is remarkable given the fact that Lithuania earlier took great effort in ensuring that Russian-backed firms were kept at a distance.

Seventeenth, relations with China have been strongly affected. There has long been a debate whether Russia should build a pipeline from Siberia to either Daqing in China or to Nakhodka on the Pacific coast (for shipments to Japan and elsewhere). Yukos, which has been exporting oil to China, initiated and for long opted for the Chinese alternative. This collided with the Kremlin's priorities of avoiding dependence on China for eastward exports. In September 2004, Yukos stopped sending oil to China due to finance difficulties resulting from the affair. At the same time, Russia promised China to sell 70 million barrels of crude oil (delivered by train) during 2005 and another 105 million in 2006. Lukoil stated it would make up for the losses.<sup>324</sup> At that time, the state-owned

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<sup>322</sup> Valdez, *et al.* 'Comparative Mineral Law of the Russian Federation and Central Asian Republics', p. 22.

<sup>323</sup> Baltic Times (2005e), 'New Supply Glitches Beset Mazeikiu Refinery', *The Baltic Times*, 7-13 April 2005, p. 6.

<sup>324</sup> AP (2004), *China Signs Deal to Import More Russian Oil by Train for Next Two Years*, 22 December 2004 on AP (Reposted at Alexander's Gas and Oil Connections).

Russian railway company also stated that it would lower tariffs more than half as Lukoil starts delivering.<sup>325</sup> China has also been interested in acquiring shares of Yuganskneftegaz. The national oil company CPNC, for example, has been interested in 20 per cent of the new Yuganskneftegaz, which, in turn leads to increased competition with India (which also wants to bid on a stake in Yuganskneftegaz).<sup>326</sup>

Further, Yury Matveev, the Deputy Chairman of Rosneft has stated that Rosneft signed a contract with China on 50 million barrels of crude oil per year to the year 2010.<sup>327</sup> For this purpose, Rosneft will be provided with an opportunity to utilise the newly acquired Yuganskneftegaz. In 2005, when Russia decided that the new pipeline would go to Nakhodka and the new CEO of Yukos, Simon Kukes, stated that Yukos was prepared to support 'any' eastern pipeline.<sup>328</sup> Apparently, Yukos under its new management has shifted position in one of the most important strategic initiatives in Russian energy policy. Soon after, the government would as well.

Finally, perceptions of Russia developing towards democracy have been given a serious blow. No matter if the trial has political underpinnings or not, many believe that it has and therefore it also has an impact. Several observers have put the trial into the context of the Soviet legal system and claimed that the verdict was "a memorial to Basmany justice", implying that both the Basmany and the Mesghansky Courts (where the trial was held) are under the Kremlin's control.<sup>329</sup>

The conclusion is striking – the state, state controlled companies and the Kremlin are the winners in the Yukos affair. Yukos, its shareholders and Khodorkovsky are the losers. State-controlled companies have been greatly strengthened and the affair entrenched most of the Kremlin's

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<sup>325</sup> Dorman 'Oil Companies Rush in to Take Yukos' Place as Top Explorer', p. 8.

<sup>326</sup> Marcelo, Ray (2005), 'India Looks to Russia and Iran for Energy', *Financial Times*, 8-9 January 2005, p. 1.

<sup>327</sup> Dorman 'Oil Companies Rush in to Take Yukos' Place as Top Explorer', p. 8.

<sup>328</sup> Glazkov, Sergei (2004), 'Licence Boom: Russia Targets Fast-Track Licensing of Petroleum Projects for Eastern Pipeline', *Russian Petroleum Investor (World Trade Executive)*, Last accessed: 15 February 2005, Internet: <http://www.wtexec.com/RPILicenseBoom.html>.

<sup>329</sup> Arutunyan 'Khodorkovsky Sentenced to 9 Years in Prison', p. 2.

priorities. By and large, all of the consequences listed above (although most are short-term in nature) can contribute to a list of reasons why the affair was launched in the first place. The long-term magnitude of the affair is still too early to assess in full and the picture is complex and full of contradictions. It surely had an impact on foreign investments, but it can be argued that willingness to invest in Russia was low even before the affair. Yet, if Russia aspires to attract foreign capital – such actions are counter-productive. The long-term impact of the Yukos-affair on Russia's reputation as an energy exporter will most likely be small. One reason is that Russia's problems with instability on the market are rather small compared to the civil unrest in Africa and instability in the Middle East.

### **Drivers behind the Yukos and Khodorkovsky Affairs**

Canvassing the Kremlin's agenda for launching the attack on Yukos and Khodorkovsky reveals a plethora of dimensions and causes/drivers of which a few will be scrutinised below. To single out one reason as the pivotal one is a mistake; rather they are to be seen as a whole.

Firstly, there is the issue of Khodorkovsky's enemies. During the course of action, Khodorkovsky and his comrades-in-arms in Menatep and Yukos made many powerful enemies.<sup>330</sup> It would be somewhat far-fetched to rely on this reason for explaining the factors behind the affairs. Even if Putin and Sechin held a grudge, it is highly unlikely that they, men of tactics, would act solely on that rationale. Yet, the framing of Khodorkovsky was probably met with support among Yukos' enemies. It is also worth underlining that there was popular support for Putin in this case. Launching a high-profile case was probably expected to generate much criticism both from the domestic media and from the international community. At the same time, its rationale was cheered within both the power structures and the public. Had Khodorkovsky been blessed by Putin, charges would never have emerged.

Secondly, there is the reason that Khodorkovsky's political ambitions constituted a threat to the state. Delyagin argues that supporting SPS and Yabloko financially did not contradict the informal agreement with Putin

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<sup>330</sup> Olcott 'Vladimir Putin and the Geopolitics of Oil', p. 12.

of not interfering in politics. He claims that Khodorkovsky's rationale for doing so was based on a belief that it would benefit society.<sup>331</sup> As Harley Balzer points out, neither of these parties would likely have passed the five per cent barrier for entering the Duma and it therefore appears irrational to launch the affair for this reason. A more plausible explanation is that Yukos allegedly paid the Communist Party (KPRF) and other deputies to affect their votes on legislation on taxes for the oil industry.<sup>332</sup>

Putin basically had three approaches to choose from when confronted with Khodorkovsky's agenda – jail him, exile him or submit to him.<sup>333</sup> Submitting to an oligarch was not really Putin's mode. On the other hand, Khodorkovsky had to choose how to tackle Putin's plan. A few years earlier, Vladimir Gusinsky and Boris Berezovsky faced the same options and chose to accept an offer of exile. It is likely that Putin had let go of Khodorkovsky as well if he in early stages had pleaded for mercy and submitted to Putin's will. Being faithful to his ideals, or possibly struck by hubris, Khodorkovsky took the fight and lost. Putin's actions in such a perspective are logical and the answer of what to do naturally emerged – jail Khodorkovsky.

Thirdly, there is an argument that Putin wished to regain what the oligarchs stole. True, Putin has led a crusade against the powerful oligarchs that dictated much of the development of the 1990s in Russia (and that are increasingly unpopular). This reason is highly plausible as it goes hand-in-hand with Putin's wider agenda of strengthening the Kremlin's grip on power in general and specifically in the natural resources sector. Putin has a conviction: what belongs to the state belongs to the Russian people. The oligarchs, sometimes referred to as the 'robber barons', made their fortunes at the expense of the people in rigged auctions and the loans-for-shares programmes of the 1990s. This is for both production assets and taxes.

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<sup>331</sup> Delyagin *The Yukos Case as a Mirror on the "Dictatorship of Squalor"*.

<sup>332</sup> Balzer 'The Putin Thesis and Russian Energy Policy', p. 212.

<sup>333</sup> Olcott 'Vladimir Putin and the Geopolitics of Oil', p. 13.

There is more to it than hard assets and the issues do not only concern oil. The state could have retaken assets in several ways without having to apply law selectively and cause international annoyance. The symbolic act of retaking state property and punishing the 'robber barons' thus has a value *per se*. At certain times, the president has not been strong enough to fight the oligarchs and, therefore, he has been forced to work with them. One case that at least partly could be seen in this light was before the 1996 election when Yeltsin sought their support, another is when Putin used the Russian Union of Industrialists and Entrepreneurs as an advisory board.<sup>334</sup>

Fourthly, the Kremlin had good reasons to make an example and provide a precedence case. In combination with other points raised here, it is reasonable to assume that the Kremlin wanted to make a case – be it the main driver or not. Thus, a precedent case would be made. This means that once and for all, other oligarchs would be shown who was in charge and everyone would know where the political threshold for actions on the market was. In the aftermath of the affair, corporations and oligarchs would know that if they opposed the Kremlin's wish, they would be punished in one way or another.

However, the power of the precedence case lost some credibility in the aftermath of the affair. Faced with the risk of losing investments and revenues from production, the Kremlin tried to tackle all allegations of having a plan of expropriation and re-nationalisation by claiming that Yukos was a one-time exception. This undermined some of the power of the precedent case built-up earlier. If the Kremlin was honest in its statement of Yukos being an exception, and that no other cases of re-nationalisation would be seen, the political motives behind the affairs stand out much clearer. However, if it really were an ordinary legal process to investigate and punish tax evasion and fraud, few companies would remain in operation in Russia. True, selective prosecutions exist elsewhere, but the reasons for targeting Yukos (instead of Sibneft that had an almost identical history) have far too many political undertones to be overlooked. This issue bears great importance for the future.

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<sup>334</sup> Ibid., p. 6.

Fifthly, thwarting Yukos' great power ambitions has been a priority for Moscow. Yukos was becoming too powerful an actor in the Kremlin's opinion. It was pursuing foreign energy policy of its own that was not appreciated. This included ambitions to increase exports to the United States and support for oil pipelines to China and Murmansk (against the Kremlin's wishes). It is therefore interesting to note that a few years after the affair was initiated, the Kremlin turned and the Chinese option was advocated by the Kremlin. This can however be interpreted as a tactical manoeuvre aimed at putting pressure on Japan for providing more economic support to the project.

It appears as if the Kremlin was not most upset about Yukos affairs as such, but rather that it had conducted policy not sanctioned by the Kremlin. As the relations with China improved over time (and the Kremlin regained momentum), the final outcome ended up being the very same as Yukos once suggested. However, this remains to be seen.

One key point in this context is that the energy strategy underscores that decisions on infrastructure development are taken by the state, not individual companies.<sup>335</sup> Adopting this document and idea could therefore be seen as an unofficial starting point for the Yukos affair as the mental preparedness and vision already was outlined.<sup>336</sup>

In addition, there was a risk of Yukos giving up between 24 and 40 per cent to ExxonMobil or Chevron Texaco.<sup>337</sup> One source indicates that the documents already had been drawn up for a 25 per cent plus one share.<sup>338</sup> If this were realised, Russia would lose much power to strong foreign competitors. Even domestic ambitions to grow were worrying for Moscow. This was one of the main reasons why Putin did not approve of the merger with Sibneft and Yukos. If the affair solely were about fraud and tax evasion, it would also be enough to press charges

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<sup>335</sup> Ministry of Industry and Energy 'Energeticheskaya Strategiiia Rossii na period do 2020 goda [Russia's Energy Strategy until the Year 2020], Utvershdena no 1234-r, 28 August, 2003.' p. 70.

<sup>336</sup> Fredholm *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, p. 13.

<sup>337</sup> Olcott 'Vladimir Putin and the Geopolitics of Oil', p. 13.

<sup>338</sup> Belton 'Khodorkovsky's High Stakes Gamble'.

against the individuals of Yukos. Instead, the Kremlin chose to split the company and transferred its most important assets to the Kremlin's reach. Not surprisingly, German Gref opposed the allegations of a link between the state strengthening its powers and the affair; instead, it indicated other (undisclosed) reasons.<sup>339</sup>

### *Unlikely Reasons behind the Affair*

Some arguments emerging in the debate lack substance, for example the reason of boosting the oil price. Given the magnitude of the Yukos affair, it is virtually out of the question that the government would stage the affair and by that bring a long a set of risks for the unpredictable gain of extra revenues from oil exports. Indeed oil revenues are paramount to the Russian state budget, it does not make sense at a time when Russia's trade and budget surplus in combination with its currency reserve and oil funds are all time high. It can also be stated that although Russia's energy policy often is short-term in nature, the long-term losses in terms of investments and future production losses might be higher than the short-term revenues. The drop in production, resulting from the split of Yukos, also indicates that this does was not a valid reason. At most, the rise in oil prices cushioned some of the economic losses of the affairs.

Moreover, the official argument of bringing justice to the energy sector is also open to discussion. The due process of the court had many faults. Yukos was not alone in dodging tax but in fact, Yukos paid more tax for each ton of produced oil than any other company; at least according to the Russian Minister of Finance.<sup>340</sup> It is also somewhat noteworthy that as soon as Yuganskneftegaz was taken over by Rosneft, all tax claims were dropped. The officials that were supposed to have covered up for Yukos in the process of tax evasion were not examined.<sup>341</sup>

### **Aggregated Outcome of the Affairs**

It is unlikely that all of the (for the Kremlin) positive consequences listed in the previous section individually were a part of a master plan

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<sup>339</sup> Buckley 'Free Market Advocate: German Gref, the Economy Minister, talks to Neil Buckley', p. 2.

<sup>340</sup> Delyagin *The Yukos Case as a Mirror on the "Dictatorship of Squalor"*.

<sup>341</sup> Ibid.

developed by the Kremlin. To what extent the Kremlin had counted on the negative consequences is difficult to say. Some type of cost-benefit analysis has probably been made and obviously, the Kremlin believed that the fall-out would be advantageous. The Kremlin was right.

In conclusion, it can be stated that if the affair is seen as two affairs – the Khodorkovsky affair and the Yukos affair, the drivers and consequences combination make more sense. In essence, the Khodorkovsky affair, in the Kremlin's view, has mainly been about him, his political ambitions, and his unwillingness to submit to the president, his foreign policy, and his background as a thief of state property. Nine years in prison camp for now, appears to be end of the Khodorkovsky saga.

The Yukos affair, in contrast, has taken place at a much higher level. It has been about transferring powers to the state. In the process, the state has retaken some of what has been stolen, the Kremlin's and state controlled (or approved of) companies have been strengthened at the expense of Yukos – in the Kremlin's view a pro-Western and 'unreliable maverick'. Risks of foreign influence have therefore successfully been averted.

In essence, the outcome was positive for Moscow. The numerous negative consequences for Russia as a state and for national and international companies have but subsidiary roles. From Putin's point of view, they could easily be disregarded, as the importance of strengthening the state is a far greater good than a shortfall in investments under a limited time. Dodging international criticism is also a trademark of Putin. Certainly, Putin is well aware of the fact that the political instability in Russia is not in the same league as the Middle East, Africa or Venezuela. The world would not abandon the Russian market for a nuisance of this marginal size.

Several items are notably disturbing about the Yukos affair from a Western point of view. The case appears to have been based, for example, on the retroactive use of law. Basically, Yukos actions were legal at the time committed. This has been approved of by the Audit

Chamber (*Chetnaya Palata*) during its examination of Sibneft.<sup>342</sup> It might have made a difference that Sibneft's CEO, Roman Abramovich, has been a friend of Putin, but that is speculation. As indicated above, selective use of law against Yukos is also problematic from a legitimacy point of view. The affair also affects perceptions of Russia's development, as the next section will elaborate on.

### **Risks of Further Expropriation in Light of the Yukos Affair**

The question of whether other companies run the risk of sharing Yukos' fate is debatable. Predictability, reliability and transparent rules, laws and regulations are important both for private companies operating on the market and for foreign importers of Russian energy (that preferably would refrain from costly diversification). The state of affairs under Putin has thus been contradictory. Compared to the anarchy of the Yeltsin era, it has been rather stable. It has also been stable in an international perspective, if compared to Iraq, Western Africa or Venezuela. Instability has yet been the trademark if the Yukos affair is considered in addition to uncertainties concerning private property, investments, transports, taxes and licences.<sup>343</sup> Therefore, the reason of stating an example must be further scrutinised by looking at the prospects for the future.

Putin's aide, Igor Shuvalov, has advised other oil companies to check their taxes in order to avoid Yukos' fate,<sup>344</sup> which certainly can be seen as a warning. The difficulty is that during the turbulent years of the 1990s, the ongoing transactions left no company or actor clean. Adding to these unclear rules, regulations and laws in combination with interpretation priority to the authorities, the Kremlin can do whatever it likes even within the loosely defined legal framework that exists today. Essentially, every actor on the market is in the hands of the good will of the state structures. Therefore, these warnings add instability to the nervous market and affect most businesspeople.

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<sup>342</sup> Ibid.

<sup>343</sup> Monaghan *Russian Oil and EU Energy Security*, p. 11f.

<sup>344</sup> Moscow News 'Putin's Aide Opposes Further Tax Increases in Russian Oil Sector'.

More warnings came after Khodorkovsky's sentence. They were made public as the Deputy Prosecutor General of Russia, Vladimir Kolesnikov, stated that Khodorkovsky's case was not the last one. In a TV interview, Kolesnikov was asked why the other oligarchs were still at large and stated, "Unfortunately, some of them fled. We were too humane, and they managed to escape."<sup>345</sup>

The question naturally arises whether more cases will follow or not. The Finnish researcher Peeter Vahtras does not believe that there will be more cases. This is supposed to be a one-time statement. By attacking the Menatep group, the Kremlin reached its goals, namely eliminating the political lobbying power of Khodorkovsky's team and send a clear message to others not to interfere in economic policymaking, he argues.<sup>346</sup> This view is also put forward in official Russian statements. Yet, Steven Theede, the Chief Executive of Yukos, warns that if it happens to Yukos it can happen again and that Russia should not be allowed to tear up the international rulebook.<sup>347</sup> It would nonetheless be remarkable if Yukos did not take this standpoint.

When in the spring of 2005 new tax claims came, this time against TNK-BP, the question was again whether history would repeat itself. The tax claims amounted to one billion US dollar and came at the same time as the new law on foreign ownership was launched.<sup>348</sup> Some analysts drew the conclusion that this was a reminder of the risks, even if Putin reaffirmed his support for the merger between BP and TNK (but failed to comment on the reasons behind the tax claims).<sup>349</sup> German Gref made it clear that the merger would not be possible today as a maximum ownership is limited to below 50 per cent.<sup>350</sup>

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<sup>345</sup> RosBusinessConsulting (2005v), 'More Jailed Oligarchs to Come, Prosecutor Warns', *RosBusinessConsulting*, Published: 6 June 2005, Last accessed: 7 June 2005, Internet: [http://top.rbc.ru/english/index.shtml?/news/english/2005/06/06/06130041\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/news/english/2005/06/06/06130041_bod.shtml).

<sup>346</sup> Vahtra *Russian Oil Sector Today and Tomorrow: The Implications of the Case of OAO Yukos*, p. 27.

<sup>347</sup> Kirchgaessner 'Putin's Critics Call on Bush to get Tougher', p. 2.

<sup>348</sup> Ostrovsky and Gorst 'TNK-BP Chief Attacks Russia's Uncertain Investment Climate', p. 4.

<sup>349</sup> Gorst, Isabel and Boxell, James, 'Putin Tells BP Chief Venture has his Support', p. 1.

<sup>350</sup> Buckley 'Free Market Advocate: German Gref, the Economy Minister, talks to Neil Buckley', p. 2.

The liberal Financial Times differed somewhat from the mainstream press and its leader argued that the tax claims on TNK-BP did not occur because Putin has stated so, but because the bureaucrats had gotten momentum and that Putin has lost control. In FT's harsh words:

*The implications for Russia's political and economic future are serious because they suggest that Mr Putin is no longer in full control of the many-headed monster that is Russia's bureaucracy. Having feasted on the riches of Yukos, the beast is hungry and wants to eat again.*<sup>351</sup>

It is questionable if the point has any substance. Although the phenomenon of uncontrollable bureaucracy is endemic in Russia, issues of this magnitude would hardly emerge without being sanctioned at the top level. In addition, there is no real evidence that Putin has lost control. Signals like this are frequently used in Russia and contradicting messages are therefore not as outlandish as they first appear. Anders Åslund has been an advocate of the idea that the bureaucracy is out of control and that Putin's power base is diminishing.<sup>352</sup> On the question of whether more affairs will follow, he states that the political price would be too large, but as the bureaucracy is uncontrollable, it cannot be ruled out.<sup>353</sup> One evidence of the deliberate ambiguity was when Putin in April 2005 tried to appease Russian companies by suggesting a shortening of the prescription period from ten to two years for past economic crimes.<sup>354</sup> Within the democracy discourse, this issue have a larger magnitude than within the business discourse.

Even if the issues discussed above are seen as re-nationalisation of the energy sector, the impact might be smaller than it first appears. If Russian companies are nationalised or domestic prices rise, it does not have to have severe implications for foreign firms as long as levels, reliability and predictability of supplies are kept at a level (although this

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<sup>351</sup> Financial Times (2005), 'Another Yukos?' *The Financial Times*, Editorial, 13 April 2005, p. 13.

<sup>352</sup> See Åslund, Anders (2005), *Putin's Decline and America's Response*, Washington D.C.: Carnegie Endowment for International Peace, August 2005, No 41.

<sup>353</sup> Buckley, Neil (2005a), 'Aftershocks Will Continue to Keep Foreign Investors on the Edge', *The Financial Times*, 17 May 2005, p. 4.

<sup>354</sup> Kniivilä 'Mannen som blev för mäktig för Putin [The Man Who Became too Powerful for Putin]'

may prove difficult). However, new players on Russia's energy field should take into consideration what Nina Poussenkova calls the five commandments for doing business in Russia.<sup>355</sup>

- 1) Be a good corporate citizen.
- 2) Be a conscientious taxpayer.
- 3) Be politically correct.
- 4) Be patriotic.
- 5) Be sensible about your licences.

It must be remembered that the ongoing processes are not only driven by actors that have the end-goal of transferring assets to the state, but also to themselves. Besides the constant rumours of bribery and corruption, there are allegedly plans that might give the state officials that are on company boards' substantial wealth. For example, Rosneft has indicated that it might offer 49 per cent of its shares in an internal public offering (IPO). The state-employed managers would turn into shareholders and the IPO would create liquid shares that legitimise their ownership. Sources to the Financial Times claim that in the near future there will be a "smooth transition of assets from private businessmen to semi-state ownership and back into private hands - but different ones".<sup>356</sup> This is possibly not the main rationale why it is conducted as it is a way of obtaining available means for conducting major acquisitions. A result may yet be that the board members benefit. Further IPO's have also been announced. Harvey Balzer concludes in one of his articles that the:

*[...] current political system provides few checks and balances in determining those interests or how they are defended, and that insiders often derive profits from acting as agents of state interests. Russia is unlikely to have a full state-controlled energy sector, but it will be difficult to guarantee credible commitment in Russia's current policy environment.*<sup>357</sup>

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<sup>355</sup> Poussenkova 'From Rigs to Riches: Oilmen vs. Financiers in the Russian Oil Sector', p. 40.

<sup>356</sup> Ostrovsky 'The New Oligarchs? Winners and Losers in the Kremlin's Grab for Oil Wealth', p. 13.

<sup>357</sup> Balzer 'The Putin Thesis and Russian Energy Policy', p. 223.

### **Summary and Conclusions**

The Yukos affair and the framing of Khodorkovsky should both be seen in light of Putin's struggle against the oligarchs and his endeavours to strengthen his and the Kremlin's control over Russia at large. Consequences of the affair were that Yukos was split and that further structural changes may follow. There was a huge loss in oil production and exports and planned mergers will not be realised. Several market consequences also followed (i.e., Yukos' shares fell dramatically, the Russian stock exchange fell, businesspersons became increasingly inclined to transfer company revenues out of the country and the investment rate fell). More important was that Khodorkovsky's political agenda was stalled and that Russia's foreign relations (US and China) were negatively affected in the short term. Perceptions of Russia developing towards democracy have been given another serious blow. Great assets in Russia were thus transferred from an independent to a state-controlled company (Rosneft). This type of instability is yet small compared to the civil unrest found elsewhere (Africa, Middle East, Venezuela). The affair hence entrenched most of the Kremlin's strategic priorities and the long-term impacts on Russia's reputation as an energy exporter will clearly be minute.

Apparently, there are two affairs with different rationales. The Khodorkovsky affair has been about him, his political ambitions, his unwillingness to submit to the president, and to his background as a perceived 'thief of state property'. Khodorkovsky's political ambitions and activities constituted a threat to the state. In addition, Putin wanted to retake what was seen as stolen. The Yukos affair, in contrast, has been about transferring powers to the state and thwarting Yukos' great power ambitions. In addition, Moscow wanted to state an example, but later toned down some of these aspects. The message was yet clear. Drivers such as boosting the oil price or bringing justice to the energy sector are of marginal importance as explanations.

The numerous negative consequences (economic and political etc.) have but a subsidiary impact. For Putin they could easily be disregarded, as the importance of strengthening the state is far greater. International criticism is dodged. Other companies do run the risk of sharing Yukos'

fate, but the threshold for actions of the same magnitude is rather high. To reduce the risks, companies ought to pay tax, be politically correct, and be patriotic.

In controlling the pipeline grids, the state enjoys great leverage on foreign importers and on domestic actors. The Russian state has recaptured its influence in several areas and put strong limitations on what foreign firms can do. Foreign investors are met with obstacles, unpredictable changes of the regulatory framework and politicised decisions aimed at promoting national interest on the expense of the market. Marketisation will continue and there will probably be a process of demarcation of areas between liberalisation and enhanced state control. Apparently, regulation concerning core areas will be less liberal, but more clear.

## 5 State Control of the Energy Sector

**Question:** How large is the Kremlin's control over the energy sector?

**Approach:** The chapter approaches the question by mapping the enmeshment of state structures and private enterprises within the Russian energy sector.

**Main findings:** The Kremlin has great influence over important state bodies, including the committees of the Federation Council and the State Duma. The Kremlin also has strong formal or informal ties to the major energy companies, Gazprom, Sibneft, Rosneft, Transneft, Surgutneftegaz, Zarubezhneft, RAO UES and Lukoil. The Putin-loyal hardliners are appointed both to positions within state organs and energy corporations. They are the new, politically correct, oligarchs of Russia. Even if the agendas are different, the mindset and *modus operandi* of these people, who often have a background in the security sector, are often similar.

Self-censorship has emerged and firms are reluctant to conduct politically incorrect activities, even if market-based actions are the norm. Rogue behaviour exists, but in strategic matters, the Kremlin's wish is frequently obeyed. Marketisation and authoritarianism coexist.

### Presidential Control of the Sector

The formal powers of the President and his administration are extensive and continuously strengthened,<sup>358</sup> but these powers, for example the right to rule by decree (*ukaz*), are not assessed here. There are also informal powers and connections. Only connections brought to attention by the media are scrutinised here. Thus far, secret associations could be more extensive. Both types of relations are difficult to assess but consist of personal, political and business connections.

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<sup>358</sup> Leijonhielm, *et al.* *Ryske militär förmåga i ett tioårsperspektiv - problem och trender 2005* [Russian *Military Capability in a Ten-Year Perspective - Problems and Trends 2005*], especially chapter 2 and 3.

### *The St. Petersburg Connections*

During his time as an official in St. Petersburg, Putin created a vast network of people that have now moved into the corridors of power in Moscow. Several of them can be found both in company boardrooms and in state bodies. For example, the deputy chiefs of the presidential administration were until recently chairpersons of Aeroflot (the state airline company), Almaz-Antey (the most prominent producer of missiles in Russia) and TVEL (the main trader of nuclear fuel).<sup>359</sup> To a great extent, the common denominator of Putin and some of his closest allies that in one way or another is involved in the energy sector is that they were all members of Anatoly Sobchak's team in St. Petersburg.<sup>360</sup> Alexei Kudrin, German Gref, Igor Sechin, Dmitry Kozak,<sup>361</sup> Viktor Ivanov, Anatoly Chubais and Alexei Miller for example belong to the so-called 'St. Petersburg Clan'. Igor Sechin, an ex-KGB officer working in the presidential administration, is a close friend of Putin's and currently the head of Rosneft's board.<sup>362</sup> Viktor Ivanov is also a former KGB Colonel that fought in Afghanistan and was appointed by Putin to head the administrative departments of St. Petersburg City Hall.<sup>363</sup>

Up until November 2005, Dmitry Medvedev, head of the presidential administration (when he was appointed to the post of first deputy prime minister) is since 2004 the non-executive chairperson of Gazprom and heads its exports branch Gazexport. There are reasons to believe that Sechin is closer to Putin and is more trusted than Medvedev. However, since he prefers to stay out of the public eye, Medvedev got the position as head of administration. When he was promoted to the position of first deputy prime minister, he was in fact dismissed from the administration. By becoming a part of the government, he was removed from the corridors of real power. It is interesting to note that his replacement was

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<sup>359</sup> Buckley, Neil (2005d), 'With His Eyes on Keeping Control, Putin Misses a Moment for Economic Control', *The Financial Times*, 15 April 2005, p. 13.

<sup>360</sup> Tokareva, Marina (2005), 'Anatoly Sobchak: The Man Who Discovered Putin', *The Moscow News*, 1-7 June 2005.

<sup>361</sup> Kozak has earlier been head of Sovkomflot, the main state shipping company.

<sup>362</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 22.

<sup>363</sup> Kupchinsky 'Russia. Putin's Former Colleagues Make Up Today's Energy Team'.

Sergei Sobyenin, the governor of the Tyumen region, famous for its oil wealth. Sobyenin is also close to the company Rosneft.<sup>364</sup>

Alexei Miller is a key figure in Russia's energy market as the Chief Executive of Gazprom (and an old ally of Putin). According to Anders Åslund, he meets Putin three times a week. This is evidence of his (and Gazprom's) importance to Russia. No one has such access to the President. When he took over Gazprom, he promised to scrap the strict limits on foreign investments and claimed to want to end any existing questionable financial practice. This has never transpired. He is regarded as a person who is loyal to Putin.<sup>365</sup>

In addition, there is Igor Yusufov, Russia's former Energy Minister, who also is representative to the boards of Gazprom, Rosneft and Transnefteprodukt<sup>366</sup> and Nikolai Tokarev, former vice-President of Transneft and now President of Zarubezhneft. Reportedly, Tokarev is a former deputy head of the FSB and an ally of Putin.<sup>367</sup> The conclusion is that there exists a large and important network of people from Putin's time in St. Petersburg who today occupy high positions. It is reasonable to assume that these channels are used to a great extent and that the formal decision-making procedures become diluted.

### *The Siloviki Connections*

The 'silovikis' are a case in point. These are usually hardliners with a background in the security services, for example the KGB or its successor organisations: the Foreign Intelligence Service (SVR), the Federal Security Service (FSB), Federal Border Service (FPS), the Federal Agency for the Protection of Government Communications (FAPSI), the Federal

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<sup>364</sup> Latynina, Yulia (2005), 'What Really Happened to Medvedev', *Moscow Times*, Published: 23 November 2005, Last accessed: 23 November 2005, Internet: <http://www.moscowtimes.ru/stories/2005/11/23/007.html>.

<sup>365</sup> Arvedlund and Mouawad 'Breakup of Yukos Hits Output in Russia', p. 8.

<sup>366</sup> Jack, Andrew (2004), 'Kremlin Tightens Hold on Russia's Energy Sector', *The Financial Times*, 25 August 2004.

<sup>367</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 22.

Guard Service (FSO) or the Main Directorate for Special Programmes (GUSP).<sup>368</sup>

Putin, with a background in the KGB and FSB is naturally well connected in the security sphere. During the turbulent years of the 1990s, several officers from the security services started either to work for the energy corporations or for other state structures (such as the presidential administration).

The sociologist Olga Kryshstanovskaya, who is the Director of the Russian Academy of Sciences' Centre for the Study of Elites, has revealed that up to 58 per cent of the circle closest to Putin consists of silovikis.<sup>369</sup> If the whole entire elite are taken into consideration, it is apparent that the degree of siloviki is much higher today than it was during the last years of the Soviet Union. It is a question of definition, but by having a wide definition of 'elite' it can be stated that up to 77 per cent of the political elite in Russia consist of siloviki.<sup>370</sup> In actual numbers, this would mean more than 6,000 silovikis at high positions.<sup>371</sup>

One example of this is Yevgeny Shkolov, a former KGB officer who has been deputy head of the presidential administration, but who later became vice-president of Transneft. Another vice-president of Transneft is Sergei Grigoriev, also a former KGB officer.<sup>372</sup> Several board members of Transneft have a background within the KGB. Its director, Semyon

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<sup>368</sup> FAPSI has since 2003 been split and incorporated into FSB, SVR and FSO while FPS has merged with FSB. See further Vendil Pallin, Carolina (2005), *Russian Military Reform: A Failed Exercise in Defence Decision Making*, Stockholm: The Swedish Defence Research Agency (FOI), FOI-R--1777-SE, pp. 35ff.

<sup>369</sup> Kryshstanovskaya cited in Yaroshevskii, Besedoval Vitalii (2004), 'Operatsiya 'vnedrenie' zavershena! [Operation 'Intrusion' Completed]', *Novaya Gazeta*, Published: 13 August 2005, Last accessed: 5 July 2005, Internet: <http://2004.novayagazeta.ru/nomer/2004/63n/n63n-s43.shtml>.

<sup>370</sup> Novaya Gazeta (2005), 'Agenti Vliyaniya [Agents of Influence]', *Novaya Gazeta*, Published: 30 August 2004, Last accessed: 5 July 2005, Internet: <http://2004.novayagazeta.ru/nomer/2004/63n/n63n-s45.shtml>.

<sup>371</sup> Novaya Gazeta (2003), 'Uzhe bolee 6000 chekistov zanimayot vysshie gosudarstvennye dolzhnosti [Already More Than 6000 Chekists Borrow the Highest State Posts]', *Novaya Gazeta*, Published: 14 July 2003, Last accessed: 5 July 2005, Internet: <http://2003.novayagazeta.ru/nomer/2003/50n/n50n-s03.shtml>.

<sup>372</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 28.

Vainshtok, may also have worked for the FSB at various times, some evidence suggests.<sup>373</sup> The Director of the energy company Mosenergo, Arkady Evstafev, is another example.<sup>374</sup> Even if most of the silovikis work with issues related to security, they are also found in the private sphere and in civil governmental bodies. At least five members of the Trade and Industry Chamber (*Torgovo-promyshlennaya palata*) have a background in FSB, SVR, or FAPSI.<sup>375</sup> Sechin has already been mentioned.

It would be incorrect to assume that everyone with a background in the security sector is a friend of Putin.<sup>376</sup> It would also be erroneous to assume that all silovikis or hardliners have a common agenda. Instead, it is imperative to note the numerous connections between these people that share similar backgrounds. Even if the agendas are different, the mindset and *modus operandi* of these people are in most cases similar. By a high degree of enmeshment, a culture is created where there are silent understandings on what needs to be done and how it should be done. These connections can also be seen as a measurement of the Kremlin's power, as few persons with a fragile career would refuse to obey the President. At the same time, there are personal agendas and power politics that are connected to conflicting interests of energy firms, for example Gazprom and Rosneft.

The siloviki connection existed already under Boris Yeltsin, even abroad.<sup>377</sup> In 1999, for example, Russia replaced its ambassador in Lithuania with the former KGB officer Yuri Zubakov. One suggestion of why this occurred was that Russia wanted to support Lukoil in the negotiations with the American energy company Williams International by influencing Lithuania's government. Allegedly, this was the first time

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<sup>373</sup> Ibid., p. 22.

<sup>374</sup> Novaya Gazeta 'Agenti Vliyaniya [Agents of Influence]'

<sup>375</sup> Ibid.

<sup>376</sup> Further examples of appointments to the boards of Svyazinvest, Sukhoi, RZHD, TRV, TVEL and Channel One are found in: Fredholm *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, p. 10.

<sup>377</sup> Energy interest groups existed also during Yeltsin, see Khripunov, Igor and Matthews, Mary M. (1996), 'Russia's Oil and Gas Interest Group and Its Foreign Policy Agenda', *Problems of Post-Communism*, No. May-June.

in the post-Cold War history that an intelligence officer became ambassador in order to affect a commercial negotiation.<sup>378</sup> Another case in point abroad is Viktor Chernomyrdin, the Russian ambassador to Kyiv. He was previously Russian prime minister and head of Gazprom. His loyalty to Gazprom is strong and has even been subject to jokes in which his political party, Our Home Russia, is referred to as Our Home Gazprom (*Nash Dom Gazprom*) partly because Gazprom supported his party.

There is reason to assume that the mindset of the silovikis is incompatible with market values. Actions and reactions are perceived as zero-sum-games and to a great extent, things should be kept state secret and any problems are best handled by force. Natural resources are seen as national and strategic assets that must be controlled by the state and foreign intervention should be restricted. Data, such as reserves, must be secret and the Military-Industrial Complex must be granted priority to scarce resources.

The silovikis of the energy sector are of two types, low and high. The 'low-level' siloviki consists of former officers taking care of the dirty work of the energy firms, such as cash-transactions abroad or protection. It has for example been common for energy companies, especially during the 1990s, to have a politically connected security service as protection from powerful rivals (know as a 'roof' or *krysha*).<sup>379</sup> It is however difficult to assess of the impact these types of groups have.

In contrast, the 'high-level' silovikis have a key role in the boardrooms of privatised companies. Allegedly, Rosneft is occasionally referred to as the 'KBG Company'. According to sources that Keith Smith has spoken to, there are so many former intelligence personnel present during international negotiations that "it is difficult to know who is or is not on active duty".<sup>380</sup> This is an extreme opinion, but it cannot be ruled out that many actors in their relations to Russia feel this way.

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<sup>378</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 6.

<sup>379</sup> *Ibid.*, p. 27.

<sup>380</sup> *Ibid.*, p. 28.

There are hardliners that cannot be labelled siloviki, but most siloviki are hardliners. The increased role for the hardliners and siloviki does not just occur; it is promoted by the state by providing responsibilities for economic policy to the security structures. Prime Minister Fradkov spoke at the annual meeting of FSB. Although the meeting was held behind closed doors, the Russian press later revealed that he had put emphasis on FSB's increasing role for Russia's economic development.<sup>381</sup>

### *The Murky Connections*

There are rumours of dubious connections between Putin and criminal structures, of which one frequently mentioned example is the Tambov mafia that operates in St. Petersburg.<sup>382</sup> Some sources claim that there are connections between the Tambov structures and the energy companies Surgutneftegaz and Kineks, which controls the flow of oil and petrochemical products from St. Petersburg to world markets, and Putin himself.<sup>383</sup> In this context, a key figure at Kineks is Gennady Timchenko of Kineks Holding and Kineks St. Petersburg, who are involved also in the Swedish-based company International Petroleum Products AB and Interpera Holding AB.<sup>384</sup> According to the Russian politician Ivan Rybkin, Timchenko has been responsible for much of Putin's business actions.<sup>385</sup> It is interesting to note that soon after these (and several other outspoken allegations) Rybkin suddenly disappeared. Rybkin, who was running for President against Putin, appeared after several days, but had

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<sup>381</sup> Swedish Embassy in Moscow/Ministry for Foreign Affairs (2005), *Premiärminister Fradkov talar till säkerhets tjänsten vid årligt möte: fokus på FSB:s roll för Rysslands ekonomiska utveckling [Prime Minister Fradkov Speaks to the Security Service at Annual Meeting: Focus on FSB's Role for Russia's Economic Development]*, Moscow: Swedish Embassy in Moscow/Ministry for Foreign Affairs, 31 January 2005, 31 January 2005.

<sup>382</sup> For a background of the Tambov mafia, see Dixelius, Malcolm and Konstantinov, Andrej (1994), *Rysslands undre värld [The Underworld of Russia]* (Sweden: Fischer & CO).

<sup>383</sup> Kirillov and Vaysberg 'Svoi sredi chuzhikh, chuzhoy sredi svoikh: o prezidenta est ne tolko novoye pravitelstvo, no i starie druzya po neftyanomi biznesi [One Among Others, Others Among One: the President Has Not Only a New Government, but Also Old Friends Within the Oil Business]'

<sup>384</sup> Ibid.

<sup>385</sup> Rybkin, Ivan (2004), 'Putin - samii krupnii oligarkh v Rossii [Putin is Russia's Biggest Oligarch]', *Kommersant (Reposted at Kompromat)*, Published: 2 February 2004, Last accessed: 13 April 2005, Internet: <http://www.compromat.ru/main/putin/rybkin.htm>.

problems explaining where he had been.<sup>386</sup> Explanations ranged from being on holiday to being drugged and photographed in compromising situations in Ukraine. He also withdrew from the presidential race, letting his supporters know that the climate for opposition was harsh. It is presumptuous to conclude there is a direct correlation to the article above, however, his disappearance and withdrawal from the race can be perceived in the context of the opposition's relentless efforts against the government. Possibly, he also had the desire to discredit his opponent by these allegations. In either case, it shows that there is a murky side to Russia's energy sector.

During Putin's time in St. Petersburg in the 1990s, he was involved in distributing exports licences for natural resources and precious metals. At one time, a group of lawmakers, deputies from the 'Lensoviet', under the direction of Marina Saliye and Yuri Gladkov, undertook an investigation of Putin that resulted in accusations of corruption and misuse of power. Among other things, they found an incident of Putin granting export licensing in return for shipments of food that never arrived. The commission advised the mayor of St. Petersburg, Anatoly Sobchak, to dismiss Putin.<sup>387</sup> He was not dismissed. Putin had been a protégé of Sobchak during his time as a law student, as pro-rector of Leningrad State University and as deputy mayor of St. Petersburg. Hence, his bands of loyalty were very strong.

As motivation for the recommendations, Saliye claimed that Putin should be dismissed for "incompetence bordering on lack of conscientiousness" and "unprecedented negligence and irresponsibility in providing the investigating commission with documents".<sup>388</sup> In the spring of 2000, Saliye presented these allegations at the Glasnost

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<sup>386</sup> Belorus, Yegor (2004), 'Ivan Rybkin: Show Must Go On', *Pravda.ru*, Published: 12 February 2004, Last accessed: 13 April 2005, Internet: [http://english.pravda.ru/main/18/88/351/12045\\_Rybkin.html](http://english.pravda.ru/main/18/88/351/12045_Rybkin.html).

<sup>387</sup> Ames, Mark (2000), 'Too Hot to Handle: About the Secret Dossier of Putin's Criminal Misdeeds', *Exile (Reposted at Johnson's Russia List)*, Published: 10 November 2000, Last accessed: 6 February 2005, Internet: <http://www.cdi.org/russia/johnson/4630.html###4>.

<sup>388</sup> Baker, Peter and Glassner, Susan (2005), *Kremlin Rising: Vladimir Putin's Russia and the End of Revolution* (New York: Scribner), p. 47.

Foundation, but later disappeared from public life.<sup>389</sup> The foundation was not popular among the authorities and in August 2000, its office was raided by the police. The grounds were, allegedly, for an identity document check. However, the documents were never checked. Amnesty International connects the raid to an annual conference held by the foundation, entitled 'KGB: yesterday, today and tomorrow' that the authorities did not approve of.<sup>390</sup>

Naturally, solid evidence concerning Putin's business-relations is difficult to come by, as few journalists dare to investigate such issues (and state bodies cannot or dare not do it), especially when they contain elements of corruption. Given the widespread corruption in Russia, allegations may well have substance. However, the cases presented here on Putin's allegedly involvement in corruption or similar wrongdoings are not enough to be perceived as conclusive evidence.

### **Bureaucratic Control of the Sector**

In regards to several of the smaller governmental bodies, laws are often complicated and difficult to interpret. In many cases, it is unclear what the responsibilities, authorities and powers of interference are. Powers rest at several levels, for example federal, regional and municipal. The most important is the federal level and the level that Putin has tried to strengthen the most.<sup>391</sup>

The following section describes the most important decision-making and implementing bodies within the energy sector. Four ministries as well as a number of services, agencies, commissions and committees are involved in the oil and gas sector (coal, electricity and nuclear powers are excluded). The President appoints most of the officials listed below.

Unlike the practice during Yeltsin's reign, one aim of Putin's administrative reform is to streamline the state structures.<sup>392</sup> As a result,

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<sup>389</sup> Ibid., p. 392.

<sup>390</sup> Amnesty International (2000), 'Russian Federation: Intimidatory Raid on Glasnost Foundation', *Amnesty International*, Published: 31 August 2000, Last accessed: 13 December 2005.

<sup>391</sup> Ögütçü 'Attracting Foreign Direct Investment for Russia's Modernization: Battling Against the Odds', p. 8f.

<sup>392</sup> Vendil Pallin *Russian Military Reform: A Failed Exercise in Defence Decision Making*.

some of the bodies discussed in this report no longer exist. A brief comment on the bodies discussed is therefore necessary. Governmental bodies are (after Putin's administrative reform) mainly of three types. First, there is the ministry level (*Ministerstvo*) that is supposed to be the ideological policy-making level. Second, the federal service level (*Federalnaya Sluzhba*) supervises other bodies. Third, the federal agency level (*Federalnaya Agentura*) controls state property and provides state services to individuals and other entities. The presidential administration is divided into directorates (*Upravleniye*) that have expert support functions, for example in energy issues. The main directorate level (*Glavnye upravleniya*) do no longer exist within the presidential administration. At other ministries they largely remain. Beneath the directorates, there are departments (*Departamenti*). In addition, there are administrative organs within the presidential administration (*Apparati*) that also supports bodies such as the Security Council. Several of these have the status of 'directorate'.<sup>393</sup>

### *The Ministry of Industry and Energy*

The Ministry of Industry and Energy (*Ministerstvo Promyshlennosti i Energetiki RF – Minpromenergo*) is the most prominent ministry in terms of energy issues and Viktor Khristenko heads it. With a background in economics and finance, his involvement in the energy sector, has been sparse until he took office in March 2004.<sup>394</sup> It has four executive bodies (*organy*) of which one is dedicated to energy and headed by Sergei Aramovich Oganessian (who until 2004 was vice-President of Rosneft).<sup>395</sup> It has over 300 personnel and deals with state property, usage of fuel resources, maintenance of power system and supervision of other subordinated bodies. It also coordinates activities of the organisations that deal with forecasts of development of the electrical and power system (except the atomic industry). Other questions include trunk

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<sup>393</sup> Leijonhielm, et al. *Ryske militär förmåga i ett tioårsperspektiv - problem och trender 2005* [Russian *Military Capability in a Ten-Year Perspective - Problems and Trends 2005*], p. 42f.

<sup>394</sup> Ministry of Industry and Energy (2005a), 'Biografiya Khristenko Viktora Borisovicha [Biography of Viktor Borisovich Khristenko]', *Ministerstvo promyshlennosti i energetiki Rossii*, Published: Last accessed: 16 March 2005, Internet: <http://www.mte.gov.ru/docs/21/66.html>.

<sup>395</sup> Ministry of Industry and Energy (2005d), 'Podvedomstvennye organy ispolnitelnoi vlasti [Subordinated Executive Bodies]', *Ministerstvo promyshlennosti i energetiki Rossii*, Published: N/A, Last accessed: 7 July 2005, Internet: <http://www.mte.gov.ru/docs/106/1501.html>.

pipelines of oil and gas and related products, in addition to unconventional power sources. The documents that pinpoint its responsibilities demonstrate that it not only has executive tasks, but also tasks relating to analysis, research and control of other bodies.<sup>396</sup>

A directorate that allegedly is found under the auspices of the Minenergo (but that is not mentioned on its website) is the Central Dispatch Unit (CDU) (sometimes called the Central (Production) Unit or the Central Dispatch Administration) (*Tsentrālnoe Dispetcherskoe Upravlenie* or *Tsentrālnoe proizvodstvenno-dispetcherskoe upravleniye* (TsPDU)). This unit approves the monthly schedules for energy dispatch and has been pivotal in controlling gas flows in pipelines.<sup>397</sup> It is claimed to operate and supervise 23 gas and gas-transport enterprises, over 150,000 km of trunk gas pipelines and 251 compressor stations in addition to 22 underground storehouses (with a capacity of 56 billion cubic meters). It is meant to provide a reliable supply of natural gas for the industry, to household consumers of Russia and deals with exports to the countries of Western Europe, the CIS, and the Baltic countries and likely Turkey.<sup>398</sup>

At several times and by several instances, the independence of the TsPDU has been questioned,<sup>399</sup> including by the IEA.<sup>400</sup> A 2004 OECD report states that the TsPDU in reality is an integral fraction of Gazprom. Moreover, it is shielded from insight, both from private and state actors

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<sup>396</sup> Ministry of Industry and Energy (2004), 'Postanovlenie Pravitelstva ot 8 aprelya 2004 g. No 197 [Govenmental Decision from 8 April 2004, No 197]', *Ministerstvo promyshlennosti i energetiki Rossii*, Published: N/A, Last accessed: 7 July 2005, Internet: <http://www.mte.gov.ru/docs/22/1486.html>.

<sup>397</sup> Lyudmila, Lyudina (2001), 'Klyuch ostanetsya v rukakh Gazproma [The Key Remains in the Hands of Gazprom]', *Trud*, Published: 8 September 2001, Last accessed: 18 March 2005, Internet: <http://www.trud.ru/Arhiv/2001/09/08/200109081650106.htm>.

<sup>398</sup> TeploGaz (2001), 'Gazovaya promyshlennost Rossii [Russia's Gas Industry]', *TeploGaz*, Published: N/A, Last accessed: 7 July 2005, Internet: <http://www.teplogas.com/legend.htm>.

<sup>399</sup> AK&M (2003), 'Minekonomrazvitiya RF schitaet neobkhodimym obosoblenie TsPDU Gazproma, OAO 'Gazprom' nastaiavaet na sokhraneni TsPDU v sostave golovnoi kompanii [The Ministry for Economic Development of the Russian Federation Considers it Necessary to Isolate TsPDU of Gazprom, OAO 'Gazprom' Insists on Preservation of TsPDU in the Structure of the Head Company]', *AK&M (Reposted at Skandaly.Ru)*, Published: 15 September 2003, Last accessed: 7 July 2005, Internet: <http://spider2.mediastandart.ru/archive/2871555.html>.

<sup>400</sup> IEA *Russia Energy Survey 2002*, p. 90.

in terms of data on the level or structure of pipeline usage.<sup>401</sup> This is one of the arguments of why it should be isolated from Gazprom and have an independent position.<sup>402</sup> The key issue is that if Gazprom is the only actor with access to this information, any laws or regulations to third party access is hindered. Apparently, Gazprom only grants access if there is spare capacity in the pipelines. It can further deny access on technical grounds.<sup>403</sup> This is one of the bodies whose status has occasionally taken the role of being a governmental body, for example when it is involved in international negotiations, but whose loyalty appears to rest with Gazprom. It is clear that the importance of TsPDU is pivotal, and its status is symptomatic for the Russian energy market.

*The Ministry of Economic Development and Trade and the Ministry of Finance*  
The Ministry of Economic Development and Trade (*Ministerstvo Ekonomicheskogo Razvitiya i Torgovli RF*) is headed by German Gref who has a background in the St. Petersburg administration. The Deputy Minister, Vitalii Savelev, in contrast, has a background in the energy sector, for example in Minenergo, Menatep and Gazprom.<sup>404</sup> The Ministry has departments for investments, military matters and security as well as economic cooperation with CIS states.

One of the most interesting agencies beneath the ministry level is the Federal Agency for State Reserves (*Federalnaya Agentstvo po Gosudarstvennym Rezervam – Rosrezerv*). It is a federal authority dealing with the management of state's stocks and reserves of certain materials

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<sup>401</sup> Ahrend and Tompson *Russia's Gas Sector: The Endless Wait for Reform?*, p. 8.

<sup>402</sup> AK&M 'Minekonomrazvitiya RF schitaet neobkhozhdimym obosoblenie TsPDU Gazproma, OAO 'Gazprom' nastaiavaet na sokhraneni TsPDU v sostave golovnoi kompanii [The Ministry for Economic Development of the Russian Federation Considers it Necessary to Isolate TsPDU of Gazprom, OAO 'Gazprom' Insists on Preservation of TsPDU in the Structure of the Head Company]'.

<sup>403</sup> Ahrend and Tompson *Russia's Gas Sector: The Endless Wait for Reform?*, p. 8. This issue in particular has been well assessed in Moen, Ketil Boe (2002), 'The Gas Directive: Third Party Transportation Rights - But to What Pipeline Volumes?' *Center for Energy, Petroleum and Minerals Law Policy (CEPMLP) Internet Journal*, Vol. 13, No. 1.

<sup>404</sup> Ministry of Trade and Economic Development (2005a), 'Rukovodstvo Ministerstva [Management of the Ministry]', *Ministerstvo ekonomicheskogo razvitiya torgovli RF*, Published: Last accessed: 3 March 2005, Internet:

[http://www.economy.gov.ru/wps/portal/lut/p/.cmd/cs/.ce/7\\_0\\_A/.s/7\\_0\\_O5/\\_th/J\\_0\\_CH/\\_s.7\\_0\\_A/7\\_0\\_O9/\\_s.7\\_0\\_A/7\\_0\\_O5](http://www.economy.gov.ru/wps/portal/lut/p/.cmd/cs/.ce/7_0_A/.s/7_0_O5/_th/J_0_CH/_s.7_0_A/7_0_O9/_s.7_0_A/7_0_O5).

that is seen as of special importance for the security of Russia.<sup>405</sup> The head of Rosrezerv is Alexander Grigorev, who worked for the KGB and the FSB between 1997 and 2001 when he came to Rosrezerv as General Director. Some of his previous positions included being vice director of the FSB (as he was the head of the directorate in St. Petersburg (*Nachalnik upravleniya*) and Leningrad's oblast). As a vice director, he was also a member of the collegium of the FSB.<sup>406</sup>

An additional body that is important for the energy sector is the Federal Agency for the Management of Federal Property (*Rosimushchestvo*). It is responsible for privatisation programmes of state enterprises and was deeply involved in the planned Gazprom and Rosneft merger.<sup>407</sup> Ivan Aksyonov is the Chief of the Privatisation Directorate of Federal Property and has been an advocate of facilitating privatisation regulation.<sup>408</sup>

The Ministry of Finance (*Ministerstvo Finansov RF*) and the Federal Taxation Service (*Federalnaya Nalogovaya Sluzhba*) are involved in taxation and controlling financial flows also within the energy sector. According to official biographies, the chiefs do not have a background in the energy sphere. As this report is not focused on the financial aspects of the energy market, it is here left aside.

### *The Ministry of Transportation*

Apparently, the Ministry of Transportation (*Ministerstvo Transporta RF*), which is headed by Igor Yevgenevich Levitin, has a marginal role in the Russian energy market as most of the oil and gas is transported by pipeline. However, in certain cases, transport of energy carriers by river

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<sup>405</sup> Rosrezerv (2005b), 'Zakonodatelnie i normativnie pravovie akti [Legislative and Normative Legal Acts]', *Rosrezerv*, Published: Last accessed: 3 March 2005, Internet: [http://www.rosreserv.ru/classify.asp?c\\_no=129#1](http://www.rosreserv.ru/classify.asp?c_no=129#1).

<sup>406</sup> Rosrezerv (2005a), 'Rykovoditel agentstva [Manager of the Agency]', *Rosrezerv*, Published: N/A, Last accessed: 8 July 2005, Internet: [http://www.rosreserv.ru/classify.asp?c\\_no=136..](http://www.rosreserv.ru/classify.asp?c_no=136..)

<sup>407</sup> Fredholm *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, p. 35.

<sup>408</sup> Siberian News/NewsLab (2005), 'Rosimushchestvo Preparing a Set of Amendments to Privatization Legislation', *Siberian News/NewsLab*, Published: 27 July 2005, Last accessed: 18 October 2005, Internet: <http://english.newslab.ru/news/168193>.

barge or railway is the only option (or a necessary complement when it comes to exports). This position is somewhat ambiguous as occasionally the ministry co-operates with Minenergo while on other occasions pursues its own agenda. The Ministry of Transportation, for example, promotes railway transport instead of advocating pipeline construction. These types of turf wars are however not remarkable.

One of the agencies found under its supervision is the Federal Agency for Sea and River Transport (*Federalnoe Agentstvo Morskogo i Rechnogo Transporta*) headed by Vyacheslav Ruksha. It deals with sea-lane communication and transport on water.<sup>409</sup> There is also the Federal Agency for Railway Transport (*Federalnogo Agentstvo Zheleznodorozhnogo Transporta*),<sup>410</sup> and the Federal Service for Supervision in the Sphere of Transportation (*Federalnaya Sluzhba po Nadzoru v Sfere Transporta – Rostransnadzor*), that deals with safety and security of transportation by air, road, railway and water.<sup>411</sup>

### *The Ministry of Natural Resources*

The Ministry of Natural Resources (*Ministerstvo Prirodnikh Resursov RF*) (MPR (or MNR in English)) is based on the old Soviet Ministry of Geology that later became the Committee for Geology and the Exploitation of Subsurface (Subsoil) Resources (*Roskomenedra*). In 1996, it merged with the Committee for Water Resources and received its current name. In 2000, the State Committee for Environmental Protection and the Federal Forestry Service were folded into the ministry.<sup>412</sup> Today it is headed by Yuri Trutnev, who in May 2004 succeeded Vitaly Artyukhov

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<sup>409</sup> Ministry of Transport (2005c), 'Struktura federalnogi agentstva morskogo i rechnogo transporta [Structure of the Federal Agency for Sea and River Transport]', *Ministerstvo Transporta RF*, Published: N/A, Last accessed: 26 April 2005, Internet: [http://www.morflot.ru/Default.aspx?id=1&lvl=0&href=/html/struct/struktura\\_morflot.htm](http://www.morflot.ru/Default.aspx?id=1&lvl=0&href=/html/struct/struktura_morflot.htm).

<sup>410</sup> Ministry of Transport (2005b), 'Federalnogo agentstvo zheleznodorozhnogo transporta [Federal Agency for Railway Transport]', *Federalnogo agentstvo zheleznodorozhnogo transporta*, Published: N/A, Last accessed: 25 April 2005, Internet: <http://www.mintrans.ru>.

<sup>411</sup> Ministry of Transport (2005a), 'Federalnaya sluzhba po nadzoru v sfere transporta [Federal Service for Supervision in the Sphere of Transportation]', *Federalnaya sluzhba po nadzoru v sfere transporta*, Published: N/A, Last accessed: 25 April 2005, Internet: <http://www.ftoa.ru/structure/>.

<sup>412</sup> Fortescue 'The State Versus the Resource Sector: Resource Rent Issues in Russia', p. 4.

on this post.<sup>413</sup> It is a federal executive body that deals with the study, protection and administration of natural resources in Russia. This includes forests, natural reserves, underwater assets and subsoil resources (among which coal, oil and natural gas).

Another key figure is Sergei Fyodorov, who is the head of the Policy and Regulation Department of the Ministry for Natural Resources. The MNR coordinates and controls several agencies. For oil and gas issues, the Federal Subsoil Use Agency (*Federalnaya Agentstvo po Nedropolzovaniyu*) is of most importance. The agency organises economic-geological evaluation and cost estimates of mineral deposits and subsoil sites. In addition, it organises tenders and auctions for the right to use subsoil resources; registers applications for licenses and informs other governmental bodies on these issues. In relation to auctions and tenders, it grants the right to use subsoil resources.<sup>414</sup> Alexei Ledovskikh heads the Federal Subsoil Use Agency.

### *The Federal Energy Commission and Federal Tariffs Service*

The Federal Energy Commission (*Federalnaya Energeticheskaya Komissiya* – FEK (FEC in English)) does not serve under any ministry and has a central role in the Russian energy sector by handling issues such as tariffs on trade. It worked in conjunction with 80 Regional Energy Commissions (RECs). In 2001, it was announced that FEK was to be replaced by a new ‘unified’ body.<sup>415</sup> It kept its name and was vested with new powers. In March 2004, the FEK was replaced by the Federal Tariff Service (*Federalnaya Sluzhba po Tarifam* – FST) in accordance with presidential decree.<sup>416</sup> Allegedly, when the Anti-Monopoly Ministry was

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<sup>413</sup> Ministry of Natural Resources (2005), 'Biografiya: Yuri Petrovich Trutnev', *Ministerstvo Prirodnikh Resursov*, Published: Last accessed: 3 March 2005, Internet: <http://www.mnr.gov.ru/part/?pid=98>.

<sup>414</sup> Ministry of Natural Resources (2004), 'The Regulations on the Federal Subsoil Use Agency Approved by Resolution of the Government of the Russian Federation # 293, dated June 17, 2004.' *Ministerstvo Prirodnikh Resursov*, Published: Last accessed: 3 March 2005, Internet: <http://www.mnr.gov.ru/part/?pid=399>.

<sup>415</sup> IEA *Russia Energy Survey 2002*, p. 121.

<sup>416</sup> President of Russia (2004), 'Ukaz Prezidenta RF ot 09.03.2004 N 314 'O sisteme i strukture federalnikh organov ispolnitelnoi vlasti' [Presidential Decree from 9 March 2004, no. 314, 'About the System and Structure of the Federal Enforcement Authorities']', *President of Russia*, Published: Last accessed: 3 March 2005, Internet: <http://document.kremlin.ru/doc.asp?ID=021438>.

abolished, some of its powers were transferred to the FST,<sup>417</sup> while others were left to the new Federal Anti-Monopoly Service (*Federalnaya Antimonopolnaya Sluzhba*). At times, the Anti-Monopoly Ministry tried to challenge Gazprom. It was too weak to make a difference but one of the findings of the Anti-Monopoly Ministry was that in 2004 Gazprom had abused its position (with assistance from FEK) in the downstream sector.<sup>418</sup>

### *The Governmental Commission for Oil and Gas Pipeline Use*

In November 2000, the Governmental Commission for Oil and Gas Pipeline Use (sometimes called the (Governmental) Commission on Access to Oil and Gas Pipelines) (*Komissiya Pravitelstva Rossiskoi Federatsii po Voprosam Ispolzovaniya Sistem Magistrnykh Neftegazoprovodov i Nefteproduktoprovodov*) was established. In short, the commission relishes a strong position in controlling exports of oil from Russia. It was created to regulate exports access and review quarterly balances provided by Minenergo. These balances are the foundation for deciding what exports volumes are granted (while taking into consideration domestic needs). It also sets schedules for energy shipments.<sup>419</sup> The TsPDU grants access to pipelines (not grants to export). The commission is also responsible for holding auctions for export quotas and is headed by the Minister of Industry and Energy/Deputy Prime Minister Viktor Khristenko.<sup>420</sup> It consists of 17 members and coordinates the federal organs that oversee supply of energy. It is meant to represent the interest of state producer and energy consumers and aims to create non-discriminatory conditions for access to infrastructure.<sup>421</sup>

The Governmental Commission for Oil and Gas Pipeline Use has by and large replaced the interdepartmental commission (*Mezhvedomstvennaya komissiya - MVK*) which was created in 1994 "to monitor pipeline use, design quarterly export tables, ensure priority access under intergovernmental agreements and state contracts and monitor supplies

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<sup>417</sup> Ahrend and Tompson *Russia's Gas Sector: The Endless Wait for Reform?*, p. 9.

<sup>418</sup> *Ibid.*, p. 19.

<sup>419</sup> IEA *Energeticheskaya Politika Rossii: obzor 2002*, p. 108. and IEA *Russia Energy Survey 2002*, p. 89

<sup>420</sup> IEA *Russia Energy Survey 2002*, p. 93

<sup>421</sup> *Ibid.*, p. 93.

of oil and products to the domestic market".<sup>422</sup> Practically, this means that the MVK had to monitor Gazprom's activities, but some analysts have argued that Gazprom's position vis-à-vis the state was too strong within certain areas, as it gradually took over several tasks of the state in managing the gas market. It can be argued, as an OECD report does, that a Russian gas market does not exist, as it rather resembles a command-controlled rationing mechanism.<sup>423</sup>

The process of rationing gas is largely handled by Gazprom. Therefore, when certain consumers request a certain amount of natural gas, the requested quantities are subject to negotiation between Gazprom and the consumer and it is usually lowered. OECD points out that Gazprom controls all the data on export commitments, pipeline capacity and production information. This data is shielded from insight and the rules for distribution are unclear or secret. Not even the government is stated to have full access.<sup>424</sup> At the time of its existence, third party actors that wanted to object to being rejected by Gazprom for pipeline access complained to the MVK, which had the power to require Gazprom to inform about spare capacity.<sup>425</sup>

Even today, an MVK with similar responsibilities exists, but it has less authority and it serves under the National Security Council (NSC) and thus the presidential administration. The NSC has had many (7-10) MVKs for various issues, such as for problems within the Military-Industrial Complex, information security, ecologic security and border policy. Another MVK is the NSC MVK for economic security that during 1997 was headed by Duma deputy Alexander Shokhin, but who was replaced in 2000 by the First Deputy Secretary of the NSC, Alexey Moskovsky.<sup>426</sup> The energy-related responsibilities of the MVK that exist today include:

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<sup>422</sup> Ibid., p. 93.

<sup>423</sup> Ahrend and Tompson *Russia's Gas Sector: The Endless Wait for Reform?*, p. 7f.

<sup>424</sup> Ibid., p. 7f.

<sup>425</sup> Ibid., p. 9.

<sup>426</sup> Vendil, Carolina (2000), *Den innersta kretsen: det ryska Säkerhetsrådets inflytande [The Inner Circle: The Influence of the Russian Security Council]*, The Swedish Defence Research Establishment (FOA/FOI), December 2000, FOA-R-00-01701-170-SE, p. 38, 47.

- monitoring of competition in the market,
- preparation of issues for the NSC concerning foreign investments
- participation in the development of Russia's strategy concerning subsoil use,
- regulation of access for foreign companies to extract deposits of natural reserves,
- handling issues of energy safety.<sup>427</sup>

It consists of approximately 35 members at governmental, ministerial or departmental levels that according to Presidential decree number 1603, are defined by posts held, (which means that people may change over time). As it is an interdepartmental commission, it includes people within the fields of finance, natural resources, nature management and energy.<sup>428</sup> While the previous MVK had an operative function, the current MVK primarily deals with strategy and policymaking.

### **Clandestine Control of the Sector**

In addition to what has been stated above, there is also a formal dimension. Although few things are made public, there is evidence that the security services, most notably the FSB, not only are involved, but also have formal responsibilities in the energy sector. For example in 1996, a Consultative Council of the FSB was created. It was a body with the responsibility to cooperate with private security companies and develop contacts with the business community. The intention was to promote state interests with the overall mission to assist authorities in

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<sup>427</sup> President of Russia (2000a), 'Polozhenie o Mezhhvedomstvennoj komissii Sovieta Bezopasnosti Rossiiskoi Federatsii po bezopasnosti v sfere ekonomiki, Utverzhdeno Ukazom Prezidenta Rossiiskoi Federatsii ot 1 sentyabr 2000 g. No 1603. [Regulation of the Interdepartmental Commission of the Security Council of the Russian Federation on Security within the Economic Sphere. Presidential Decree 1 September 2000, No. 1603]', *The National Security Council*, Published: Last accessed: 15 March 2005, Internet: <http://www.scrf.gov.ru/Documents/Decree/2000/1603-4.htm>.

<sup>428</sup> President of Russia (2000b), 'Sostav Mezhhvedomstvennoi komissii Soveta Bezopasnosti Rossiiskoi Federatsii po bezopasnost v sfere ekonomiki po dolzhnostyam, Utverzhden Ukazom Prezidenta RF ot sentyabrya 2000 g. No 1603. [Composition of the Interdepartmental Commission of the Security Council of the Russian Federation on Security within the Sphere of Economic Debts, Decree by the President of the RF from September 2000, No. 1603.]', *Soveta Bezopasnosti Rossiiskoi Federatsii*, Published: 1 September 2000, Last accessed: 22 March 2005, Internet: <http://www.scrf.gov.ru/Documents/Decree/2000/1603-4.htm>.

the defence of society and individuals.<sup>429</sup> The FSB has a special service (*sluzhba*) for economic security, which is headed by General-Lieutenant Alexander Bortnikov.<sup>430</sup> Its exact tasks are unknown.

During the Soviet era, the clandestine services were also involved in business intelligence tasks and the energy sector was highly important. Most cases remain classified or are unknown, but it deserves to be mentioned as this was not only aimed at advanced technology or limited to issues of strategic importance. Small states were also subject to Soviet/Russian espionage in the energy sector of a political and technical nature. One such incident in Sweden that was categorised as a political operation but that had strong economic underpinnings concerns the KGB-officer Andrei Pannikov. He was a Trade Counsellor (*handelsråd*) at the Soviet embassy in Stockholm between 1984 and 1998 and worked for two major energy companies dealing with Sweden. During this time, he continuously tried to recruit people who were willing to supply information. The main areas of interest was Sweden's preparation for negotiations with foreign actors on gas trade; how Western states perceived the oil business of the Soviet Union in addition to information that if exposed to foreign actions would cause severe harm both to Sweden and other Western states. Pannikov was expelled in 1991 after having been exposed by the Swedish Security Service (SÄPO) and is since an oil trader in the West.<sup>431</sup> The *Rezident* of Pannikov was Igor Nikiforov, who enjoyed the cover of Counsellor (*ambassadråd*) at the embassy, and at the time led several operations against Sweden (of which at least five resulted in Russians being expelled from Sweden).<sup>432</sup>

During the 1980s, companies such as the Swedish power company Vattenfall frequently had visitors from the Russian embassy.<sup>433</sup>

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<sup>429</sup> Bennett, Gordon (2000), *The Federal Security Service of the Russian Federation*, London: Conflict Studies Research Centre (CSRC), March 2000, C102, p. 23.

<sup>430</sup> Leijonhielm, *et al.* *Ryske militär förmåga i ett tioårsperspektiv - problem och trender 2005* [*Russian Military Capability in a Ten-Year Perspective - Problems and Trends 2005*], p. 44.

<sup>431</sup> Forsberg, Tore (2003), *Spioner och spioner som spionerar på spioner: spioner och kontrapioner i Sverige* [*Spies and Spies who are Spying on Spies: Spies and Counter-Spies in Sweden*] (Stockholm: Hjalmarson och Högberg), p. 370f.

<sup>432</sup> *Ibid.*, p. 179.

<sup>433</sup> Nordblom, Charlie (1984), *Industrispionage* [*Industrial Espionage*] (Stockholm: Timbro), p. 214.

Prioritised areas for technological industrial espionage within the energy sector in Sweden was, among other areas: turbines, power generators, power transmission, supra conductors, bio mass, fusion technology, security systems, particle research, plasma physics and energy efficiency.<sup>434</sup>

However, there were also highly prioritised political dimensions. One evident example is the Norwegian State Secretary (*statssekreterare*) Arne Treholt who, working as a KGB agent, during demarcation negotiations on the Barents Sea sold out the Norwegian tactics and standpoints (that subsequently led to enormous losses for Norway and gains for the Soviet Union).<sup>435</sup>

Today, the magnitude of this practice is not available in open sources, but it is reasonable to assume that this practice still exists and Russia's Foreign Intelligence Service (SVR) has a special function for business and economic intelligence. In 1997, it was revealed that the SVR had been provided new responsibilities concerning economic intelligence and commodities were on the areas covered. In 1996, Yeltsin complained at a meeting of the National Security Council (where SVR Director Trubnikov was present) that Russia only made use of 25 per cent of information collected through industrial espionage (and that this figure was too low).<sup>436</sup>

### **Putin's 'Parliamentarian' Control of the Energy Sector**

The legislative branch has a rather subsidiary role in Russian politics. The executive power is central and since Putin came to power, the presidential influence over the lower house of parliament - the State Duma (*Gosudarstvennaya Duma*) has increased significantly. Examples of this are the committees of the Duma. As a result of the parliamentary election in 2003, Putin's party United Russia (*Yedinaya Rossiya*) received 37.57 per cent of the party votes and also secured 306 out of 450 seats in

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<sup>434</sup> Ibid., p. 279f.

<sup>435</sup> Ibid., p. 91f.

<sup>436</sup> FAS (1997), 'SVR Operations', *Federation of American Scientists (FAS)*, Published: 26 November 1997, Last accessed: 20 January 2006, Internet: <http://www.fas.org/irp/world/russia/svr/ops.htm>.

the Duma. This was 68 per cent of the deputies. Nevertheless, someone from United Russia chairs every one of the 29 committees. Moreover, both the Speaker of the Duma and the two Vice Speakers belong to United Russia, as does eight out of eleven deputies in the Council of the Duma.<sup>437</sup>

There are several committees in the Duma dealing with energy issues. Firstly, the Committee on Energy, Transport and Communications (*Komitet Gosudarstvennoi Dumi po energetike, transportu i svyazi*) is headed by Valerii Yazev, with a history in the energy sector. In all, 78 per cent of the members of the committee belong to United Russia. Remaining members belong to Rodina, Communist Part of Russia (KPRF) or the nationalist so-called Liberal Democratic Party of Russia (LDPR).<sup>438</sup> Second, Martin Shakkum, with a dubious past involvement in the fund 'Reform' in the 1990s,<sup>439</sup> heads the Committee on Industry, Construction and Science-technology (*Komitet po promyshlennosti, stroitelstvu i naukoemkim tekhnologiyam*). Up to 70 per cent it consists of members of United Russia, while others are from the parties Rodina, KPRF or LDPR.<sup>440</sup> Third, Natalya Komandova, who has had a long career in the energy and commodity sector – both as administrator and academic within the state structures,<sup>441</sup> heads the Committee on Natural Resources and Nature Management (*Komitet Gosudarstvennoi Dumi po prirodnym resursam i prirodopolzovaniyu*). This committee has 78 per cent of its

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<sup>437</sup> Leijonhielm, *et al.* *Rysk militär förmåga i ett tioårsperspektiv - problem och trender 2005* [Russian *Military Capability in a Ten-Year Perspective - Problems and Trends 2005*], p. 40f.

<sup>438</sup> State Duma (2005c), 'Sostav komiteta [Committee Composition]', *Komitet Gosudarstvennoi Dumi po energetike, transportu i svyazi*, Published: Last accessed: 18 March 2005, Internet: <http://www.duma.gov.ru/energy/info/sostav.html>.

<sup>439</sup> Smirnov, Sergei (1999), 'Chto khotyat ot Martina Shakkuma obmanutie vkladchiki? [What do the Deceived Investors Want from Martin Shakkum?]', *Novaya Gazeta (Reposted at Kompromat)*, Published: 25 October 1999, Last accessed: 18 March 2005, Internet: <http://www.compromat.ru/main/shakkum/a.htm>.

<sup>440</sup> State Duma (2005a), 'Deputatskii sostav [Deputy Composition]', *Komitet po promyshlennosti, stroitelstvu i naukoemkim tekhnologiyam*, Published: Last accessed: 18 March 2005, Internet: <http://www.duma.gov.ru/promstroykom/about/members.htm>.

<sup>441</sup> State Duma (2005b), 'Predsedatel Komiteta Komarova Natalya Vladimirovna [Chair of the Committee Komarova Natalya Vladimirovna]', *Komitet Gosudarstvennoi Dumi po prirodnym resursam i prirodopolzovaniyu*, Published: Last accessed: 18 March 2005, Internet: [http://www.duma.gov.ru/cnature/committee/komarova/komar\\_biogr.htm](http://www.duma.gov.ru/cnature/committee/komarova/komar_biogr.htm).

members from United Russia, while the rest consists of deputies from LDPR, Rodina and KPRF.<sup>442</sup>

Before Putin came to power, the chairs of the two former committees mentioned above were farther away from presidential reach. The chairperson of the Committee on Industry, Construction, Transport and Energy (*Komitet Gosudarstvennoi Dumii po promyshlennosti, stroitelstvu, transportu i energetike*) was Vladimir Gusev from Zhirinovskiy's party (LDPR), while the vice chairs came from the Communist Party (KPRF) and Yabloko respectively.<sup>443</sup> The Committee for Natural Resources and Nature Management (*Komitet Gosudarstvennoi Dumii po prirodnim resursam i prirodopolzovaniyu*) was, in contrast, chaired by Mikhail Glubokovskii from Yabloko.<sup>444</sup> This can be perceived as an indication of the slightly more democratic atmosphere that existed under Yeltsin.

Concerning the upper, inferior, chamber of the parliament – the Federation Council (*Sovet Federatsii*) – presently treats energy issues through the Apparatus Committee on Natural Resources and Environmental Protection (*Apparat komiteta po prirodnym resursam i okhraneniye okryzhayushchei sredy*), which is headed by Zjakslyk Altynbaev<sup>445</sup> that apparently has been or is a member of Chernomyrdin's party Our Home Russia.<sup>446</sup> The Apparatus Committee on Industrial Policy (*Apparat komiteta po promyshlennoi politike*) is headed by Andrei Yakimchuk.<sup>447</sup> He has not had a party career, but has been involved in the energy company

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<sup>442</sup> State Duma 'Sostav komiteta [Committee Composition]'.

<sup>443</sup> State Duma 'Komitet Gosudarstvennoi Dumii po promyshlennosti, stroitelstvu, transportu i energetike [State Duma Committee on Industry, Construction and Energy]', *Gosudarstvennaya Duma*, Published: Last accessed: 15 March 2005, Internet: [http://www.akdi.ru/gd/sprav\\_in/kom11-1.htm](http://www.akdi.ru/gd/sprav_in/kom11-1.htm).

<sup>444</sup> State Duma 'Komitet Gosudarstvennoi Dumii po prirodnim resursam i prirodopolzovaniyu [State Duma Committee on Natural Resources and Nature Management]', *Gosudarstvennaya Duma*, Published: Last accessed: 16 March 2005, Internet: [http://www.akdi.ru/gd/sprav\\_in/kom12-1.htm](http://www.akdi.ru/gd/sprav_in/kom12-1.htm).

<sup>445</sup> Federation Council (2005), 'Apparaty Komitetov i Komissii Sovieta Federatsii', *Sovieta Federatsii RF*, Published: Last accessed: 8 March 2005, Internet: [http://council.gov.ru/sostav/apparat/ap\\_k\\_k.htm](http://council.gov.ru/sostav/apparat/ap_k_k.htm).

<sup>446</sup> Rin.ru (N/A), 'Altynbaev Zhakslyk Kuantaevich', *Rin.ru*, Published: N/A, Last accessed: 11 July 2005, Internet: <http://persona.rin.ru/cgi-bin/rus/view.pl?id=15875&a=fall&idr=6&n=>.

<sup>447</sup> Federation Council 'Apparaty Komitetov i Komissii Sovieta Federatsii'.

Dalenergo.<sup>448</sup> These committees are inconsequential for formulating energy policy (as that is prepared by the government and presidential administration), but it partially explains why the Duma has become a conveyor belt for presidential decisions.

### *Control by Spin-doctors and 'Independent' Actors*

It deserves to be briefly mentioned that besides these formal institutions listed above, there are independent analysts and institutes that take part in the energy debate. Several of them follow the line of the state – others do not. Some of them, such as Vladimir Milov, both work as independent analysts at the same time as they are involved in the policy making process. This has given room to question how independent these analysts are. Another example is Stanislav Belkovsky at the National Strategy Institute. It is rumoured that he acts on behalf of the Kremlin and performs the role of a spin-doctor or acts as a trial balloon for policy suggestions stemming from the presidential administration.<sup>449</sup>

### **The Kremlin and the TEK**

The most apparent way to assess the Kremlin's control of the TEK is to examine ownership. However, ownership figures and company structures are not necessarily proof of who controls the company since the Kremlin's grip on some of these companies is much stronger than what the actual shares indicate. State ownership might thus be interesting to discern, but is a poor measurement of leverage. For example, some companies are close to the Kremlin although, formally, they are not state-owned. Consequently, it is elusive to discuss 'state-owned companies'. 'State-controlled companies' or 'Kremlin-loyal' are better terms for this broader group of companies that have ties to the Kremlin (or other state bodies).

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<sup>448</sup> Zakonodatelstvo i investitsii (2002), 'Sovet direktorov [Council of Directors]', *Zakonodatelstvo i investitsii*, Published: 25 April 2002, Last accessed: 11 July 2005, Internet: [http://www.datex.ru/db/emitent/51456CC87D08C2A5C3256D3D0057FD25/section/management/discl\\_org\\_digest.html](http://www.datex.ru/db/emitent/51456CC87D08C2A5C3256D3D0057FD25/section/management/discl_org_digest.html).

<sup>449</sup> Lavelle, Peter (2005), 'UT Comment: Belkovsky as "Artificial Negativity?"', *Untimely Thoughts*, Published: 28 April 2005, Last accessed: 18 April 2005, Internet: <http://www.untimely-thoughts.com/?art=1438&action=printer>.

One indication of state control is the degree of which board managers have links to state bodies. Presumably, the higher the degree of managers that stand close to the state structures (presidential administration, the security structures or the government) – the higher degree of state control.<sup>450</sup> Putin does not perceive any problems or anything unusual in having state officials on the boards of privatised companies. According to Putin, they do not get shares or acquire wealth, but are only there to represent the interest of the state.<sup>451</sup>

### *The Kremlin's Strengthened Grip on Gazprom*

In 1993, Gazprom was founded by presidential decree as a joint stock company on the foundation of the old Ministry of Gas Industry. During the first decade of its existence, it was state-owned to 38.7 per cent but the state, as a part of a major restructuring scheme, increased its ownership share to 51 per cent during 2005. Most analysts agree that Gazprom is a largely mismanaged, rigid and typical Soviet-style company. Gazprom's structure, lack of transparency, state-connections, monopoly position and its actions on the market are widely criticised. One example is Gazprom's influence over third-party access to the pipeline system. Critics claim that Gazprom has a discriminatory policy and states that "in short, Gazprom at present has both the means and the motive to abuse its position".<sup>452</sup>

It is however difficult to trace evidence of the aforementioned issues since Gazprom controls several companies that do not appear to be tied to Gazprom. For example, Gazprom only appears to have a minority stake in companies that are actually owned by companies in which Gazprom has the majority stake. In this manner, it can use its subsidiaries for different purposes without being directly implicated.

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<sup>450</sup> This report does not supply even the basic facts of the energy companies, for further information, see: Kryukov, Valery and Moe, Arild (1996), *Gazprom: Internal Structure, Management Principles and Financial Flows*, London: The Royal Institute of International Affairs (RIIA), and Gazprom (2004), *Gazprom in Questions and Answers*, Moscow: Gazprom, and Stern *The Future of Russian Gas and Gazprom*.

<sup>451</sup> Ostrovsky 'The New Oligarchs? Winners and Losers in the Kremlin's Grab for Oil Wealth', p. 13.

<sup>452</sup> Ahrend and Tompson *Russia's Gas Sector: The Endless Wait for Reform?*, p. 18

The board of directors indicates how closely Gazprom is linked to the state. The board members are presented in Table 5.<sup>453</sup>

<b>Table 5: Board of Gazprom 2005</b>	
Member	On the Board in the position of:
Dmitry Medvedev	Head of the Presidential Administration
Alexei Miller	CEO of Gazprom
German Gref	Minister for Economic Development and Trade
Viktor Khristenko	Minister for Industry and Energy
Alexander Ananenko	Deputy Chairman of Gazprom's Management Committee
Bruckhard Bergmann	Chairman of the Executive Board of E.ON Ruhrgas AG, member of the Executive Board of E.ON AG
Elena Karpel	Head of the Department for Pricing and Economic Expert Analysis
Mikhail Sereda	Deputy Chairman of Gazprom's Management Committee and Head of the Administration of Gazprom's Management Committee
Boris Fedorov	Gazprom Shareholder
Igor Yusufov	Ex-Minister of Energy, Now Special Envoy for the President on issues of international energy cooperation
Farit Gazizullin	Ex-Minister for Property Relations
<b>Source:</b> Gazprom (2005d), <i>Gazprom's Board of Directors</i> , Gazprom, Last accessed: 21 March 2005, Internet: <a href="http://www.gazprom.com/eng/articles/article8823.shtml">http://www.gazprom.com/eng/articles/article8823.shtml</a> .	

As mentioned above, Alexei Miller is a close friend of Putin and has been Gazprom's CEO for several years. According to the think-tank Stratfor, one of his tasks has been to retake what the former CEO, Rem Vyakhirev, "gave away".<sup>454</sup> Furthermore, Alexander Medvedev became Acting Deputy Chairman of the Company's Management Committee in

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<sup>453</sup> Gazprom (2005d), 'Gazprom's Board of Directors', *Gazprom*, Published: Last accessed: 21 March 2005, Internet: <http://www.gazprom.com/eng/articles/article8823.shtml>.

<sup>454</sup> Stratfor (2004a), 'Special Report, Part 1: The Rise of Gazprom Inc.' *Stratfor*, Published: 20 October 2004, Last accessed: 3 December 2004, Internet: <http://www.stratfor.com/seo/Story.neo?storyId=238117>.

2005 and will oversee Gazprom's export policy and foreign relations in addition to being Gazexport's (Gazprom's subsidiary for exports) Director General.<sup>455</sup> Having another two ministers on the board also facilitates communication between the Kremlin and Gazprom. These individuals have good networks and numerous informal channels between the political levels and Gazprom. However, it is difficult to declare where their loyalties lie. In this case, Igor Yusufov, as a Special Envoy on Energy Cooperation presumably stays close to the Kremlin, as does Miller and Medvedev.

Restructuring of Gazprom is a frequently discussed topic for analysts and market actors alike. By now, the first phase is finished. An internal reform aimed at enhancing efficiency has taken place during the past three years and several goals have reportedly been reached. This includes improved governing structure, cleared responsibilities, development of regulations and introduction of a budget system. In Gazprom's words, the second phase will aim at increasing operating efficiency:

*[...] as a vertically integrated company carrying on activities along the entire gas chain, including gas exploration, infrastructure construction, production, processing, transmission, underground storage and marketing. The crucial task here is to optimize the core business management structure at the subsidiaries' level. Each subsidiary must run its core business, fulfill [sic] one function and not squander resources to related and sometimes non-core activities. We want all the core businesses to be consolidated within separate companies, achieving, thus, full transparency of financial flows.<sup>456</sup>*

This second phase began in 2004, but it is doubtful whether it actually involves concrete measures. The restructuring scheme that Gazprom addresses is far from the requirements put forward by its critics. Criticism is usually directed towards Gazprom's monolithic structure

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<sup>455</sup> Gazprom (2005a), 'Alexander Medvedev Named as Acting Deputy Chairman of Gazprom's Management Committee', *Gazprom*, Published: 7 April 2005, Last accessed: 13 April 2005, Internet: <http://www.gazprom.com/eng/news/2005/04/16004.shtml>.

<sup>456</sup> Izvestia (2004), 'Alexander Ananenkov, Deputy Chairman of Gazprom's Management Committee: All Gas Production, Transmission and Trading Subsidiaries will Remain under Gazprom's 100% Ownership', *Izvestia (Reposted at Gazprom)*, Published: 14 April 2004, Last accessed: 21 March 2005, Internet: <http://www.gazprom.com/eng/articles/article14536.shtml>.

that not only affects efficiency, but also makes shareholders losing money. Criticism also stems from competitors who criticize Gazprom's total sector dominance. According to independent analysts, Gazprom's sections for transmission, extraction and sales should be divided. For a long time, Putin rejected all forms of restructuring and claimed that Gazprom's up-stream and down-stream sections could only be separated within Gazprom.

Another possibility that has been put forward is that new subsidiaries for transmission should be created. In addition, there might be an increased usage of Gazprompererobotka (that will oversee gas and liquid hydrocarbon processing) and Gazpromneftedobycha (dealing with extraction of oil and condensate) and Gazpromavtogaz (automated gas-filling compressor stations).<sup>457</sup> This so-called second phase is occasionally claimed to have been prepared years earlier. The second phase was however not launched until 2004. One reason for this that has often been suggested in the energy debate is that the launch was meant to be timed with the presidential election. At that time, the Minister of Trade and Economic Development would be too busy with the election so that he would have little time to focus on (and subsequently hinder of) Gazprom.<sup>458</sup>

When Gazprom was opened up to foreign investors, it brought about no immanent risks for Moscow to lose control as its sheer size would make it virtually impossible for a foreign actor to take it over. Possibly a consortium could make an attempt to acquire parts of it. One analyst suggests that ExxonMobile could acquire, at most, a blocking stake of 25 percent plus one share.<sup>459</sup> The risk of this is nonetheless rather low, and the Kremlin does not have to be concerned Gazprom would be

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<sup>457</sup> Gazprom (2005b), 'Gazprom - the Second Phase of Restructuring', *Gazprom*, Published: 29 January 2005, Last accessed: 21 March 2005, Internet: <http://www.gazprom.com/eng/articles/article15503.shtml>.

<sup>458</sup> Butrin, Dmitry (2004), 'Gazprom Cast the Net', *Kommersant (Reposted at Gazprom)*, Published: 19 March 2004, Last accessed: 21 March 2005, Internet: <http://www.gazprom.com/eng/articles/article11085.shtml>.

<sup>459</sup> Stratfor (2004b), 'Special Report, Part 2: The Rise of Gazprom Inc.' *Stratfor*, Published: 21 October 2004, Last accessed: 3 December 2004, Internet: <http://web2.stratfor.com/channel.php?ID=7&fPage=5>.

completely overtaken (even if a blocking stake would be serious enough from the Kremlin's point of view). The conclusion is, nonetheless, that Gazprom's dominant position will remain for the foreseeable future. This is in accordance with the wishes of both Putin and Gazprom.

There are several indications that Gazprom has the ambition to be the main player in all fields of Russia's energy sector. First, in 2004 Gazprom took over parts of the main electricity company Unified Energy System of Russia (UES). Unconfirmed information suggests that Gazprom by early 2005 already had a blocking stake in Mosenergo (that supplies 70 per cent of Moscow's power).<sup>460</sup> Mosenergo, however, already depends on gas from Gazprom.

Second, Gazprom bought a majority stake in Atomstroiexport in 2004. The company is connected to the Russian Nuclear Energy Agency that oversees exports of nuclear technology.<sup>461</sup> One example of its activities is the involvement in the construction of the nuclear power plant Bushehr in Iran.<sup>462</sup> This means that Gazprom has acquired necessary know-how for running all of Russia's nuclear power plants.<sup>463</sup> It can be interpreted that Gazprom wants an option to affect all parts of the Russian TEK. Gazprom has also been involved in politics. In the 1999 election, it supported 130 candidates to the party 'Our Home is Russia' by paying for advice to them from a leading political consultancy firm.<sup>464</sup>

Third, by acquisition of the Siberian-Urals Oil and Gas Chemicals Company (Sibur), Gazprom will control all gas processing in Russia.<sup>465</sup> Gas is naturally not a new field as such, but it will further strengthen Gazprom's hold of the existing market.

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<sup>460</sup> Stratfor 'Special Report, Part 1: The Rise of Gazprom Inc.'

<sup>461</sup> Ibid.

<sup>462</sup> Kupchinsky, Roman (2004), 'The Dismantling of Russian Oil Giant Yukos', *RFE/RL (Reposted at Johnson's Russia List)*, Published: 19 October 2004, Last accessed: 14 April 2005, Internet: <http://www.cdi.org/russia/johnson/8416-11.cfm>.

<sup>463</sup> Stratfor 'Special Report, Part 1: The Rise of Gazprom Inc.'

<sup>464</sup> Stern *The Future of Russian Gas and Gazprom*, p. 172.

<sup>465</sup> Ahrend and Tompson *Russia's Gas Sector: The Endless Wait for Reform?*, p. 5.

Fourth, Gazprom is trying to set up a gas consortium with TNK-BP for operations in the Kovytko field, a major but not yet developed field.<sup>466</sup> One of the main reasons for this is possibly that Gazprom wants to have a say in all projects of importance in Russia. Without a deal with Gazprom, any gas project is doomed to fail, as transportation requires usage of Gazprom's pipelines.<sup>467</sup> TNK-BP has been perceived as a challenger, albeit small, to Gazprom's position in the market. Still, shortly after the consortium plans became known, Gazprom's Head of Strategic Development claimed that this issue was not a priority and that the future of the project is still uncertain.<sup>468</sup>

Fifth, the merger with Sibneft strengthens Gazprom's position within the oil sector. Earlier, Gazprom mainly operated on the gas market. Prime Minister Fradkov told Gazprom's board to approve the deal on 12 October 2005 and Gazprom went on to buy a 72.663 per cent stake in Sibneft from Millhouse Capital (owned by Roman Abramovich). This improved the creditworthiness of Gazprom, but German Gref, the Minister of Economic Development and Trade, has criticised the deal from a macroeconomic point of view and stated that it would increase the "government's presence in the sector and expand the sphere of the gas monopolies activities". Miller's deputy, Alexander Ryazanov, will chair Sibneft.<sup>469</sup> Ryazanov is believed to be the informal head of the siloviki fraction at Gazprom.<sup>470</sup>

Finally, Gazprom has moved into the media market. After Vladimir Gusinsky was forced to relinquish his media stronghold, Media Most and NTV, Gazprom stepped in. This type of non-core business of

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<sup>466</sup> RosBusinessConsulting (2005k), 'Gazprom Refuting Information on Gas Consortium with TNK-BP', *RosBusinessConsulting*, Published: 15 June 2005, Last accessed: 15 June 2005, Internet: <http://www.rbcnews.com/free/20050614124112.shtml>.

<sup>467</sup> Ostrovsky 'The New Oligarchs? Winners and Losers in the Kremlin's Grab for Oil Wealth', p. 13.

<sup>468</sup> RosBusinessConsulting (2005p), 'Kovytko Plans "No Gazprom Priority"', *RosBusinessConsulting*, Published: 16 June 2005, Last accessed: 16 June 2005, Internet: <http://www.rbcnews.com/komment/komment.shtml>.

<sup>469</sup> RosBusinessConsulting (2005u), 'Minister Criticizes Gazprom-Sibneft Deal', *RosBusinessConsulting*, Published: 19 October 2005, Last accessed: 20 October 2005, Internet: [http://top.rbc.ru/english/index.shtml?/news/english/2005/10/19/19114442\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/news/english/2005/10/19/19114442_bod.shtml).

<sup>470</sup> Kupchinsky 'Russia. Putin's Former Colleagues Make Up Today's Energy Team'.

Gazprom appears to expand gradually. Presently 38 per cent of Gazprom's employees work in non-core business, that according to some caused Gazprom losses of \$US350 million in 2004.<sup>471</sup> This trend was confirmed when Gazprom in June 2005 announced that it might buy the daily newspaper Izvestiya. The stated reason for acquiring Izvestiya was that Gazprom needed it for a complete media portfolio. Gazprom claims that it continuously tries to cut away non-core assets, such as farms and holiday resorts but it can be questioned, as the Economist has, why Gazprom feels a need to have a media branch at all.<sup>472</sup>

### *State-owned Rosneft*

The oil company Rosneft was created in 1995 by presidential decree. It is 100 per cent state-owned and according to its official website:

*NK Rosneft is the only company which remained in full property of the state. It is an efficient market instrument for adjustment of Russia's fuel and energy complex. One of Rosneft basic functions is execution of state commissions in most various areas, beginning with creation of a favorable investment climate in the country and ending with specific social tasks related to leveling out of the regional and branch disproportions.*<sup>473</sup>

Since it is a state-owned company, it is not surprising to find almost exclusively prominent ministers and officials on Rosneft's board. According to the Russian website, which can be expected to be updated more recently, the Board of Directors consists of several officials.<sup>474</sup>

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<sup>471</sup> Belton, Catherine (2005b), 'The Rising Price of Pipes for Gazprom', *The Moscow Times*, Published: 16 June 2005, Last accessed: 16 June 2005, Internet: <http://www.moscowtimes.ru/stories/2005/06/16/002.html>.

<sup>472</sup> Economist (2005b), 'Russia's Energetic Enigma', *The Economist*, 8 October 2005, p. 74.

<sup>473</sup> Rosneft (2005c), 'State Policy', *Rosneft*, Published: Last accessed: 21 March 2005, Internet: [http://www.rosneft.ru/english/company/state\\_policy/index.html](http://www.rosneft.ru/english/company/state_policy/index.html).

<sup>474</sup> The Russian and English version of Rosneft's websites differ somewhat. Rosneft (2005b), 'Sovet Direktorov "NK Rosneft"', *Rosneft*, Published: N/A, Last accessed: 21 March 2005, Internet: <http://www.rosneft.ru/company/management.html>.

<b>Table 6: Board of Rosneft 2005</b>	
Member	On the Board in the position of:
Igor Sechin	Deputy Head of the Presidential Administration
Sergei Oganessian	Head of the Federal Energy Agency
Yurii Medvedev	Minister of Property Relations
Sergei Bogdanchikov	President of Rosneft
Sergei Vyazalov	First Deputy Finance Minister
Anatolii Ledovskikh	Head of the Federal Subsoil Management Agency
Anatolii Yurevich	First Deputy Head of the Economic Directorate of the Presidential Administration
Ivan Matlashov	Department Director at the Ministry of Industry and Energy
Andrei Reus	Deputy Minister of Industry and Energy
Kirill Androssov	Department Director at the Ministry for Economic Development and Trade
<p><b>Source:</b> Rosneft, (2005b), <i>Sovet Direktorov "NK Rosneft"</i>, Rosneft, Last accessed: 21 March 2005, Internet: <a href="http://www.rosneft.ru/company/management.html">http://www.rosneft.ru/company/management.html</a>.</p>	

Earlier, the former Minister of Energy, Igor Yusufov used to be chairperson of the board (he is now at Gazprom). In addition, the First Deputy Minister of Energy, Ivan Matlashov, was on the board as were another ten key individuals within the highest levels of the government and presidential administration.<sup>475</sup> Rosneft does little against the Kremlin's wishes and often receives special treatment. One incident is the acquisition of the Val Gamburtseva field by Slavneft that won the tender despite the fact that it was not the highest bidder, just to be bought by Rosneft.<sup>476</sup> The state thus sold the assets to Rosneft under market value. As Rosneft is state-owned, the profit will reach the state in either case at the same time as the pro-Kremlin firm was strengthened.

To most observers of the Russian energy market, it is clear that there will not be a merger between Rosneft and Gazprom, but the process is a clear of how these things work and how the various players act on the market. It is therefore reasonable to describe the deal in some detail. On 14

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<sup>475</sup> Rosneft (2005a), 'Board of Directors', *Rosneft*, Published: Last accessed: 21 March 2005, Internet: <http://www.rosneft.ru/english/company/management/index.html>.

<sup>476</sup> Fortescue 'The State Versus the Resource Sector: Resource Rent Issues in Russia', p. 8.

September 2004, it was announced that Gazprom and Rosneft would merge. It was a long process and the new structure was not entirely completely revealed until June 2005. The merger process took place simultaneously as the Yukos affair and several of the issues are related. One central aspect is that the state decided that Yukos' oil producing section, Yuganskneftegaz, was to be offered on the market.

In short, Gazprom (via its subsidiary Gazpromneft) aimed at taking over Yuganskneftegaz, which, in combination with the merger with Rosneft, would have given Gazprom control of 15 per cent of Russia's oil production. The problem was, however, that Yukos filed for bankruptcy and tried to keep Gazprom away.<sup>477</sup> As a consequence, the auction was won by a company called Baikal Finance Group. It later sold its newly acquired company to Rosneft.<sup>478</sup> Quite soon and not surprisingly, it was revealed that Baikal Finance was a shell company with connections to Putin and Sechin.<sup>479</sup>

The original plan was to transfer the shares of Rosneft to Rosneftegaz (which was created for this purpose) in early June of 2005 and the transfer was made at market value as payment for an additional issue of Rosneftegaz' shares. Afterwards, Rosneftegaz bought 10.74 percent stake in Gazprom's gas subsidiaries. This resulted in "securing the government a controlling interest in Gazprom."<sup>480</sup> Rosneft's shares were later sold at open market value in order to:

*[...] raise funds necessary to pay debts and strengthen capitalization of the joint-stock company [with the aim to] create a public and investor-attractive company. Rosneftegaz will be liquidated and the government will become the owner of a controlling stake in both Gazprom and Rosneft.*

Another issue is the lack of investments at Gazprom. Even if in the long run the merger would be successful, Gazprom still has huge debts and,

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<sup>477</sup> Arvedlund and Mouawad 'Breakup of Yukos Hits Output in Russia', p. 8.

<sup>478</sup> Grizodubova 'Gazprom, Rosneft Approaches Unnecessary Merger', p. 9.

<sup>479</sup> Gurin 'The Heart of Yukos is Nationalized'.

<sup>480</sup> RosBusinessConsulting (2005m), 'Gazprom Valuation Keeps Merger on Track', *RosBusinessConsulting*, Published: 31 May 2005, Last accessed: 1 June 2005, Internet: [http://top.rbc.ru/english/index.shtml?/news/english/2005/05/31/31115744\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/news/english/2005/05/31/31115744_bod.shtml).

in fact, some \$US 100 billion in investments are needed at the same time as it has a low share price.<sup>481</sup> This should be seen in light of sustainability of Russia's gas production. Gazprom simultaneously wants to get into the US market and the way forward goes via foreign partners and explorations of new fields in the north of Russia.<sup>482</sup> Later, the joint statement of Yuganskneftegaz and Gazprom declared Yuganskneftegaz would be an "independent state-run oil company" headed by Sergey Bogdanchikov that would closely cooperate with Gazprom.<sup>483</sup> The Minister of Energy and Industry, Viktor Khristenko further stated that the merger was to be an exchange of assets – not an exchange of shares. The merger would as a consequence be carried out in two stages where the first would include a raising of the state share to 51 per cent and, secondly, a liberalisation of the 'gas group's' shares.<sup>484</sup>

The situation was unclear for a long time, but the bottom line of Alexei Miller's vision for Gazprom has been a transformation into a diversified energy giant dealing in gas, oil and electricity.<sup>485</sup> Miller's vision was expressed as: "We've come up with a final resolution on the Gazprom and Rosneft merger scheme placing Gazprom's controlling stake in the hands of the State in exchange for 100% of shares in Rosneft excluding Yuganskneftegaz".<sup>486</sup> In this context, Khristenko stated that Yuganskneftegaz would not be integrated in Gazprom when it merged with Rosneft. Instead – it was to become an independent company.<sup>487</sup>

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<sup>481</sup> Arvedlund and Mouawad 'Breakup of Yukos Hits Output in Russia', p. 8.

<sup>482</sup> Dorman, Oleg (2005a), 'Gazprom Chooses Partners to Develop US Liquefied Natural Gas Market', *Moscow News*, 16-22 February 2005, p. 8.

<sup>483</sup> Gazprom (2005c), 'Gazprom's Management Committee Chairman Alexey Miller and Rosneft's President Sergey Bogdanchikov's Official Statements on the Gazprom and Rosneft Merger, Broadcast on March 2 by the NTV and First Channels.' *Gazprom*, Published: Last accessed: 21 March 2005, Internet: <http://www.gazprom.com/eng/articles/article15499.shtml>.

<sup>484</sup> RosBusinessConsulting (2005n), 'Gazprom-Rosneft Merger Scheme Agreed', *RosBusinessConsulting*, Published: 16 March 2005, Last accessed: 21 March 2005, Internet: [http://top.rbc.ru/english/index.shtml?/english/2005/03/16/16175446\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/english/2005/03/16/16175446_bod.shtml).

<sup>485</sup> Ostrovsky 'Chief Executive Has a Vision for Gazprom: Alexei Miller tells Arkady Ostrovsky about his Global Ambitions', p. 6.

<sup>486</sup> Gazprom 'Gazprom's Management Committee Chairman Alexey Miller and Rosneft's President Sergey Bogdanchikov's Official Statements on the Gazprom and Rosneft Merger, Broadcast on March 2 by the NTV and First Channels.'

<sup>487</sup> Marcelo 'India Looks to Russia and Iran for Energy', p. 1.

There was an interesting debate between the factions that exist within Gazprom, Rosneft and the Presidential Administration on how this should be carried out. Rosneft's Bogdanchikov was aligned with Sechin. Miller of Gazprom and Dmitry Medvedev represented the other side. Beneath this top level, there were newcomers running the errands of their masters, one of them being Sechin's protégé Mikhail Sereda, who in the process was appointed Deputy Head of the Managerial Board of Gazprom.<sup>488</sup>

If the deal had been successful, experts predicted that the state's powers would be so great that "the government will be able to tell the company what it should spend funds on".<sup>489</sup> Initially, it was also believed that it might be problematic for Gazprom to acquire new companies such as Surgutneftegaz or Sibneft due to the merger with Rosneft. There were rumours that Gazprom or Rosneft (or jointly) would acquire a controlling stake in Sibneft. The paper 'Kommersant Daily' stated that it could not be excluded that Rosneft would use the law enforcement agencies to 'convince' Sibneft owners to let Rosneft take a stake.<sup>490</sup> Instead, Gazprom took over Sibneft in October 2005.

### *Itera and Eural Trans Gas: Gazprom's Imaginary Competitors?*

The natural gas company Itera, founded in 1992, has had a special position on the Eurasian energy markets. Initially, Itera and Gazprom operated in harmony within the former Soviet Union. Itera, for example, sold Turkmen gas to other CIS-states with the permission of Gazprom. Despite its modest size (4 per cent of the Russian market), it outranked all European companies, including Gas de France and British Gas in terms of sales volumes.

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<sup>488</sup> Sapozhnikov and Butrin 'Damage Control'.

<sup>489</sup> RosBusinessConsulting (2005j), 'Gazprom not Likely to Venture Notorious Takeovers', *RosBusinessConsulting*, Published: 20 June 2005, Last accessed: 21 June 2005, Internet: <http://www.rbcnews.com/free/20050620133411.shtml>.

<sup>490</sup> Skornyakova, Anna (2005), 'Sibneft' tryakhnula pribylyo ['Sibneft' has Shaken Profit]', *Kommersant*, Published: 5 July 2005, Last accessed: 5 July 2005, Internet: <http://www.kommersant.ru/doc.html?docId=588900>.

Given its close relation to Gazprom, it was not a genuine competitor and was used, on numerous occasions, as a vehicle for deals within the CIS that Gazprom did not want to become openly involved in. Itera's role as a *de facto* subsidiary of Gazprom changed after the dismissal of Rem Vyakhirev in May 2001. An Audit Commission and Price Waterhouse Coopers investigated most of Itera's corrupted practice, but they found little evidence of any wrongdoings.<sup>491</sup> Not every aspect was however investigated and there are still many unclear issues. Afterwards, when Gazprom wanted to create fake competition, in order to avoid criticism of its monopoly position or just having additional possibilities for bold financial transactions, Gazprom used an until then unknown company called Eural Trans Gas.

On 5 December 2002, Gazprom and Ukraine's national oil company Naftogaz, appointed the company Eural Trans Gas as an agent to transport gas from Turkmenistan to Ukraine. On the following day, Eural Trans Gas was created. It was founded in Hungary by three Romanians and one Israeli. The deal between Gazprom and Naftogaz comes down to the fact that Eural Trans Gas was to keep 38 per cent of transported gas, which it could sell for its own profit. Consequently, it received 57 per cent of the Ukrainian gas market whilst appearing to be a competitor to Gazprom. As a result, Eural Trans Gas made \$US767 million in net profit (in 2003 alone) without having any hard assets.<sup>492</sup>

In 2003, three new shareholders also appeared in Eural Trans Gas: the Atlantic Caspian Resources (a British oil exploration company), the Dutch JKC Gas and the Austrian DEG Handels. JKC Gas sold its shares to an undisclosed buyer in December 2003. The Atlantic Caspian was at the time insolvent, but was later rescued by a newly created Cyprus-based company called Denby Holdings whose shareholder allegedly was a British hotel owner.<sup>493</sup> Gazprom's bank, Gazprombank, helped financing Eural Trans Gas.

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<sup>491</sup> Stern *The Future of Russian Gas and Gazprom*, p. 23.

<sup>492</sup> Bush, Jason (2004), 'Murky Deals at Gazprom', *Business Week*, Published: 21 June 2004, Last accessed: 15 February 2005, Internet: [http://businessweek.com/magazine/content/04\\_25/b3888073\\_mz054.htm](http://businessweek.com/magazine/content/04_25/b3888073_mz054.htm).

<sup>493</sup> Ibid.

Investors in Gazprom, i.e. Hermitage Capital Investment, have bemoaned about the fact that by removing profit from Gazprom to third parties, Gazprom's shares became undervalued.<sup>494</sup> Hermitage has also calculated that Russia loses some \$US184 million in tax revenues through activities by the Eural Trans Gas. Gazprom has also lost an enormous amount by letting Eural Trans Gas use its pipelines.<sup>495</sup> Apparently, there are forces that want to transfer profit and money from the shareholders into other pockets. Apparently, this is tolerated by the Kremlin. It is hence not only importing states that lose from the Kremlin's and the Kremlin-loyal firm's action, but shareholders as well.

These are not the only cases of obscure business relations of Gazprom. Another case in point is of the company Trubny Torgovy Dom. It handles pipeline procurements for over \$US700 million for Gazprom. Not much is known about the company, but it was founded in 2003 with a \$US350 charter capital and that it is owned by Yelena Russkaya who is 27 years old. Apparently, the guard working at the address on which the company is registered has never heard of the company. The building where it is registered is owned by United Russia – Putin's political party.<sup>496</sup>

### *Zarubezhneft – A Foreign Arm of the Kremlin*

Zarubezhneft is a relatively a small company by Russian standards. It used to be a foreign economic cooperation association (The State Enterprise Russian Foreign Economic Association) serving within the Soviet Ministry of Oil Industry in 1967. A presidential decree from 1995 preserved its status by attaching it to the Ministry of Fuel and Energy. It was then used to implement cooperation deals between Russia and foreign organisations and companies. Putin later, by decree no. 137 in

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<sup>494</sup> Arvedlund, Erin E. (2004), 'U.S. is Looking to Russia for Gas', *The International Herald Tribune*, Published: 11 June 2004, Last accessed: 15 February, Internet: <http://www.iht.com/articles/524428.html>.

<sup>495</sup> Mortishead, Carl (2004), 'Ex-British Gas Chief in \$2bn Gazprom Row', *The Times Online*, Published: 8 June 2004, Last accessed: 20 February 2005, Internet: <http://business.timesonline.co.uk/article/0,,9072-1138587,00.html>.

<sup>496</sup> Belton 'The Rising Price of Pipes for Gazprom'.

2004, transformed it into a joint stock company of which the state owns 100 per cent of its shares. The decree as reason stated:

*In order to protect the state interests of the Russian Federation in the process of transforming the state enterprise 'Russian Foreign Economic Association 'Zarubezhneft' and ensure the fulfilment of the international economic obligations of the Russian Federation<sup>497</sup>*

That Zarubezhneft is being an arm of the Kremlin is not a secret – it is the very purpose of its existence. It may have appeared strange to privatise the company, but on the background as to why the decree (on transforming Zarubezhneft into a joint stock company) came about, Zarubezhneft's website states that:

*[...] We are a federal state-owned unitary enterprise, the country has oriented itself for eliminating them[...]the Ministry of Energy offered to include us into the privatization program for unitary enterprises in 2003. We agreed under the condition that "Zarubezhneft" will have a 100-percent state own share holding without the right of sale in the future. We received such guarantees and prepared all the documents, necessary for the transformation into a joint stock company. We did our best to defend ourselves from the changes of life, mitigate risks, because in accordance with the traditional Russian scheme some people appeared who wanted to win over "Zarubezhneft" and pull it from the state control. The schemes are easy: joint-stock but insolvent enterprise is put up for an auction and bought for 6 kopecks.<sup>498</sup>*

Zarubezhneft has by and large kept its profile of being a firm operating abroad. Its main partners have been Vietnam, Syria and India. These are all states with which Russia has good relations and that are important customers for arms and military hardware.<sup>499</sup> According to Zarubezhneft, this type of international cooperation is possible because

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<sup>497</sup> Zarubezhneft (2005a), 'Development Prospects of the Company', *Zarubezhneft*, Published: N/A, Last accessed: 22 March 2005, Internet:

[http://www.zarubezhneft.ru/www/nestroweb.nsf/index/enpr\\_prospect\\_eng](http://www.zarubezhneft.ru/www/nestroweb.nsf/index/enpr_prospect_eng).

<sup>498</sup> Becker, Alexander (2004), 'Nikolay Tokarev: "Production Sharing Agreement Is Like a Sharp Knife"', *Vedomosti (Reposted at Zarubezhneft)*, Published: 1 June 2004, Last accessed: 22 March 2005, Internet:

<http://www.zarubezhneft.ru/www/nestroweb.nsf/554c7e081b919700c3256c2100282e3c/692a2332d0de421dc3256f110049f351?OpenDocument>.

<sup>499</sup> Leijonhielm, *et al.* *Ryske militär förmåga i ett tioårsperspektiv - problem och trender 2005 [Russian Military Capability in a Ten-Year Perspective - Problems and Trends 2005]*, p. 238f.

of the strong state connections.<sup>500</sup> Since 2004, Zarubezhneft has taken on the Russian market, for example by acquiring the company Dinyolneft.

Nothing points in the direction of the company being opened up for other owners and this standpoint is underscored by its head, Nikolai Tokarev, who states that it is not on the agenda for the near future.<sup>501</sup> Some information indicates that Gazprom may take over Zarubezhneft, but this is still uncertain.<sup>502</sup> If so, it would definitely enhance Gazprom's power in the foreign oil markets. In terms of state control, few things will change as result of this as most board members already are strongly connected to the state structures.<sup>503</sup> In January 2005, Prime Minister Fradkov signed an instruction that outlined a few candidates to the board that had been approved of to represent the state's interests.<sup>504</sup>

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<sup>500</sup> Rossiyskaya Federatsia (2003), "'Zarubezhneft': A Russian Enterprise in the World Market of Hydrocarbon Resource Exploration', *Rossiyskaya Federatsia (Reposted at Zarubezhneft)*, Published: September 2003, Last accessed: 22 March 2005, Internet: <http://www.zarubezhneft.ru/www/nestroweb.nsf/554c7e081b919700c3256c2100282e3c/45a00321f17836c4c3256e05002aeb2?OpenDocument>.

<sup>501</sup> Yenukov, Mikhail (2004), 'President of Zarubezhneft N. Tokarev's Interview', *Reuters (Reposted at Zarubezhneft)*, Published: 21 May 2004, Last accessed: 22 March 2005, Internet: <http://www.zarubezhneft.ru/www/nestroweb.nsf/554c7e081b919700c3256c2100282e3c/692a2332d0de421dc3256f110049f351?OpenDocument>.

<sup>502</sup> Stratfor 'Special Report, Part 1: The Rise of Gazprom Inc.'.

<sup>503</sup> Zarubezhneft (2005c), 'Sovet Direktorov [Board of Directors]', *Zarubezhneft*, Published: N/A, Last accessed: 22 March 2005, Internet: [http://www.zarubezhneft.ru/www/nestroweb.nsf/index/SovetDir\\_rus](http://www.zarubezhneft.ru/www/nestroweb.nsf/index/SovetDir_rus).

<sup>504</sup> Zarubezhneft (2005b), 'The Russian Government Approved a List of Candidates to Represent the State's Interests in the Board of Directors of Zarubezhneft JSC', *Zarubezhneft*, Published: 3 February 2005, Last accessed: 26 July 2005, Internet: <http://www.nestro.ru/www/nestroweb.nsf/2fc4c60e9fdaaa5fc3256a70004302f7/9ec308d702bbd616c3256fa40052cb28?OpenDocument>.

<b>Table 7: Board of Zarubezhneft in 2005</b>	
Member	On the Board in the position of:
Andrei Reus	Deputy Minister of Industry and Energy
Kirill Androsov	Director of the State Department on regulation of Tariffs and Infrastructure Reform at the Ministry for Economic Development and Trade
Oleg Gordeev	Deputy Head of the Federal Energy Agency
Igor Nagornii	Deputy Head of the Directorate for Internal Affairs of the Presidential Administration
Gleb Nikitin	Head of the Directorate for property Management in the Commercial Sector under the Federal Agency for Management of State Property
Andrei Kondakov	Director of the Department for Economic Cooperation of the Ministry for Foreign Affairs
Nikolai Tokarev	Director of Zarubezhneft, formerly in the Administrative Department of the Presidential Administration and Head of Transneft
<b>Source:</b> Zarubezhneft (2005b), <i>Sovet Direktorov [Board of Directors]</i> , Zarubezhneft, Last accessed: 22 March 2005, Internet: <a href="http://www.zarubezhneft.ru/www/nestroweb.nsf/index/SovetDir_rus">http://www.zarubezhneft.ru/www/nestroweb.nsf/index/SovetDir_rus</a> .	

### *Lukoil – the Kremlin's Lapdog*

Lukoil was created as a state oil combine in 1991 by a Soviet Council of Ministers resolution on the basis of three oil producing and three processing industries (Langepasuralkogalymneft). It has been state-owned to 14 per cent during most of the post-Soviet period. This share is now reduced. It has the Kremlin's backing in its quest to become a global player and has an offensive market approach. It has bought many foreign firms in Finland, Germany and Iraq to mention but a few countries.<sup>505</sup> Lukoil controls, according to its website, 19 per cent of the Russian oil production and 19 per cent of its oil refining capacity. It is the second largest oil company in the world in terms of proven reserves of hydrocarbons. In terms of production of hydrocarbons, it ranks sixth in

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<sup>505</sup> Dorman, Oleg (2005b), 'Lukoil Set to Become Global Player', *Moscow News*, 23 February - 1 March 2005, p. 8.

the world.<sup>506</sup> Unlike Gazprom and Rosneft, it does not have prominent officials on its board.<sup>507</sup>

Apparently, Lukoil is more independent than the other firms discussed hitherto. In terms of board members and ownership, this may be true, but Lukoil in fact stands close to the Kremlin on an informal basis. Lukoil acts highly tactical, adapts to the setting and often volunteers to provide a helping hand to the Kremlin. This is evident, for example, in the case of the Far Eastern oil pipeline or the policy towards the Baltic countries.

Officially, Lukoil's president, Vagit Alekperov takes a position that is more liberal than the Kremlin's and he has stated that Russia's reserves do not only belong to the place where they are located but also 'to the world'. Therefore, he argues, non-discriminatory actions are crucial, as is fairness, consistence, democratic ideals and free markets. Discrimination would undermine world energy security.<sup>508</sup> On other occasions, he has stated that he wishes to avoid any separation between company interest and national ones.<sup>509</sup> There are reasons to believe that Alekperov has a less altruistic agenda for Lukoil than what he claims in a journal aimed at the international community. On a personal basis, he is close to Putin and he has pledged his allegiance to the state by saying: "We support the activity of the V. Putin government, just as we once supported the governments of Viktor Chernomyrdin, Sergei Kiriyenko, Yevgenii Primakov, and Sergei Stepashin".<sup>510</sup> In short, Lukoil is a market-driven company with politically fine-tuned *fingerspitzengefühl*.

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<sup>506</sup> Lukoil (2005b), 'Global Business of Lukoil', *Lukoil*, Published: N/A, Last accessed: 21 March 2005, Internet: <http://www.lukoil.com>.

<sup>507</sup> Lukoil (2005a), 'Board of Directors', *Lukoil*, Published: 24 January 2005, Last accessed: 21 March 2005, Internet: [http://www.lukoil.com/back/staff\\_\\_head\\_6\\_5dep\\_20\\_.html](http://www.lukoil.com/back/staff__head_6_5dep_20_.html).

<sup>508</sup> Alekperov, Vagit (2000), 'The Oil Business: A Responsible Approach', *International Affairs (Moscow)*, Vol. 46, No. 2, p. 37

<sup>509</sup> Allison 'Strategic Reassertion in Russia's Central Asia Policy', p. 283.

<sup>510</sup> Alekperov 'The Oil Business: A Responsible Approach', p. 39.

### *Surgutneftegaz*

Most analysts agree that Surgutneftegaz, Russia's second largest gas producer, is one of the Kremlin's most loyal firms.<sup>511</sup> Its reputation is contradictory. It is considered to be one of the best run companies in Russia, but at the same time, much criticism is delivered about its management. The head of the company, Vladimir Bogdanov, is considered to be very discreet and is never involved in scandals. He does not give interviews and even goes by the nickname 'the Surgut Hermit'. He is stated to have xenophobic views, and he is in all respects authoritarian and conservative, according to Russian observers.<sup>512</sup>

The company has not undertaken necessary reforms and it is one of the least transparent oil firms. One opinion is that the company is a 'dinosaur' on the capital market, as it is not concerned with increasing its capitalisation and has "meagre dividends, primitive accounting and under-utilized cash reserves".<sup>513</sup> At the same time, Bogdanov is perceived as competent and in the 2000 elections; he was Putin's envoy and was praised by Putin who offered him to be minister of energy, an offer he turned down.<sup>514</sup> In particular, Surgutneftegaz' foreign operations have been praised. Despite its special status, it is far from a questionable company. It has received awards for adopting Western technology<sup>515</sup> and Forbes Magazine has called Bogdanov competent, honest, and successful. This stems from the fact that he, quite successfully, has run Surgutneftegaz since 1984 when he took the reins at the age of 32.<sup>516</sup> The board members are listed below.<sup>517</sup>

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<sup>511</sup> For example: Kupchinsky 'The Dismantling of Russian Oil Giant Yukos'.

<sup>512</sup> See for example, Ostrovsky, Andrew (1998), 'Economy Shows its Two Faces', *The Financial Times (Reposted at Johnson's Russia List)*, Published: 4 November 1998, Last accessed: 15 February 2006, Internet: <http://www.cdi.org/russia/johnson/2460.html>.

<sup>513</sup> Poussenkova 'From Rigs to Riches: Oilmen vs. Financiers in the Russian Oil Sector', p. 6.

<sup>514</sup> Ibid., p. 21.

<sup>515</sup> Surgutneftegaz (2005b), 'Surgutneftegaz' udostoen premii 'Evropeiskii standart' ['Surgutneftegaz' Awarded Prize by 'European Standard']', *Surgutneftegaz*, Published: 27 April 2005, Last accessed: 25 May 2005, Internet: [http://www.surgutneftegas.ru/rus/show\\_company\\_news.xpml?mds\\_objectid=8826](http://www.surgutneftegas.ru/rus/show_company_news.xpml?mds_objectid=8826).

<sup>516</sup> Poussenkova 'From Rigs to Riches: Oilmen vs. Financiers in the Russian Oil Sector', p. 6f.

<sup>517</sup> Surgutneftegaz (2005a), 'The Board of Directors', *Surgutneftegaz*, Published: N/A, Last accessed: 25 April 2005, Internet: [http://www.surgutneftegas.ru/eng/structure\\_direct.xpml](http://www.surgutneftegas.ru/eng/structure_direct.xpml).

<b>Table 8: Board of Surgutneftegaz 2005</b>	
Member	On the Board in the position of:
Alexander Usoltsev	Chairman
Vladimir Bogdanov	Director General
Sergei Ananyev	Head of Production Division "Fedorovskneft"
Alexander Bulanov	Head of Production Division "Surgutneft"
Igor Gorbunov	Head Production Division "Bystrinskneft"
Nikolai Matveev	First Deputy Director General
Nikolai Medvedev	Deputy Director General
Alexander Resyapov	Deputy Director General
Ildus Usmanov	Head of Gas Production Division "Nizhnesortymskneft"
<b>Source:</b> Surgutneftegaz (2005), <i>The Board of Directors, Surgutneftegaz</i> , Last accessed: 25 April 2005, Internet: <a href="http://www.surgutneftegas.ru/eng/structure_direct.xpml">http://www.surgutneftegas.ru/eng/structure_direct.xpml</a> .	

Another aspect of Surgutneftegaz' (and Bogdanov's) political loyalty is that it has been awarded with licences<sup>518</sup> and invited to join the forthcoming Rosneft and Gazprom consortium in Siberia.<sup>519</sup> One of Surgutneftegaz's assets is a refinery in Kirishi near St. Petersburg. It had an output of almost 111.7 million barrels in 2003.<sup>520</sup> Kirishi belongs to the Kineks group on which there is a longer comment below in the context of Putin's connections.

### *The Newcomer: Russneft*

Russneft, a VIC, was created in 2002 and has since become more significant. Mikhail Gutsiriev, as most of its board members, came from the Russian-Belarus Slavneft and is not directly connected to state structures.<sup>521</sup> He owns a controlling stake of "around 70 percent, while

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<sup>518</sup> Poussenkova 'From Rigs to Riches: Oilmen vs. Financiers in the Russian Oil Sector', p. 17.

<sup>519</sup> Ibid., p. 19.

<sup>520</sup> Ibid., p. 12.

<sup>521</sup> Russneft (2006b), 'Management of the Company', *Russneft*, Published: N/A, Last accessed: 31 January 2006, Internet: <http://eng.russneft.ru/ceo/>, and Russneft (2006a), 'Biography', *Russneft*, Published: N/A, Last accessed: 31 January 2006, Internet: <http://eng.russneft.ru/biografy>.

the rest belongs to his relatives".<sup>522</sup> In 2004, most analysts believed that he was not a force to count with, but he has regained strengths since.<sup>523</sup>

Despite being involved in the turbulence at Slavneft, Gutsiriev is an ideal manager in many ways. His CV reveals that he has been highly awarded by the state for his efforts, including the 'Honest Tax-Payer Annual Premium', a letter of gratitude from the Federal Service on Drugs Turnover Control and the order of the St. Sergius of Rodonezh for assisting building orthodox churches. He has furthermore written on the problems of free trade zones and has received a medal for 'Distinguished Services in Special Operations by the Federal Security Service'.<sup>524</sup>

He has a strong vision of making Russneft a major Russian player. One example of this was when the Slovakian oil pipeline company Transpetrol (which is owned by the Yukos group) offered 49 per cent its share of a 512 km section of the large Druzhba pipeline at an auction. The Russian government announced that Russneft was to take part in the bid. Whether this asset would fit Russneft's profile or not is debated among analysts. The bid nonetheless has the Kremlin's explicit backing. Tatneft and Rosneft were previously interested, as was Italy's Enel. One explanation why Russneft, which stands close to the Kremlin, took the opportunity instead of Rosneft is that Rosneft has huge financial debts and would be unable to acquire the stake.<sup>525</sup> Another example is that Russneft has acquired Krasnodarekoneft, Saratovneftegaz, Orenburgnefteprodukt, the Orsk refinery, the Orenburg-based Neftemaslozavod and the refinery Krasnodarekoneft for a sum of almost

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<sup>522</sup> Dempsey, Judy (2005a), 'Gazprom Tests Limits of Customers Dependence', *International Herald Tribune*, Published: 26 December 2006, Last accessed: 31 January 2006, Internet: <http://www.iht.com/articles/2005/12/26/business/gazprom.php>.

<sup>523</sup> Kommersant (2004), 'The Oil and Gas Industry 2000-2004', *Kommersant*, Published: 17 May 2004, Last accessed: 31 January 2006, Internet: [http://www.kommersant.com/tree.asp?rubric=3&node=38&doc\\_id=474677](http://www.kommersant.com/tree.asp?rubric=3&node=38&doc_id=474677).

<sup>524</sup> Russneft 'Biography'.

<sup>525</sup> RosBusinessConsulting (2005€), 'Russneft Eyes Yukos Asset', *RosBusinessConsulting*, Published: 15 December 2005, Last accessed: 15 December 2005, Internet: <http://www.rbcnews.com/komment/komment.shtml>.

\$US1billion.<sup>526</sup> Whether the Kremlin will continue to support Russneft remains to be seen, but it will probably be an increasingly important actor on the energy markets.

### *United Energy System – The Omnipotent Electricity Giant*

The power and electricity company Unified Energy System of Russia (RAO UES of Russia) was created in 1992 by resolution of the Russian Federation State Committee for Government Property Management.<sup>527</sup> Today it is state-owned to 52 per cent. By far, it is the largest and most important actor in the electricity market and it has numerous subsidiaries in several former Soviet republics. It is closely connected to the gas sector, which is why it has been included in this section that predominately covers the oil and gas firms. Domestically it controls 73 out of the 75 regional power monopolies (*energors*), the power grid, all large power plants and hydro-electrical plants and several hundred smaller companies. As discussed above, it will probably not remain in its current form after the electricity reform has kicked in, but the powers possessed by it will probably remain within the Kremlin's reach. UES is headed by Anatoly Chubais, at one time the richest man in Russia.<sup>528</sup> If Gazprom keeps on taking over parts of UES, his future will be at stake. A confrontation with Putin may be imminent, as indicated above, and his power base is rather small outside of St. Petersburg. Concerning UES's board, the members can be found at the top level of both other companies and in the state structures.<sup>529</sup>

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<sup>526</sup> Finam (2005), 'Sector Analysis: Oil and Gas', *Finam*, Published: 27 December 2005, Last accessed: 31 January 2005, Internet:

<http://www.finamrus.com/sector/oilgas0000400D63/default.asp>.

<sup>527</sup> UES is an electricity company, but this sector is closely connected to the gas sector and operates to a large extent in the CIS, which is why it is briefly covered in this report.

<sup>528</sup> Kommersant Dengi (2001), "'Dengi" - Top-100', *Kommersant Dengi*, No. 43, 31 October 2001.

<sup>529</sup> UES (2004), 'Directors Board of the Russian Stock Company of the Unified Power System of Russia (RAO UES of Russia)', *RAO UES*, Published: 30 June 2005, Last accessed: 22 March 2005, Internet: [http://old.rao-ees.ru/en/management/dir\\_personal.htm](http://old.rao-ees.ru/en/management/dir_personal.htm).

<b>Table 9: Board of RAO UES of Russia 2005</b>	
<b>Member</b>	<b>On the Board in the position of:</b>
Alexander Abramov	President of EvrazHolding
Grigory Berezkin	Chairman of the Management Board ESN Group of Companies
Andrei Bugrov	Managing Director Interros Company
Alexander Voloshin	Advisor to Head of the Administration of the President
German Gref	Minister of Economic Development and Trade
Valentin Zavadnikov	Chairman of the Committee for Industrial Policy of the Federation Council
Alexander Kazakov	Chairman of the Committee for the Federation Issues and Regional Policy of the Federation Council
Mikhail Odintsov	Member of the Board of Directors UES
Vladimir Rashevsky	General Director Sibenco
Kirill Seleznev	General Director Mezhhregiongaz, on the Management Board of Gazprom
Yakov Urinson	Deputy Chairman of the Management Board UES
Viktor Khristenko	Minister of Industry and Energy
Anatoly Chubais	Chairman of the Management Board UES
Andrei Sharonov	First Deputy Minister of Economic Development and Trade
Ilya Yuzhanov	Member of the Board of Directors UES
<b>Source:</b> UES (2004), <i>Directors Board of the Russian Stock Company of the Unified Power System of Russia (RAO UES of Russia)</i> , RAO UES, Last accessed: 22 March 2005, Internet: <a href="http://old.rao-ees.ru/en/management/dir_personal.htm">http://old.rao-ees.ru/en/management/dir_personal.htm</a> .	

### *Transneft – Putin's Pipes*

Transneft, created by governmental decree in 1992 on the basis of the old Central Department for Oil Transport and Supplies (Glavtransneft), today owns 48,000km of crude oil pipelines and has been responsible for controlling 99,6 per cent of all oil transports.<sup>530</sup> As a state monopoly, Transneft is 100 per cent state-owned. The monopoly circumstance is frequently used by Transneft and the Kremlin. For example, the head of Transneft, Semyon Vainshtok often attempts to use Transneft's monopoly position to attract investments by emphasising the stability and tax-paying abilities of Transneft. He claims that it is "reliable and

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<sup>530</sup> Transports by train and river have nonetheless increased somewhat since 2000.

attractive from the point of view of investing in it".<sup>531</sup> He further states that:

*Transneft's activities are fully controlled by the state through licensing, distribution of rights of access to export oil pipelines, the setting of transportation service tariffs, and the planning of the company's development and mapping out its investment policy.*<sup>532</sup>

Its pipelines are aging even if Transneft states that the average age of its pipelines is decreasing since they replace thousands of kilometres of pipelines every year. Other hindrances that Transneft itself claims are the most important are threats to information security and crude oil theft. Theft has especially taken place in Samara, Volgograd and Saratov.<sup>533</sup>

Transneft is unwilling to let go of its monopoly position. State control must be kept according to Transneft. As a rationale, it points out that a privatised market will result in every pipeline operation setting its own tariffs, which is problematic. Moreover, all operations will have different levels of safety and security as they spend various amounts on modernisations. Finally, tariffs will be differentiated depending on customer – hence not equal for everyone.<sup>534</sup> Given the fact that Transneft neglects most of its pipelines and together with certain state structures give priority to pro-state oil companies (e.g. Lukoil vs. Yukos) these arguments appear somewhat lucid.

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<sup>531</sup> Vainshatok, Semyon (2000), 'Transneft: 46,700 km of Oil Pipelines', *International Affairs (Moscow)*, Vol. 46, No. 2, p. 44.

<sup>532</sup> Ibid., p. 44.

<sup>533</sup> Tseselskiy, Ivan (2004), 'Transneft is Out of Policy: Interview with Sergey V. Grigoriev - Vice President of Transneft JSC', *Transneft*, Published: 25 October 2005, Last accessed: 21 March 2005, Internet:

<http://www.transneft.ru/press/Default.asp?LANG=EN&ATYPE=9&PG=0&ID=6965>.

<sup>534</sup> Ibid.

As is evident from the table below, most board members have high-ranking positions within the state structures that in some way deal with energy issues.<sup>535</sup>

<b>Table 10: Board of Transneft 2005</b>	
<b>Member</b>	<b>On the Board in the position of:</b>
Viktor Khristenko	Minister of Industry and Energy
Simon Vainshtock	President of Transneft
Arkady Dvorkovich	Head of President's Expert Department
Yuri Medvedev	Deputy Head of the Federal Property Management Agency
Gleb Nikitin,	Head of the Business Sector Organisations Management Department of the Federal Property Management Agency
Sergey Oganessian	Head of the Federal Energy Agency
Dmitriy Petrov	Adviser of the President's Expert Department
Andrei Sharonov	Deputy Minister for Economic Development and Trade
Evgeny Shkolov	Vice-President of Transneft
<b>Source:</b> Transneft (2005a), <i>About Transneft: Management</i> , Transneft, Last accessed: 21 March 2005, Internet: <a href="http://www.transneft.ru/About/Management/List.asp?LANG=EN&amp;DTYPE=3">http://www.transneft.ru/About/Management/List.asp?LANG=EN&amp;DTYPE=3</a> .	

Transneft is one of the Kremlin's strongest levers in its foreign energy policy. As a transport monopoly, Transneft is, in many ways, the perfect lever for the Kremlin. It can be used for staging oil cut-offs to foreign customers and constitutes a vehicle for geo-strategic priorities. Keith Smith in his report argues that:

*A disturbing trend over the past two years with serious implications for the neighbourhood, however, has been Putin's successful move to consolidate state control over the energy sector and to eliminate any competing source of power that might come from privatized energy firms.*<sup>536</sup>

### *Six Categories of Russian Energy Companies*

Earlier in this report, the character of certain energy corporations was discussed. Peeter Vahtra and Kari Liuhto at the Turku School of

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<sup>535</sup> Transneft (2005a), 'About Transneft: Management', *Transneft*, Published: N/A, Last accessed: 21 March 2005, Internet: <http://www.transneft.ru/About/Management/List.asp?LANG=EN&DTYPE=3>.

<sup>536</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 5.

Economics and Business Administration have tried to divide the Russian firms into categories on the basis of how they act on foreign markets. The conclusion is that they fall within six broad categories:<sup>537</sup>

- 1) Patriots (controlled by Russian government).
- 2) Conformers (adapts to Russian foreign policy).
- 3) Fugitives (established for money transfers and tax evasion reasons, etc.).
- 4) Balancers (balances between business and government interest).
- 5) Outlaws (engaged in illegal activities such as money laundering, etc.).
- 6) Free marketers (operate in the non-strategic business sector or are small in size.).

Four energy corporations are mentioned by name and according to Vahtra and Liuhto, Gazprom and Rosneft are considered as patriots, while Lukoil and Surgutneftegaz are conformers.<sup>538</sup> This classification should not be seen as dogmatic, as most firms could fall into several categories at once. Presumably, Yukos would (according to Western views) fall into the balancers category, while the Yukos affair shows that the Russian state considers it an outlaw. There are many free marketers, but these are (as the definition suggests) so small that their impact on the political or international level is marginal. A not too bold speculation would be that Zarubezhneft is a patriot. Eural Trans Gas could be seen as a fugitive but it is doubtful if it has been regarded as such by the Kremlin.

### **Harmony and Confrontation between State and Energy Companies**

One of the most fundamental questions is whether the agendas of the Kremlin and the energy corporations converge. Are they acting in harmony or do they have incompatible means and goals? The answer appears to be both.

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<sup>537</sup> Vahtra and Liuhto *Russian Corporations Abroad: Seeking Profit, Leverage or Refuge?*.

<sup>538</sup> Ibid.

### *Harmony between the State and Energy Companies*

It is apparent that the Russian state promotes Russian business interest domestically and abroad. The Russian Deputy Minister of Foreign Affairs, Andrei Denisov, explicitly argues that Russia's practice of 'economization' of its foreign policy is in line with international practice. He states that there is an absolute understanding of the need for increased governmental support for Russian businesses on world markets and that the president has called for just that. He argues that:

*[...]in external markets, we must act as staunch statist, aiming to uphold the interest of our producers and exporters in a resolute way. The foreign missions of the MFA and the Ministry of Economic Development 'spearhead' the efforts to promote Russia's economic interests abroad.<sup>539</sup>*

He further states that he observes an increase in trust between companies and the diplomatic service. Currently, Russia, as other countries, provides diplomatic support for negotiations for important contracts, assists companies in the privatisation of production facilities and in investment tenders abroad and insists in taking part in settling disputes over antidumping investigations, he claims. Furthermore, the MFA is providing support for exports and databases on trade and economic matters. In addition, it provides assistance in organising business associations of Russian companies and banks operating in certain geographical areas.<sup>540</sup>

This policy of using state powers to promote Russian business interests is far from unique. Most states have a connection between the state and energy corporations and one can even argue that this relation is underdeveloped in Russia. Denisov's vision, therefore, is that the MFA, similar to the British Foreign Office-system, one day should have one-third of its total number of staff working abroad concerned with trade and economics.<sup>541</sup> Russia's energy strategy also bears witness of the importance Russia puts on its economic independence and in such a perspective, crucial elements of the energy sector must be directed from the centre. Vainshtok, the president of Transneft, in 2000 stated that

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<sup>539</sup> Denisov 'How the MFA Promotes Russian Business Interests Abroad', p. 67.

<sup>540</sup> Ibid., p. 68.

<sup>541</sup> Ibid., p. 69.

“‘Transneft’ is seen as one of the federal energy systems guaranteeing the country’s economic independence [...]”.<sup>542</sup>

National or quasi-national energy companies usually serve the purpose of advancing state interests, but there is a risk of them becoming too powerful either in an international context or in domestic politics. If a state within the state is created, it may well end up using state resources to promote its own interest.<sup>543</sup> This occurred in the 1990s during Yeltsin’s reign. The top-level business elite, the oligarchs, at the time had both great economic power and large political influence.<sup>544</sup> According to the arch-oligarch at the time, Boris Berezovsky, seven oligarchs controlled half of the Russian economy.<sup>545</sup> In addition, the oligarchs supported Yeltsin (and the ‘family’) and ensured that he was re-elected. Today, the old oligarchs have largely been curbed by Putin and through the Yukos affair; Putin demonstrated that the time when the oligarchs that came from the banking sector<sup>546</sup> could blackmail the state was over. As indicated here, there is a new generation of oligarchs in Russia. These are found within the energy sphere are often loyal to the state. By promoting these people, Putin has managed to create a new business culture of oligarchs that are as powerful as the old oligarchs, but that act politically correct.

### *Confrontation between State and Energy Companies*

Despite what has been stated regarding the state and market acting in tune, there are constant disputes between energy companies and the state.<sup>547</sup> There are also clashes between and within the state actors,

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<sup>542</sup> Vainshtok 'Transneft':46,700 km of Oil Pipelines', p. 44.

<sup>543</sup> Stevens, Paul (2004), 'National Oil Companies: Good or Bad?' *Center for Energy, Petroleum and Minerals Law Policy (CEPMLP) Internet Journal*, Vol. 14, p. 13.

<sup>544</sup> See Hoffman, David E. (2003), *The Oligarchs: Wealth and Power in the New Russia* (New York: Public Affairs).

<sup>545</sup> Kryshantovskaya and White 'The Rise of the Russian Business Elite', , p. 297. This article also has a review of trends in terms of influence among the business elite and their background at aggregated level.

<sup>546</sup> Hoffman *The Oligarchs: Wealth and Power in the New Russia* .

<sup>547</sup> Some of the market-related problem stemming from state-business-relations are well-covered in Locatelli, Catherine (Forthcoming 2006), 'The Russian Oil Industry Between Public and Private Governance: Obstacles to International Oil Companies' Investment Strategies', *Energy Policy*, , Locatelli, Catherine and Boussena, S. (2005), *The Bases of a New Organization of the Russian*

companies and groupings within the presidential administration. Aside from 'normal competition', there are also cases of rivalry and confrontation that indicate that the Kremlin is not in complete control. This could explain why it is "so eager to tighten its grip over the 'commanding heights' of Russia's economy".<sup>548</sup> One example is Lukoil.

Occasionally, Lukoil has diverging views on Russia's foreign energy relations, for example concerning Iran. Yevgenii Primakov, the former prime minister and presently Chairman of Russia's Chamber of Commerce and Industry (popularly known as the 'Trade Union of the Oligarchs') promoted increased cooperation between Iran and Russia on energy. The proposed deals however went against Lukoil's wish, among other things since Vagit Alekperov is involved in US Getty Petroleum that is a competitor.<sup>549</sup>

There are also numerous illegal regional cartels that upset Moscow. There have for example been cases with price collusion in Udmurtia in 2003. Lukoil was one of the actors involved but allegedly, the authorities (the Anti-monopoly Ministry) were too weak at the time to do anything about it.<sup>550</sup> Also in 2003, the then Minister for Energy, Vitaly Artyukhov launched investigations into both Lukoil and Gazprom. The findings of the investigation concluded that numerous violations of the environmental law had taken place. In addition, an investigation by the Audit Chamber found that several branches of Gazprom operated without state licences. Actions were taken against neither Lukoil nor Gazprom.

### *The Military Connections*

There have always been strong links between the energy and the military sectors in Russia and the Soviet Union. Natural resources are, for example, earmarked for the Military-Industrial Complex and quotas are

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*Oil Sector- Between Private and State Ownership.*, Grenoble: LEPII-EPE, University of Grenoble, April 2005.

<sup>548</sup> Ostrovsky, Andrew (2004), 'Politics First: the Kremlin Tightens its Control over the Commanding Heights of Russia's Economy', *The Financial Times*, 5 August 2004.

<sup>549</sup> Stratfor *Global Market Brief*, 14 February 2005,

<sup>550</sup> Smirnov, Mikhail (2004), 'Russian Gasoline is More Expensive than American', *International Affairs (Moscow)*, Vol. 50, No. 4, p. 63f.

meant to ensure that its industries can operate in peacetime.<sup>551</sup> The energy strategy states that defence related objects are to be given priority, but there are also examples that may cast light on some aspects of Russia energy.<sup>552</sup>

First, Russia intends to increase its gas extraction on the Barents Sea coast and therefore Alexander Ananikov, the Deputy Chairman of Gazprom together with the Commander-in-Chief of the Russian Navy, Vladimir Kuroyedov, held a meeting on the 18 March 2005 on this topic. Three things were covered: constructing the North-European Gas Pipeline (NEG), creation of a LNG production and shipping system within Gazprom (that is to be located on the Barents Sea coast) and, finally, transportation of high-pressure gas by sea (that might need to use some of the military infrastructure in the area).<sup>553</sup> This was not the first time Gazprom cooperated with the Russian navy. Already in 2002, Gazprom and the Navy signed a protocol aimed at promoting interaction and long-term cooperation in terms of oil and gas offshore exploration and development.<sup>554</sup>

Further evidence of the connection between the military and the energy industry is that there are suggestions that the energy (and fishing) industry could help finance shipbuilding for the navy in return for military protection of its projects and infrastructure.<sup>555</sup> It is interesting to note that is the suggestion came closely after the incident with the

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<sup>551</sup> See chapters 3.2 and 3.5 in Leijonhielm and Larsson *Russia's Strategic Commodities: Energy and Metals as Security Levers*, and Unge, Wilhelm (2000), *The Russian Military-Industrial Complex in the 1990s - Conversion and Privatisation in a Structurally Militarised Economy*, The Swedish Defence Research Establishment (FOA), december 2000, FOA-R-00-01702-170-SE.

<sup>552</sup> For a longer discussion on this topic, see Rosefielde, Steven (2005), *Russia in the 21st Century - The Prodigal Superpower* (Cambridge: Cambridge University Press).

<sup>553</sup> Gazprom (2005e), 'Meeting of Gazprom and RF Navy's Working Group Held', *Gazprom*, Published: 18 March 2005, Last accessed: 14 April 2005, Internet: <http://www.gazprom.ru/eng/news/2005/03/15670.shtml>.

<sup>554</sup> Ibid.

<sup>555</sup> Solovev, Vadim and Ivanov, Vladimir (2005), 'Voenno-morskoi flot samoustanihsya ot vypolneniya ekonomicheskikh zadach [The Navy Has Withdrawn from Carrying Out Economic Tasks]', *Nezavisimoe Voennoe Obozrenie*, Published: 3 November 2005, Last accessed: 3 November 2005, Internet: [http://nvo.ng.ru/forces/2005-11-03/1\\_flot.html](http://nvo.ng.ru/forces/2005-11-03/1_flot.html).

Russian fishing vessel 'Electron' that was forced to leave Norwegian territorial waters outside Svalbard.<sup>556</sup>

Second, the ongoing militarization of the Caspian Sea is connected to the energy business. New patrol vessels (the Tatarstan), three new high-speed boats and three Mirage-type guard boats have been deployed by Russia.<sup>557</sup> One reason is naturally the threat from Chechen terrorists. Kazakhstan has also started to patrol their fields by helicopter and Iran has increased the activities within its Caspian navy.<sup>558</sup>

Third, there are links to the exports of arms. For example, Rosoboroneksport accepts hydrocarbons reserves for payments of material and weapons sales according to its General Director Sergei Chemezov. This type of barter payment is common. Thailand for example pays in poultry.<sup>559</sup> Another example is between Russia and Belarus that have reached complex deals on gas and arms (on which there is a longer comment in chapter seven).<sup>560</sup> In all, this means that energy issues occasionally are closely connected to the military sector and that certain processes cannot be seen only in light of market actions, as some market analysts tend to do.

Finally, as few Russian companies would be willing to upset the Kremlin after having witnessed what happened to Yukos, it is not remarkable that they adhere to a policy of appeasement. In most cases, this basically means resuming business, while staying away from politically sensitive fields or issues. In some cases, firms have paid large sums to governmental funds. An example is the All-Russian National Military

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<sup>556</sup> Vendil Pallin *Russian Military Reform: A Failed Exercise in Defence Decision Making*, p. 186.

<sup>557</sup> Chufirin, Gennady (2004), 'Russia's Caspian Energy Policy and its Impact on the U.S.-Russian Relationship', *The Energy Dimension in Russian Global Strategy* (Houston: The James A. Baker III Institute for Public Policy of Rice University), p. 7.

<sup>558</sup> See also, Vendil Pallin, Carolina (2006), *NATO-operationen Active Endeavour: ett test för det militära samarbetet mellan NATO och Ryssland [The NATO Operation Active Endeavour: a Military Cooperation Test for NATO and Russia]*, Stockholm: The Swedish Defence Research Agency (FOI), January 2006, Memo 1626, p. 48f.

<sup>559</sup> Moscow News (2005b), 'News in Brief', *Moscow News*, 16-22 February 2005, p. 9.

<sup>560</sup> Bruce, Chloë (2005), *Friction or Fiction? The Gas Factor in Russian-Belarusian Relations*, London: Chatham House, May 2005, Briefing Paper REP BP 05/01, p. 6.

Fund that was created by Putin in 1999.<sup>561</sup> It is headed by an ex-KGB officer, Alexei Molyakov, and is aimed at providing financial support to soldiers and their families after service in North Caucasus.<sup>562</sup> The donors include Energotopkompleks, Transneft, Mosenergo, Lukoil, Yukos, Permenergo, Rosneft, Russneft, Sibneft, Slavneft, Surgutneftegaz and TNK-BP.<sup>563</sup> Alfa-bank is one of the donors that utilise this in its marketing campaign when trying to profile itself and claiming that it takes its 'social-corporate responsibility'.<sup>564</sup>

Another fund, where for example Alexei Miller, Vagit Alekperov and Semyon Vainshtok are on the advisory board, is the fund for the Centre for Help to Homeless Children.<sup>565</sup> This is a way for the state to fund the military structures.<sup>566</sup> One interpretation of this phenomenon is that it is one of many ways for prominent companies to show the Kremlin that it acts in the national interest by implicitly providing money for the campaign in Chechnya – a modern form of political indulgence letters.

### What Does this Imply?

Even if this review of Russian energy companies is not exhaustive, a few things must be emphasised. First and foremost, the power structure of the energy sector is concentrated to a block consisting of energy

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<sup>561</sup> All-Russian National Military Fund (2005a), 'Natsional voennie fond [National Military Fund]', *All-Russian National Military Fund*, Published: Last accessed: 18 October 2005, Internet: <http://www.nvfond.ru/show.html?pid=1&ppid=1>.

<sup>562</sup> Udmantsev, Vadim (2002), 'Tochnikh dannikh o postradavshikh net [Exact Data on Victims are not Present]', *Nezavisimoe Voennoe Obozrenie*, 25-31 October 2002, p. 1, 8.

<sup>563</sup> All-Russian National Military Fund (2005b), 'Zhertovateli Fonda [Donors of the Fund]', *All-Russian National Military Fund*, Published: Last accessed: 18 October 2005, Internet: <http://www.nvfond.ru/show.html?pid=5&ppid=5>.

<sup>564</sup> Alfa-Bank (2004), 'Alfa-Bank videlil obshcherossiiskomu natsionalnomu voennomu fondu 2 mln dollarov SShA dlya pomoshchi rossiiskim voennosluzhashchim [The Alfa-Bank has Allocated \$US 2 Million to the All-Russian National Military Fund for Help to Russia's Military Men]', Published: 12 September 2005, Last accessed: 10 March 2005, Internet: <http://alfabank.ru/press/news/2004/12/9/1.html>.

<sup>565</sup> Center for Help to Homeless Children (2004), 'Personalnii sostav popechitel'skogo sovieta blagotvoritel'nogo fonda "Tsentr pomoshchi besprizornim detyam" TPP RF [Personel of the Advice Commitee of the Center for Help to Homeless Children]', Published: N.A., Last accessed: 10 March 2005, Internet: <http://www.tppdetfond.ru/tppdetfond.nsf/pages/7FE17E73E85EA617C3256E6E0052E092>.

<sup>566</sup> Vendil Pallin *Russian Military Reform: A Failed Exercise in Defence Decision Making*, p. 227f.

corporations, a few bureaucratic bodies, the Kremlin and the security services. Often these overlap to form something such an 'energy elite' of the Russian society. Putin's network facilitates implementation of decision and possibly also contributes to the bureaucracies acting in line with Putin's wish, even without formal directives. Hence, the formal and informal structures smooth the implementation process, even if intra-departmental clashes occur.

Besides structural advantages, it can also be expected that key figures and Putin share the similar views on central matters. Similar mindsets may stem from similar background, for example in the security services. It is impossible to generalise and to declare that everyone with a former connection to Putin or the security service acts in harmony. The trend of promoting loyalty to Putin does not only relate to the energy sector, but the whole state structure.

As the Duma is weak compared to the president, the domination of United Russia is important in two aspects. First the parties are involved in the natural resources sector since parties like United Russia, the Communist Party (KPRF) and Zhirinovsky's party LDPR can be expected to have a more conservative view of natural resources than, say, Yabloko. This is crucial when it comes to issues such as allowing foreign interventions, declassifying data on reserves or other issues of strategic nature. Second, the share of United Russia-members demonstrates which committees that are most important to the Putin regime. As shown, all the committees reviewed here have a much higher share of United Russia-members than the average.

It is also interesting to note that nobody from the energy sector has a position in the Security Council, neither as a member or permanent member.<sup>567</sup> Considering that the council has expanded quite substantially during Putin's term,<sup>568</sup> it would not be surprising to find

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<sup>567</sup> Security Council (2005), 'Sostav Soveta Bezopasnosti Rossiiskoi Federatsii [Composition of the Security Council of the Russian Federation]', *Soveta Bezopasnosti Rossiiskoi Federatsii*, Last accessed: 18 March 2005, Internet: <http://www.scrf.gov.ru/Personnels/Members.htm>.

<sup>568</sup> Leijonhielm, *et al.* *Ryske militär förmåga i ett tioårsperspektiv - problem och trender 2005* [Russian Military Capability in a Ten-Year Perspective - Problems and Trends 2005].

the Minister of Industry and Energy as a member. However, one explanation for this could be that issues of energy security and usage of energy for political reasons differs somewhat in nature from more traditional security issues, such as war or terrorism. Another aspect is that the NSC is not as important today as it has been.<sup>569</sup>

There are arguments against the conclusion that the manageability and responsiveness of the energy sector is both substantial and augmenting. The Financial Times has argued, for example, that Putin has lost control and that the bureaucrats now act on their own initiative. This is reflective in the aftermath of the Yukos affair. The case against Yukos was Putin's idea, but afterwards he did not want to push it anymore, the Financial Times claims. The new tax claims against TNK-BP were made against Putin's wish. According to the Financial Times, it is the 'statists' that act either out of their own conviction or out of self-interest, or possibly both. Collectively this is claimed to have limited Putin's room for political manoeuvres.<sup>570</sup> This would explain some of the illogical aspects of the claims against TNK-BP and the contradictory statements made after the Yukos affair. However, little else in the Russian development suggests that Putin has lost control. Yet, it must be stated that these types of comments occasionally are put forward by analysts.

### **Summary and Conclusions**

The Kremlin and Putin have great influence over important bureaucratic bodies. Putin has a vast network of people from St. Petersburg that are now in Moscow. The mainly Putin-loyal siloviki are continuously gaining in strength and although the agendas are not always identical, the mindset and *modus operandi* of these people are similar. The siloviki of the energy sector are of two types. The 'low-level' silovikis consist of former officers taking care of the dirty work for the energy firms while the 'high-level' silovikis have entered the boardrooms of important companies. The role for the siloviki is promoted by the state. There is evidence that the security services (FSB) have formal responsibilities in the energy sector.

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<sup>569</sup> Ibid., p. 45ff.

<sup>570</sup> Financial Times 'Another Yukos?', p. 13.

Putin's people are found at every position of importance and the presidential influence over the parliament and its energy-related bodies has tightened significantly. The overall power structure of the energy sector is concentrated to a block consisting of energy corporations, a few bureaucratic bodies, the Kremlin and the security services that often overlaps and together forms something of an 'energy elite' of the Russian society. Several governmental bodies have unclear status and alternate between being a governmental body and market actor. At least one have together with Gazprom abused their position. Putin has managed to create a new business culture of oligarchs that are as powerful as the old oligarchs, but that act politically correct.

The Kremlin has strong formal or informal ties to nearly all of the major energy companies, Gazprom, Sibneft, Rosneft, Transneft, Surgutneftegaz, Zarubezhneft, RAO UES and Lukoil while only a few of the major enterprises remain independent (TNK-BP and the crippled Yukos). Power is accumulating at Gazprom and Rosneft, which are two of the most loyal firms. Actions of companies that are more market than politically driven are in accord with state strategy as well. Rogue behaviour exists, but self-censorship has emerged and firms are reluctant to conduct politically incorrect activities. The Russian state promotes Russian business interests abroad and firms promote state interests even if there are constant disputes between energy companies and the state. Questionable activities by companies loyal to the Kremlin appear to be sanctioned or tolerated. One result of this is that stockholders lose money on actions that are either legally obscure or politically motivated.

## 6 Russia's Foreign Energy Policy

**Questions:** What is Russia's foreign energy policy and; what is Russia's track record in terms of reliability and usage of the energy levers?

**Approach:** The chapter constructs a survey of Russia's energy relations with selected key actors. The chapter also attempts to identify Russia's track record concerning a coercive usage of its energy policy.

**Main findings:** Russia does not covet to become dependent on third parties for transit and is prepared to go to great lengths to bypass the risk by geopolitically motivated infrastructure projects. It is not afraid of having surplus capacity for exports as this gives room for manoeuvring. Deep-seated problems in energy relations often originate from disparate views on cooperation and Russia prefers bilateral to multilateral relations as it gives greater leverage. Its strategic priorities of keeping the influence over the CIS overshadow market aspects. States within the CIS are vulnerable to Russian pressure and are often unwilling to bestow Russia with increased influence. However, this is what Russia gradually acquires.

Russia is utilising its commodities as baits for states such as Japan and China to compete about favours to Russia. Competition between Russia, China, India and the US exist within the CIS, but Russia keeps the upper hand. The international competition for energy largely takes place in Russia and the CIS and is of utmost importance. Herein lie the grand politics that affects all market-based priorities. It also explains parts of Russia's coercive policy (see also next chapter).

### Overview of Russia's Energy Relations

Politics, not geology, runs the fate of oil supply, the argument goes,<sup>571</sup> but geography is a crucial factor that connects to politics and geology. Infrastructure projects of a strategic nature are frequently underpinned by geopolitical/geoeconomic considerations. In many ways, Russia's pipeline system is working at full capacity today and in order to reduce the problem with bottlenecks, new projects are required (even if there are ongoing debates about whether Russia has sufficient oil and gas for taking full advantage of the initiated projects).

#### *Energy Exports*

A core issue is that Russia does not want to become dependent on third parties for transit to consumer markets. This has remained a constant case and Mikhail Kasyanov stated during his time as Prime Minister that "transit is a matter of state strategy and is not subject to debate".<sup>572</sup> Apart from the strategic motivations, Russia claims that is also is a financial reason for its approach to diversify export routes. Dependence on ports for exports in Latvia and Lithuania has cost Russia \$US600 million, according to the Russian Minister of Transport – Nikolai Tsakh.<sup>573</sup> For the last couple of years, 60 per cent of Russia's crude oil has been shipped by tanker and 50 per cent of this from the port of Novorossiysk at the Black Sea Coast. The rest is essentially taken care of by the Druzhba pipeline system that runs from Russia to the central and eastern parts of Europe.<sup>574</sup> Primorsk has however come to take over large shares from Novorossiysk. As a consequence of these aforementioned perceptions, Russia moves forward on several fronts, but pipelines are not the only factor.

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<sup>571</sup> Jaffe, Amy Myers and Manning, Robert A. (2000), 'The Shocks of a World of Cheap Oil', *Foreign Affairs*, Vol. 79, No. 1, p. 29.

<sup>572</sup> Paszyc, Ewa (2003), 'The Russian Energy Policy', in: Labuszezowska (Ed.) *The Resource Wealth Burden: Oil and Gas Sectors in the Former USSR* (Warsaw: Osrodek Studiów Wschodich (OSW)), p. 19.

<sup>573</sup> Pasukeviciute, Irma and Roe, Michael (2005), 'Strategic Policy and the Logistics of Crude Oil Transit in Lithuania', *Energy Policy*, No. 33, p. 859.

<sup>574</sup> The proposed connection to the Adria pipeline (Omialj at the Adriatic Sea) have not materialised, according to Russia due to political reasons and the stand of Croatia. Vahtra *Russian Oil Sector Today and Tomorrow: The Implications of the Case of OAO Yukos*, p. 7, and Pasukeviciute and Roe 'Strategic Policy and the Logistics of Crude Oil Transit in Lithuania', p. 858.

The non-pipeline-related transport also increases in Russia (since Russia has set out to increase its train and seaborne exports).<sup>575</sup> A couple of these projects include Lukoil's new terminals on the Caspian Sea (Ilyinka), in Varandei on Barents Sea and in Vysotsk in the Gulf of Finland. Rosneft has also built a new terminal in Arkhangelsk in the far north and in Vostochny on the Sea of Japan.<sup>576</sup> On 24 July 2003 Rosneft for example closed an agreement with the Ministry of Railways to increase shipments of oil in the Far East and North Caucasus (that resulted in expansion of the tank car fleet, especially on the Sverdlovskaya and Severnaya railroads).<sup>577</sup> Both Rosneft and Lukoil have their own shipping subsidiaries called Rosnefteflot and Lukoil-Arktik-tanker (LAT) respectively.<sup>578</sup> Many pipelines are being proposed or constructed.

Despite Putin occasionally stating that "the choice of routes for new pipelines should not be based on political considerations but made after taking into account economic and well as environmental factors",<sup>579</sup> it is certain that political and geostrategic considerations overshadow everything. This is not remarkable, but it is also the case for European, Chinese or American projects. Putin, similar to other world leaders, occasionally pretends that it is not a key factor. An overview of some of the mentioned pipelines is found in Table 11.<sup>580</sup> The perspective of this list is American and it contains several options of the same route. Some of them have already been built (Baku-Tbilisi-Ceyhan) while other will not be built. The table neither takes the political considerations into perspective, which is why Iran appears to be a plausible option. The

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<sup>575</sup> EIA 'Russia: Country Analysis Brief'.

<sup>576</sup> Baidashin, Vladimir (2003), 'Export Alternatives: Majors Boost Marine and Rail Transport Capacities To Hike Oil and Products Exports', *Russian Petroleum Investor (World Trade Executive)*, Published: Last accessed: 14 February 2005, Internet: <http://www.wtexec.com/RPIExportAlternatives.html>.

<sup>577</sup> Ibid.

<sup>578</sup> Fredholm *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, p. 29f.

<sup>579</sup> Chufrin 'Russia's Caspian Energy Policy and its Impact on the U.S.-Russian Relationship', , p. 14.

<sup>580</sup> For a deeper analysis of the pipeline diplomacy, see Fredholm *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*.

table identifies what the tentative differences in costs are for various routes and capacities.

<b>Table 11: Length, Capacity and Costs of Selected Oil Pipeline Routes</b>				
<b>Route</b>	<b>Length in km</b>	<b>Capacity Tb/day</b>	<b>Total cost \$US billion</b>	<b>Cost/barrel in \$US/barrel</b>
Murmansk	2,500	2,000	2.50	0.76
Murmansk	2,500	2,000	4.00	1.21
Ukhta-Murmansk	3,600	2,000	4.00	1.21
Baku-Tbilisi-Ceyhan	1,700	1,000	2.90	1.75
Baku-Tbilisi-Supsa	850	900	1.30	0.87
Baku-Tbilisi-Supsa	850	1,500	1.60	0.65
Burgas-Alexandroupolis	317	600	0.70	0.71
Burgas-Vlore	915	750	0.80	0.65
CNPC to China	3,000	1,000	3.50	2.12
CNPC to Iran	1,200	250	1.10	2.66
CAOPP to Pakistan	1,667	1,000	2.70	1.63
Irkutsk-Daqing	2,247	600	2.00	2.02
Irkutsk-Nachodka	3,884	1,000	6.00	3.63
Irkutsk-Nakhodka	3,884	1,000	8.00	4.84
Azerb/Turkmen/Kharg	2,150	1,500	3.00	1.21
Azerb/Turkmen/Kharg	2,150	900	3.00	2.02

**Source:** Jaffe, Amy Myers and Soligo, Ronald (2004), 'Re-evaluating U.S. Strategic Priorities in the Caspian Region: Balancing Energy Resource Initiatives with Terrorism Containment', *The Energy Dimension in Russian Global Strategy* (Houston: The James A. Baker III Institute for Public Policy of Rice University), p. 15.

**N.B.** Cost estimates are based on an assumed 30-year life and 20% rate of return. Costs do not include right-of-way acquisition and transit fees. The original table appears to have had an error as it used the unit "Mb/d", which should have been thousands (Tb/d), not millions, barrels/day.

Several of Russia's energy companies are transnational. Lukoil for example, has operations in Azerbaijan, Iraq, Kazakhstan, Egypt, Colombia, Iran, Saudi Arabia, Bulgaria, Ukraine, Romania, the Baltic countries, USA, China and UK to a total value of up to nine billion dollars.<sup>581</sup> Largely, the CIS area is of highest priority for Russian according to Togrul Bagirov of the Public Consultative Centre on International Oil and Gas Projects at the RF government.<sup>582</sup> Table 12 below provides a few examples of assets in the Former Soviet sphere controlled by Gazprom and UES. Neither this list is complete, but is

<sup>581</sup> Vahtra and Liuhto *Russian Corporations Abroad: Seeking Profit, Leverage or Refuge?*.

<sup>582</sup> Bagirov, Togrul (2000), 'Energy Cooperation and the CIS', *International Affairs (Moscow)*, Vol. 26, No. 2, p. 41.

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gives an indication of Gazprom's and UES's actions. Some of these deserve a closer look.

<b>Table 12: Gazprom's and UES's Assets in the CIS and Baltic Countries</b>					
<b>Mother Comp.</b>	<b>Country</b>	<b>SCA</b>	<b>Activity</b>	<b>Company</b>	<b>% owned</b>
Gazprom	Kazakhstan	-	Gas extraction	ZAO Kazrosgaz	50%
Gazprom	Uzbekistan	2012	-	-	-
Gazprom	Kyrgyzstan	2028	Gas and oil exploitation	AO Kyrgyzneftegaz	85.16% held in trust
Gazprom	Tajikistan	2028	-	-	-
Gazprom	Turkmenistan	2028	-	-	-
Gazprom	Georgia	2028	-	-	-
Gazprom	Armenia	-	Gas exploitation	ZAO Armrosgazprom	45%
Gazprom	Ukraine	2028	Gas pipeline operator	SP Rosukrenergo	50%
Gazprom	Moldova	-	Gas pipeline operator	AO Moldovagaz	50% + 1 share
Gazprom	Estonia	-	Gas distribution	Eesti Gaas	37%
Gazprom	Latvia	-	Gas distribution	Latvijas Gaze	34%
Gazprom	Lithuania	-	Gas distribution	Lietuvos Dujos	25%
Gazprom	Lithuania	-	Power plant	Kaunas CHP	Unclear
UES	Georgia	-	Electricity distribution	AO Telasi	75%
UES	Georgia	-	Power generation	OOO Mtkvari	100%
UES	Georgia	-	Electricity export	OOO AES Transenergy	50%
UES	Georgia	-	Khrami -1/-2 hydroelectric power plant	AO Khramesi	Right to run until 2024
UES	Armenia	-	Hydroelectric power plant	Sevan-Hrazdan	100%
UES	Armenia	-	Thermal power plant	ZAO Hrazdan TPP	Management control
UES	Armenia	-	Nuclear power plant	Metsamor NPP	Management control
UES	Kazakhstan	-	Hydroelectric power plant	Ekibastuz	50%

**Source:** Table compiled on data in Fredholm, Michael (2005), *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, Conflict Studies Research Center, September 2005, 05/41, pp. 21-22.

**N.B.** SCA = Agreement on strategic cooperation, in force until the year mentioned in the table.

This list, in conjunction with what has been stated in chapter five, point to the tools Russia has for its foreign energy policy. The pro-Kremlin energy companies are hence the ones that have to take actions if Moscow so wishes.

### The Energy Lever

As stated in the beginning of this report, a tool becomes a lever or weapon when it is used as such. There are many such tools, especially on the domestic market, but issues related to foreign policy will be given special attention here. The term 'energy weapon/lever' hence includes all tools used for this purpose, not only supply interruptions even if it is the most serious tool. In combination with the intentions, as expressed in the energy strategy and stated by President Putin (and other prominent politicians), it is intriguing to observe what its policy can result in and what the consequences can be. Herein lay the core of the question whether Russia is a reliable energy supplier. The question of 'for who is Russia reliable' is also of importance.

Utilising energy policy as a political or economic lever can be accomplished in several ways. A few energy tools of special importance were identified during the research process, namely:

- supply interruptions (total or partial),
- threats of supply interruptions (covertly or explicit),
- pricing policy (prices as carrots or sticks),
- usage of existing energy debts,<sup>583</sup>
- creating new energy debts and,
- hostile take-overs of companies or infrastructure.

These tools have been used as a filter when assessing the sources and materials. When, during the research process, any of these tools have been visible or mentioned, they have been included (or at least considered for inclusion) in this report. A thorough discussion on what this means and what type of conclusions that can be drawn are found in the next chapter. A more narrow definition of 'energy weapon' would thus have resulted in far less cases, while others could have been included. Yet, not all of the actions listed above are given same priority. For example, coercive pricing policy is not acknowledged as serious as supply interruptions, but they often go hand-in-hand. The main thrust is on the latter and several incidents of coercive or discriminatory pricing

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<sup>583</sup> A table of the debts, as of 1 January 2005, of the CIS states to Russia is found in Appendix IV.

policy have been omitted. Listing all of Russia's non-market practices is an overwhelming task and it should stand clear to every observer of Russia that its energy market cannot be compared to, for example, the European markets.

The following sections of this report are a non-comprehensive review of Russia's energy relations where some of the cases where Russia has, or has been accused of, using the energy weapon as defined above are highlighted. No dependence, vulnerability or sensitivity analysis of importers of Russian energy is made. This is the topic for further research. Analysis of the cases and pattern is made in the following chapter, with the exception of the gas conflict between Russia and Ukraine during the winter of 2005-2006 on which there is a longer comment below.

### **Energy Relations with the EU**

Europe is highly important for Russian exports, and Russia is important to Europe. In short, of Russian energy exports 80 per cent of oil exports and 60 per cent of natural gas goes to Europe. From Europe's point of view, Russian gas made up 38 per cent of Europe's gas imports in 2003 (see table below).

EU's gas production gradually falls and the net imports will, according to IEA, increase dramatically. In 2030, the import needs will be five or six times higher than gas production. Russia's exports of gas to Europe will not necessarily meet this demand. Any rise in Russian exports could well go to the Pacific instead,<sup>584</sup> but in the short-term, Europe will be the key market for the bulk of Russian gas.

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<sup>584</sup> Murray 'Russian Energy and European Dependence'.

**Table 13: European Gas Dependence on Russian Gas Supplies 2003**

Country	% of total imports	% of total consumption
Austria	77	65
Finland	100	100
France	24	23
Germany	37	33
Greece	76	76
Italy	32	26
Netherlands	17	6
EU15	28	18
Czech Republic	74	73
Hungary	86	66
Poland	85	58
Romania	91	29
Slovakia	100	97
Slovenia	60	60
Central/Eastern Europe (12 states)	87	60
Turkey	61	60
Total Europe (28 states)	38	26

**Source:** Calculated from Cedigaz, Trends and Figures in 2003 from *Natural Gas in the World 2003*, cited in Stern, Jonathan (2005), *The Future of Russian Gas and Gazprom*, Oxford: Oxford Institute for Energy Studies, p. 143.

There is an ongoing debate among energy experts on the energy outlook for Europe and some argue that Europe will import less gas from Russia relatively speaking,<sup>585</sup> while others instead argue that imports from Russia will escalate.<sup>586</sup> Undoubtedly, Russia will continue to play an important role and continued energy cooperation is of special importance for the EU. The exact amounts are thus not interesting here. The geographic proximity is reason enough for stating that the relationship is paramount for the future. A responsible approach from the EU would however ensure that this proximity not be the only

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<sup>585</sup> Götz, Roland (2002), *Russlands Erdgas und die Energiesicherheit der EU [Russia's Natural Gas and the Energy Security of the EU]*, Berlin: Stiftung Wissenschaft und Politik (SWP), April 2002, S 12, and Götz, Roland (2004), *Russlands Energiestrategie und die Energieversorgung Europas [Russia's Energy Strategy and the Energy Supply of Europe]*, Berlin: Stiftung Wissenschaft und Politik (SWP), Mars 2004, S 6.

<sup>586</sup> Umbach 'Europe's Energy Non-Policy', p. 59.

guiding factor. There are also great opportunities to give Turkey as greater role as an energy hub in exports from the Caspian basin.

There are ongoing projects for bringing Caspian energy to Europe without Russian transit. One such option is the Baku-Tbilisi-Erzurum (BTE) pipeline, aimed at bringing gas from the Caspian Sea via Georgia to Turkey. Given Turkey's interest in EU membership, it is possible that Brussels would be willing to take advantage of Turkey as a transit state even if this would not be a part of the formal EU plan.<sup>587</sup> Even Iranian gas could be imported to Europe via either Azerbaijan and/or Armenia via Georgia to Turkey. Thus far, the most important EU projects for international cooperation are:<sup>588</sup>

- The European Economic Area agreements;
- The Baltic Sea Energy Cooperation;
- The Multi-lateral Nuclear Environmental Programme for Russia;
- The Energy Charter Treaty;
- The EU-Russia Energy Partnership;
- The Interstate Oil and Gas Transport to Europe (INOGATE) Programme;
- The Mediterranean Energy Partnership;
- The Balkan Energy Interconnection Task Force.

The Energy Charter Treaty and the Transit Protocol have not yet been ratified by Russia<sup>589</sup> (but by other CIS states). This is a key project that Russia needs to adhere to if it wants to convince Europe that it is honest in its intentions of becoming a reliable supplier. It by and large has to let go of its strategic obsession in energy relations.

Furthermore, there is the EU-sponsored regional project INOGATE that in the main is no longer a vital programme. Also, other areas have had

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<sup>587</sup> Lynch, Dov (2000), *Russian Peacekeeping Strategies in the CIS: the Cases of Moldova, Georgia and Tajikistan* (Basingstoke, New York, N.Y.: Macmillan in association with the Royal Institute of International Affairs Russia and Eurasia Programme: St. Martin's Press), pp. 20-22.

<sup>588</sup> Andrews-Speed 'Energy Security in East Asia: A European View', p. 8f.

<sup>589</sup> The main reason has been Gazprom's position and ability to create opposition in the Duma, especially up until 2001. Stern *The Future of Russian Gas and Gazprom*, p. 137.

little impact on the larger picture, while concurrently facilitated several of the practical arrangements in negotiations. Russia and Europe have been trading in energy for a long time, but in essence, the Russian-EU energy partnership was launched in 2000 by the sixth EU-Russia summit that proposed a new energy dialogue. However, only a few issues are dealt with on the aggregated EU-Russia level, partly because not all European states are members of EU, and partly because most states pursue their own agendas and therefore opt for bilateral policies towards Russia. This is circumstance that is promoted by Russia. It prefers a situation where it can deal directly with Brussels when it suits Russia and go for bilateral approach when Brussels is difficult to tackle or lack the authority to be decisive. This disunity is of gain to Russia when dealing with Europe. The EU has not yet taken any actions to prevent single members from entering long-term contracts that other members considers problematic.

If the EU would take a common stand as a consumer group, it would be easier to affect Russia and more difficult for Russia to set the rules of the game and exploit differences between EU members. It must be remembered that from Russia's point of view, its institutional tradition in cooperation with the EU is only a few decades old, while relations to the individual countries, such as Germany, France or the UK are centuries. There have nonetheless been some achievements between 2000 and 2003 according to the EU Commission, namely:<sup>590</sup>

*Access for Russian companies to the EU's internal energy market,*

*The confirmation of the importance of long-term natural gas supply contracts and the work in resolving the issue of destination clauses that exist in certain long-term contracts for gas,*

*The increased opening of the Russian energy sector to European investments,*

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<sup>590</sup> EU Commission (2003), 'Conclusions of the Round Table on Energy Strategies Held in the Context of the EU-Russia Energy Dialogue's Conference on the Comparative Analysis of European and Russian Energy Strategies', *The European Commission's Delegation*, Published: 17 October 2003, Last accessed: 25 April 2005, Internet: [www.delrus.cec.eu.int/en/images/pText\\_pict/217/Energy%20RT%20Conclusions.doc](http://www.delrus.cec.eu.int/en/images/pText_pict/217/Energy%20RT%20Conclusions.doc).

*The identification of a number of important energy infrastructure projects as being of common interest, including the Northern Trans-European gas pipeline,*

*The forthcoming mandate from the EU Member states for the Commission to negotiate on the issue of trade in nuclear materials. This will mean that negotiations should commence in January 2004,*

*Close co-operation between the EU and the Russian Federation in the field of enhancing the safety of the transportation of oil by maritime transport,*

*The agreement to analyse the feasibility of a non-commercial risk guarantee mechanism which could significantly improve investments in the Russian energy sector by reducing the perceived risks,*

*The establishment of a technical joint working group to examine all the issues related to the interconnection of the continental European electricity grid with that of the Russian Federation.*

As apparent from the sentences above, cooperation exists but is rather vague in nature and much remains to be done. The deep-seated problem in energy relations between Russia and Europe is not technical in nature, but originates from disparate views on cooperation. While one of the core ideas behind EU is interdependence, Russia does not intend to become dependent on anyone or anything. It prefers an asymmetrical dependence on Russia, whereas others should be dependent on Russia while Russia stands independent. This is the most fundamental rationale behind Russia's energy policy. It is what infringes upon Russia's, although modest, strive to get integrated into international structures. There is hence not a ground for common values in this field, even if Putin has refrained from confronting the West. The strategic partnership that Putin often boosts about, is not respected by Russia.<sup>591</sup>

Some analysts argue that the tide has turned and that a view of a positive-sum game is emerging.<sup>592</sup> This is however only the case concerning smaller firms, while at state level, the trend is opposite and suggests that Russia is moving in the opposite direction, especially after

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<sup>591</sup> See, for example, Menkiszak, Marek (2006), *Russia vs. the European Union: a "Strategic Partnership" Crisis*, Warsaw: Centre for Eastern Studies (OSW), January 2006, 22.

<sup>592</sup> Lo *Vladimir Putin and the Evolution of Russian Foreign Policy*, pp. 74-76.

2003.<sup>593</sup> From the Baltic perspective, there is a conviction that the Commission lacks an understanding of the Russian influence, in particular to the new member states.<sup>594</sup> For both the EU and WTO, a topic of friction is the gas sector but Putin has taken a firm stand and in 2003 declared that:

*The gas pipeline system is the creation of the Soviet Union. We intend to retain state control over the gas transportation system and over Gazprom. We will not divide Gazprom. And the European Commission should not have any illusions. In the gas sector, they will have to deal with the state.*<sup>595</sup>

This problem may prove to be the real Gordian knot for the development of a common energy policy for the EU. The lack of a common value community between Russia and the EU may also hinder development of a common market, for example for natural gas. Agreements based on asymmetric dependence will not provide the sought after stability.

A common energy policy for the EU has long been in the making, but momentum has never been gained. There have been attempts to incorporate energy issues into some of the chapters of the treaties of the numerous intergovernmental conferences, but some of EU's members have been reluctant to approve of the idea. Due to high energy prices and emissions of greenhouse gases, there are indications that new efforts will be made. For the first time, also the UK has called for a common energy policy. However, disunity still plagues cooperation and the different agendas of EU member states make it difficult to join forces.<sup>596</sup>

Apart from what is stated below, there are reasons to question Russia's reliability on the grounds of technical problems and inability to supply gas on cold winter days. For example in January 2006, a few weeks after the Russian-Ukrainian gas row, Gazprom reduced supplies to Hungary,

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<sup>593</sup> See Leijonhielm, *et al.* *Ryske militär förmåga i ett tioårsperspektiv - problem och trender 2005* [Russian Military Capability in a Ten-Year Perspective - Problems and Trends 2005].

<sup>594</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 55.

<sup>595</sup> Putin cited in Fredholm *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, p. 9.

<sup>596</sup> Oxford Analytica (2005a), 'Disunity Hampers Common Energy Policy', *Oxford Analytica*, Published: 1 December 2005, Last accessed: 2 December 2005, Internet: <http://www.oxan.com>.

Bosnia and Herzegovina. While gas supplies were cut to Europe, Russia's domestic consumers received more gas.<sup>597</sup> This is an indication that Russia supply may not be totally reliable even if the political dimensions are overlooked.

### **Energy Relations with Selected EU-members**

This section has selected a few EU-members with which Russia has special energy relations. An attempt is made to include new and old members, as well as small and large ones that have positive or negative relations to Russia in a broad understanding. At the end of the section, some regional energy infrastructure projects are discussed.

#### *Lithuania*

Energy is a key factor in Russia's relations with all three Baltic countries; all three states perceive the problem of dependence on Russia as so serious and problematic that they have included the issue in their national security strategies or other guiding documents.<sup>598</sup> The reason is first and foremost their historical relationships with Russia and the Soviet Union, but the issues gained in importance due to Russia's coercive energy policy after 1991.

For example, in the winter of 1992-1993, Yeltsin cut energy supplies to Estonia, Latvia and Lithuania in order to affect a policy change and claiming their failure to pay a four-fold increase in energy price, which followed their demands to remove Russian troops from the Baltic countries.<sup>599</sup> Yet another example was in mid-February 1992, when all oil supplies were cut to Lithuania for four days, when Russian demands concerned the amount and forms of payments. Lithuania argued that the

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<sup>597</sup> Grib, Nataliya (2006), 'Gazprom Cuts Gas Supply to Europe', *Kommersant*, Published: 19 January 2006, Last accessed: 19 January 2006, Internet: <http://www.kommersant.com/doc.asp?idr=500&id=641939>.

<sup>598</sup> Svensson *Ekonomi och säkerhet i de baltiska staterna: en studie av relationen mellan säkerhetstänkande och ekonomiska beroenden* [Economy and Security in the Baltic States: A Study of the Relation between Security Thinking and Economic Dependence].

<sup>599</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 6.

Russian Central Bank withheld Lithuanian funds and that Russian enterprises owed Lithuania over five billion roubles.<sup>600</sup>

Between July and August 1992, Russia again cut all oil deliveries, reduced gas supplies by 55 per cent due to Lithuania's debts, and stated that Lithuania was not allowed to re-export any of the Russian oil in order to acquire hard currency. Russia nonetheless required payments in hard currency and applied price increases retroactively to previous deliveries.<sup>601</sup> In the late fall of 1992, Russia again cut supplies, this time in such a way that it stopped work at the Mažeikių refinery. Vytautas Landsbergis argued that Russia placed Lithuania under an "energy embargo" in order to affect the upcoming election. The pro-Russian Democratic Labour Party (formerly the Communists) subsequently won and its leader's, Algirdas Brazauskas', platform stressed the importance of the relations to Russia and that Lithuania is dependent on Russian energy.<sup>602</sup> Between 1998 and 1999, Transneft cut oil supplies on nine occasions to Lithuania. According to Lithuania, the reason was that it wanted Lithuania to cede control over pipelines, ports and refineries to Lukoil.<sup>603</sup>

One of the most vital points of friction between Russia and Lithuania is the Lithuanian company Mažeikių Nafta. Initially, it was made up of three parts, Mažeikių refinery, the Klaipėda port terminal Kleipėdos Nafta and the Naftotiekis oil pipeline, which is connected to the port of Ventspils in Latvia. Eventually the three parts merged and became AB Mažeikių Nafta. Today this includes the Butinge import/export oil terminal.<sup>604</sup>

Lithuania has attempted to keep foreign interests away – especially Russian. When it decided to sell Mažeikių Nafta, it chose the US Corporation Williams International instead of a Russian company.

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<sup>600</sup> Kramer, John M. (1993), "Energy Shock" from Russia Jolts Baltic States', *RFE/RL Research Report*, Vol. 2, No. 17, p. 42.

<sup>601</sup> Ibid., p. 42.

<sup>602</sup> Ibid., p. 43.

<sup>603</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 6.

<sup>604</sup> Pasukeviciute and Roe 'Strategic Policy and the Logistics of Crude Oil Transit in Lithuania', p. 860.

Williams International took over parts of Mažeikių Nafta in 2001, but Lukoil, which delivered oil to the refinery then made it more difficult to get oil from Russia.<sup>605</sup> This could be interpreted as a statement that Russia's reliability is greater if Russia controls the Lithuanian company. The game around Mažeikių has been complex and the Lithuanian Competition Council found the situation problematic.<sup>606</sup> One problem was that Yukos later bought Mažeikių Nafta<sup>607</sup> and when the Yukos affair started, it meant that the refinery risked ending up in the hands of the Russian state.

Several oil cut-offs occurred in the spring of 2005. Apparently, these were due to technical difficulties and the fact that Latrostrans did not have a formal contract for being a forwarding company (Transneft delivered oil to the border and Latrostrans took over from the border to Mažeikių).<sup>608</sup>

Yukos, furthermore, has had a challenging time running the business. It was later even barred from delivering oil (as Lukoil and 6-8 other companies wanted to take over). One of the reasons was that Lukoil wanted to purge competition on the Ukrainian market. It is namely so that the quality of the Ukrainian oil is so low that Ukraine has to import 90 per cent of its high quality oil needs. Lukoil wants to be the one to do it.<sup>609</sup>

In the summer of 2005, Yukos still owned Mažeikių Nafta (via its subsidiary, the Netherlands-based Yukos Finance B.V.) and was entitled to buy another 9.72 per cent, but it could not afford it at the time. The question of future ownership was therefore unsolved. The Russian Ministry of Justice required that Yukos' shares and assets should not be sold but at the same time, Lukoil and Gazprom were waiting to buy it. The Lithuanian government wished to approve of any strategic investor.

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<sup>605</sup> Zashev *Russian Investments in Lithuania: Politics, Business, Corporate Culture*, p. 17.

<sup>606</sup> Competition Council (2001), 'Prohibited Agreements', *Annual Report 2001* (Vilnius: Competition Council, Republic of Lithuania).

<sup>607</sup> Wagstyl, Stefan (2005), 'Oil and Gas Needs Give Moscow Influence', *Financial Times*, A, 21 February 2005, p. 11.

<sup>608</sup> Baltic Times 'New Supply Glitches Beset Mazeikiu Refinery', p. 6.

<sup>609</sup> Ibid., p. 6.

If the buyer was not approved of, it considered buying the shares itself.<sup>610</sup> This wish was again expressed by Prime Minister Brazauskas in September 2005. Financing is said to have been made with governmental loans,<sup>611</sup> but the government apparently did not intend to keep the shares, but was only concerned of them being given to an acceptable buyer. Thus, if Yukos sells its shares to a strategic investor that is acceptable to Lithuania, the government may not seek shares of its own.<sup>612</sup>

When Kazakhstan, by the company Kazmunaygas, wanted to take part in the bidding, Russia tried to force it out of competition by letting Transneft cancel a ten-year contract on deliveries and let Lukoil take control over the company.<sup>613</sup> In February 2006, the issue was still not solved.<sup>614</sup>

Thus, the Lithuanian government does not want to spend time and money in order to keep Russia away. The practice cannot be seen as proof of Russia's guilt and Lithuania's innocence, as the way of conducting business within the energy sphere is of such a nature that no actor has a clear record. What it does say, however, is how strong the Lithuanian perceptions of Russia's policy are. The Minister of Economy of Lithuania even uttered the phrase "Don't Let Ivan to the Pipe".<sup>615</sup>

Further, Gazprom has taken over 25 per cent of the company Lietuvos Dujos and provides 90 per cent of the gas needed for the coming decade. Gazprom's plan has been to appoint two representatives to the board

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<sup>610</sup> Baltic Times (2005d), 'Mazeikiu Oil Refiner Slammed by Anti-Monopoly Authorities, Faces Huge Fines', *The Baltic Times*, 21-27 July 2005.

<sup>611</sup> RosBusinessConsulting (2005q), 'Lithuanian Gov't to Acquire Yukos' Stake in Mazeikiu Nafta', *RosBusinessConsulting*, Published: 15 September 2005, Last accessed: 16 September 2005, Internet: <http://www.rbcnews.com/free/20050915182152.shtml>.

<sup>612</sup> Baltic Times (2005f), 'State Prepared to Sell Half its Stake in Mazeikiu Nafta to Strategic Investor', *The Baltic Times*, 22-28 September 2005.

<sup>613</sup> Baltic Times (2005c), 'Intrigue around Mazeikiu Nafta Sale Increases as Kremlin puts Squeeze on Kazakh Bidder', *The Baltic Times*, Business, 24-30 November 2005.

<sup>614</sup> Baltic Times (2006), 'Kazakhs, Poles Step up Lobbying Efforts', *The Baltic Times*, 26 January - 2 February.

<sup>615</sup> Quote by the Minister of Economy of Lithuania, Vincas Babilus, cited in Zashev *Russian Investments in Lithuania: Politics, Business, Corporate Culture*, p. 13.

and one of the two CEOs.<sup>616</sup> For quite some time, Lithuania refused to sell Lietuvos Dujos, but in January 2004 it announced that it would sell a 34 per cent stake (out of the governmentally controlled 58 per cent) to Gazprom for \$US37 million. One result is that the national gas grid possibly becomes connected to EU's gas grid, but several analysts, for example the former Chairman of the Lithuanian parliament, Vytautas Landsbergis, have strongly opposed the deal and claim that it is politically rather than economically motivated.<sup>617</sup> In the view of Baltic politicians, it can thus be seen as a real curse having Gazprom taking over a small country's infrastructure. The fact is that Gazprom in many ways is much more important to Lithuania than Lithuania is to Gazprom. Lithuania for example only made up 1.4 per cent of Gazprom's total exports in 2002.<sup>618</sup>

Lithuania is not self-sufficient in energy. One reason is that one nuclear reactor at the Ignalina plant was closed in 2004, as part of a deal made with the EU. Another reactor is due to be closed in 2009 in spite of the fact that it is seen to have at least 20 years left.<sup>619</sup> Building a new reactor at Ignalina could solve the problems according to the Lithuanian Minister of Economy Viktor Uspaskich.<sup>620</sup> If new reactors are not an alternative, Lithuania has few choices but to import energy from Russia (and becoming even more dependent and vulnerable) or resort to coal (which not only is dirty, but also probably will not be enough to meet energy demands). Kaliningrad, Russia's exclave, gets most of its electricity from Ignalina and this has provided Lithuania some leverage on Russia, but now it appears that this opportunity is lost.

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<sup>616</sup> Infolex (2004), 'Gazprom Promises to Pay 100 Million Litas for Lietuvos Dujos in February', *Infolex.lt Legal Portal*, Published: 23 January 2004, Last accessed: 15 February 2005, Internet: <http://www.infolex.lt/portal/ml/start.asp?act=news&Tema=43&str=8535>.

<sup>617</sup> Mite, Valentinas (2004b), 'Lithuania: Gazprom Purchase Prompts Concern over Russian Influence', *RFE/RL*, Published: 13 January 2004, Last accessed: 21 June 2005, Internet: <http://www.rferl.org/featuresarticle/2004/01/fd85fd51-5572-4e88-a9f9-9fe59d17b7e7.html>.

<sup>618</sup> Zashev *Russian Investments in Lithuania: Politics, Business, Corporate Culture*, p. 16.

<sup>619</sup> Baltic Times (2005b), 'Ignalina CEO Reminds Latvia of Tough Energy Times Ahead', *The Baltic Times*, 7-13 April 2005, p. 7.

<sup>620</sup> Baltic Times (2005a), 'Energy Officials Want Baltics to Remain Atomic', *The Baltic Times*, 19-25 May 2005, p. 16.

It is reasonable to assume that the key drivers behind most of these actions against Lithuania are economic, although not purely market based. They categorically have political backing and coincide with Russia's strategic priorities. Politics and economics are hence joint explanations for Russia's policy. One should not oversee that there is room for individual agendas as the level of corruption is very high. This does not exclude links to the Kremlin, but is rather one aspect of a complex relationship. An assessment of Russian businesses in Lithuania for example concludes that most firms have "unbroken links" to the Russian state and take the opportunity to use bribes when necessary. Efficiency and productivity is of less of concern even if there is not that demonstrate that Russian ownership brings lower productivity.<sup>621</sup> There are rumours of questionable connections between Lithuanian officials (such as the Minister of Economy - Eugenijus Maldeikis) and Gazprom.<sup>622</sup> Another example is the Prime Minister Algirdas Brazauskas, who allegedly has close connections to Lukoil and Vagit Alekperov.<sup>623</sup>

### *Estonia*

Estonia's relations to Russia have been less problematic, partly because the level of cooperation is less strategic than with the other Baltic countries. Russian firms have also been forced, to a greater extent than in the Caucasus, Moldova or Ukraine, to buy infrastructure (rather than receiving it in exchange for debts). The political dimension was nevertheless highlighted when Russian officials ahead of the Estonian election in 1993 stated that "the government and parliament of Russia have quite a few levers to make Estonian authorities realize the impermissibility of violating the rights of the republics nonindigenous population", which included "suspending the interstate treaty and imposing economic sanctions on Estonia."<sup>624</sup> Gas cut-offs coincided with the adoption of Estonia's law on aliens, which affected the situation for

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<sup>621</sup> Zashnev *Russian Investments in Lithuania: Politics, Business, Corporate Culture*, p. 34f.

<sup>622</sup> N.Y. University Law School (2001), 'Constitutional Watch', *East European Constitutional Review*, Vol. 10, No. 1.

<sup>623</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 37.

<sup>624</sup> Kramer "'Energy Shock" from Russia Jolts Baltic States', p. 44.

the ethnic Russians living in Estonia.<sup>625</sup> This can be seen as a form of punishment or political statement with regard to Estonia's political orientation.

Vitalii Churkin, the first deputy foreign minister of Russia, afterwards affirmed that the government saw such measures as "one of probable options" for its future policy on Estonia, Latvia and Lithuania. Alexander Rutskoi, then Vice President of Russia (a post abolished in the constitution of 1993) in 1993 stated that if Russia did impose tough sanctions against Estonia they would "grind to a halt within a week".<sup>626</sup> The situation today is much the same, even if Russia appears to be less inclined to cut supply.

### *Latvia*

The core problem in Russian-Latvian energy relations has been Russia's strident attempts to attain control over the Ventspils Nafta in Latvia by staging a cut-off of oil supply to the port. A blockade has been going on since 2002 and the official reason has been that Ventspils' tariffs are too high, compared to tariffs at Primorsk. This policy is approved of by Russia, and several Russian independent oil companies have objected and filed official complaints to Moscow. Latvian authorities have contacted the Commission of the EU, pointing out Russian aggressive policy as 'politically coloured', but those complaints have been met with little understanding.<sup>627</sup>

The Mayor and his friends who are connected to Lukoil control the port of Ventspils. In both the US and Latvia, it was seen as problematic that Itera (in Latvia) was headed by the ex-KGB officer Juris Savickis.<sup>628</sup> Whether this was seen as problematic from a US interest standpoint of a general business-climate standpoint was not revealed. The Prime

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<sup>625</sup> Oldberg, Ingmar (2003), *Reluctant Rapprochement: Russian-Baltic Relations in the Context of NATO and EU Enlargements*, Stockholm: The Swedish Defence Research Agency (FOI), FOI-R--0808--SE, p. 51.

<sup>626</sup> Kramer "'Energy Shock' from Russia Jolts Baltic States', p. 44.

<sup>627</sup> Lelyveld, Michael (2003), 'Moscow Seeks Takeover of Latvian Oil Port', *RFE/RL*, Published: 12 February 2003, Last accessed: 19 July 2005, Internet: <http://www.rferl.org/features/2003/02/12022003171518.asp>.

<sup>628</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 37.

Minister of Latvia, Aigars Kalviti, has however urged for an agency to monitor foreign investments, as the risk of Russia taking over is “very serious”.<sup>629</sup>

The Latvian government has been reluctant to sell Ventspils to Russia. One result linked to this is that Russia has reduced supply to the port (that thus received too little oil and forced it to work at one third of its capacity).<sup>630</sup> The issue is that the government wants to sell, but not to Russia and not on Russian conditions.<sup>631</sup> This despite Rodionov, the Deputy Chairman of the Board of Gazprom stating “No buyer of Russian gas has ever had problems linked to reliability of supplies from Russia”.<sup>632</sup>

### *Finland*

Concerning Finland, it can be held that Gazprom owns 25 per cent of the Finnish gas distributor Gasum and owned 50 per cent of the company North Transgas (which later became the NEG) when Fortum sold the remaining 50 per cent to Gazprom.) Nafta Moskva owns the companies Teboil and Soumen Petroli.<sup>633</sup> The extent of Russian involvement is so large that in mid-2004 over 2000 companies in Finland had some type of Russian managerial or government involvement. In total, 80 per cent of Finland's oil imports and 100 per cent of its gas imports comes from Russia.<sup>634</sup>

Many firms in Finland with Russian involvement have low equity and are rather weak,<sup>635</sup> and it can be the importance of Russia's presence. Russians often holds the position of chairperson of the board (in 45.4 per

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<sup>629</sup> Baltic Times (2004), 'Kalvitis: Latvia Risks Being Bought out by Russia', *The Baltic Times*, 16-22 December 2004.

<sup>630</sup> Wagstyl 'Oil and Gas Needs Give Moscow Influence', p. 11.

<sup>631</sup> Peach, Gary (2005), 'Cleaning up the Mess of Previous Government [Interview with Aigars Kalvitis]', *The Baltic Times*, 24 February - 2 March 2005, p. 18.

<sup>632</sup> Rodionov, Pyotr (2000), 'Gazprom in Shaping Russia's Energy Strategy', *International Affairs (Moscow)*, Vol. 46, No. 2, p. 32.

<sup>633</sup> Vahtra, Peeter and Lorentz, Harri (2004), *Russian Involvement in Finnish Companies: The Energy Sector in Focus*, Turku: The Turku School of Economics and Business Administration/Pan-European Institute, 11/2004, p. 5f.

<sup>634</sup> *Ibid.*, p. 43f.

<sup>635</sup> *Ibid.*, p. 11.

cent of the cases) and has 27.7 per cent of the board posts. Russians are still less involved in the hands-on running of the companies.<sup>636</sup> It is true that Russia has been a reliable supplier of energy to Finland, but Finland is nevertheless concerned about selling assets to Lukoil or Surgutneftegaz.<sup>637</sup>

A similar approach has been taken by the Czech Republic that wanted to keep Russia away when its Unipetrol was privatised. This was also the case in Slovakia with Slovenske Elektrarne.<sup>638</sup> Russia, by its ambassador, has also put explicit pressure on the Czech Republic for its willingness to join NATO and diversify its energy imports from Norway.<sup>639</sup>

### *Germany*

The relations with Germany are different from many other relations (since Germany is strong and one of the most important customers of Russian energy). Cooperation between, for example, Gazprom and German E.ON/Ruhrgas and BASF/Wintershall<sup>640</sup> has tied the states together, but there are also implications by close cooperation. On the one hand close cooperation is sought after as it, according to the philosophy of the EU, is a road to peace teaching Russia 'to behave', at least when dealing with Western Europe. On the other hand, dependence and cooperation makes Germany a hostage to Russian energy.

A link between increased dependence on Russian gas and German reluctance to criticise Russia was evident under Chancellor Gerhard Schröder who rarely spoke about Russian human rights violations. He even called Putin a "dyed-in-the-wool democrat".<sup>641</sup> Also, other leaders have taken this position, but Schröder and Silvio Berlusconi of Italy have

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<sup>636</sup> Ibid., p. 16.

<sup>637</sup> Ibid., p. 18.

<sup>638</sup> Wagstyl 'Oil and Gas Needs Give Moscow Influence', p. 11.

<sup>639</sup> Stern *The Future of Russian Gas and Gazprom*, p. 115.

<sup>640</sup> Ministry of Industry and Energy (2005b), 'Doklad V.B. Khristenko na otkritii Rossiisko-germanskogo dnya ekonomiki [Statement by V.B Khristenko on the Opening of Russian-German Day of Economy]', *Ministerstvo promyshlennosti i energetiki Rossii*, Published: 11 April 2005, Last accessed: 14 April 2005, Internet: <http://www.mte.gov.ru/docs/108/2713.html>.

<sup>641</sup> Benoit and Thornhill 'Fear That Gas Supply Gives Russia Too Much Power over Europe', p. 2.

stood out as particularly friendly with Putin. Other explanations for Germany's positive line on Russia have been pressure from German energy groups and, naturally, Germany's dependence on Russia.<sup>642</sup> There is a clear link between Germany's dependence and its foreign policy, according to Claudia Kemfert, the Director of the Energy Department of the German Institute for Economic Development.<sup>643</sup> Approximately 30-40 per cent of Germany's gas imports are coming from Russia and Schröder has encouraged German companies to invest in Russian energy sector to secure German energy supplies.<sup>644</sup>

The German election in the fall of 2005 was an open question. One crucial issue was whether Germany's policy towards Russia would be maintained if a new Chancellor took office. Prior to the election, Angela Merkel, then opposition leader, met Putin and declared that there would not be a major policy shift in Germany's foreign policy line if she were elected. This and the apparent friendly atmosphere, is interesting to note as she and her party, the Christian Democratic Union (CDU), previously have been critical of Russia's human rights record.<sup>645</sup> Yet, at a meeting in Moscow in early 2006, she made it clear that it is possible to combine economic cooperation with criticism of the Russian leadership.

Rumours have been circling about Schröder getting a top position at Gazprom after leaving office.<sup>646</sup> The rumours are not confirmed, but they show the conception held by several analysts on how close the Schröder-Putin-Gazprom alliance has been. Another rumour, put forward by the Economist, is that Putin would head Gazprom after 2008.<sup>647</sup> Today, it appears highly unlikely.

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<sup>642</sup> Ibid., p. 2.

<sup>643</sup> Dempsey, Judy (2005b), 'Russian Gas to Flow to Europe via Baltic Sea', *International Herald Tribune*, 12 April 2005, p. 4.

<sup>644</sup> Benoit, Bertrand and Buckley, Neil (2005), 'German Groups Shun Russia', *The Financial Times*, 5 April 2005, p. 1.

<sup>645</sup> Benoit, Bertrand and Williamson, Hugh (2005), 'Merkel's Meeting with Putin Signals Policy Continuity', *The Financial Times*, 9 September 2005.

<sup>646</sup> RosBusinessConsulting (2005□), 'Schroeder May Be Offered Job in Gazprom', *RosBusinessConsulting*, Published: 11 October 2005, Last accessed: 20 October 2005, Internet: [http://top.rbc.ru/english/index.shtml?/news/english/2005/10/11/11144449\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/news/english/2005/10/11/11144449_bod.shtml).

<sup>647</sup> Economist 'Russia's Energetic Enigma', p. 75.

Germany's line on Russia has worried many actors, among them both France and Great Britain that have indicated that they see the German-Russian energy relation as an economic and political hazard for all of Europe. It can be argued that France, for example, wants to justify its own nuclear program instead of concern for Europe's future. From Russia's point of view, strapping Germany to Russian pipes is advantageous both from an economic point of view, but also since it reduces the ability for Germany to act in a hostile way against Russia. However, as long as the relation is asymmetric, it will not serve the purpose of being peace glue in the same way as the Coal and Steel Union between France and Germany once did.

Russia is dependent on Europe for energy exports and raw materials as well as bringing home investments and technology. Similarly, Europe is dependent on imports from Russia. However, the character of this dependence is such that Russia's energy leverage on Europe is greater than Europe's leverage on Russia in the short-run.

### *The North European Gas Pipeline – the NEG*

The North European Gas Pipeline – the NEG (sometimes called the Baltic Undersea Gas Pipeline or abbreviated NEP or even NEGP) received great attention when it, on 11 April 2005, was announced at a trade fair in Germany that Russia and Germany had signed an agreement on the pipeline. Schröder claimed that there now was interdependence in economic issues".<sup>648</sup> Financing is not finally settled yet but the pipeline is expected to cost some \$US8-10 billion. Gazprom will own 51 per cent and BASF/Wintershall and E.ON/Ruhrgas will take 24.5 per cent each. The UK is very positive about it<sup>649</sup> and the Netherlands' Gasunie has also expressed its will to take part.<sup>650</sup> Work is expected to start by the end of

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<sup>648</sup> Dempsey 'Russian Gas to Flow to Europe via Baltic Sea', p. 1.

<sup>649</sup> Wagstyl 'Oil and Gas Needs Give Moscow Influence', p. 11. Although the UK has been rather worried by Gazprom's intentions to acquire a stake in British Gas, Macalister, Terry, *et al.* (2006), 'Russia's Gazprom Considers Bid for British Gas Owner Centrica', *The Guardian*, Published: 3 February 2006, Last accessed: 6 February 2006, Internet: <http://www.guardian.co.uk/russia/article/0,,1701338,00.html>.

<sup>650</sup> Global Pipeline Monthly (2005), 'Netherlands: Gasunie May Join Baltic Gas Pipeline Project', *Global Pipeline Monthly*, Vol. 1, No. 1, p. 4.

2005 and be completed in 2010, but this schedule appears optimistic. Neither costs nor capacity has been confirmed so far, but Gazprom's Alexei Miller has stated that it might be about 30 billion cubic meters a year.<sup>651</sup> The project has Putin's blessing.

The NEG route would be from Vyborg at the Gulf of Finland to Greifswald in Germany, but the exact stretch is not decided yet. If it materialises, the projected Yamal 2 pipeline is unlikely to be built. The strong political underpinning of the NEG is enhanced by the fact that it would have been cheaper to expand existing pipelines via Ukraine, Poland or Belarus. The rationale behind it is that Russia does not want to be dependent on any state for exports to Germany and the West. Possibly, there will also be a branch to Kaliningrad according to Miller.<sup>652</sup> If so, the NEG would reduce the problems from Russia with transit over Lithuanian or Belarusian territory to its exclave. There has also been a discussion whether a leg would be built to Sweden, Kaliningrad and the UK.<sup>653</sup> Sweden has thus far refrained from taking stand, but has so far indicated that it sees any participation to the project as one to be handled by private interests.

Poland is highly displeased with the NEG project. Some politicians called it a nightmare and ex-Prime Minister Marek Belka has pushed for alternatives at the EU in Brussels. Then opposition leader, Jan Rokita, also urged that the NEG should be on the agenda in the negotiations between Russia and the EU.<sup>654</sup> Zbigniew Siemiltkowski, the former Head of Poland's Security Service illustrates what many Poles think, "Russia's new imperialism - yesterday tanks, today oil".<sup>655</sup> The reasons for the aversion is that from Poland's point of view it increases Russia's leverage

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<sup>651</sup> Dempsey 'Russian Gas to Flow to Europe via Baltic Sea', p. 4.

<sup>652</sup> RosBusinessConsulting (2005f), 'Gas Pipeline to Secure Kaliningrad Supply', *RosBusinessConsulting*, Published: 4 July 2005, Last accessed: 6 July 2005, Internet: [http://top.rbc.ru/english/index.shtml?/news/english/2005/07/04/04133414\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/news/english/2005/07/04/04133414_bod.shtml).

<sup>653</sup> Moscow News (2005d), 'Russia's Gazprom Begins Construction of a North European Gas Pipeline', *Moscow News*, Published: 22 August 2005, Last accessed: 28 November 2005, Internet: <http://www.mosnews.com/money/2005/08/22/gazprompipeline.shtml>.

<sup>654</sup> Pustilnik, Marina (2005b), 'Russia, the New Energy Imperialist', *Moscow News*, 10-16 August 2005, p. 9.

<sup>655</sup> Zalewska, Luiza and Majewski, Michail (2004), 'Siemiatkowski odeslal J&S ad acta', *Rzeczpospolita*, 3 December 2004. (Quote kindly translated by Wilhelm Unge)

on Poland, as Russia can turn off gas supply to Belarus or Poland without affecting the much more important customer Germany. Poland and Belarus' vulnerability therefore increases by the NEG. This causes further friction in the tense Russian-Polish relations and boosts Poland's striving to go into nuclear energy.<sup>656</sup> If Germany was to connect its gas pipeline network to Poland, Poland's scepticism might decrease.<sup>657</sup> Also, if the NEG continues past Germany to the Netherlands and the UK, important European states would receive greater leverage on Russia. Due to the NEG and Russia' actions towards Ukraine, Poland have come to take a leading role in advocating a common energy strategy that incorporates many of the concerns held by new or smaller EU members. The key points from their horizon have been expressed by the Institute for Strategic Studies in Krakow:

*Policies should deal with guaranteeing uninterrupted supplies to the EU, long-term viability of extraction and use of energy resources (incl. renewability) with regard to the environment and ensuring competitive energy systems. They should address short-, mid-, and long-term aspects of access to energy. They should also take into account the quickly and immensely increasing energy demand of strategic competitors like China (and India).*

*The EU must be prepared for increasing competition on the energy market (first of all China) and therefore adopt a proactive strategy to ensure its future access to energy.*

*A proactive EU energy policy should comprise encouragement of all EU energy suppliers by offers of financial and technological assistance in extraction and transportation. This would create incentives to supply to the Union, introduce energy-saving technologies, create workplaces in the Union as well as in the supplying countries. Such energy cooperation should also be used to promote democracy and the development of rule-of-law societies.*

*A common energy policy of the EU is of outmost importance. Single member states have very limited leverage on the biggest energy suppliers. Only as a collective can the EU achieve reasonable goals of cost-effectiveness, guarantees of uninterrupted supplies and hence energy security. Energy non-solidarity undermines the overall idea of political and economic solidarity of the Union.*

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<sup>656</sup> Tobiczky, Mateusz and Unge, Wilhelm (Forthcoming 2006), *The Energy Problem - Security Leverage and Dependence (DRAFT)*, Krakow: The Institute for Strategic Studies (ISS).

<sup>657</sup> Poland's attempts to diversify its imports by taking energy from Norway has so far failed. Stern *The Future of Russian Gas and Gazprom*, p. 116.

*A solidaric EU should allow for the Baltic gas pipeline since it takes into account only a few member states' energy interests at the expense of others'. Such a project is highly inconducive to a common EU energy policy. This pipeline should be built on land with the aim of connecting several member states to the Russian supply.*

*The EU should expand its redistribution possibilities within the Union in order to be able to solidarily assist a member state facing energy shortage or cut-off.*

*The EU must hedge against energy shortage and blackmail by having energy reserves, diversified sources of energy and diversified suppliers. It would be healthy for the Union to decrease its dependence on Russian energy carriers in a short- and mid-term perspective. At the same time Russia will remain one of the most important suppliers of oil and gas to Europe in a long-term perspective. Hence, the EU-Russia energy dialogue should be intensified and brought to be built on trust and without blackmail possibilities. Russia will have to abandon its energy strategy until the year 2020, which explicitly states that energy will be used as a means to exert influence on other countries. Such a doctrine cannot be the basis for friendly cooperation with the EU and EU neighbours.*

*Russia is not the only supplier of oil and gas to the EU. Countries around the Caspian Basin, in the Middle East, Central Asia, Northern Africa and Northern Europe are important suppliers of today and tomorrow even though they might have different potentials and prospects. Countries of geostrategic importance in this respect are Turkey and Ukraine. Turkey is a natural bridge between Europe and Asia. Infrastructural projects through Turkey allowing for transit of energy carriers from the Caspian and Central Asian regions would have two major benefits: securing EU energy security and at the same time making Turkey an important EU partner (and with all likelihood also member).*

*Financing R&D of energy-saving technologies should be increased. Introduction of existing energy-saving technologies should be made compulsory in the EU (transfer and consumption) and suppliers should be forced to (in cooperation with the Union) to use energy-saving techniques although this might not in a short-term always be the most cost-effective.*

*Exploration of alternative sources of energy for large-scale production and consumption is vital and should continue and the efforts increase substantially (hydropower, wind power, solar power, biofuels, earth-heated housing etc.). Politicians and industrial representatives do not take alternative sources for large-scale production seriously today, but in a long-term perspective such sources will be needed. Some of them also have the benefit of being renewable.*

*Nuclear power (fission power) will remain a cornerstone of energy production in many member states. Since the prospects for industrial-scale fusion power are still distant the possibilities of further developing the safety and effectiveness of fission power should be further explored. Financing R&D of fusion power (like ITER) is still imperative because of the enormous potential benefits if it should be possible to build a fusion reactor in the future.*

*In a long-term perspective, the role of coal should be considered. On the territory of the EU (and some potential future members such as Ukraine) there are large reserves of coal. Technology for relatively clean energy production exists and should be further developed. Hydrogen can also be extracted from coal – and hydrogen is with all likelihood a fuel of the future (for example as fuel for automobiles).*

*EU energy legislation should be reviewed. Single member states should not be able to enter long-term contracts of energy supplies in defiance of current EU legislation and suppliers should be encouraged to accept market mechanisms on the energy market, such as SPOT-trading etc.<sup>658</sup>*

The Baltic countries have also tried to shift the debate on the pipeline to relate to the environment, for example by joint attempts within the Baltic Assembly. There, they have pointed to the environmental and ecological risks by having the pipeline at the bottom of the Baltic Sea. They state that chemical weapons dumped in the sea during the Second World War may be affected. Gazprom defied the allegations.<sup>659</sup> In August 2005, Gazprom started construction of the first leg in the Leningrad Oblast.<sup>660</sup>

The Head of Dresdner Bank's Russia Operations, Matthias Warnig, is meant to be CEO of the project. It is intriguing to note that Warnig and Putin, according to sources of the Wall Street Journal, have been acquainted even since Putin's time in Dresden in the 1980s. Warnig was then an officer of Stasi, the East German Secret Police and Putin a representative for the KGB. Warnig and Putin today claim that they first

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<sup>658</sup> Zamarlik, Monika, *et al.* (2006), *Ideas for an EP Resolution on EU Energy Security*, Krakow: Insitute for Strategic Studies (ISS), 6 January 2006.

<sup>659</sup> Vodo, Vladimir, *et al.* (2005), 'Pribaltiiskie strani vykrychivayot Rossii gazoprovod [Baltic Countries Twist Russian Gas Pipeline]', *Kommersant*, Published: 28 November 2005, Last accessed: 28 November 2005, Internet: <http://www.kommersant.ru/doc.html?docId=630188>.

<sup>660</sup> Moscow News 'Russia's Gazprom Begins Construction of a North European Gas Pipeline'.

met in St. Petersburg in the 1990s. Dresdner was also the bank that took care of the valuing of Yukos core assets before it was sold to Rosneft.<sup>661</sup>

Whether Schröder himself will be awarded the position of head of the shareholders committee, which is similar to a board of directors, remains to be seen. The financial aspects of this appointment have not been disclosed. The reactions on the appointment have been disparate. Some consider the appointment to be positive as it provides the project political clout, while Reinhard Buetikofer, the co-chairman of the Germany's Green Party, and Rainer Bruederle, an official of the Free Democratic Party, have questioned whether Schröder will be able to keep public and private affairs separate. The Chief strategist of the Russian Alfa Bank, Chris Weafer, sees the appointment as a reward by the Kremlin for Germany's soft treatment concerning sensitive issues, such as Chechnya.<sup>662</sup>

The case raises questions about how suitable it is for a prominent politician to take a job after leaving office, which is so closely connected to previous responsibilities. It will also indicate that Schröder's successor, Angela Merkel, will face a tougher challenge in improving relations to the Baltic countries and Poland if Schröder's heritage continuously colours the relations.

### *Other Infrastructure Projects*

A Baltic Oil Pipeline System has also been suggested, but is still waiting for the 'go ahead' after several years of negotiations. Another proposal is the 2700 km network from Kharyaga in the Russian Far North to Primorsk near St. Petersburg, with a capacity of 62 million ton/year.<sup>663</sup> Stakeholders are believed to be Transneft, Rosneft and Komitek together with some foreign companies. Lukoil is also stated to support the

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<sup>661</sup> Crawford, David and White, Greg (2005), 'Dresdner Official to Get Post with Baltic Pipeline', *The Wall Street Journal Online*, Published: 9 December 2005, Last accessed: 9 December 2005, Internet: <http://online.wsj.com/article/SB113407711212417638.html>.

<sup>662</sup> Korchagina, Valeria (2005), 'Schroder to Head New Gas Pipeline', *The Moscow Times*, Published: 12 December 2005, Last accessed: 12 December 2005, Internet: <http://www.moscowtimes.ru/stories/2005/12/12/001.html>.

<sup>663</sup> Koptubenk 'Government Should Say if the Country Needs the Eastern Pipeline'.

project.<sup>664</sup> This can be seen in light of new expansions (by 152 per cent from 2003-2004) of the Primorsk oil terminal. The reason for this is stated to be the high tariffs and high fees at Baltic ports.

It is claimed that using Primorsk instead of Baltic ports would save Russia \$US 1.5 billion/year in transit tariffs.<sup>665</sup> As a result, the port of St. Petersburg will also expand by 21.7 per cent. Allegedly, representatives of Russia's Railways and Ministry of Transports have complained even if deliveries by rail have continued.<sup>666</sup> The reason is that they have been in charge of much of the energy transport to Baltic ports and if Russia decides to ship oil from Primorsk, they will lose transit money.<sup>667</sup> Thus, Russia spends a great deal of money on Primorsk to bypass the Baltic countries, despite them being underutilised.<sup>668</sup> This is also one of the driving factors behind the NEG.

Moreover, there are proposals of a Trans-Balkan pipeline aimed at reducing the pressure on the Bosphorus strait. There are many problems circumventing the Bosphorus and the environmental hazards are several. Together they result in long waiting times for passage. During the winter of 2003-2004, the waiting times caused delays of 20-25 days. One option to bypass the strait is by a pipeline from Burgas at the Bulgarian Black Sea Coast to Alexandroupolis in Greece. This idea is supported by Russia and in May 2005, an agreement was signed on setting up a company for the construction of the \$US880 million pipeline. Russian stakeholders include Tatneft, TNK-BP, Stroitransgaz and Sovkomflot.<sup>669</sup> The competing option, Burgas-Vlora, is supported by ChevronTexaco and ExxonMobil.<sup>670</sup>

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<sup>664</sup> Pasukeviciute and Roe 'Strategic Policy and the Logistics of Crude Oil Transit in Lithuania', p. 859.

<sup>665</sup> Ibid., p. 859.

<sup>666</sup> Nimmo, Ben (2005), 'Russia's Ports a Challenge, Not a Threat', *The Baltic Times*, 17-23 February 2005, p. 6.

<sup>667</sup> For further: Ivanov 'Russia and Regional Energy Links in Northeast Asia'.

<sup>668</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 21.

<sup>669</sup> Reuters (2005), 'Countries Reach Deal on Pipeline', *The Moscow Times*, Published: 30 May 2005, Last accessed: 30 May 2005, Internet:

<http://www.moscowtimes.ru/stories/2005/05/30/049.html>.

<sup>670</sup> Yakovleva, Maria and Grigoryev, Ivan (2003), 'Alternative Routes: Exporters of Caspian Crude Look for Routes that Skirt Bosphorous Straits', *Russian Petroleum Investor (World Trade*

When it comes to bringing Russian oil to Western markets, the US might have to choose between supporting either of these options or relying on the Ukrainian Odesa-Brody Pipeline. Yet another option is the Trans-Tracian oil pipeline (Kiyiköy-Ibrihaba) that is also meant to go from the Turkish Black Sea Coast to the Aegean Sea. Russia is already involved in this project as Transneft and Anadoulu Turkey signed a memorandum of understanding in 2004. Costs are estimated to \$US900 million,<sup>671</sup> but Transneft is not supposed to be a financial participator.<sup>672</sup> The long planned Druzhba-Adria pipeline has been stalled and according to Russian sources, it is Croatia that has halted the development.<sup>673</sup> It is unlikely to be built.

### **Energy Relations with Ukraine**

Ukraine's energy crisis has been persistent. It depends on Russia for imports and has a high inefficiency in energy usage. Transparency is furthermore missing and Ukraine lacks real channels for energy diversification.<sup>674</sup> The key energy infrastructure projects in recent years has been the Odesa-Brody oil pipeline, aimed at bringing oil from the Caspian region via Odesa in southern Ukraine to Brody and later to Płock in Poland (although the Polish leg has been stalled for political reasons, but could well come back on the agenda). Russia wanted to use the pipeline in its reverse direction for exports via the Bosphorus.<sup>675</sup> Then Prime Minister Viktor Yanukovych was initially reluctant to this, but gave in after Russian pressure. One segment of 25 km was consequently

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*Executive*), Published: Last accessed: 14 February 2005, Internet:  
<http://www.wtexec.com/RPIAlternativeRoutes.html>.

<sup>671</sup> WPS *The Russian Oil and Gas Report*.

<sup>672</sup> Sapozhnikov, Peter (2004), 'Russia Does not Have Need in Transit via the Foreign Territories', *Kommersant (Reposted at Transneft)*, Published: 17 June 2004, Last accessed: 21 March 2004, Internet:  
<http://www.transneft.ru/press/Default.asp?LANG=EN&ATYPE=9&PG=0&ID=5704>.

<sup>673</sup> Tseselskiy 'Transneft is Out of Policy: Interview with Sergey V. Grigoriev - Vice President of Transneft JSC'.

<sup>674</sup> Balmaceda, Margarita M. (2004), 'Ukraine's Persistent Energy Crisis', *Problems of Post-Communism*, Vol. 51, No. 4, p. 41.

<sup>675</sup> Hedenskog, Jakob (2004), *The Ukrainian Dilemma: Relations with Russia and the West in the Context of the 2004 Presidential Elections*, Stockholm: The Swedish Defence Research Agency (FOI), FOI-R-1199--SE, p. 17.

reversed in 2003. As the pipeline is of high symbolic value, Viktor Yushchenko promised before the presidential election of 2004 to use it as it was intended to and expressed hope that the Płock extension will be a “grand joint project” with the EU.<sup>676</sup> Ideas of using the pipeline in the southward direction have also upset Turkey that wants to decrease shipments through the Bosphorus (although it was less upset when Ukraine imported oil from the Middle East to its ports at Odesa).

There are several examples of Russia attempting to put pressure on Ukraine. One example was in 1993 when Russia gave Ukraine an ultimatum, demanding Ukraine to give up its remaining nuclear weapons to Russia and transfer its Black Sea fleet to Russia.<sup>677</sup> One week prior to the negotiations between Presidents Yeltsin and Kravchuk, in the city of Massandra, 25 per cent of Ukraine's gas supply was cut-off (officially due to non-payments).<sup>678</sup> However, it was clear what was behind the cut-off. If Ukraine gave in to Russia's demands, the energy debt was to be annulled. Russia let it be known that refusal would result in further cut-offs. Kravchuk initially agreed on the demands, but later changed his mind under severe domestic pressure.<sup>679</sup>

Another case in point was when Russia raised its export price on gas for Ukraine above the world market price at the same time as it proposed that Ukraine would join the CIS Custom Union in 1995. This has been interpreted as a covert threat.<sup>680</sup> According to Jonathan Stern, it was “Ukrainian political sensitivity towards Russian influence”, that were a “considerable obstacle to finding any commercial solution that involves Gazprom taking some degree of ownership in Ukrainian gas

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<sup>676</sup> Jane's (2005), 'Oil Pipeline Stirs Trouble for Ukraine', *Jane's Foreign Report*, 24 February 2005, p. 6.

<sup>677</sup> For details of see Felgenhauer, Tyler (1999), *Ukraine, Russia and the Black Sea Fleet Accord*, Woodrow Wilson Center, Woodrow Wilson Case Study 2.

<sup>678</sup> Bukkvol, Tor (2001), 'Off the Cuff Politics: Explaining Russia's Lack of a Ukraine Strategy', *Europe-Asia Studies*, Vol. 53, No. 8.

<sup>679</sup> RFE/RL (1993), 'More Divergent Interpretations of Massandra 'Agreements'', *RFE/RL (Reposted at Friends-Partners)*, Published: 7 September 1993, Last accessed: 19 July 2005, Internet: <http://www.friends-partners.org/friends/news/omri/1993/09/930907.html>.

<sup>680</sup> Balmaceda, Margarita Mercedes (1998), 'Gas, Oil and the Linkages between Domestic and Foreign Policies: the Case of Ukraine', *Europe-Asia Studies*, Vol. 50, No. 2, p. 260.

transmission and storage assets".<sup>681</sup> Given the political blackmail by Russia on Ukraine concerning the demands on the Black Sea Fleet, it is straightforward to explain Ukraine's unwillingness to give up powers over its energy security to Russia.

### *Ukraine 2004-2005*

In the presidential election of 2004, Russia backed the pro-Russian Viktor Yanukovich against the western-minded Viktor Yushchenko. Part of the backing included offers of advantageous gas contracts at reasonable prices (US\$50/tcm). When it was clear that Yanukovich had lost, Gazprom and Russia were less willing to treat Ukraine gently.

Prime Minister Yulia Timoshenko, on the 14 May 2005, accused Russia of suspending oil deliveries to Ukraine, despite Ukraine having "all the necessary agreements". These accusations came just a few days after the Russian oil majors (that also own most petrol stations) raised prices and only sold petrol to buyers with special coupons. Lukoil and Tatneft claimed that oil was still being sent. TNK-BP made similar statements, although smaller volumes than usual were pumped, allegedly due to maintenance work on one of the pipelines.<sup>682</sup> This incident occurred at the same time as Russia again accused Ukraine of stealing gas. The background was that Ukraine had kept some 7.6 bcm of natural gas in an underground facility in order to manage network pressure. This gas belonged to Gazprom and apparently, Ukraine either used it or sold it. Russian state television claimed that Naftogaz had stolen it.<sup>683</sup>

Given Ukraine's general shortfall (about 10 per cent of annual consumption needs), this incident put Ukraine in a difficult bargaining position vis-à-vis Russia. Simultaneously, Gazprom asked for re-negotiation of the ten-year contract (signed in 2002).<sup>684</sup> The tone became somewhat more conciliatory a few days later, but the frictions

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<sup>681</sup> Stern *The Future of Russian Gas and Gazprom*, p. 87.

<sup>682</sup> Bellaby, Mara D. (2005), 'Timoshenko Blaming Oil Shortage on Russia', *The Moscow Times*, Published: 16 May 2005, Last accessed: 17 May 2005, Internet: <http://www.moscowtimes.ru/stories/2005/05/16/042.html>.

<sup>683</sup> Warner, Tom and Ostrovsky, Andrew (2005), 'Ukraine Admits Big Gas Shortfall', *Financial Times*, 9 June 2005, p. 3.

<sup>684</sup> *Ibid.*, p. 3.

remained.<sup>685</sup> Putin also made it clear that the gas was, by European prices, worth \$US1.3 billion, and the experts must therefore “sort out the problem”.<sup>686</sup> During the following months, Russia and Ukraine were far from a settlement and a showdown came during the winter. In the Russian press it became known as “the gas war”.<sup>687</sup>

### *The Showdown during the Winter 2005/2006*

In December 2005, Gazprom put forward a comprehensive plan for a dramatic price rise in order to reach ‘market levels’ of natural gas prices for a number of countries. The raise for Georgia was 100 per cent, for Moldova 100 per cent, for Armenia 100 per cent and for Ukraine over 400 per cent. Practically it would mean that the gas bill reached a level of US\$4.5 billion (compared to today’s of US\$1.25 billion per annum).<sup>688</sup> Belarus and the Baltic countries were spared for the time being. Russia also required Ukraine to hand over its transit pipeline and that the company Rosukrenergo was to be the intermediary between Gazprom and Naftogaz in gas trade. Transit fees were also to be renegotiated.

For Ukraine, this meant a price increase from 50 to US\$230/tcm and it refused to accept the Russian demands. One reason was that Ukraine already had an existing contract on prices. According to the Head of the Department of Oil and Gas Resources at Naftogaz, Mykola Honcharuk, the contract guaranteed Ukraine a gas price of \$US50 until 2009.<sup>689</sup>

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<sup>685</sup> RosBusinessConsulting (2005i), 'Gazprom Helping Ukraine over Fuel Shortfall', *RosBusinessConsulting*, Published: 14 June 2005, Last accessed: 15 June 2005, Internet: [http://top.rbc.ru/english/index.shtml?/news/english/2005/06/14/14123907\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/news/english/2005/06/14/14123907_bod.shtml).

<sup>686</sup> RosBusinessConsulting (2005f), 'Putin Prods Ukraine on \$1.3bn Gas Debt', *RosBusinessConsulting*, Published: 15 June 2005, Last accessed: 16 June 2005, Internet: [http://top.rbc.ru/english/index.shtml?/news/english/2005/06/15/15130156\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/news/english/2005/06/15/15130156_bod.shtml).

<sup>687</sup> Zigar, Mikheil, *et al.* (2006), 'Kak Evropa budet spacatsya ot Rossii [How Europe Will be Saved by Russia]', *Vlast*, No. 2, 16 January 2006, p. 20.

<sup>688</sup> It is also interesting to note that Ukraine also will see a dramatic price increase for nuclear fuel, which is bought from Russia. See Kommersant (2005b), 'No More Reduced Nuke Fuel Prices for Ukraine', *Kommersant*, Published: 5 December 2005, Last accessed: 5 December 2005, Internet: <http://www.kommersant.com/page.asp?id=632407>.

<sup>689</sup> Ukrayinska Pravda (2006), 'Ukraine Regains Initiative in the Gas War', *Ukrayinska Pravda*, Published: 6 January 2006, Last accessed: 17 January 2006, Internet: <http://www.pravda.com.ua/en/news/2006/1/6/4970.htm>, Original scans of the documents in Russian are found at: <http://www2.pravda.com.ua/news/2005/12/22/36935.htm>.

Ukraine further disputed that Gazprom's suggested price was a market price. In Ukraine's opinion, the 'objective' market price of Russian gas in Ukraine is between \$US 75 and 80/tcm.<sup>690</sup> Several analysts noted that it is wrong to speak about market prices, as there is no real gas market compared to other markets. Gazprom is in a monopoly position and is thus able to apply monopoly prices.<sup>691</sup>

Furthermore, Ukraine already had a contract on transit fees and parts of that agreement have been published in the *Ukrayinska Pravda*. It identifies that the gas transit rate was not specified, but any disagreements or disputes were to be solved by the Arbitration Institute of the Stockholm Chamber of Commerce.<sup>692</sup> As many observers noted, Russia did not use the arbitration mechanism and there are uncertainties why the contract on prices were not followed.<sup>693</sup> Ukraine's Prime Minister Yury Yekhanurov and the Fuel and Energy Minister Ivan Plachkov claimed that it also had valid contracts for importing 40bcm gas from Turkmenistan during 2006.<sup>694</sup>

Both sides tried to attain public scores by showing a conciliatory line. Russia, in late December 2005, tried to make a point of having offered Ukraine a commercial loan for meeting payment demands (and by that ensure that supplies were not cut off). The loan of up to \$US3.6 billion was to be carried out under the guarantees of a European or US bank.<sup>695</sup> According to Putin, Ukraine's residential customers would not be affected by any cut in gas supply, as Ukraine's own resources would be

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<sup>690</sup> RosBusinessConsulting (2005w), 'Moscow and Kiev Agree on Gas Transportation', *RosBusinessConsulting*, Published: 30 December 2005, Last accessed: 9 January 2006, Internet: [http://top.rbc.ru/english/index.shtml?news/english/2005/12/30/30163739\\_bod.shtml](http://top.rbc.ru/english/index.shtml?news/english/2005/12/30/30163739_bod.shtml).

<sup>691</sup> Unian (2006a), 'Opinion Europe: Putin's Mafia Politics', *Unian*, Published: 3 January 2006, Last accessed: 9 January 2006, Internet: <http://www.unian.net/eng/news/news-94560.html>.

<sup>692</sup> *Ukrayinska Pravda* 'Ukraine Regains Initiative in the Gas War'.

<sup>693</sup> Semikhova, Olga (2006), "'Gas Contract': a Forced Compromise, a Victory or Betrayal on Interests", *Ukrayinska Pravda*, Published: 5 January 2006, Last accessed: 12 January 2006, Internet: <http://www.pravda.com.ua/en/news/2006/1/5/4966.htm>.

<sup>694</sup> Socor, Vladimir (2006a), 'Controversial Aspects of Russia-Ukraine Gas Agreement Disclosed in Kyiv', *Eurasia Daily Monitor*, Vol. 3, No. 4.

<sup>695</sup> Zhdannikob, Dmitry (2005), 'Gazprom Pulls a Trump Card', *Moscow Times*, Published: 30 December 2005, Last accessed: 9 January 2006, Internet: <http://www.moscowtimes.ru/stories/2005/12/30/042-print.html>.

able to handle this. It would primarily be the industrial consumers that would be affected. Ukraine should neither claim that they lack money as much Western credits as it gets, he states.<sup>696</sup> Yury Yekhanurov, the new Prime Minister in Ukraine, in turn stated that Russia had declined in all twelve offers made by Ukraine.<sup>697</sup> Ukraine further threatened Russia with an infringement on its transit exports to the rest of Europe.<sup>698</sup>

The Kremlin provided strong support for Gazprom's position. Gazprom's CEO, Alexei Miller, was even invited to a public session at the Russian Security Council meeting. At the meeting, Miller stated

*Recently all of the Ukrainian side's actions demonstrate that obviously Ukraine is trying to artificially create problems for European gas consumers and, in this way, improve its negotiating position with Gazprom.<sup>699</sup>*

The Russian Prime Minister Fradkov also made a clear statement that "we support Gazprom's position".<sup>700</sup> The meeting, as it was public and translated into English, something that only selected meetings are, was a clear signal of the alliance between the Kremlin and Gazprom vis-à-vis the international community, not the least Ukraine.

Ukraine refused to bow to the Russian demands and Gazprom confirmed its intention to cut supply if the deadline was not respected. Russia subsequently cut gas supplies on 1 January 2006, only to resume it one day later. The supply drop quickly affected Ukraine, Poland, Slovakia, Romania, Austria, Hungary and Croatia to mention but a few.

At the time of the cut-off, a key topic of public debate was whether Ukraine siphoned Russian gas aimed for the European market. Gazprom's spokesperson, Sergei Kupriyanov, claimed that Ukraine had

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<sup>696</sup> Socor, Vladimir (2005c), 'Russia Insists on Transforming the Terms of Gas Trade with Ukraine', *Eurasia Daily Monitor*, Vol. 2, No. 229.

<sup>697</sup> RosBusinessConsulting 'Moscow and Kiev Agree on Gas Transportation'.

<sup>698</sup> Socor, Vladimir (2005b), 'Kremlin has Upper Hand in Gas Negotiations with Ukraine', *Eurasia Daily Monitor*, Vol. 2, No. 230.

<sup>699</sup> President of Russia (2006), 'Transcripts of the Meeting with Security Council Members', *President of Russia*, Published: 31 December 2005, Last accessed: 9 January 2006, Internet: [http://www.kremlin.ru/eng/speeches/2005/12/31/1620\\_type82913\\_99924.shtml](http://www.kremlin.ru/eng/speeches/2005/12/31/1620_type82913_99924.shtml).

<sup>700</sup> Ibid.

stolen 104.8mcm of gas between 1 January to 2 January and another 118.7mcm between 2 January and 3 January 2006. Gazprom would compensate European customers of this shortfall, he stated.<sup>701</sup> Ukraine, in turn, claimed that it only consumed 15 per cent of the gas, which it was entitled to as a transit fee, but later admitted that it had taken some of the gas.<sup>702</sup>

During the crisis, an agreement was reached within short notice. The agreement is rather complex and much misinformation about what it actually encompassed came out. As it appears, Ukraine will buy 34 bcm of Russian and Central Asian gas (45 per cent of its needs) for \$US95/tcm during the first six months of 2006, according to Serhiy Lukyanchuk, the spokesperson of Naftogaz. Changes must be agreed on by both sides and the company Rosukrenergo will act as an intermediary between Gazprom and Naftogaz Ukraine. It was unclear whether Gazprom's own gas would be included in the deal (which might be more expensive). In addition, Ukraine will receive 22 bcm of gas from Turkmenistan under a separate contract for \$US50/tcm during the first half of the year and for \$US60/tcm in the second half of the year.<sup>703</sup> The transit fees for Russian gas were set at \$US1.6/tcm/100km, which is to be paid for in cash (rather than in gas or subsidized gas price, which was the case in previous agreements). The agreement on transit fees was set to be valid until 2011.<sup>704</sup>

A new contract was nonetheless reached within a few weeks and Russia eventually obtained some of its goals. The new contract stipulated that Russia was to obtain monopoly of use and partial control of Ukraine's transit system, in addition to a monopoly on supply and price setting for

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<sup>701</sup> RosBusinessConsulting (2006b), 'Russia and Ukraine to Settle Gas Dispute', *RosBusinessConsulting*, Published: 5 January 2005, Last accessed: 9 January 2006, Internet: [http://top.rbc.ru/english/index.shtml?/news/english/2006/01/05/05181235\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/news/english/2006/01/05/05181235_bod.shtml).

<sup>702</sup> Moscow News (2006g), 'Ukraine Admits Withholding Russian Gas Meant for Europe', *Moscow News*, Published: 24 January 2006, Last accessed: 24 January 2006, Internet: <http://www.mosnews.com/news/2006/01/24/ukraineadmits.shtml>.

<sup>703</sup> Kyiv Post (2006c), 'Yekhanurov: Ukraine Will try to Hold Gas Prices Steady for the Public', *Kyiv Post*, Published: 6 January 2006, Last accessed: 9 January 2006, Internet: <http://www.kyivpost.com/top/23674>.

<sup>704</sup> RosBusinessConsulting 'Russia and Ukraine to Settle Gas Dispute'.

many years.<sup>705</sup> According to Vladimir Socor, the men behind the change of tactics were Glev Pavlovsky, Sergei Markov and Vyacheslav Nikonov that orchestrated much of the Kremlin's pro-Yanukovych campaign in 2004.<sup>706</sup> The company Ukgaz-Energo will be the joint venture between Russia and Ukraine.<sup>707</sup>

### *Critical Voices in the Aftermath of Cut-off*

Despite the fact that the reached agreement was a face-saving agreement for both parties, criticism followed suit. Most of the international community criticised Russia, and to some extent also Ukraine. The Ukrainian authorities pretended that the deal was favourable and President Yushchenko's block 'Our Ukraine' claimed to be pleased with it.<sup>708</sup> However, criticism from the Ukrainian opposition was directed at both Russia, and against the government, especially Prime Minister Yekhanurov who was behind the agreement. As a consequence, the Ukrainian parliament voted for dismissing the government, but as Ukraine has no constitutional routine of electing a new government, it will stay in office until next general election in the spring of 2006.

One of the most prominent domestic critics was former Prime Minister, Yulia Tymoshenko. In an article (that appeared in the Taipei Times), she stated that:

*Today's crisis over gas supplies must not be overblown. Objectively speaking, Ukraine today is more secure as a nation than at any time in its history. But Ukrainians do not feel as secure as they should.*<sup>709</sup>

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<sup>705</sup> Socor, Vladimir (2006c), 'Moscow Changes Tactics in Ukraine', *Eurasia Daily Monitor*, Vol. 3, No. 24.

<sup>706</sup> Ibid.

<sup>707</sup> Regnum (2006), 'Prime Minister of Ukraine: Ukgaz-Energo has been Established', *Regnum*, Published: 2 February 2006, Last accessed: 15 February 2006, Internet: <http://www.regnum.ru/english/583813.html?forprint>.

<sup>708</sup> Semikhova "'Gas Contract": a Forced Compromise, a Victory or Betrayal on Interests'.

<sup>709</sup> Tymoshenko, Yuliya (2006), 'Ukraine's Gas Settlement: the Wrong Solution', *Taipei Times*, Published: 9 January 2006, Last accessed: 9 January 2006, Internet: <http://www.taipeitimes.com/News/editorials/archives/2006/01/09/2003288213/print>.

She points out Russia as one of the main problems, but also the company Rosukrenergo, which she calls “a shadowy company linked to international criminals”.<sup>710</sup>

The US and the Bush administration have for long been diplomatic in its criticism of Russia, but now, the US Secretary of State, Condoleezza Rice used harsh words saying that “When you say you want to be...a responsible actor in the international economy, then you [should] play by its rules.”<sup>711</sup> She further claimed that Russia's actions were “undoubtedly directed by political motives”.<sup>712</sup> More specifically, she accused Russia of “using its energy resources as a political weapon”, calling the activities “politically motivated efforts to constrain energy supply to Ukraine” as a punishment for Ukraine's pro-western orientation.<sup>713</sup> Russia's response was that Foreign Minister Lavrov called the US statement as “politicized and biased”.<sup>714</sup> Russia let it be known that it was “surprised by the tone” of the comments and saw it as strange that the US objected to the abolishment of subsidised gas.<sup>715</sup>

Importers of Russian gas also expressed concerns about Russia's behaviour. Bulgaria, for example, rejected Russian demands of renegotiating its existing contracts.<sup>716</sup> Even Germany, a close partner to Russia, suggested that it would “think twice” before importing more gas if Russia was not reliable.<sup>717</sup> Chancellor Merkel even stated that: “We

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<sup>710</sup> Ibid.

<sup>711</sup> KraleV, Nicholas (2006), 'Rice Calls Cutoff a Political Move to Punish Ukraine', *The Washington Times*, A, 6 January 2006, p. A15.

<sup>712</sup> Moscow News (2006f), 'Russia Rejects US Criticism Over Gas Dispute with Ukraine', *Moscow News*, Published: 6 January 2006, Last accessed: 9 January 2006, Internet: <http://www.mosnews.com/news/2006/01/06/ricecriticism.shtml>.

<sup>713</sup> KraleV 'Rice Calls Cutoff a Political Move to Punish Ukraine', p. A15..

<sup>714</sup> White, Gregory L. (2006), 'West Hits A Wall With Putin', *The Wall Street Journal*, 12 January 2006.

<sup>715</sup> Kyiv Post (2006a), 'Russia Reacts Angrily to Sharp U.S. Criticism over Gas Dispute', *Kyiv Post*, Published: 6 January 2006, Last accessed: 9 January 2009, Internet: <http://www.kyivpost.com/top/23673>.

<sup>716</sup> Moscow News (2006b), 'Bulgaria Refuses to Review Gas Transit Contract with Russia's Gazprom', *Moscow News*, Published: 6 January 2006, Last accessed: 9 January 2006, Internet: <http://www.mosnews.com/money/2006/01/06/bulgariagazprom.shtml>.

<sup>717</sup> Page, Jeremy (2006), 'Russia Restoring Gas Supplier after Selling Customers Short', *The Times Online*, 3 January 2006.

must not allow ourselves to become dependent".<sup>718</sup> However, when Angela Merkel visited Moscow at the end of January 2006, she emphasised economic cooperation and the strategic pipeline partnership with Russia.<sup>719</sup> Furthermore, Andris Piebalgs, the EU Commissioner for Energy stated:

*Europe needs a clear and more collective and cohesive policy of security of energy supply. Today the issue of security of energy supply is only really considered at the national member-state level, but in reality we need a much greater, European-wide approach to this issue.*<sup>720</sup>

Piebalgs' statement, as most of his comments on Russia, was diplomatic but nevertheless indicated that Europe must pay increased attention to the problems of energy imports from Russia. Several observers, among them 'The Economist', noted that much of the hope for energy security in Eastern Europe is pinned to a common European policy, but that such line required time and money that unlikely will materialise.<sup>721</sup> The Economist also indicated how it saw Russia's actions by stating: "If you leave a loaded weapon lying around, it is bound to go off sooner or later."<sup>722</sup>

Georgia, a fierce opponent of Russia, took the opportunity to point fingers. President Saakashvili, in an article in the Washington Post, stated that "Russia's arbitrary cutoff sent a clear message to the European Union: There can be no energy security when an undependable neighbour is willing and able to use its energy resources as a weapon of political influence."<sup>723</sup> Saakashvili, drawing on the

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<sup>718</sup> White 'West Hits A Wall With Putin'.

<sup>719</sup> Kolesnikov, Andrey (2006), 'Our Friend Angela', *Kommersant*, Published: 17 January 2006, Last accessed: 17 January 2006, Internet: <http://www.kommersant.com/doc.asp?id=641202>.

<sup>720</sup> Moscow News (2006c), 'EU Commissioner Welcomes Ukraine-Russian Gas Deal', *Moscow News*, Published: 6 January 2006, Last accessed: 9 January 2006, Internet: <http://www.mosnews.com/news/2006/01/05/eucomissioneer.shtml>.

<sup>721</sup> Economist (2006a), 'The Energy Empire', *The Economist*, 7-13 January 2006.

<sup>722</sup> Economist (2006b), 'Nervous Energy', *The Economist*, 7-13 January 2006, p. 61.

<sup>723</sup> Saakashvili, Mikhail (2006), 'The Path to Energy Security', *The Washington Post*, Published: 8 January 2006, Last accessed: 9 January 2006, Internet: [http://www.washingtonpost.com/wp-dyn/content/article/2006/01/08/AR2006010801167\\_pf.html](http://www.washingtonpost.com/wp-dyn/content/article/2006/01/08/AR2006010801167_pf.html).

Georgian experience of negotiations with Russia and Gazprom, stated that:

*There is nothing 'free market' or 'market rate' behind Russian energy prices. Manipulation of energy prices and supplies is a critical tool of those in Russia who believe that hydrocarbons are the best means of political influence. In Georgia, both Abkhazia and South Ossetia, two areas that are outside of our control and whose separatist authorities are directly controlled by Russia, receive natural gas free – hardly a practice free-marketeers would applaud.<sup>724</sup>*

Foreign policy is not something that Russians in general pay much attention to and criticism against Putin's foreign policy line is seldom heard. According to the unscientific web-poll at RosBusinessConsulting, 50 per cent of the over 10,000 voters stated that the conflict is not over yet, but more interestingly, 22.5 per cent considered Russia to be the winning side (compared to 8.3 per cent for Ukraine). 10.9 per cent of the respondents stated that none won and only 2.6 per cent considered both countries as winners.<sup>725</sup> In a similar web-poll in the Ukrainian Kyiv Post (only 492 voters), 30.6 per cent stated that Ukraine won while 29.8 per cent stated that Russia won. 26.6 per cent stated business interests won while 12.8 per cent stated that nobody benefited.<sup>726</sup> Given the nature of these web-polls, no real conclusions can be drawn, but it can at least be stated that the line between winners and losers in the eyes of the voters is not clear-cut. International perceptions of Russia have nonetheless taken a negative turn and most people, for example in France, have a negative view of Russia today.<sup>727</sup>

Andrei Illarionov, once a member of Putin's team but now a strong opponent of the regime, even likened Russian demands on Ukraine to the Nazi and Soviet ultimatums to Eastern European states in the eve of the Second World War.<sup>728</sup> Illarionov noted that he was "absolutely sure"

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<sup>724</sup> Ibid.

<sup>725</sup> RosBusinessConsulting (2006a), 'In Your Opinion, Who is the Winner of the Russia-Ukraine Gas Dispute?' *RosBusinessConsulting*, Published: 16 January 2006, Last accessed: 20 January 2006, Internet: [http://www.rbcnews.com/yourchoice/voters/2006\\_20060116.shtml](http://www.rbcnews.com/yourchoice/voters/2006_20060116.shtml).

<sup>726</sup> Kyiv Post (2006b), 'Vox Populi: Who Won the Gas Dispute between Ukraine and Russia?' *Kyiv Post*, Published: N/A, Last accessed: 20 January 2006.

<sup>727</sup> Baev 'Putin, Gazprom, and "The Other Norwegian Company"'.  
*Opinion Europe: Putin's Mafia Politics*.

<sup>728</sup> Unian 'Opinion Europe: Putin's Mafia Politics'.

that Russia would not be invited to the G8 today.<sup>729</sup> Vladimir Milov wrote in the Financial Times that:

*[Y]ou cannot build a global energy security architecture on the basis of non-transparent state-dominated monopolies, destruction of successful private businesses, closing doors to international investment and using energy as a tool of neo-imperial politics.*<sup>730</sup>

The topic of expelling Russia from G8 was mentioned in several newspaper editorials, but it is clear that this will not occur. Diplomats cited by the Wall Street Journal stated that there was no “appetite for punishing Russia”.<sup>731</sup>

### *Consequences of the Showdown*

There are at least eleven consequences of the cut-off, Russia's actions, and the new agreement on gas transportation and purchases. First: for Ukraine, the rise in gas prices is problematic as it is dependent on cheap gas. According to Ukrainian calculations, the chemical industrial sector for example needs a gas price of less than \$US95/tcm to be competitive and the metallurgy industries requires a price of less than \$US103/tcm. Together these sectors make up 30 per cent of the Ukrainian GDP and 45 per cent of its inflow of hard currency.<sup>732</sup>

It is worth noting that if these sectors are negatively affected by the rise in price, it will first and foremost be in the eastern part of Ukraine where most of the energy-intensive industries are located. This is traditionally the area that has the strongest support from Russia. It is uncertain whether people in these regions will blame Russia for what has happened. The Yushchenko administration is likely to take the heat and the Russian-backed opposition politician Viktor Yanukovich will

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<sup>729</sup> Finn, Peter and Anderson, John Ward (2006), 'Gas Dispute Leave Cloud Over Russia's Chairmanship of G8', *The Washington Post*, A, 6 January 2006, p. A16.

<sup>730</sup> Milov, Vladimir (2006), 'Russia Ill-Equipped to Lead on Global Security', *Financial Times*, Published: 25 January 2005, Last accessed: 25 January 2006, Internet: <http://news.ft.com/cms/s/eeb4cda8-8d0e-11da-9daf-0000779e2340.html>.

<sup>731</sup> White 'West Hits A Wall With Putin'.

<sup>732</sup> RosBusinessConsulting 'Russia and Ukraine to Settle Gas Dispute'.

probably be the winner as he can stand up as the alternative to Yushchenko.

It is however doubtful that Yanukovych would be able to affect gas prices and save the ailing chemical and metallurgy sectors. Possibly, he if is elected president or his party gains majority in the upcoming parliamentary election (which current polls suggest he would), he could facilitate for Russian companies to take over parts of Ukrainian industries, infrastructure and enterprises and by that create room for self-subsidies.

In the long-term, it may be an advantage if Ukraine is forced to restructure its energy inefficient industrial sector and bring about an improved investment climate,<sup>733</sup> but it is questionable whether Ukraine would prefer to do it under pressure from Gazprom.

Second: despite the fact that Yushchenko hailed the new gas contract, evidence of Ukraine's reluctance to rely on Russia emerged when Ukraine made it clear that it aims to produce its own nuclear fuel (instead of importing fuel from Russia).<sup>734</sup> Also, Poland's future nuclear programme is clearly linked to a need for reducing dependence on Russia, but also Germany and France demonstrate increased interest in nuclear power.<sup>735</sup>

Third: Ukraine has indicated, on several occasions, that it might use the Sevastopol naval base as a counter lever on Russia. The base fell into Ukrainian hands after 1991, but Russia rents the base under a 20-year contract since 1997. Ukraine has indicated that it will not renew the contract when it expires and has also suggested that it may raise the

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<sup>733</sup> Unian (2006b), 'Russia's Strong-Arm Tactics May Do Ukraine a Favour', *Unian*, Published: 4 January 2006, Last accessed: 9 January 2006, Internet: <http://www.unian.net/eng/news/news-94664.html>.

<sup>734</sup> AP (2006), 'Ukraine May Make Own Nuclear Fuel', *Moscow Times*, Published: 16 January 2006, Last accessed: 16 January 2006, Internet: <http://www.moscowtimes.ru/stories/2006/01/16/043-print.html>.

<sup>735</sup> Moscow News (2006d), 'Europe Should get Accustomed to Russia's Political Behavior Due to Need of Russian Gas - Experts', *Moscow News*, Published: 8 January 2006, Last accessed: 9 January 2006, Internet: <http://www.mosnews.com/news/2006/01/08/europegas.shtml>.

rent.<sup>736</sup> Today, Russia pays \$US100 million annually and the rent is drawn from Ukraine's gas dept. As it is small in comparison to the gas bill, it is doubtful whether it will have any impact.<sup>737</sup> The Russian Minister of Defence, Sergei Ivanov, consequently threatened Ukraine with "fatal consequences" if it did raise the rent.<sup>738</sup> Ukrainian attempts to create a barter deal by exchanging Ukrainian manufactured weapons to Gazprom that could sell them to the Russian Ministry of Defence has not been approved of and Gazprom demands all payments in cash.<sup>739</sup>

Fourth: it would perhaps be too presumptuous to state that the gas conflict destabilised Ukraine, but it certainly added tension to the political setting in front of the upcoming parliamentary election. Taras Voznyak, a writer of the *Ukrayinska Pravda*, concluded that the pro-American Yushchenko-administration looked incompetent and adventurous; Ukraine was depicted as a zone of instability and seen as unreliable in the eyes of the EU. The timing of Russian demands further came at a time when gas demands peaked and Ukraine was most vulnerable. Russia's action also showed who was 'in charge'. These consequences were not only results of the showdown, but also the reasons behind it, Voznyak argues.<sup>740</sup>

Fifth: the gas conflict demonstrated to Europe how vulnerable it is to interruptions of gas supply, and new attention will likely be given to diversification. One possible outcome is that it will serve Turkey with an argument for EU membership, as it would facilitate EU access to the Caspian energy reserves.<sup>741</sup> However, even if most of the critical voices were blaming Russia, the incident may well serve as an argument for the

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<sup>736</sup> Moscow News (2005e), 'Ukraine Raises Russia's Black Sea Fleet Issue in Gas Row', *Moscow News*, Published: 20 December 2005, Last accessed: 9 January 2006, Internet: <http://www.mosnews.com/news/2005/12/20/russianfleet.shtml>.

<sup>737</sup> Socor, Vladimir (2005a), 'Does Ukraine Really Have Counter Levers for Gas Supplies?' *Eurasia Daily Monitor*, Vol. 2, No. 230.

<sup>738</sup> Unian 'Opinion Europe: Putin's Mafia Politics'.

<sup>739</sup> Dow Jones Newswire (2005), 'Ukraine Offers Weapons For Russian Gas', *The Wall Street Journal Online*, 26 November 2005.

<sup>740</sup> Voznyak, Taras (2006), 'What is Putin Striving For? The Geopolitical Aspect of the Russian "Gas Counterattack"', *Ukrayinskaya Pravda*, Published: 6 January 2006, Last accessed: 12 January 2006, Internet: [http://www.pravda.com.ua/en/news\\_print/2006/1/6/4969.htm](http://www.pravda.com.ua/en/news_print/2006/1/6/4969.htm).

<sup>741</sup> Ibid.

NEG (see above) through the Baltic Sea, as it is aimed at bypassing Ukraine.

Sixth: European importers of Russian energy will probably be on their watch when it comes to future disagreements on contracts or prices. The Moscow News has nonetheless noted that it makes little sense to lecture Russia on the topic, since Europe is dependent and Russia gets most of its hard currency from oil and gas.<sup>742</sup> Some US politicians, such as Senator John McCain, prefer the US to take a harder line on Russia, but analysts believe that it is unlikely despite Rice's strong words.<sup>743</sup>

Seven: the conflict has given EU member states a strong incentive for boosting the process of developing a common European energy strategy. This does not indicate, however, that it will be any easier to accomplish, as bilateral agreements with Russia may infringe on the willingness to take a common European stand on energy. One example of this is the debate that followed the incident and the work on drafting a new resolution on energy security.

In the aftermath of the crisis, Presidents Yushchenko and Voronin of Moldova also appealed to the EU for setting rules in negotiations with Russia. They underscored that they had similar experiences of Russian pressure and called for participation of EU experts during negotiations. Other suggestions included determining a transition period for Russian price hikes and adaptation of the EU methodology for price formation. In addition, they wanted a moratorium on prices and transit rates and, finally, they would guarantee stable transit of Russian gas to Europe.<sup>744</sup>

Eight: the conflict has most likely dampened the willingness for further cutting of supplies for the time being, at least if it would affect more states than just Ukraine. Russia is aware of its situation and that it cannot conduct similar cut-offs without destroying its reputation even further.

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<sup>742</sup> Moscow News 'Europe Should get Accustomed to Russia's Political Behavior Due to Need of Russian Gas - Experts'.

<sup>743</sup> Daniel, Caroline and Dinmore, Guy (2006), 'Restrained US Rebuke to Putin on Gas Dispute', *Financial Times*, A, 6 January 2006, p. 5.

<sup>744</sup> Socor, Vladimir (2006d), 'Ukrainian and Moldovan Presidents Close Ranks, Appeal to European Union on Gas Crisis', *Eurasia Daily Monitor*, Vol. 3, No. 2.

Ninth: Turkmenistan's role during the conflict was modest, but rumours claim that it has plans to raise its price on natural gas substantially, as it wants a larger share of the profits made by Gazprom. Turkmenistan's embassy in Moscow has denied the rumours.<sup>745</sup>

Tenth: the gas agreement stipulates that prices will be renegotiated during the summer of 2006, which provides new room for Moscow to coerce a deal favourable to Russia and Gazprom at a time when transit fees are set through other contracts. By that, Ukraine is deprived of some of its best leverage on Russia.

Eleventh: a notable outcome of the agreement is that the company Rosukrenergo will act as an intermediary between Gazprom and Naftogaz, giving it a pivotal position in energy relations. This demands a closer look.

### *The Winners: Rosukrenergo and Ukgazenergo*

Rosukrenergo was set up by the Kuchma administration and at the time dealt with providing Turkmenistan's gas (previously taken care of by Eural Trans Gas) to Ukraine. As seen in chapter five, Eural Trans Gas was also a questionable company, which appears to have been created as an imaginary competitor to Gazprom, aimed a skimming profit.

When created, Rosukrenergo was registered in Zug in Switzerland and up to 50 per cent owned by Arogas Holding AG that was affiliated with Gazprombank (Gazprom's bank subsidiary) and Gazprom itself.<sup>746</sup> Today, Gazprom will take the entire 50 per cent stake. The other 50 per cent was (and is) held in a trust of the Raiffeisen Bank in Austria. Who the real owners are has never been made public, but they are supposed

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<sup>745</sup> Belton, Catherine (2006c), 'Turkmens May Seek New Deal', *The Moscow Times*, Published: 16 January 2006, Last accessed: 16 January 2006, Internet: <http://www.moscowtimes.ru/stories/2006/01/16/041.html>.

<sup>746</sup> Kupchinsky, Roman (2006b), 'Russia/Ukraine: Questions Raised About Gas Deal Intermediary', *RFE/RL*, Published: 4 January 2006, Last accessed: 25 January 2006, Internet: <http://www.rferl.org/featuresarticle/2006/01/a320b03b-185f-4733-b8df-e9322d7ccf8f.html>.

to be Ukrainians. Both the Russian Duma and the Ukrainian Rada have demanded to know who is behind the company.<sup>747</sup>

Rosukrenergo has been under investigation by the (now former) Head of the Ukrainian Security Service (SBU), Alexander Turchinov, for its links to organised crime syndicates.<sup>748</sup> In mid-August 2005, he dropped the investigation on Rosukrenergo after Yushchenko, allegedly in person, told him to do so (as it was upsetting the Kremlin).<sup>749</sup> By that, Turchinov also accused the first aide to the president for covering up for that “transnational criminal system”.<sup>750</sup> According to the Ukrainian daily website *obozrevatel.com.ua* on 21 September 2005, the SBU officer in charge of the investigation, Andriy Kozhemyakin, was transferred from the case.<sup>751</sup> Turchinov has since been expelled from the post of the Security Service part of Tymoshenko's block and heavily criticises Ukraine's energy policy.<sup>752</sup> Some of the links Turchinov is referring to are to Semyon Mogilevich, who is wanted by the American FBI.<sup>753</sup> Both Mogilevich and Rosukrenergo have denied any links.<sup>754</sup>

However, shadowy energy business is not limited to this company. Regional clans control much of the industrial sector and corruption is widespread in Ukraine. The former President, Leonid Kuchma, his son-in-law Viktor Pinchuk and Yuri Boyko (the Head of Naftogaz Ukraini have strong ties to Lukoil (Lukoil has for example taken control of the Odesa refinery). In addition, the former Prime Minister, Pavlo Lazarenko has been prosecuted in the US after receiving bribes in order to support Itera on the Ukrainian market. Another case is brought to light by Serhiy Yermilov, the former Fuel and Energy Minister who has stated that

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<sup>747</sup> Belton, Catherine (2006b), 'Miller and Medvedev Talk of Transparency', *The Moscow Times*, Published: 17 January 2006, Last accessed: 17 January 2006, Internet: <http://www.moscowtimes.ru/stories/2006/01/17/041-print.html>.

<sup>748</sup> Semikhova "'Gas Contract": a Forced Compromise, a Victory or Betrayal on Interests'.

<sup>749</sup> Belton 'Miller and Medvedev Talk of Transparency'.

<sup>750</sup> Semikhova "'Gas Contract": a Forced Compromise, a Victory or Betrayal on Interests'.

<sup>751</sup> Kupchinsky 'Russia/Ukraine: Questions Raised About Gas Deal Intermediary'.

<sup>752</sup> Semikhova "'Gas Contract": a Forced Compromise, a Victory or Betrayal on Interests'.

<sup>753</sup> Ibid.

<sup>754</sup> Belton 'Miller and Medvedev Talk of Transparency'.

Ukrtransnafta, the state oil company, has acted in the interests of Transneft and Russia as an intermediary.<sup>755</sup>

Ukrgazenergo, the company that will act as intermediary between Rosukrenergo and Naftogaz is also run from Moscow and its head is Alexander Ryazanov, the deputy Chairman of Gazprom and informal leader of the hardliners at Gazprom.<sup>756</sup>

### *The 'Market Driver' behind Russia's Actions*

Neither the economic nor the political drivers behind Russia's general energy policy should be underestimated. This report shows, for example in chapter three, that both dimensions are pivotal and can hardly function individually to fulfill Russia's goals. Economic drivers should, however, not be seen as synonymous to market drivers.

Adopting a 'market approach' and applying 'market prices' were mantras during the Russian-Ukrainian gas row. It is therefore important to stress that Russia may not be as keen on marketisation as it pretends to be. Much of this is merely lip service. Russia and Gazprom naturally want (and need) high prices regardless of them being market prices or not. Gazprom is a *de facto* monopoly gas supplier and it has been, with the Kremlin's support, unwilling to allow real competition. Third party access to pipelines is virtually impossible against the Kremlin's and Gazprom's will. Gazprom is effectively denying requests for transparency. Requiring Rosukrenergo, a shadowy company with possible links to organised crime, to act as intermediary is scarcely market practice.

In addition, neither Gazprom nor its half-owned Rosukrenergo has revealed all of its owners or subsidiaries. Gazprom also discriminates among its customers. All of them do not have to pay the 'market price', and the Moscow-loyal separatist regions of Transnistria, South Ossetia and Abkhazia have practically received gas for free (despite the fact that

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<sup>755</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 36.

<sup>756</sup> Kupchinsky 'Russia: Putin's Former Colleagues Make Up Today's Energy Team'.

Transnistria owes Gazprom over one billion US Dollar.<sup>757</sup> Giving support to separatist regions against the central powers of sovereign states has been one of Moscow's best leverages against Moldova and Georgia. If these regions move closer to the central powers, Moscow could easily point to a gas bill and put pressure on them for their actions.

Neither can Gazprom's demands for taking over Ukraine's transit pipeline network (or Belarus Beltransgaz) be seen as market practice in line with Gazprom's earlier requirements of avoiding barter payments and moving towards cash-only payments. Finally, the timing of this and other cut-offs and coercive pricing policy coincides with peak demands for Russian energy at times when the political situation is filled with tension.

An economic rationale behind subsidising prices is lacking and Gazprom is keen to boost its efforts to create opportunities for new investments and maintenance and Russia's domestic and intra-CIS price subsidies are not endorsed by the international community either. The issue has been a core problem for WTO negotiations, especially as Russia not yet is prepared to let domestic customers pay the full price for consumed gas.

Monaghan underscores that the EU pressures Russia to raise also its domestic prices to the level of world markets. Putin therefore argued in 2003 that "the EU will not succeed in twisting Russia's arm in its desire to achieve a sharp hike in fuel prices".<sup>758</sup> It appears that Russia is reluctant to raise prices domestically in the same way as it is against its political adversaries. The geopolitical underpinning is here a crucial factor.

### *The Geopolitical Context*

Igor Torbakov, writing for the Eurasia Daily Monitor, pinpoints the core issue. The Kremlin's strategists have reached two important conclusions concerning the changing geopolitical environment in the former Soviet area. Firstly, the former Soviet republics are moving along two opposing

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<sup>757</sup> Socor, Vladimir (2006b), 'Gazprom Halts Gas Supplies to Moldova', *Eurasia Daily Monitor*, Vol. 4, No. 2.

<sup>758</sup> Monaghan *Russian Oil and EU Energy Security*, p. 7.

trajectories, one being pro-Moscow and the other pro-West. Secondly, the pro-Western countries (especially Georgia and Ukraine) have had colour revolutions supported by the West. For Russia, Ukraine is most important and the trend must come to a halt.<sup>759</sup> Other interpretations, which connect to Torbakov's analysis, claim that Russia has a 'psychological needs of enemies and conflicts'. Now it is Ukraine's turn, Voznyak argues, and Russian policy coincides with Putin trying to stand out as the "saviour of Russia".<sup>760</sup>

Michael Meyer, a writer for Newsweek, underscores that Putin has told him that "Power is a double-edged weapon" and likened it to a razor in the hands of a drunk. Now, Putin has played the drunk, he argues. One of the reasons for Putin's behaviour, as explained by Pavel Felgenhauer, is that Putin trusts no one, nor the information he receives. The result is that he delays decisions until he by events is forced to react, which in turn causes an overreaction.<sup>761</sup>

Konstantin Kosachev, Chairman of the State Duma Foreign Affairs Committee, let it be known in public that even if Gazprom claims that its actions are purely market-based, there are political underpinnings. Kosachev stated that Moscow "will continue to subsidize energy supplies to its 'allies'" and at the same time "purely market mechanisms" in its bilateral relations with those states that are not loyal enough to Moscow and that have a "suspicious geopolitical orientation". He further stated "We simply suggest applying market principles while doing business with those countries with which we don't have an alliance-type relationship".<sup>762</sup>

Voznyak explains that Russia's method of tackling the problem is to destabilise Ukraine by making the Yushchenko administration look

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<sup>759</sup> Torbakov, Igor (2006), 'Kremlin Energy Policy in Ukraine: Unwieldy Combination of Strategic Objectives and Private Interests', *Eurasia Daily Monitor*, Vol. 3, No. 4.

<sup>760</sup> Voznyak 'What is Putin Striving For? The Geopolitical Aspect of the Russian "Gas Counterattack"'.  
Counterattack".

<sup>761</sup> Meyer, Michael (2006), 'The Man with the Razor', *Newsweek*, No. 16 January 2006, 16 January 2006, p. 43.

<sup>762</sup> Torbakov, Igor (2005), 'Kremlin Uses Energy to Teach Ex-Soviet Neighbours a Lesson in Geopolitical Loyalty', *Eurasia Daily Monitor*, Vol. 2, No. 224.

incompetent and adventurous and depicting Ukraine as a zone of instability in the eyes of the EU.<sup>763</sup> A primary goal of this policy is to keep Ukraine away from NATO and possibly, the next steps are to target Ukraine's oil pipelines in the summer (when oil demands peak), and further target American interests in Central Asia and the Caucasus.<sup>764</sup>

Energy relations do not take place in a vacuum. Russia has taken also non-energy related actions against Ukraine. One example is a newly imposed ban on imports of meat products, which Russia claims fail to fulfil basic veterinary norms.<sup>765</sup> Karina Litvack, head of governance at F&C Asset Management in London, remarked that investment clients have been worried and she brings to attentions "Can you imagine if Exxon or Chevron switching off the pump to Canada or Mexico because these countries disagreed with the view on Iraq?"<sup>766</sup>

### **Energy Relations with Belarus**

Beginning in the early 1990s, there have been fierce discussions between Russia and Belarus on gas (among other things). The various agreements are too many to be discussed here, but a few illuminating examples of the links between energy and politics in the Belarus-Russian relations can be given. First, in April 1994 Russia managed to exchange gas for the right to deploy Russian soldiers on Belarusian soil.

Second, Belarus was greatly indebted already by 1995 (\$US428 million only for gas deliveries). Despite this, no cut-offs occurred. Chloë Bruce points to three reasons for this: the Custom Union between Russia and Belarus was in the making and still fragile; talks on the Yamal pipeline were under way and Gazprom did not want to disturb the negotiations and, in addition, the reunification of Belarus and Russia was on the agenda, especially in the context of the upcoming presidential election of 1996.<sup>767</sup>

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<sup>763</sup> Voznyak "What is Putin Striving For? The Geopolitical Aspect of the Russian "Gas Counterattack".

<sup>764</sup> Ibid.

<sup>765</sup> Zhdannikob 'Gazprom Pulls a Trump Card'.

<sup>766</sup> Matthews, Owen (2006), 'Hoping for a Gusher', *Newsweek*, No. 16 January 2006, 16 January 2006, p. 42.

<sup>767</sup> Bruce *Friction or Fiction? The Gas Factor in Russian-Belarusian Relations*, p. 4-5.

Third, during the negotiations in 1996 (on cancellation of the Belarusian gas debt in exchange for further military concessions), Gazprom explicitly threatened Belarus with a gas supply reduction. From Gazprom's point of view, the outcome was an unfavourable price agreement. Presumably, the explanation is that closer integration with Belarus (e.g. due to Yamal) and the re-election of Yeltsin was important for Gazprom and thus underpinned the negotiations. What makes this even more intriguing is that Gazprom allegedly received financial compensation from the Russian government. According to Bruce:

*Belarus gave Gazprom a 'promissory note' (veksel') to cover its accumulated debt of \$916,791 million. The company sold the promissory note to the Ministry of Finance in exchange for \$650 million in the form of tax exemptions and \$200 million in cash. Belarus then failed to pay the promissory note.<sup>768</sup>*

Fourth, by 1997, the political importance of Belarus had decreased, as no real union had come about. Yeltsin had also been re-elected. When Gazprom was forced to pay \$US1.2 billion in back-taxes, there was therefore little preventing it from taking a tough line on Belarus' gas debts as it probably needed the money. Supplies were therefore reduced three times only in one year, by 50, 30 and 40 per cent respectively.<sup>769</sup>

Fifth, when the Russian-Belarusian union came back onto the agenda at the end of 1998, the two states reached a deal favourable to Belarus. Belarus received a \$US200 million credit from certain banks to pay its debt to Gazprom. Gazprom, subsequently, used the money for paying its back taxes to the Russian budget. The Ministry of Defence was the sole beneficiary and spent the money on supplies for the Russian army. The deal however stipulated that the Russian ministry was required to buy Belarusian goods for the money. This, in turn, made it possible for Belarus to pay off its credit to the banks. The rest of the debt to Gazprom was paid for in barter, currency and by state bonds.<sup>770</sup>

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<sup>768</sup> Ibid., p. 5.

<sup>769</sup> Ibid., p. 5.

<sup>770</sup> Ibid., p. 6.

Sixth, Putin's half-year as prime minister was a positive time for Belarus and coincided with the opening of the Belarus leg of the Yamal pipeline. Yamal gave Belarus higher transit importance at the expense of Ukraine, which at the time had tapped large volumes of Russian gas and therefore was rather unpopular in Moscow. When Putin was inaugurated as president, he took a pragmatic, rather than brotherly, policy line and gas supplies to Belarus were reduced on several occasions. The relations fluctuated greatly during the following years, as did gas supply and prices.<sup>771</sup>

Finally, in 2001 and 2002 Belarus agreed to provide Gazprom with a 50 per cent stake of Beltransgaz, the Belarusian pipeline operator, largely in return for a gas price close to the domestic Russian price. Again, this process of negotiations was taking place in parallel to those concerning a merger of the two states. Russia proposed either an EU-like structure or a full integration. Lukashenko was insulted (as he would have to give up the presidential post), the deal concerning Beltransgaz came to a halt and Belarus refused to pay Gazprom's prices on gas. Gazprom hence cut gas supplies by 50 per cent and called for a full privatisation of Beltransgaz.<sup>772</sup>

It is worth underlining that Belarus is one of Russia's closest partners within the CIS and most often gets a special treatment, but this has not prevented Russia from acting coercively. However, the Russia-Belarus Union has not progressed and few Russians are concerned if it loses momentum. Belarusians approve of an economic union with Russia, but do not support the idea of becoming a Russian province.<sup>773</sup>

### *Belarus End-2003*

In the fall of 2003, Gazprom again suspended gas deliveries to Belarus demanding "a higher price for deliveries and favourable terms in the potential purchase of a controlling stake in Belarus' gas-pipeline

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<sup>771</sup> Ibid., p. 6f.

<sup>772</sup> Ibid., p. 7f.

<sup>773</sup> Mite, Valentinas (2004a), 'Belarus: Minsk Seeks Independence and Affordable Russian Gas - but Can it Have Both?' *RFE/RL*, Published: 26 January 2004, Last accessed: 21 June 2005, Internet: <http://www.rferl.org/featuresarticle/2004/01/520cba36-af0e-43ca-a4a2-40d0ed158396.html>.

operator Beltranshaz".<sup>774</sup> In November 2003, Belarus finally agreed to let Gazprom lease Beltranshaz for 99 years in return for increased gas deliveries (that would be enough for Belarus to re-export some gas). The parliament refused to ratify the agreement.<sup>775</sup>

A core problem was that Russia offered to pay \$US600 million for Beltranshaz, but according to Belarus, international auditors valued the company at some \$US5 billion. In order to put pressure on Belarus, Russia therefore closed the gas valve at a time of the year when Belarus was vulnerable. Lukashenko has complained over this kind of blackmail several times, but has been impotent to do anything about it. During this particular cut-off, Belarus turned to Itera, Sibur (which is owned by Gazprom) and Transnafta for gas deliveries. However, as they sell gas extracted by Gazprom (and exports gas via Gazprom's pipeline network), Belarus' diversification is largely artificial.<sup>776</sup>

### *Belarus February 2004*

This was not the end, as on the 18 February 2004, Transnafta cut gas supplies to Belarus (that made up about 30 per cent of Belarus' consumption needs) for over 30 hours. Poland, Latvia and Lithuania were affected. After Itera had cut its deliveries a week earlier, Transnafta cited the imminent reason that the contract between Transnafta and Belarus had expired. Belarus already owed Transnafta \$US16.7 million for gas deliveries in January (and another \$US26 million for February), but the Belarus government responded by severely criticising the Russian behaviour. Alexander Lukashenko even stated "now our relations with Russia will be poisoned by gas for a long time".<sup>777</sup> Miller,

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<sup>774</sup> RFE/RL (2004b), 'RFE/RL Newslines 18 February 2004', RFE/RL, Published: 18 February 2004, Last accessed: 21 June 2005, Internet: <http://www.rferl.org/newsline/2004/02/180204.asp>.

<sup>775</sup> Bruce *Friction or Fiction? The Gas Factor in Russian-Belarusian Relations*, p. 4.

<sup>776</sup> Maksymiuk, Jan (2004), 'Will Belarus Abandon "Agreements" with Russia over Gas Dispute?' RFE/RL, Published: 19 February 2004, Last accessed: 21 June 2005, Internet: <http://www.rferl.org/newsline/2004/02/190204.asp>.

<sup>777</sup> RFE/RL (2004c), 'RFE/RL Newslines 19 February 2004', RFE/RL, Published: 19 February 2004, Last accessed: 21 June 2005, Internet: <http://www.rferl.org/newsline/2004/02/190204.asp>.

the CEO of Gazprom, later admitted that the cut-off was approved of by the Russian government.<sup>778</sup>

Beyond the issues of payments, this can be perceived as a reminder to Belarus at a time when it faced few options. It could either bow to Russian demands or let go of Beltransgaz (which would be the last resort), or try to extend contracts with Itera or Transnafta (which had become increasingly difficult when Belarus had not paid for contracted deliveries). It could also siphon transit gas aimed at the European market.<sup>779</sup> Even after Belarus had signed a new contract and Gazprom resumed deliveries, Lukashenko took actions by unilaterally doubling Russian transit fees from \$US0.5 to 1.02/tcm (per 100 kilometres of route). He further stated:

*I think it's an act of terrorism at the highest level to take natural gas away from a country that is not totally foreign, from people half of whom have Russian blood in their veins, when it's minus 20 degrees outside.<sup>780</sup>*

A rapprochement came about in late 2005. Russia then refrained from raising the price on gas to 'market levels' in the same fashion as it did against Ukraine. Instead, Belarus was granted a price of \$US46.68/tcm. Possibly, this was carrot for Belarus to hand over Beltransgaz to Russia.<sup>781</sup>

The full-scale cut-off is of special importance as it was the first time (in 30 years) that Gazprom conducted a total cut-off against a key transit country,<sup>782</sup> (although more would come against Ukraine and Moldova in 2006). It can be seen as the crescendo of the ten-year quarrel between Russia and Belarus. It is also a precedent case for future negotiations. It is likely that this cut-off was sanctioned at the highest level in Russia. Whether a cut-off is total (100 per cent) or not is not only symbolical, but

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<sup>778</sup> Stern *The Future of Russian Gas and Gazprom*, p. 99.

<sup>779</sup> Maksymiuk 'Will Belarus Abandon "Agreements" with Russia over Gas Dispute?'

<sup>780</sup> RFE/RL (2004d), 'RFE/RL Newline 20 February 2004', RFE/RL, Published: 20 February 2004, Last accessed: 21 June 2005, Internet:  
<http://www.rferl.org/newline/2004/02/200204.asp>.

<sup>781</sup> Marples, David (2006), 'Energy Dilemma for Belarus', *Eurasia Daily Monitor*, Vol. 3, No. 25.

<sup>782</sup> Bruce *Friction or Fiction? The Gas Factor in Russian-Belarusian Relations*, p. 8.

it also has a practical dimension as it is technically difficult, time consuming and staff-intensive to conduct a full cut-off compared with a strong reduction (due to pipeline pressure problems). Presumably, this high threshold has had a preventive effect on previous occasions (also against other states), but apparently this occasion was so important that it was seen as worthwhile. A conclusion is that although Russia appears to be less inclined to cut energy supplies during Putin reign than during Yeltsin's, it has done so against Belarus and Ukraine quite recently, and with shoddily camouflaged market arguments.

### **Energy Relations with Moldova**

Moldova's energy relation with Russia is characterised by its 98 per cent energy dependence. Its energy infrastructure has been in appalling shape and the state is hugely indebted. In 2001, for example, Moldova owed over \$US861 million (of which \$US600 million only to Gazprom).<sup>783</sup> This is one of the main reasons for Russian companies being able to acquire assets in Moldova.

Gazprom's strategy has been to utilise its subsidiary Gazexport for market-based actions (i.e., not allowing the customer to buy gas without continuous payments), while Gazprom itself can use built-up debts to acquire new assets. Hence, Moldova realised in 1998 that its debts were so high that it would be impossible to pay off and it thus felt pressured to hand over (parts of) its gas supply system to Gazprom.<sup>784</sup> The situation improved for some time, but in mid-2003, Moldova's total debt again amounted to \$US 1.137 billion.<sup>785</sup>

Also in the case of Moldova, gas cut-offs and threats thereof have been common. In 1998, Gazprom threatened to cut off Moldova's gas supply

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<sup>783</sup> Lieven, Anatol and Wallander, Celeste (2001), 'Make Russia a Better Neighbour', *The New York Times*, Published: 14 March, Last accessed: 28 January 2004, Internet: <http://www.nytimes.com/2001/03/14/opinion/14LIEV.html>.

<sup>784</sup> Jamestown (1998b), 'Moldovan Government Caves in to Gazprom', *The Jamestown Foundation*, Published: 16 October 1998, Last accessed: 19 July 2005, Internet: [http://www.jamestown.org/publications\\_details.php?volume\\_id=21&issue\\_id=1402&article\\_id=14280](http://www.jamestown.org/publications_details.php?volume_id=21&issue_id=1402&article_id=14280).

<sup>785</sup> Infotag (2003), 'Moldova's Gas Debt Growing', *Moldova Azi*, Published: 23 May 2003, Last accessed: 19 July 2005, Internet: <http://www.azi.md/news?ID=24176>.

due to non-payments and a contractual dispute. As a response, Moldova threatened to cut the transit of gas to Bulgaria, Turkey and Greece. This would have resulted in economic losses for Russia, but the cut-off never occurred.<sup>786</sup> Russia (through Gazprom) has also taken over some of Moldova's energy generating systems. There are also links to the negotiations on the Russian troops in the breakaway region of Transnistria. Chişinău has none or limited control over the region and as Russia holds its hand over it, the problems related to it have proven to be fertile ground for the disputes between Russia and Moldova.<sup>787</sup> In the winter of 1999, also, Gazprom cut gas supply to Moldova claiming Moldova's rising debt as a reason.<sup>788</sup>

During the row with Ukraine in 2006, Russia also cut supply to Moldova, which affected Bulgaria, Greece and Turkey. Gazprom also doubled prices from \$USD80 to 160/tcm. Moldova asked for 30 per cent increase in two stages, but Gazprom refused.<sup>789</sup> President Voronin officially perceives Russian practice as a way to press Moldova on the issue of Transnistria.<sup>790</sup> The problems are still unsolved, and they will likely remain for some time.

### **Energy Relations with Georgia**

Georgia has small reserves of hydrocarbons, but its strategic leverage on the energy market is underpinned by its geopolitical location and importance as a transit country, for example for gas from Russia to Armenia and oil and gas from the Caspian basin to Western markets.<sup>791</sup>

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<sup>786</sup> Levyveld, Michael (1998), 'IMF Rescue Does Little for Gazprom's Suppliers', *RFE/RL (Reposed at Balkan Info)*, Published: 23 July 1998, Last accessed: 28 July 2005, Internet: <http://www.b-info.com/places/Bulgaria/news/98-07/jul23a.rfe>.

<sup>787</sup> Jamestown (1998a), 'Gazprom, Cutting Moldova Off, May Let Her Off the Hook', *The Jamestown Foundation*, Published: 16 November 1998, Last accessed: 19 July 2005, Internet: [http://www.jamestown.org/publications\\_details.php?volume\\_id=21&issue\\_id=1423&article\\_id=14496](http://www.jamestown.org/publications_details.php?volume_id=21&issue_id=1423&article_id=14496).

<sup>788</sup> Johansson, Andreas (2003), *Whither Moldova? Conflicts and Dangers in a Post-Soviet Republic*, Stockholm: The Swedish Defence Research Agency (FOI), FOI-R--0990--SE, p. 29.

<sup>789</sup> Socor 'Gazprom Halts Gas Supplies to Moldova'.

<sup>790</sup> Socor 'Ukrainian and Moldovan Presidents Close Ranks, Appeal to European Union on Gas Crisis'.

<sup>791</sup> For background on the regional issues, see IEA (2001), *Caspian Oil and Gas: The Supply Potential of Central Asia and Transcaucasia*, Paris: The International Energy Agency (IEA)/The Energy

Georgia, largely dependent on foreign energy suppliers, has had its gas cut off on several occasions during the 1990s. Some of the cut-offs have occurred on politically important occasions, according to former President Eduard Shevardnadze.<sup>792</sup> During the time of Shevardnadze, Georgia often accused Russia of these things, but Russia often did put pressure on Georgia and it appears that there was some ground in the Georgian accusations (even if a strong reason for Russia's actions was Georgia's debts).<sup>793</sup> Georgia's new president, Mikhail Saakashvili, also argues that Russia in the winter of 1999 for no given reason cut gas supplies. Only due to the US, Georgia managed to overcome the winter.<sup>794</sup>

In January of 2001, the Georgian-Russian relation was particularly strained and Russia attempted to halt Georgia's orientation away from Russia. Russia imposed a unilateral visa regime, cut gas supply and neglected agreements on military withdrawal. The reasons were that Georgia at the time implicitly supported Chechnyan guerrillas and was active in the anti-Russian GUUAM. In addition, it aspired to NATO membership and advocated the BTC pipeline that was undermining Russia's position concerning energy transport from the Caspian Sea.<sup>795</sup>

On numerous occasions during the 1990s and early 2000s, cut-offs coincided with special events, such as elections, bilateral negotiations or Russian bombardment of Georgian territory, occasionally under the

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Charter Secretariat, and Tsalik, Svetlana (2003), *Caspian Oil Windfalls: Who Will Benefit* (New York: Caspian Revenue Watch).

<sup>792</sup> Civil Georgia (2003b), 'Shevardnadze Calls for 'Revising the Contract' with the U.S. Energy Company', *Civil Georgia*, Published: 10 January 2003, Last accessed: 19 July 2005, Internet: <http://207.218.249.154/cgi-bin/eng/detail.pl?id=5034>.

<sup>793</sup> Civil Georgia (2003a), 'Iteera to Cut Gas Supply to Georgia Because of Debt', *Civil Georgia*, Published: 28 August 2003, Last accessed: 19 July 2005, Internet: <http://207.218.249.154/cgi-bin/eng/detail.pl?id=4833>.

<sup>794</sup> Saakashvili 'The Path to Energy Security'.

<sup>795</sup> Baran, Zeyno (2001), 'Georgia under Worst Pressure Since Independence', *The Center for Strategic and International Studies (CSIS)*, Published: 10 January 2001, Last accessed: 19 July 2005, Internet: [http://www.csis.org/ruseura/georgia/gaupdate\\_0101.htm](http://www.csis.org/ruseura/georgia/gaupdate_0101.htm).

pretext of non-payments.<sup>796</sup> Yet another example was on 16 August 2002, when Itera managed to obtain a controlling stake of Tbilgaz, the main distributor of gas in Georgia. Before cooperating with Itera, Georgia's debt was rather small, but in due time, it exceeded \$US32 million. Georgian experts claim that Itera intentionally let the debt rise in order to facilitate a take-over of the strategic distribution networks almost at no price. Georgia's State Minister, Akaki Zoidze, stated on TV that the agreement possibly avoided any destabilisation during the winter. Many experts noted in relation to this occasion that it coincided with particularly bad relations with Russia. At the time, Russia even bombed Georgian territory.<sup>797</sup>

In July 2003, the Russian Unified Energy System also managed to take over the lion's share of the electricity market when the American Energy System (AES) gave up its stake (in the company Telasi) after a few years of relentless struggle for profit.<sup>798</sup> During 2002 and 2003, there were also numerous cut-offs of electricity in Georgia. A majority of these were related to accidents, bad weather or lack of maintenance, but on several occasions, the reason was sabotage. Also the gas pipelines from Russia were targeted for sabotage on the Russian side of the border.<sup>799</sup> The Russian Duma often discusses topics related to Georgia and MPs make polemic statements against Georgia on the topic of energy. Similarly, Georgian officials, especially MPs, often disconcert strongly against Russia and a recurrent point is that there are political rationales behind these cut-offs. During these power cuts, no concrete allegations of Russian deliberate involvement were heard from Georgia, which shows that not even the most chauvinistic Georgian MPs blame everything on Russia.

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<sup>796</sup> Cornell, Svante, E. (2001), 'The Caucasus under Renewed Russian Pressure: Realities on the Ground and Geopolitical Imperatives', *Analysis of Current Events*, Vol. 13, No. 3, p. 10.

<sup>797</sup> Bakhtadze, Revaz (2002), 'Russian Energy Giant Takes Over Georgian Gas Distribution System', *Civil Georgia*, Published: 16 August 2002, Last accessed: 20 January 2004, Internet: <http://207.218.249.154/cgi-bin/eng/detail.pl?id=2490>. and Bakhtadze 'Russian Energy Giant Takes Over Georgian Gas Distribution System'.

<sup>798</sup> Gularidze, Tea (2003b), 'Russian Company Seals Controversial Takeover of Tbilisi Electricity Distribution', *Civil Georgia*, Published: 2 August 2003, Last accessed: 16 January 2004.

<sup>799</sup> Gularidze, Tea (2003a), 'Heartwarming Putin', *Civil Georgia*, Published: 24 January 2003, Last accessed: 19 January 2004, Internet: <http://207.218.249.154/cgi-bin/eng/detail.pl?id=3058>.

Itera continued to cut supplies to Georgia on a regular basis, for example on 3 March<sup>800</sup> and 29 August 2003.<sup>801</sup> At the time, the Georgian gas distributor Tbilgaz owed \$US26 million to Itera and \$US700,000 to Itera's subsidiary Sakgazi only for January 2003, and the arrears were due on 15 February.<sup>802</sup> Georgia's debts are a legitimate reason for halting energy exports and as indicated, Itera was after 2001 not a tool of Gazprom. However, in 2002, Georgia and Itera had closed an agreement stating that Georgia did not have to pay its debt for seven years and it is therefore rather peculiar that such claims were made.

In 2003 when former President Edward Shevardnadze initiated cooperation with Gazprom, he was fiercely criticised. The opposition warned that selling any infrastructure to Russia would jeopardise projects such as the BTE (Shah-Deniz) gas pipeline that was highly important to Georgia.<sup>803</sup> In January 2005, (now late) Prime Minister Zhurab Zhvania stated that Gazprom was not allowed to buy any strategic assets, such as the companies Telasi or Tbilgaz. The Chairwoman of Parliament, Nino Burjanadze, was also "categorically against selling of the gas pipeline system, especially to Russia."<sup>804</sup> If Georgia did, Gazprom would attain control over the power plants and distribution pipelines for Armenia.<sup>805</sup> This would indicate that Gazprom could cut some supply to Georgia without affecting the pro-Russian Armenia. This has been a type of safeguard against Russia using the energy weapon against Georgia.

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<sup>800</sup> Civil Georgia (2002), 'Gas Supply Ceased to Tbilisi', *Civil Georgia*, Published: 5 March 2002, Last accessed: 20 January 2004, Internet: <http://207.218.249.154/cgi-bin/eng/detail.pl?id=1449>.

<sup>801</sup> Civil Georgia 'Itera to Cut Gas Supply to Georgia Because of Debt'.

<sup>802</sup> Ibid.

<sup>803</sup> Sepashvili, Giorgi (2003), 'Georgia-Gazprom Deal Signed', *Civil Georgia*, Published: 25 July 2003, Last accessed: 23 February 2005, Internet: <http://www.civil.ge/eng/article.php?id=4642>.

<sup>804</sup> Civil Georgia (2005e), 'PM: Privatization of Gas Pipelines Currently Not on the Agenda', *Civil Georgia*, Published: 31 January 2005, Last accessed: 24 February 2005, Internet: <http://www.civil.ge/eng/article.php?id=8930>.

<sup>805</sup> Civil Georgia (2005a), 'Gazprom Eyes Georgian Pipelines', *Civil Georgia*, Published: 21 January 2005, Last accessed: 25 February 2005, Internet: <http://www.civil.ge/eng/article.php?id=8854>.

In November 2005, it was also announced that Gazprom was to raise gas prices for Georgia from 63 to \$US110. Georgia's Prime Minister Zhurab Nogaideli claimed that it was a "purely political decision", but that it would only marginally affect Georgia's economy. He also claimed that US\$63 was a market price for a country in the South Caucasus and that Russia raised prices more for Georgia than for other countries.<sup>806</sup> This was not entirely accurate, as Ukraine had to pay even more. President Saakashvili also claimed that the decision was politically grounded and Georgia's economy would be affected, even if Russia would not be able to "suppress [the] democratic mood".<sup>807</sup>

Parallel to the new demands by Gazprom, Russia indicated that it might cut gas supply altogether. The threat came just before the meeting of the CIS Energy Council in Tbilisi where Georgia subsequently and without any reservations accepted all of Russia's conditions for entering the CIS united energy market. By doing so, Russia guaranteed gas supplies to Georgia.<sup>808</sup>

It is somewhat ironic that after these guarantees, energy exports to Georgia came to a halt in January 2006 when the Kavkasioni electricity transmission lines and the pipelines transporting gas from Russia were destroyed in the Russian republic of North Ossetia. It was unclear who was behind the sabotage,<sup>809</sup> but president Saakashvili accused Russia of deliberately trying to blackmail Georgia to hand over its energy-related

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<sup>806</sup> Civil Georgia (2005b), 'Georgian PM: Increase of Gas Price Political Decision', *Civil Georgia*, Published: 25 November 2005, Last accessed: 28 November 2005, Internet: <http://www.civil.ge/eng/article.php?id=11216>.

<sup>807</sup> Civil Georgia (2005g), 'Saakashvili: Increase of Gas Price Will Hit Georgia's Economy', *Civil Georgia*, Published: 2 December 2005, Last accessed: 2 December 2005, Internet: <http://www.civil.ge/eng/article.php?id=11255>.

<sup>808</sup> Alkhazashvili, M. (2005), 'Georgia Still in Russian Energy Empire: Russia Angry with Georgia's Pro-Western Orientation, Threatens to Activate Energy Levers', *The Georgian Messenger*, Published: 31 October 2005, Last accessed: 31 October 2005, Internet: [http://www.messenger.com.ge/issues/0979\\_october\\_31\\_2005/economy\\_0979\\_1.htm](http://www.messenger.com.ge/issues/0979_october_31_2005/economy_0979_1.htm).

<sup>809</sup> Moscow News (2006a), 'Blasts Leave Georgia Without Russian Gas, Power Supplies, Sabotage Suspected', *Moscow News*, Published: 22 January 2006, Last accessed: 24 January 2006, Internet: <http://www.mosnews.com/news/2006/01/22/georgmore.shtml>.

infrastructure.<sup>810</sup> Even the usually balanced speaker of parliament, Nino Burjanadze on Russian radio (Ekho Moskvu) on 23 January that the attacks were “deliberate action against Georgia,” and “I am more than sure that major Russian forces, including special services, are unfortunately interested in destabilizing the situation.”<sup>811</sup>

Despite the outspoken risks, there is not a consensus among Georgia's prominent politicians. President Saakashvili stated in February 2005 that talks on selling strategic infrastructure were underway, and that nothing was ruled out. Economy Minister Kakha Bendukidze, who is a keen spokesperson for privatisation, has stated that there is no security problem in selling to Russia.<sup>812</sup>

Also the new Prime Minister Zhurab Nogaideli has at times stated that he sees no problem in selling strategic assets.<sup>813</sup> He later changed his mind and stated that there will not be any privatisation of the most important trunk pipelines. He has also tried to convince Russia that Georgia will not cause any problems for Russia's gas deliveries to Armenia. However, Georgia cannot guarantee that it will buy gas from Russia if gas via the BTE is cheaper.<sup>814</sup> The MP Davit Gamkrelidze, who chairs the New Rights-Industrialists parliamentary faction, has called on the authorities to refrain from selling the pipelines and stated

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<sup>810</sup> Moscow News (2006e), 'Georgia's President Accuses Russia of Blackmail Following Gas Supply Cut', *Moscow News*, Published: 22 January 2006, Last accessed: 24 January 2006, Internet: <http://www.mosnews.com/news/2006/01/22/saakblames.shtml>.

<sup>811</sup> Yasmann, Victor J. (2006), 'Georgian Gas Crisis May Hint at Moscow's New Energy Strategy', *Moscow News*, Published: 23 January 2006, Internet: <http://www.mosnews.com/commentary/2006/01/23/georgia.shtml>.

<sup>812</sup> Civil Georgia (2005h), 'State Minister: No Threat in Privatizing Gas Pipelines', *Civil Georgia*, Published: 22 February 2005, Last accessed: 24 February 2005, Internet: <http://www.civil.ge/eng/article.php?id=9147>.

<sup>813</sup> Civil Georgia (2005d), 'PM Comments on Privatization of Gas Pipeline', *Civil Georgia*, Published: 23 February 2005, Last accessed: 24 February 2005, Internet: <http://www.civil.ge/eng/article.php?id=9165>.

<sup>814</sup> Civil Georgia (2005f), 'PM: Privatization of Trunk Gas Pipeline Ruled Out', *Civil Georgia*, Published: 26 April 2005, Last accessed: 27 April 2007, Internet: <http://www.civil.ge/eng/article.php?id=9714>.

“transferring this facility to Russia will finally destroy Georgia’s energy independence.”<sup>815</sup>

It appears as if Georgia is willing to privatise most energy-related infrastructure, possibly except trunk pipelines, high power transmission lines and the Enguri Hydro Power Plant. Some estimates suggest that it would bring about \$US108.6 million to the state.<sup>816</sup> No matter the case, Russia has gained substantial influence over Georgia by acquiring important energy infrastructure and corporate power during the last couple of years. Gazprom has, among other things, already taken control over much of the gas sector.

The American Energy System (AES), which partly owned the Georgian energy company Telasi, has withdrawn from Georgia. The Russian UES replaced it and thus became a monopolist in the electricity sector.<sup>817</sup> Numerous Russian take-overs, such as in Georgia, have been accepted by the state in question, in this case Georgia. One reason is that Russian companies have been much more efficient than their Western competitors in the CIS markets. In fact, Russia is aiming to create a new united market within the CIS that has a common budget and network and is controlled from and by Moscow.<sup>818</sup>

In recent years, the strategically most important pipeline in the former Soviet territory has been the Baku-Tbilisi-Ceyhan (BTC) oil pipeline, inaugurated on 25 May 2005. Its purpose is to bring Caspian oil from Azerbaijan via Georgia to Turkey bypassing Russia. It is of utmost importance for Georgia, but also for Turkey and Azerbaijan. It has been debated whether it is economically sensible with a this pipeline, but its

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<sup>815</sup> Sepashvili, Giorgi and Gularidze, Tea (2005), 'Of Pipes and Men', *Civil Georgia*, Published: 24 February 2005, Last accessed: 25 February 2005, Internet: <http://www.civil.ge/eng/article.php?id=9168>.

<sup>816</sup> Civil Georgia (2005c), 'Government Unveils Plan over Privatization of Energy Facilities', *Civil Georgia*, Published: 2 March 2005, Last accessed: 3 March 2005, Internet: <http://www.civil.ge/eng/article.php?id=9237>.

<sup>817</sup> Leijonhielm and Larsson *Russia's Strategic Commodities: Energy and Metals as Security Levers*, pp. 117-121.

<sup>818</sup> Alkhazashvili 'Georgia Still in Russian Energy Empire: Russia Angry with Georgia's Pro-Western Orientation, Threatens to Activate Energy Levers'.

rationale has foremost been political. It is perceived as a great achievement, especially in Washington whose role has been a driving force.

The oil for BTC is expected to come from, for example, the Azeri-Chirag-Guneshli (ACG) field near Baku<sup>819</sup> and the geological and economic constraints appear to go hand-in-hand for BTC. In short, the difficulty is that the pipeline has an annual capacity of 50 million tons and an expected service life of 40 years. Hence, two billion tons of crude oil is required. When the contract was signed some ten years ago, this did not appear to be a problem. However, by 2005, nine contracts had become void due to lack of crude in contracted areas (and another two have been frozen by Iran who has a 20 per cent claim on the Caspian continental shelf).

ACG has only approximately 890 million tons of oil and the field will therefore be depleted already by 2025. In addition, some of this oil is counted on for filling the existing Baku-Supsa pipeline. Several of the participants in the BTC-projects have also, for economic reasons, chosen to use the shipping port of Batumi (on the Georgian Black Sea coast) instead of using the BTC. In sum, only 75 per cent of the BTC's capacity will be covered.<sup>820</sup> The fact that the West has driven the BTC project while overlooking important economic and geological implications further add fuel to the Russian argument that the BTC is a vehicle of the Western engagement.

Nonetheless, some argue that even if the BTC is meant to bypass Russia, it can actually be beneficial as Russia can use its own pipelines to transport its own oil and use the BTC for Caspian oil, if it wishes.<sup>821</sup> This idea is supported by TNK-BP, which even wants Russia to reverse its

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<sup>819</sup> For a comprehensive and up-to date review of the BTC, see: Starr, Frederick S. and Cornell, Svante E. (Eds.) (2005), *The Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West* (Uppsala, Central Asia-Caucasus Institute/Silk Road Studies Program).

<sup>820</sup> Vladimirov, Mikhail and Zaslavsky, Ilya (2005), 'The Baku-Ceyhan Oil Pipeline: Political Considerations Hold', *The Moscow News*, Published: 30 May 2005, Last accessed: 30 May 2005, Internet: <http://english.mn.ru/english/issue.php?2005-19-2>.

<sup>821</sup> Milov 'Problemi energeticheskoi politiki Rossii [Problems of Russia's Energy Policy]'

Baku-Novorossiisk pipeline for sending its own oil via BTC.<sup>822</sup> It is however highly unlikely that Moscow would be supportive of this idea, given its stand on BTC. At one time even Lukoil embraced the idea of using the BTC, but that idea quickly died.<sup>823</sup> Today, most of the stakeholders are Western, but China's National Offshore Oil Corporation (CNOOC) has its single largest asset in ACG fields and has expressed an interest in joining BTC.<sup>824</sup>

Despite the problem of the superfluous capacity of the BTC, there are numerous suggestions on how to bring out Caspian energy carriers to the world market. The mentioned BTE gas pipeline is similar to the BTC in its aim to bring gas from Azerbaijan via Georgia to Turkey. This was also initiated by the US and is highly politicised. When Georgia decided to increase its cooperation with Gazprom, the US argued against it. The arguments included that Gazprom's gas is expensive and that the BTE can provide enough gas with a capacity of 15-20 bcm/year.<sup>825</sup>

### **Energy Relations with in the Wider Caspian Region**

Armenia, which does not have any oil and gas, has had to rely on imports. For long, Russia and Armenia were close allies and it is the only place in the South Caucasus where its military presence is welcomed. Armenia's energy debts have however resulted in Russia managing to swap the \$US150 million debt in exchange for the largest thermal plant and the Metsamor nuclear power plant. Gazprom presently holds 45 per cent of the local gas distributor and together with the UES controls 80 per cent of Armenia's energy resources. The deal when the UES took over Armenia's power grid was seen as especially murky by observers.<sup>826</sup> When relations deteriorated with Russia and Armenia started to cooperate with Iran. Iran was permitted take over parts of Hrazdan and a new gas pipeline will be constructed to Armenia. Russia is especially

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<sup>822</sup> Vladimirov and Zaslavsky 'The Baku-Ceyhan Oil Pipeline: Political Considerations Hold'.

<sup>823</sup> Morse and Richard 'The Battle for Energy Dominance', p. 27.

<sup>824</sup> Morrison, Kevin (2005), 'China and India Raise the Stakes', *The Financial Times*, 12 January 2005, p. 8.

<sup>825</sup> Sepashvili 'Georgia-Gazprom Deal Signed'.

<sup>826</sup> Danielyan, Emil (2005), 'Surge in Russian Gas Prices Raises Eyebrows in Armenia', *Eurasia Daily Monitor*, Vol. 2, No. 227.

upset by Armenian moves to interact with Iran.<sup>827</sup> In particular, Russia dislikes the idea that the gas pipeline would be of such dimension that it would be able to bring Iranian gas to Georgia.<sup>828</sup> This can be perceived as one reason behind the raise in price that Armenia faced at the same time as Ukraine in the winter of 2005.

In fact, Russia pushed for increased prices also in Azerbaijan in 2005 (which in 2000 started to buy gas from Russia). The price that Gazprom asked from Azerbaijan meant a rise in price from 60 to US\$100/tcm. Baku quickly agreed to Russia's demands as it did not want to upset Russia at a time when progress on, for example, Nagorno-Karabakh was being made. The Azeri government also decided not to make a diplomatic scandal and started to subsidise its citizens that subsequently did not have to bear the burden of the price rise. However, Fariz Ismailzade is right in his conclusion that it would be difficult for Russia to further pressure Azerbaijan by the energy levers.<sup>829</sup>

Other infrastructure projects include the US-proposed Trans-Caspian oil and gas pipeline, but most analysts have concluded that it is undesirable, primarily for environmental reasons.<sup>830</sup> The Caspian-south Iranian coast suggestion, which possibly could include an energy swap aspect,<sup>831</sup> is economically best, but the US will not support anything that adds power to Iran. Linking Turkmenistan, via Pakistan to Afghanistan is another suggestion (sometimes referred to as the Central Asian Oil Pipeline) and a memorandum of understanding has been signed, but progress has not been made.<sup>832</sup>

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<sup>827</sup> Socor 'Gazprom Halts Gas Supplies to Moldova'.

<sup>828</sup> Danielyan 'Surge in Russian Gas Prices Raises Eyebrows in Armenia'.

<sup>829</sup> Ismailzade, Fariz (2006), 'Russia's Energy Gambit: It Won't Work in Azerbaijan', *Central Asia-Caucasus Analyst*, Vol. 7, No. 2, p. 7.

<sup>830</sup> Chuftrin 'Russia's Caspian Energy Policy and its Impact on the U.S.-Russian Relationship', p. 14.

<sup>831</sup> This would mean that Iran exports own energy from the southern parts of the country while consuming imported energy from the northern parts.

<sup>832</sup> Bahgat, Gawdat (2004), 'The Caspian Sea: Potentials and Prospects', *Governance: An International Journal of Policy, Administration and Institutions*, Vol. 17, No. 1, p. 120.

The debate on the legal status of the Caspian Sea is related to whether it is seen as a lake or a sea (and if it therefore should be covered by the UN Convention on the Laws of the Sea (UNCLOS) dating from 1982).<sup>833</sup> However, this has partially proven to be a misconception. Even if this question were settled, the problems of demarcation and ownership of hydrocarbon resources would remain.<sup>834</sup> The turns have shifted many times and the political and diplomatic game has been taken to the highest levels. Russia initially advocated a condominium principle “under which a 45-nautical mile coastal zone would fall under the jurisdiction of the respective littoral states and the rest of the Caspian Sea would be shared jointly”.<sup>835</sup> However, it later changed its mind and opted for a “position in favour of demarcation of Caspian seabed resources between the littoral countries by a median line.”<sup>836</sup>

After some serious setbacks for Russian diplomacy,<sup>837</sup> Russia's proposal was supported by Kazakhstan and Azerbaijan. Iran and Turkmenistan on the other hand now resolute with the condominium approach and claim that agreements between the three northern states are illegal.<sup>838</sup>

The prospects for solving the problems are bleak. Most involved actors downplay the risk of conflict, but it must be remembered that the conflicts are not primarily about territory, but about deposits. Military strength cannot guarantee security, and even small conflicts may scare off investors.<sup>839</sup> Thus far, the risk has not provided a great deal of protection against increasing tension and military build-up. Disputed fields are since a couple of years back patrolled by navy vessels and the Russian Caspian Sea Flotilla conducts numerous exercises in the region,

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<sup>833</sup> Haghayeghi, Mehrdad (2003), 'The Coming of Conflict to the Caspian Sea', *Problems of Post-Communism*, Vol. 50, No. 3, p. 33.

<sup>834</sup> Lee, Yusin (2005), 'Toward a New International Regime for the Caspian Sea', *Problems of Post-Communism*, Vol. 52, No. 3, p. 38f.

<sup>835</sup> Chufrin 'Russia's Caspian Energy Policy and its Impact on the U.S.-Russian Relationship', p. 9.

<sup>836</sup> *Ibid.*, p. 9.

<sup>837</sup> Lee 'Toward a New International Regime for the Caspian Sea', p. 41f.

<sup>838</sup> Chufrin 'Russia's Caspian Energy Policy and its Impact on the U.S.-Russian Relationship', p. 9.

<sup>839</sup> Haghayeghi 'The Coming of Conflict to the Caspian Sea', p. 40.

usually under the pretext of counter-terrorism.<sup>840</sup> Even if the threat from nearby Chechnya and Dagestan is genuine, there is reason to assume that several of the large-scale military exercises are not purely aimed at handling issues of terrorism. It is simultaneously a show of force and fits into the general exercise pattern of Russia.

Some of the disputed fields are between Turkmenistan and Azerbaijan over the Hazar (Azeri), Osman (Chirag), Altyn Asyr (Sharg) and Serdar (Kyapaz) fields that are on the median line. Azerbaijan has been accused by Turkmenistan of exploiting them (since Turkmenistan has not accepted certain adjustments for the Apsheron Peninsula in concluded agreements). Iran and Azerbaijan have fought over the Araz-Sharq field, while Russia and Kazakhstan has been quarrelling over the Kurmangazy field.<sup>841</sup> Naturally, cooperation exists, for example concerning the Kazakh-Russian joint development over Khvalynskoe and Tsentralnoe.<sup>842</sup>

Essentially, Russia's Caspian policy has been characterised by a relatively constructive relationship with outside powers in the region. At the same time, Russia tries to prevent them from establishing any type of economic, military and political control.<sup>843</sup> Relations change over time, but it is clear that also in Central Asia, Russia's policy has become more active after 2003. A number of agreements on prices, sales volumes and terms of Russian assistance, exploration, production and modernisation have been made.<sup>844</sup> On the whole, Russia's foreign policy has become much more assertive and self-assured than before and economic strengths have facilitated a stronger regional position. Today, Russia does not have to resort to military pressure as it has something to

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<sup>840</sup> Leijonhielm, *et al.* *Ryske militär förmåga i ett tioårsperspektiv - problem och trender 2005* [*Russian Military Capability in a Ten-Year Perspective - Problems and Trends 2005*], p. 152ff.

<sup>841</sup> Haghayeghi 'The Coming of Conflict to the Caspian Sea', p. 35.

<sup>842</sup> *Ibid.*, p. 36.

<sup>843</sup> Chufrin 'Russia's Caspian Energy Policy and its Impact on the U.S.-Russian Relationship', p. 2f. and Allison 'Strategic Reassertion in Russia's Central Asia Policy', p. 277.

<sup>844</sup> Chufrin 'Russia's Caspian Energy Policy and its Impact on the U.S.-Russian Relationship', p. 18.

offer.<sup>845</sup> By this new approach, Russia is able to improve its geopolitical situation with the help of energy corporations seeking to diversify its business risk and exploit the advantages of transport systems through Russia.<sup>846</sup>

Many of the regional relations are affected by the Chinese engagement in Central Asia, for example by the construction of a pipeline from Kazakhstan. Construction of the 2,350 km has already started and the first 450km between Atyrau and Kenkiyak became operational in the spring of 2004. An agreement was also reached on 17 May 2004 concerning the second section from Atasu to the borders of Xinjiang (1240km).<sup>847</sup>

Suggestions of an 11,000km pipeline from Central Asia to China's East Coast were not seen as economically feasible by analysts at the time,<sup>848</sup> but presently appears to materialise as the Kazakh leg of the pipeline has been inaugurated and the Chinese leg is under construction. China has also bought a 33 per cent stake of PetroKazakhstan, but needs some Russian oil if it wants to bring oil to Western China at full capacity.<sup>849</sup> The 1000km leg between Atasu in central Kazakhstan to Alashenku at the Chinese border is the first oil pipeline from Central Asia that does not cross Russian territory. The politics surrounding the pipeline is evidence of China's active and comprehensive policy in Central Asia

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<sup>845</sup>Sandström, Emma (2003), *Afghanistan and Central Asia after September 11: The Security-Political Development*, Stockholm: The Swedish Defence Research Agency (FOI), FOI-R--0821-SE and Sandström, Emma (Forthcoming 2006), *Afghanistan and Central Asia: A Security Up-date 2005*, Stockholm: Swedish Defence Research Agency (FOI).

<sup>846</sup> Guseynov, Rauf (2004), 'Russian Energy Companies in Central Asia', *Central Asia and the Caucasus: Journal of Political and Social Studies*, Vol. 29, No. 1, p. 69.

<sup>847</sup> Hill, John (2004), 'China Struggles to fulfil Spiralling Energy Demands', *Jane's Intelligence Review*, No. N/A, 1 July.

<sup>848</sup> Umbach, Frank (2004b), 'Future Impacts of Chinese and Asian Dependency on Energy Imports from the Middle East and Central Asia', in: Reiter and Hazdra (Eds.), *The Impact of Asian Powers on Global Developments* (New York: Heidelberg), p. 161.

<sup>849</sup> Yermukanov, Marat (2005), 'Chinese Need Russian Oil to Fill Pipeline from Kazakhstan', *Eurasia Daily Monitor*, Vol. 2, No. 216.

where it has created whole enclaves of Chinese operations within the energy field.<sup>850</sup>

Another failed project has been the Central Asia Gas Pipeline that became the object of a memorandum of understanding in 1997 between Turkmenistan, Afghanistan, Pakistan and Uzbekistan but concluded when Gazprom withdrew.<sup>851</sup> In November 2005, Russia made a contract with Kazakhstan making Russia the sole transporter of gas from Central Asia to Europe. Assumably, this will thwart Ukraine's ambitions to take control over parts of this transport and become less dependent on Gazprom for transport.<sup>852</sup>

Other issues of concern are the US military presence and China's and India's growing interest in Caspian oil and gas. This competition for Caspian energy has resulted in Central Asian states being able to exploit the rivalry between Russia and the US for their own benefit.<sup>853</sup> However, despite the fact that Russia's activities in Central Asia are more energetic than in the 1990s or even before 2003, several initiatives have stranded. One of these was the initiative that Putin took by launching an idea of creating a 'gas-OPEC' consisting of Kazakhstan, Turkmenistan, Uzbekistan and Russia, that nothing appears to come out of.<sup>854</sup> Gas exports from Iran or Central Asia via Pakistan to India are also unlikely, as India does not want to be dependent on Pakistan for energy transit.<sup>855</sup> India is about to change its position concerning Iran. Neither has the energy dimension of the Shanghai Cooperation Organisation (SCO) materialised even if the organisation as such is thriving.

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<sup>850</sup> Barbasov, Muhamedjan (2004), 'An Oil Pipeline to China: An Element of Struggle for Caspian Resources', *Central Asia and the Caucasus: Journal of Political and Social Studies*, Vol. 28, No. 2, p. 109f.

<sup>851</sup> Bahgat 'The Caspian Sea: Potentials and Prospects', p. 12.

<sup>852</sup> Grib, Nataliya and Gavrish, Oleg (2005), 'Russia to Control the Flows of Central Asian Gas to Europe', *Kommersant*, Published: 14 November 2005, Last accessed: 18 November 2005, Internet: <http://www.kommersant.com/page.asp?id=626007>.

<sup>853</sup> Bohr, Annette (2004), 'Regionalism in Central Asia: New Geopolitics, Old Regional Order', *International Affairs*, Vol. 80, No. 3, p. 501f.

<sup>854</sup> Gorst, Isabel (2005), 'Gazprom Launches Emergency Talks with Turkmenistan in Bid to End Gas Embargo', *The Financial Times*, 14 April 2005, p. 1.

<sup>855</sup> Pandian, S. (2005), 'The Political Economy of Trans-Pakistan Gas Pipeline Project: Assessing the Political and Economic Risks for India', *Energy Policy*, No. 33, p. 659.

Turkmenistan is probably the country that has caused the most difficulty for Russia's energy policy during the last couple of years. Turkmenistan is strong in natural gas and exports much of it to Russia and Ukraine (delivered via Russia by Gazprom and Itera). In 2003, Russia concluded its now famous contract that granted it the right to buy all Turkmen gas out of existing contracts for 25 years, at the price of \$US44/tcm (half of which was to be paid in commodities until 2006). The terms after 2007 were not agreed upon. The amount would possibly reach a level of 80 mcm/year and Russia's plan has been to re-export the gas to Europe at approximately \$US120-130/tcm.<sup>856</sup> However, at the beginning of 2005, Turkmenistan and its rather eccentric dictator, President Saparmurad Niyazov, wanted a 30 per cent price increase (\$US58/tcm), which Russia refused to pay. Turkmenistan as a consequence imposed an embargo.

The deputy head of Gazprom, Alexander Medvedev, was swift to announce that the contract terms will not be revised, but Miller soon flew to speak to Niyazov.<sup>857</sup> The outcome of the meeting appears to have been that the barter agreement will be replaced by a cash agreement, while the price will be kept at the contractual level.<sup>858</sup>

As indicated, also Ukraine has had major problems with Turkmenistan. The problem for Ukraine is that even if it got 30-40 bcm under its old contract,<sup>859</sup> Itera, its main supplier was expelled from Ukraine in 2001,<sup>860</sup> and its contract expired in 2004, but a new contract was soon negotiated. The contracts with Russia and Ukraine will nonetheless make it difficult for Turkmenistan to send any gas to Pakistan or India via Afghanistan and it is unlikely that it will come about.<sup>861</sup>

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<sup>856</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 17f.

<sup>857</sup> Gorst 'Gazprom Launches Emergency Talks with Turkmenistan in Bid to End Gas Embargo', p. 1.

<sup>858</sup> RosBusinessConsulting (2005h), 'Gazprom Changes Barter Procedures', Published: 15 April 2005, Last accessed: 18 April 2005, Internet: <http://www.rbcnews.com/free/20050415182124.shtml>.

<sup>859</sup> Balmaceda 'Ukraine's Persistent Energy Crisis', p. 41.

<sup>860</sup> Ibid., p. 42.

<sup>861</sup> Gartung, German (2005), 'Ashkhabad Intends to Export Gas to Pakistan and India via Afghanistan', *Rossiiskie Vesti (Reposted at Ferghana Information Agency)*, Published: 11 February 2005, Last accessed: 18 February 2005, Internet: <http://enews.ferghana.ru/detail.php?id=86543210976.591,1585,7424885>.

From Russia's point of view, the great importance of Central Asia and the Caspian region is first and foremost not due to the actual reserves of hydrocarbons. The vital point is the strategic presence. The region is seen as Russia's backyard and sphere of influence. From the US point of view, the region is also of strategic importance but according to some, it relates to a wish of managing world politics.<sup>862</sup> Western companies are neither impressed by the actual reserves that by world standards are rather modest.<sup>863</sup> What matters is that in the Caspian region, western firms are able to operate. The implications are large, but at least it is possible, which it hardly is in the Middle East. This factor has allegedly been seen as so important in the Middle East that Saudi Arabia and Kuwait actually have been speaking about opening up for foreign investors.<sup>864</sup>

### **Energy Relations with China and Japan**

The Chinese-Russian relation takes a central role in the Eurasian energy game and can hardly be assessed without taking the wider picture into consideration.<sup>865</sup> The relations are characterised by China's augmenting thirst for energy and Russia's possession of hydrocarbons in combination with a distrust of China. The relation consists of a fundamental aversion, scepticism and non-affiliation according to Alexander Lukin, who also explains that it is based on geopolitical threats of two kinds. First, China may grow strong and pose a threat to Russia and, secondly, China might implode and create chaos that might spill over to Russia.<sup>866</sup> These issues may not be visible in all aspects of the relation, but underpins the view held by Russia.<sup>867</sup> Pragmatism and a rapprochement during 2005 have paved the way for deepened cooperation.

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<sup>862</sup> Brzezinski, Zbigniew K. (1997), *The Grand Chessboard: American Primacy and its Geostrategic Imperatives* (New York: Basic Books).

<sup>863</sup> IEA *Caspian Oil and Gas: The Supply Potential of Central Asia and Transcaucasia*, .

<sup>864</sup> Morse and Richard 'The Battle for Energy Dominance', p. 23.

<sup>865</sup> This is done in a series of reports by FOI. See Kiesow *Energy in Asia: an Outline of Some Strategic Energy Issues in Asia*, , Kiesow *China's Quest for Energy: Impact upon Foreign and Security Policy*, , and Sandklef *Energy in China: Coping with Increased Demand*.

<sup>866</sup> Lukin, Alexander (2003), *The Bear Watches the Dragon: Russia's Perception of China and the Evolution of Russian-Chinese Relations Since the Eighteenth Century* (New York: M.E. Sharpe), p. 246f.

<sup>867</sup> For an assessment of the contemporary problems from the Japanese horizon, see Iwashita, Akihiro (2005), *Siberia and the Russian Far East in the 21st Century: Partners in the "Community of Asia"*, Sapporo: Slavic Research Center, Hokkaido University, Slavic Eurasian Studies 6-1.

More specifically, from China's point of view,<sup>868</sup> it feels that it cannot rely on Russia due to their 'special relationship', This refers to the long-lasting and underlying competition dating from the Cold War when the Soviet Union wanted to be the sole leader of the international communist community.<sup>869</sup> Also China had this ambition. Today, analysts often speak about the strategic partnership between Russia and China. But it must be remembered that this partnership basically is based on a common aversion towards the US, not on common values. It is further worth noting that even if China is growing strong, it is weak and vulnerable when it comes to energy imports, which it sees as highly worrisome.<sup>870</sup>

Concerning energy deliveries, Russia has doubled its electricity deliveries to China in the last couple of years. In 2005, Russia would for example deliver 500 mm kWt/hrs of electric energy to China, according to the Deputy Chairman of the Unified Energy System, Leonid Drachevsky. Oil exports by rail from Russia have strongly increased and Russia is now the world's second largest oil exporter to China (who in turn is the world's second largest oil consumer). Most of the oil is supplied by Rosneft (that in 2005 supplied approximately 4 million tons and is scheduled to supply 8.9 million metric tons through the next five years). Lukoil will also supply approximately 4 million tons. In all, the Russian-Chinese trade is worth \$US 20 billion, but is according to China expected to grow to \$US60-80 billion in the near future.<sup>871</sup>

Lukoil has still confronted China on a few occasions. One was when the China National Petroleum Corporation (CNPC) targeted the Canadian-owned PetroKazakhstan and Lukoil opposed the deal and tried to hinder

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<sup>868</sup> For a deeper analysis, see: Constantin, Christian (2005), *China's Conception of Energy Security: Sources and International Impact*, Institute of Strategic Studies/Tsinghua University, March 2005, Working Paper 43.

<sup>869</sup> Lei, Wu (2004), 'China's Oil Security Challenges and its Countermeasures', *Geopolitics of Energy*, Vol. 11, No. 26, pp. 2-4.

<sup>870</sup> Giragosian, Richard (2005), 'Competition between China and Japan for Russia's Far Eastern Oil Pipeline Project', *Natural Resources and Contemporary Conflicts*, Université du Québec à Montréal, Montreal, 29-30 September 2005, p 4f.

<sup>871</sup> Moscow News (2005c), 'Russia Looks to China for Partnership', *Moscow News (Reposted at Alexander's Gas and Oil Connections)*, Published: 6 April 2005, Last accessed: 13 April 2005, Internet: <http://www.gasandoil.com/goc/news/ntr51419.htm>.

it.<sup>872</sup> China's offensive for new assets has also encompassed an interest by the China National Offshore Corporation (CNOOC) to buy some of the minor assets of Yukos. The interests are not primarily financial and therefore analysts perceive it as less likely that Yukos' foreign assets would be of any interest to China. Instead, it is exploitable resources to be shipped to China that is the main target. Analysts also find it more likely that Gazprom would be able to acquire these stakes from Yukos instead of letting China lay hands on them.<sup>873</sup> This can be seen in light of the US not permitting China to acquire American energy companies.

The disputed islands Senkaku (Daioyu) and Nansha (Spratly) have also been troublesome, as has the lack of a peace treaty after the Second World War and the growing number of Chinese settlers in East Siberia.<sup>874</sup> Since 2003, some progress has been made, especially in the economic area and the border problems are stated to be solved. China and Russia have received support from each other vis-à-vis Chechnya and Taiwan. Both states share concerns over the increasing power of the US.<sup>875</sup> A parallel problem for Russia is that it is hard to advance relations with Japan and China (and Korea) concurrently.<sup>876</sup> This does not freeze relations, and Japan and South Korea have made a deal on sending LNG from Russia to a value of approximately \$US 20 billion.<sup>877</sup>

In 2001, Russia concluded a contract with China to supply 20 million tons/year of crude oil between 2005 and 2010 and another 30 million tons/year in 2010-2030. Indications suggest that there is not enough oil for such a deal and what is curious is that it is only the Russian state and Transneft that have taken care of the deal. Producers have not been

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<sup>872</sup> Kommersant (2005a), 'Lukoil Willing to Substitute for CNPC', *Kommersant*, Published: 26 October 2005, Last accessed: 27 October 2005, Internet: <http://www.kommersant.com/doc.asp?id=620983..>

<sup>873</sup> RosBusinessConsulting (2005b), 'China Eyeing Russia's State Oil Assets', *RosBusinessConsulting*, Published: 12 December 2005, Last accessed: 12 December 2005, Internet: <http://www.rbcnews.com/komment/komment.shtml>.

<sup>874</sup> Kiesow *China's Quest for Energy: Impact upon Foreign and Security Policy*, pp. 33-38.

<sup>875</sup> Sugino, Ayako (2004), 'Russia's Energy Policies for Asia', *The Energy Dimension in Russian Global Strategy* (Houston: The James A. Baker III Institute for Public Policy of Rice University), p. 8f

<sup>876</sup> *Ibid.*, p. 14.

<sup>877</sup> Mallet, Victor (2005), 'Fuel for Rivalry: Asia's Thirst for Energy Brings Fresh Alliances but also Tensions', *The Financial Times*, 25 February 2005, p. 11.

involved, which from China's point of view has resulted in extreme uncertainty.<sup>878</sup> China has, partly due to this, been turning to other producers and has even given \$US6 billion to Rosneft as prepayment of oil.<sup>879</sup> Chinese efforts to bring oil and gas from Central Asia have resulted in an approach that runs adjacent to Russia's liking (at the same time, it must include Russia to realise the full potential of conducted projects). China cannot afford to upset Russia, as it wants to keep positive relations in the competitions with Japan for oil in Siberia and the Far East.

On the topic of competition between China and Japan for Russian energy, a strong Chinese lobby campaign against Russia has been going on and as late as in June 2005, China's president Hu Jintao was in Moscow expressing an interest in an oil pipeline and the Kovytko gas field.<sup>880</sup> TNK-BP is one of the actors intending to export from the Kovytko field (a so-called supergiant field near Irkutsk) to China and Korea. This is a gigantic, \$US18 billion, project that Gazprom has tried to interfere with since it wants to be the operator.<sup>881</sup>

The most important issue during 2005 was the Eastern Siberia Oil Pipeline. For years, Russia wished to build a new oil pipeline eastwards from the Angarsk field in Siberia. Several destinations were proposed and numerous stretches were discussed. The question has been whether it should take the long and expensive northern route to the Russian Pacific Coast (for example to Nakhodka or Perevoznaya Bay) for further transport to Japan (or elsewhere) or if it was to take the shorter southern route to Daqing in northern China. Given China's and Japan's urge for oil, it became an issue of pivotal importance for all three states. The question thus arose if Russia would be willing to support the Japanese or the Chinese option.

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<sup>878</sup> Milov *Russian Energy Sector and its International Implication*, p. 15.

<sup>879</sup> Mallet 'Fuel for Rivalry: Asia's Thirst for Energy Brings Fresh Alliances but also Tensions', p. 11.

<sup>880</sup> Korchagina, Valeria and Pronina, Lyuba (2005), 'Chinese President to Talk Energy', *The Moscow Times*, Published: 30 June 2005, Last accessed: 30 June 2005, Internet: <http://www.moscowtimes.ru/stories/2005/06/30/001-print.html>.

<sup>881</sup> Stratfor 'Special Report, Part 2: The Rise of Gazprom Inc.'.

The northern route would allow Russia to export 80 million tons a year of crude to whomever it likes,<sup>882</sup> while the route to Daqing is cheaper and has a guaranteed market in China (at least according to China).<sup>883</sup> As indicated, Russia does not intend to become dependent on China as an importer and when it was decided, it was not a surprise that it was the northern route that won the battle. The exact stretch is still a topic of discussion, but the tentative route appears to be from Taishet to Nakhodka. However, Perevoznaya Bay, near Vladivostok, appears like a better option as it has the capacity for accepting large tankers (unlike Nakhodka).<sup>884</sup> It was believed that this put an end to the main question of Japan or China, but the problems were far from solved.

In the fall of 2005, Putin announced that Russia would be willing to build a leg also to China. It did not take long before Russia also declared that the Chinese leg would be built first. When Putin declared this, he also stressed that the border problems with China had been solved, but not those with Japan. As Russia wants to “sell [oil] to the whole of Asia”, as he put it, two thirds will initially be sent to China, and the remaining oil will go to Nakhodka.<sup>885</sup> The geostrategic situation thus appeared to change in only a few weeks time, but this was most likely a tactical manoeuvre from Putin in order to squeeze Japan to pay a greater interest in financing the pipeline.

Financing is not completely solved either. The costs are high and amount to \$US14-15 billion (\$US 3.4 million/km pipeline). As Transneft does not have oil of its own, it cannot guarantee any deliveries. Cooperation with producers has also been shaky. Lukoil was initially reluctant to take part and Transneft states that it must have strategic issues in mind.<sup>886</sup> Tariffs are probably going to be high and companies in Western Siberia have at times been loath to pump oil long distances at cheap prices. The idea is yet foremost to use fields in Eastern Siberia. Analysts see this in light of

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<sup>882</sup> RIA Novosti 'Russia's Energy Sector: Priorities Remain'.

<sup>883</sup> Milov *Russian Energy Sector and its International Implication*, p. 15.

<sup>884</sup> Ogawa 'The Asian Premium and Oil and Gas Supply from Russia', p. 9.

<sup>885</sup> Chazan, Guy (2005), 'Russia Confirms China-Pipeline Plan', *The Wall Street Journal*, A, 7 September 2005, p. 2.

<sup>886</sup> Koptubenk 'Government Should Say if the Country Needs the Eastern Pipeline'.

the Yukos affair and its support of the Daqing option. Yukos is the licence holder of important fields in East Siberian, Yurubcheno-Takhomskoye for example, hence some analysts underscore that there is a risk of the state taking these parts from Yukos too.<sup>887</sup>

There are also serious internal and interdepartmental struggles concerning the exact route. Environmental arguments are often heard, for example that wildlife at the coast would be affected, or that the close distance to Lake Baikal would be dangerous should an oil-spill occur.<sup>888</sup> At times, these are just excuses for supporting one option instead of another on other grounds than environmental. In fact, the issue can be seen as a power struggle between, for example, Yukos and Lukoil or between the Ministry of Transportation and Ministry of Energy. As shown in the chapters above, Yukos has been advocating closer cooperation with China, while Lukoil does what the Kremlin wants. The Ministry of Transport sees it as more advantageous with a pipeline to the Pacific Coast so that it can continue to send oil to China by rail. This has also resulted in Rosneft having to expand its tanker fleet in North West Russia. High oil price are nonetheless required to make these types of exports profitable.<sup>889</sup>

According to Moscow News, China undertakes a pragmatic change of its position when it is needed. China has the financial means to invest in the Russian economy and apparently also a willingness to do so. Moscow News therefore argues that what the Russian authorities need to do in order to improve the relations is to provide an investment regime that would satisfy both Russia and China. In that case, China would willingly invest its money in Russia and Russia would not have to be afraid of selling its resources to 'foreigners'.<sup>890</sup> To administer this and the issues mentioned above, some argue that Russia and the Asian states should

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<sup>887</sup> Milov *Russian Energy Sector and its International Implication*, p. 15f.

<sup>888</sup> Ivanov 'Russia and Regional Energy Links in Northeast Asia', p. 22f.

<sup>889</sup> Baidashin 'Export Alternatives: Majors Boost Marine and Rail Transport Capacities To Hike Oil and Products Exports'.

<sup>890</sup> Moscow News 'Russia Looks to China for Partnership'.

use the EU-Russia energy dialogue as a model, but thus far, bilateral cooperation is the norm.<sup>891</sup>

Also in Russia's relations with Japan a dispute over a few islands is impeding cooperation. The Kurile islands, which were taken by Russia from Japan in the Second World War, have since then been a hindrance in the bilateral relations and a peace treaty has yet to be signed. When Putin visited Japan on 22 November 2005, the topic was not discussed, but Japan's Prime Minister, Junichiro Koizumi, claimed that it would not be an obstacle to further energy cooperation.<sup>892</sup>

Japan obtains approximately 90 per cent of its oil from the Middle East and is thus eager to diversify its imports, especially at lower prices. Despite its lobby activities, Russia has been reluctant to take Japan's stand at the expense on China. Russia has stated that it is prepared to provide Japan a special treatment if Japan is willing to bear some of the initial costs for any infrastructure projects that it gets involved in.<sup>893</sup> In January 2006 Putin announced that construction of the pipeline will begin in 2006. The stretch will be from Taishet to Perevoznaya bay. The first segment will run from Taishet to Skovorodino and should enter into service in 2008 according to Putin.<sup>894</sup>

A final topic about the Far East should be mentioned. On the island of Sakhalin,<sup>895</sup> there are numerous projects. Sakhalin I is run by the Indian ONGC, Rosneft and the Japanese Sakhalin Oil and Gas Development. The long-term plan is to build a sub-sea pipeline to Japan.<sup>896</sup> Sakhalin II was initiated in 1992 and is planned to ship LNG from 2007. Shell has a

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<sup>891</sup> Ivanov 'Russia and Regional Energy Links in Northeast Asia', p. 7.

<sup>892</sup> Moscow News (2005a), 'Koizumi Reiterates Hope for Resolution of Russia-Japan Kuriles Row', *Moscow News*, Published: 14 November 2005, Last accessed: 14 November 2005, Internet: <http://www.mosnews.com/news/2005/11/14/koizumiint.shtml>.

<sup>893</sup> Oxford Analytica (2005b), 'Economic Ties Balance Kuril Impasses', *Oxford Analytica*, Published: 29 November 2005, Last accessed: 2 December 2005, Internet: <http://www.oxan.com>.

<sup>894</sup> AFP (2006), 'Russia to Begin Siberia-Pacific Oil Pipeline Construction This Year', *AFP (Reposted at Alexander's Oil and Gas)*, Published: 26 January 2006, Last accessed: 8 February 2006, Internet: <http://www.gasandoil.com/goc/news/ntr60477.htm>.

<sup>895</sup> For more info, see: Stern *The Future of Russian Gas and Gazprom*, p. 145.

<sup>896</sup> Milov *Russian Energy Sector and its International Implication*, p. 18.

55 per cent share in the project while Mitsui has a 25 per cent share and Diamond Gas Sakhalin, a Mitsubishi company, has 20 per cent.<sup>897</sup> In 2003, Gazprom forced out ExxonMobile from Sakhalin III.<sup>898</sup> Gazprom has also approached Shell to take over 20 per cent of Sakhalin II in exchange for a 50 per cent stake in the Zapolyarnoye project (extreme north of Western Siberia, which is believed to hold 2.8 trillion cubic meter of gas). Shell had several demands but in short, even if Shell will retain its status as a Sakhalin II operator, Gazprom will probably manage to enter the Southeast Asian liquefied gas market in 2007.<sup>899</sup> Gazprom has stated it would give priority to Sakhalin instead of Kovytko for exporting gas to Korea and China.<sup>900</sup>

### **Energy Relations with the US**

A process of rapprochement between Russia and the US has been ongoing at the general level, much due to the fight against terrorism after 11 September 2001, even if certain backlashes have been seen (for example in the winter of 2005-2006). Energy has not really been a factor of irritation, even if there is a clear case of competition within the Caspian area. It is important to underscore that the competition for energy on world markets is between China, Japan, EU, India and the US while the competition for influence on the Eurasian landmass includes also Russia. Russian-US energy relations thus have great room for cooperation rather than competition. It is therefore unlikely that Russia is prepared to sacrifice the rather positive relations with the US, by pushing too hard to defend its sphere of influence in Central Asia.<sup>901</sup>

In Bratislava, on 24 February 2005, Bush and Putin made a joint statement and pledged to:

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<sup>897</sup> Sakhalin Energy (2005), 'Project Partners and Consortium History', *Sakhalin Energy*, Published: N/A, Last accessed: 14 April 2005, Internet: [http://www.sakhalinenergy.com/about/abt\\_partners.asp](http://www.sakhalinenergy.com/about/abt_partners.asp).

<sup>898</sup> Stratfor 'Special Report, Part 2: The Rise of Gazprom Inc.'

<sup>899</sup> RIA Novosti (2005a), 'Gazprom Pays Off Shell with 50% of Arctic Deposit', *RIA Novosti*, Published: 8 April 2005, Last accessed: 14 April 2005, Internet: [http://en.rian.ru/rian/index.cfm?prd\\_id=160&msg\\_id=5494559&startrow=11&date=2005-04-08&do\\_alert=0](http://en.rian.ru/rian/index.cfm?prd_id=160&msg_id=5494559&startrow=11&date=2005-04-08&do_alert=0).

<sup>900</sup> Hartley 'Russian Natural Gas Supply: Some Implications for Japan', p. 4.

<sup>901</sup> Sandström *Afghanistan and Central Asia after September 11: The Security-Political Development*, p. 73ff.

*[...] develop recommendations and specific proposals in areas of energy security, transparency, commercial energy partnerships and energy-related environmental problems.*<sup>902</sup>

The issues relate to a proposed expansion of the pipeline system and increasing Russia's LNG capacity, which is the only option if the US wants to import natural gas from Russia.

This and other issues, such as promoting a transparent business and investment environment, are meant to increase Russian oil and gas exports to the US and other markets. Putin has stated that "In the years 2010, 2011, a large amount of LNG can be supplied from Russia to the United States." In short, this means that several energy projects "should be initiated no later than 2008".<sup>903</sup> An example of the over 50 ongoing projects is the development of LNG infrastructure in the USA, where about ten places in California or Baja California in Mexico are designated to host new LNG terminals.<sup>904</sup> Another example is when in September 2004, the US Overseas Private Investment Corporation (OPIC) signed an agreement with Russian companies on financing the construction of a marine terminal (together with Lukoil) in Vysotsk, which may benefit exports to the US.<sup>905</sup> Moreover, this can be questioned, as there are certain capacity problems in the Baltic Sea. The US has been interested in the huge Shtokman gas field and the US Export-Import Bank may help finance a \$51US billion project for bringing the gas to Western markets.<sup>906</sup>

A new terminal on the Kola Peninsula has also been asked for by Washington. Yukos was the likely candidate for such a project, but the idea came to a halt in the wake of the Yukos affairs. There are

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<sup>902</sup> Bureau of International Information Programs (2005), 'Russia and US Pledge to Intensify Energy Cooperation', *Bureau of International Information Programs (Reposted at Alexander's Gas and Oil Connections)*, Published: 10 March 2005, Last accessed: 13 April 2005, Internet: <http://www.gasandoil.com/goc/news/ntr51095.htm>.

<sup>903</sup> Ibid.

<sup>904</sup> Ogawa 'The Asian Premium and Oil and Gas Supply from Russia', p. 16.

<sup>905</sup> Baidashin 'Export Alternatives: Majors Boost Marine and Rail Transport Capacities To Hike Oil and Products Exports'.

<sup>906</sup> Arvedlund 'U.S. is Looking to Russia for Gas'.

nonetheless signs that Lukoil may take Yukos' reins. A related issue is the proposed Murmansk Pipeline System (MPS) and a feasibility study is to be prepared by Transneft. Even if the oil would not be ideal (in terms of sulphur content), the project is backed by the US administration. Rosneft has not been eager to support the idea as it is about to increase exports by railroad,<sup>907</sup> which is something that goes against the Kremlin's wishes.

Relations with the US are extremely important to Russia, but it has not meant that Russia dances to Washington's pipe. Russia wants to be seen as a great power, and dealing with the USA (on an equal basis) makes this possible.<sup>908</sup> Despite this idea, Putin is believed to have a genuine desire to improve the energy relations with the US. Simultaneously, Russia does not want to jeopardise its strategic foundation of guarding its natural resources assets.<sup>909</sup> Cooperation may be extensive, but surely, neither Russia nor USA would be willing to take part in any cooperation that is against their strategic interests. Russia's economic upswing has also been a factor in its new strives for international cooperation.

It is evident that Russia is increasingly less responsive to foreign opinions relating to the domestic development (eg. the Yukos affair). The US leads the way in many fields. Withdrawing from the ABM treaty or declaring preparedness for preventive/pre-emptive strikes against terrorists are two aspects in which Russia has accepted and followed America's policy. According to Lavrov, this is also the case when it comes to acting in the energy field where the US also leads the way.<sup>910</sup> Given the fact that Russia's policy is reactive,<sup>911</sup> any US action can be expected to be met by similar means.

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<sup>907</sup> Baidashin 'Export Alternatives: Majors Boost Marine and Rail Transport Capacities To Hike Oil and Products Exports'.

<sup>908</sup> Oldberg, Ingmar (2005), 'Foreign Policy Priorities under Putin: a Tour d'horizon', in: Hedenskog, *et al.* (Eds.), *Russia as a Great Power: Dimensions of Security under Putin* (London: Routledge).

<sup>909</sup> Olcott 'Vladimir Putin and the Geopolitics of Oil', p. 3.

<sup>910</sup> Ozerov 'Neloyalniye ostanutsya bez nefi i gaza [Disloyalty Will Remain without Oil and Gas]'.

<sup>911</sup> See chapter four in Leijonhielm, Jan, *et al.* (2005b), *Ryske militär förmåga i ett tioårsperspektiv - problem och trender 2005 [Russian Military Capabilities in a Ten-Year Perspective: Problems and Trends 2005]*, Stockholm: Totalförsvarets forskningsinstitut (FOI), juni 2005, Användarrapport. FOI-R--1662-SE.

It is reputed that from the US horizon, the Russian business climate is problematic with its inadequate rule of law, lack of transparency and accountability in addition to lack of protection of minority shareholder rights. In addition, it is a factor of aggravation that the Kremlin favours its state controlled firms with its state policy.<sup>912</sup> Even if US enterprises have similar backing, the problems with investing in America are far from as serious as the problems in Russia.

### **Energy Relations with OPEC and Saudi Arabia**

All of the actors hitherto mentioned are net importers of oil or gas and Russia's relations with either OPEC or OPEC-member states are by necessity different from those above. Russia cannot take advantage of dependence but is instead facing a competitor at the same time as there are Russian companies working in the Middle East.

The fundamental point with Russian-OPEC relations is their different approach to energy supply. Russia is content to be outside OPEC since it wants to have the freedom to supply as much oil as it would like to at times when OPEC cuts down on production. At the same time, Russia is free to follow every OPEC escapade it wishes. However, harmonising oil output with OPEC is easier stated than done for Russia. While OPEC tries to act rapidly on price changes and swiftly adapt its production, Russia is unable to do the same, as it has little or no spare capacity. Russia's short-term approach of over-exploitation thus limits the manoeuvring space it seeks at the political level.

One way out of the predicament is for Russia to increase its storage capacity. Analyses suggest that if Russia had a strategic oil reserve of the same type that the US has (of some 588-735 million barrels) it could adapt to market changes.<sup>913</sup> Lacking this capacity, Russia cannot really challenge Saudi Arabia.<sup>914</sup> It has been proven twice that Saudi Arabia is

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<sup>912</sup> Barnes, Joe, *et al.* (2004), 'Geopolitics of Russian Supply and Russian Foreign Policy', *The Energy Dimension in Russian Global Strategy* (Houston: The James Baker III Institute for Public Policy of Rice University), p. 8f.

<sup>913</sup> Ivanov 'Russia and Regional Energy Links in Northeast Asia', p. 18.

<sup>914</sup> For an overview of the relations, see Katz, Mark N. (2004), 'Saudi-Russian Relations Since 9/11', *Problems of Post-Communism*, Vol. 51, No. 2.

the strongest supplier, and that it is prepared to accept economic losses if the losses are smaller than they are for its adversary. For example, in 1990, Venezuela decided to maximise its production and aimed to triple its increase in supply, as it wanted to become the premier supplier to the USA. This was unpopular in the Gulf and Saudi Arabia and after an initial phase of diplomacy, Saudi Arabia boosted its supply and caused the price to collapse.<sup>915</sup>

Despite Russia occasionally producing more oil than Saudi Arabia, it will scarcely be a serious challenger in the long term. The reasons are three fold. Firstly, Russia uses all of its capacity and will probably not develop any new in the future. Saudi Arabia has a spare capacity of at least 1.4-1.9 mbd (in 2003), which can be expected to be kept. The spare capacity of Saudi Arabia is so large that it is greater than the total exports of all the countries together, (excluding Russia).<sup>916</sup> Secondly, Russia's oil is relatively expensive and located geographically far-off in harsh environments. Saudi oil is on the other hand the cheapest oil in the world. Thirdly, Russia is not yet a real global player, as most of its exports, ownership and relations are with actors on the Eurasian landmass. While Saudi Arabia supplies oil to the USA, East Asia and Europe, Russia supplies large quantities of oil only to Europe.<sup>917</sup>

Another difference between Russia and Saudi Arabia is that Saudi Arabia (and several other Gulf States) opts for production levels that are sustainable. Several of these states discern that oil is to be their main income for the foreseeable future. Thus, the oil must be well taken care of. In the Gulf, it is perceived as necessary that prices are high for as long as possible, and that the oil lasts for coming generations.

OPEC and Russia do not understand each other and do not have a common base. In the fall of 2001, OPEC for example asked for Russian cooperation, but Russia did not want to follow suit. Russia's stand was that it was so dependent on revenues from oil that it felt required to cooperate with Saudi Arabia. As a consequence, Saudi Arabia threatened

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<sup>915</sup> Morse and Richard 'The Battle for Energy Dominance', p. 20.

<sup>916</sup> Ibid., p. 18.

<sup>917</sup> Barnes, *et al.* 'Geopolitics of Russian Supply and Russian Foreign Policy', p. 10.

to blackmail Russia by launching a price war.<sup>918</sup> At the time, Yukos and others had become somewhat used to non-state intervention and did not want to limit their supply. Neither they nor Moscow liked being blackmailed and they saw the incident in light of Saudi support to Afghanistan; to Central Asia in 1980s and to Chechnya in the 1990s.<sup>919</sup>

Russia also dislikes the close relationship between Saudi Arabia and the USA. The essence of this relationship is that the US gets oil subsidised by \$US1/barrel and pays for it by protecting Saudi Arabia with its troops.<sup>920</sup> Thus, when the US and Saudi Arabia, both stronger than Russia in this particular respect, joined forces, Russia's greatness vanished and frustration took over. A rapprochement has nevertheless come about during the last couple of years and Lukoil is again conducting investments in Saudi Arabia.

Another intriguing case is Iraq as Russia's involvement in Iraq is somewhat questionable. It partly explains why Russia opposed the war. In 2004, it was discovered that the Russian state, private companies and individuals greatly benefited from the Hussein regime, as they were awarded allocations (vouchers) of crude oil. On the basis of documents obtained from Iraq's former State Oil Marketing Organisation (SOMO), the Baghdad-based newspaper al-Mada demonstrates that the Russian state was the largest beneficiary in the oil-for-food programme by 1,366,000,000 barrels.<sup>921</sup> According to the Middle East Media Research Center, the vouchers had two primary purposes:

*A: Payments in the form of bribes to individuals or organizations for their support of the regime.*

*B: Vouchers may have been issued to pay for goods and services that fell under U.N. Security Council sanctions and could not be financed under the "Oil for Food" program. Goods may have included military equipment or military parts,*

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<sup>918</sup> Morse and Richard 'The Battle for Energy Dominance', p. 28.

<sup>919</sup> Ibid., p. 29.

<sup>920</sup> Ibid., p. 21.

<sup>921</sup> al-Mada (2004), 'The Beneficiaries of Saddam's Oil Vouchers: The List of 270', *al-Mada* (Translated and reposted at the Middle East Media Research Institute (MEMRI), Published: Last accessed: 8 February 2005, Internet: <http://memri.org/bin/articles.cgi?Page=archives&Area=ia&ID=IA16004>).

*luxury automobiles that Saddam distributed as gifts inside and outside Iraq, and general luxury goods for the benefit of high-ranking officials in the Ba'ath party and government.*<sup>922</sup>

Al-Mada also compiled a long list of beneficiaries of Iraq's oil vouchers. For this report, the single Russian beneficiaries have been extracted from the whole list and are presented below in Table 14. Predictably, the Communist Party, the Russian Orthodox Church and the LDPR have denied these connections.<sup>923</sup> Zarubezhneft claims that it has not received a great deal from the 'oil for food programme', although it got some commission (on which it paid taxes).<sup>924</sup> Other accusations have come from Iyad Allawi of the Iraqi National Accord who in May 2003 accused the former Russian Prime Minister Primakov of accepting money in return for defending Saddam Hussein.<sup>925</sup> On the whole, Russia has progressively tried to distance itself from Hussein, but in the preparing phase for the war against Iraq, Russia warned of British and US intervention, something that analysts connected to Russia's firm stand against the policy against Iraq.<sup>926</sup> When the UN released a new report, claiming that Russia was one of the countries that channelled most of the illegal surcharges to Hussein, it received little attention in Russia. Foreign Minister Lavrov disputed the report and stated it was not backed up by evidence.<sup>927</sup>

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<sup>922</sup> Ibid.

<sup>923</sup> RFE/RL (2004a), 'RFE/RL Newline 4 February 2004', RFE/RL, Published: 4 February 2004, Last accessed: 21, Internet:  
[http://en.rian.ru/rian/index.cfm?prd\\_id=160&msg\\_id=5370918&startrow=1&date=2005-02-02&do\\_alert=0](http://en.rian.ru/rian/index.cfm?prd_id=160&msg_id=5370918&startrow=1&date=2005-02-02&do_alert=0).

<sup>924</sup> Suponina, Elena (2003), 'Russia Will Have to Put up with Loosing Everything in Iraq', *Vremya Novostei* [Reposted at Zarubezhneft], Published: 28 March 2003, Last accessed: 22 March 2005, Internet:

<http://www.zarubezhneft.ru/www/nestroweb.nsf/554c7e081b919700c3256c2100282e3c/ed16b4804f399086c3256d900048ea86?OpenDocument>.

<sup>925</sup> Zashv Russian Investments in Lithuania: Politics, Business, Corporate Culture, p. 28.

<sup>926</sup> Lo Vladimir Putin and the Evolution of Russian Foreign Policy, p 63.

<sup>927</sup> Bigg, Claire (2005), 'Russia: Oil-For-Food Corruption Report Leaves Russians Cold', RFE/RL, Published: 28 October 2005, Last accessed: 1 November 2005, Internet:  
[http://www.rferl.org/features/features\\_Article.aspx?m=10&y=2005&id=96BA7F9C-2F38-49D0-BD01-3E7331316912](http://www.rferl.org/features/features_Article.aspx?m=10&y=2005&id=96BA7F9C-2F38-49D0-BD01-3E7331316912).

## Russia's Energy Policy

<b>Table 14: Russian Beneficiaries of Iraq's Oil Vouchers under Saddam Hussein</b>	
The Russian State	1.366.000.000 million barrels
Zarubezhneft	174.5 million barrels
The Liberal Democratic Party (Vladimir Zhirinovskiy)	79.8 million barrels
Lukoil company	63 million barrels
Rosneft	35.5 million barrels
Vladimir Putin's Peace and Unity Party (Saji Umalatova)	34 million barrels
Yetumin	30.1 million barrels
Gazprom	26 million barrels
Soyuzneftegaz (Shafrannik)	25.5 million barrels
The Moscow Oil Company	25.1 million barrels
Onako	22.2 million barrels
Sidanco	21.2 million barrels
The Russian Association for Solidarity with Iraq	12.5 million barrels
The son of the former Russian Ambassador to Iraq	19.7 million barrels
Nikolay Ryzhkov (Ex PM of the USSR)	13 million barrels
Russneft (and) Gazexport	12.5 million barrels
Transneft	9 million barrels
The Ural Invest company	8.5 million barrels
Sibneft	8.1 million barrels
Stroyneftegaz	6 million barrels
The Rus. Com. for Solidarity with the People of Iraq (Rudasev)	6.5 million barrels
The Russian Orthodox Church	5 million barrels
The Russian President's office director	5 million barrels
The Moscow Academy of Sciences	3.5 million barrels
The Chechnya Administration	2 million barrels
The National Democratic Party	2 million barrels
The Nordwest group	2 million barrels
Yukos	2 million barrels
Russian MFA (Al-Fayko)	1 million barrels
Mashinoimport	1 million barrels
Slavneft	1 million barrels
The Caspian Invest Company (Kalika)	1 million barrels
The Russian Communist Party	1 million barrels
Tatneft	1 million barrels
Surgutneft	1 million barrels
Siberia's oil and gas company	1 million barrels
<p><b>Source:</b> al-Mada (2004), <i>The Beneficiaries of Saddam's Oil Vouchers: the List of 270</i>, al-Mada (translated and reposted at the Middle East Media Research Institute (MEMRI), Last accessed: 8 February 2005, Internet: <a href="http://memri.org/bin/articles.cgi?Page=archives&amp;Area=ia&amp;ID=IA16004">http://memri.org/bin/articles.cgi?Page=archives&amp;Area=ia&amp;ID=IA16004</a>.</p> <p><b>N.B.</b> Names in brackets are the ones that appeared on the list. Translation from Arabic may have brought along errors. Some have been corrected by author of this report.</p>	

### Russia as a Victim of Foreign Energy Levers

Russia's energy strategy indicates that Russia not only strives to use energy as a sword, but also as a shield against financial and geopolitical threats. The Russian fear of being blackmailed does have some ground as indicated above. Four known cases that can be mentioned are by

Moldova, Ukraine, Turkey and Turkmenistan. Moldova has already been mentioned and, as indicated, Ukraine used to be the worst offender when it came to tapping oil and gas from Russian transit pipelines.<sup>928</sup> In the wake of the crisis in May 2005, Naftogaz' chairperson Alexei Ivchenko even stated that Ukraine must have to resort to siphoning gas from the trunk lines.<sup>929</sup> Gazprom as a consequence decided to cut gas deliveries with the same amount that had disappeared and Ukraine had to promise not to re-export any of the gas.<sup>930</sup>

Marina Pustilnik of Moscow News concluded that Ukraine's actions during these events would result in a backlash. The concern is that Ukraine has threatened Gazprom with using its leverage over gas transit to the rest of Europe. Therefore, it is of little consequence if Russia has been reliable or not, Ukraine will stand out as an unreliable obstacle in European energy trade. By this action, Ukraine has provided Russia with an exceptional rationale for building the North European Gas Pipeline (NEG).<sup>931</sup> Ukraine thus lost.

Turkmenneftegaz in Turkmenistan, in the beginning of 2005, also suspended gas deliveries to Gazprom in violation of the 25-year contract from 2003. The reason for the supply interruption was that President Niyazov wanted to raise the gas price for both Russia (re-exporter) and Ukraine (consumer). Yuri Boiko of the Ukrainian Naftogaz bowed to the demands, but Russia did not.<sup>932</sup> After prolonged negotiations, Miller of Gazprom and President Niyazov reached a compromise over the forms of payments.<sup>933</sup> Turkmenistan was thus successful in pressuring Russia

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<sup>928</sup> Bruce *Friction or Fiction? The Gas Factor in Russian-Belarusian Relations*, p. 4.

<sup>929</sup> RosBusinessConsulting (2005f), 'Ukraine, Russia Rattle Swords in Gas Stand-off', *RosBusinessConsulting*, Published: 29 June 2005, Last accessed: 30 June 2005, Internet: [http://top.rbc.ru/english/index.shtml?/news/english/2005/06/29/29150938\\_bod.shtml](http://top.rbc.ru/english/index.shtml?/news/english/2005/06/29/29150938_bod.shtml).

<sup>930</sup> Gavrish, Oleg (2005), 'Ukraine Will Keep Russian Gas', *Kommersant*, Published: 30 June 2005, Last accessed: 30 June 2005, Internet: <http://www.kommersant.com/page.asp?id=587909>.

<sup>931</sup> Pustilnik, Marina (2005c), 'The State of Gas', *Moscow News*, 13-19 July 2005, p. 9.

<sup>932</sup> Grivach, Aleksei (2005), 'Gazprom Would not Bow to Turkmenistan's Blackmail', *Vremya Novostei (Reposted at Fergana Information Agency)*, Published: 9 February 2005, Last accessed: 20 February 2005, Internet: <http://enews.ferghana.ru/detail.php?id=69306930698.221,993,12665857>.

<sup>933</sup> RosBusinessConsulting 'Gazprom Changes Barter Procedures'.

to concessions, which puts some of Russia's power and practice into perspective.

The case with Turkey also concerns gas prices, but from the consumer side. After the costly Blue Stream Pipeline under the Black Sea was completed, Turkey declared that it wanted a price concession. Otherwise, it would not import Russian gas. As Turkey, so far, is the only consumer of gas via Blue Stream, Russia felt that it had to accept and subsequently did. Russia lost and was successfully blackmailed.

### **Summary and Conclusions**

Russia's policy and relations essentially harmonise with stated intentions and activities. They are very much in line with the energy strategy. Russia refuses to get enmeshed in structures it cannot control and it does not want to become dependent on third parties for transit. It is prepared to go to great lengths to bypass such risk by geopolitically motivated infrastructure projects (i.e. the North European Gas Pipeline (NEG)).

Dependence on Russia should be avoided according to most of the states with which Russia has relations. This may have to be done at the expense of the environment and has its rationale in the experiences both from the USSR and Russia's post-Soviet policy. Russia has acquired substantial assets (i.e., firms and infrastructure) abroad, despite a particular unwillingness in target states. However, many of Russia's take-overs have been promoted by the state power in question, since Russian companies are often better suited than Western competitors to act in the CIS markets.

A common EU energy strategy does not exist yet, and most states pursue their own agendas and opt for bilateral policies towards Russia. Deep-seated problems in energy relations originate from disparate views on cooperation. There is not a common ground for common values. A strong correlation between increased German links to Russia and a reluctance to criticise Russia exists. This may also happen to other states that increase their dependence. Many states (i.e. Lithuania Latvia, Georgia, Moldova, Ukraine, and Belarus) are vulnerable to Russian pressure. All of these, in addition to other European states are reluctant

or even unwilling to give Russia increased influence. However, this is what Russia gradually obtains.

Russia's foreign policy has become much more assertive and self-assured and economic strengths have promoted a stronger regional position. In Central Asia, Russia today does not have to resort to military pressure as the regional states are dependent and Russia has something to offer. The demarcation of the Caspian Sea will not presently be solved. China's energy needs and Russia's distrust of China is another core problem. Russia has refused to become dependent on China and has prioritised freedom of exports, to Japan's gain. There have been quick changes, and a rapprochement with China has been evident under 2005. Relations to the US have altered, but energy has not been the factor of irritation that it could have been (even if the competition between Russia and the US within the CIS is vexing). Increased energy cooperation was initially halted by the Yukos affair, but may return in greater strength as other firms stand in for Yukos.

OPEC states and Russia have different approaches towards energy supply. Russia will scarcely be a serious challenger to Saudi Arabia in the long-term unless Saudi Arabia collapses. In short, Russia's energy policy follows the lines of its economic and foreign policy.

The review conducted above is far from exhaustive and would have more extensive if a broader definition of energy security and the energy weapon had been used. There have possibly also been more incidents that are not officially known today. Even if supply interruptions have been given most attention (total and partial), it can be concluded that issues of threats, pricing policy, usage and creating of debts in combination with take-overs of companies or infrastructure have occurred. It has mainly been done against the Baltic countries, Ukraine, Belarus, Moldova, Georgia and most of Europe. Further analysis of this is found in the next chapter.

## 7 Russia's Energy Levers under Scrutiny

**Questions:** What are the objectives, drivers, trends, patterns, outcomes and method of utilising the energy levers? What and how strong are the barriers against further usage of the energy levers?

**Approach:** The chapter addresses and analyses the energy levers and barriers against further usage covered in previous chapters.

**Main findings:** Market, political and economic goals are parts of the immediate objectives of Russia's coercive energy policy, but they are all subjugated to strategic drivers and priorities. This explains why all features are present simultaneously. Analysts that claim that all cut-offs are purely market driven appear to be mistaken. Energy cut-offs has always been aimed at CIS states, but has affected most of Europe. Other states have also been objects to coercive policy. The frequency of interruptions has decreased by half under Putin, but coercive policy is still pursued.

The risks to supply interruptions depend on the context, the receiver and the time perspective. The Baltic and CIS countries run greatest risk, but the rest of Europe may well be affected by cut-offs aimed at the CIS. Most barriers against further cut-offs are rather weak against short-duration cut-offs. The barriers are much stronger against long-duration cut-offs.

The energy levers and the issue of supply reliability are related since, as defined in chapter one, there are two sides of the coin. The political will to supply energy is one part, while the other is the intention to cut off supply deliberately. If supply is cut off on purpose (as opposed to technical failure, bad weather etc.), Russia's reliability is reduced.

### **Approach to Russia's Energy Lever and Supply Reliability**

Many facts concerning Russia's coercive energy policy and cuts of energy supply to the CIS can be put into question. Have supply interruptions occurred at all and what do we know really about the

cases? Are there problems, and are the market drivers stronger than the political ones? If there are political underpinnings – so what?

That incidents (supply interruptions, debts and infrastructure take-overs etc.) have occurred is undisputed. The analytical problem lies in assessing the drivers behind Russia's actions. As Michael Fredholm correctly points out, Ukrainian or Georgian politicians claiming that Russia has put pressure on them by using the energy lever is not enough to be seen as conclusive evidence.<sup>934</sup>

In fact, nothing of what has been presented here are in its own sustainable proof of explanations in a judicial sense, but merely circumstantial evidence. At the same time, what would be sufficient proof of reasons? Even if Russia publicly stated that it has cut energy supply to the CIS for a specific reason, can we be sure that this was the genuine and only reason.

This does not mean, however, that it is pointless to assess the problem. Instead, one has to look for political statements, correlation of incidents, what has actually happened and the present context – all in combination. The key issue is therefore not the single incidents or events, but the aggregated pattern that emerges when it is looked upon in a larger perspective. It must also be put in the overarching context of Russia's development.<sup>935</sup> In fact, there is a risk that the strategic dimension is given less attention on behalf of market-related explanations because it is easier to support such an argument by drawing upon accessible sources.

As indicated in previous the chapter, the energy levers of special importance are defined as supply interruptions (total or partial), threats of supply interruptions (covert or overt), discriminatory pricing policy (prices as carrots or sticks), usage of existing energy debts, creating new energy debts and, finally, take-overs of companies or infrastructure.

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<sup>934</sup> Fredholm *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, p. 14.

<sup>935</sup> For a summary, see Leijonhielm, *et al. Russian Military Capability in a Ten-Year Perspective - Problems and Trends 2005: Summary and Conclusions from a Study for the Swedish Ministry of Defence.*

### **Usage Pattern of Russia's Energy Levers**

Here, an attempt is made to show the pattern and frequency of Russia's usage of the energy (oil and gas) lever. The section is basically based on the previous chapter, but it is important to stress that definitions are not always undisputable and actions are not always verified.<sup>936</sup>

Firstly, the number of incidents (cut-offs, explicit threats, coercive price policy and certain take-overs) exceeds fifty-five (of which only a few are unconfirmed) since 1991. Of these incidents, at least twenty have occurred during Putin's reign and between twenty and thirty during Yeltsin. The frequency has thus not been reduced dramatically. Over forty incidents appear to have economic underpinnings and over thirty to have political underpinnings. Only eleven of the incidents occurred without any known political connection. This is attributed to the majority being both political and economic underpinnings. However, but it is at the same time important to stress that there are long-term strategic underpinnings in almost every case.

Second, over forty cut-offs of energy supplies have occurred against the Baltic and CIS countries since 1991 (three that are unconfirmed and technical failures or sabotage are not included). Approximately twenty-five of these occurred during Yeltsin and around fifteen during Putin. Half of these cases had notable political underpinnings. In addition, there have been serious threats on at least three occasions (Belarus 1996, Georgia 2005, Moldova 1998) that were put forward by Russia without any actions taken. Numerous cut-offs due to technical and/or weather explanations occurred (but are not mentioned in this report) and examples of sabotage can also be seen. Some of these have allegedly been made by Russia on purpose, but no credible evidence of this has been seen in the press (Georgia 2006).

Third, incidents where Russia has put forward political demands in connection to its energy policy (or conducted clear punishment for

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<sup>936</sup> By 'unconfirmed', unspecific allegation or inconclusive data are meant (Belarus in February 2004, Georgia 'in the 1990's', Moldova February 2000). 'Confirmed' are incidents that are have been detailed in time and place and that are reported of in the press. Incidents that solely appear to have market-related features have been omitted.

unwanted actions) is a matter of discussion and definition, but on seven occasions appear to be the case (Belarus 1994, 1996, Estonia 1992, Georgia 2001, 2005, Ukraine 1993, 2005/2006).

Fourth, the number of incidents is approximately equally divided between oil and gas. Gazprom has been involved on around twenty occasions and Itera at five. Transneft and Lukoil have been involved in eleven respectively twelve. In addition, Transnafta and Tatneft have also been involved in a few cases. Information about several incidents is incomplete.

Finally, under Putin, supply interruptions have been utilised much less frequently than under Yeltsin (even if the number of incidents appears to remain at the same level). It is impossible to make definitive comparisons of the two periods, as Putin still has two years left on his term.

### *Assessing the Unknown*

From the material that this report relies on, it is also impossible to say anything about the shares of the total (unknown) number of incidents (as this review is not exhaustive). However, given the nature of these incidents, it is possible that more cases would be found if 1) a wider definition of the energy lever is employed, 2) increased attention is given to the non-interruption cases of using the energy weapon, 3) information that today is secret or shielded from insight is made public or if 4) a more systematic or thorough review than this one is made.

The magnitude of covert threats, i.e., threats put forward by Russia that were never carried out or made public, will perhaps be forever unknown. Just because Russia appears to be less inclined to stage energy cut-offs during Putin's than during Yeltsin's reign does not mean that it actually is. It could be used as frequently now if it is undertaken secretly or conducted under the pretext of technical difficulties. Given the endemic problems with lack of maintenance, technical problems or failures, they have credibility as explanations if ever used as excuses for politically motivated interruptions. One should yet be careful in assuming that all interruptions are politically grounded as energy-

related infrastructure is in poor shape and highly sensitive to bad weather or accidents. This report has found no evidence of this being the case.

However, it would not be incorrect to assume that Russia in silent or secret agreements would be willing to guarantee energy supply given some kind of return, either in political or economic terms. Georgia is one plausible case where there occasionally appears to be momentum for better relations but where political prestige and polemic statements from both sides reduce the opportunities for rapprochement. These kinds of agreements could well exist simultaneously to polemic statements for MPs or even government officials.

### **Analysis of Targets and Non-targets of Russia's Energy Levers**

There appears to be a three-layer concept in Moscow concerning targets of its energy policy. The first layer is territorial Russia where customers traditionally have been spared from cut-offs, but that are now facing increased payment demands. There is a strong difference between how the pro-Kremlin and independent firms are treated on the domestic market. Pro-Kremlin firms appear to enjoy greater privileges than others. The second layer is the former Soviet territory. Several cases of usage of the energy levers can be seen here. Lithuania has been targeted on twenty occasions, Belarus and Georgia on nine each and Moldova on six. Ukraine has been targeted at least five times, Estonia and Latvia two times but Armenia only once.<sup>937</sup> The third layer includes non-FSU Europe, the US, India, China and Japan. Against these states no cut-offs have been aimed at them as far is known, but issues of concern exist and Russia appears to see them as 'affordable collateral damage'. This layer-conception harmonises well with Russia's over-arching strategic and geopolitical priorities.<sup>938</sup>

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<sup>937</sup> Also these figures depend on if the incidents are divided into parts or seen as a longer process. Here they are seen as separate incidents if there have been 'calm' periods between them.

<sup>938</sup> See Trenin, Dmitri (2002), *The End of Eurasia: Russia on the Border Between Geopolitics and Globalization* (Washington D.C.: Carnegie Endowment for International Peace), and Hedenskog, Jakob, et al. (Eds.) (2005), *Russia as a Great Power: Dimensions of Security under Putin* (London, Routledge).

Russia's relative strength within the CIS is overwhelming and in combination with other means, Russia's influence is remarkably strong. Dependence does not necessarily lead to vulnerability, but many states lack the capacity to store oil or gas, or diversify imports (either due to a financially poor circumstance or because of a landlocked location). If they are targeted for pressure or coercive energy policy (or problems derived from non-antagonistic actors for that matter), dependence leads to vulnerability. This is why Russia's coercive policy is problematic and why politicised marketisation is more problematic than it first appears.

According to IEA, no full cut-off has occurred to Western customers since 1968 when energy deliveries started.<sup>939</sup> This discrepancy bears witness to Russia acknowledging a difference in importance between former Soviet states and Europe. Russia has still not let go of the idea that the former Soviet territory belongs to Moscow. Russia clearly perceives these states as its sphere of influence where other rules or ethical norms apply than what is customary in Europe and in relation to Europe. The most central thesis of Andrew Monaghan, which is presented as his first 'key point', is that:

*There are concerns in Western Europe that Russia may try to use its energy exports as a political lever by threatening to "turn off the taps". Such concerns are usually supported by evidence drawn from Russia's dealing with the Newly Independent States/Formal Soviet Union.<sup>940</sup>*

This is true and nothing that energy analysts have tried to marginalise, the FSU perspective has on the contrary been very explicit.<sup>941</sup> It is nonetheless worrisome that he, along with many others, sees the security of supply only to 'Western Europe' as the most important factor. Eastern Europe does not mean the Warsaw Pact anymore. This stand could implicitly indicate that Western Europe does not have to worry, as it is *only* the new EU and NATO members or CIS states that are targeted. Adopting such a standpoint would undermine much of what the EU has accomplished in terms of integrating east and west.

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<sup>939</sup> Ahrend and Tompson *Russia's Gas Sector: The Endless Wait for Reform?*, p. 21.

<sup>940</sup> Monaghan *Russian Oil and EU Energy Security*.

<sup>941</sup> For example by the author of this report in Leijonhielm and Larsson *Russia's Strategic Commodities: Energy and Metals as Security Levers*.

From the perspective of the new EU members and the states of the FSU, it is also regretful that much of the European discussion on Russia's energy policy focuses on the issue of security of supply, while the dimensions of energy security and dependence are far more important to the security architecture in the Eastern and Central Europe. In addition, a conclusion stating that Western Europe is safe is also flawed. The Russian-Ukrainian gas row of 2005/2006 made it all clear that also Western Europe can be affected (even if Russia's actions were not aimed at Western Europe).

### **Immediate Objectives of Usage of the Energy Lever**

If the cases in previous chapter are described in generic terms, it appears that the immediate goals during the incidents have been to:

- 1) coerce some type of political concession in ongoing negotiations,
- 2) commandeer infrastructure take-over,
- 3) execute economically favourable deals and,
- 4) make a political statement.

First, usage of the energy levers appears to have generated little or no gain for Russia in terms of political concessions, at least from what can be seen in open sources (and it has not been made overtly in that many cases). There is, of course, a possibility that secret concessions after overt threats have been made. In that case, Russia's strategy has been successful and can explain why it is so persistent in what appears to be a relentless and un-awarding effort (Belarus 94, Ukraine 1993). Yet, this is impossible to elucidate.

Second, when it comes to commandeering infrastructure take-over, Russia's has been rather successful in acquiring foreign assets (for example in Moldova, Georgia). This has led to an entrenchment of Russia's presence within the CIS and elsewhere. While Russia gradually has come to lose some ground within the military field,<sup>942</sup> it has by far retaken the ground by economic means. This also means that while

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<sup>942</sup> Leijonhielm, *et al.* *Ryske militär förmåga i ett tioårsperspektiv - problem och trender 2005* [Russian Military Capability in a Ten-Year Perspective - Problems and Trends 2005], pp. 163-165.

states such as Georgia welcome import routes that are not controlled by Russia, it has also welcomed increased Russian control over its domestic energy sector. The majority of the cases of take-overs have not been done under pressure (all cases are not mentioned in this report). It cannot, however, be concluded that Russia's take-over attempts are made without force. On the most important occasions (Ventspils, Mažeikiu, Beltransgaz and the trunk pipelines in Ukraine and Georgia) Russia has tried to acquire them by force – but failed just because these states see it as pivotal to keep Russia away.

Thirdly, enforcing economically favourable deals appears to be a reason that is subjugated to other parts, since delivering energy to non-paying customers (Belarus, Moldova) and unwillingly affecting paying customers (most of Europe) does not boost profit. If the cut-off, however, facilitates infrastructure take-over, the gains are substantial. It also provides stronger leverage and entrenches Russia's/Russian companies' positions on the foreign markets (possibly before any 'pure' market actors get a foothold). It is also a way of keeping insolvent customers if one believes that they will be able to pay in the future.

Much of this has been done within a market framework and Russian companies have been much better than other foreign entities in operating on the CIS market. UES replacing AES on the Georgian electricity market is one example of this. At the same time, one of the reasons for this is naturally that the Soviet heritage (encompassing everything from culture to language and corruption) gives Russia a competitive advantage. Pricing regimes and contractual agreements furthermore appear to have unfolded Russia's way in the majority of the cases.

Fourth, from Russia's point of view, a limited number of cut-offs has the advantage of showing opponents that Russia is serious about its threats. The deterring effect ensures that future threats will be more credible. The effect grows if previous cases have brought along economic losses for Russia (at least in the short term), especially if Russia despite these losses has followed through with its threats (eg. Ukraine and Belarus). There have also been threats without any action taken (Belarus 1996, Moldova 1998, Georgia 2005).

However, the deterring effect only rises during the first few cases and gradually levels out. After that, everyone is aware of to what length Russia is willing to go. Thus, if Russia wishes to increase the deterring effect, or create an aura of ambiguity, it has to take other measures. It has pushed the limit in a few cases. For example, Russia has gone from partial to full cut-offs (eg. Belarus), or combined the cut-off with other means of pressure (eg. Ukraine). A serious step to increase the deterrent effect would be to do something that Russia has not done before and that generates a severe negative backlash for Russia. For example, this could be the energy cut-off that affected Western Europe in January 2006.

If cut-offs have occurred out of the public eye, the deterring effect would then be small towards third parties, but still large against the opponent in question. This would be the case if the opponent were prone to keep the incident a secret. If the threat is made public, a certain amount of badwill falls upon Russia. It is, therefore, important for Russia to legitimise its threats. This has been far from difficult as most states have debts to Russia or Russian companies (Georgia, Belarus, Moldova, and Ukraine). It is difficult for the target to defend itself against such verbal attacks, even if they are well aware of the fact that Russia has deliberately allowed them to get indebted. Using energy policy as a mean to punish states also appears to have been the case (the Baltic countries after independence). Having stated this, it cannot be concluded that a key objective for Russia has been to build deterrence power. It should rather be seen as a consequence of Russia's policy.

Essentially all incidents where Russia has used the energy lever are political statements. It sends a signal what Russia wants and how eagerly it wants it. Judging from what politicians in targeted states have stated, there is no question about the message Russia wants to send by supply interruptions. Hence, despite the fact that some of these interpretations are exaggerated and polemic in nature, they clearly perceive Russia as a problem. Russia, in turn, has done little to improve its reputation and therefore vicious circles have come about. Russia's Chairmanship of the G8 is nonetheless an opportunity for Russia to show the world that it is on the right track. A few steps forward can be expected, at least as

statements, but it is not impossible that it at the same time will backtrack within other areas.

### **The Underlying Drivers of Russia's Energy Policy**

While the immediate goals refer to the incidents, the underlying drivers are aimed at fulfilling Russia's overarching priorities. Several interpretations of the underlying drivers exist. Vladimir Milov for example concludes in his report that increased state control results in low growth and economic efficiency. The Russian state systematically makes wrong choices by sacrificing economic efficiency for political objectives.<sup>943</sup> Bobo Lo, in contrast, put greater emphasis on money and claims that Russia has been willing to sacrifice good relations with the West in return for profit-related actions.<sup>944</sup> Jonathan Stern argues that except for the cases against the Baltic countries in the early 1990s, there is not a single case of politically motivated supply interruptions by Russia. All known cut-offs are market driven and a natural consequence of non-payments.<sup>945</sup> This contrasts the argument that Russia and Russian actors are rent-seekers (put forward for example by Anders Åslund) and that Stern argues against.<sup>946</sup>

Andrew Monaghan also claims that there has never been any clear example of purely political use of the energy weapon by Russia.<sup>947</sup> If emphasis is put on 'pure', this is almost true (it happened against the Baltic states after independence and possibly also after that). However, this fundamentally misses a crucial point in the analysis of issues related to political economy, as there rarely is such a thing as a pure motive behind *any* pursued policy. Economics and politics go hand in hand, and it is of little use trying to pin them exactly along a scale of 'purity'.

Instead, this report argues that there are reasons to adopt a less dogmatic model of explanation. The reason is that it is scientifically dubious to rest on monocausal explanations. There is not enough transparency to draw

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<sup>943</sup> Milov *Russian Energy Sector and its International Implication*, p. 9f.

<sup>944</sup> Lo *Vladimir Putin and the Evolution of Russian Foreign Policy*, p. 61.

<sup>945</sup> Stern 'European Gas Supply and Security Issues'.

<sup>946</sup> Stern *The Future of Russian Gas and Gazprom*.

<sup>947</sup> Monaghan *Russian Oil and EU Energy Security*, p. 6.

such conclusions and those who have tried have failed to take the wider context into consideration. Linkages between intentions, causes and actions should be seen as 'correlation' (be it causal, indirect or coincidental). If the overarching perspective is considered, it stands clear that market factors, political factors and economic factors coexist in different fractions of Russia's policy. Russia is not a unified actor and it would be wrong to claim that all actors are driven by the same objectives. However, the Kremlin has the ultimate responsibility and as seen here, it also has great influence over key firms. It is at the same time eager to facilitate business for these firms and thus promote their objectives. The Kremlin sets the strategic framework and over-arching priorities that are supposed to serve Russia's national security. The strategic dimension is for example visible in:

- 1) Russia's stated intentions.
- 2) The geopolitical context and the targets of Russia's coercive energy policy.
- 3) The timing of coercive measures.
- 4) Russia's way of conducting foreign energy policy.

The details are found throughout the report,<sup>948</sup> but a few points can be reiterated. First and foremost, Russia sees its energy policy in a strategic and security perspective. The energy strategy identifies that the energy policy's fundamental task is to ensure Russia's national security. Political and economic actions are meant to support this overarching idea. It is and will be utilised to avert threats and to extend Russia's influence abroad. The Kremlin's geopolitical vision is to keep its influence over the CIS and one of the means is its energy policy.

On the topic of the strategic goals of state policy in the energy sector, Putin has stated that it is "aimed at furthering the geopolitical interests and maintaining the national security of Russia".<sup>949</sup> The CEO of Lukoil, Vagit Alekperov, has also explicitly admitted that state's that has an oil sector largely owned by Russia is unlikely to pursue an anti-Russian

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<sup>948</sup> And in Leijonhielm and Larsson *Russia's Strategic Commodities: Energy and Metals as Security Levers*.

<sup>949</sup> Putin *Mineralno-syrevye resursy v strategii razvitiya Rossiiskoi ekonomiki* [*Mineral Raw Materials in the Strategy for Development of the Russian Economy*].

foreign policy.<sup>950</sup> Lavrov, the Minister for Foreign Affairs, at a closed session in the Federation Council declared that Russia is prepared to exert economic pressure against the CIS states.<sup>951</sup>

Second, previous chapters bear witness of that in almost every case when Russia has acted coercively (and especially with regards to supply interruptions) it has been against states that are important to Russia for transit or other strategic reasons. What is pivotal in this context is not the single incidents, but the aggregated and over-arching perspective. When seen against the overall development of the Russian Federation, Russia's energy policy against the CIS countries, back to front, fit the model for what Russia's perceptions and intentions are. Energy policy is found in the intersection of Russia's economic development and foreign policy line, in combination with an ongoing strategic realignment. Russia's foreign energy policy and incidents of using energy as a political tool fits the tradition and vision of keeping the influence over the CIS, to ensure economic growth and managing the risks of becoming dependent on third parties for energy exports. Debts are hence merely one aspect of it. As evidenced, it does not have to be a central component (Ukraine 2005).

It would however be inaccurate to claim that Russia's energy actions are driven solely by a strive for ownership and control within the CIS. A nuanced conclusion of Russia's action is put forward by Fredholm who on the topic of Russia's actions states:

*This development should not necessarily be interpreted as an attempt to gain political control over these [CIS] countries. Russia is, however, right that it makes economic sense for the CIS states to co-operate in production, distribution and export of the available energy resources. The key word is re-integration, not political control.*<sup>952</sup>

Fredholm is correct when claiming that the keyword is re-integration, but the outcome is nonetheless a strengthened Russian presence that, in all importance, is on the Kremlin's priority agenda. Russia's pursued

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<sup>950</sup> Monaghan *Russian Oil and EU Energy Security*, p. 2.

<sup>951</sup> Ozerov 'Neloyalniye ostanutsya bez nefti i gaza [Disloyalty Will Remain without Oil and Gas]'

<sup>952</sup> Fredholm *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, p. 16.

policy may thus result in strengthened political control. This is occasionally observed as favourable by the targeted states as it makes economic sense, but Russia's vision and past actions have made several countries nervous (Finland, Baltic States, Georgia).

Third, as indicated, the timing of Russia's most serious attempts to put pressure on energy importers is politically crucial. On most occasions, relations have been dire or disadvantageous for Russia. When relations have been good, no cut-offs, dramatic prices rise, threats or call for market measure have been seen (eg. Belarus).

Fourth, using overt or covert threats, discriminatory pricing, and staging of cut-offs, and on some occasions explicitly demanding political concessions or the right to locate military troops are clear examples of Russia using its energy lever for strategic purposes by political and economic means.

### *The Market Argument*

Using a pair of strong market spectacles, as Stern does, the argument of why Russia's actions are purely market-driven is clear. He essentially argues that every action that Gazprom takes a market approach and the main problems in this marketisation campaign is the CIS states. Basically, the market-argument for Russia's cut-offs of energy supplies to the CIS states are based on a few points, namely:

- 1) no market actor would provide energy without getting paid,
- 2) Russian companies are market actors,
- 3) Russia could not deliberately cut-off energy supply for political reasons as affected people in the wintertime would freeze (and Russia would never do such a thing),
- 4) the amount of money is so large that politics is awarded a subsidiary role.

Firstly, there is the question of whether no actor would supply energy without getting paid. If that is true, the key question is why companies (market-driven or not) deliver energy for several years and for several billions of dollar without getting paid? As otherwise customers would

freeze? Russia has deliberately provided substantial amounts of energy to non-paying customers within the CIS for almost a decade and a half. If this is done against Gazprom's wish (which it is), the Kremlin's priorities overshadows Gazprom's agenda and Gazprom's actions cannot be called market actions. Neither cannot Gazprom be stated to be committed to true market norms if it stubbornly fights to keep its monopoly position.

The result has been debts that constitute leverage on the customers. In turn, this has made possible take-over of infrastructure (instead of cash payments). Whether this was on Russia's agenda from the beginning is moot to discuss, but it is difficult to see how it could have been. It was nevertheless the result. Russia has thus become a pusher of energy to insolvent customers. Consequently, supply interruptions of various magnitudes has occurred. For long, any mechanism for handling these kinds of problems did not exist, but today when Russia calls for marketisation, it still aims to acquire infrastructure in the Baltic states, Georgia and Ukraine.

Debts are a natural consequence on non-payments. Cutting supply is therefore the logic consequence of non-payments. The interruptions have however coincided with important political events on several occasions, and there have been political demands or statements connected to the interruption (or threats thereof). At times, there have also been dramatic rises in energy price instead or in combination of interruptions (or threats thereof). The Kremlin thus appear to have interfered and decided when and how marketisation in relations to foreign entities should be carried out.

Discriminatory prices are further not a characteristic of a deregulated market, even if it is not a security problem. Russia is free to give price concessions on gas to poor but relatively friendly states (Belarus), high prices to poor and 'unfriendly' states (Georgia) or high prices to friendly rich states (Germany) if it wishes. As unjust and unfair as it is, Russia is free to take advantage of its monopolistic situation in order to boost revenues (if it wishes to act against prevailing market norms of third-party access). It however does become a security problem when Russia on politically important occasions raises prices dramatically, demands

immediate payments and threatens with cut-offs unless some political or military concessions are given (Ukraine and Baltic countries). In short, it is not market practice to invoke the market argument selectively, discriminatory and only at times when there is a political imperative (and refrain from it when it is not).

Secondly, one has to be rather generous in the definition of 'market' if Russia's state-controlled actors are labelled 'market actors' in the same way as Western companies. Companies, such as Gazprom, have not only been market-driven even if they seek profit. In addition to what has been stated above, Gazprom and Transneft are *de facto* monopolists and can thus act as such. That Kremlin officials are on the board of these and other companies in order to ensure the state's interests also bear witness of the political connections. In February 2006, Finance Minister Kudrin hinted that Russia might ease its grip on gas pipelines,<sup>953</sup> but Gazprom quickly declared that it would keep it its monopoly.<sup>954</sup> The Russian firms discussed here usually act by market rules (or at least practice) but there are political limitations to this, which means that they hardly can be compared to market actors in Europe for example.

Thirdly, cutting gas to the southern members of the CIS for a short period of time frustrating and problematic for the targets. It becomes cold and possibly life threatening in some cases, but it depends on the duration of the interruption in addition to when and where it is conducted. Russia has rarely paid attention to the well-being of its own or other citizens. Russia's or Gazprom's empathy is of little use as explanatory variable. It is in this context that the argument functions as a ricochet. What the argument says is that Russia cannot cut gas supplies, as people would freeze, while at the same time it is Russia's right to cut gas as a consequence of non-payment. This would indicate that people deserve to freeze for market reasons, but not for political reasons.

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<sup>953</sup> Boykewich, Stephen and Humber, Yuriy (2006), 'Kudrin Hints as Energy Reforms', *The Moscow Times*, Published: 13 February 2006, Last accessed: 13 February 2006, Internet: <http://www.moscowtimes.ru/stories/2006/02/13/001-print.html>.

<sup>954</sup> Belton, Catherine (2006a), 'Gazprom Rebuffs Western Pressure', *The Moscow Times*, Published: 14 February 2006, Last accessed: 14 February 2006, Internet: <http://www.moscowtimes.ru/stories/2006/02/14/041.html>.

Finally, money is important to Moscow. The cases mentioned here may have resulted in some minor economic losses, but for Russia that currently sits on a US\$162 billion currency reserve, it is negligible. The argument is only sustainable when it comes to long-duration cut-offs or when administering with countries important to Russia (eg. Germany). In the short-run or concerning small, non-paying customers, it is not an issue and it must be remembered that Russia is willing to take economic sacrifices for political gains.

### **The Barriers against Further Supply Interruptions**

A frequently occurring argument, especially from the business community, is that Russia is dependent on other states for revenues from energy exports. Therefore, the argument is that Russia would be unwilling to cut energy supplies.

#### *Russia's Need for Revenues*

The argument that Russian revenue needs constitute a barrier against supply interruptions is not entirely valid. Chapter two of this report shows how important exports revenues are for Russia. Stern argues that political cut-offs tend to become very expensive given the large value of gas exports and "consequently there is a tendency for them to be short term."<sup>955</sup> This proves the point that the barriers against cut-offs is only functional against long-term cut-offs.

The direct economic losses from the supply interruptions mentioned hitherto however appear to be rather small. For example, a two-day, 25 per cent, cut-off to Moldova that only buys 2-3bcm/year is not a real burden for Russia (while it would be highly bothersome for Moldova). As long as Moldova does not pay properly for its energy, it would not be a loss at all, but rather a gain (if the energy that transited through Moldova, which is around 22bcm/year, is excluded from the equation). In fact, even if it was only money, Russia could afford to lose several smaller states as customers. It would probably not have any bearing on important customers such as USA or China in terms of confidence in reliability.

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<sup>955</sup> Stern *The Future of Russian Gas and Gazprom*, p. 104.

If the magnitude of the losses is small, what conclusion can be drawn? Is Russia willing to cut supply and take economic losses and/or that Russia does not experience any heavy losses? If Russia's vision and intentions are considered in combination with what has happened, it can be stated that Russia is willing to take economic losses for political gains (but only if they are strategically important). It appears as if Russia initially takes enormous losses by supplying energy without getting paid. When supplies are cut, the additional economic losses are marginal (if the target does not pay for its energy it is only revenue from transit to third parties that are lost). If the result is that Russia is paid in kind, by infrastructure for example, there is room for great economic gains in the future. Therefore, it is reasonable to conclude that Russia's need to export energy for the reason of state revenues might have a restraining effect, but it is not enough to provide a barrier against supply interruptions that are short, partial and/or aimed at inconsequential customers.

Even if short interruptions have little impact on the energy needs, they are troublesome to handle in industrial, economic and political aspects. Hence, there is more to it than just the question of security of supply. Even if the debts are paid (for example by Moldova or Ukraine), their geopolitical importance remains. The conclusion is thus that Russia may see great political gains for a low economic price. Thus far, Russia has been more than willing to pay the price and the booming economy continuously provides Russia with greater room for further actions of this kind if it so wishes. A strong oil fund and currency reserves back-up Russia's actions. It can afford to be even less sensitive to international criticism than it is today.

In the long-term perspective, the situation is different. There is nothing that suggests that Russia would be willing to cut energy supplies for a prolonged period of time, not in peacetime at least. Here the economic argument is a case in point, as revenues are needed. Yet, there are scenarios where it could happen. Given the fact that Russia's extractable reserves gradually decline, there might not be enough oil to satisfy a booming domestic economy at the same time as exports simultaneously go to China, Japan, the US and Europe. Russia has already reached a

point where it has, to some extent, to prioritise among its customers (eg. China and Japan). Naturally, the domestic sector takes the first batch, but any surplus might go to consumers that are friendly, economically strong and where the technical and geographical prerequisites are advantageous. Any emerging spot-market of natural gas and LNG will hardly provide any plausible alternative to pipeline-borne gas from Russia to Europe. Russia's strong position as gas supplier will therefore remain.

If Russia's relations with a key consumer become troublesome at the same time as it has the possibility to export its entire energy surplus in another direction, the political and economic threshold for Russia to cut supply would be extremely low. This is currently not an issue, but given the unpredictability and discommodious development of Russia, it cannot be completely ignored.

### *Russia's Dependence on Transit States*

Another argument is that Russia is dependent on transit states for transit to third parties and, therefore, it cannot cut energy supply. In theory, being a transit country does provide a counter-lever, but it can be debated how strong it actually is. Former Soviet states host transit pipelines for 95 per cent of Gazprom's exports to Europe. It is thus exceedingly important for Russia that this large amount of gas can flow to export markets. Supply interruptions against Moldova affects also Romania, Bulgaria and Greece<sup>956</sup> while interruptions to Ukraine affect also most of Europe (as the Russian-Ukrainian gas row of 2005/2006 showed). Today it is highly unlikely that all supplies would be cut even if other aspects than volumes are disregarded. Parts of it could of course be cut, but not all. Hence, also this argument is only valid when it comes to long-duration cut-offs.

Europe has been affected by cut-offs to Belarus and Ukraine but, on the other hand, one expected cut-off to Moldova never materialised as it would also have affected Romania and Bulgaria. As Russia sees it, there are therefore geopolitical reasons to end its dependence on transit states

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<sup>956</sup> Fredholm *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, p. 6.

and foreign ports.<sup>957</sup> This is done for example by the Blue Stream or the NEG. Simultaneously, Russia increases its leverage on Belarus, Poland and the Baltic countries, to mention but a few. As such, Russia's foreign policy manoeuvring space increases. Transit dependence, trade, investments and loans provide some inertia, but are not complete safeguards.

### *Integration in the World Economy*

Integration with the West is another argument for securing energy supply and raise the threshold for cut-offs. To a large extent, this is true: the higher the degree of real interdependence, the higher the barrier. Today many states are dependent on Russian oil or gas, but Russia is also dependent on them for imports and as markets for its energy exports. Russia's dependence on, for example, Europe should not be underestimated, but this is, again, only a barrier against long-duration cut-offs – not against coercive policy in general or short-term interruptions.

However, there are also disadvantages. From the Baltic countries' point of view, integration in the EU has not only been beneficial but has made it easier for Russian firms to establish themselves and this is seen as a threat.<sup>958</sup> This only shows integration of a target, not by the perpetrator, which is something to bear in mind as some argue that Russia's aspirations to join WTO would promote rule of law, fair competition, transparency and predictability.<sup>959</sup> Thus far – it has not, but it might.

During 2006, when Russia chairs the G8, it will likely take the opportunity to stand out as a responsible great power. Already in February 2006, Finance Minister Kudrin indicated that Russia would undertake new reforms in line with international practice. France called on Russia to ratify the EU Energy Charter, but Russia could not say when it would.<sup>960</sup> If it did, and took other measures to become integrated

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<sup>957</sup> See Brodin, Alf (2002), 'Breaking Loose? Russian Reasons to End its Dependence on Foreign Ports', in: Joenniemi (Ed.) *The NEBI Yearbook 2001/2002* (Berlin: NEBI/Springer).

<sup>958</sup> Zashvili *Russian Investments in Lithuania: Politics, Business, Corporate Culture*, p. 32.

<sup>959</sup> Ögütçü 'Attracting Foreign Direct Investment for Russia's Modernization: Battling Against the Odds', p. 3.

<sup>960</sup> Boykewich and Humber 'Kudrin Hints as Energy Reforms'.

into international structures what it does not control itself, it would be an improvement from the current situation. Certain steps along this road can be expected.

### *EU or NATO Membership*

The EU does still not have a common energy strategy. The EU is a way neither out of dependence nor out of vulnerability. The cases above demonstrate that Russia has acted forcefully against the Czech Republic or the Baltic countries despite these being both EU and NATO members. Keith Smith has concluded that:

*[...] the large members of the EU are more interested in securing increased supplies of Russian oil and gas for themselves than protecting the new members against Russian monopolies and unethical trade practices".<sup>961</sup>*

If the EU developed a common energy strategy, there would still be intra-union conflicts over goals and means. Given the established bilateral cooperation, the impact may not be daunting at first. In either case, it will take a long time before the EU can act as a coherent unit to pressure Russia to stop using its foreign policy levers on its members.

Most often, the international setting and status of bilateral relations are of greater importance than membership in an organisation. For example, Belarus has been important for Russia, not the least as a transit state, and Belarus' alienation from the West has given Russia a stronger hand. But, when Russia's relations with Ukraine have been good, Belarus has been neglected and vice versa.

### *Dependence Management*

Domestic actions taken to secure energy supply and reduce dependence include measures such as diversification of imports or constructing storages for energy carriers. Self-sufficiency is not a cure against supply cut-offs, but a way of managing the problem. It is rarely enough for large crises, such as the one in the 1970s.<sup>962</sup> For some states, storages are also insignificant from a political perspective (as Russian companies own and

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<sup>961</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 63.

<sup>962</sup> Neu, C. R. and Wolf, Charles Jr. (1992), *The Economic Dimensions of National Security*, Santa Monica: RAND/National Defense Research Institute, MR-466-OSD, p. 52.

manage them).<sup>963</sup> They can therefore only be of assistance against natural disasters. This has value as natural disasters or technical failing often have a much larger impact than political unreliability, which Jonathan Stern correctly concludes.<sup>964</sup> This is also a relevant aspect when it comes to planning and assessing the safety of supply, but from a security policy point of view, it is not relevant.

If dependence reduces the foreign policy manoeuvrability by affecting relations to other states, it also infringes on the opportunities to affect Russia's development. Failing to see this dimension makes any security analysis of Russian energy supply flawed. It is therefore regretful that Monaghan connects the term of dependence to 'doomsday beliefs'. He further argues that it is a problem that analysts see the sum of the individual parts as resulting in a higher risk than if seen individually.<sup>965</sup> In combination, Russia's intentions, capabilities, track record, democratic trend and unpredictability is nonetheless an equation that raises concerns.

Most European states opt for diversification policies, but this has nothing to do with Russia. On the contrary, Russia is perceived as an alternative that reduces dependence on the volatile Middle East. Several EU states (and the US, China, Japan and India) have competed for access to Russian/CIS energy. Russian energy helps in diversifying their imports. It is thus not perceived as a reason for further diversification. This is an effect of increased dependence on imported energy and the geographic proximity to Russia. As long as this dependence continues, political badwill is of little importance to Russia. No sensible and dependent importer would stop trading with Russia for this reason. Russia's energy leverage will therefore remain.

Every state targeted by Russia's energy levers (or that runs the risk of being targeted) still perceives it as a top priority for its national security to reduce its dependence on Russia. Georgia, for example, will presently (due to the BTC and BTE pipelines) be able to turn its back on Russia for

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<sup>963</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 61.

<sup>964</sup> Stern 'European Gas Supply and Security Issues'.

<sup>965</sup> Monaghan *Russian Oil and EU Energy Security*, p. 16.

oil and gas deliveries. Had it not been for Russian control over the domestic energy sector and imports of electricity, Georgia would have leverage on Russian transit to Armenia. It is however implausible that all consumers of Russian energy will be able to diversify imports to the same extent as Georgia has. However, this is not that important. What is important is that states, such as Poland, USA and China, securitise the energy dimension and by that move energy into the list of national security priorities that may cause frictions. Perceptions of Russian unreliability (and historical policy towards Poland) may therefore guide Poland's policy to a much wider extent than it would have, had Russia not used its energy levers against the CIS states.<sup>966</sup>

Every incident of supply interruption; technical difficulties; fluctuating prices; unpredictable actions; political steering of the energy sector; expropriation would be an irritant for an importer. In a small scale, it would probably not affect the importing nation (but rather the importing company). End-consumers would subsequently be affected and finally the country as a whole would feel the effects. It might have little impact on the energy needs for power generation, but the commercial factors of refining and re-export would definitely experience the interruptions as soon as executed. If bilateral relations were dire, foreign companies located in Russia would also be targeted for exceptional bureaucratic hassle.

The government of the importing state must thus be conscious of the fact that domestic firms, third parties (those set to receive the re-exported products) and end consumers (that constitute the electorate) may react to governmental policy if they are affected by the negative consequences of the pursued policy. Resentment, therefore, may be directed towards the own government, not against the exporter that staged the interruption (as was the case with Ukraine in 2006).

In addition, there are environmental aspects linked to the security problems of energy. Both the EU and the Kyoto protocol require states such as Poland to decrease its emissions of greenhouse gases (GHG). This means that using more coal is not an option and unless it resorts to

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<sup>966</sup> See further, Tobiczyk and Unge *The Energy Problem - Security Leverage and Dependence (DRAFT)*.

building more nuclear plants, it has to import more energy from Russia. Another case is Estonia that has possessions of shale oil, but using it would be an environmental drawback.<sup>967</sup> Hence, the energy needs can be satisfied in one of three ways. Russia's neighbour can choose to pay for its needs in: 1) increased dependence on Russia, 2) increased pollution or 3) in money, for example by building nuclear reactors or paying excessive amounts for diversification (for example from Norway). The conclusion is hence that dependent management is not a barrier, but rather a way of ease the problems.

### *Risk of Badwill*

There is animosity in the eyes of the international community in Russian open supply interruptions. Russia must thus consider at least theoretically the negative implications to be of less significance than the political or economic objectives it aims to reach. The less the international community cares, the lower the threshold. Also, the greater the magnitude of such actions, the greater the negative implications are.

The badwill Russia has received in the West up until 2006 was less than what could have been expected from such behaviour. Western states understand that the threshold for Russia to attempt extortion or likewise against them is so high that only very important political objectives could provoke such actions. In times of good relations, there are few such objectives. Yet, amity can quickly turn into enmity, resulting in boycotts or something equally disruptive. Given the structural instability and unpredictability that exists in Russia, it would be unwise to see this as strong barrier. In 2006, Europe erudited that it could be affected by actions taken by Russia at third parties.

Circumstances where Russia's relations with the international community are amiss that Russia considers the negative implications to be of only marginal importance would provide few barriers against bad behaviour. Some economic losses and damaged reputation within the CIS does have not troubled Russia. Probably it knows that most states have to import energy from Russia also in the future.

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<sup>967</sup> Smith *Russian Energy Politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?*, p. 29f.

It could be argued that the drivers behind Russia's policy are of minor importance, as the actor being targeted will be affected. This is true, but the underlying factors illustrate two things. One is that the political level is prepared to endure political animosity not only for its political priorities, but also for economic factors (where the revenues mainly but not exclusively go to energy firms). The second point is that energy companies are willing to conduct economically unwise activities in the interest of the state.

### *Friendship and Partnership with Russia*

The argument of a sole market rationale behind Russia's energy policy would be enhanced if Russia did not supply energy to any non-paying customer. Domestically there are entities that according to the energy strategy for social or strategic reasons cannot be left without power, but this is not the case abroad. Despite frictions, Belarus is perceived as Moscow's ally, but still it has had its supply cut. The explanation is that Russia cuts supplies when relations are bad and refrain from doing so when it needs Belarus (and relations are good).

Categorically speaking, Russia does not have any real allies or friends within the international community, especially not based on common values. Therefore, any discussion about 'strategic partnership' is void. The strategic partnership with China, often referred to by analysts, is under closer scrutiny revealed as a 'tactical partnership' aimed at thwarting American hegemonic ambitions. Friendly relations with Armenia, Belarus and Tajikistan are rather to be characterised as dependence.<sup>968</sup> Previous chapter demonstrate that even if Belarus has a positive relationship with Russia, frictions exists and unless Belarus follows in Moscow's leash, the relation quickly worsens. Russia also has a partnership with the EU, but Russia's actions against its members have been far from partner-like.

Naturally, export volumes make, for example, Germany more important to Russia than CIS states. Relations have also been positive with the existence of a close friendship between Gerhard Schröder and Putin.

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<sup>968</sup> Leijonhielm, *et al.* *Ryske militär förmåga i ett tioårsperspektiv - problem och trender 2005* [Russian *Military Capability in a Ten-Year Perspective - Problems and Trends 2005*], pp. 64-91 and pp. 182-184.

Hence, there have been few reasons for supply interruptions. However, as seen above, Germany has refrained from taking a policy line that would upset the Kremlin and hence there has been no indication of friction that could result in a cut-off. The result has thus been that Germany's foreign policy manoeuvrability has, at least partially, been infringed – a problem not seen in the energy relations *per se*.

### *True Barriers*

As this report concludes, the only strong barriers against misconduct are that Russia has a sincere intention of becoming a reliable supplier. This does not stem from Russia turning to an altruistic policy, but rather that it aims to show the world how important it. In addition, Russia is dependent on the overall relations and trade with the international community (even if the economic dependence on one single trade partner is less important). By being one of the supreme suppliers of gas and oil, it in some ways has retaken its great power status. With 'great-powership', responsibility follows and having this position stipulates that Russia would hardly exploit every possibility to act forcefully. But, by all means, Russia would (as other great powers) be prepared to, if it finds it necessary.

### **Extent of Russia's Capability and Intentions**

Domestically Russia cannot control all actions on the oil or gas markets, but it can, to a large extent, control the important ones. If superfluous actions do occur, the state has both capability and intention of correcting or punishing them (like in the case of Yukos). The manoeuvrability and responsiveness of the energy market is extremely high and the Kremlin gradually strengthens its powers over the sector. There are infringements, for example interdepartmental struggle, but in most strategic cases, the Kremlin's desires are essentially observed by both state bodies and energy corporations. This is imperative as it relates to the Kremlin's ability to utilise energy as a foreign policy tool.

The Kremlin can also control energy flows from Russia. It has a firm grip on key positions in the most important corporations, has a *de facto* veto over strategic projects and controls all pivots and important infrastructures, especially pipelines. Also in this context, the Kremlin has

the last word. It does not always have to act by force, as several actors act in harmony with the Kremlin's wishes. Similar to the development of Russian media, there is a form of self-censorship where energy firms refrain from acting in opposition with Moscow's intentions. Putin is basically creating a culture of a 'politically correct market economy'.

Russia's actions abroad confirm what has been stated in its energy strategy, especially in the CIS context. Energy firms and the state often have converging interests. Strategic priorities and security policy set the framework that private actors work within. Occasionally energy firms have conflicting agendas and become obstacles to state policy. Whether further re-nationalisation of the sector will come about is uncertain. A full-scale expropriation programme would not be in the interest of the current administration, but the Kremlin will definitely continue to strive to secure control over the market. Strategic assets will be kept or retaken into state control, while in other cases it is likely that privatisation and marketisation will be guiding principles.

A key factor is the unpredictability of Russia's development. Russia's political institutions are not as stable as they appear and the Russian constitution provides the President almost unlimited power to conduct policy as he sees fit. The parliament has become a conveyor belt for presidential decisions and today consists of officials who formally represent the regions, but who are handpicked by the presidential administration (which is not consistent with the constitution). There are no democratic barriers against bad behaviour; neither checks nor balances.

Hence, the situation is contradictory. The energy strategy and pursued policies are signs of stability and predictability. Since 2003, the policy line is more coherent than before. The problem is at the structural level. The lack of institutional stability questions the predictability. Ruptures may appear quickly, for example due to acts of terrorism or in connection with the presidential election of 2008. As Russia has 'securitised' many of the energy issues, it has indicated that it is prepared to tackle them by extraordinary means. The existing stability is therefore a mirage.

### *Control of Neighbours by the Energy Levers*

Concerning natural gas, which is not yet traded on an international spot-market, Russia's strength is not seen in its effect on prices or the amount of gas provided to the international market. Russia's supply levels nonetheless have a direct bearing on end-consumer and/or transit states. Gas deliveries chiefly rely on pipelines, which make diversification difficult or impossible in the short-run. This is one reason why several states have chosen to build LNG regasification terminals. Gas dependence is hence more problematic than oil dependence.

Russia is able to control the gas flows to those states to which it is the sole provider. As proven, this has not resulted in control of the actions of the target states, but it has clearly affected them and possibly, it has an impact on the margin of their behaviour. It can be assumed that the greatest impact has been increased scepticism of Russia's policy in general.

In regards to oil, Russia's premier position as producer naturally affects world market prices, but as it functions at maximum capacity, it has little power to affect prices or supply by raising export levels. Even if it wanted to increase exports at the expense of domestic customers, bottlenecks would today infringe on this possibility. An oil glut is therefore unlikely to originate from Russia.

As Andrew Monaghan correctly points out, the link between consumers and producers of energy is vital to explore and three ramifications must be highlighted. First, there is the issue of prices that have a great impact on the method and willingness to export. For example, oil deliveries by train to China would not be conducted unless prices are high. Secondly, Russia as an exporter wants reliable export facilities it must include the threats of a blockade at a transit state. Third, perceptions are key factors in energy security. It adds to the feeling of vulnerability, even if fears are not always justified. This connects to the second point and consumer countries have in fact staged boycotts against producers more often than producers have turned off the tap.<sup>969</sup> Despite the fact that Monaghan acknowledges the dimension of perceptions, he fails to acknowledge that

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<sup>969</sup> Monaghan *Russian Oil and EU Energy Security*, p. 4.

perceptions held by the newly independent states at least partly are based on the policy pursued by Russia and the Soviet Union.

Importantly, Russia is not able fully to control the importing states even if it controls the energy flows. Russia has definitely been able to affect them but the outcome from Russia's point of view has been meagre. The ability is continuously strengthened by the take-over of infrastructure and companies.

It must be remembered that Putin has adhered to a pro-Western policy, something he has been criticised for at home. The current development has been far from a worst-case scenario for Europe. This is stressed, as this review may serve as an ominous prophecy. If the next president is anti-Western, the energy policy would be expected to take the same route. Unpredictability and uncertainties are key arguments for importers of energy to abstain from relying entirely on Russia.

When Monaghan assesses this aspect, he finds that if it was to happen, it is unlikely that Russia would pursue a deliberate policy of threatening the EU. A negative development would rather reflect an emerging 'energy security dilemma'.<sup>970</sup> In short, this indicates that if the EU is apprehensive of Russia cutting supply, it will spend greater efforts to diversify, which leads to Russia trying to find other export routes (as the EU appears unwilling to trade with Russia). This is a key problem. However, if Russia further isolates itself from Europe and has the option of selling energy to other customers, there would be no barriers keeping Russia from cutting the energy flows. This generates at least two points to consider.

First, the perceptions held by Putin and other key actors in combination with the pursued policy and the energy strategy are evidence that Russia today would not be less prepared to use the energy weapon, but rather the opposite. Second, given the nature of pursued policy and Russian attempts to create an image of being a reliable supplier, it is reasonable

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<sup>970</sup> Ibid., p. 15. This is a term developed on the basis of the 'security dilemma', a key concept of the Copenhagen School of Political Realism in IR theory, see Buzan, Barry, *et al.* (1998), *Security: A New Framework for Analysis* (Boulder: Lynne Rienner).

to assume that the energy lever will not be utilised excessively and inconsiderately. Instead, if used at all, it will likely be utilised selectively, probably covertly and surely under a legitimate pretext. As usage serves no end *per se*, Putin is probably wise to reduce the frequency of its use as much as possible. Russia's great power ambitions demonstrate that its intentions are consistent over time, while the capability and tools at disposal change, as does the method of utilising them. Russia has a pragmatic approach and it resorts to economic instead on military means in its foreign policy.

## 8 Summary and Prospects for the Future

The objective of this study is to elucidate on Russia's role as a strategic energy supplier by analysing its energy policy from a security perspective. Consequently, the aim has been to assess the question of whether Russia is a reliable supplier of energy.

This has been completed by assessing the research questions: Why, to what extent and for who are Russia's energy resources important? What are Russia's perceptions, intentions and position to its commodities, exports and energy relations? What are the Kremlin's capabilities and how are they used when it comes to managing the domestic market? How large is the Kremlin's control of the energy sector? What is Russia's foreign energy policy? What is Russia's track record in terms of reliability and usage of the energy levers? What are the objectives, drivers, trends, patterns, outcomes and ways of using the energy?

A few over-arching conclusions that can be deduced from the material is shown in the beginning of this report. Below is a summary of the domestic trends, intentions, strategic priorities, capabilities and prospects for the future. Key conclusions are found in the beginning of the report.

### **The Domestic Trends**

Since the Yeltsin era, there have been tremendous changes in the energy market in Russia. Chaos and anarchy have been replaced with order and authoritarianism. Since Putin's inauguration, state control over the sector has gradually been restored, especially since 2003. An energy strategy has been launched, the last of Yeltsin's disciples have been ousted, and Putin has appointed loyal personnel to virtually every important position in state controlled energy corporations (Rosneft, Gazprom, UES, Transneft etc.) and governmental bodies (ministries, agencies, services, commissions, committees, parliament, etc.).

Wealth and power are transferred not only to the state, but also to individuals who stand close to the Kremlin. This group typically consists of hardliners or siloviki, i.e. persons with a background in the security

structures, who now holds both top positions within the state bodies and energy firms. They have come to replace the banking oligarchs as the real men of power in Russia. These new oligarchs act politically correct and controls both politics and business. There are indications that privatised assets might be brought under state control, just to be later redistributed to the state-loyal energy oligarchs at a later time.

Laws and regulations (including taxes, tariffs, licensing, duties, and quotas) have been altered in order to increase state control of the market. Some privatisation and liberalisation attempts have been carried out, but transparency is decreasing in vital areas. While private companies have a strong impact on economic growth in Russia, the growth stemming from state-controlled enterprises is negligible.

The gas sector is still administered in Soviet style and the ongoing restructuring will only improve the situation marginally in the near future. The oil sector has largely come to function as a normal market, but state control remains over resources and pivots for exports. Huge oil and gas windfalls have made Russia economically insensitive for the time being, but structural problems remain and undermine the stability.

To a large extent, formal and informal powers are transferred to Kremlin-loyal firms (Gazprom, Rosneft, Lukoil, RAO UES of Russia, Zarubezhneft, Surgutneftegaz and Transneft) at the expense of more market-oriented ones (Yukos, TNK-BP). A *de facto* re-nationalisation has struck Yukos (and its leader Mikhail Khodorkovsky). The Khodorkovsky affair has mainly been about him, his political ambitions, his unwillingness to submit to the president, and his background as a 'thief of state property'. The Yukos affair has taken place at a much higher level. It has been about transferring powers to the state and a 'retake' of what has been stolen in combination with thwarting behaviour not sanctioned by the Kremlin.

At least 17 negative consequences of these affairs can be distinguished. In almost every aspect, the Kremlin's priorities have been fulfilled. The lasting negative outcomes have been modest. It was a precedent case, but more cases may follow. The threshold for this is high, but history has

shown to what lengths the Kremlin is prepared to go. The state has interpretation priority in these types of processes and the practice has a history of selective and retrospective application of law. Political underpinnings of the judicial processes are also present. Seen in light of the growing power of the hardline, there is room to question the ongoing marketisation and stability.

State-loyal energy firms essentially implement the Kremlin's wishes and the Kremlin supports them versus competitors – foreign and domestic. The state and the market often act in conjunction on strategic matters. Rogue actions by the major actors are continuously decreasing. If they occur, they appear to be sanctioned or tolerated by the Kremlin. Putin has managed to create a culture of a politically correct, state-controlled but semi-market-run energy sector.

Strategic decisions are formulated and carried out within a state-centric security framework, while many of the actions abroad take place and adapt to market rules. This does not signify that prominent companies are purely market-driven actors in a Western sense. There are numerous companies (Eural Trans Gas, Baikal Finance Holding, Trubny Torgovy Dom, Kineks) that could be characterised as questionable and that have been acting in tune with the pro-Kremlin firms listed above (and that allegedly have or have had connections to Putin or his party United Russia). This has had severe implications for stockholder and foreign entities both politically and financially.

### **Russia's Intentions**

At aggregated levels, Russia's intentions are not entirely secret. Perceptions and intentions are vividly expressed in statements and official documents. The next security concept and doctrines will include, in all probability, energy issues.

Russia's strategic ambition is to utilise its energy policy as a sword and a shield in its security policy. It takes opportunities to increase both political and economic influence domestically and abroad. As the overarching task of the energy policy is to ensure national security, Russia's foreign energy policy ought to be seen in a geopolitical perspective. The

strategic drivers behind Russia's energy policy do not necessarily stand in contrast to economic, political or market goals. These are all present but, nonetheless, subjugated to the overall strategy. Securing Russia's independence and integrity is highly prioritised. The policy aims at thwarting upcoming threats. The most important ones are the economic threat of being blackmailed (which has occurred by Turkmenistan, Turkey, Moldova and Ukraine), the geopolitical threat stemming from increased foreign interventions in what is seen as the Russian sphere of influence (i.e. competing pipelines such as the BTC and BTE) and the economic risks from dependence (i.e. transit fees).

Simultaneously, Russia aims to become integrated in international structures and be a reliable trading partner. This aim is seriously meant, but Russia sees specific limitations to the processes. In the Russian notion of security, there is a contradiction between integration and security. Integration relates to the dependence and therefore less manoeuvrability. Hence, integration can hence only continue as long as it is not at the expense of independence. Likewise, Russia tries to play by the international rules, but appears to prefer to create and play by its own rules. These balancing acts explain much of Russia's contradictory behaviour. Authoritarianism and marketisation develop hand-in-hand.

In addition, there is the perceived risk in Russia of commodities ending up in foreign hands. Laws have therefore been introduced concerning maximum shares of foreign ownership and state control over subsoil resources. This has been strongly criticised by foreign investors. The state will undoubtedly keep its grip on the strategic assets (i.e. subsoil resources, energy corporations, and infrastructure) in addition to bureaucratic control over certain pivots and core bodies. Outside of this strategic frame, marketisation will continue. Collectively a pattern of mixed authoritarianism and market features emerge. Marketisation continuously provides foreign actors and investors vast business opportunities, but there are strong embedded political risks. Uncertain and unclear laws/regulations have made all business-relation actions questionable. The political risks however are smaller than those in Africa, the Middle East or Venezuela.

### **Strategic Priorities**

Russia strives to become a regional superpower and a strong international player, but is not yet a global power. It aims to reintegrate the energy sectors of the CIS and Eastern Europe but ownership *per se* is not the key issue; it is the ability to control, affect and influence that matters in the political and economic contexts. One tool is the Common CIS Energy Market. Russia's intentions to acquire infrastructure and energy companies abroad can be seen in this light. By this undertaking, Russia's dependence on foreign actors decreases. The objects nonetheless see it as a security problem with increased Russian influence as it provides Russia with greater leverage. At the same time, the risk of Russia using the leverage on its own entities is minute

Good relations with the EU and the USA are sought after and coincide with Putin's pro-Western policy, but Russia trusts neither them nor any other player (i.e., Japan, China). Despite partnerships with the EU, Russia has acted forcefully against its members. The pro-Western course could quickly change in 2008 when Russia gets a new president.

Actions abroad are often conducted within a market framework, but there are also economic and political drivers that aim to reach geopolitical goals. Analysts who argue that there are only market drivers are incorrect. Russia is using its commodities as bait for foreign actors. Therefore, China and Japan, for example, compete for access to Russia's energy resources, but Russia's strategic priority is to avoid dependence on one route of exports. This indicates that in the eastern dimension, Russia strives to ship energy from the pacific coast so that it can reach several customers. China's political stand and willingness to pay for Russian energy ensures access.

### **Russia's Capability**

Russia's supply of oil and gas are tremendously important to world markets. Export revenues from energy are of paramount importance for Russia's economy and growth. Given the size of its resources and level of production, supply has an extremely strong impact on the markets and any fluctuation is instantly felt. However, Russia can only marginally control consumers and markets. Furthermore, it cannot control all

actions in the domestic oil or gas markets. However, to a large extent it is able to control all important actions and has the ability to affect most consumers. It has the power to act in an obstructionist manner. In addition, the Kremlin has the power to correct or punish unwanted actions.

The manoeuvrability and responsiveness of the fuel and energy complex appears to be high. There are both strong formal (laws, regulations) and informal (personal connections) ties. The President, the Kremlin and the state have strengthened their control over the sector in both formal and informal practices. The security and clandestine services have generally been strengthened under Putin, as well as their influence over the energy sector (i.e., FSB has been given new tasks concerning economic security).

The powers of the president are nonetheless problematic. He is powerless and powerful at the same time. This has, and may further result in overzealous actions, for example by *de facto* renationalisation of private companies. In strategic energy matters, it appears that all state intentions can be implemented. The Kremlin's wishes are most often obeyed by both state bodies and by energy corporations. The parliament has become a conveyor belt for presidential decisions.

The Kremlin is also capable of controlling energy flows from Russia. It has a firm grip on key positions in the most important corporations and has the last word in all strategic projects. In terms of production, the Kremlin basically controls 100 per cent of the gas and 30 per cent of the oil. In addition, it controls all vital pivots and important infrastructures for exports. It does not consistently have to act by force as several actors act in harmony with the Kremlin's desires, sometimes due to a form of self-censorship where energy firms refrain from undertaking things that stands in conflict with Moscow's intentions. This example of the Kremlin's subtle power should not be forgotten.

### **Usage of the Energy Levers**

The energy levers have been used in several ways and for several reasons. Underlying and correlated drivers include enforcement of political concession in ongoing negotiations; enforcement of

infrastructure take-over, enforcements of economically favourable deals and for making political statements. Practically this means that several actors have been subject to supply interruptions (total or partial), threats of supply interruptions (covert or explicit), pricing policy (prices as carrots or sticks), usage of existing or creation of energy debts and hostile take-overs of companies or infrastructure.

Apart from domestic actors, this has been used against three kinds of actors: primarily it has been against the former Soviet territory, even if some are EU and NATO members (Baltic countries). It has, although not intentionally, struck former Warsaw Pact members that now are EU and NATO members (Poland) as 'collateral damage'. Thus far, the West has been spared from cut-offs, but has been greatly affected by other forms of energy policy, such as take-over of companies (Finland). An analysis of the underlying drivers suggests that there are both political and economic underpinnings even if certain actions appear market driven.

### **Outcome and Consequences of Usage of the Energy Levers**

Usage of the energy lever must be seen as an extensive process. It has been identified that Russia has been unsuccessful in enforcing political concessions, but has been rather successful in taking over infrastructure or advocating discriminatory pricing policies. Hence, if primarily the interruption is considered, Russia appears to have gained little and lost much. In fact, the Russian inclination to repeatedly conduct this type of policy has remained.

The deterrent aspect of cut-offs have also been substantial as there is immense credibility in these type of actions especially given Russia's previous behaviour. Dependence on Russia appears to have affected their foreign policy and increased the element of appeasement (i.e. Germany). States with energy needs must thus prioritise between spending money on diversified imports (Georgia), adhere to further pollution (Estonia), promote nuclear power (Poland) or increase its dependence on Russia thereby running the risk of limiting the foreign policy and manoeuvring space. Dependent states must be, in such a case, willing to sacrifice both its freedom of actions as well as its relations to less important countries (i.e. Germany towards the new EU-members).

Russia's behaviour causes serious frictions between Russia and importers, for example the EU. It will also constitute an obstacle for development of a common European energy strategy or a common gas market with Russia.

The barriers against Russia using the energy weapon are low or non-existent, especially in the short run. Control over transit is a counter-lever, but is insignificant in the short run as Russia is willing to accept both economic losses and political badwill. EU or NATO membership is not a strong safeguard and Russia becomes increasingly insensitive for both political criticism and economic losses due to its political course and currency fund. The frequency of cut-offs is clearly decreasing, but its capability is however increasing.

### **Russia's Reliability as an Energy Supplier**

Russia's political reliability as an energy supplier depends on the time perspective, the receiver and the context. By and large, Russia is a reliable supplier in such that most of its energy exports has reached (and will reach) its destination. This does not mean, however, that energy flows necessarily will be spared from interruptions or political and economic frictions.

The risk for supply interruptions aimed at the states of the Former Soviet Union (FSU) is present today. Depending on bilateral relations and the present context, the risk for partial and/or short-duration cut-offs is high, especially against Belarus, Ukraine, Moldova and Georgia. In the short-run, the risk for total and/or permanent cut-offs is low for all these states. In the long run, risks are difficult to estimate, but cannot be overlooked.

The risk for supply interruptions aimed at non-FSU Europe is presently very low. There is, however, a high risk for non-FSU Europe to be affected by interruptions aimed at any of the FSU states. Russia appears to see certain European states affordable collateral damage.

Preceded by a severe political crisis, the risk for partial and/or short-duration cut-offs aimed at non-FSU Europe increases. In that case, it

would likely be aimed at a specific importer rather than at a group of states (such as the EU). Risks in the long-run perspective are difficult to estimate. Anything can happen. If a total and/or permanent cut in supply to Europe would materialise, it would have to be preceded by a serious degeneration of relations in combination with a developed technical ability for Russia to export energy elsewhere.

The barriers (Russia's needs for exports revenues, transit dependence and risks of destroyed reputation etc.) against short and partial supply interruptions and coercive policy are weak. They are only safeguards against long duration cut-offs against or against important customers. If Russia were to develop in a democratic direction and show genuine commitment to market reforms, the threshold would increase. It would also increase if Russia would ratify and follow the EU Energy Charter. It would also have to pay less attention to its strategic ambitions and adhere to the European tradition of embracing true interdependence.

Presently, there is a risk for experiencing coercive policy, 'annoying behaviour', 'technical problems', 'contractual disputes', 'discriminatory price policy' or similar problems aimed at reaching geopolitical, political, or economic goals for almost all receivers of Russian energy. The risk is higher for the FSU as Russia's priorities and leverage are strongest there. Practically, Russia does not have the resources to target all states but can act on a few markets at a time. It is apparent that the consequences are far-reaching no matter is the target. Russia will likely not strive to use the energy lever for the sake of it, but it will by all means strive for a strengthened capability. By all means, it would be prepared to use it if it deems so necessary.

From Europe's perspective, Russia is moving in the wrong direction. Russia has largely ignored criticism, and has been unwilling to change its behaviour. Dependence on Russian energy would not be a problem if Russia played by the same rules as other energy players or European states. In conclusion, the core problem is the combination of Russia's perception, intentions, capabilities and track record along with lack of real stability, a high degree of unpredictability and a development away from democracy, rule of law and market norms.

## Appendix I: Acronyms

<b>ABM</b>	Anti-Ballistic Missile
<b>ACG</b>	Azeri-Chirag-Guneshli
<b>AES</b>	American Energy System
<b>ASPO</b>	Association for the Study of Peak Oil
<b>Baltrel</b>	the Baltic Ring Electricity Co-operation Committee
<b>Bd</b>	Barrels/day
<b>Bcm</b>	Billion cubic meters
<b>Bmt</b>	Billion metric tons
<b>BPS</b>	Baltic Pipeline System
<b>BTC</b>	Baku-Tbilisi-Ceyhan Oil Pipeline
<b>BTE</b>	Baku-Tbilisi-Erzurum Gas Pipeline
<b>Btu</b>	British thermal units
<b>CDU</b>	Central Dispatch Unit
<b>CNOOC</b>	China's National Offshore Oil Corporation
<b>CSIS</b>	Center for Strategic and International Studies
<b>Cif</b>	Cost, insurance, freight (for prices)
<b>CIS</b>	Commonwealth of Independent States
<b>EIA</b>	Energy Information Agency
<b>EU</b>	European Union
<b>FAPSI</b>	Federal Agency for the Protection of Government Communications
<b>FEC</b>	Federal Energy Commission
<b>FEK</b>	<i>Federalnaya energeticheskaya komissiya</i> (Federal Energy Commission)
<b>FOA</b>	<i>Försvarets forskningsanstalt</i> (Swedish Defence Research Establishment, FOI)
<b>FOI</b>	<i>Totalförsvarets forskningsinstitut</i> (Swedish Defence Research Agency)
<b>FPS</b>	Federal Border Service
<b>FSB</b>	<i>Federalnaya Sluzhba Bezopasnosti</i> (Federal Security Service)
<b>FSO</b>	Federal Guard Service
<b>FT</b>	Financial Times
<b>FTS</b>	Federal Tariff Service ( <i>Federalnaya Sluzhba po Tarifam</i> )
<b>IEA</b>	International Energy Agency
<b>IPO</b>	Internal Public Offering
<b>KPRF</b>	Communist Party of the Russian Federation
<b>G8</b>	Group of eight
<b>GDP</b>	Gross Domestic Product
<b>GHG</b>	Greenhouse Gases
<b>GTE</b>	Gas Transport to Europe
<b>GUSP</b>	Main Directorate for Special Programmes
<b>GUUAM</b>	Georgia, Uzbekistan, Ukraine, Azerbaijan, Moldova (organisation)
<b>IGO</b>	International Governmental Organisations
<b>INOGATE</b>	Interstate Oil and Gas Transport to Europe
<b>JSC</b>	Joint Stock Company
<b>LDPR</b>	Liberal-Democratic Party of Russia
<b>LNG</b>	Liquefied Natural Gas
<b>MIC</b>	Military-Industrial Complex (also VKP/OPK)
<b>MFA</b>	Ministry for Foreign Affairs (MID)

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<b>Mcm</b>	Million cubic meters
<b>Mmt</b>	Million metric tons
<b>MP</b>	Member of Parliament
<b>MPR</b>	<i>Ministerstvo Prirodnikh Resursov</i> (Ministry of Natural Resources)
<b>MPS</b>	Murmansk Pipeline System
<b>MNR</b>	Ministry of Natural Resources
<b>MVK</b>	<i>Mezhhvedomstvennaya komissiya</i> (Interdepartmental Commission)
<b>NATO</b>	North Atlantic Treaty Organization
<b>NEG</b>	North European Pipeline System (Baltic Undersea Pipeline System)
<b>NGO</b>	Non-Governmental Organisation
<b>NSC</b>	National Security Council
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>OPEC</b>	Organization for Petroleum Exporting Countries
<b>OPIC</b>	US Overseas Private Investment Corporation
<b>P/R</b>	Production/reserve ratio
<b>PPP</b>	Purchase Power Parity
<b>PSA</b>	Producer Sharing Agreement
<b>REC</b>	Regional Energy Commissions
<b>RFE/RL</b>	Radio Free Europe/Radio Liberty
<b>RTS</b>	Russian stock exchange
<b>SCO</b>	Shanghai Cooperation Organisation
<b>SOMO</b>	State Oil Marketing Organisation
<b>SPS</b>	Union of Right Forces
<b>SVR</b>	<i>Sluzhba Vneshey Razvedki</i> (Foreign Intelligence Service)
<b>SÄPO</b>	<i>Säkerhetspolisén</i> (Swedish Security Service)
<b>TEK</b>	Fuel and Energy Complex
<b>Trcm</b>	Trillion cubic meters
<b>Tcm</b>	Thousand cubic metres
<b>TRA</b>	Tax/Royalty Agreements
<b>TRACECA</b>	Transport Corridor Europe Central Asia
<b>TPES</b>	Total primary energy supply
<b>TsPDU</b>	<i>Tsentralnaya Dispetcherskim Upravleniem Ministerstva Energetiki or Tsentralnogo proizvodstvenno-dispetcherskogo upravleniya</i> (Central Dispatch Unit)
<b>TWG</b>	Trans World Group
<b>UCTE</b>	Union for the Co-ordination of Transmission of Electricity
<b>UES</b>	United Energy System
<b>UNCLOS</b>	UN Convention on the Laws of the Sea
<b>UHL</b>	Unconventional Hydrocarbon Liquids
<b>UN</b>	United Nations
<b>VAT</b>	Value-Added Tax
<b>VIC</b>	Vertically Integrated Company
<b>WTO</b>	World Trade Organisation

## Appendix II: Comments on Data and Statistics

In general, energy statistics have great uncertainties. Russian energy statistics have further peculiarities that must be considered. A few issues adding to the uncertainty are:<sup>971</sup>

### Issues of Uncertainty

- 1) Figures are often estimates that are rounded.
- 2) There are continuous changes in the patterns of consumption of non-petroleum-based additives and substitute fuels.
- 3) There are disparities in terms of definitions and conversions concerning measurement and data.
- 4) There are stock changes and it is often unclear what has been included.
- 5) Reports rely on different sets of data.
- 6) Large amounts of oil are transported, especially in the early and mid-1990s, outside ordinary channels, labelled 'regulated exports' to CIS states.
- 7) Occasionally oil produced by other countries is routed via Russia and therefore is considered to be Russian, although it is not.
- 8) Some exports are shielded from official statistics and are thus not accounted for.
- 9) The constant reorganisations of the market have led to statistics not being able to keep up in a satisfactory way.<sup>972</sup>

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<sup>971</sup> A few of these point are outlined in: BP (2003b), *Statistical Review of World Energy - June 2003*, London: BP.

<sup>972</sup> See, for example: Stinemetz 'Russian Oil Sector Rebound under Full Swing', p. 30.

- 10) There are not only problems with Russian statistics. EU data, for example, show imports of oil by country of destination – not country of origin.
- 11) As far as export figures are concerned, exports by train are usually not included in statistics and the use of this form of transport for exports is increasing.<sup>973</sup>
- 12) Concerning prices, only approximately 50 per cent of the world's oil is traded on a single and integrated spot market. Often, the oil does not leave the country of origin and is thus domestically priced. Apart from politics, prices are dependent on small differences and actions that are sensitive to costs and qualitative factors, such as viscosity and sulphur contents.
- 13) Various idiosyncratic methodologies may have been employed by the institution providing the data.
- 14) In terms of reserves, it must be noted that categories such as 'hypothetical'<sup>974</sup> do not have support of geological evidence.
- 15) Another reason why figures differ between countries is temperature. Gas volumes in Russia are measured at 20 degrees Celsius while European standard is 15 degrees. The difference in volume is 7%, which explains some discrepancies
- 16) Figures of imports/exports are often based on data of contracts instead of physical amounts actually imported or exported.
- 17) Issues such as 'transfer pricing' add uncertainty to financial energy data.
- 18) There are different ways of calculating and estimating GDP (i.e., IEA vs. Russia).<sup>975</sup>

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<sup>973</sup> Labuszezwska, Anna (Ed.) (2003), *The Resource Wealth Burden: Oil and Gas Sectors in the Former USSR* (Warsaw, Osrodek Studiów Wschodnich (OSW)), p. 11.

<sup>974</sup> See Table 15: Comparative Classification of Oil Reserves.

### Models of Classification

Russia has several crude qualities, but two are of special importance: Ural Crude, which is a blend of several qualities that are mixed during production and transport, and Siberian Light, which is of much higher quality when it comes to sulphur content. The latter is exclusively transported in pipelines from the Tyumen region to Tuapse at the Black Sea coast, while the former goes by other pipelines.

It is also worth pointing out that assessments of oil reserves differ between various countries and the table below illustrates how they can be compared. For example concerning the term 'proven', what is considered to be proven in the Russian system also encompasses what is considered to be only 'probable' in the international system. Usually in international standards, 'proven reserves' are defined as

*[...]those quantities which geological and engineering information indicates with reasonable certainty can be recovered from known reservoirs under existing economic and operating conditions.<sup>976</sup>*

If one attempts to compare the two estimates, an indication of how to read the Russian half of the table is given when looking at an assessment of Yukos' oil made by international auditing firms. This assessment suggests that approximately 80% of the Russian categories A+B+C1 are feasible as 'proven'. Category C2 ought to be reduced by 50% in order to be in line with international estimates.<sup>977</sup>

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<sup>975</sup> IEA *Russia Energy Survey 2002*, p. 50.

<sup>976</sup> BP (2004b), *Statistical Review of World Energy - June 2004*, London: BP.

<sup>977</sup> Energimyndigheten *Den ryska oljan: nuläge och framtidsmöjligheter [The Russian Oil: Current State and Possibilities for the Future]*, p. 31.

Table 15: Comparative Classification of Oil Reserves						
Russia and Former Soviet Union			USA and Saudi Arabia et al.			
Reserves	Proven	A	Identified	Showed	Drilled	Proven
		B			Unused	
		C1			Indicated	Probable
	Estimated	C2			Calculated	
Assets	Expected	C3	Possible			
	Foreseen	D1	Hypothetical			
		D2	Speculative			
<p><b>Source:</b> Russian Ministry of Energy, in Energimyndigheten (2003), <i>Den ryska oljan: nuläge och framtidsmöjligheter</i>, (Stockholm: Energimyndigheten), p. 29.</p> <p><b>N.B.</b> Unlike figures of oil production, reserves do not include oil sands or shale oil. Classification is similar for natural gas.</p>						

Having stated this, it stands clear that figures primarily are intended to serve as a relative measurement of Russia's role and abilities versus other actors. Forecasting should not be seen as definite predictions, but will be subject to change.

### Comments on Oil Reserves

According to BP, "all numbers are, at best, informed estimates. Within the broad concept of oil 'reserves' there are several key distinctions: *proven reserves*, *oil in place* and *ultimately recoverable resource*.

*Ultimately recoverable resource* (URR) is an estimate of the total amount of oil that will ever be recovered and produced. It is a subjective estimate in the face of only partial information. Whilst some consider URR to be fixed by geology and the laws of physics, in practice estimates of URR continue to be increased as knowledge grows, technology advances and economics change. Economists often deny the validity of the concept of ultimately recoverable reserves as they consider that the recoverability of resources depends upon changing and unpredictable economics and evolving technologies.

The ultimately recoverable resource is typically broken down into three main categories: cumulative production, discovered reserves and undiscovered resources. Cumulative production is an estimate of all of the oil produced up to a given date. Discovered reserves are typically

defined in terms of a probability distribution, and are classified in terms of proven, probable and possible reserves.

*Proven reserves* are usually defined as "the estimated quantities of oil which geological and engineering data demonstrate with reasonable certainty to be recoverable in future years from known reservoirs under current economic and operating conditions", i.e., having a better than 90% chance of being produced. Proven reserves are the proportion of *oil in place* that is technically and economically recoverable, given today's economics and technology. Probable reserves have been variously designated as "indicated" or P50 reserves - reserves not all of which are yet proven but which are estimated to have a better than 50% chance of being technically and economically producible. Possible reserves have been designated as "inferred" or P10 or even P20 reserves - including reserves which, at present, cannot be regarded as 'probable', but are estimated to have a significant, but less than 50% chance of being technically and economically producible. Undiscovered resource is also defined typically in terms of a probability distribution with estimates of "yet-to-find" resource based on geological, technological and economic factors.

The reserve numbers published in the BP Statistical Review of World Energy are an estimate of *proven reserves*, drawn largely from data compiled by the Oil and Gas Journal. The reserves figures published by the Oil and Gas Journal are "based on survey responses and updates released by individual countries, which in many cases are not released every year-if ever. OGJ changes a particular reserves figure only when it receives not only evidence that a change is necessary but also a reliable, new estimate." - Oil and Gas Journal (Dec 23 2002). In reality different countries use different methodologies and the data have varying levels of reliability. Precise comparisons between nations and analyses of time series should be treated with great caution.

Proven reserves can fall as oil is produced and increase in face of successful exploration, advances in the technology of discovery and recovery and cost reductions. The level of reported proven reserves has

continued to rise over long periods of time as reported discoveries, additions and extensions have exceeded depletion of proven reserves."<sup>978</sup>

### **BP's Methodology**

BP states concerning its data that: "[s]tatistics published in this [BP Energy Survey] Review are taken from government sources and published data. No use is made of confidential information obtained by BP in the course of its business

*Reserves* - Generally taken to be those quantities that geological and engineering information indicates with reasonable certainty can be recovered in the future from known reserves under existing conditions.

*Reserves/Production (R/P) ratio* - If the reserves remaining at the end of any year are divided by the production in that year, the result is the length of time that those remaining reserves would last if production were to continue at that level.

*The oil reserves estimates* with the exception of Azerbaijan and Kazakhstan and Egypt (for 2001), are those published by the Oil and Gas Journal, plus an estimate of natural gas liquids for USA and Canada. Reserves of shale oil and oil sands are not included.

*The gas reserves estimates* with the exception of Azerbaijan and Egypt (for 2001) are those published by the Oil and Gas Journal.

Annual changes and shares of total in the tables showing oil consumption, production, refining and trade movements could be calculated on either a volume (barrels per day) or on a weight (tons) basis. We have elected to use a weight basis when performing calculations on overall oil production and consumption data. We have used a volume basis when manipulating the oil product consumption, reserves history, refining and trade data.

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<sup>978</sup> BP (2004a), 'Oil Reserves', *BP*, Published: Last accessed: 6 June 2004, Internet: <http://www.bp.com/genericarticle.do?categoryId=108&contentId=2004232>. Passages concerning coal omitted.

*Percentages:* Calculated before rounding of actuals.

*Rounding differences:* Because of rounding, some totals - including the 2002 share of total - may not agree exactly with the sum of their component parts."<sup>979</sup>

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<sup>979</sup> BP (2003a), 'Data Definitions', *BP*, Published: Last accessed: 1 March 2004, Internet: <http://www.bp.com/sectiongenericarticle.do?categoryId=108&contentId=2006879>. Emphasis added and passages concerning coal omitted.

## Appendix III: Debts of CIS States

Country	Debt
Armenia	1,881 million
Belarus	258,881 million
Georgia	158,045 million
Kyrgyzstan	181,815 million
Moldova	140,739 million
Tajikistan	305,730 million
Uzbekistan	654,343 million
Ukraine	1 583,355 million

**Source:** Regnum, cited in Ozerov, Viktor (2005), 'Neloyalniye ostanutsya bez nefti i gaza [Disloyalty Will Remain without Oil and Gas]', *Nezavisimaya Gazeta*, Last accessed: 17 October 2005, Internet: [http://www.ng.ru/printed/politics/2005-10-13/1\\_notloyal.html](http://www.ng.ru/printed/politics/2005-10-13/1_notloyal.html).

**N.B.** Debt in \$US, 1 January 2005.

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The index mainly covers people, places, companies and governmental bodies. Priority has been given to actors, while analysts, journalists or researchers are exceptions. Certain features, concepts or activities are also included. Pipelines are listed either by starting point or by its popular name. Only governmental bodies and positions in Russia have been included.

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