

Katholieke Universiteit Leuven
Leuven School of Business and Economics
Naamsestraat 69
3000 Leuven



MASTER THESIS

Russia and Energy as a Political Means

This thesis is written by
Philippe DESPLENTER
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Supervisor: Prof. Dr. Christophe Crombez

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List of Abbreviations

Bcm	billion cubic metres
BP	British Petroleum
CEE(C)	Central and Eastern Europe(an countries)
CEO	Chief Executive Officer
CIEP	Clingendael International Energy Programme
CIS	Commonwealth of Independent States
DG Tren	Directorate-General Transport and Energy
EC	European Commission
EIA	Energy Information Agency
est.	estimated
EU	European Union
FDI	Foreign Direct Investment
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
IEA	Institute of European Affairs
IMF	International Monetary Fund
Mcm	thousands cubic metres
Mtoe	Millions of Ton of Oil Equivalent
OECD	Organization for Economic Co-operation and Development
OPEC	Organization of Petroleum Exporting Countries
PCA	Partnership and Cooperation Agreement
RAO UESR	<i>РАО Единые Энергетические Системы России</i> RAO Unified Energy System of Russia
RUB	Russian Rubbles
<i>RUBb</i>	<i>billion RUB</i>
SBC	Soft Budget Constraints
US	United States (of America)
USA	United States of America
USD	United States Dollar
<i>USDb</i>	<i>billion USD</i>
WTO	World Trade Organization
γ	year

Remarks:

- In this paper, the dollar sign (\$) means USD, unless otherwise stated;
- By a trillion, the US meaning of trillion is meant (10^{12}).

Introduction & Methodology

Not so long ago, in the 1990s, there were only a few people that really cared about energy in Europe. Businesses wanted to become energy giants and thought the integrated European market was an opportunity, governments were divided between “green energy,” making sure energy stayed a national priority and matter, and making sure the energy consumers – industries, transport and households – were kept satisfied. Indeed, most people only cared about energy as a number on their quarterly bill.

But then, around the turn of the year 2005-2006, there was a crisis between Ukraine and Russia. Both ex-Soviet countries, the Russian state-owned gas giant Gazprom agreed to sell gas to the Ukraine at a price well below the market price.¹ Under the veil of demands by the EU and the USA, Gazprom, announced to charge as from the 1st of January 2006 300% more for its gas and said it would in the future increase it further to 450% of the initial price. In that way, Ukraine would have to pay the market price. Although discussions between Gazprom and Kiev started in March 2005, it wasn't until late December 2005 that people in Western Europe heard about it and started to worry. It was then that Russia started to threaten to shut down the oil supply to Ukraine if they did not accept the higher price. A stop of oil supply to Ukraine would mean an important drawback in the supply of energy to the European Union as many of the pipes destined to transport oil and gas to Europe run over Ukrainian territory.

The reasons for the sudden, unilateral and steep increase in gas prices by Gazprom are diverse. Indeed the EU asked for an ending of the two-tiered pricing system, but political arguments should not be underestimated. The fact that Ukraine was acceding faster than Russia to the World Trade Organization, an institution to which Russia already since a long time wants to be a part, was very painful to Russia. But also other political actions by Kiev to make it clear to Moscow that Ukraine was now an independent country, made it, according to some, time to retaliate.

Others say that it was a demonstration of the power of Russia against the European Union. The Soviet Union may have ceased to exist and the Cold War is over, but Russia still has a strong army: an army of oil, gas and pipelines.

This is exactly what I want to examine in my Master's thesis: can Russia win an energy war with Europe? Is Europe in a puppy position vis-à-vis Russia? Does Russia use energy as a political means in Europe? To answer these questions, there will be two parts in this paper. The scope of this Master thesis is political as well as economic.

In a First Part, I will discuss whether Russia is *able* to use energy as a political means, regardless whether they do it or not. For Russia to be able to use energy as a political means, politicians must have access to energy. The First Chapter will discuss the importance of energy for the Russian economy and the connections between the government and the energy sector. The first paragraph will give a short overview of the Russian economy. The second paragraph will explain the importance of energy for the Russian economy. A third and concluding paragraph will then analyse the

¹ Russia's gas was paid at 50 USD per cubic metre, compared to a normal market price of 230 USD per cubic metre. On top of that Ukraine takes 15% of all gas passing through the country in pipelines.

importance of the Russian government in the energy sector as well as its real power. The question whether the “energy-oligarchs” control the government or the government controls the “energy-oligarchs,” will be answered.

Chapter Two will discuss the importance of Russian energy for the European Union. For Russia to be able to efficiently use energy as a political means of pressure in Europe, the EU needs to be dependent from, or at least have important interests in Russian energy. This is the second condition. A first paragraph will give some statistical information about this. This will be followed by a short analysis why this dependency can be dangerous. A second paragraph will discuss the efforts the EU makes to become more independent from Russian oil and will give a status report on the progress.

Chapter Three will discuss the importance of Russian interests in Europe. As explained above, Russian companies may have an interest in the European Union. To make sure that these interests are protected, the company itself or the government may put pressure on the EU through energy. This chapter will discuss this possibility by analysing whether Russian interests are worth this risk.

Part Two of this paper will research whether Russia actually does use energy as a political means in Europe. This part will start off with an introduction note: does Russia need to use *energy* as pressure means? In other words, what is the intensity of energy as opposed to military pressure, other economic pressure, etc?

Chapter Four will analyse whether Russia actually uses energy as political means and if so, to what extend. I will answer this question by using a case study about the Russian-Ukrainian gas dispute of January 2006. The case will be analysed following the “4 I’s” theory and a conclusion will be given.

Part I

*Can Russia use Energy as a Political
Means?*

1

CHAPTER ONE

The importance of energy for Russian politicians

This chapter will deal with the relations between Russian politicians and the Russian energy sector. First, the role of the energy sector for the Russian economy will be analysed. I will provide basic economic information to explain the importance of energy for the existence of the Russian state. In a second paragraph the energy sector as such will be discussed. I will merely give a short overview of the energy sector based on political economic factors. The third and concluding paragraph will explain that, although privatisation has occurred, the government still has an important role in many of Russia's energy companies.

1.1 The role of energy in the Russian economy

Koen Schoors (2005) argues that between 1990 and 1998 Russia's GDP has halved. The standard of living has decreased and the number of people living in poverty grew fast. In August 1998 a financial crisis hit Russia. The government was obliged to devalue the Rubble and to stop the reimbursement of its foreign debt. In a way, one could argue that this crisis was the beginning of a revival of the Russian economy. Indeed, the devaluation of the Rubble made Russian products more price competitive and thus stimulated export. In the same way, imports become more expensive, thus promoting domestic production and manufacturing. Under the presidency of Putin, a much needed economic and political stability was reached. While Yeltsin stood against a hostile Communist parliament, which was blocking every reform proposal, Putin was able to handle corruption, enforce taxation (an important source of government revenue) and to promote Russia as a country of investment. This good economic leadership, together with high oil prices,² made the Russian economy boost.

Table 1—1 GDP of Russia (1998-2008)

year	Nominal in RUBb	GDP per capita	Change y-1	nominal in USDb	GDP per capita
1998	2,629.60	17,791.61	-5.3 %	271.04	1,833.82
1999	4,823.20	32,699.66	6.4 %	195.91	1,328.18
2000	7,305.60	49,731.79	10.0 %	259.70	1,767.88
2001	8,943.60	61,131.92	5.1 %	306.58	2,095.58
2002	10,817.50	74,590.22	4.7 %	345.07	2,379.38
2003	13,243.20	91,332.41	7.3 %	431.43	2,975.37
2004	17,048.10	118,225.38	7.2 %	591.86	4,104.44
2005	21,614.70	150,625.09	6.4 %	763.88	5,323.19
2006	26,621.30	186,423.67	6.7 %	979.05	6,856.08
2007 (est.)	30,237.63	212,788.39	6.4 %	1,166.56	8,209.32
2008 (est.)	34,445.57	243,591.32	5.9 %	1,344.54	9,508.27

Source: IMF, *World Economic Outlook*, April 2007, 297p., Internet, <http://www.imf.org> [27/05/2007].

² For why high oil prices contributed as much to the growth of the Russian economy, see below.

Table 1—1 represents the Gross Domestic Product of Russia between 1998 and 2007. Since 1999, Russia experiences an average growth of 6.2%, which is much more than its biggest trade partner, the Europe Union (average 2.26% growth between 1999-2007ⁱ). According to the Russian Economic Report of the World Bankⁱⁱ, a booming domestic market continues to drive strong economic growth in Russia. Substantial net capital inflows have joined receipts from resource exports in fuelling domestic demand. Fixed capital investment and FDI have also exhibited impressive growth. The economic expansion continues to be concentrated primarily in non-tradable sectors of the economy that have profited from a stronger Rubble.

Indeed, the OECDⁱⁱⁱ agrees that the financial crisis of 1998 has been an important driver for the Russian economy but raises some concerns. Although consumption is booming, Russia still imports a lot of finished products. This brings a factor of risk along: instead of producing goods that can be used within the country, Russia mainly produces goods destined for export. By doing this, Russia depends heavily on foreign countries. They will not only provide income for the Russian government and economy, foreign countries must also be relied upon to produce consumption goods for the Russian people.

Table 1—2 gives an overview of major sectors in the Russian economy. Manufacturing is still important, which is a heritage from the Soviet period (Spuller, 2003). The most important sector, however, is the trade sector. If, however, at one point, foreign countries are no longer interested in the products Russia exports, this may have disastrous consequences for the Russian economy.

Table 1—2 GDP per sector in % of total (2002-2005)

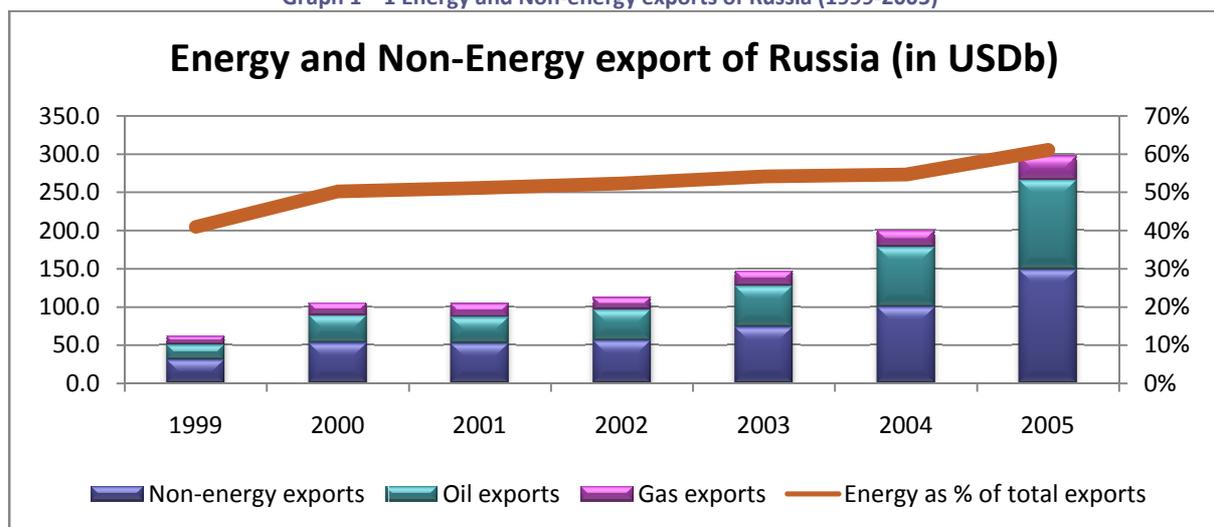
	2002	2003	2004	2005
Agriculture, hunting, and forestry	6.3	6.2	5.6	5.0
Fishing	0.3	0.5	0.4	0.4
Extraction	6.7	6.6	9.5	10.5
manufacturing	17.3	16.7	17.5	17.5
Electricity, gas and water	3.7	3.6	3.5	3.4
Construction	5.4	6.0	5.5	5.7
Trade and other miscellaneous services	22.6	21.8	20.7	20.5
Hotels and restaurants	0.9	0.8	0.9	0.9
Transport and communications	10.2	10.6	11.1	10.2
Finance	3.1	3.4	3.4	3.7
Real estate	10.5	10.6	9.1	9.1
Public administration and defence; social security	5.0	5.5	5.1	5.1
Education	2.9	2.7	2.7	2.6
Health and social services	3.3	3.2	3.1	3.1
Other public utilities, social and personal services	1.9	1.9	2.0	2.1
Total	100.0	100.0	100.0	100.0
Growth against y-1		7.3	7.2	6.4

Source: IMF, Russia Federation: statistical appendix, Country Report No. 06/431, December 2006, p. 6, Internet, <http://www.imf.org>, [30/03/2007].

According to the US government’s Energy Information Administration,^{iv} Russia’s economic growth over the past five years has been fuelled primarily by energy exports, given the increase in Russian oil production³ and relatively high world oil prices during the period.⁴

Russia’s economy is heavily dependent on oil and natural gas exports, making it vulnerable to fluctuations in world oil prices. In 2006, around 66% of all export revenues came from energy or energy-related products. According to an IMF study,^v a 1 USD per barrel increase in Urals blend oil prices for a year is estimated to raise federal budget revenues by 0.35 percent of GDP, or 1.8 billion – a fact that underlines the influence of oil on Russia's fiscal position and its vulnerability to oil market volatility.

Graph 1—1 Energy and Non-energy exports of Russia (1999-2005)



Source: IMF, Russia Federation: statistical appendix, Country Report No. 06/431, December 2006, p. 33, Internet, <http://www.imf.org>, [02/04/2007].

The Russian economy is one that is depending very much on trade. The degree of openness, which represents the importance of exports and imports against GDP, of Russia is higher than that of EU (excluding intra-EU trade) or the USA. Export products are mainly natural resources, like energy and precious metals, which makes Russia’s economy difficult to be sustainable.

Some further problems with the energy sector are discussed in the next paragraph. The need for privatisation, the lack of competitiveness and corruption are some of the elements which make it hard to believe in a sound and sustainable Russian economy.

³ Russia has increased its production from 6,000 barrels in 1998 to around 9,500 in 2005 [+60%] (EIA, 2005).

⁴ World oil prices rose with a third between 1998 and 2005 from \$55 to \$72 per barrel crude oil (EIA, 2005).

1.2 The Russian energy sector

1.2.1 Overview of the energy sector

The Russian energy sector can be divided into three parts: the oil sector, the gas sector and the electricity sector.

Table 1—3 World importance of Russian energy sector

Energy Sector in Russia: importance in the world	
Oil	<ul style="list-style-type: none">- With 760 billion barrels (2005) Russia is among the top ten in proven oil reserves (USA: 22; Saudi Arabia: 259)- Russia is the second largest oil exporter in the world.
Gas	<ul style="list-style-type: none">- Russia has the largest natural gas reserves in the world: 47.57 trillion m³ versus 5.35 trillion m³ in the USA and 6.65 trillion m³ in Saudi Arabia.- Russia is the world's largest producer and exporter of gas.
Electricity	<ul style="list-style-type: none">- Electricity is almost not exported and thus relatively unimportant for the Russian economy

Source: BP, [BP Statistical Review of World Energy 2005](http://www.eia.doe.gov/emeu/ipsr/11b.xls), Oil & Gas Journal, December 2004, Internet, <http://www.eia.doe.gov/emeu/ipsr/11b.xls>, [03/04/2007].

1.2.2 Political-Economic challenges of the energy sector

Energy policy in Russia

The Russian government has moved to take control of the country's energy supplies. It is arguable that this was partly the motivation behind the government's prosecution of Mikhail Khodorkovski, CEO of Yukos, who acquired state-owned assets during privatisation and adopted open and "transparent" business practices while transforming Yukos into a major global energy company. Yukos has been broken up, with its principal assets being sold off to meet alleged tax debts. Yuganskneftegaz, Yukos' main oil production subsidiary, was sold at a state-run auction and through a third company to Rosneft, the state oil company. (Gelb, 2006)

When Russia started its privatisation in 1992, the purpose was to make the economy more competitive. Brown, Earle and Telegdy (2006) have calculated that privatisation indeed has a positive effect on a company's revenue and a negative effect on the cost. A second step was the diminishing of soft budget constraints,⁵ which is a consequence of good economic policy. Knowing that privatised companies can go bankrupt, they are thus forced to become more competitive and efficient in order to survive.

⁵ A company has soft budget constraints (SBC) when it is (constantly) bailed out when having budgetary problems. This bail-out can be done by a bank, another (parent) company or by the government, as was a common habit in the Soviet Union. The fact that a company *knows* it is going to be helped when in trouble makes it highly unmotivated to be efficient (Kornai, Maskin, Roland; 2003).

The role of the state in the Russian energy sector and the general philosophy of the Russian energy policy have changed after the beginning of the second presidential term of Putin. During his first term, the Russian president had avoided interference into economic activities, leaving the economic policy up to the government, and providing only general signals to the government through his annual addresses to the Federal Parliament. Most of the content of these addresses on economic issues promoted a liberal economic policy agenda, associated with further deregulation and privatisation of the economy.

After his re-election, it became clear that Putin has his own economic agenda, which was different from the deregulation slogans popular during his first term. This “new policy” affected the energy sector in the first place; it is restoration of the state control over energy industries, instead of the deregulation agenda, and became the heart of this new policy (Milov, 2005). The Yukos affaire (briefly discussed below) is a good example of this.

This re-nationalisation of the energy sector, with a focus on the oil industry, does not only destroy the effects a privatisation may bring, such as competitiveness, new technologies, higher motivation and new management skills. There are *reversal costs* to be taken into account: these are the costs of reversing a privatisation and the total of money spend on the privatisation of a sector (Roland; 2002).

The oil industry

Most of the problems in the oil sector are directly associated with the efforts of the Russian authorities to restore control over the sector, and are affecting both the business climate and the strategic investment decisions of the companies active in the sector (Milov, 2005). Russia’s oil and gas fields are aging, modern Western energy technology has not been fully implemented and there is insufficient investment capital for improving and expanding Russian oil and gas production and pipeline systems (Gelb, 2006). Locatelli (2006) calculated that there is indeed every year less oil produced and more exported.⁶

Russia faces not only on production level challenges, but also on export level. According to Gelb (2006), there is insufficient export capacity in the crude oil pipeline system controlled by Russia’s state-owned pipeline monopoly, Transneft. Bottlenecks in the Transneft system prevent its export capacity from meeting oil producers’ export ambitions. Currently, only about two thirds of the oil produced can be transported in major trunk pipelines; the rest is shipped by more costly rail and river routes. Most of what is transported via alternative transport modes is refined petroleum. The rail and river routes could become less economically viable if oil prices fall sufficiently. The Russian government and Transneft are striving to improve the export infrastructure.

The Gas industry

Grigoryev (2006) sees two major problems in the Russian gas sector, as seen from abroad. First, there is the question whether Russia will be able to continue to supply the growing global demand with an efficient and economical method of delivery. Furthermore, it is also uncertain whether Russia can (and wants to) give the assurance that supplies are not interrupted as a result of political intervention.

⁶ See Appendix 1 for numeric information about the oil production and export.

Issues have arisen with the growth of Gazprom's sales to Europe. European Union trade representatives have criticised Gazprom's dominant market position and two-tiered pricing system.⁷ Russia agreed to grant independent natural gas producers access to Gazprom's pipelines. Also, in response to calls for fair pricing, the Russian government doubled prices to Russian industrial consumers. But the new price level still is less than half of the prices charged at the German and Ukrainian borders (Ahrend, Tompson; 2003).

A second problem the gas sector is facing is the declining gas production by Gazprom. Due to declining production of the major existing gas fields, Gazprom is no longer able to supply both the domestic as well as the foreign market. While the domestic gas consumption in Russia is rising, Gazprom chooses to supply primarily to foreign countries as gas revenues are higher (cf. two-tiered pricing system above). This gives the possibility for smaller independent oil suppliers to deliver to Russian consumers but makes Gazprom, still responsible for 88% of all gas production in Russia, very dependent of foreign markets. Furthermore, these independent oil suppliers have no access to exports (Milov, 2005).

The Electricity and Coal industry

Both the electricity and coal industries have little to no importance for the Russian economy. This is mainly the case because there are no exports in these two industries. Under EU and US pressure, Russia has started to privatise these sectors. RAO UESR, the state electricity giant, has accepted the "5+5" plan in December 2003 which breaks RAO UESR up into four independent companies. This breaking up is at this moment "almost" [sic] finished. During the first 5 years (2003-2008), the government will own in all companies still a minor or major share; thereafter, the state will sell off gradually all remaining shares. The "5+5" plan explicitly states that the reasons for this restructure are "to increase the efficiency of power utilities [and] to make the sector attractive for private investment." (RAO UESR Company Website, 2007)^{vi}

Box 1—1 Overview of main challenges in Russian energy sector

Summary	
Main problems challenging the Russian energy sector	
-	Not enough foreign investment
→	Lack of modernisation
→	Lack of new management technologies
-	Not enough privatised (too much government interference)
→	Not competitive enough
→	Not efficiency enough
→	Conflicts of interests

⁷ In order to make the transition period for CIS countries not even more difficult, Russia agreed to a "special oil price," valid for a "certain" number of years (Ahrend, Tompson; 2003), see introduction.

1.3 Conclusion: The *real* power of politicians in the energy sector

The previous paragraph demonstrated that the government and the energy sector in Russia are much connected. In the oil industry, the Russian state has a full share (100% stake) in Rosneft and Transneft (owner of the crude oil pipe lines); in the gas industry, the government owns 51.5% of Gazprom's shares. The willingness of the Russian government to have more influence on the "Big Four Energy Giants" (Gazprom, Lukoil, Surgutneftegaz and Rosneft) seems in contraction to the demand of privatisation by the WTO, EU and the USA (Locatelli, 2006).

Rather than re-nationalising companies, the Russian government slowly sells its shares. There are two ways in which the government still has a lot of power on energy companies. First, all oil pipes remain in hands of the fully stated owned Transneft Company. Export volumes are thus regulated by the government and negotiated by private companies. Secondly, the government gives a lot of subsidies. In doing so, politicians can pressure energy companies to accept government regulations and rules and threaten with the removal of subsidies.

It is, on the other hand, doubtful whether the Russian government has the same impact on the "Big Four." Unlikely, but possible, the threat of subsidy diminishing can be answered by a threat to stop paying taxes or to augment export volumes which causes prices to fall and thus government revenues to plunge. More likely are the friendships and similar business interest of important managers at Russian energy companies and the politicians, who need, after their mandate, another job.

There is an evolution from Yeltsin to Putin. Under the "loan for shares" programme in 1995, Russian banks received several shares owned by the Russian government. If they government was unable to repay its debts within three years, the shares would definitely become ownership of the banks. Those banks were in hands of a handful people, called the oligarchs. These oligarchs became very rich and agreed to pay Yeltsin's re-election campaign in return for favourable laws and regulations. Putin, however, was able to cut the political power of the oligarchs, e.g. by making taxation enforceable. He paid attention, though, not to make the oligarchs an enemy. It this way the state gained – again – a say in the business life, as it was used to be in Soviet Era (Hill, Fee; 2002).

Endnotes

ⁱ Source: EUROSTAT, Real GDP growth rate, 2007, Internet, <http://ec.europa.eu/eurostat>, [01/04/2007].

ⁱⁱ Source: WORLD BANK, Russian Economic Report, December 2006, p. 2, Internet, <http://www.worldbank.org>, [29/03/2007].

ⁱⁱⁱ Source: OECD, Economic Survey of the Russian Federation 2006, Policy Brief, November 2006, p.1-3, Internet, <http://www.oecd.org>, [02/04/2007].

^{iv} Source: EIA, Russian Energy Data, Statistics and Analysis, Internet, www.eia.doe.gov, [01/04/2007].

^v Source: SPILIMBREGO, A., Measuring the fiscal performance in Russia, IMF working paper 05/241, December 2005, 19p., Internet, <http://www.imf.org/external/pubs/ft/wp/2005/wp05241.pdf>, [02/04/2007].

^{vi} Source: RAO UESR, Concept of RAO UESR's strategy, Company Website, Internet, <http://www.rao-ees.ru/en/reforming/conc/show.cgi?con2003.htm#1>, [05/04/2007].

2

CHAPTER TWO

The interests of the European Union in Russia

If the European Union has no interests in Russia, there is no possibility for Russia to be able to use energy as a political means. In this chapter I will analyse these European interests in Russia. I will focus on the most important interest: energy. A first paragraph will explain the importance of Russian energy for the EU. With some numbers it will become clear that Europe is dependent on Russia what concerns energy. In order to guarantee the safe and stable flow of oil and gas, the EU has concluded agreements. These will be analysed as well as some forecasts for possible future problems. A second paragraph will deal with the latest events of the European Union to become less dependent from Russia. An important factor is the forming of a unified European internal energy market and the search for new, efficient and sustainable – hence: “renewable” – sources of energy.

2.1 Importance of Russian energy for the European Union

2.1.1 The European energy dependency

The Clingendael International Energy Programme (CIEP) analysts diagnosed a “growing exposure to security supply risks for the European Union” (van der Linde, et al.; 2004, p. 81). This ‘growing exposure’ is explained in Table 2—1 (next page): the great weight of oil and gas in the consumption of primary energy in the EU;⁸ the strong EU dependency of imports of fossil energy; the forecast of a constant growth of both consumption and of dependency from imports; and finally the concentration of the mentioned purchases in a few countries⁹ (Mañé-Estrada, 2006).

Knowing from Table 2—1 that the European Union is dependent for its energy, it is understandable that the security of energy supply¹⁰ is a vital interest of the member states. If security of supply is or becomes uncertain or the level of security is asymmetric among the member states, the urge to implement national energy security policy by certain member states might become stronger. However, due to the integration and liberalisation of the EU energy markets, the scope for national policies to ensure adequate levels of security of their own has decreased significantly. This means that it is up to the European Commission to provide a sustainable and efficient energy policy (van der Linde, et al.; 2004). A good energy policy is, however, not yet achieved by the European Commission. The internal energy market has yielded benefits but is hampered by the fact that there is no integrated European market yet, but rather a string of national markets with bilateral interconnections – at least what concerns energy. Every member states has build up an own

⁸ For numeric information about this statement, see Appendix 3.

⁹ Cf. paragraph 2.1.2, p. 2, below.

¹⁰ The security of energy incorporates three aspects: (1) European energy needs should be met; (2) under economically acceptable conditions and (3) from an accessible and stable (internal or external). Source: de Joode, 2003.

electricity networks and energy storage facilities, and are reluctant to let other nations use these capital intensive constructions (Helm, 2005).

Table 2—1 EU-25 primary energy import dependency

<i>Mtoe</i>	1990	1995	2000	2002	2004	2010	2020	2030
Production	877.84	896.80	892.02	895.86	882.65	859.00	738.90	660.00
Solid fuels¹¹	40.04%	29.49%	22.62%	22.39%	21.58%	17.73%	16.80%	15.39%
Oil	13.71%	18.10%	16.97%	17.40%	15.21%	15.31%	13.80%	13.09%
Gas	15.91%	19.42%	22.04%	21.57%	21.78%	22.92%	19.98%	17.74%
Nuclear	22.44%	24.01%	26.64%	27.73%	28.82%	28.57%	28.92%	28.06%
Renewables	7.69%	8.72%	10.42%	10.55%	12.37%	15.47%	20.50%	25.70%
Other	0.19%	0.26%	1.30%	0.36%	0.25%	0.00%	0.00%	0.00%
Net imports	708.96	701.17	802.06	826.24	907.27	979.80	1,215.50	1,371.60
Solid fuels	10.61%	10.54%		12.26%		9.29%	10.55%	14.18%
Oil	71.65%	69.99%	64.59%	63.57%	61.75%	58.54%	52.00%	48.26%
Gas	17.40%	19.22%	23.33%	23.89%	25.07%	31.94%	37.05%	37.38%
Electricity	0.31%	0.20%		0.23%		0.22%	0.15%	0.17%
Renewables	0.02%	0.05%		0.05%		0.01%	0.25%	0.00%
Inland consumption	1,553.01	1,571.44		1,676.89	1,747.20	1,788.30	1,895.00	1,968.40
Solid fuels	27.79%	21.98%		18.22%	17.90%	13.61%	13.31%	15.04%
Oil	38.23%	39.52%		38.05%	37.30%	36.60%	35.76%	34.82%
Gas	16.69%	19.56%		22.95%	23.90%	28.51%	31.56%	32.00%
Nuclear	12.68%	13.70%		14.81%	14.60%	13.72%	11.28%	9.41%
Renewables	4.37%	5.00%		5.66%	6.30%	7.43%	7.99%	8.62%
Other	0.25%	0.24%		0.30%	0.00%	0.13%	0.09%	0.13%
Import dependency (%)	44.6	43.6	47.2	48.0	50.5	53.3	62.1	67.5

Source: EUROSTAT, *Environment and Energy Statistics*, Internet, <http://epp.eurostat.ec.europa.eu/>, [06/04/2007] and MANTZOS, L., CAPROS, P., *European Energy and Transport: trends to 2030 – update 2005*, European Commission, May 2006, 148p., Internet, http://ec.europa.eu/dgs/energy_transport/figures/trends_2030_update_2005/energy_transport_trends_2030_update_2005_en.pdf, [06/04/2007].

2.1.2 Where does European energy come from?

In this paragraph I am going to focus on gas and oil only. As seen in the previous paragraph, those two are the main sources for European energy.

Present

To date, about a third of all gas and half of all oil originate in the former Soviet Union. When focusing on Russia, we see that it is the responsible for one fourth of all oil imports and a half of all gas imports. With this, it leaves Norway for both import products far behind. Furthermore, we can state that the EU gets most of its energy imports from three countries. This lack of diversification for EU energy imports makes the EU dependent from a few countries and puts it, thus, in a much undesired position. Not only is negotiating more difficult, the security and sustainability of supply are harder to

¹¹ Solid fuels include charcoal, coal, peat and wood among others.

control¹² and energy prices are higher due to only a few suppliers (EC, DG Transport & Energy; van der Linden, et al., 2004; Mañé-Estrada, 2006).

Table 2—2 Origin of European energy imports

Crude Oil imports (EU-25, in %, 2005)		Gas imports (EU-25, in %, 2005)	
Former USSR	36.38	Russia	50.66
Russia	30.29	Norway	22.46
Norway	16.43	Algeria	19.08
Saudi Arabia	11.12	non spec. origin	7.15
Libya	9.21	Nigeria	3.69
Iran	6.29	Qatar	1.58
Middle East not spec.	1.63	Other origins	0.38
Other origin	18.94	Total Imports	100.00
Total Imports	100.00		

Source: EUROPEAN COMMISSION, DG Energy and Transport, *Energy and Transport in figures: statistical pocketbook 2006*, Internet, http://ec.europa.eu/dgs/energy_transport/figures/pocket_book/2006_en.htm, [08/04/2007].

Future

Although Algeria, Norway and Russia will continue to be the main suppliers to EU well into the next decade, according to Kjærstad and Johnsson (2007), substantial volumes can be expected to be supplied from a number of additional countries in foremost Africa and the Middle East. In addition, the Caspian states may emerge as suppliers, but most likely not until after 2010. While Russia probably will struggle to increase their share in total exports to Europe over the next decade, North African suppliers and Norway will have every possibility to increase their market share taking into consideration their location close to markets with large growth potential (Italy, Portugal, Spain, Greece for North Africa and Germany and UK for Norway). Post-2020, it seems probable that the Middle East will emerge as a main supplier (together with Russia), mainly through increased imports from Iran and Qatar. In addition, Saudi Arabia and Iraq may by that time have started exports to Europe. It seems unlikely that Russia will be able to increase exports to EU substantially in the short-term. As explained in the first chapter, there are several reasons for this:

- The rapid decline in production from the super giant fields such as Urengoi, Yamburg, and Medvezhye.
- Increasing capital expenditure and gas production cost to open new production areas on Yamal (Stern, 2005).
- The Russian domestic gas pricing system which, at least up to 2004, resulted in that Gazprom made significant loss on their domestic gas sales.
- Poor cost control and high debts combined with significant expansion plans. Staff costs have for instance doubled between 2002 and 2004, from 67 billions RUB to 123 billions (Gazprom, 2005) while net debts reached 15 billions USD during the 3rd quarter of 2004.
- Large investments required in the existing gas infrastructure.
- Insufficient incentives for independent producers to increase production, and no possibility to export.
- Poor investment climate.

¹² There are no adequate alternatives if there is, for example, a shortfall due to delay in production in Russia.

2.1.3 Conclusion: Is the EU dependent of Russia?

The European Union cannot produce enough energy to sustain its own needs. Around 50% of the Union's energy consumption is imported, of which half the gas is imported from Russia and a third of all the oil. It is clear that Russia is very important for Europe's energy needs. But, on the other hand, Europe is also very important for Russia, in terms of export revenues. This may make the EU dependency to Russian oil seem "less dangerous."

The energy sector, according to Cleutinx (2006), faces the following strategic challenges to become less dependent from foreign countries and more efficient:

Box 2—1 Summary of challenges in EU energy sector

- Europe should focus more on renewables and/or nuclear energy;
- The energy sector in the EU should become more efficient, with more transparency and predictability;
- All industries should become more energy efficient and the EU should promote research in energy efficient technologies;
- There is a necessity of open and competitive energy markets within and outside the EU;
- There is a need for more investments in oil and gas production and transport means;
- There is a need for a larger mix of energy, with a larger part of internal and renewable sources of energy with a low level of carbon;
- Our energy supply as well as their routes should become more diversified.

Source: CLEUTINX, C., *De energiedialoog EU-Rusland en de mondiale veiligheid van de energievoorziening*, EC DG Tren, 30 November 2006, Internet, http://ec.europa.eu/energy/russia/presentations/doc/2006_11_30_denhaag_nl.pdf [09/04/2007], own translation.

Europe is, however, making work of the security of energy supply through focusing on renewable energy sources (so-called "green energy") and on nuclear energy. This brings us to the next paragraph in which two things will be analysed: (1) how can the EU become less dependent from imported energy and (2) how can the EU secure its energy supply given that it is unable to become less dependent from imported energy? The latter will discuss numerous agreements the EU has made with Russia.

2.2 European measures to secure the supply of energy

2.2.1 EU-Russian energy relations

Now that oil is become so expensive, the EU relies more and more on gas for electricity generation. Russia is close-by, has the necessary pipes to transport the gas and has a reasonable stable government. This makes Russia a key to securing European energy. To date, Europe has approached this growing dependency in two ways: (1) by trying to persuade Russia to ratify the “energy charter,” and in particular to sign up to the “Transit Protocol,” which would open up access to Gazprom’s pipes;¹³ and (2) by pushing on with liberalisation and competition policy within Europe. The former has failed (Russia has signed the Energy Charter but it unwilling to ratify it); the latter, though of merit, does little in itself to mitigate the external position. A third option – diversification to non-carbon sources, like nuclear and/or renewables, has yet to have made serious impact;¹⁴ indeed, Europe is primarily pursuing the gas option (Helm, 2006a).

This strategy does not, however, change anything to the source of the problem: dependency of energy and dependency towards energy imports from almost one country only; a country where the energy sources are declining due to mismanagement and a lack of (foreign) investment (Spanjer, 2006). Although the talks and agreements between Russia and the EU do not make Europe less dependent for its energy, they do contribute to the security of supply.

The EU-Russian energy relations, in form of an Energy Dialogue, have started on an EU-Russia Summit in Paris in October 2000. Both parties decided “to institute, on a regular basis, an energy dialogue which will enable progress to be made in the definition of an EU-Russia energy partnership and arrangements for it. This will provide an opportunity to raise all the questions of common interest relating to the sector, including the introduction of cooperation on energy saving, rationalisation of production and transport infrastructures, European investment possibilities, and relations between producer and consumer countries. The planned ratification of the Energy Charter Treaty by Russia and the improvement of the investment climate will be important aspects in this context.”¹⁵

According to Piper (2004), the objective of the energy dialogue is to have a gradual integration of the energy markets in the EU and in Russia. This has to be done in order to safeguard the security of oil and gas supply in the EU and to make the Russian economy more efficient through competition and business opportunities. The dialogue also works on reciprocity issues concerning electricity and safety in the production of energy through nuclear programmes.

¹³ The terms “Energy Charter” and “Transition Protocol” are explained in Appendix 4.

¹⁴ Cf. next paragraph.

¹⁵ Extract from the Joint Declaration on the EU-Russia Summit in Paris on 30 October 2000. Source: EU, External Relations, *The EU’s relations with Russia*, Internet, http://ec.europa.eu/comm/external_relations/russia/summit_30_10_00/statement_en.htm, [09/04/2007].

Table 2—3 Priorities of the Energy Dialogue

<p>For the EU:</p> <ul style="list-style-type: none"> - Reform of the “natural” monopolies; - Improving the business environment; - Reciprocity in marketing opening; - Environmental protection & a high level of nuclear safety; - Non-discriminatory access to exploration, production & transit; - Security of energy supplies & the energy transportation network. 	<p>For Russia:</p> <ul style="list-style-type: none"> - Long term contracts for natural gas; - Attracting investments; - Participation of the European Investment Bank; - Developing beyond just exporting primary energy; - No limits to the imports of energy products into the EU; - Interconnection of the electricity grids; - Energy efficiency improvements; - Independent advice.
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Source: PIPER, J., *Towards an EU-Russia Energy Partnership*, DG Tren, 2004, <http://ec.europa.eu> [09/04/2007]

Critics of the energy charter, notably Russian president Putin, have found it to be too unilateral, focusing only on what Russia should do and giving nothing in return.

Europe does not only try to change Russia’s energy market to become more EU favourable by using bilateral agreements, but also by using the WTO accession discussions. Russia started these in 1993 but has not yet been able to become a member of the WTO. One of the most difficult phases to obtain membership is the bilateral accession talks during which all major trade partners of the potential accessing country negotiate the conditions that have to be fulfilled prior to become a full member. These usually concern tariff reductions, market liberalisation and transparency of the market conform the five WTO principles.¹⁶

Soon after Yeltsin was replaced by President Putin, Russia’s interest in the WTO revived, aided by the support of his leading economics minister, German Gref. Russia wants to be part of the WTO because it would allow them access to foreign markets on the same conditions as other states. Aside from this main reason, Russia wants to join the WTO because it would provide Russia with protection against unfair competition (through the “Dispute Settlement Body”), include Russia more in the international community and attract more FDI (because of the transparency regulations). In return, the WTO and Russia’s main trade partners, the EU and the US, ask Russia to adopt international technical standards, provide more transparency concerning trade regulations (import tariffs and necessary documents), protect more the International Property Rights, make border formalities and administration more easy and standardised, reduce non-tariff trade barriers, and liberalise certain sectors of the economy more. The US uses a lot of political pressure to make Russia privatise and liberalise its banking sector; the EU focuses on the liberalisation of the energy market (Hare, 2002; Yudaeva, Guriev, Gorban, 2002).

Russia has now been accepted as a member of the WTO by all but one country: the United States. With Europe, Russia has signed an agreement in March 2004. Among other deals, Russia agreed to augment the energy price of its CIS trade partners, who were, and are still, benefiting a lower price

¹⁶ The five WTO principles are: no discrimination (most favoured nation principle), reduction of barriers to trade, improving the predictability (transparency) of trade, promoting fair competition and encourage development and economic reforms. Source: WTO, *GATT 1947, adopted 1994*, Internet, http://www.wto.org/english/docs_e/legal_e/legal_e.htm, [14/04/2007].

for Russian energy (cf. Chapter 1). This discrimination is an important issue for both the EU and Russia. Undiminished the negative aspects of a not enough liberalised energy market, including low competition, low quality and high prices, Europe sees the two-tiered pricing as making the European companies less competitive compared with their counterparts in Eastern Europe. Russia, on its side, fears the difficult political talks it will have to face with the governments of the CIS countries.ⁱ

2.2.2 Renewable and nuclear energy

Helm (2006a) says that the European Union has understood the seriousness of the situation, and with the Hampton Court summit in October 2005, followed by the energy green paper in March 2006, a series of sensible measures have been proposed – notably, reinforcing the interconnections within the EU and completing the physical infrastructure, and thereby not only gaining greater efficiency and security of supply internally, but also increasing resilience against external shocks and facilitating mutual assistance between member states. The implementation of these measures is, however, the biggest challenge for Europe, as national governments want to keep energy as a national competence.

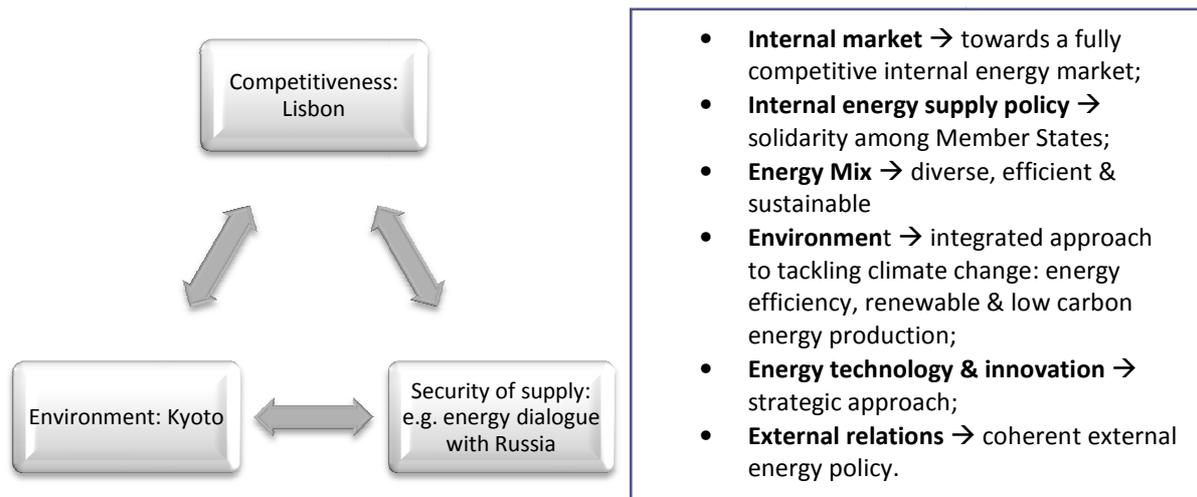
Box 2—1 Energy policy targets and objectives

- Reducing **greenhouse gas emissions** from developed countries by 30% by 2020 (the EU has already committed to cutting its own emissions by at least 20% and would increase this reduction under a satisfactory global agreement);
- Improving **energy efficiency** by 20% by 2020;
- Raising the share of **renewable energy** to 20% by 2020;
- Increasing the level of **biofuels** in transport fuel to 10% by 2020.

Source: EC, Energy, Energy for a Changing World: the need for action, Internet, http://ec.europa.eu/energy/energy_policy/index_en.htm, [10/04/2007]

In order to meet these objectives, the European Commission agreed on a Common Energy Policy, visualised in Figure 2—1a. All decisions on energy should be in accordance with three principles: (1) they should help to meet the Lisbon strategy; (2) decisions should help meet the Kyoto norms; and (3) the security of energy supply should be maintained. A recent example of the Common Energy policy is the Green Paper (08 March 2006) that has to make Europe more independent for its energy needs. Figure 2—1b explains the six priority areas of the Green paper.

Figure 2—1 Green Paper objectives



Source: EC, DG Tren, Green Paper on a European Strategy for Sustainable, Competitive & Secure Energy, 2006, Internet, http://ec.europa.eu/energy/green-paper-energy/index_en.htm, [10/04/2007].

Endnotes

ⁱ EC, Russia-WTO: EU-Russia deal brings Russia a step closer to WTO membership, Internet, http://ec.europa.eu/comm/external_relations/russia/intro/ip04_673.htm, [14/04/2007].

3

CHAPTER THREE

The interests of Russia in the European Union

Another important question to be resolved is: "Is Russia also dependent of the EU?" If so, this will have a minimising effect on our prime research question. If Russia has interests in the European Union, using energy to obtain the political direction it wants to have, can backlash into a "battle of the strongest," where both the EU and Russia are lobbying against each other. If Russia has no interests in the European Union, the EU cannot – economically – persuade Russia to alter its political course if found necessary. The question whether Russia has interests in the European Union will be dealt with in the third chapter.

3.1 The importance of the EU as trade partner

3.1.1 Trade

The importance of exports for the Russian economy has already been explained in Chapter One. This paragraph will deal with the destination of the majority of Russian export products. The destination has evolved in time from 80% of total exports towards the CIS countries in the 1950s, over 60% at the end of the Soviet Union to around 13% in 2005 (Spuller, 2003; IMF, statistical appendix, 2006). The reason for this change is mainly political-economic. According to Smith (1996), the Soviet Union exported a lot of crude oil, gas and other resources, and imported a lot of machinery and foods. The heads of the Soviet Union did not like the idea of trading with the capitalist world and thus limited exports and imports to the strict minimum. After the fall of the Soviet Union, trade with the richer West was not a problem, even a must to preserve the existence of Russia as a country, according to Spuller (2003).

As indeed shown in Table 3—1, in 2005 60% of all Russian exports were designated for Europe. There are three conclusions to draw from this table. (1) Already during the Soviet period, Russia exported a lot to East Germany. After the fall of the Berlin Wall and the reunification of the two German parts, the trade continued. After the fall of the Iron Curtain, Russia increasingly exported to Europe and Asia. (2) It is remarkable, however, how the exports towards the US have fallen from 6% in 1999 to around 2.5% in 2005. The main reason for this is that oil and gas became more a bigger part of Russia's export products. The US do not import a lot of Russia's natural resources but find them somewhere else (Middle East, South America and own resources). (3) Trade between Russia and CIS countries as percent of total trade has not much changed between 1999 and 2005 (14.70% to 13.50%).

Table 3—1 Export destination of Russian products

	1999	2000	2001	2002	2003	2004	2005	2005 in % of total exports
Total exports	72,885	103,093	99,970	106,712	133,656	181,600	241,219	100.00%
CIS	10,707	13,824	14,617	15,711	20,667	29,471	32,594	13.51%
Non-CIS	62,178	89,269	85,353	91,001	112,989	152,129	208,625	86.49%
Europe	40,490	59,660	56,092	59,662	72,542	98,419	145,992	60.52%
Asia	10,972	16,948	17,035	19,078	27,093	37,643	44,402	18.41%
US	4,709	4,644	4,198	3,989	4,216	6,624	6,318	2.62%
Other	6,007	8,017	8,028	8,272	9,138	9,443	11,913	4.94%

Source: IMF, Russian Federation: statistical appendix, December 2006, p. 34, Internet, <http://www.imf.org>, [12/04/2007].

Table 3—2 represents Russia's trade balance. The EU is, with 44.81%, for Russia its main import as well as export partner (56.23%, EUROSTAT, or 60.52%, IMF, according to the source). On the other hand, Russia is only the third most important import and export partner for the EU (9.08% and 5.32% respectively). This data suggests that Russia is more dependent on the EU concerning the amount of products imported and the amount of revenue received through exports.

Table 3—2 Trade between the Russia and the EU

Year	Imports	Yearly % change	EU Share of total imports	Exports	Yearly % change	EU Share of total exports	Balance	Imports - Exports
2001	19 588		47.77	52 251		56.88	32 663	71 839
2002	22 719	16.0	47.43	55 758	6.7	49.39	33 039	78 477
2003	22 986	1.2	46.09	59 328	6.4	51.37	36 342	82 314
2004	27 307	18.8	49.43	71 006	19.7	53.72	43 699	98 314
2005	34 904	27.8	44.81	107 494	51.4	56.23	72 590	142 397
3m 2005	6 351		47.85	21 504		59.80	15 153	27 855
3m 2006	16 007	152.0	59.34	31 218	45.2	59.39	15 212	47 225
Average annual growth		15.5			19.0			10.7

Source: EC, External Trade: Bilateral trade issues: Russia, September 2006, Internet, <http://trade.ec.europa.eu/doclib/html/113440.htm>, [12/04/2007].

Tables in Appendix 5 suggest the opposite, however. Although Russia is more dependent from European goods and services, almost 65% of the products imported by the EU originating in Russia are energy or energy-related. This represents around 27.5% of the Europe's total energy imports. Imports from Russia are thus highly undiversified. Seen from the Russian side, imports from the EU are much more diversified (machinery, food, manufactured goods, etc.). Russia, being Europe's third largest import partner, can in this way more easily use energy as a means of pressure against the EU as can the EU use any other product as a means of pressure against Russia.

However, Europe's dependency of Russian gas is around 50% but Russia sells 67% of its gas to Europe. This makes the two economies interdependent from each other. Any threat from Russia in reducing the volume of energy to the EU will consequently also have a negative influence on Russia (Trenin, 2006).

3.1.2 Foreign Direct Investment

Prior to the 1998 bank crisis in Russia, there were more investors in Russia than Russia invested abroad. As from 2000, this has changed. The Russian economy became better and Russians had more money to invest in their own economy and abroad.

Kalotay (2003) suggests that the EU-25 is the main destination for the Russian firms. The member states of the EU have attracted half of all the Russian FDI. Besides Germany, the eastern part of the EU is a particularly attractive investment target for the Russian firms. In absolute terms, Poland is the leading country in Central Eastern Europe (CEE) with nearly \$ 1.3-billion investment from Russia. Correspondingly, Latvia and Lithuania are the leading countries measured in relative terms. In both the countries, Russia accounts for 5% of the total inward FDI. With about a quarter of Russian outflow FDI, the USA is the second largest destination of the Russian FDI after the enlarged EU.

Vahtra and Liuhto are convinced that the Russian corporations have a strong foothold in the CIS, even if the Russian FDI does not usually appear in the statistics of CIS countries. Another reason for the absence of Russia in these statistics, besides statistical deficiencies, is simply the fact that Russian corporations have invested via another country. To put it differently, Russian corporations may be detected behind investments from the Bahamas, Panama, the Virgin Islands, or even from the USA, or some EU countries, in particular Cyprus. Cyprus was prior to her EU accession perhaps the most significant transit point for Russian capital targeting to CEE and destined for re-entry into Russia (tax avoidance).

Appendix 6 lists the ten most transnational corporations of Russia. Five out of them are active in the energy sector (either gas or oil); the others are all active in the (precious) metal sector.

3.2 The Partnership and Cooperation Agreement (PCA)

One of the most important reasons why Russia does not want to ratify the Energy Charter is that Putin prefers a general agreement with the EU about the business environment rather than an agreement that only focuses on energy, and, therefore, focusing more on what Russia, unilaterally, should do and not so much on what the EU should change (Putin in International Herald Tribune, 20/10/2006).

The EU's main objective is to engage with Russia to build a genuine strategic partnership, founded on common interests and shared values to which both sides are committed in the relevant international organisations such as the UN, Council of Europe, and OSCE, as well as with each other

in the bilateral Partnership and Cooperation Agreement (PCA). These interests and values include in particular democracy, human rights, the rule of law, and market economy principles. The PCA sets the principal common objectives, establishes the institutional framework for bilateral contacts, and calls for activities and dialogue in a number of areas. It is a **'mixed' agreement** covering matters falling under EU/EC and under national competence of the Member States.ⁱ

At the *St. Petersburg Summit in May 2003*, the EU and Russia agreed to reinforce their co-operation by creating in the long term four 'common spaces' in the framework of the Partnership and Cooperation Agreement. It was decided to create a common economic space; a common space of freedom, security and justice; a space of co-operation in the field of external security; as well as a space of research and education, including cultural aspects.

The PCA agreed upon in 1997 will end in 2007 but a new agreement is being made to give a legal basis for the relations between the two economies. The latest Russia-Europe summit (Samara, Russia, 18 May 2007) did not contribute much to the making of a new PCA as "the foreign policy outlook of the EU and Russia has in the recent years fundamentally changed, as a result of the accession of new east European members, and the growing assertiveness of energy-rich Russia." There are other reasons for the EU-Russia rift: the deadlock over Moscow's ban on Polish food imports (so-called for food safety reasons but which the European Commission says is groundless); Russian policy towards former Soviet neighbours; growing EU concern about authoritarian policies within Russia; differences over sanctions on Iran; Russian opposition to independence for Kosovo; the location of a US missile defence system in the Czech Republic and Poland; and most recently, the flare up in Estonia over the removal of a Soviet war memorial (The economist, 18 May 2007).

All of the above should first be resolved before the EU and Russia can talk about what *really* interests them: trade, security and energy.

3.3 Conclusion: Russian interests in the EU

Russia has a great interest in Europe. Not only is Europe the most important FDI destination of Russian investors, the EU is also the most important trade partner of Russia. This makes it more difficult for Russia to put political pressure on regulations it would like to see altered, because, indeed, the EU could do exactly the same. There is one important difference concerning the dependency of the two regions: (1) the EU is dependent for Russian energy; (2) Russia is dependent on the EU for a whole range of different products. This diversification of Russian interests in the EU makes it more difficult to efficiently put pressure on Russia: a range of different measures covering different products should be taken.

Endnotes

ⁱ Source: EC, External Relations, The EU's Relations with Russia – Overview, May 2006, Internet, http://ec.europa.eu/comm/external_relations/russia/intro/index.htm, [14/04/2007].

Part II

*Does Russia use Energy as a Political
Means?*



INTERMEZZO

What about Russia's military strength?

Today, there are not a lot of ways to politically pressurise a developed country. To put pressure on a country, you, as a country, should have something that the developed country does not have and cannot buy easily. When looking at the contemporary problems developed countries are facing today, and focusing among those only on problems that are directly caused by – and thus can only be resolved by – other humans, we find these aspects: environment, immigration, economical, and military. Especially the latter two can be used, if available, by a developing country as a strong method of persuasion to make sure a more favourable political action is taken. A good example is military pressure of North Korea or China, causing both Japan and the US to take preliminary counteractions. The formation of an oil cartel (e.g. OPEC) is an example of economic pressure.

This intermezzo wants to step back for a moment from our main research goal. The question arises that although Russia may be able to use energy as a political means, it might choose not to use it because other means of pressure are available, notably military. There are a few conditions to the use of military pressure. First of all, a strong military should be present and should be sustainable by securing the supply of motivated soldiers. Secondly, the military power should be visible and be able, if needed, to worry other countries. And, thirdly, precaution should be used as any means of pressure can backfire. A military threat is often a more immediate and direct threat compared with an economic threat. Therefore it is a more dangerous situation.

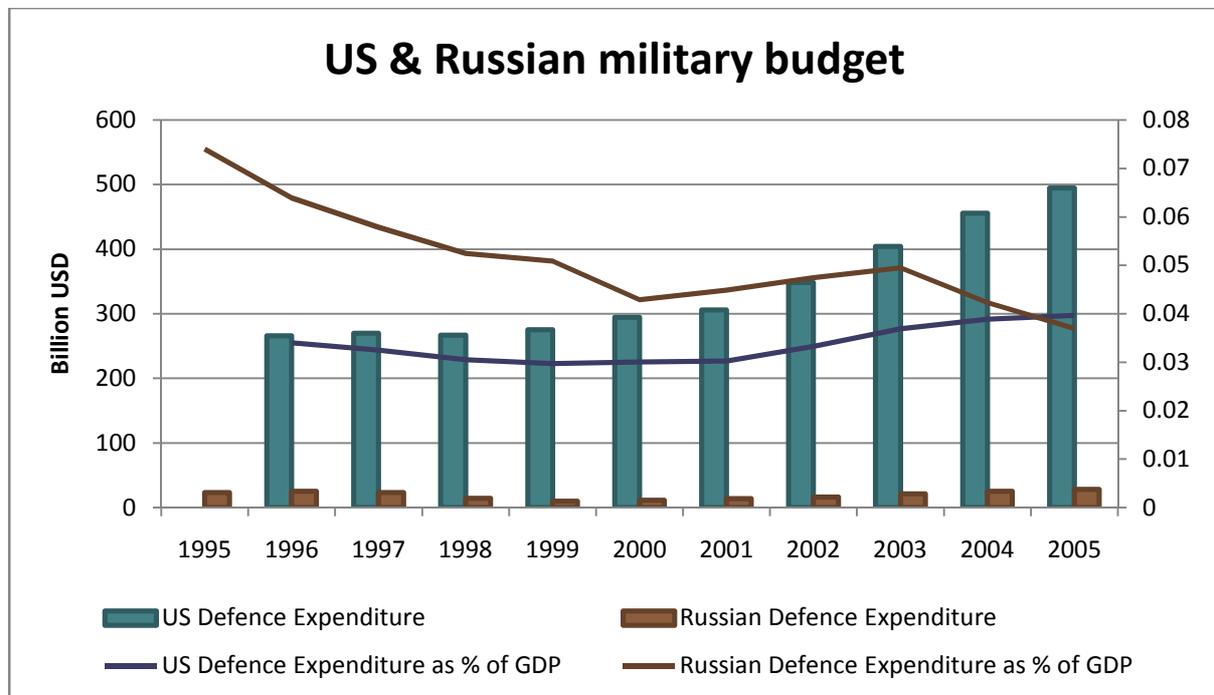
According to Rohall et al (2001), the Russian army underwent a major downsizing during the mid-1990s. In the late 1980s, the Soviet Union collapsed. This had an immediate impact on the different armies around the world: military budgets were reduced and the size of national armed forces declined. In this context, a number of nations have abandoned the “mass army” model based upon mobilisation through military conscription. They have adopted in its place smaller and more professional armed forces.

When the Soviet Union collapsed, the Russian military inherited a “universal service” model, based upon widespread conscription and a professional officer corps (Jones, 1985). It also experienced a loss of mission with the disappearance of the bipolar confrontation between the Warsaw Treaty nations and the North Atlantic Treaty Organization. At that time, however, the process of downsizing had already begun because Mikhail Gorbachev announced to the UN General Assembly in 1988 that the Soviet Union would unilaterally downsize its armed forces by 500,000 personnel. This was rapidly accomplished. Between 1990 and 1993, the number of armed forces personnel decreased from 3.4 million to 2.3 million. In 1993, the defence law established that by the 1st of January 1995, the size of the peacetime Russian army would not exceed one percent of the population of Russia, which would make it roughly 1.5 million personnel. Today, this number has fallen to about 1 million personnel, with 20,000 reserves. A comparison places Russia today together with India (1.3 million),

China (2.25 million), North Korea (1.1 million) and the USA (1.5 million) as a country with one of the highest number of army personnel.^{i,17}

The budget of the Russian federation is presented in the graph below.

Graph 0—1 US & Russian military budget (1995-2005)



Source: N.N. (2007) *North America (USA and Canada)*, *The Military Balance*, Vol. 104, Nr. 1, pp. 14-34 and N.N. (2006) *Russia*, *The Military Balance*, Vol. 106, Nr. 1, pp. 147-164, own calculations.

It is visible that Russia uses less and less of GDP resources to finance its army although the nominal amount of defence expenditure remains approximately the same the last years. This means that Russia has more money free to invest in other parts of the economy, to pay of foreign debts or to save for the future. In 2007, the military expenditure is around 28.26 billion USD, which is very few for such a large country, especially when compared with the USA, who spent in 2005 around 500 billion USD. But even France and the United Kingdom spend almost double of that amount (both countries spend just over 50 billion USD). In contrast to the worldwide trend of declining the number of army personnel employed and the defence expenditures is the increasing expenditure of the US army since 2001. This is a direct consequence of the September 11 attacks and the subsequent “War on Terror” policy of the Bush administration.

We can conclude that Russia’s military strength has strongly weakened. Although Russia still has one of the largest armies in the world, the number of army personnel and the defence expenditure has decreased over the years. The growth of the Russian economy and the importance of Russian energy for Europe (and abroad) make this a much more efficient means of putting political pressure.

¹⁷ In percentage of army personnel over the entire population, Russia (.92%) is only preceded by North Korea (4.78%). The USA (.5%), China (.17%) and India (.12%) follow. Only professional army personnel are taken into account (no reserves, volunteers).

4

CHAPTER FOUR The Ukrainian gas crisis: an analysis

This chapter will give an overview of the Ukrainian gas crisis in the beginning of 2006. This crisis has started a new awareness in the EU concerning energy security and thus justifies its importance. The goal of this chapter is to analyse this crisis through the 4 I's model and to learn something more about Russian energy as a political means.

4.1 The Issues¹⁸

4.1.1 From 1990 till 2004

In 2004, Gazprom exported around 150 Billion cubic metres of gas to 22 European countries. In a Europe of 35 countries, Russian gas accounted for nearly 40% of total imports and 28% of gas demand in that year. All Russian gas exports to Europe (except deliveries to Finland and the portion of Turkish exports delivered via the Blue Stream pipeline) transit through three countries: Ukraine, Belarus and Moldova. Ukraine holds the pivotal geographical position with more than 80% of Russian gas exports to Europe delivered via that country in 2004.

During the 1990s, the Ukrainian/Russian gas relationship was characterised by:

- Ukrainian inability to pay for up to 50 Bcm/year which it imported from Russia, leading to very high levels of debt and unpaid bills which led to...
- reduction of Russian gas supplies to Ukraine for short periods of time, aimed at restoring payment discipline which in turn led to...
- unauthorised diversions of the volumes in transit to European countries.

From 1991-2000, the details of the levels of debt, the delivery reductions which took place and whether they were justified, and the diversion of gas by Ukrainian parties, became hotly contested issues.

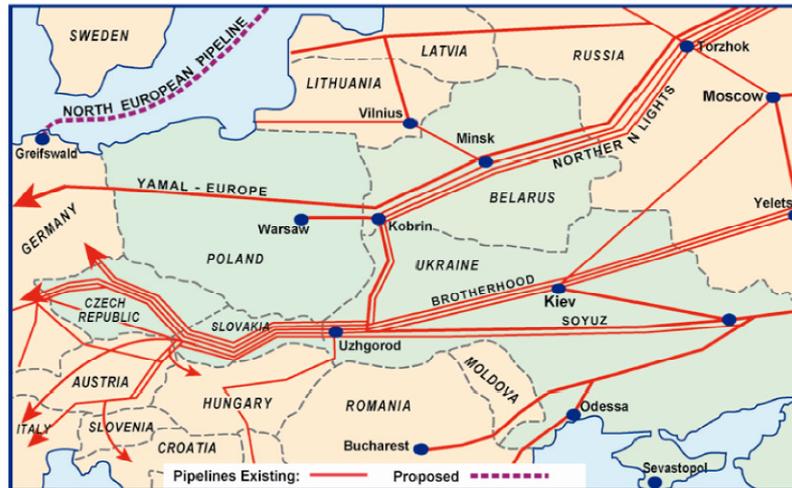
By late 2004, it seemed that the required elements for regularising Russian-Ukrainian-Turkmen gas trade were in place for the next 5-10 years:

- Ukrainian debts to Gazprom had been agreed and settled;
- Delivery of Turkmen gas to Ukraine in terms of sales volumes and shipping arrangements had been agreed;
- Sales volumes and prices of Russian gas to Ukraine, and transit volumes and tariffs for Russian gas to Europe, had been agreed as a barter deal;

¹⁸ This paragraph is based on Jonathan Stern's "The Russian-Ukrainian gas crisis of January 2006" paper (2006). For a more complete overview of the crisis, I refer to his work.

- A consortium of Gazprom and Naftogaz (potentially with German and other European participation) had been founded with the aim of operating and refurbishing the Ukrainian transit pipeline network. Gazprom had long expressed the wish to take ownership in Ukrainian transit pipeline assets. This would have allowed Gazprom control over the network and a way of minimising transit costs and risks.

Figure 4—1 Major pipelines between Russia and EU



Source: Stern, 2005

4.1.2 2005: Gazprom negotiates higher prices

By late 2005, the \$50-80/mcm which the countries of the former Soviet Union were paying for Russian gas contrasted sharply with European border prices of 3-4 times that level. During the final three months of 2005, negotiations between Gazprom and Naftogaz Ukraine failed to make progress:

- Gazprom demanding that from the beginning of 2006, Ukraine must pay “European prices” of between \$160-230/mcm unless it was prepared to consider allowing Gazprom an equity stake in the transit pipeline network (consistent with the Consortium idea described above).
- Ukraine responding that it was prepared to pay market prices for gas but that these must be phased in over a period of time and that the maximum it was prepared to pay in 2006 was \$80/mcm.

Gazprom’s strong position on the \$230/mcm price was backed at the highest political levels in the Kremlin. Gazprom had already suggested that, if Ukraine could not afford to pay higher prices, the company would extend loans to Ukraine for this purpose. President Putin – in what proved to be a final offer which could have been considered a political concession to his Ukrainian counterpart – suggested that if the Ukrainian side was prepared to agree to this gas price, the increase could be suspended for three months before the switch to market prices. The Ukrainian side rejected both suggestions and at 10.00am Moscow time on 1st of January 2006, Gazprom cut off gas supplies to Ukraine.

4.1.3 1st of January 2006: the Ukrainian gas crisis

The impact of Gazprom action on European countries was immediate. With Gazprom insisting that it was supplying the correct contractual volumes to its European customers, and Ukraine insisting that it was not taking gas from the transit pipelines to Europe to which it was not entitled, it was initially difficult to understand what was happening. But falling pressures and non-delivery of gas reported by European companies on January 1 can only have resulted from Ukrainian companies diverting gas from the pipelines or because Gazprom failed to pump enough gas into those pipelines. Given Gazprom's concern about supply security and desire to earn money from gas exports to Europe, the only explanation is that gas was taken by Ukrainian customers.

On the 4th of January 2006 Gazprom and Naftogaz announced an end to the dispute with the signing of a 5-year contract with the following terms:

1. Gazprom will pay Naftogaz a **tariff** of \$1.60/mcm per 100km for **transit** of gas to Europe.
2. RosUkrEnergo¹⁹ will be the company which delivers gas to Ukraine. Gazprom will not deliver Russian gas to Ukraine, and Naftogaz will **not export** any gas which it has received from Russia.
3. RosUkrEnergo and Naftogaz will form a **joint venture** by the 1st of February 2006 in order to market gas in Ukraine which has been received via the territory of the Russian Federation.
4. **RosUkrEnergo's** annual gas balance will consist of:
 - a. 41 Bcm of Turkmen gas purchased from Gazexport²⁰;
 - b. up to 7 Bcm of Uzbek gas purchased from Gazexport;
 - c. up to 8 Bcm of Kazakh gas purchased from Gazexport;
 - d. up to 17 Bcm of Russian gas purchased from Gazprom with a base price of \$230/mcm.
5. Transit payments and gas prices may only be changed by the **agreement** of all parties.

More concretely are the sources of Ukrainian gas for 2006 are listed in the table below.

Table 4—1 Ukrainian sources of natural gas

Sources of Natural Gas for Ukraine's January 2006 Supply Agreement			
Country	Amount (BCM/y)	Acquired by	Price (\$/CMC)
Turkmenistan	41	Joint-venture	65.00 USD
Uzbekistan	7	Gazexport	65.00 USD
Kazakhstan	8	Gazexport	65.00 USD
Russia	17	Gazexport	230.00 USD

Source: Cohen, M. (2006) Country Analysis Briefs: Ukraine, Energy Information Administration, p. 3-6, <http://www.eia.doe.gov/emeu/cabs/Ukraine/pdf.pdf> [28/05/2007].

¹⁹ RosUkrEnergo is a Swiss-registered venture company that transports natural gas from Turkmenistan to East European countries. 50 percent of the company is owned by Gazprom, through its daughter Swiss-registered ARosgas Holding A.G., and another 50 percent by Raiffeisen Investment AG.

²⁰ Gazexport is the leading exporter of natural gas in the world, supplying Europe and the Commonwealth of Independent States. It is a 100% subsidiary of Gazprom. It changed its name to Gazprom Export on the 1st of November 2006.

4.2 The Interests

Most of the interest groups in this dispute have divided feelings about the Russia-Ukraine gas dispute. Russia and the EU agree that the lower prices Ukraine pays for its gas are not correct towards countries that pay more for their energy and that this Ukrainian price should be increased. Even Ukraine knows it cannot expect to continue to pay such a low price. The deeper problem is, however, the way that this is implemented: was it not too fast, too soon? This paragraph will also analyse the interests of the different interest groups on issues that are related to the January 2006 gas crisis.

Box 4—1 The different interest groups

The different interest groups:

- Ukrainian consumers
- Ukrainian gas suppliers
- Gazprom
- European consumers
- European gas suppliers

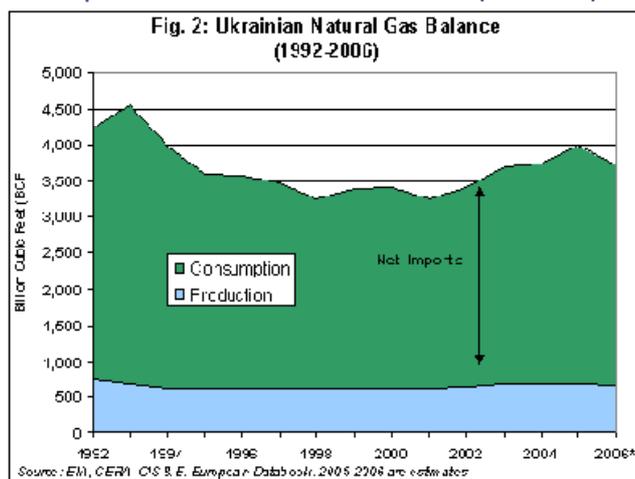
4.2.1 Ukrainian consumers

Ukrainian gas market

According to Graph 4—1 below, Ukraine imports about 78% of its gas need. Ukraine the world's 6th biggest gas importer and consumes more gas than Poland, the Czech Republic, Hungary, and Slovakia combined. Since the early 1990s, Ukraine's usage of natural gas as a share of its total energy consumption has increased 10 percent to comprise almost half (47%) of Ukraine's energy usage. Ukraine is also known as one of the most energy-inefficient countries in the world (Nichol, Woehrel, Gelb; 2006).

Ukraine plays a significant role to world energy markets as an intermediary connecting Russia, the world's largest natural gas producer, with growing European markets. Russia partially supplied Ukraine via natural gas offered as payment in kind for transiting Russia's gas onwards to Europe, and partially through annual sales contracts. Also, as gas exports from the Caspian to Europe and Russia grow, Ukraine serves as the largest market for this natural gas. Roughly 93 percent of Ukraine's natural gas imports are re-exported to world markets (Cohen, 2006).

Graph 4—1 Ukrainian Natural Gas Balance (1992-2006)



Source: Cohen, M. (2006) Country Analysis Briefs: Ukraine, Energy Information Administration, p. 3-6, <http://www.eia.doe.gov/emeu/cabs/Ukraine/pdf.pdf> [28/05/2007].

Crisis interests

According to Putin household consumers in Ukraine pay less for gas than do households in Russia. He noted that Russia subsidises Ukraine on the gas matter by the amount of 1 billion USD every year. This figure is calculated by the loss in profit tax from Gazprom by allowing Russia to pay a lower price for gas. Given that 25 million Russians live beneath the poverty line, Putin asked whether this subsidisation and the heavy burden this means still is an option for Russia.ⁱⁱ

In contrast with this statement is it in the interest of the Ukrainian consumers to remain paying a low price for their gas because of the heavy dependence to Russian gas for individual consumers and companies. If Ukraine had to pay a higher price for gas, it would hurt the economy by an overall increase in the production cost. This would mean that Ukrainian companies become less competitive and thus have a lesser chance of being able to compete with Western companies. On top of that, Ukraine's key export industries, especially iron and steel production, are heavily dependent on cheap energy.

On the other hand, an increase in the gas price would force Ukrainian companies to become more efficient, and stimulate innovation (in the long run). A road in between these two conflicting interests may resolve them: Yushchenko has acknowledged that Ukraine must eventually pay market prices for gas, but has insisted that the increases occur gradually to permit the economy time to adjust.

4.2.2 Ukrainian gas suppliers

Ukrainian gas suppliers have two main purposes. First, they have to supply gas to the Ukrainian consumer (companies and households) at a low price. Secondly, they have to supply gas to the rest of the world, mainly Europe, through a network of transit pipes coming from Russia and the East.

Ukraine's control of pipelines from Russia to Western European markets has long been balanced by Ukraine's dependence on Russian energy. As occurred during the January 2006 gas crisis, Russian efforts to impose higher prices can be countered by Ukraine imposing higher transit tariffs or even by diverting gas destined for Europe. However, Russia plans to build a pipeline under the Baltic Sea to Germany by 2010 that would bypass Ukraine and could remove Ukraine's leverage (Nichol, Woehrel, Gelb; 2006).

In conclusion, Ukrainian gas supplier Naftogaz is against this price rise. It is clear that although Ukraine was able to bargain its way out of a (too) high price increase, it will not be able to do so in the future. Ukraine and Naftogaz should thus foresee another price increase after which they will pay the market price.

4.2.3 Gazprom

Gazprom states that its price increase is not political intended but is pure business (Nichol, Woehrel, Gelb; 2006). However, many (mainly based in Europe and Ukraine) find this implausible and say that the Ukrainian politics and its tendency towards the West have at least something to do with it (see conclusion, p.33).

Gazprom wants part in Ukrainian pipe lines to reduce the cost it needs to pay for transferring gas to Europe. At this moment, Russia pays Ukraine for this service by allowing it to tap 15% of the gas that passes Ukraine. By allowing this, Ukraine has too much the possibility to "cheat" and take more gas than it says. When Gazprom saw during the December 2005-January 2006 negotiations that getting a part in the Ukrainian pipe lines was very unlikely to happen, it changed its demands. Ukraine will no longer be allowed to keep a part of the transferred gas as a payment, but will receive a fixed amount of 1.60 USD per 1,000m³ of gas per 100 km travelled on Ukrainian territory (BBC News article, 04/01/2006).

On the same time, Gazprom wants Ukraine to pay more for gas. It argues that Ukraine paid until 2005 much below the market value of Russian gas, namely 50 USD per MCM. Under pressure of the WTO of which Russia wants to become a member, Gazprom feels obliged (sic) to augment the gas price for Ukraine.

As a conclusion, Gazprom's interest in this matter is to get a price as close to the actual market price (approximately 230 USD per MCM) *and* either a stake in the Ukrainian transit pipes or a change in the payment method for gas transition to Europe.

4.2.4 European consumers

As explained in Chapter 2, Europe is largely dependent from Russia for its energy needs. According to a BBC News articleⁱⁱⁱ Ukraine has stolen gas for 25 million USD after it had been cut off by Russia

on the 1st of January 2006. This has an immediate effect on European energy supply: several EU countries have felt a sharp decrease in Russian gas supplies.

Box 4—2 Decrease in Russian gas imports on 02/01/2006

EU countries affected by the Ukrainian gas crisis:

- Hungary: -40%
- Poland: -14%
- Austria, Slovakia, Romania: -33%
- France: -25% to -30%
- Italy: -24%

Source: N.N. (02 January 2006) Ukraine 'stealing Europe's gas', BBC News, <http://newsvote.bbc.co.uk> [28/05/2007].

The primary interest of the EU is to secure its own gas supply. To achieve this in a short term, it is in the best interest of the EU that a secure and long lasting enforceable agreement between Kiev and Moscow is made as fast as possible. At a later stage, the EU can talk with Russia about new ways to secure energy better. A second interest is that gas – and in general energy – prices in the CIS countries go up to the normal market price so that European companies loose their energy disadvantage vis-à-vis Russian, Ukrainian and Belarusian enterprises.

4.2.5 European gas suppliers

European gas suppliers lobbied together with European consumers by the EU to end the two-pricing systems Russia uses for its energy. The EU lobbied then by the WTO to make the abolishment a prerequisite to obtain membership. Russia now uses this as one of the arguments to raise Ukraine's gas prices. Knowing this, the EU gas suppliers are stuck in the middle: they want Ukraine to pay higher prices, but they need supply security.

European gas suppliers warn for the dangers of the European energy supply: not only is it mainly dependent on the sources of one country, it is also dependent on a transit country. This doubles the political risks of energy supply as clearly demonstrated by the January 2006 gas dispute. Gas suppliers in Europe are thus a big supporter of building a direct pipeline from Russia through the Baltic Sea to Germany. This is expected to lower the political risks and to lower the price of gas.

4.3 The Institutions

When describing the interests of Gazprom and Naftogaz Ukraine or the Ukrainian consumers, it is very difficult not to talk about the Russian and Ukrainian governments. The interests of both the company and the government are much alike as indeed the companies are mostly state-owned.

On one hand, as explained in chapter 1 (p. 2, above), Russian politics and the energy sector are closely knit. It is therefore not surprising that Gazprom's demands are backed-up by the Russian government. The implication of the Russian government, not only as a reactor and a middleman between Gazprom and Naftogaz, but as an actor in this dispute, will be analysed more deeply in the conclusion below (p. 33).

On the other hand, the Ukrainian ambassador to the EU, Mr. Roman Shpek (2006) blames Gazprom to be "unreasonable" in its proposal "for a sudden, nearly fivefold increase of gas prices" (sic). The Ukrainian President Yushchenko, among other Ukrainian government members, accused Moscow of political blackmail, especially on the eve of Parliamentary elections in Ukraine (March 2006).

According to a Forbes news article,^{iv} the EU took a neutral position, arguing that it were two companies who had disagreements that could be resolved soon.

4.4 The Information

There are two important aspects to analyse when talking about the information: the presence of information for all interest groups and the time this information was released.

Jonathan Stern (2006) follows Russia by stating that this price hike was not a sudden fact. There were during 2005 enough reasons to believe that a price increase would happen. The question remains how concrete this information was. It did, indeed, not say when the price increase would happen and by how much the price would go up.

During the crisis, say the last weeks of December until the 4th of January, there was plenty of information about what was happening and what both sides' demands were. The *reasons* for those demands were more vague: some say it were purely economic reasons, most believe politics were very much involved.

These politically motivated reasons are supported by the time chosen for this price increase. It was just after Ukrainian 2004 president elections and at a time that pro-Western President Yushchenko was sitting in office (see conclusion).

4.5 Conclusion²¹

Most of the events summarised in paragraph 4.1 "The Issues" (p.26, above), and most of the arguments of different interest groups defined in paragraph 4.2 "The Interests" (p. 29, above) are economic. As raised during the analysis of "The Information" (p. 33, above), there is another event that should be taken into account: Ukrainian politics. The fact that Moscow was losing grip on

²¹ This paragraph is based on Jonathan Stern's "The Russian-Ukrainian gas crisis of January 2006" paper (2006) and my own ideas.

Ukrainian politics through a pro-European president is for many a sign that the Russian-Ukrainian gas dispute is more than having economic opposite goals, but also having opposite *political* goals.

Indeed, the bulk of the commentary in the European press agreed with Ukrainian President Yushchenko's position that this was a politically motivated dispute in which the Russian side was attempting to blackmail Ukraine politically by placing it under extreme economic pressure.

The suggestion that the motive behind Russian actions was political, was also supported by reference to the focus on countries which had either left the Soviet Union (the Baltic countries) or those which had elected pro-European (rather than pro-Russian) governments. Gazprom has implemented price increases for all the CIS countries in 2006:

- Armenia, Georgia and Azerbaijan are required to pay \$110/mcm;
- Moldova was required to pay \$160/mcm but has refused to do so. In some accounts the Gazprom-Moldova contract has been replaced by an arrangement under which the Naftogaz/RosUkrEnergo joint venture will take over gas to the Gazprom. No gas was delivered to Moldova by Gazprom during the first 12 days of 2006.

Only Belarus will continue to pay the same price of \$46.7/mcm in 2006 justified by Gazprom on the grounds not only of a prospective economic union between the countries but also that – in sharp contrast to Ukraine – Gazprom already owns the Belarusian section of the Yamal export pipeline to Europe, and there are ongoing negotiations about the formation of a Beltransgaz joint venture to own and operate the domestic pipeline network. None of this commentary recalled that, in February 2004, Gazprom cut off supplies to Belarus (for less than a day) in support of a price increase when the contract between the countries had expired. To date, Belarus agreed to a price increase to 100 USD per mcm (CNN, 31/12/2006).

Many commentators from Europe and North America widened the scope of this analysis questioning, in the light of this episode, whether:

- Russian gas could henceforth be considered a secure source of gas supply for Europe;
- Fundamental changes should be made to European energy policy in the direction of reducing dependence on Russian energy in general, and gas in particular, and that the EU should attend to such matters without delay.

The crisis can be considered political in the sense that all commercial gas relationships between CIS countries require the approval – and very often the signing of the key documents – by presidents and prime ministers. It was also political in that, had President Yushchenko not won the 2004-05 elections, then relations between the two countries would not have deteriorated to the same extent, and a price accommodation between Gazprom and Naftogaz would probably have been reached. However, President Putin's proposal of a three month delay in the application of the new price regime which would have protected President Yushchenko from any effects of the price increase until after the March 2006 elections and after the worst of the winter period, could be regarded as a conciliatory political gesture.

A logical political interpretation to be placed on these events is that if Ukraine wishes to turn away politically from Russia towards the EU and NATO – and is opposed to any relationship with Gazprom in terms of ownership of gas assets – then it can expect the same commercial terms as those

countries. This is akin to the political and commercial changes which took place between Russia and the former CMEA countries in Central/Eastern Europe after 1990. Had Ukraine chosen to maintain a closer political relationship with Russia, it would have been very likely that Ukraine could have continued to pay lower gas prices at least for a period of time.

Nevertheless, the price changes which Gazprom has instigated with a range of other former Soviet countries – Moldova, Georgia, Azerbaijan and Armenia – represent a paradigm shift in Russia-CIS energy relations: a determined step-by-step movement towards market-based prices. Only Belarus retains gas prices at the same level as Russians domestic customers; but this is now unique among former Soviet states and continuation of these price levels may be dependent on whether Gazprom obtains a 50% share in a newly created Belarusian Beltransgaz joint venture.

Endnotes

ⁱ Source: N.N. (2007) Country comparisons – commitments, force levels and economics, *The Military Balance*, Vol. 107 Nr. 1, pp. 385-418.

ⁱⁱ Source: N.N. (12 December 2005) Путин: Украина в состоянии покупать газ по рыночной цене, Vesti News Channel, <http://www.vesti.ru/doc.html?id=72229> [28/05/2007].

ⁱⁱⁱ Source: N.N. (02 January 2006) Ukraine 'stealing Europe's gas', BBC News, <http://newsvote.bbc.co.uk> [28/05/2007].

^{iv} Source: N.N. (29 December 2005) EU not planning to intervene in Russia-Ukraine gas dispute, AFX News Limited, Forbes, <http://www.forbes.com/work/feeds/afx/2005/12/29/afx2418581.html> [29/05/2007].

Conclusion

Chapter 1 explained that Russia's energy sector is highly interconnected with politics. This used to be so during the Soviet Era, but then, after privatisation, the energy companies were led by a handful of people, "the oligarchs". Putin managed to get the energy sector back from the oligarchs and re-enforced the state's hand on the energy matter instead of the other way around. This seemingly "re-nationalisation," of Russian energy companies is a global phenomenon.

Since the OPEC crises of the 1970s, the nationalisation of the world's oil and gas reserves has been a dominant theme. State-owned oil companies now control over 90% of the world's proven oil reserves, and they control depletion policy. Whilst western energy importers lambaste the lack of access for their companies, is this really the wrong approach? (Helm, 2006b)

Although there are better ways than re-nationalisation – e.g. governments that define clear energy policy frameworks and depletion policies to match, and then let the private sector to do the work – such approaches rely on well-developed legal frameworks, the absence of corruption, and appropriate and enforced tax regimes. Most countries with large reserves lack these, and even those that do not – like the United Kingdom – have followed very questionable depletion policies, such as the rapid exploitation of North Sea oil and gas to fund tax cuts and public expenditure. Perhaps only Norway stands out as an example of how this mixed approach should work – but then it has a very small population as well as active state participation.

Given the situation in which Russia finds itself, Helm (2006b) finds that nationalisation of reserves is therefore not such a bad policy. It enables Russia to strengthen its market power very quickly, dictate terms for exports, and manage the development of new production. In the importing countries, the call is for more output to meet demand, but it is not at all obvious that Russia should oblige: the reserves may well be worth more tomorrow than they are now. Indeed, the conclusion of Chapter 1 was that the New Russia depends on its energy exports as the main source of revenue and should thus be careful to strategically calculate the line between exporting too little and exporting too much.

This brings us to Chapter 2 which concludes that the EU is highly dependent on Russian energy, and is, especially since the Russian-Ukrainian gas dispute, on the lookout for sustainable and renewable energy that can be made within the Union. This should be seen in relation to Chapter 3. This chapter proves that Russia's revenues do not come only from exporting energy to the EU, but that the EU is also Russia's prime trade partner, accounting for around 56% of all exports and 45% of all imports. This makes the EU and Russia interdependent partners. Although there are many problems between them, they would each be far worse off without the other partner. Keeping this in mind, the answer of my research question – Does Russia use energy as a political means in Europe? – is now due an answer.

All of the above proves that Russia, as a result of Europe's dependency on Russian energy, *can* use energy as a political means. Russia should be careful when doing so, however, because of the backlash it may provoke, such as European retaliation by import measures on Russian goods, etc.

At one point in history, the end of the 1980s, Russia changes its way by influencing global politics from military pressure, as known under the Cold War, towards economic pressure. This is shown most clearly in the Russian-Ukrainian gas dispute of January 2006. The conclusion of Chapter 4 shows that in this dispute it is not very clear whether the crisis has emerged because of political reasons (Ukraine electing a pro-Western government rather than a pro-Russian one and Putin's fear to loose grip on Ukrainian politics), which are conveniently followed by economic arguments (WTO asks for stop of two-tiered pricing system, more profit for Gazprom, etc.) and allow for a more conventional pressure. Alternatively, Gazprom wanted to augment its prices already, but waited for permission and support from the Russian parliament, which came only after the Ukrainian politics became less pro-Russian.

Either way, this clearly shows that Russia is *prepared* to use gas, and energy, as a political weapon in Europe. Although this case study should be seen in the context of a politically difficult situation – Ukraine being a CIS country – it stands without doubt that the whole dispute between Moscow and Kiev enabled Russia to show who has the control over European gas supply.

A direct threat from Russia to the European Union is less likely. First, and most important, because there is no need to as from a Russian point of view, the EU is a reliable trade partner and a financial sustainable partner for energy export. Second, because Russia has too much interests in the EU as its main source of FDI and its biggest trade partner. Therefore, a clear distinction between the EU and the Baltic countries on one hand and the CEECs and CIS countries on the other hand should be made concerning Russia's political interests.

The level of potential threats through the use of energy by Russia is directly linked to the (economic) interest Russia has in that country or region. Indeed, even during the Cold War, during which Europe also relied heavily on the Soviet Union for its energy needs, Moscow never cut off Europe and guaranteed a relatively secure supply of oil and gas. One of the reasons may be that the Soviet Union needed Europe to be not completely in the camp of the USA. The interests of the Soviet Union in Europe were too important to risk by using energy as a political means.

It is like Andrey Kokoshin, member of the Russian parliament said: "It is up to Western countries: To rely even more on the Middle East and Africa or to build stronger relations with Russia." (BBC News, 14/02/2006). The Russian-Ukrainian gas dispute made the European Union aware that it has to make an important strategic decision: continue and strengthen relations with Russia or to diversify the energy sources towards other regions and/or possibly become more autocratic on energy needs. It seems that the latter is a better option – although impossible to reach. However, the cost of getting gas and oil from the Middle East may well exceed the cost of the political risks of relying on Russia for European energy needs.

In my opinion Russia will use energy as a political means, also in the EU, when there is no alternative. Although knowing this, the EU has no other possibility than to continue relations with Russia. Indeed, using energy as a political means can be useful, but Russia knows, as learned through the Cold War, that long lasting agreements make both parties better off. The EU should, however, prepare itself by (1) focusing on renewable energy, if not only for the Russian threat, but also for environmental issues; (2) continue thorough relations with Russia based on enforceable and sustainable agreements. This should be done by helping Russia in the exploitation of oil and gas and the transportation of it, either by loans or by forming joint ventures.

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Appendices

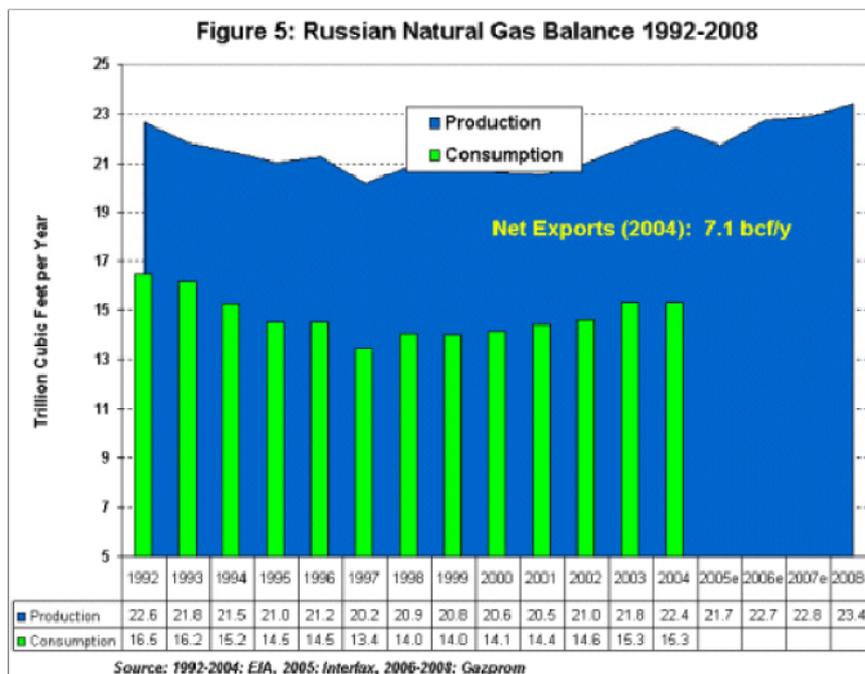
Appendix 1: Evolution of oil production and oil exports in Russia

Table 2
Evolution of the Russian oil production and exportation, 1992–2003, Millions of barrels per day

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2003
Production	7.9	7.2	6.4	6.1	6.0	6.2	6.2	6.1	6.5	7.1	8.4
Exportation	2.76	2.46	2.61	2.46	2.52	2.55	2.75	2.70	2.90	3.23	3.76
CIS	1.44	0.86	0.77	0.53	0.41	0.34	0.39	0.38	0.34	0.47	0.76
Outside CIS	1.32	1.60	1.84	1.93	2.11	2.21	2.36	2.32	2.56	2.76	3.0

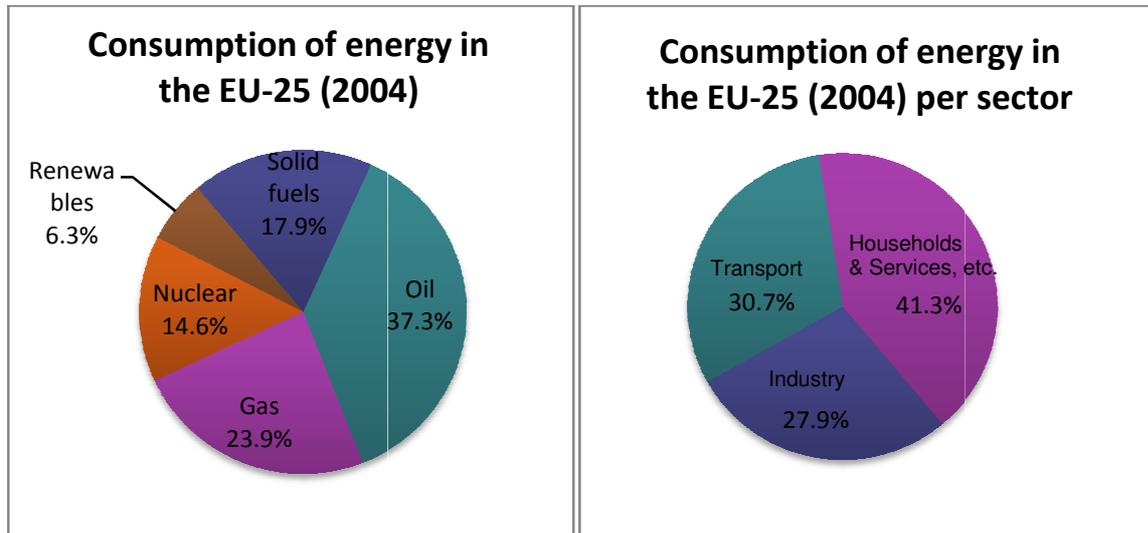
Source: LOCATELLI, C., The Russian oil industry between public and private governance: obstacles to international oil companies' investment strategies, IN "Energy Policy", Vol. 34, 2006, p. 1075-1085, visited through Elsevier database, Internet, <http://www.elsevier.com/locate/enpol> [04/04/2007].

Appendix 2: Evolution of gas production and consumption in Russia



Source: ENERGY INFORMATION ADMINISTRATION, Country Analysis Briefs: Russia, January 2006, p.3, Internet, <http://www.eia.doe.gov/emeu/cabs/Russia/pdf.pdf>, [04/04/2007].

Appendix 3: What kind of energy does the EU-25 use?



Source: EUROPEAN COMMISSION, DG Energy and Transport, Energy and Transport in figures: statistical pocketbook 2006, Internet, http://ec.europa.eu/dgs/energy_transport/figures/pocketbook/2006_en.htm, [07/04/2007].

Appendix 4: The Energy Charter and the Transition Protocol

The roots of the Energy Charter date back to a political initiative launched in Europe in the early 1990s, at a time when the end of the Cold War offered an unprecedented opportunity to overcome previous economic divisions. Nowhere were the prospects for mutually beneficial cooperation clearer than in the energy sector, and there was a recognised need to ensure that a commonly accepted foundation was established for developing energy cooperation among the states of Eurasia. On the basis of these considerations, the Energy Charter process was born.

In a world of increasing interdependence between net exporters of energy and net importers, it is widely recognized that multilateral rules can provide a more balanced and efficient framework for international cooperation than is offered by bilateral agreements alone or by non-legislative instruments. The Energy Charter Treaty therefore plays an important role as part of an international effort to build a legal foundation for energy security, based on the principles of open, competitive markets and sustainable development.

Source: ENERGY CHARTER, About the charter, Internet, <http://www.encharter.org/index.php?id=7>, [09/04/2007]

The Treaty's provisions focus on five broad areas:

- The protection and promotion of foreign energy investments;
- Free trade in energy materials, products and energy-related equipment;
- Freedom of energy transit through pipelines and grids;
- Reducing the negative environmental impact of the energy cycle through improving energy efficiency;
- Mechanisms for the resolution of State-to-State or Investor-to-State disputes.

Source: DONOGHUE, J., CURTIN, J., Energy Policy Newsletter, IEA, November 2006, Internet, http://www.iewa.com/images/managed/publications_attachments/Energy%20Newsletter%20November.doc.pdf, [09/04/2007]

The Energy Charter Treaty's existing Transit provisions oblige Signatory states, in accordance with the GATT/WTO principles of freedom of transit, to facilitate transit on a non-discriminatory basis.

However, following the Treaty's adoption in 1994, a consensus emerged within the Treaty's governing body, the Energy Charter Conference, that these provisions on energy transit issues could be amplified and strengthened in order to mitigate some specific operational risks that continued to affect energy transit flows.

In December 1999, the Charter Conference mandated the start of negotiations on an Energy Charter Transit Protocol. Negotiations on the text of the Transit Protocol began in early 2000.

Agreement was reached on the bulk of the Protocol's text at the end of 2002. There remained only a few outstanding issues to be resolved before the Protocol could be finalised, and these have been the subject of continued discussion since then between the European Union and Russia. A text was tabled for adoption at the meeting of the Energy Charter Conference on 10 December 2003.

However, it became clear at this meeting that a unanimous decision could not be achieved on the basis of the compromise text; a complicating factor was that energy issues, including transit, were also a subject on the bilateral agenda for the European Union and Russia in the context of Russian negotiations for accession to the World Trade Organisation. The Protocol negotiations were temporarily suspended.

This suspension was lifted at the June 2004 meeting of the Energy Charter Conference, after Russia and the EU reached agreement on the terms of Russian WTO accession; further bilateral consultations between the EU and Russia have been taking place since the autumn of 2004.

Source: ENERGY CHARTER, Transit Protocol, Internet, <http://www.encharter.org/index.php?id=37>, [09/04/2007]

Appendix 5: Trade between Russia and the EU

Source appendix 5: EC, External Trade: Bilateral trade issues: Russia, September 2006, Internet, <http://trade.ec.europa.eu/doclib/html/113440.htm>, [12/04/2007].

European Union, Imports from ... Russia

rank	SITC Rev.3 Product Groups	Mio euro	Share of total EU imports	%
3	TOTAL	106 766	9.08	100.0
7	Agricultural products	2 440	3.01	2.3
1	Energy	68 720	27.52	64.4
4	Non-agricultural raw materials	415	30.46	0.4
33	Office/telecom. Equipment	71	0.04	0.1
18	Power/non-electrical mach.	502	0.69	0.5
25	Transport equipment	530	0.54	0.5
6	Chemicals	3 460	3.69	3.2
35	Textiles and clothing	179	0.25	0.2
1	Iron and steel	3 013	19.47	2.8

European Union, Exports to ... Russia

rank	SITC Rev.3 Product Groups	Mio euro	Share of total EU exports	%	Balance
3	TOTAL	56 445	5.32	100.0	-50 322
2	Agricultural products	4 971	8.04	8.8	2 531
18	Energy	316	0.81	0.6	-68 403
12	Non-agricultural raw materials	90	0.74	0.2	-325
3	Office/telecom. Equipment	7 793	8.20	13.8	7 722
3	Power/non-electrical mach.	9 702	5.92	17.2	9 200
7	Transport equipment	5 679	3.39	10.1	5 149
4	Chemicals	8 167	5.00	14.5	4 707
3	Textiles and clothing	2 618	7.93	4.6	2 439
12	Iron and steel	469	2.22	0.8	-2 544

RUSSIA'S TRADE BALANCE WITH MAIN PARTNERS

(2005)

The major import partners

Partners	Mio euro	%
World	77 900	100.0
1 EU	34 904	44.8
2 Ukraine	6 250	8.0
3 China	5 819	7.5
4 Japan	4 695	6.0
5 Belarus	3 709	4.8
6 USA	3 674	4.7
7 Korea	3 213	4.1
8 Kazakhstan	2 580	3.3
9 Brazil	1 883	2.4
10 Turkey	1 397	1.8
11 Uzbekistan	725	0.9
12 Switzerland	706	0.9
13 India	630	0.8
14 Norway	599	0.8
15 Malaysia	540	0.7
16 Argentina	499	0.6
17 Moldavia	441	0.6
18 Canada	413	0.5
19 Ecuador	376	0.5
20 Thailand	362	0.5

The major export partners

Partners	Mio euro	%
World	191 173	100.0
1 EU	107 494	56.2
2 China	10 489	5.5
3 Ukraine	9 949	5.2
4 Turkey	8 729	4.6
5 Switzerland	8 410	4.4
6 Belarus	6 507	3.4
7 USA	6 008	3.1
8 Kazakhstan	5 248	2.7
9 Japan	3 028	1.6
10 Romania	2 447	1.3
11 Korea	1 901	1.0
12 India	1 860	1.0
13 Iran	1 552	0.8
14 Bulgaria	1 528	0.8
15 Israel	1 237	0.6
16 Egypt	844	0.4
17 Uzbekistan	692	0.4
18 Azerbaijan	688	0.4
19 Croatia	684	0.4
20 Vietnam	594	0.3

The major trade partners

Partners	Mio euro	%
World	269 073	100.0
1 EU	142 397	52.9
2 China	16 308	6.1
3 Ukraine	16 200	6.0
4 Belarus	10 215	3.8
5 Turkey	10 126	3.8
6 USA	9 682	3.6
7 Switzerland	9 116	3.4
8 Kazakhstan	7 828	2.9
9 Japan	7 721	2.9
10 Korea	5 114	1.9
11 Romania	2 635	1.0
12 India	2 450	0.9
13 Brazil	2 369	0.9
14 Bulgaria	1 721	0.6
15 Iran	1 665	0.6
16 Israel	1 504	0.6
17 Uzbekistan	1 417	0.5
18 Norway	1 150	0.4
19 Egypt	910	0.3
20 Azerbaijan	853	0.3

EVOLUTION OF THE RUSSIA'S TRADE BALANCE

(Mio euro)

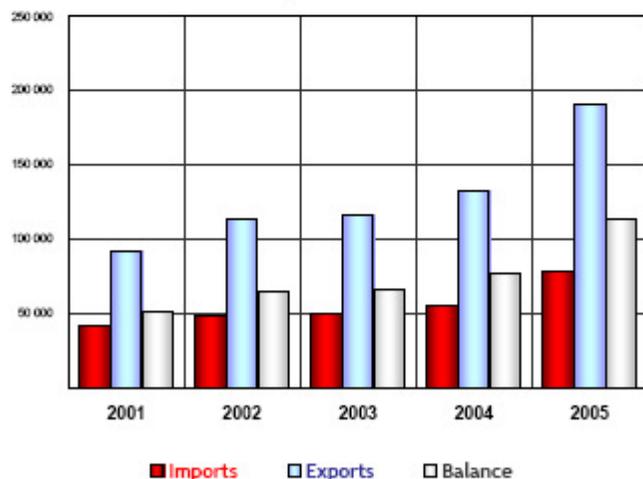
Russia, Trade with the World

Year	Imports	Yearly % change	Exports	Yearly % change	Balance	Imports + Exports
2001	41 006		91 864		50 858	132 869
2002	47 899	16.8	112 883	22.9	64 984	160 781
2003	49 875	4.1	115 493	2.3	65 618	165 368
2004	55 241	10.8	132 172	14.4	76 932	187 413
2005	77 900	41.0	191 173	44.6	113 273	269 073
3m 2005	13 272		35 961		22 689	49 233
3m 2006	26 975	103.2	52 561	46.2	25 586	79 537
Average annual growth		17.4		20.1		19.3

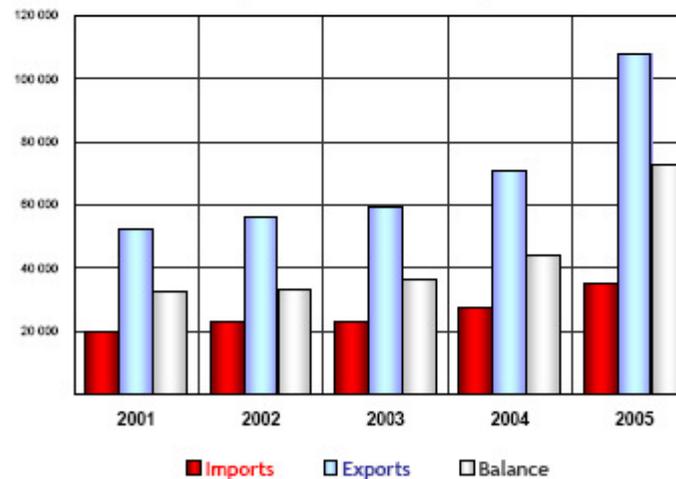
Russia, Trade with the European Union

Year	Imports	Yearly % change	EU Share of total Imports	Exports	Yearly % change	EU Share of total exports	Balance	Imports + Exports
2001	19 588		47.77	52 251		56.88	32 663	71 839
2002	22 719	16.0	47.43	55 758	6.7	49.39	33 039	78 477
2003	22 986	1.2	46.09	59 328	6.4	51.37	36 342	82 314
2004	27 307	18.8	49.43	71 006	19.7	53.72	43 699	98 314
2005	34 904	27.8	44.81	107 494	51.4	56.23	72 590	142 397
3m 2005	6 351		47.85	21 504		59.80	15 153	27 855
3m 2006	16 007	152.0	59.34	31 218	45.2	59.39	15 212	47 225
Average annual growth		15.5			19.8			18.7

Russia, Trade with the World



Russia, Trade with the European Union



European Union: 25 members.

Source: IMF (Dots)

European Union, Imports from ... Russia

Products (Sitc Sections) by order of importance	Mio euro	%	Share of total EU imports
TOTAL	106 766	100.0	9.1
Mineral fuels, lubricants and rel. Materials	68 720	64.4	27.5
Manuf goods classif. chiefly by material	10 408	9.7	8.9
Crude materials inedible, except fuels	3 767	3.5	8.2
Chemicals and related prod., n.e.s.	3 460	3.2	3.7
Commodit. and transactions n.e.c.	2 413	2.3	9.4
Machinery and transport equipment	1 235	1.2	0.3
Food and live animals	617	0.6	1.1
Miscell. manuf. Articles	492	0.5	0.3
Animal and vegetable oils, fats and waxes	69	0.1	1.7
Beverages and tobacco	35		0.7

European Union, Exports to ... Russia

Products (Sitc Sections) by order of importance	Mio euro	%	Share of total EU exports
TOTAL	56 445	100.0	5.3
Machinery and transport equipment	26 603	47.1	5.6
Chemicals and related prod., n.e.s.	8 167	14.5	5.0
Miscell. manuf. Articles	7 410	13.1	6.2
Manuf goods classif. chiefly by material	6 256	11.1	4.7
Food and live animals	3 704	6.6	10.5
Commodit. and transactions n.e.c.	644	1.1	2.2
Beverages and tobacco	629	1.1	3.9
Crude materials inedible, except fuels	569	1.0	2.9
Mineral fuels, lubricants and rel. Materials	316	0.6	0.8
Animal and vegetable oils, fats and waxes	249	0.4	10.3

Appendix 6: The ten most transnational corporations of Russia

Company	Main countries / regions abroad	Type of activity abroad	Estimated value of foreign assets
Gazprom	Several countries in the CIS, CEE and EU plus South-East Europe	Trading, distribution, and marketing of gas, manufacturing of petrochemicals and gas, pipeline construction	...
Lukoil	Azerbaijan, (Iraq), Kazakhstan, Egypt, Columbia, Iran, Saudi-Arabia, Bulgaria, Ukraine, Romania, Baltic States, USA	Production and exploration of oil and gas, oil refining, retailing and marketing of petroleum	~ \$ 6-9 billion
RusAl	Armenia, Romania, Ukraine, Guinea, Germany, USA, China, UK	Refining, processing and production of aluminium, bauxite mining, sales and marketing units overseas	~ \$ 2-3 billion
Norilsk Nickel	UK, USA, Switzerland, Belgium, South Africa	Sales, marketing, and production of platinum-group metals, production of cobalt, mining and production of gold	~ \$ 2 billion
Itera	USA, Armenia, Belarus, Estonia, Georgia, Latvia, Moldova, Turkmenistan, Uzbekistan	Headquarters (USA), gas distribution, plastic manufacturing, fertiliser production, metal production, pipeline construction	~ \$ 1 billion
Yukos	UK, Slovakia, Kazakhstan, Lithuania, Austria, China	Oil exploration, process technology, pipeline construction, oil transportation, oil refining	~ \$ 1 billion
OMZ	Romania, Netherlands, USA, Armenia, British Virgin Islands, Tunisia, Ukraine	Production of metal devices, investing and sales activities, technology development, engineering services	~ \$ 0.5-1 billion
Rosneft	Kazakhstan, Algeria, Columbia, Afghanistan	Oil and gas production, field development, reconstruction of oil and gas infrastructure	~ \$ 0.5 billion
Alrosa	Angola, Belgium, Israel, UK	Diamond mining, sales and marketing, product development	~ \$ 0.5 billion
Severstal	USA	Metal production	~ \$ 0.5 billion

Source: VAHTRA, P., LIUHTO, K., Russian Corporations Abroad – Seeking Profits, Leverage or Refuge?, Turku School of Economics, Finland, 20p., Internet, http://www.tukkk.fi/pei/NewEurope/SessionA1/Vahtra_Liuhto.pdf, [15/04/2007].