A Bear at the Door

Keith C. Smith

Gazprom's January 1, 2006, cutoff of natural gas to Ukraine was a long-overdue wake-up call for the West. Belatedly, policymakers in Europe and the United States are coming to grips with Moscow's willingness to use its energy resources as political leverage in its relations with Europe. More recently, sharp increases in the price of the natural gas Russia provides to Ukraine, Georgia, Armenia and Moldova—and its increasing control over Europe's gas pipeline systems—have added to international worries over Moscow's economic policies and their security implications.

For the U.S. and its allies across the Atlantic, Russia's energy politics may be a comparatively new phenomenon. For many new EU member states such as Poland, Latvia, Lithuania, and for new democracies like Ukraine, Georgia, and Moldova, they are decidedly not. Until quite recently, however, attempts by Central European states to raise the issue of Russia's energy clout in Western capitals have been brushed aside. Instead, the countries of "old Europe" have preferred a benign view of the Kremlin's energy plans, as the European Commission's rapid acceptance of the "Nord Stream" Russo-German undersea gas pipeline back in 2005 eloquently illustrated. As recent months have made equally evident, the concerns voiced by the Central Europeans should have been examined in detail in Brussels and other European capitals.

The slow response in Europe to Moscow's energy policies has been a boon to the Kremlin, giving Russian companies time to stitch together additional

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bilateral deals with Western governments anxious to gain an investment foothold in the Russian energy sector. For its part, the Kremlin, represented by the natural gas monopoly Gazprom, has capitalized on those overtures, confident that high energy prices and the instability of other producers (particularly in the Middle East) have strengthened its bargaining position vis-à-vis the EU.

Russia has managed to manipulate American attitudes as well. In some circles in the United States, there is an unrealistic expectation that Russian natural gas supplies from the Russian Far East or the Barents Sea will fill the gap created by declining domestic production and by political instability in Latin America, Nigeria and the Middle East. The reality, however, is that Russian oil and gas exports are not growing at the pace they were just three to four years ago. In addition, investment in Russian exploration and development has declined from the level that existed before the Kremlin's systematic destruction of Yukos began in 2003, and the Russian government's parallel efforts to centralize control over almost all national oil and gas resources.

Pipeline politics and Western vulnerabilities

Russian "pipeline imperialism" boasts a comparatively long history. It dates back to 1990, when Moscow interrupted energy supplies to the Baltic states in a futile attempt to stifle the independence movements in those countries. The "energy weapon" was again used against those countries in 1992, in retaliation for their demands that Russia remove its remaining military forces from the region. Then in 1993 and 1994, Russia reduced gas supplies to Ukraine, in part to force Kiev to pay for previous gas shipments, but also to pressure Ukraine into ceding more control to Russia over the Black Sea Fleet and its energy infrastructure. Even erstwhile Russian ally Belarus (and indirectly Poland and Lithuania) suffered supply disruptions in 2004 as part of the Kremlin's effort to take over the national gas pipeline system there. From 1998 to 2000, in an attempt to stop the sale of Lithuania's refinery, port facility, and pipeline to the Williams Company of Tulsa, Oklahoma, Russia's Transneft oil shipment monopoly stopped the flow of crude oil to Lithuania no fewer than nine times.

Russia, in other words, knows that its energy resources are a weapon, and is not afraid to use them. Today, Russia's Gazprom, with the help of Germany's Ruhrgas, exercises control over the gas facilities and pipelines in all three Baltic states, and has monopoly control of the domestic gas markets there. This has allowed the Kremlin to effectively control the energy contacts of these countries with the outside world.

Thus, Transneft has refused to allow Kazakhstan to supply oil to Lithuania's Mazeikai Refinery through the Russian pipeline system, even though Kazakhstan's oil company has the legal right to ship crude oil to the Baltic coast. Moscow, however, is determined to prevent any but a Kremlin-approved company from taking over ownership of Lithuania's facilities. Three years ago, Russia stopped all piped shipments of oil to Latvia in an effort to gain control over the oil port at Ventspils. Now, Moscow is again attempting to keep non-Russian companies from buying Lithuania's Mazeikai Nafta Refinery and the port facilities at Butinge, on the Baltic Sea.

This use of pipeline imperialism is generally ignored in the West, even though Latvia and Lithuania are members of both the EU and NATO. In fact, Russia's pipeline monopolies, Gazprom (natural gas) and Transneft (oil), have been given free rides in terms of the open-market requirements of WTO and the EU's own Energy Charter. The EU in effect has given Moscow's increasingly monopolistic pipeline and production companies carte blanche to avoid following accepted Western business practices.

Russia's conduct has everything to do with its internal politics. Former intelligence officers (known as *siloviki*) in the Putin administration and in Russia's energy companies play a large role in determining national energy strategy. The head of Rosneft, Igor Sechin, is a former KGB associate of President Putin who helped engineer the breakup of Yukos and his company's seizure of its most valuable assets. Former KGB and GRU officers sit on the boards of almost all the country's major energy companies. And most former intelligence officers view granting majority control to a Western energy firm as a danger to Russia's national security interests. The idea of a win-win investment strategy with Western firms—or of a cooperative energy strategy with the countries of the West—is difficult for them to fathom, and even harder to accept.

Western capitulation

So far, Europe has given Russia's aggressive energy policy neither the attention nor the response it deserves. Instead, the continent's energy relationship with Russia has, for the past several years, been directed by only a few of the larger member countries. All too often, the leaders of those nations have praised President Vladimir Putin's democratic credentials while ignoring Russia's backsliding on democracy and the coercive use of Russian energy power. At the same time, they have acquiesced to questionable commercial deals giving Moscow increasing leverage over Europe's energy—and political—future.

Today, for example, against both market economics and common sense, Russia is poised to greatly increase its market share in, and leverage over, Germany and the rest of Europe through the construction of the undersea Northern Europe Gas Pipeline (NEGP). An alternate route, running parallel to the Yamal I line that traverses Poland would have been a much cheaper alternative; the price tag for the NEGP is now estimated at $10.5 billion, while Yamal II would have cost just $2.8 billion. In addition, the enlargement of the Yamal line would have provided Central and Western European energy consumers with greater political and economic security. Instead, however, the EU is poised to build an overly-expensive energy route that will give Russia's state-run Gazprom a significant voice in German domestic energy policies, and indirectly over the gas markets in all of Central Europe.

Sadly, on this score, U.S. policy has proven to be little different. Until quite recently, policymakers in Washington have been far more eager to secure energy supplies from Russia than to pressure the Kremlin into reforming its economy. In the process, they have ignored the non-competitive and political aspects of Russia's energy export policies.

That this state of affairs is dangerous is clear. Relying on energy from an increasingly authoritarian government intent on expanding its political influence in neighboring countries is deeply troubling. If, on the other hand, Russia's energy wealth were more transparently and competitively managed, it would dramatically increase domestic Russian living standards, bring Moscow real international respect and make Europe feel more unified and secure.

The importance of good relations between Russia and the West, and particularly between Germany and Russia, cannot be underestimated. Nevertheless, it is a mistake to give Moscow the impression that the West believes it needs Russian energy supplies more than Russia needs the oil and gas revenue that comes from Western markets. Nor is it wise to let the Putin government believe that its authoritarian domestic policies are acceptable to the West as long as the oil keeps flowing. Simply put, Russia will not be able to develop its vast energy fields in Siberia, the Pacific Coast and in the Barents Sea before the middle of the next decade without Western capital and technology.

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Indeed, there are growing indications that Russia will be unable to meet European, Chinese, Japanese and American expectations for significant increases in energy imports unless it offers foreign investors significantly greater participation in the exploration and development of its energy. Russian gas exports to the West are already dependent on Gazprom's ability to monopolize and control gas exports from Turkmenistan, Kazakhstan and Uzbekistan. This Russian dependency on Central Asia will increase over the next seven to ten years, until there are substantial gas flows from the Shtokman field in the Barents Sea, and from new wells in the Sakhalin and Siberian fields. In the past, Gazprom has not been known in the industry for either its innovation or its ability to increase productivity. With the company now under tighter control by the Kremlin, there are good reasons to question whether Gazprom and the increasingly powerful Rosneft will have the managerial skills, financing and technology necessary to meet Russia's export contracts through increased domestic production.

All of this is leverage that the West can and should use. Yet until now, there has been no coordinated push by either the EU or the U.S. to require Russia to open its energy market to foreign investors in the same way that Western companies and markets are open to Russian investors. Lukoil, for example, has been allowed to buy 100 percent of Getty Petroleum in the U.S., along with 1,500 gas stations. Yet according to Russian law, American energy companies can only own 49 percent of a Russian firm, and in practice 20 percent ownership appears to be the ceiling set by the Kremlin.

Instead of acquiescing to this model, the West should be using its considerable leverage to force Russia to play by the same transparent, competitive rules that guide business in the West. Such a strategy would help promote the kind of investment that would increase, rather than decrease, economic reform and more balanced growth in Russia itself. President Putin has compared the new Gazprom colossus to Norway's Statoil, but the latter has real domestic competition, its exports are divorced from foreign policy, and it is a totally transparent company. Gazprom, with its interlocking ties to the Kremlin and its gas pipeline monopoly, cannot be compared to any Western firm.

More thought likewise should be given by Western governments to the potential power of Gazprom to control the gas markets in Central Europe following the completion of the Baltic pipeline system in 2011-12. Under the German-Russian agreement to construct the NEGP, Gazprom will be able to buy significant shares in Germany's gas companies. Will this allow Gazprom to veto shipments of gas from Germany to Poland if the Poles have a dispute with Gazprom over price or availability? Could the increased power of Gazprom be used to stop liquefied natural gas (LNG) receiving plants from being constructed in Poland, Latvia, or even in Germany? Moscow's political influence in Berlin can only be expected to increase as a result of Germany's growing energy dependency on Russia.

Indeed, Russian policies increasingly run counter to Europe's own energy plans. The EU has proposed that member states increase their levels of natural gas storage as part of efforts to attain a modicum of energy self-reliance. But this may become more difficult now that Poland and the Baltic states are being bypassed by the NEGP. Likewise, European states have signaled their growing interest in acquiring energy from Central Asia and the Caspian Basin. But Russian purchases of all gas from Turkmenistan, Uzbekistan, and Kazakhstan are designed to deny the West, including countries such as Ukraine, the ability to buy this oil and gas directly or at prices negotiated between producer and consumer, rather than by Gazprom.

The stakes are high. Among other things, there are real questions as to whether this coercive pipeline policy of the Kremlin is compatible with WTO membership. Considering the unfortunate experience of China's WTO compliance, there are good reasons to doubt that Russia will let up its monopolistic pressure on Central Asian gas shipments after it has been admitted to the WTO. Demanding more open and competitive energy policies by Moscow before its WTO accession would be wiser than repeating the China experience. Russia is also using energy to attempt to drive a wedge between "new" and "old" Europe. Gazprom, for example, is pressuring Bulgaria into breaking a binding agreement on gas price and availability that would be in force until 2010. It is prudent—and politically important—for the EU to support this new member. And yet so far, there is no sign that Brussels will intervene.

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We have already seen a portent of things to come. The Russia-Ukraine "gas war" of winter 2006 may have been resolved relatively quickly, but it provided a telling glimpse into how Russia hopes to use energy to steer European politics. From the statements of Russian officials and their sympathizers in Kiev, Moscow's agenda was clear: to hammer home the real costs of then-

Prime Minister Viktor Yushchenko's plans to move Ukraine closer to the EU and NATO. It is highly unlikely that Moscow would have demanded that Ukraine immediately pay "world market prices" for Russian energy imports if the country's pro-Kremlin candidate, Viktor Yanukovich, had managed to take power. And it should not have surprised anyone that the cutoff came in the middle of one the coldest winters in recent Ukrainian memory, and less than three months before the country's crucial parliamentary elections.

Seizing the initiative

Today, Europe should be taking a more active role in breaking Gazprom's stranglehold over Russia's monopoly pipeline system, and in helping Central Asian energy producers secure direct access to Western markets. It is clear that Europe has the economic and legal ability to create a more transparent and competitive energy relationship with Russia. The question is whether there is sufficient political will in Brussels or other European capitals to force Moscow to adopt more transparent, competitive and reciprocal energy policies.

If they choose to do so, the countries of Europe still have the ability to reorder the playing field in their energy relationship with Russia—at least for the moment. The EU can make greater investments in building a more secure network of electricity inter-connectors between the countries of Western, Central and Eastern Europe. It also could help marshal international banks such as the EBRD and EIB to take equity positions in the pipeline systems of Ukraine, Bulgaria, Moldova and Poland, thereby helping those countries modernize their pipelines and prevent them from being controlled by non-transparent Russian companies.

At the same time, the EU should actively enforce the Energy Charter Treaty it has signed with Russia—and which, though legally in effect, is honored by Russia entirely in the breach. It also should enforce the Rome Treaty's competition and anti-trust rules in cases of cross-border deals between Transneft, Gazprom and individual European states. The goal should be the creation of a "level playing field" for European and Russian investors in the energy sector—one in which the rules on both sides are clear, transparent and enforceable.

Because Kremlin dominance over Caspian energy is not good for business, European governments also need to do more to publicize the true costs to the continent's consumers of Russia's current de facto monopoly on Central Asian energy. In cooperation with the U.S., these governments also should provide more leadership in convincing the Central Asian states to supply gas and oil directly to the EU, without the use of Russian intermediaries. At the same time, Europe must collectively prevent its member states from reaching separate deals with Russia that undercut the viability of EU energy plans.

Such steps are essential if Europe is to preserve its economic and political freedom in the face of growing Russian energy pressure. But they are just as important for Russia itself. Without being held to account, Russia will remain a state that wields energy as a strategic weapon, rather than as a tool for closer ties with Europe and for the prosperity of its own citizenry. It is in everyone's interests that Russia be steered toward the latter course.