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Russia's Energy Policy

Jurgis Vilemas

This chapter presents the various ways in which Russia's energy policy and foreign policy interacted with each other after the collapse of the Soviet Union and the subsequent consequences for developments in neighboring countries. In the difficult process of transition from central planning and state ownership to a market-oriented economy and private ownership, Russia efficiently exploited several newborn, semiprivate companies such as Lukoil, Gazprom, and United Energy Systems (UES) to expand its economic control and political influence. This chapter presents some concrete examples of that process. Vast reserves of natural resources are a very important factor in Russia's relations with the European Union and other Western countries. Russia's urgent need for huge investments in order to exploit its resources has a particular influence on those relations.

New discoveries of oil and gas around the Caspian Sea have fomented long-running strategic disputes among many countries, particularly in the area of transportation to the markets. The deposits are located between high-volume consumers—today Europe and Russia, China in the future, and Iran—and are of great geopolitical interest for all of them, as well as the United States.

The significance of Russia's vast natural resources, and especially energy resources, to Russian energy and foreign policy cannot be overemphasized. Russia controls the greatest oil, gas, coal, and uranium deposits on the globe. It has a comparatively well-developed technical infrastructure for exploration and development of those resources, and that infrastructure is backed by a cheap and experienced labor force. During its post–Soviet period, Russia used those assets not only to influence the former satellite countries' domestic economic and energy policies, but also as a very powerful instrument of foreign policy. This influence is particularly strong in

Russia's relations with all neighbors, but especially with the ex-Soviet and east European countries. Given the political and financial instabilities that Russia faced after the collapse of the Soviet Union, the oil, gas, and nuclear sectors performed reasonably (and surprisingly) well, particularly in sustaining export volumes. Thus, the energy factor, as a Russian policy instrument, has likely been underestimated in the West and the details of its mechanics not properly understood.

ENERGY POLICY BACKGROUND

Russia inherited the Soviet Union's completely state-owned energy sector, which was managed by vertically integrated monopolies. The process of economic reorganization and privatization in Russia started just after the breakup of the Soviet Union. The oil sector, for example, consisted of more than ten vertically integrated companies and a series of independent regional producers. A vast majority of these companies were privatized and the state now owns only a small stake in a number of them.

The gas and electricity sectors have developed very differently. The vertically integrated monopolies Gazprom and UES still dominate, maintaining almost full control over each respective sector. Nevertheless, the Russian government has only a 38 percent stake in Gazprom and 52 percent of UES.

Never before had any society transferred such huge values from state to private ownership in so short a time, and the state encountered great difficulties in controlling the process. During that period very powerful and influential private owners or "oligarchs" arose, and they are very resourceful in seeking further enrichment and influence. Lack of proper legislation, a corrupt governing bureaucracy, and an underdeveloped banking sector (a significant part of which was controlled by the same oligarchs) created unprecedented possibilities for transfers of vast financial sums to accounts in foreign countries through establishment of numerous daughter companies or local affiliates, particularly in former Soviet and Eastern bloc countries. Indeed, most of Russia's biggest semiprivate energy companies, such as Lukoil, Gazprom, and UES, followed this strategy. The new companies not only conduct export operations, but also control a significant share of the refining and petrochemical businesses.

Broad involvement of newly born, aggressive, and inventive private companies in oil and gas exports made it possible over the past decade to maintain or even increase export volumes, even though production was gradually deteriorating. Evidently, the economic crisis and subsequent deep reduction in domestic consumption helped stabilize exports. But only the private sector was able to fully exploit the situation. Very low domes-

tic prices (several times lower than the international prices) also helped encourage exports.

Oil and gas exports generate roughly 50 percent of Russia's hard currency revenues. In 2000 alone, sales of Russian oil companies exceeded U.S.$60 billion. But the owners of the largest companies are reluctant to share any income with the state. President Vladimir Putin clearly understands that without properly controlled "oil and gas money" it is impossible to start rebuilding and modernizing Russia's ailing industry and deteriorating infrastructure. Investments in each sector must be increased considerably even to maintain existing export capacity. Establishing more strict controls on the energy business is one of President Putin's most important near-term tasks. Recent replacements in the government and the appointment of a new chairman of the Gazprom board confirm this fact.

However, attempts to strengthen control of the powerful, private giants may only achieve short-term success. The long-term target should be basic restructuring and liberalization of the economy, a goal that may require a decade to achieve. Another big obstacle to substantial increases in oil and gas exports is that large-scale domestic consumption is dependent on energy-intensive industry and transportation. However, in Russia nearly all industries require more than twice as much energy than in modern economies. An extremely wasteful heat supply system, combined with a harsh climate and long distances for fuel delivery, needs more primary energy resources than a more developed system. Country-wide modernization will require enormous investments. Additionally, few new power plants were built in Russia during the last twenty years. And soon the country will face the enormous task of renovating the old generation of plants. Otherwise, the reliability of the heat and power supply will fall to an unacceptable level, as it happened in Russia's far east and in Siberia. Any cold winter, even in European territory, can be disastrous.

The government's "Russian Energy Strategy for the Period up to 2020" calls for 3 percent annual growth of electricity generation capacity, which will require huge investments: from U.S.$2.5 billion in 2001 to U.S.$6.5 billion in 2010. At least U.S.$2 billion are needed just to keep natural gas production at 2001 levels. According to the strategy, annual natural gas production will climb by 27 percent, to 750 billion cubic meters in 2020 from 590 billion in 2000. Oil industry expansion will also be expensive. About U.S.$15 billion is to be raised between 2001 and 2005, while total investment in the upstream oil industry between now and 2020 will be as high as U.S.$43 billion. Together with downstream investments, the figure could reach U.S.$115 billion to $135 billion.[1] Russia's urgent need for huge investments—to keep running the country's energy industry and to maintain oil and gas export levels—exceeds any realistic internal possibility even if oil prices stay high.

With output falling and gas exports set to rise, domestic customers should gradually switch to other fuels. Gazprom does not want to supply fuel for power plants for U.S.$12 per 1,000 cubic meters. Thermal power plants consumed 135 billion cubic meters in 1999, while Gazprom requires a 30 percent reduction of gas consumption in power generation.[2] The situation with fossil fuels can explain why Russian energy strategists revitalized a great idea of the 1980s: to use nuclear power as the main source to justify growing demand. In May 2000 the government of the Russian Federation issued a "Nuclear Power Development Strategy in Russia in the First Half of the Twenty-first Century," in which it postulated that nuclear power generation should grow from 15 percent of total generation in 2000 to 21 percent in 2020.[3] That means that production in NPP (net power production) should almost triple from 129 TWh (Terawatt hours) to 340 TWh (210 TWh in 2010). Taking into account that nuclear power plants require much bigger investments per unit of capacity and that foreign capital is difficult to attract, the program does not appear to be achievable. Many analysts have raised questions about whether Russia will be able to meet the rising demand for huge investments. Where will funds come from to put the energy industry on a growth track?

To avoid an energy crisis without the infusion of enormous amounts of foreign capital is impossible. This situation is well understood by President Putin and the country's politicians, and to some degree not only determines the country's energy policy but also is shaping external relations with developed industrial countries, particularly within the European Union (EU).

In 2000, within the EU, much of the debate in the political circles has centered on the long-term strategic issue of how best to justify the constantly growing demand for energy and how to ensure a secure supply, given the union's significant and growing dependence on energy imports. The European Commission's green paper, "Toward a European Strategy of Energy Supply," clearly expresses renewed attention to the importance and inevitability of Russia as a supplier of oil and, in the greatest extent, gas to West European markets. By 2020, almost 70 percent of the European Union's gas will have to be imported. Up to 40 percent will come from the world's larger producer and largest reserve keeper—Russia.[4]

Therefore, the EU governments clearly have an interest in maintaining close relations with Russian authorities on energy policy matters. In fact, both sides decided to create the Strategic Energy Partnership, which was formally signed at a summit between Presidents Jacques Chirac, Romano Prodi, and Putin in Paris on October 30, 2000. The aim of the partnership is to build a long-term program based on the convergence of interests between the European Union and Russia in the area of energy cooperation. On one hand, the European Union has a growing demand for energy imports, which will become significantly greater after the East European countries join. On the other hand, Russia needs a substantial injection of

foreign capital in order to increase oil and gas production, to modernize its power sector, and to secure an overall strategy for economic growth.[5] The Strategic Energy Partnership's aims and objectives are fully in line with the new Concept of Russian Foreign Policy adopted by President Putin in July 2000. The concept emphasizes the importance of attracting foreign investments into the key sectors of the Russian economy and a readiness to create the needed legal basis for economic cooperation and the security of foreign investments. The European Union's role in the energy partnership is that of a facilitator to improve investment opportunities for European companies, to upgrade the infrastructure, and to introduce efficient and environmentally friendly technologies. But the necessary preliminary step to investment is Russia's ratification of the Energy Charter Treaty, currently being stalled by Gazprom lobbies in the Duma.

The Strategic Energy Partnership Agreement calls for natural gas exports from Russia to Europe to rise to 200 billion cubic meters by 2008. As part of the agreement, Gazprom will form a consortium with leading gas companies from Germany, France, and Italy to build a U.S.$2 billion gas pipeline to carry an additional 60 billion cubic meters of gas to the European Union each year via Belarus, Poland, and Slovakia.[6]

Gazprom has recently begun focusing on another export project to carry gas from northern Russia to Germany and perhaps to Scandinavian countries via the Baltic Sea. The consortium agreement for a feasibility study was signed in spring 2001 between Gazprom, Fortum (Finland), and German companies.[7] With the changing political climate in Europe, it is realistic to analyze cheaper paths for crossing some Baltic countries.

Geographical proximity, economic necessity, and long-term strategic interests strongly stimulate both Russia and the European Union to move toward increased coordination of future energy policies. Such a coincidence of critically important strategic interests strongly favors political stability and fruitful economic cooperation in the region.

A perfect demonstration of that new climate and Russia's seriousness in improving relations with the West is the government's reaction to the tragic events of September 11, 2001. Russia's cooperation with the United States in antiterrorist actions and its clearly expressed intention of providing western Europe with additional deliveries in case of supply disruptions from the Middle East (as noted, for example, in President Putin's speech in Essen on September 26) opens a new era of political and economic relations. Both sides must take advantage of this favorable climate without delay.

However, it is unrealistic to expect that Russian oil will be able to replace shipments from the Middle East in the event of a serious political crisis. To be competitive in the international oil sector, Russia first must fundamentally improve its domestic energy sector. That will take a long time and huge investments. Russia's recent and speedy economic recovery has been coupled with growing domestic demand for oil and gas. Most of the grow-

ing oil production should go to the domestic market, which will not leave very much export expansion.

RELATIONS WITH FORMER SATELLITES

The situation is very different for independent countries that were part of the former Soviet Union, and somewhat different for the east European countries. For Russia, it is difficult to rid itself of the imperial habits, traditions, and mentality that have lasted several centuries. Many of the newly independent states are experiencing a rise in nationalism and Russophobia, and they are ignorant of some very important realities. Moreover, the extremely painful economic transition in all of these countries means that mutually helpful economic relations continue to be unfavorable. However, the factors interact differently in different regions. For example, the processes in the Baltic countries are developing differently from those in the Caspian Sea region or in Ukraine or Moldova. Moscow itself is experiencing difficulties in the transition from the Soviet unilateral command style to relationships based on democratic, economic, and political cooperation between countries that are truly independent and sovereign but very young and inexperienced in self-governance. All of those countries, excluding the Caspian Sea region, completely depend upon energy supplies from Russia and do not have any alternative source in the near future. For Russia it is difficult to avoid temptation and not exploit this superior position. A variety of methods have been used over the past ten years. Just after 1990, Russia tried bullying, blackmailing, and direct cuts of supply. After 1991, when it became evident that restoration of the Soviet Union was impossible, Russia deployed an intelligence strategy to maintain significant influence or even control in one region or another, using oil, gas, and to a lesser extent electricity supplies.

The recent history of oil and gas supplies in the Baltic countries, particularly Lithuania, provides a good example of how Russia has developed methodologies to restore political influence in the post-Soviet area. Already the first attempts to cut oil and gas supplies in 1991 demonstrated that such actions are inefficient and generate adverse and undesirable effects for the initiator. Supply cuts are only effective and justifiable when caused by accumulated and sizable nonpayment.

As early as 1992, in almost every post-Soviet and East European country, Russia started to create joint ventures with local, newly established private enterprises trading oil and gas or penetrating industries whose products were based on imports from Russian raw materials. Some of these enterprises were managed by former local Communist Party bosses. Gradually, those companies began to dominate the gas supply and significantly influenced the oil trade with oil (particularly heavy oil). For example, in 2000

only 25 percent of the natural gas consumed in Lithuania was directly supplied by Gazprom to the Lithuanian grid operator and distributor Lietuvos Dujos. The remaining amount was supplied by the intermediate companies Stella Vitae, Itera Lietuva, and Itera Lit, jointly owned by Lithuanian private investors and Gazprom or Itera. The gas supplied directly to Lietuvos Dujos by Gazprom was always more expensive than that supplied by intermediates, yet the original owner was the same. Intermediates get a significant discount from Russian suppliers, which allows them a substantial profit. In 2000, Stella Vitae supplied 693 million cubic meters and earned a clear profit of U.S.$1.5 million. Itera Lietuva supplied 1.5 billion cubic meters and earned U.S.$8 million.

It is possible to conclude that such a scheme will gradually enable Russian energy companies to create financially strong, local, private companies, the further success of which completely depends upon the Russian "mother" companies. This means that the local companies must be loyal and obedient to the mother company.

In fact, newly developing Russian capitalists are using focused trade arrangements to develop strong economic and political lobbies everywhere. A similar plan has been put into effect in Poland, Slovakia, Hungary, and Bulgaria. In Poland, the owner of the large private company Bartimpex is tightly connected with Gazprom. In Hungary, the chemicals firm BorsodChem—the country's largest chemicals company—is controlled by companies representing Gazprom interests. In September 2000, Gazprom bought almost 25 percent of BorsodChem through its Ireland-based, offshore affiliate Milford Holding. But BorsodChem owns nearly 30 percent of TVK (Tiszai Vegyikombinát, a company providing intermediate petroleum products to BorsodChem), which stirred up fear in Hungary that Gazprom was using BorsodChem as a springboard for taking over TVK.[8] Meanwhile, Panrusgaz, a 50:50 joint venture of MOL (Hungarian Oil) and AEB Bank, the wholly owned Hungarian banking arm of Gazprom, posted a U.S.$8 million net profit in 2000. The company imported 8 billion cubic meters of Russian gas last year, around 60 percent of Hungary's supply. Finally, in Bulgaria, Lukoil owns 58 percent of the country's largest refinery, with a capacity of 7.5 million tons per year, and in 2000 made a net profit of U.S.$51 million. It is planning to invest this profit in the country. Lukoil wants to increase the number of its filling stations from 13 to 130 and to gain a 25 percent share in the retail fuel market by 2005. Similar examples can be found in other East European countries.

In general, Russia's giant, vertically integrated energy companies have gradually become strong and efficient instruments for Russian foreign policy, even in those countries that have succeeded in their economic transition and have avoided big debts to Russia. Future restructuring of the Russian energy sector involves the strengthening of new competitors for Gazprom and Lukoil (or even their possible fragmentation) and penetra-

tion of Western companies into upstream business. Thus, much stronger competition may make the aforementioned plan less efficient. But in any case it cannot be reduced to zero, as Russia will be the dominant, primary energy supplier for a few decades to come. Creating a balance for Russia's strong presence will be a challenging task both for local and Western political and economic strategists.

Danger to sovereignty is much greater for those countries that were not able to avoid huge debts for energy supplies from Russia. Ukraine owes Russia more than U.S.$2 billion for gas, Moldova owes close to U.S.$1 billion, and Georgia owes nearly U.S.$200 million. Despite the fact that gas and electricity are supplied to Belarus at very low prices, this country is also wallowing in debt. Widespread corruption, inefficient management, and an enormously negative trade balance with Russia caused by primary energy imports is pushing these countries to economic stagnation, and is igniting social discontent and political instability. Almost everywhere Russia is proposing or planning to exchange debt for shares of strategically important infrastructure installations: electricity and gas networks, refineries, the petrochemical industry, etc. The lack of proper radical reforms is preventing the expansion of Western economic assistance. It goes without saying that Russia's presence is expanding. Belarus has come closer to political unification with Russia; a similar trend is gaining more and more supporters in eastern Ukraine; and huge Moldavian debts are blocking possibilities for reunification with Romania.

Ultimately, very weak economies and the growing flow of Russia's energy to the West are preventing any chance for reducing the dependency of European and former Soviet countries on Russia's energy supply for the foreseeable future. It is difficult for them to believe that oil or gas imported from the West is competitive with Russian supplies. The significant presence of Western capital in the energy sector, as well as political influence in the West, may be strengthened and broadened only in cooperation with Russian companies. One good example is the sequence of events related to the Lithuanian government's deal with the U.S. company Williams International. In 1999, Williams International bought a 33 percent stake of the Lithuanian refinery Mazeikiu Nafta, together with an oil import-export terminal on the Baltic Sea coast in Butinge. But the refinery could not operate efficiently without long-term agreements with such Russian companies as Lukoil or Yukos, which were supplying oil via the existing pipeline. Imports through the Butinge terminal from the North Sea would not have been competitive. Negotiations for long-term supplies were not fruitful until an agreement was reached to sell a separate 27 percent stake of Mazeikiu Nafta to Russia's second-largest private company, Yukos, on June 25, 2001. The requisite legislative changes to implement this agreement were enacted by the Lithuanian parliament on August 2, 2001. The agreement opens a new period of positive economic cooperation in energy

business between Western and Russian companies in the Baltic states and could be a catalyst for future cooperation in other regions.

The Williams International deal also marks the appearance of real competition between Russian companies. For many years Lukoil dictated the terms for supplying oil to the Mazeikiu Nafta refinery by refusing to sign a long-term supply contract and by significantly influencing its performance. Yukos' move broke Lukoil's dominance in the region. Another private Russian oil company, TNK, also wants to acquire shares in exchange for a long-term supply contract. Real competition is beginning to work even in this region.

CASPIAN PIPELINES

Recent discoveries in and around the Caspian Sea have made the region one of the most exciting oil and gas provinces in the world. The climate is not too harsh, and the region is reasonably close to the principal consumers. But the development of a transportation system and ports system faces a long list of technical, political, legal, and other obstacles. It will require agreements between local governments, energy companies, and main potential consumers. There are also geopolitical interests involved.

The legal status of the Caspian Sea has been in dispute since the Soviet Union collapsed. Up until that point, the land around it was divided by just one boundary between the Soviet Union and Iran. However, now Russia, Kazakhstan, Turkmenistan, and Azerbaijan each have a claim to control some part of the Caspian region. During the 1990s, Russia blocked any decision about the legal status of the sea. But when President Putin came to power, Russia proposed to divide the seabed by medial lines providing each country with control over its own resources. The exact location of those lines has not yet been decided. Russia has also proposed to divide resources 50/50 between any two countries involved if oil or gas fields are found to overlap offshore boundaries, regardless of the volume of reserves lying in individual territories. Except for Iran, almost all of the countries have accepted the proposal. Iran is insisting that the Caspian Sea be divided into five equal portions providing each state with a 20 percent share. The medial line approach would give Iran around 13 percent.[9] Reaching a common agreement may take many years of difficult negotiations.

The presence of Western oil companies on Russia's southern border and the high political profile Washington has assigned to Central Asia raises fears that the U.S. military will not be far behind.[10] Russia has attempted to retain influence over Caspian oil and gas developments in a number of different ways, trying to ensure a partnership role for Russian companies by using the political influence stemming from the former Soviet infrastructure and its advantageous geographical position. It has also come to understand

that it is impossible to prevent the construction of new pipelines that bypass Russia. Now the question is only one of time. Under President Putin, Russia is turning to economic competition and a partnership attitude. In fact, Russia increased Kazakhstan's quota of shipments into the Russian pipeline system and invited its Caspian neighbors to use the new pipeline to Makhachkala on the western Caspian shore in Dagestan (the Russian province bordering Chechnya). The Caspian Pipeline Consortium (CPC), which includes U.S., Kazakh, and Russian oil companies, has built a pipeline that can transport 28 million tons of oil per year from the Tengiz oil field to Novorossiysk on the Black Sea. It was scheduled to start operations by the end of 2001.

Recent new discoveries of oil and gas in all of the Caspian countries have resulted in the active return of Western companies. The inevitable large-scale energy exports through newly planned pipelines (i.e., Baku-Ceyhan, a Trans-Caspian gas pipeline, and connections with China) are more generally seen as a threat to Russia's strategic plans to dominate European energy markets and restore Central Asian supplies to Russia. Growing export demand, as well as increasing domestic demand, cannot be satisfied by domestic production alone. Now Russia is boosting imports from Kazakhstan and Turkmenistan,[11] because participation in the development of fields in this area may prove more economically worthwhile than exploring the remote and environmentally hostile Siberia and the Arctic.

The current nominal capacity of the system linking Turkmenistan with Russia is 65 billion cubic meters per year. Yet the pipes are crossing Kazakhstan. Why was Gazprom negotiating to replace Belgium's Tractebel as operator of the Kazakh gas pipeline network? Tractebel left Kazakhstan discouraged by low domestic prices and corruption scandals.[12]

Another area of competition is Turkey's gas market. Gas demand in Turkey is expected to rise rapidly from 13 billion cubic meters per year in 1999, to 55 billion in 2010, and 82 billion in 2020. At this moment Russia has gained a strong lead in the race to capture the Turkish gas market and already supplies 70 percent of the country's imports through the pipelines crossing Ukraine, Romania, and Bulgaria. Russia will maintain or even raise this figure after the Blue Stream pipeline across the Black Sea to northern Turkey up to Ankara is finished.[13]

If Turkey's demand growth proceeds as expected, then there will be room for several supply paths, including a Trans-Caspian pipeline. Transit via Turkey to southern Europe, where the expected growth rate is high, supports even the most optimistic projects. There is room for many actors and much competition, which is confirmed by the latest moves by such Western companies as Eni, Total Fina Elf, and BG, as well as Gazprom, and local Kazakh and Azeri companies (see Figure 4.1). A Caspian pipeline systems is not a dream, but an imminent reality: a reality in which pipelines cross almost all participating countries without any dominance or monop-

oly by any particular country. Thus, there is a good chance that economics and common sense will prevail.

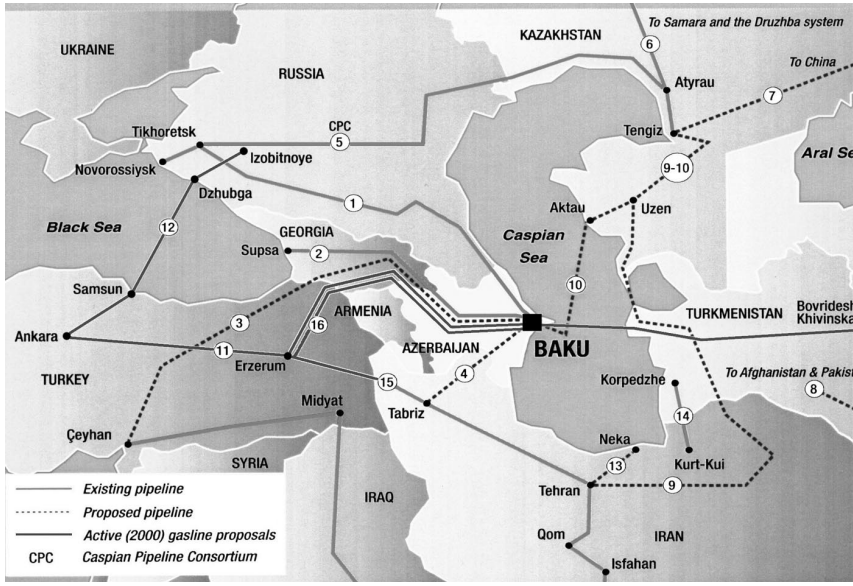

Figure 4.1. Caspian Oil and Gas Pipelines

1. Novorossiysk; used by AIOC.
2. Baku-Supsa; "early oil" line for AIOC fully operational March 1999.
3. Baku-Ceyhan; designated by the governments of Azerbaijan, Georgia, Turkey, and the United States as MEP route.
4. Baku-Iran (possibly Tabriz).
5. Atyrau-Novorossiysk; project now completed, operation scheduled for the end of 2001.
6. Atyrau-Samara-Druzhba system.
7. Tengiz-China; under study by China National Petroleum Corporation.
8. Chardzhou-Pakistan; with possible tie-in from Turkmen and Kazakh fields on/near the Caspian.
9. Tengiz/Uzen-Kharg.
10. TransCaspian Oil.
11. TransCaspian Gas.
12. Blue Stream Russia-Turkey gas line.
13. Neka-Tehran; financing being sought for line which could constitute major element in swaps/pipeline export system from Caspian to Persian Gulf.
14. The KKK gas line; opened in 1997, Turkmenistan's only current export line that does not transit Russia.
15. Tabriz-Erzerum gas connector; Iranian section completed by end of 1999.
16. Baku-Turkey gas pipeline; new 16 bcm\y line involving the linkage of existing lines in Azerbaijan and Georgia with a new line in eastern Turkey.

CONCLUSIONS AND RECOMMENDATIONS

The significance of Russia's vast natural resources, particularly its energy resources, to the country's energy and foreign policy is hard to overemphasize. Russia controls a vast territory with huge oil, gas, coal, and uranium deposits. It has a comparatively well-developed technical infrastructure for exploration and development of those resources, backed by a cheap and experienced labor force. Now, in its post-Soviet period, Russia is using its treasures not only with regard to its domestic economic and energy policies, but more and more as a powerful instrument of foreign policy. This strategy pervades Russia's relations with all of its neighbors, but especially with the ex-Soviet and East European countries.

The energy sector can be a source of conflict, but it also offers much opportunity for cooperation between Russia and not only all of its neighbors, but all of Europe and Asia. But in any case, energy as a Russian policy instrument has been underestimated in the West.

Oil and gas exports generate roughly 50 percent of Russia's hard currency revenues. However, to maintain the existing energy sectors' export capacities, investments in each sector must be increased on manifold levels. Without being able to attract enormous amounts of foreign capital, growth will be impossible. The European Union looks ready to assist Russia in securing the needed investments for its energy sector. Moreover, the EU governments are clearly interested in maintaining close relations with Russia on energy policy matters.

Geographical proximity, economic necessity, and long-term strategic interests provide a strong stimulus for both Russia and the European Union to coordinate future energy policies. The overlap of very important strategic interests favors political stability and fruitful economic cooperation in the region.

The situation is very different for the independent countries of the former Soviet Union and somewhat different for the East European ones. Russia is encountering great difficulties ridding itself of the habits, traditions, and mentality from its imperial past. Many of the newly independent states are experiencing a rise in nationalism and Russophobia, and are ignorant of some important realities. Moreover, the extremely painful economic transition in all of these countries means that mutually helpful economic relations continue to be unfavorable. However, the interaction of these factors is different in each region. Processes in the Baltic countries are developing differently from those in the Caspian Sea region, Ukraine, or Moldova. Moscow itself is experiencing difficulties in its transition from the Soviet unilateral command style to relationships based on democratic, economic, and political cooperation between countries that are truly independent and sovereign, but very young and inexperienced in self-governance.

Russia's giant, vertically integrated energy companies gradually have become strong and efficient instruments of Russian foreign policy, even in those countries that have succeeded in the economic transition and have avoided big debts to Russia. Creating a balance for Russia's strength will be a challenging task both for local and Western political and economic strategists.

For the near future, weak economies and the growing flow of Russia's energy to the West have stifled any chance of the European and former Soviet bloc countries reducing dependency on Russia as a primary source of energy. The significant presence of Western capital in the energy sector and political influence in those countries may be strengthened and broadened only in cooperation with Russian companies. Ignorance of this reality will cause great economic and political losses.

NOTES

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