Russia and European Energy Security
Divide and Dominate

Author
Keith C. Smith

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### Russian Oil and Natural Gas at a Glance

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Russia’s Energy Challenge to Europe and the Atlantic Alliance

Officials of the Putin/Medvedev administration routinely deny that Russia employs its energy resources for political purposes. On the other hand, Russia’s actions again and again demonstrate that the Kremlin leadership will use its enormous energy wealth in an effort to increase its political and economic influence in Europe and the wider world. This should not come as a surprise to European officials.

Russia is not the first country to have utilized natural resources as political and economic leverage. Europe and the United States have used energy in the past as a foreign policy tool, although rarely as an instrument to coerce their immediate neighbors. Until the mid-twentieth century, Western Europe and the United States resorted to resource politics to influence domestic policies in countries where the resources were being extracted, particularly in the Middle East and Africa. Today, much of the international community is working together to discourage others from exploiting Iran’s oil and gas production in an attempt to prevent nuclear weapons from being developed.

In the twenty-first century, however, there is greater recognition in the West that after two world wars, establishing (or reestablishing) hegemonic control over one’s neighborhood by military or economic means does not bring long-term security. Nevertheless, Russians continue to believe that their national security requires control, or at very least broad influence, over the lands bordering Russia. The collapse of the Soviet Union and break up of the Moscow-based empire in Central Europe left Russians with deep feelings of humiliation, insecurity, and inferiority. Even in the best of circumstances, it will take generations for Russians to develop the self-confidence and democratic values now shared by the rest of Europe. The determined authoritarianism of the present Russian government has seriously set back hopeful efforts to establish a “Europe whole and free.”

Moscow’s recent attempt to set limits to the national security policies of Georgia and Ukraine are only the latest manifestation of Russian insecurities and the shortsightedness of its foreign policies. The brief but deadly war waged by Moscow against Georgia over South Ossetia and
Abhkazia was to a large extent meant to warn Georgia and Ukraine that NATO membership will not be tolerated. In addition, it was a signal to the West that Moscow will also respond to the West’s support for the independence of Kosovo. The concern created in Europe by Moscow’s short but successful war against democratic Georgia may turn out to have a transformational effect on Europe’s policies toward Russia. This is, however, another case of tough action by Russia causing political fallout in the West that the Kremlin did not count on. In the short run, however, Moscow will have severely damaged Western efforts to route new non-Russian oil and gas pipelines through Georgia, thereby making Europe even more dependent on Russian pipelines and “goodwill.” Europe is not likely to tolerate this high level of dependency on an authoritarian Russia over the long run. For the present, however, we see that this dependency has a direct effect on the foreign policies of Germany, Italy, and France.

Russians find it difficult to understand that the Baltic states and the Visegrad countries of the Czech and Slovak Republics, Hungary, and Poland would probably not be full members of both the European Union and NATO today if Russia had demonstrated in the 1990s that it understood its neighbors’ insecurities arising from more than 50 years of domination by the Soviet Union. There would have been no need for these countries to rush to be under the NATO umbrella. It is doubtful that Putin and his advisers understand the depth of fear caused in Estonia, Latvia, and Lithuania by the Russian Foreign Ministry’s repeated assertion of Stalin’s claim that the Baltic states voluntarily joined the Soviet Union in 1940. Perhaps the Russians do recognize the impact of their remarks, but the Kremlin clearly believes that this is an opportune time to reassert its influence over the states of the former Soviet Union and the Warsaw Pact.

The United States is viewed as overextended militarily and weakened by financial crisis. Europe is seen in Moscow as divided politically and lacking the will to respond to Russian energy imperialism. European reaction has been muted to threats by Russia to target its missiles against Poland, the Czech Republic, and Ukraine. Europe’s defense spending decreases as Russia’s rises. Meanwhile, the Kremlin interprets the European Union’s inability to put together a unified energy policy as a manifestation of its systemic weakness. An effective EU response would unify member states to counter Russia’s growing energy monopoly, including the corruptive effects shrouding East-West energy trade.

Why does the Kremlin still view NATO as a military threat to Russia? Some Russians appear to honestly believe that Spain, Denmark, or Greece could be forced by the United States to approve and take part in an alliance attack on Russian territory. This is absurd to us in the West. Russian insecurities are, however, only part of this problem. Putin and his advisers consider NATO the only institution capable of denying Russia the ability to reestablish its dominion over Central and Eastern Europe, the Caucasus, and the Slavic states in the Balkans. A unified NATO is also viewed by many Russians as the organization that prevents Russia from separating Europe from the United States. The prime objective of Russia’s hard-line anti-Americanism is to see Moscow replace Washington as the most influential partner of “old and new Europe.” At the same time, the Russian government under Prime Minister Putin is playing a masterful game of keeping Europe divided on energy policy. He successfully plays off the large states of “old Europe”
against the smaller states of “new Europe” in order to control the construction of new strategic pipelines linking Central Asian and Russian oil and gas, thereby increasing Moscow’s political and economic influence.

In the latest manifestation of Russian use of its energy “weapon,” Russia’s Transneft, the monopoly exporter of all Russian oil, deliberately cut supplies to the Czech Republic one day (July 18, 2008) after Prague signed an agreement with the United States regarding the stationing of an antimissile radar site in that country. The usual excuse of “technical difficulties with the pipeline” was offered up by the Kremlin in 2006, when it cut oil supplies to Lithuania following the sale of its oil facilities to a Polish, rather than a Russian, company. The Czech disruption, however, closely followed public assurances this spring by both Prime Minister Putin and President Medvedev that Russia would never use the supply of oil or gas for political reasons.

Unfortunately, the Czech government and the European Union were so intimidated by Moscow that they refused to criticize publicly the Kremlin for its flagrant hypocrisy. In 2007, Moscow agreed to establish an early warning mechanism in which the European Union and Russia would notify the EU Commission of any supply disruptions. In the case of the July 2008 cutoff to the Czech Republic, the early warning mechanism was ignored. The EU Commission in effect gave Moscow a free ride with this politically motivated action against the Czechs. The lack of reaction from the Commission only confirmed Moscow’s views that the European Union is too weak and too intimidated by Russia to respond forcefully.

Putin and his former intelligence officer colleagues have been much more effective than their predecessors in influencing and intimidating European policymakers. They have created suspicion in Western Europe about the policies of the Central Europeans toward Russia, and they have taken full advantage of the foreign policy blunders of the Bush administration. For more than four years, the troika of Gerhard Schroeder, Jacques Chirac, and Silvio Berlusconi met frequently with President Putin to decide among themselves key Russian-European policies, thus reinforcing Europe’s inability to create a unified policy toward Moscow. Much of Europe preferred to ignore Moscow’s energy policies in Central Europe and Russia’s use of excessive force in Chechnya. Russia is still seen by many EU government leaders and their publics (particularly in Germany) as a more benign and peace-loving state than the United States.

The U.S. war in Iraq gave Russia the opportunity to present itself to Europeans as less threatening to the world than the United States; this in spite of the ongoing brutality of the conflicts in Chechnya and Georgia and the murders of many in the Russian media who were critical of Russian government policies. There was even widespread acceptance in Europe of Moscow’s claim that its insecurities stemmed from an expanding NATO and a policy by the United States of keeping Russia weak and down. It is still too early to gauge the long-term effect of the Russian war in Georgia on elite and public opinion in Europe.

Putin and his closest colleagues, during their many years in the intelligence business, have been trained in the art of influencing and coercing foreign officials and people in sensitive positions to support Moscow’s foreign and security policies. The fact that former German chancellor
Schroeder benefited financially from his relationship with Putin, as did allegedly several of Berlusconi’s friends, is no coincidence. Former American cabinet secretaries have also been offered lucrative positions in Russian companies by Putin, even though they were not particularly prepared by experience for the jobs. Many Western public relations and law firms, in addition to private researchers, have been recruited with attractive financial packages to shine a favorable light on Moscow’s motives and actions. Record-high world oil and gas prices have helped make this possible. Greed by Westerners, who are well aware of the values of the companies making the offers, plays an important part in enlarging the Kremlin’s influence in Europe and the United States.

Many European policymakers have come to believe that their countries are so dependent economically on Russia that they have no choice but to defer to Moscow in order to ensure increased future supplies of Russian oil and gas. This opinion prevails in many countries, in spite of the fact that today’s Russia is significantly weaker economically than any large European state, with the exception of Ukraine. With its huge energy resources, Moscow appears to be playing with a stronger hand in East-West economic relations than Brussels, Berlin, or Paris. Europe’s soft power has turned out to be less influential with Moscow than many Central Europeans expected. Neither Europe nor the United States has been able to reverse the rush toward authoritarianism in Russia. Russia’s ability to wield its “energy weapon” stems, to a large degree, from the inaction, division, or inattention to this issue on the part of European and American leaders.

**Russia as a “Reliable” Energy Supplier**

In Western Europe, one repeatedly hears that Russia has “always been a reliable supplier of energy to Europe,” when in fact it has used supply disruptions as a political tool more than 20 times since 1990. These disruptions have been documented by several reliable European analysts. Nevertheless, many in Western Europe act as if “real Europe” includes only the countries west of the German-Polish border. Disputes between Russia and Central European EU members are frequently seen in Western Europe as political remnants of the Cold War, with the victims of the Soviet Union too often being held more responsible for poor relations with Russia than is Moscow. For this reason, prior to January 1, 2006, any energy cutoff by Moscow to Central European countries was of little concern in Brussels, Berlin, or Paris.

Russia’s reliability as an energy supplier was first questioned in many European capitals only after Gazprom shut off the supply of natural gas to Ukraine in January 2006, in the middle of an especially cold winter. This was the first disruption that seriously affected, even if indirectly, energy supplies to much of Western Europe. The cutting of both gas and electricity supplies to Georgia at the same time as the gas disruption to Ukraine, however, generated little comment in Western Europe. At that time, Georgia was seen by many in Europe as a distant land, informally in Moscow’s sphere of influence. More important, the disruptions to Georgia had no direct effect on supplies to the rest of Europe. Most EU members were even at a loss about whether or how to
react to the partial oil cutoff in early 2008 to the Czech Republic, even if it was clearly an act of political retaliation to a fellow member state in the heart of Europe.

When in January 2006 Gazprom shut off gas exports, Ukraine was viewed by most European observers as at least as responsible as Russia for the disruption. Many Europeans accepted Moscow’s explanation that Ukrainians had been siphoning off “Russian gas” and had not been paying for gas supplied under their contract. There was no visible effort in European capitals to examine the intertwined relationship between Gazprom and Ukrainian oligarchs. Both sides had benefited from nontransparent gas transactions and the nonpayment for supplies allegedly already made. The shutoff of natural gas occurred shortly after the 2005 election in Ukraine of a pro-European government in Kyiv, an event causing a high level of fear and paranoia in Moscow. The Leonid Kuchma/Viktor Yanukovich government usually more readily followed the lead of Moscow.

At Gazprom’s insistence (and with the Kremlin’s backing), one nontransparent company after another has been established in Russia since 2001 in order to monopolize all of the natural gas shipments to Ukraine and the gas going from Russia through Ukraine to the rest of Europe. The Ukrainians were pressured to accept these unnecessary and costly intermediaries, even though 80 percent of the gas consumed in Ukraine originates in Turkmenistan, not in Russia. A number of opaque companies, first Itera, then EuralTransGas, and finally RosUkrEnergo, became monopoly suppliers of Gazprom gas to Ukraine and much of Central Europe. With the creation of each of these companies, numerous questions were raised in Russian and European media concerning the companies’ accounting and reporting practices. They could not be called transparent by any stretch of the imagination.

Alexander Medvedev, the head of Gazprom Export, has repeatedly stated that the present monopoly, RosUkrEnergo, was established only at the insistence of Ukraine. Medvedev and other Gazprom executives claimed that the company did not even know who its Ukrainian partners were. It strains credibility to believe that Gazprom would allow an unknown group to market billions of dollars worth of the company’s gas. Even Gazprom shareholders, like William Browder of Hermitage Capital Management, questioned why Gazprom would voluntarily forgo more than $1 billion yearly in profit to a company (then EuralTransGas) located in a small office on the outskirts of Budapest. The government of Yulia Timoshenko in early 2008 attempted to eliminate RosUkrEnergo as the middleman for gas shipments to Ukraine. It was the Russian government and Gazprom (including Alexander Medvedev) who insisted that these nontransparent arrangements be continued.

There is still a tendency within much of Europe to blame Russian energy disruptions on hostile policies toward Russia by the recipient state, or on domestic corruption within the energy sectors in the targeted countries of Central Europe. These views ignore the politically motivated disruptions that took place from 1990 to the present. From 1998 to 2000, Russian oil supplies to Lithuania were cut off nine times by Transneft in an attempt to ensure that a Russian company would benefit from the privatization policies of the Lithuanian government. These energy
disruptions by Russia were totally ignored in Western Europe. The cessation in 2004 of Russian oil shipments through the Druzhba pipeline to Latvia, also a hostile reaction by Moscow designed to force Latvia to privatize its oil port to a Russian company, passed almost without comment in the rest of Europe.

Oil through the Druzhba pipeline was definitively terminated to EU-member Lithuania in July 2006 following the sale of its energy facilities to a Polish instead of a Russian company. The reaction in Brussels was slow and reluctant. At Lithuania’s insistence, a long-delayed letter asking Moscow for an explanation was sent from EU Commission president José Manuel Barroso to Russian president Putin. No response from the Kremlin ever came, and so the issue was quietly dropped by the EU Commission. When Lithuania and Latvia attempted to use EU-Russia agreements as leverage to stop Moscow’s energy blackmail, they, not Russia, were criticized by most of the EU states on the grounds that they were endangering European security interests.

Russia and Germany decided in 2005 to construct the extremely expensive (estimates range from $12 to 15 billion) Nord Stream gas pipeline through the Baltic Sea. The EU Commission had quietly agreed to a German request to make it a priority project but declared that it did not have the competency to delay the project for further study, in spite of the fact that the project was strongly opposed by Poland, the Baltic states, and Sweden. And yet, EU commissioner for energy Andris Piebalgs and EU Commission president Manuel Barroso later came out publicly in support of the project. They even allowed a former East German intelligence officer and close Cold War colleague of former KGB officer Vladimir Putin to come to Brussels to explain to the European Union why the project should go forward. If they themselves didn’t have the “competency” to approve or disapprove of the project, why did Barroso and Piebalgs personally support it? Why did the Directorate General for Energy not do a technical and financial study of the Nord Stream venture, even if only to understand better the market ramifications of it and how it compares with the proposed alternative Yamal II and Amber projects, both much cheaper and more environmentally friendly than Nord Stream? What is the reaction of the Directorate General for Competition Policy (DG COMP) concerning the competition and antitrust implications of Nord Stream for the European consumer? So far, we have not been informed.

The EU Commission and EU Council’s relatively passive reactions to the increased monopoly power of Gazprom that will result from the construction of the Nord Stream gas line in the Baltic Sea and the South Stream line through the Black Sea are perplexing. Piebalgs could have been carrying out extensive talks with the Azeris and Turkmen regarding the Nabucco line, the European Union’s priority pipeline. Instead, the Azeris claim to be puzzled by the failure of the EU energy commissioner to consult more closely with them regarding the supply of gas for the non-Russian Nabucco project. Moscow’s “divide and conquer” policy has not been seriously resisted by the EU Commission. Russia has now outflanked the European Union on its plan to construct Nabucco, with Austria putting the final nail in the coffin through its agreement in early 2008 to sell to Gazprom a 50 percent ownership of its Baumgarten gas storage facilities near the Austrian-Slovak-Hungarian borders. Under the European Union’s energy plan, Baumgarten was to be the terminal point for Nabucco gas. The Austrians ignored an EU requirement to first secure
a competition study for DG COMP. Where was the visible reaction from the energy commissioner to the Austrian sale? It was nowhere to be seen.

**Monopolies and Antimonopoly Rules**

For the past eight years, the EU Commission has acted to stop the Microsoft Company from its alleged violation of EU antimonopoly rules, on the grounds that it should have opened up its operating system to its competitors. The right of the Commission to take this course of action is generally accepted and is in accordance with Article 82 of the European Community (EC) Treaty that prohibits antitrust and anticompetitive behavior on the part of European and foreign companies doing business within the borders of the EU member states. Although reluctantly, Microsoft has paid almost $1 billion in fines to the Commission and has agreed to open its operating system to competing companies. Intel, another American high-tech company, is also the target of EU competition enforcement.

Although the price tag to the European consumer of Microsoft’s monopolistic behavior is not insignificant, it is only a small fraction of the cost paid by Germans, Czechs, Hungarians, Italians, Greeks, and Austrians for Russian oil and gas as a direct result of the state-dictated export monopolies of Transneft and Gazprom. Russian state companies have pressured Kazakhstan, Turkmenistan, and Uzbekistan to sell Gazprom their natural gas production at prices ranging from one-eighth to one-half the price that Russia has been able to resell the same gas molecules to the West. Even though this situation was created by Russian laws, giving only two of its companies export rights, neither the EU Commission nor any European state has yet brought a case in European courts against Transneft or Gazprom on Article 82 grounds.

Although Russia signed the Energy Charter Treaty in 1997, it has refused to implement it, claiming in its defense that the treaty has never been ratified by the Russian Duma. However, Article 45 of the treaty states that it goes into effect in member states on signature, not ratification. Again, no action has been taken in European courts to enforce Article 45. Instead, Russian representatives have been invited to become members of the Energy Treaty Commission. This commission is tasked with ensuring that the obligations within the treaty, such as opening energy markets and trading to greater competition and ensuring a common carrier system in the use of pipelines. Some Europeans even excuse Russia’s noncompliance with the treaty as justified because the United States refused to sign the treaty in the first place. Again, Moscow is given a free ride to violate an agreement with the European Union. Under EU rules, member states are not prevented from reexporting oil or gas imported from third countries. And yet, Transneft and Gazprom continue to freely enforce “take or pay” contracts with member states, a clear violation of the European Union’s competition policies.

Meanwhile, a debate within the European Union is underway concerning a directive from DG COMP that would increase competition in domestic energy markets within member states through the unbundling of imports from marketing. A company would be prohibited from both importing and marketing energy. The proposal is generally opposed by German, French, and
Italian companies, who are concerned about the prospect of losing their domestic monopolies. Large energy companies in the three countries are monopolies or part of an oligopoly dealing with importing, refining, distributing, and the final marketing of energy products. The proposed directive would result in greater domestic competition and would have long-term economic benefits for European consumers. But the European Union would need to introduce additional rules in order to prevent Russian companies (who often are better positioned than many Western firms) from capitalizing on greater market opening within the European Union. Unbundling by itself might grant an advantage to Russian firms, enabling them to buy increased shares in existing European companies, further adding to their monopoly power.

Russian firms are in every case already operating abroad with the approval of the Russian government. Because the Russian state controls the domestic and export prices of energy units, Moscow is able to ensure that its companies can undercut Western competition by selling gas and oil at cheaper prices set by Moscow. A slight price advantage not only results in locking in a long-term market, it also creates an advantage when bidding for refineries and pipelines. Russian firms can accept short- or even medium-term losses or low profit margins in order to capture new markets. Unbundling, therefore, would result in unfair advantages for Russian firms, unless greater competition is enforced all across the board. Russian firms possess the benefit of having direct access to their country’s oil and gas fields, a situation becoming increasingly difficult for their Western competitors. Up to now, the European Union has not brought an antidumping action against a Russian energy firm. This, in spite of the fact that Russian prices vary widely, often depends on bilateral political relationships or on the Russian desire to benefit a favored Western energy company.

Both European and Russian consumers would benefit if the European Union insisted on complete reciprocity in ownership and marketing. This would mean that European energy firms operating in Russia would have the same advantages as Russian firms in Europe. When one considers the history of Russian behavior toward Western energy firms operating within Russia, any demand for reciprocity would require close monitoring and a willingness to retaliate against Russian companies doing business in Europe. Although there is talk within the European Union of demanding reciprocity regarding energy investments, it would be difficult for the Commission to implement a reciprocity regime without a sufficiently strong enforcement mechanism, something that would be hard to achieve in today’s divided European Commission.

Sources within the Commission believe, however, that if unbundling were to take place, individual EU members might finally demand reciprocal access to Russian energy fields and facilities. But that has yet to be proven, and Moscow has made clear that it will fight any effort by the European Union to secure majority control, or even grant Western firms more than 20 percent ownership in any Russian natural resource company. Unbundling, without reciprocity, however, would only open the door to increased Russian monopoly power in Europe and even greater Kremlin influence in Western capitals.
Putin and Gazprom officials are also interested in the creation of a “gas OPEC” with enough power to control the price of gas sold to Europe from any source. Of course, countries such as Norway and some of the newer producers in West Africa would likely oppose a Russian-dominated organization. Russian leaders already have effective control over the gas exports from the Central Asian states of Kazakhstan, Turkmenistan, and Uzbekistan. Russia has been working hard for the past two years to increase its influence in Algeria, Egypt, Morocco, and Libya. Three new gas pipelines are being built from North African fields to Europe. If the monopoly price leverage of Russia is combined with effective control, or even substantial influence, over exports from Central Asia and North Africa, Moscow is certain that other producers, like Norway and Trinidad, will follow suit. Norwegian oil prices have generally increased or decreased in response to changes in OPEC prices.

Corruption: The Hidden Virus Accompanying the Energy Trade

There is serious political risk to Europe from its growing dependency on Russian energy resources. However, the greater danger is that this dependency is making a significant portion of Europe’s political and economic elite reliant on nontransparent financial payments that erode national sovereignty and distort national decisionmaking. Over the past decade, the Kremlin has systematically created or cultivated “friendly” interest groups in both Central and Western Europe who benefit financially from their formal and informal ties to Russian state energy companies. The temptation to accept money from Russian companies too often overrides the knowledge that these firms are direct instruments of Moscow’s foreign and security policy. Up to now, very little investigative journalism in Europe and the United States has focused on the corrosive effects of nontransparency in the Russian-European energy trade. Nor is there much interest in looking at the lack of both open markets and good governance resulting from energy imports from the East.

The potential for enormous profits in energy trading and refining has historically tempted individual energy companies to eliminate or weaken their competitors by buying influence within the host government and/or among elite groups in the importing country. Governments can bless favored firms with access to the best oil and gas fields. They can also set up favorable tax regimes for companies involved in the extraction and marketing of energy raw materials and refined products. From the middle of the nineteenth century to the middle of the twentieth, Western firms were often less than transparent, and sometimes they were used by their governments as instruments of foreign policy. As previously mentioned, at times, they openly interfered in the internal affairs of host governments. This period has passed into history—at least for Western firms.

But at no time were energy disruptions used to exercise control over their immediate neighbors. Today’s international energy markets are increasingly dominated by state-owned firms, whether in the Middle East, Latin America, Africa, Central Asia, or Russia. Western energy companies have been largely eliminated from securing majority shares in existing and new oil and gas fields.
in the above regions. With Putin’s renationalization of Russia’s private energy companies, in addition to the direct control exercised over these firms by Kremlin operatives, there is a replay of nineteenth century energy imperialism with a vengeance. The historical “great game” is becoming more one-sided with the expanding control over natural resources by national governments and the resulting increase in corruption.

The renationalization of energy companies in all the major exporting countries has also weakened the resolve of some Western firms to engage in the use of best practices when taking part in East-West energy trading. The growing dominance of state-controlled energy companies in major producer countries has coincided with a marked reduction of alternative investment possibilities for Western companies within their own borders. This further increases the temptation on the part of Western firms to agree to demands by Russian suppliers to engage in practices not acceptable when dealing with another Western firm. In addition, it also increases the likelihood that some Western governments will choose to ignore questionable business practices by their countries’ energy suppliers. Tight world energy supplies may also take the pressure off producing countries to increase democracy at home, because wealthy elites are able to buy off much of the population with the use of growing energy revenues. In this way, the increasing competition for energy supplies has led to more corruption in both supplier and producer countries and also to a weakening in domestic pressure for democratic government. It should be noted that an examination of the records of the Iraqi Oil Ministry by outsiders demonstrated that the largest illegal beneficiaries of the United Nation’s oil for food program were Russian companies, including the relatively unknown firm, Zarubeshneft, a creation of the Kremlin administration under Putin.

Predictability in making business decisions is already difficult for Western energy firms. This is a result of the increased danger of intervention at any point by elite cartels that dominate the energy trade, particularly in Russia and Central Asia. These cartels are composed of government leaders, intelligence officials, and favored business oligarchs. The composition of these elite groupings can suddenly change with a shift in the local political balance, only adding to business uncertainty. Western businesses are often compelled to work with partners favored by elite cartels, with Gazprom and Rosneft as prime examples. The same often holds true in Ukraine, Kazakhstan, and Turkmenistan. The purpose of these elite cartels is to build national and transnational networks and alliances that solidify their own power while they stave off opposition by more transparent and democratic business groups. The result is to enrich networks of higher-level elites, making it even more difficult for reform elements to bring about political and economic change.

Polling among Russian business leaders indicates that corruption has significantly increased in the past six to eight years. Why should we in the West assume that the increase in business corruption in Russia has not already spilled over into the activities of these same state-directed firms when they operate in the European Union or even in the United States? The 2007 Transparency International index of perceptions of corruption by business people ranked Russia as the 143rd most corrupt out of 179 countries surveyed.
It is worth keeping in mind that President Dmitri Medvedev spent the past several years involved in Gazprom decisionmaking. Since assuming power, the energy investment climate for foreign firms has not improved in spite of his public support for the rule of law, judging by the recent treatment meted out to British Petroleum in its joint venture with Russia’s TNK. The Russian government clearly assisted the TNK oligarchs in their bid to increase their leverage over the joint company.

Swedish economist Anders Åslund, who has worked for many years in Russia and Ukraine, estimates that 50 percent of Gazprom’s investments are lost through corrupt practices. He has also pointed out that the cost of building the Blue Stream pipeline from Russia to Turkey was three times higher per kilometer when constructed by Russia, compared to the section of the pipeline constructed by Turkish companies. William Browder, who is now barred from reentering Russia and for years has been active in Hermitage Capital Management, a firm that is heavily invested in Gazprom, has questioned publicly why Gazprom voluntarily forgoes significant profits each year by consigning a large amount of its business to murky intermediaries. Russian experts generally assume that Browder’s “visa problems” are punishment for having the temerity to question the practices of a firm indirectly managed from the Kremlin. But Browder asks a fair question, one that any Western firm dealing with Gazprom or one of the other state-controlled Russian companies ought to consider before increasing their financial exposure in the energy sector.

Some Western energy companies attempting to negotiate joint ventures with Russian state firms have called off talks with potential Eastern partners rather than agree to funnel profits through offshore accounts and well-known havens for “confidential funds” or to intermediary firms that bring no added value to the venture. Cyprus, Lichtenstein, and other offshore banking centers are favorite locations for intermediary companies engaged in the energy business among Russia, Central Asia, and Europe. Many of these offshore “energy” companies are not designed to add transparency to business transactions. It would be an exaggeration to think that all offshore energy firms are money-laundering operations, but many of them do appear to have been established for that reason alone. A number of Cyprus, Lichtenstein, and Netherlands companies are, however, believed by some to be prime vehicles for backdoor financing for companies that want to conceal their Russian connection and for key individuals in the West who want to hide the source of their “consulting fees.” Those Western companies and critics who can’t be bought off are often bullied with a wide range of tools available, from the sudden loss of key clients to legal harassment of individuals. Any foreign energy company with the audacity to publicly criticize Russian business practices will pay a steep price, including loss of access to oil and gas fields.

In the past 30 years, significant strides have been made in the West toward bringing greater transparency to business transactions, through better accounting and reporting. The Organisation for Economic Co-operation and Development (OECD) rules regarding bribing of foreign officials is generally adhered to by member states. Some countries have also adopted tough national laws and enforcement mechanisms to punish firms involved in corrupt business operations. The U.S.
Foreign Corrupt Practices Act (FCPA) has forced most American energy firms (although possibly not all) to adhere to transparent and standardized accounting and business procedures.

At the same time, in major exporting countries (with the exception of Norway), when the state takes over the nation’s energy fields and facilities from private international firms, there usually develops a cozy relationship between the new state-owned company and the nation’s political leadership. The World Bank has attempted, unsuccessfully, to break the link between high energy revenues and governmental corruption. In many non-Western nations the high world market price for energy appears to have resulted in fewer constraints on corrupt practices than in the past. Allegations of corruption in Nigeria, Iraq, Libya, Russia, and with the Central Asian producers have mushroomed along with the price of oil.

Siloviki Influence

In the case of Russia, the governing boards of all of the leading energy companies have representatives of top government officials, many with a background in intelligence work. The corruption and nontransparency evident in Russia’s energy business makes the country a questionable partner for foreign firms in terms of reliability. Nevertheless, no Western capital is today without prominent lobbying and public relations firms representing Russia’s powerful monopoly energy companies. Their Russian clients are not bound by a FPCA or by the OECD’s transparency standards, although foreign clients often have to be more circumspect. The vast financial profits of Russian clients can be used to buy off or intimidate critics in the West. The old saw that “men of money buy men of influence” holds especially true when dealing with the enormous sums at stake in the energy business. The situation becomes especially serious when the men with money are trained intelligence officers who benefit personally from the enormous profits now being made in the allocation of oil and gas sales.

With Germany, Italy, and France in Hand, the Rest Will Follow

Soon after taking over the presidency in 2000, Putin developed a foreign policy strategy that would enlist the support of the German government in his administration’s broader policies toward Europe. With his career background as a German specialist and being a German speaker, he quickly developed the trust of the Schroeder government and, according to opinion polls, the trust of most Germans. He took advantage of Chancellor Schroeder’s desire to be the leading figure in the West’s relationship with Russia. He also capitalized on strong German opposition to U.S. policies.

Putin enlisted the support of a key ally in the German banking sector, even before he was named to replace President Boris Yeltsin. While Putin was deputy mayor of St. Petersburg in the early 1990s, he worked closely with Mattias Warnig, a Dresdner Bank official who had been a former Stasi officer and reportedly Putin’s East German intelligence contact. Warnig later played the key
role in bringing Schroeder together with Putin in planning the Nord Stream natural gas pipeline that is to run under the Baltic Sea from Russia to Germany. Today, Gerhard Schroeder is CEO of the Nord Stream Company headquartered in Zug, Switzerland, and Warnig is his deputy CEO. The company was granted a German government loan guarantee while Schroeder was still chancellor and before announcing his intention to work for Gazprom.

Putin found greater acceptance by Schroeder and the German people as a result of the widespread unpopularity of the Bush administration and the U.S. war in Iraq. In addition, many Germans have a fascination with Russia, and there are Germans who feel that their country “owes” Russia more political leeway as a result of guilt over World War II. The war in Chechnya never became an important political issue in Germany, at least to the extent it was in France and the United Kingdom. A majority of Western loans extended to the former Soviet Union came from German banks. After Putin brought stability to the Russian economy and paid off the country’s foreign debt, German industry, in particular, began to view Russia as an attractive venue for wide-scale business ventures. The Social Democratic government encouraged German businesses through large-scale loans and guarantees to invest in Russia, particularly in the energy sector. The Social Democrats also strongly campaigned for the closure of Germany’s existing nuclear power plants. If their policy is implemented, the country will become even more dependent on imported Russian gas. It is also worth noting that Germany does not have any strategic gas storage facilities. This contributes to Berlin’s vulnerability to Russian influence on German foreign and economic policy, as was noted in the German press during the debate over the proposal to increase NATO’s ties with Ukraine and Georgia.

German energy firms such as RWE, E.ON Ruhrgas, and Wintershall have become major joint venture partners of Russian state companies, particularly Gazprom. German firms have been granted more favorable consideration than companies from other Western countries by the Putin government, especially in the energy sector. It is noteworthy that foreign energy firms from the United Kingdom, United States, Netherlands, and Japan have had substantial shares of their energy investments confiscated in Russia through arbitrary action on the part of the Kremlin. The assets of German firms, on the other hand, have been left relatively untouched. Putin and his former intelligence colleagues appear to have determined that one of the keys to a successful policy of keeping Europe divided and at odds with the United States is to maintain the closest possible relationship with, and influence in, Berlin. After the war in Georgia, Germans may be adopting a somewhat more skeptical view of the course of Russia’s political and security policies. Germany’s energy options, however, are becoming more limited as the country’s reliance on Russian energy imports increase and Europe’s efforts to build alternative pipelines are being checkmated by Nord Stream and South Stream, a proposed new nuclear power plant in Kaliningrad, and a variety of other pipelines, such as the Gazprom-controlled oil line that will run through Bulgaria and Greece to the Adriatic Sea.

The German government has been remarkably tolerant of the artificially high energy prices of Russian-supplied natural gas. For the past several years, Gazprom has purchased Turkmen or Kazakh gas for one-quarter to one-sixth of the price that Gazprom has charged the German
consumer. This price gouging has met with little opposition among German politicians or consumer groups. When asked by this author about Germany’s apparent acceptance of the large rents going to Russian companies as a result of artificially high German import prices, a representative of the Association of German Industries simply remarked that German consumers were well-off and could afford to pay higher energy prices. He also seemed unconcerned with Moscow’s use of its energy leverage in countries to the east of Germany.

German industry and consumers have paid an extremely high price for the failure of the European Union to enforce antimonopoly clauses in Article 82 of the European Community Treaty and for their government’s passive reaction to arbitrary gas import prices. It is difficult to come up with a good explanation for Berlin’s acceptance of the Russian price structure unless one assumes that German energy companies are in collusion with Russian importers. Germany has also been the leading country within the European Union to oppose the DG COMP’s proposed directorate that would force the unbundling of companies dealing with both the supply of natural gas and electricity and its distribution to industry and consumers. The German energy sector not only has the closest relationship with Russia of any of the other EU member states, but it has been successfully resistant to opening its domestic market to greater competition from other European energy firms.

Some of Germany’s neighbors complain that companies such as E.ON Ruhrgas and RWE have blocked their efforts to build more electricity and gas interconnectors with neighboring states. Therefore, Germany is often accused of being the leading opponent to adoption of an effective, coordinated EU energy policy. Germany has joined with France and Italy to stop energy market reform within the European Union, thus preventing greater competition and transparency. Berlin has also been a strong opponent within NATO of efforts to develop a common policy on how to deal with Europe’s growing dependency on Russian energy. A leading official in NATO’s Economic Committee in Brussels confided to this author that Germany has consistently opposed placing the issue of Russian energy tactics on the Committee’s agenda for discussion by the alliance’s permanent representatives.

**Other European Roadblocks**

Putin also effectively enlisted the support of former French president Chirac and Italian president Berlusconi in forming a foursome of European leaders (along with Schroeder), who for many years set major policy on trade and political relations in Europe. Putin, as both president and prime minister, has been a very persuasive advocate of Russian energy interests in conversations with other European leaders. He is extremely knowledgeable about most aspects of the oil and gas industry in Russia and internationally. He takes a very hands-on approach in determining Russian energy policy initiatives in Europe, North Africa, and the Far East. His personal discussions with the leaders of Austria, Hungary, Bulgaria, and Greece have resulted in energy deals that have undercut the European Union’s plans for the diversification of Europe’s energy supplies. The smaller countries have watched with some frustration as Germany, France, and Italy
have cut their own energy supply arrangements and investment deals with Russia. Knowing that the European Union has been unable or unwilling to enforce a common energy strategy, these states are now looking for separate deals with Russia that favor their own national energy firms.

Austria is a particularly noteworthy case. This country has profited from a long-term energy supply arrangement with Russia, going back to the 1980s. The leadership of both major parties has strictly observed the 1955 troop withdrawal treaty with Russia that required Austria to maintain military neutrality. The country has been especially susceptible to Russian energy overtures. Austrian officials continue to insist that Russia has always been a reliable supplier of energy to Europe, thereby ignoring Moscow’s behavior toward Austria’s eastern neighbors. Austria, however, has never itself been the target of a disruption of energy from Russia, although supplies of natural gas dropped after Gazprom cut the flow to Ukraine and Georgia in January 2006. OMV, the Austrian state oil company, is believed by some Central European observers have worked closely during 2007–2008 with Gazprom in mounting its attempted hostile takeover bid for MOL, a larger private Hungarian oil and gas company.

Hungarians are convinced that an agreement was reached between then-President Putin and former Austrian chancellor Alfred Gusenbauer for OMV to take over MOL, knowing full well that the European Union’s competition watchers would require OMV to spin off one of the new company’s refineries. The Hungarians believe that the region’s largest and most efficient refinery at Szaelszalombata would then be sold at a concessionary price by OMV to Gazprom. The 2007–2008 Russian-Austrian agreements to sell 50 percent of the Baumgarten trading floor to Gazprom and to construct gas storage facilities at Baumgarten for Gazprom may have effectively killed the European Union’s plans for the Nabucco gas pipeline that is designed to carry non-Russian gas to Europe. These Austrian agreements have made it easier and more profitable for the construction by Russia and Italy of the competing Russian South Stream pipeline that would bypass Ukraine and Slovakia by bringing Russian gas to European markets.

Several Gazprom-related companies have established their regional headquarters in Vienna, with RosUkrEnergo reportedly planning to locate close to the ruling Social Democratic Party’s headquarters. Alexander Medvedev, the head of Gazprom Export, spent almost 15 years operating a Gazprom office in Vienna and continues to have close ties to Austrian officials. The Russian media has speculated that Medvedev was working for the KGB/FSB at the same time. It should be noted that Austria’s Raiffaisen Bank maintained the accounts of the less-than-transparent RosUkrEnergo, a joint venture between Gazprom and two Ukrainian businessmen. Raiffaisen long refused to disclose the names of the Ukrainian owners. After strong international criticism, the names of Gazprom’s alleged partners (Dmytro Firtash and Ivan Fursin) were announced in 2006 in a press release in Moscow.
Two Separate Europes Cope with Energy Dependency

Germany, Italy, France, and Spain remain opposed to a common EU energy strategy, whether it pertains to dependency on one major import source for energy or support for greater competition within EU countries. The smaller and poorer new member states have been left pretty much on their own in trying to counter Russian energy pressures. The new members within the European Parliament, led by the relatively large Polish delegation, have gained parliamentary approval for far-reaching statements on energy security, most notably the September 26, 2007, resolution calling for “a common European foreign policy on energy.” Although this resolution was supported by many Western European parliamentarians, it is unlikely to be or implemented by the Commission or by the Council. The large Western European states still call the tune within those two EU organizations.

As a result, there is considerable frustration among those EU countries that have felt the brunt of Russian energy disruptions, such as the three Baltic states, the Czech Republic, and Poland. Unlike Western Europe, these countries have weak national energy companies that are in no position to challenge contractual violations by Gazprom or Transneft. In the last 10 years, Transneft has twice refused to honor contracts with Kazakhstan that would have allowed them to ship crude oil via Russian pipelines to the Baltic states. The United Kingdom, Sweden, and possibly Finland are believed to be quietly supporting Central European efforts to develop a stronger and better-coordinated EU energy policy.

Angst in Central Europe

The Central Europeans are in some cases paying a steep price for taking the advice of the West to privatize immediately their major industries, including their energy infrastructure. Some governments that quickly took this path, such as those in the Baltic states, have seen their energy companies (particularly the gas industry) bought up and controlled by Russian state companies and as a result are now close to 100 percent dependent on Russian oil and gas imports. Most Central European EU members are burdened by having influential political and economic elites comprised of many individuals who were Communist leaders before 1991. They represent a disproportionately large percentage of today’s governmental and business leaders. These former members of the nomenklatura, in many cases, still have close ties to Communist era officials in Russia. Informal relationships like these facilitate efforts by Russian energy companies to set up daughter firms in importing countries that funnel financial help into the coffers of “friendly political groups.” This has been particularly apparent in the Baltic states, but it is believed to be practiced as well in several former Warsaw Pact countries. The lack of business transparency in these countries coupled with a weak rule of law aids nontransparent firms with strong ties to pro-Kremlin oligarchic groups in Russia (and in Ukraine) aiming to maintain control of the energy trade.
The desire of the new democracies in Central Europe to enter the European Union as soon as possible following the collapse of the Soviet Union created leverage for the Western European states that were anxious to achieve a quick reduction in the levels of air and water pollution. It was also an opportunity for those member states that oppose the principle of nuclear power to eliminate existing nuclear plants in the countries petitioning for membership. Countries with powerful antinuclear lobbies, such as Austria, Denmark, and Germany, often exaggerate the risks to Europe of all nuclear power plants either built or under construction during the Soviet period. Lithuania, for example, was pressured into an agreement to shut their existing nuclear power plants, even though these supplied 75 percent of the nation’s electricity output. The Ignalina II nuclear power plant (the newer of the country’s two reactors) in northeast Lithuania received tens of millions of dollars in safety upgrades and was considered safe to operate for another 15 years by U.S. inspectors. The United States provided most of the money for redundant safety features. Nevertheless, the antinuclear lobby within the European Union kept raising the specter of Chernobyl, insisting that membership for Lithuania would not be approved without an early schedule to close both of the plant’s reactors.

In addition, Central Europeans were not given enough time by EU negotiators to change their energy resource base away from fossil fuels to other forms of domestic energy. Nor did the negotiators consider the time and cost of constructing expensive, new infrastructure that could have shifted imports to non-Russian sources. Shale oil from Estonia came under fire from environmentalists in the European Union, as did peat burning in Latvia. While some EU structural adjustment money was provided for Ignalina decommissioning, and also for power line connections between the Nordic countries and the Baltic states, the level of funding is not adequate to pay for the loss of domestic resources. The new EU members in Central Europe are not slated to receive the same level of structural adjustment money that had gone to “old-new” members, like Greece, Ireland, Spain, and Portugal.

The sad result of all of this is that all three Baltic states, Hungary, Bulgaria, and Slovakia will in the future be more rather than less dependent on imports from Russia, thereby increasing Moscow’s leverage over these new EU members. With only a weak EU response to Russian energy shutoffs and to their arbitrary price increases, energy security in Central Europe has not improved as a result of EU membership. Most of the new member governments are today even more vulnerable to economic pressure from Moscow than before joining the European Union. The one exception is the Czech Republic. They built an oil pipeline through Germany in the 1990s that does not depend on Russian supplies.

Without a common and effective EU energy policy that diversifies the sources of oil and gas, it is not surprising that many Central European governments end up caving in to Russian demands for greater control over their energy infrastructure and distribution facilities. These countries have little choice but to accept oil and gas prices dictated by Transneft and Gazprom. The lack of political backing by the Commission in the face of Russian energy cutoffs to Latvian, Polish, Lithuanian, Estonian, and Czech facilities also leaves Central Europeans feeling powerless when
they attempt to resist Moscow’s demands for equity in their energy infrastructure, or in enforcing commercial contracts with Russian companies.

It is important to keep in mind the disadvantages of the smaller EU states. The larger, wealthier members have powerful energy companies that have the technical and financial resources and sufficient political backing from their governments to allow them to reach more advantageous energy contracts with Russia. The large state-backed Western firms can compete with each other to gain a foothold in the Russian energy sector. The Central Europeans, on the other hand, lack modern, well-financed companies that can secure more favorable terms from Russia. Not surprisingly, the large West European firms and their governmental backers are more interested in short-term profits from collaboration with Russian energy firms rather than the longer-term energy security interests of the entire EU-25. Without an enforceable EU energy policy, the interests of the smaller member states carry less weight, which leaves them more exposed to pressure—transparent and otherwise—from state-controlled Russian energy firms.

Adding to Central European frustrations are the repeated statements coming out of Brussels and West European capitals that Russia has always been a reliable supplier of energy. Are Western Europeans claiming that “real Europe” only starts on the western side of the Polish-German border? Many Central Europeans express surprise and disappointment that Latvia’s Andris Piebalgs, the EU commissioner for energy, has adopted a relatively passive position when it comes to confronting Russia.

Armenia, although not in the heart of Europe, is the classic case of a country that has been powerless to stop the almost complete takeover of its energy sector by Russia. Pressure from the Kremlin on former Armenian president Robert Kocharian resulted in Armenia turning over its gas pipeline distribution system and its pipeline to Iran to Gazprom. Even the diameter of the pipeline from Iran was reduced under pressure from Russia so that Armenia would never be able to reexport any gas from Iran to third countries. Meanwhile, Russia is currently trying to reach joint venture agreements with Iran to develop that country’s energy resources. The point for the Armenians was that Moscow, not Yerevan, will determine the export market for Iranian gas. This message regarding Russia’s energy power was heard loud and clear in the rest of Central Europe. After the invasion of Georgia by the Russian military in August 2008, European commentators have frequently cited the need to keep Russian oil and gas flowing as the reason why Europe could not react with any effective measures to stop Russian pressure on its neighbors and to “punish” Moscow for its aggressive behavior.

**Ukraine: A Case Study in Lost Opportunity**

If Ukraine today had a transparent and efficient energy sector as part of a vibrant market economy, it would rapidly have been able to reduce its oil and gas imports by 50 percent. Not only would this dramatically improve its balance of payments, it would also put the country in a much better position to bargain for lower prices and energy transit fees from Russia and the energy producers in the Caspian region. Unfortunately, the level of corruption in the energy
sector in Ukraine has slowed progress in developing a Western-style democracy capable of protecting its national interests and cementing closer ties to the European Union. The substantial level of Russian control, both directly and informally, over Ukraine’s energy business, reinforces the existing high level of corruption and nontransparency.

Ukraine is an extremely inefficient user of energy. The country has the highest ratio of energy use to per capita GDP in the world, making it the most energy intensive economy. Nevertheless, geologists believe that Ukraine has significant undeveloped oil and gas fields both on and offshore in the Black Sea and Sea of Azov. There are extensive reserves of coal and coal-bed methane that could be exploited much more efficiently. Ukraine also has a large and fairly sophisticated nuclear power industry, although it relies on nuclear fuel from Russia. In spite of its great potential for both conventional and alternative fuels, Ukraine will in the foreseeable future rely heavily on imports of oil and gas for its energy needs.

Ukraine imports most of its oil from Russia. The oil is refined at six major facilities, almost all of which are controlled by Russian oil companies. About 75 percent of natural gas consumed in the country is imported by a Gazprom-controlled monopoly, even though 80 percent of the gas originates in Turkmenistan. All imported gas has been controlled by a succession of nontransparent intermediaries, the present one being RosUkrEnergo. This company is allegedly owned by Gazprom and two Ukrainians who are rumored to have ties to a well-known organized crime figure wanted by both Interpol and the FBI. Leaders of two of the major political parties in Ukraine appear anxious to preserve this murky arrangement. Some observers believe that these politicians and the oligarchs backing them may be benefiting financially from the RosUkrEnergo monopoly.

The present government of Prime Minister Yulia Tymoshenko has attempted, so far unsuccessfully, to break the monopoly of RosUkrEnergo and instead have the Ukrainian state company deal directly with Gazprom. Powerful elements in the country, including some close to President Viktor Yushchenko, reportedly have resisted eliminating this unnecessary intermediary. Respected American energy companies have tried to operate in Ukraine in accordance with the FCPA. They have either been closed down as a result of action by pro-Russian governments or pressured into granting Ukrainian oligarchs and Russian companies’ shares in their ventures. The government of the Regions Party, in power from 2005 to 2006, was particularly hostile to Western companies. Today, it is practically a given that no Western energy investment will be allowed to succeed in Ukraine unless there is a partner who a member of the country’s oligarchy.

An example of the difficulties of Western companies was that faced by U.S.-owned Cardinal Resources, which was pushed out of business by the Yanukovich government in 2007. In order to satisfy the Yanukovich government, additional partners were added to Vanco Energy’s deal. This leaves Ukraine with little investment in the energy sector by reputable Western firms. The informal coalition of Ukrainian and Russian elites that benefits from the present arrangement has been quite successful at keeping out Western investors.
Not surprisingly, Ukraine continues to lag considerably behind Eastern and Central European members of the European Union in modernizing its energy sector. Favored industrialists continue to receive subsidized energy rates while consumer prices remain well below costs, only adding to the country’s high level of energy inefficiency. As a result of discouraging greater domestic production, coupled with the growth of consumer and industrial demand, Ukraine is becoming more and more dependent on imports—almost all of which are controlled by Russian state companies.

Ukraine is the prime example of the power of elite cartels, both Ukrainian and Russian, controlling almost all of the country’s energy trade. Imports are the monopoly of a nontransparent company, distribution is largely dominated by UkrGazEnergo, a daughter firm of RosUkrEnergo, and most oil refineries are owned by Russian oligarchs or Russian state companies. In addition, the price of imported gas is determined on an annual basis by Gazprom and the Kremlin administration, with the price level established after evaluating the recent “behavior” of Ukraine toward Russia. Moscow also factors into the price the likelihood that a slightly lower level for oil and gas for Ukrainians than that paid by Western Europe will keep Ukraine from breaking with Russian policy and moving closer toward the West. The degree to which Russia can leverage its energy monopoly over Ukraine is the determining factor when it comes to price.

Ukraine is an example of the influence that Russia would like to have over other states in Central Europe using its energy resources. Although the Kremlin may have more modest expectations regarding the degree to which it can exert control over other Central and Western Europe countries, Russian leaders at least hope to exercise a veto over major European decisions, to maintain a near monopoly in supplying natural gas, and to broaden divisions between Europe and the United States on political and security issues.

**The High North: The Next Energy Great Game?**

The U.S. Geological Survey has estimated that at least 25 percent of the world’s remaining oil and gas resources lie north of the Arctic Circle. With the shrinking of the Arctic ice cap, the ability of states to explore and develop on and offshore resources in this region is becoming more cost efficient. Extraction of Arctic oil and gas by the United States in Alaska and offshore is already under way. Norway’s Snohvit gas field is now sending regular shipments of liquefied natural gas (LNG) from Arctic waters to Cove Point, Maryland. Russian seismic vessels are actively mapping possible undersea resources in a broad swath of the Arctic Ocean north and east of the Kola Peninsula. In 2002, Russia announced to the United Nations that it had a legal claim to 460,000 square miles of the Arctic Ocean. In a highly publicized move in August 2007, then-President Putin sent an icebreaker and two submarines to the North Pole to stake Russia’s claim to the Pole and to an extensive area of the Arctic Sea between the European continent and the North Pole.
Although there are many overlapping claims to Arctic waters, including one by the United States and Canada, at present, the most ambitious energy exploration and development effort is being conducted by Russia. Preliminary exploration work is being carried out in the Shtokman field and in other areas within 500 kilometers of the Kola Peninsula. Shtokman reportedly contains 3.7 trillion cubic meters of natural gas. The first supplies of gas from this field may reach Russian and European markets by 2013, but a more likely time frame is 2015–2017. The project has been highly politicized. Russia has declared that in response to U.S. foreign policy, American companies would be excluded from working this field. U.S. consumers would also reportedly be excluded from buying gas from Shtokman. In reality, even with the production from Shtokman, Gazprom will have little gas available for the U.S. market after it supplies its domestic and European customers.

Moscow has revised its earlier expectation that the field could be developed exclusively by Gazprom. The company does not have sufficient deep water experience and has now offered a share in its development company (although not stakes in the field itself) to France’s Total and
Norway’s StatoilHydro. Joint exploration of the Arctic should present few legal problems for the French, who have no conflicting claims with Russia. Norway, on the other hand, has the best underwater drilling technology to offer Gazprom. But the two countries have at least two serious territorial disputes in the Barents Sea. One issue concerns the drawing of the territorial sea line between Russia and Norway. The other relates to the large economic zone off the east coast of the Norwegian-owned Svalbard Islands. Russian ships have reportedly carried out seismic work in the disputed zones in violation of an understanding between the two countries, but there is little the Norwegians can do to put a stop to this activity.

However, the potential profit for the companies participating in the Shtokman development overwhelms any consideration of disputes in other parts of the High North. In late 2007, StatoilHydro signed a framework agreement with Gazprom, giving the Norwegians a 24 percent stake in the management company being set up to develop the field. With StatoilHydro in the picture, chances are better that there will be a greater degree of business transparency in this project. Nevertheless, Gazprom’s Western partners will have a difficult time with governance and integrity issues, if the Russian company follows its usual practices.

The benefits to Russia of developing a giant field like Shtokman are substantial. With the prospect of enormous profits, in addition to Russia’s proven propensity to push for more and more territorial control, the chances of territorial clashes over competing claims in the Arctic are likely. Russia’s Defense Ministry has already announced that its intention is to build seven aircraft carrier battle groups, with one of them to be permanently stationed in the Arctic Sea. Norway, Canada, Denmark, and the United States will have a difficult time staking their claims to the region’s resources, as was demonstrated by Moscow’s rush to plant a titanium Russian flag on the seabed at the North Pole. The rush to exploit the Arctic region’s riches may in the future come to resemble the 1920s scramble by the great powers to lock up petroleum reserves in the Middle East and Caucasus. The High North region is an example of where the United States lags behind the others in its ability to claim seabed territory as a result of its reluctance to sign the United Nation’s Law of the Sea Treaty.

**Recommendations**

- The EU Commission should enforce the Energy Charter Treaty. According to Article 45 of the treaty, it goes into effect when a state signs the treaty, not when it is ratified, unless there is a specific declaration that the signatory state will “opt out,” as was the case with Norway. Therefore, Russia already has a binding treaty obligation with the EU member states and is in violation of the treaty.

- DG COMP should enforce the Treaty of Rome’s competition and antitrust rules in Article 82 regarding all cases of cross-border agreements among Transneft, Gazprom, and individual European states. These companies should be held to the same antimonopoly standards as Microsoft and Intel.
Western firms should petition the European Union, DG COMP, and national governments to enforce vigorously existing antitrust and competition policies, particularly in regard to Russian state companies. Greater import competition would lower prices for consumers and for Western power and refinery operators. Opening existing Russian pipelines to competitors would also increase the supply of oil and gas coming from Russia and Caspian countries and bring more supply predictability. The “unbundling” policies being pursued by DG COMP would be a positive step forward.

The European Union should calculate the true cost to the European consumer of Russia’s monopoly of Central Asian energy supplies and the construction of the very expensive Nord Stream and South Stream pipelines. It should publicize the cost estimates of the two pipelines versus the recovery costs of viable alternative pipelines and possible consumer benefit or loss from the Yamal II, Amber, and Nabucco projects.

The European Union and the International Energy Agency (IEA) should demand the right to immediately investigate the causes of disruptions of Russian or non-Russian oil or gas to any EU member state, including the Baltic states. Apply economic sanctions on the assets in Europe of Transneft and/or Gazprom in cases where their disruptions appear designed to pressure a member state to sell its facilities to Russia. Neither company should be allowed to buy assets in EU member states until the firms become more transparent in their accounting and operating practices.

The EU Commission should provide more active leadership in working with Central Asians in order to secure supplies of gas and oil directly to the European Union, without the use of nontransparent middlemen. Work more closely with Azerbaijan and Kazakhstan to secure a reliable supply of gas for the Nabucco pipeline.

The EU Commission should enforce a “level playing field” for European and Russian investors in the energy sector. The rules on both sides should be fair, transparent, and enforceable. If EU investors in Russia are limited to 25 percent ownership in Russian enterprises, then Russia should be held to the same percentage of ownership in European energy facilities and energy marketing companies.

The EU Commission and Council should push for full implementation of the Parliament’s September 26, 2007, resolution that called for a “common European foreign policy on energy.” Carrying out the Parliament’s recommendations would help equalize the EU energy market for Western investors, would reduce opportunities to engage in nontransparent or corrupt business practices in the East-West energy business, and would decrease the large profit that stems from monopoly control of piped natural gas exports from the Caspian Sea countries and Russia to Europe.

The Council and Parliament should consider establishing an independent regulatory agency with the authority to monitor (but not approve or disapprove) all major energy agreements between EU and non-EU companies. Such an agency would report to the Commission.
The agency could enforce a minimum level of revenue transparency in international energy contracts, extending to all companies (domestic and foreign) that do business within EU member states.

- All EU member governments should be required to notify the Commission at the start of negotiations with foreign entities regarding; 1) the construction of new energy pipelines, 2) the offering of tenders for energy contracts, and 3) when conducting talks for the sale of existing facilities within their border. This might counteract the “divide and conquer” activities of Russian state-owned energy firms, thereby leading to greater cooperation among EU states.

- Western energy companies would benefit from a uniform reporting requirement that applies to domestic and foreign firms doing business within EU states; one that mandates revenue transparency reporting for their operations at home and abroad. This would weaken the current advantage held by firms from countries with high levels of business corruption and an unwillingness or inability to enforce existing contracts.

- Firms should be barred from including confidentiality clauses that hide revenue transparency in contracts with foreign energy companies.

- The EU Commission should be more active in defending member states against politically motivated disruptions in energy flows from Russia, such as occurred in Lithuania and Latvia. An unwillingness to defend EU members from this kind of disruption only disadvantages the energy firms and the state interests targeted by Moscow. A lack of EU action only encourages those elements in Russia that oppose domestic reform and enforcement of the rule of law.

- NATO member states should establish an energy security subgroup within the existing Economic Committee that would have a mandate to study and report on any international supply issue that is a potential threat to Europe or the United States. Any member state should be able to call for a meeting of the full Economic Committee to hear complaints regarding possible corruption or coercion in the energy trade, as long as they can prove that they are directly affected.

The purpose of this paper is to encourage greater European and American cooperation on issues of energy security, particularly as they relate to Russian suppliers, and to highlight Moscow’s policies regarding the use of its enormous energy potential to affect political and security events in Europe. The war in Georgia, whatever the arguments concerning who shot first, is part of a Kremlin strategy to discourage the building of gas pipelines from Caspian countries to Europe and in the process bypassing Russian territory and that country’s control of all Central Asian supplies. Without a more aggressive competition policy, Europe will lose much of its ability to lead the Continent toward greater integration and cooperation.

The present situation only reinforces the impression in Moscow that transparent, competitive energy trade policies are unnecessary and would only curb the extremely high rents now collected
by Russian elites. In the long run, however, the current policies of the Kremlin will likely lead to
greater suspicion of its motives, delay the development of a modern energy sector in Russia, and
as a result, delay the country’s integration into a democratic league of nations within Europe.
About the Author

Keith C. Smith is a senior associate at CSIS. He retired from the U.S. Department of State in 2000, where his career focused primarily on European affairs. From 1997 to 2000, he was U.S. ambassador to Lithuania, with additional posts in Europe, including Hungary (twice), Norway, and Estonia. In addition to several other State Department assignments, he most recently served as director of policy for Europe and senior adviser to the deputy secretary of state for support of East European democracies (SEED program). Smith has been a consultant to several energy companies and has lectured on Russian-European energy issues in the United States, the United Kingdom, Poland, Belgium, Norway, Germany, Czech Republic, Estonia, and Lithuania. He is the author of *Russian Energy Politics in the Baltics, Poland, and Ukraine: A New Stealth Imperialism?* (The CSIS Press, 2004).