

ISSUE BRIEF

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EURASIAN ENERGY FUTURES INITIATIVE

Lowering the Price of Russian Gas: A Challenge for European Energy Security

Europe's energy discourse has been unjustifiably preoccupied with concerns about potential physical disruptions of Russian gas. Yet, the real challenge for European-Russian energy relations, and in fact, for European energy security, lies in settling on a price that leaves both sides content. While Europe will come under increasing pressure to acquire affordable energy resources to enhance its competitiveness, Gazprom may find it increasingly difficult to deliver gas at lower prices in the coming years.

Physical Disruption: An Overstated Risk

Narratives about energy security in Europe often focus on worries about Russia using its energy as a weapon. Such analyses are misleading and counterproductive. Fixation over the possibility of a physical disruption misses the point and misreads current European gas market realities.

On balance, for more than four decades, Moscow has been a fairly reliable gas partner in Europe. Gas relations with Western Europe started to flourish already during the Cold War—despite strong initial opposition from the United States. During the 1980s, the USSR's drive for developing West Siberia's gas coincided with a rapidly expanding market share for Soviet gas in Europe, generating vital foreign currency revenues for Moscow.

Gazprom and Russia carry a fair share of the blame for the misguided fixation on cuts of gas flows to Europe. The disruptions originating in Ukraine in the winters of 2006 and 2009 had a dramatic impact on several countries in

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Central and Eastern Europe, severely damaging European perceptions about Russian gas supplies. This is true even though these disruptions need to be viewed in the context of a complex pricing and payment dispute between Moscow and Kyiv and it would therefore be unfair to assign Gazprom sole responsibility for the predicament.

What is more, for many years Gazprom itself played on Europe's sense of insecurity by repeatedly emphasizing, and often overstressing, the potential threat of physical disruption of its gas sales to Europe—in this case due to

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troubled transit countries Ukraine and Belarus. It readily endorsed Europe's energy security narrative that puts the emphasis on the risks of a physical disruption, though with different culprits in mind: the transit states. This helped to justify its two grand pipeline projects, and in fact, to secure significant support among European capitals to implement them.

An additional problem with the narrative fixated on the risks of a physical disruption is that it overestimates the benefits allegedly accruing to the supplier, while underestimating the potential harm that suppliers would typically like to avoid. The act of deliberately interrupting the supply of gas is very much prone to backfire even with a "reasonable" justification and eventually hurt the supplier. It is an incident that cannot escape the public eye. In fact, even the mere threat to cut off gas supplies can hardly remain hidden, as the importing country can immediately secure international support by exposing the supplier's "plot" and impair its hard-earned credibility. The disruptions in the last decade helped galvanize a more common stance on European energy security that could eventually erode Russia's market position even in Central and Eastern Europe—hardly an outcome Moscow wanted.

Neither Gazprom nor the Russian state appear willing to further risk Russia's credibility as a reliable supplier. Not only is the Russian government heavily dependent on gas export revenues, but Gazprom also remains largely locked-in into the European market. The gas behemoth's failure to diversify its pipeline exports to Asia and its late entry into the international LNG market have solidified this dependence.

Additionally, Europe is headed towards improved capability to deal with the challenge of short-term disruptions in gas supply. Significant efforts are underway for constructing new cross-border connections and storage facilities. In the near future, countries in Central and Eastern Europe are likely to be able to withstand a gas crisis of the magnitude of the one witnessed in 2009 with substantially less damage. Gazprom's two grand pipeline projects, Nord Stream and South Stream, could also minimize the risk of disruption caused by a third party (transit country), enhancing Europe's sense of energy security.

The Price of Gas: A Key Element for Energy Security

It has become more common today to adopt a broader definition of energy security that goes beyond the traditional emphasis on the physical reliability of supply and includes the ability to acquire energy at reasonable prices. Europe's energy security discourse will need to go beyond the traditional focus on physical disruption, and it has yet to reflect the growing strategic importance of the price of gas.

First, in an increasingly competitive global economy, the price of energy can be a significant part of economic competitiveness for a country and even a whole region. With Europe bearing the extra cost of staying ahead of the pack in promoting greener forms of energy, the last thing Europeans need is overpaying for gas to its single most important supplier—Russia. The problem has the potential to be particularly acute for the new members of the European Union in Central and Eastern Europe (see below).

Second, it is in negotiations over the price of gas where Russia holds substantial leverage which could have potential implications for broader policy choices in European countries. Russia's options to either placate or punish its European partners remain wide. It is these levers that in reality could matter more than any theoretical possibilities of Moscow abruptly cutting its gas shipments to Europe.

Moscow has an array of options to approach negotiations with European clients, including: providing ad hoc price cuts; consenting to revise an existing price formula for a few years or for the duration of the contract; agreeing to exempt gas sales from export taxes (which could mean an immediate 30 percent extra revenues and more room for maneuvering for Gazprom); flexibility over the portion of gas indexed to spot market prices; and flexibility on "take or pay" obligations. Each of these options accord Gazprom a substantial clout in Europe.

Notably, in contrast to physical disruptions of Russian gas, negotiations over the price of gas are neither very rare nor are they generally exposed to public view. There are nearly constant negotiations over gas contracts between Moscow

and European capitals, and their terms mostly remain proprietary.

Central and Eastern Europe's Vulnerability to Higher Prices

Reportedly, countries in Eastern Europe, including the Baltics and Ukraine, generally pay substantially higher prices than Gazprom's clients further west. Bulgaria, for instance, has repeatedly complained that it is paying more than Greece for Gazprom's gas, even though the gas for the Greek market has to cross its own territory. Notoriously, Ukraine, geographically closer to Russia, has continued to pay more than many other Gazprom clients in Europe. A recent report by Russia's *Izvestia* highlights the substantial differences in the price of gas across Europe (see Table 1).

In a comprehensive study of Gazprom's pricing in Europe, the Russian investment bank Troika Dialog (now integrated with Sberbank) put Gazprom's European clients roughly

TABLE 1: Average Price of Gas Sold by Gazprom in European Countries in the First Half of 2012 (USD per thousand cubic meters). Source: *Izvestia*, Feb. 1, 2013

Western Europe and Turkey	
UK	313.4
Netherlands	371.4
Germany	379.3
Finland	384.8
France	393.7
Austria	397.4
Turkey	406.7
Italy	440.0
Switzerland	442.2
Greece	476.7
Denmark	495.0
Eastern Europe	
Hungary	390.8
Slovakia	429.0
Romania	431.8
Serbia	457.3
Slovenia	485.6
Bulgaria	501.0
Czech Republic	503.1
Bosnia & Herzegovina	515.2
Poland	525.5
Macedonia	564.3

TABLE 2: Share of Russian Gas in Total Imports in Select European Countries. Source: BP

Western Europe and Turkey	2000	2010
Austria	86.1	77.5
France	30.9	16.5
Germany	44.3	37.1
Greece	84.2	52.8
Italy	36.6	18.8
Turkey	73.6	45.4
Eastern Europe	2000	2010
Bulgaria	100.0	100.0
Czech Republic	88.0	73.1
Hungary	84.8	86.6
Poland	90.8	89.5
Romania	94.1	100.0
Slovakia	100.0	100.0

into two categories: the “price takers” (nearly all former communist countries in Eastern Europe) and the “price breakers” (Germany, Italy, France, and Turkey).¹ Eastern Europe has had to pay not only relatively higher prices to Gazprom, but has also faced a greater difficulty in renegotiating the terms of their contracts. For instance, Poland was able to secure a modest price reduction in November 2012, but unlike several German and Italian companies, it failed to get Gazprom's consent to index part of the sales to spot market prices.

The presence of such a dichotomy should not be a surprise. Access to alternative sources of gas — LNG or gas piped from a non-Russian source— remains the principal path for European companies to negotiate on better terms with Gazprom. As Table 2 illustrates, Gazprom's key clients in Western Europe (including Turkey) continued to diversify their sources of supply during the past decade. All six countries listed managed to reduce the share of Russian gas in their imports. By contrast, in Eastern Europe, with the partial exception of the Czech Republic (which invested in access to Norwegian gas), the level of dependence on Russian gas imports has remained nearly the same since 2000. And in fact, not much has changed for them since their days as members of the communist bloc.

¹ *Russia: Oil and Gas*, Troika Dialog, July 2010

It is notable that in the past few years, the share of Russian gas has been declining in countries with access to alternative sources of gas (generally cheaper gas indexed to spot prices). Gazprom's loss of market share to Statoil in Germany has prompted it to accept several revisions in its contracts. By contrast, Gazprom has retained its market share nearly intact in most Central and Eastern European countries, despite some drop in total sales due mainly to the economic crisis.

At the same time, it is worth recognizing that Gazprom's selective pricing policy is not always an outcome of its ability to exercise its market power. Evidence suggests that Moscow's foreign policy considerations also have an impact on Gazprom's pricing. For instance, in 2012, Russia's close ally in the South Caucasus, Armenia, continued to pay less than half of what Ukraine paid per cubic meter of gas.

An Uphill Battle on Russian Gas Prices on the Horizon

Europe's stagnant gas demand, an ongoing antitrust investigation against Gazprom by the European Commission, and the surprisingly rapid growth of lower priced spot-market gas sales in recent years spell trouble for the Russian major's market position in Europe.

For many, this is a cause for optimism that Gazprom would yield to pressures and adopt a more flexible stance in its gas contracts. Indeed, in December 2012, Gazprom announced its intention to cut its long-term contract prices in the European market in 2013.

And yet, pricing disputes are far from over. In fact, an uphill battle may well be on the horizon for years to come. This is because Gazprom may genuinely face growing constraints in response to requests for lower prices, endangering its market position. Also, in certain sub-markets, particularly Eastern Europe, it may not perceive an immediate reason to substantially revise its pricing policy.

Gazprom may still have significant room for maneuvering (with regard to pricing its gas abroad) left in the near future. This is not least because, only two years ago, it still topped Forbes's list of the world's most profitable companies. Its profits stood at USD 44 billion in 2011. While a considerable opaqueness about the company's finances limits our ability

to estimate its precise room for maneuvering, our analysis suggests that, at least for three reasons, this room may be getting smaller in the coming years:

- a sub-optimal upstream strategy amidst a rapidly changing domestic and foreign market,
- an expensive export infrastructure strategy, and
- the likelihood for increased tax pressure on Gazprom

Gazprom continues to carry out an upstream strategy that fails to take into account new realities in Russia's domestic market and abroad. This will come at a cost that could eventually curb its capacity to cut prices when needed.

Gazprom has invested in upstream capacity that does not look likely to be utilized in the near-term, and possibly even by the end of the decade. Since 2007, it has ploughed in over \$40 billion in the development of Yamal, its principal greenfield project. Before the Great Recession, such an investment decision was widely applauded, as the key concern at the time was its potential inability to meet both domestic and foreign commitments.

But market conditions have changed abruptly. European demand remains stagnant, and the IEA predicts that in 2020, the EU's total gas consumption will be only 4 bcm higher than in 2010 (540 bcm forecasted in the New Policies Scenario for 2020).² Russia's CIS market is not performing any better. In particular, Ukraine, Gazprom's largest foreign client in the CIS, remains determined to gradually reduce its Russian gas imports.

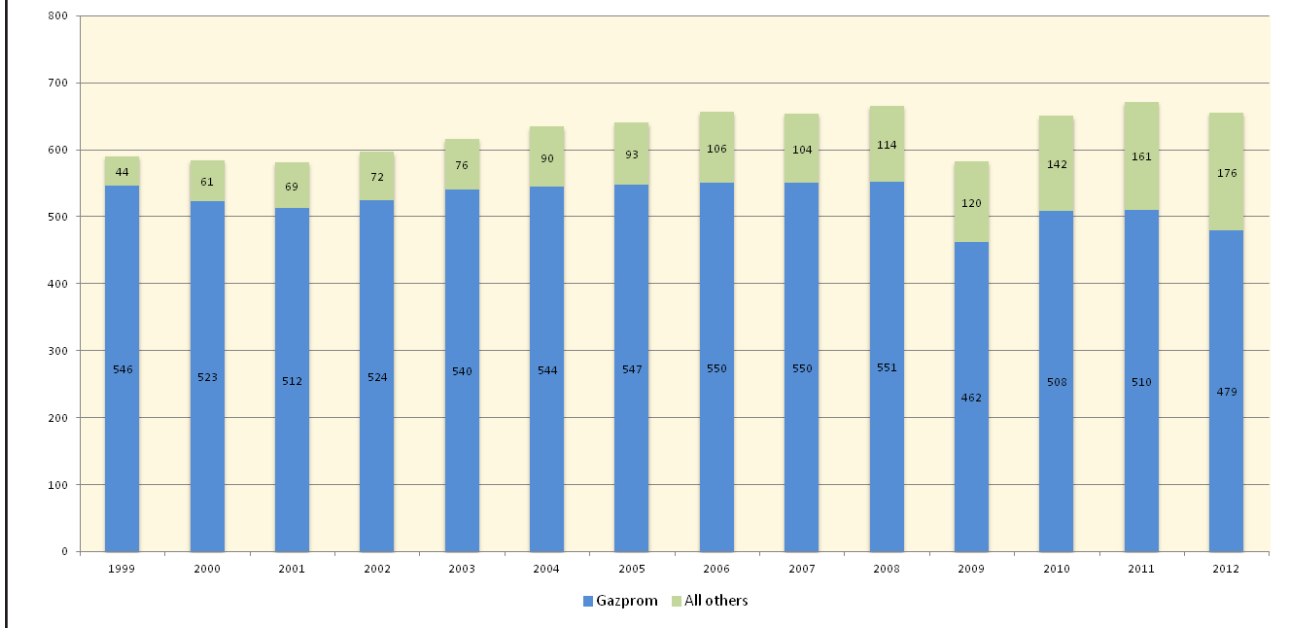
Gazprom's biggest headache, however, may well turn out to be the Russian domestic market. On the one hand, demand growth has drastically slowed since 2008. Energy efficiency measures, especially in power generation, are expected to curb further growth in demand. The IEA's most recent estimate is that Russia will consume only 4.6 percent more gas in 2020 than in 2010.³

On the other hand, the Russian domestic market is getting increasingly crowded. Independents and oil companies have aggressively expanded their output in

² *World Energy Outlook 2012*, International Energy Agency

³ *Ibid*

FIGURE 1: Gas Production in Russia (in bcm). *Source: Nefte Compass*



the past decade: their share in Russia's total gas output increased from a mere 10 percent in 2000 to about 24 percent in 2011. With no access to foreign markets, part of their growth is happening at Gazprom's expense. Some of the gas is sold to Gazprom. But a growing portion is marketed through seizing on Gazprom's clients. Novatek's recent long-term sales contracts with two major Gazprom customers, the Russian arm of Germany's EON and Mosenergo, are indicative of a troubling trend for the Russian major. Rosneft, Russia's largest oil company, has also announced plans for aggressively expanding its role in the gas business. Furthermore, non-Gazprom gas is set to grow rapidly through the end of this decade with optimistic estimates adding as much as 100 bcm of extra gas to the market by 2020.

What is striking is that non-Gazprom output has kept growing even when total Russian output has needed to be cut due to a lack of demand. Gazprom has taken the hit by cutting its own production to balance the markets. (Figure 1) With more gas expected to come from independent gas producers and Russia's oil companies, it appears highly unlikely that Gazprom will reach its pre-crisis peak output for many years to come, hurting its bottom line.

In this context, Gazprom has opted for a costly upstream strategy with some potentially significant consequences.

Every year since 2009, it has had to curb production below its annual target. What is even more troubling about Gazprom's practice has been its decision to cut production at Soviet legacy fields that produce gas at a relatively low cost, while putting vast sums of capital in greenfield development (Yamal).⁴ So far, Gazprom has demonstrated no intention for restraint in its investment plans in Yamal despite market conditions. Instead, its cheap legacy fields remain as the major candidates for continued production cuts in the future.

With Yamal output rising, this is likely to raise the average cost of Gazprom's output. This comes on top of deteriorating quality at legacy fields, where costs remain relatively lower, but are on an upward trend. As a consequence, Gazprom's upstream strategy may constrain its room for maneuvering in its pricing policy in the future.⁵

Moreover, while Gazprom's average production costs are apparently headed on an upward trend, its export strategy is likely to further raise the cost of bringing Russian gas to the European market. Exports to Europe are not expected to grow significantly by the end of the decade. And yet,

⁴ Curiously, Gazprom has - so far - failed to at least measure up domestic shale and tight gas potential though these might easily be closer to the European markets and cheaper to exploit than Yamal.

⁵ To Gazprom's credit, in 2012, the company decided to postpone investment in another highly capital-intensive field (Shtokman), which could have further strained it financially.

Gazprom keeps investing in export pipelines that far exceed its capacity needs. With the recently launched Nord Stream, Gazprom already has a substantial excess export capacity. If South Stream comes online, Russia will have a capacity to export well over 300 bcm of gas to the European market—a capacity that is about twice larger than its forecasted exports to Europe in the medium term. This implies that the average capacity utilization in Gazprom's export network will potentially remain low, raising the average cost of shipping Russian gas to Europe. Someone will eventually have to pay for the extra cost.

Finally, the Russian government has signaled an increasingly assertive stance on the relatively low level of taxation that Gazprom has been enjoying—at a time when Gazprom itself needs to maintain large capital expenditures just to sustain current production levels. At the beginning of Putin's first presidency, the tax regime for the oil sector was fundamentally overhauled, resulting in a massive transfer of rents from the oil companies to the state throughout the following decade. Gazprom continued to enjoy lower taxes partly due to its role as a supplier of relatively underpriced gas to the domestic market. In the past few years, as domestic prices have been rising, Gazprom has finally been able to make significant profits from sales at home. But this has also attracted the ire of a growing number of government officials requesting a “rebalancing” of Gazprom's tax burden.

As the Russian oil sector is about to reach its peak in the next few years, the relative importance of the gas sector as a source of revenues for the Russian state is likely to go higher. At present, the oil sector remains the largest source of government revenues. But, it faces a monumental upstream challenge as legacy fields are declining and new fields need to be urgently developed just to keep the current level of output. That is precisely why Rosneft is entering into deals with international majors, like Exxon, Eni, Statoil and BP: to lure in expertise and technology and enhance production from old (tight oil) and new (Arctic and Black Sea offshore) fields alike. But this necessitates the government to forsake substantial tax revenues from the oil sector to create a better investment environment and promote its further development.

With the gas sector possibly headed towards excess supply capacity through this decade, the Russian government may well look at Gazprom and other gas players to compensate for the foregone revenues. While this outcome is not given, it poses a major risk for Gazprom, and could eventually further raise the cost of the gas it brings to consumers in Europe.

Implications

Gazprom's increasingly suboptimal upstream strategy, its needlessly expensive export infrastructure strategy and the risk of higher taxes on the horizon cannot but complicate its pricing policy in Europe.

A key question for Europe is whether it could avoid bearing the extra costs expected to affect Gazprom's sales. If it could, this would also help minimize the potential impact of intricate price negotiations with Moscow on energy and foreign policy choices adopted by individual countries.

Europe holds variety of policy choices that could improve its bargaining position in the upcoming years. Principally, its members, with Brussels's strong support, need to undertake convincing steps in:

- **Market integration for gas:** While Europe has made substantial progress in increasing the liquidity in the gas markets throughout the continent, the task is not complete. Significant investments are needed in larger capacity cross-border interconnections and storage. Traditional national incumbent wholesalers will need to face more cross-country competition. And member states should continue forcefully to adhere to regulatory reforms that would bring the national markets closer.
- **Diversification of external gas supplies:** Alternative options for Europe include building new LNG terminals, securing progress in getting Caspian, Iraqi, and eventually, Eastern Mediterranean gas. Some of these options could come at a cost of maintaining unnecessarily large spare capacity for imports. But such costs will need to be delicately assessed in relation to potential overpayment to Gazprom.
- **Investment in unconventional gas resources:** Europe's unconventional resources are there to make

a difference. But, it is yet to be seen how quickly they will be explored and developed. EU member countries should assess, and some of them, re-assess the potential benefits of shale gas for enhancing their energy security, and undertake measures for establishing a conducive ground for investing in unconventional gas.

- **Establishing a common external energy policy:** Positive steps in this direction, such as the establishment of an information exchange mechanism for intergovernmental agreements of EU member states and third countries, will need to be enforced consistently. While this will enhance transparency in gas deals between member states and external suppliers, further steps will be necessary for Europe to speak with one voice.

For many countries in **Central and Eastern Europe**, immediate access to an alternative source is not in the cards. However, taking credible steps in this direction can make a difference. This would particularly be the case when a long-term contract with Gazprom is close to expiration and awaits renewal. Increasing leverage by actively pursuing diversification strategies, like completing the Southern Gas Corridor; building LNG terminals in Poland, the Baltics, and Croatia; and developing domestic shale resources is essential. Lack of action, on the other hand, will most likely be a recipe for even more difficult negotiations over the price of Russian gas resulting in protracted loss of competitiveness—a luxury these countries can ill afford.

For **Russia**, further complications in price negotiations with European clients could spell trouble. Gazprom may continue to lose market share, which could be troubling especially if Europe's demand for growth remains nearly stagnant. Future shifts on the global gas scene, like the prospects of US LNG exports to Asia and possibly to Europe or large-scale exploitation of shale gas in China may put additional pressure on Gazprom and limit its room for maneuver.

Yet, Russia will maintain its significant role as a gas supplier in Europe, and in fact, has the opportunity to avoid weakening its position in the European market. This

necessitates Moscow adopting a new approach towards its gas sector, and particularly towards Gazprom. It is less likely that the Kremlin will abandon the export monopoly for pipeline gas. Instead, it could focus on enhancing Gazprom's competitiveness in Europe by turning rhetoric about dealing with its inefficiencies into real action. The potential to save costs remains vast, and it would be wise for Moscow to utilize it.

MARCH 2013

A shorter version of this piece was originally published by European Energy Review.

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