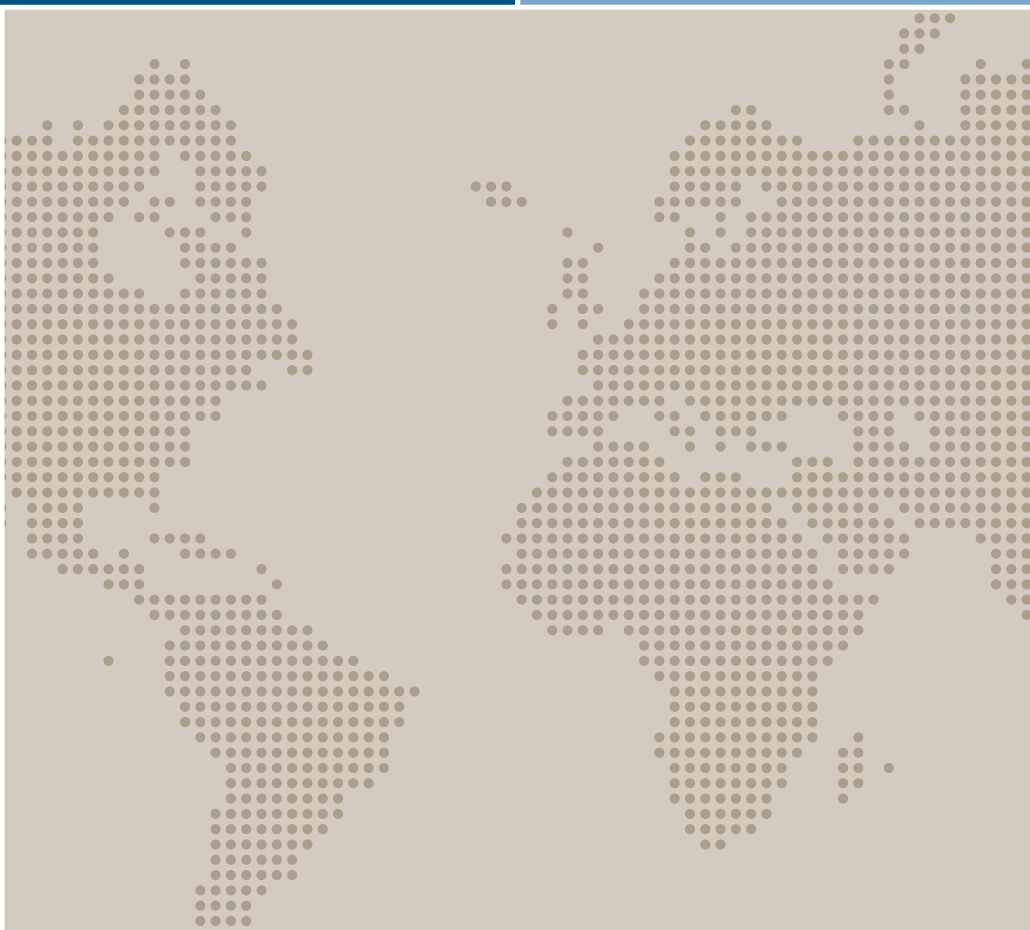


Managing the Challenge of Russian Energy Policies

Recommendations for U.S. and EU Leadership

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MANAGING THE CHALLENGE OF RUSSIAN ENERGY POLICIES

RECOMMENDATIONS FOR U.S. AND EU ENERGY LEADERSHIP

Keith C. Smith

Summary and Background

Following the breakup of the Soviet Union and the Warsaw Pact, the leaders of Russia, including then-President Boris Yeltsin, searched for new methods of continuing to exert influence over the former Soviet-controlled region. The Kremlin at first used an energy blockade to the Baltic States in 1990 in an attempt to prevent their breakaway from the Soviet Union. After that failed, it then focused on the growing opposition in the former republics of the Soviet Union and in East Central Europe to its foreign and economic policies, and in particular on demands that Russian military forces withdraw from the newly independent states. The Kremlin leadership quickly recognized that short of military action, its major foreign policy tool was the denial or threat of denial of access to Russia's vast oil and gas resources.¹ The economies of East European and Central Asian countries, and especially their rail and pipeline infrastructures, had been hardwired by Soviet leaders to assure total dependency on Moscow for their raw materials, including oil, gas, coal, and nuclear fuel.

Moscow also realized that the existing east-west energy pipelines gave Russia the ability to block European access to non-Russian gas and oil from the Caspian and Central Asian region. Russia's use of energy resources and energy transmission systems to coerce its neighbors began as early as 1990, even before the formal collapse of the Soviet Union. The first countries to be targeted for energy intimidation were the three Baltic States, but others, like Ukraine, were soon pressured with the threat of losing natural gas imports. Within a few years, the countries marked for energy supply stoppages expanded substantially. In almost all cases the Kremlin's planned interruptions occurred during the middle of winter when energy demand was at its peak. This very blunt use of energy disruption as policy is still being used to varying degrees of success in an attempt to force Russia's neighbors to follow Moscow's policy direction, although they employ more subtlety in their dealings with Western Europe.

¹ Jakob Hedenskog and Robert L. Larsson, *Russian Leverage on the CIS and the Baltic States* (Stockholm: FOI, June 2007), <http://www2.foi.se/rapp/foir2280.pdf>.

While deputy mayor of St. Petersburg, Vladimir Putin wrote an academic thesis promoting the idea that Russia should flex its “energy muscles” as a foreign policy tool.² After President Yeltsin picked him as his successor, Putin brought into power several former intelligence colleagues, the majority from the Leningrad region. Several of these former KGB officials were given key positions in the nation’s state-run energy companies, thereby giving the president greater control over this economically and politically vital resource base. Once Putin and his former colleagues consolidated power, the use of energy exports as a foreign policy tool increased considerably. Sudden disruptions of energy supplies, intimidation, and threats were used more frequently by Russia’s leaders.

This should have captured greater attention in the European Union regarding the need for Europe to diversify the sources of its energy imports. But the lesson appeared to have been lost on Brussels and on major West European top political figures. Instead, the EU leadership, after little serious debate, approved in 2005 the Russian-German Nord Stream project, which would only add to Europe’s dependency on Russia. Shortly after Nord Stream was approved, Moscow again flexed its energy muscles. On an extremely cold January 1, 2006, natural gas flows were cut off to Ukraine after a dispute over payment for gas.³ The EU countries affected were all in East Central Europe. At the exact same time that gas was stopped to the Ukraine pipeline, a crucial power station that carried Russian electricity to Georgia mysteriously exploded. Later that year, an unexplained fire occurred at the Mazeikiiai oil refinery in Lithuania. The fire followed Vilnius’s refusal to sell its energy infrastructure to a Russian state-owned or state-controlled company.⁴

Piped oil shipments to Latvia’s Ventspils oil port had been blocked since 2003, after Latvian political and business leaders rebuffed Russian demands to turn the large export facility over to Russian control.⁵ In 2008, oil shipments to the Czech Republic were substantially reduced the day after Prague signed a missile defense agreement with the United States.⁶ A major gas pipeline between Turkmenistan and Russia blew up in 2009 after Russia refused to accept the quantities of gas that it had contracted for only one year earlier.⁷ Due to Russia’s financial crisis, demand for natural gas had dropped, as had world market prices for gas, not long after a long-term contract had been signed. Whereas Moscow holds the Central Europeans to their supply contracts as

² Vladimir Putin, “The Strategic Planning of Regional Resources Under the Formation of Market Relations,” (candidate of science dissertation, St. Petersburg Mining Institute, 1997).

³ “Russia cuts Ukraine gas supplies,” BBC News, January 1, 2006, <http://news.bbc.co.uk/2/hi/4572712.stm>.

⁴ Nerijus Adomaitis, “Lithuania oil refinery blaze hits output,” Reuters, October 12, 2006, <http://www.alertnet.org/thenews/newsdesk/L12905213.htm>.

⁵ Vladimir Socor, “Russian oil supplies to Lithuania cut off,” *Eurasia Daily Monitor* 3, issue 150 (August 3, 2006), http://www.jamestown.org/single/?no_cache=1&tx_ttnews%5Btt_news%5D=31939.

⁶ Harry de Quetteville, “Russian oil supplies to Czech Republic cut after missile defence deal with US,” *Telegraph*, July 14, 2008, <http://www.telegraph.co.uk/news/worldnews/europe/russia/2403798/Russian-oil-supplies-to-Czech-Republic-cut-after-missile-defence-deal-with-US.html>.

⁷ Marat Gurt and Olzhas Auyezov, “Pipeline blast halts Turkmen gas exports to Russia,” Reuters, April 9, 2009, <http://www.reuters.com/article/idUSL959981620090409>.

“take-or-pay” deals, the same contractual obligation is not being honored by Russia. During the past five years, oil and gas shipments from Russia have been directly halted to Georgia, Ukraine, Belarus, Latvia, the Czech Republic, and Lithuania. In all cases, with the exception of Belarus, the Kremlin cited specious grounds for the disruption.

The January 2009 cutoff of gas to Ukraine caused widespread hardships in several countries of Europe. Although the Central Europeans and Balkan members of the European Union were most affected, many in Western Europe also suffered from heating disruptions. As in 2006, Gazprom and the Kremlin claimed that the stoppage was a necessary measure due to Ukraine’s alleged stealing of gas from the pipeline system. In Europe, little attention was paid to the fact that only Russia had the capacity to meter gas flows going into and out of Ukraine, or that one-third of the internal gas distribution system was owned by Gazprom and that for more than 10 years, the former CEO of Gazprom was the Russian ambassador to Ukraine. RosUkrEnergo, a nontransparent company 50 percent owned by Gazprom, controlled all of the gas imported from and through Russia. It is difficult to imagine that Russia did not know where each molecule of gas was and that any of the “diverted” gas was not moved with the prior consent of Gazprom.

During the 2006 and 2009 gas disputes between Russia and Ukraine, all of Central Europe and much of Western Europe suffered to varying degrees from sharply reduced Russian gas shipments, even in cases where the overwhelming volume of natural gas came from Central Asia and not Russia. In 1998, and again in 2006, Kazakhstan’s desire to supply oil to Lithuania’s Mazeikiu refinery via Russia’s pipeline system was blocked by Transneft, the Russian state oil export monopoly.⁸ The Kazakhs, who in each event had existing contracts with Transneft to ship oil to the Baltic Sea area, were told that they would not be allowed to ship through Russia if they intended to reach long-term supply or ownership agreements with Lithuania. By preventing Kazakh oil from transiting Russia, the leaders in the Kremlin were in violation of their existing commitments under the European Energy Charter Treaty.

Financial and other more subtle methods also appear to have been used extensively by Russian officials in repeated attempts to influence the energy and security policies of several Balkan countries, the three Baltic States, Kazakhstan, and even Germany and Italy. The use of coercion, corruption, and *kompromat* (the threat to expose compromising information regarding a member of the country’s leadership) is difficult to document. However, there is extensive circumstantial evidence that these methods are routinely employed by Russia’s officials when advancing the country’s security and political agenda, particularly in those nations that it considers to be within Russia’s self-declared “special zone of interest.” There are growing indications that corruption is now being used to influence the energy policies of European countries outside of the former Soviet area, with Germany, Italy, the Czech Republic, Poland, and Croatia as prime targets.

⁸ Vladimir Socor, “It looks, sounds, feels like a blockade: Russian oil blockade of Lithuania,” *Eurasia Daily Monitor* 3, issue 161 (August 18, 2006), http://www.jamestown.org/programs/edm/single/?tx_ttnews%5Btt_news%5D=31996&tx_ttnews%5BbackPid%5D=177&no_cache=1.

In Russia, the large sums of money generated through oil and gas sales give enormous financial leverage to current and former intelligence officers now determining the country's energy policies. Starting with Putin's second term as president in 2004, a stepped-up policy was initiated by the Kremlin of bringing Russia's private and semiprivate energy companies under direct government control. Independent oil and gas companies have been forced to turn over their ownership to the Kremlin through a series of nontransparent "sales" or, in the case of Yukos, through trumped-up criminal charges against the firm's owners. This renationalization of the energy industry considerably increased the Kremlin's ability to enrich favored elites. This occurred in Russia and in those countries where much of the Soviet-era *nomenklatura* continued to exercise political power and or control over the local energy sector.

Also, until recently, the only serious market for Central Asian oil and gas was Europe, and all pipelines except the Baku-Tblisi-Ceyhan oil line ran through Russia, giving the Kremlin effective control over exports from that resource rich region. For all of the 1990s and until at least 2008, Russian companies made extraordinarily large profits from control of Central Asian oil and gas exports. During much of the past decade, Russian companies were selling Central Asian natural gas in Europe for two to three times what they were paying the producers in Turkmenistan or Kazakhstan. During an extended period of time, Russia was paying Turkmenistan about \$70 per thousand cubic meters (TCM) for gas, while selling the same gas to Germany for about \$350 per TCM.⁹

While Gazprom claims that the price of natural gas to its customers is set by the world market price for oil, in reality the price, particularly to Central Europeans, is determined more by politics. Countries favored because of their "acceptable" policies toward Russia, such as Germany and Belgium, now pay between \$220 and \$230 per TCM. The less powerful and more "hostile" states, such as Lithuania and Latvia, pay about \$320 per TCM.

Until recently, the price of gas to Ukraine was set by Moscow annually, thus giving the Kremlin greater political leverage over Ukraine's leadership. The recent gas price agreed to by Russia with the new government of President Viktor Yanukovich allegedly included a deep discount as partial compensation for the long extension of naval base rights granted to the Russian fleet in Crimea. Even with the alleged price discount, however, Ukraine is paying Gazprom more per TCM than does Belgium and about the same or more than does Germany. It is difficult to understand what motivated the Yanukovich government to agree to such an expensive deal with Russia.

Foreign investors in the Russian energy sector, particularly Western firms, have been subjected in several highly publicized cases to pressure from the Kremlin to reduce their participation and ownership in some key joint ventures. Spurious environmental concerns were used on several occasions by the Kremlin to force several Western energy majors to either turn much of their financial interests over to their Russian partners or to pack up and leave the country, giving

⁹ Brian Whitmore, "Central Asia: Behind the Hype, Russia and China Vie for Region's Energy Resources," Radio Free Europe/Radio Liberty, March 28, 2008, <http://www.rferl.org/content/article/1347774.html>.

effective control to favored Kremlin cronies.¹⁰ Almost the entire energy sector has become highly integrated—formally and informally—within the country’s governmental structures. A few energy companies, less well known in the West, such as Zarubeshneft and Surgetneftgaz, have nontransparent ownership structures and appear to be directed entirely from the Kremlin.

Beginning in 2002, there was a sharp drop in foreign and domestic investment in Russia’s oil and gas fields as the nation’s energy firms became state controlled. This was a direct result of the new centralized and politicized ownership. Energy politics became more important than increasing energy production. With the constant rise in international oil and gas prices, the Russian leadership felt that its strong bargaining position allowed it to unilaterally cancel contracts with foreign firms, throw business opponents in prison, and act as if foreign or even domestic energy investment in new fields was unnecessary. Alexey Miller, the CEO of Gazprom Management, once confidently declared that oil prices would reach \$250 a barrel, with parallel increases in natural gas prices.¹¹

Increasing the Pressure

During the late 1990s, the Kremlin stepped up its intervention in the internal affairs of neighboring countries, in part through the use of its greater control over Russia’s energy firms. Some political parties in East Central Europe began to win elections after reportedly receiving large cash infusions from Russian energy companies. For example, in Lithuania, the Social Democratic Party, the country’s political faction most favored by Russia, benefited in 2000 from a “contribution” of funds from a Lukoil-financed company.¹² The European press has widely covered the case of former German chancellor Gerhard Schroeder, who personally benefited financially from a decision he made while in office to support a highly controversial pipeline project being promoted by Gazprom, Russia’s largest energy company. Schroeder has since been paid handsomely as CEO of Gazprom’s Nord Stream Company, as a member of the Gazprom Advisory Board, and as a board member of TNK, another oil and gas company in good standing with the Kremlin.

Close friends of one of Italy’s highest officials allegedly make billion-dollar profits from their roles as middlemen in Russian gas sales.¹³ The Kremlin’s use of a large number of intermediary companies, which serve no purpose other than to divert profits into nontransparent off-shore

¹⁰ Robin Pagnamenta and Tony Halpin, “BP suspends 148 workers over visa dispute with Russia,” *Times* (London), March 26, 2008, http://business.timesonline.co.uk/tol/business/industry_sectors/natural_resources/article3621968.ece.

¹¹ Speech by Alexey Miller, chairman of OAO Gazprom Management Committee, at European Business Council, Deauville, France, June 10, 2008, <http://www.gazprom.com/press/miller/speeches/speech100608/>.

¹² Inga Pavlovaite, “News from Lithuania: Toward the end of the campaign,” *Central Europe Review* 2, no. 34 (October 2000), <http://www.ce-review.org/00/34/lithuanianews34.html>.

¹³ Roman Kupchinsky, *Gazprom’s European Web* (Washington, D.C.: Jamestown Foundation, February 2009).

accounts, is telling in itself.¹⁴ Russian and foreign NGOs continue to report extensively on the rise of corruption in all government activities, even as President Dmitry Medvedev publicly promotes the need to curb corrupt practices. One expert on the Russian economy estimates that investments involving Gazprom require unnecessary payoffs to intermediaries of approximately one-half of the total project cost.¹⁵

Policy Confusion

The reaction in the West to politically motivated pressure on foreign investors and the increase of corruption in Russia has been muted, and in most cases, there have been little or no counter measures by Western government officials and the courts. Indeed, many European leaders have continued vying to be seen as the “best friend” of the Kremlin leadership. Part of the motivation for this is an effort to give their country’s firms a leg up in the commercial competition for access to Russia’s substantial resources. In some cases, the motivation is primarily political. German Social Democrats and some right-wing leaders in Italy argue—against evidence to the contrary—that the likelihood of democratic evolution in Russia will increase if the Kremlin is exempted from being judged by Western standards of conduct. The double standard applied to Russia by many West Europeans has only led to greater insecurity on the part of those member states bordering Russia. The “soft security” expected from EU membership is only now being seriously addressed by the West European members of the European Union. Some of this lack of focus on energy security was due to the concentration on EU expansion and internal governance. Nevertheless, the problem of energy supply politics has been clearly evident to those following Russia’s relations with the countries of East Central Europe, the Caucasus, and Central Asia.

The newer EU members, which are the most economically exposed to Russian energy blackmail, are worried about the West’s failure to hold Russia to its agreements. These countries were seriously concerned when the wealthier members of the European Union acquiesced to Russia’s failure to honor its 2008 commitment to President Nicolas Sarkozy of France to withdraw its forces from Abkhazia and South Ossetia and to allow the Organization for Security and Cooperation in Europe (OSCE) to supervise the peace agreement with Georgia. Many of the older member states also appeared to accept at face value Russia’s official explanation that Georgia was solely responsible for the war.¹⁶ The Baltic States felt particularly exposed after the French and German response to Russia’s illegal incorporation of Abkhazia and South Ossetia into Moscow’s orbit. In addition, France’s agreement to sell its Mistral warships to Russia has added to the

¹⁴ See Keith C. Smith, *Lack of Transparency in Russian Energy Trade: The Risks to Europe* (Washington, D.C.: CSIS, July 2010), http://csis.org/files/publication/100702_Smith_LackOfTransparency_Web.pdf.

¹⁵ Anders Åslund, “Gazprom in crisis: a chance for reform,” *European Energy Review*, April 26, 2010, http://www.europeanenergyreview.eu/index.php?id_mailing=67&toegang=735b90b4568125ed6c3f678819b6e058&id=1898.

¹⁶ Benjamin Bidder, “New Report on Russia-Georgia War: EU Investigators Debunk Saakashvili’s Lies,” *Spiegel Online*, October 1, 2009, <http://www.spiegel.de/international/world/0,1518,652512,00.html>.

concern felt by Russia's EU and non-EU neighbors. These ships are clearly offensive in nature, and one Russian military officer has already pointed out that his country could have subdued Georgia even more quickly had they had the Mistral in 2008.¹⁷

However, more recently private Western energy businesses have become increasingly cautious at accepting Russian claims that foreign investment is welcome in the new Russia. Most foreign firms have seen little reduction in the level of corruption or government interference in the energy sector. Over the past few years, several large foreign firms have reduced or limited their financial exposure in Russia. Nevertheless, Western companies are fearful of being barred by the Kremlin from future business deals and are reluctant to openly criticize Russia's investment policies. They have also noticed that investment from countries deemed "friends of Russia," such as Germany, are generally exempted from arbitrary restrictions or outright seizure. On a more positive note, there are influential voices in Russia's government that recognize that many of the tactics used to reduce Western investment were self-defeating. By pushing out many Western firms from energy projects, Russia lost considerable financial and technological inputs. Many of these officials are now attempting to lure back some of the same firms who were victims of Russian nationalism and short-term greed on the part of the energy elite during the 2002–2008 period.

Pipeline Politics Intensify

To date, the only successful Western project that has reduced Russia's energy export monopoly from the post-Soviet region resulted from the building of the previously mentioned Baku-Tblisi-Ceyhan oil pipeline, a venture initiated by the United States, but one that met with initial resistance from some European governments. In recent years, Europeans have announced support for a series of gas pipeline projects designed to bypass Russia. To date, none of these projects has reached the construction stage. The long-debated Nabucco gas pipeline project was first announced in 2002, but until recently support for Nabucco by the major European states has been lukewarm at best. At a "Nabucco Conference" in Budapest in early 2009, the European Commission and major EU importing countries, such as Germany and Italy, were conspicuous by their refusal to publicly support this effort.¹⁸ Over the past 10 years, it has often appeared as if there is more support from the United States than from the European Union for pipeline construction that avoids Russian control.

Instead, the European Union strongly supported the very expensive Nord Stream gas project, one that may well intensify Europe's reliance on Russian natural gas and will increase the Kremlin's political leverage over Germany, Poland, and the Baltic States. The European Commission and its

¹⁷ David J. Smith, "Mistral: A Cold French Wind Blows East," *Georgian Daily*, November 24, 2009, http://georgiandaily.com/index.php?option=com_content&task=view&id=15768&Itemid=132.

¹⁸ Peter Cassata, "Nabucco Summit Exposes Differences," *New Atlanticist*, January 30, 2009, http://www.acus.org/new_atlanticist/nabucco-summit-exposes-differences.

energy commissioner gave solid support to Nord Stream without first holding comprehensive hearings or carrying out the supporting cost-benefit studies.¹⁹ In early 2009, then-Energy Commissioner Andries Piebalgs provided written backing to Russia's proposed South Stream project, even though the issue had not been debated within the European Council or Commission.

With no identifiable source of gas, the South Stream venture was clearly designed as a Kremlin effort to prevent the construction of Nabucco, and thereby counter any weakening of Moscow's hold over shipments of Central Asian gas to Europe. The project is also being used by Russia in an attempt to pressure Ukraine into turning its gas pipeline system over to Gazprom, or risk losing the Russia-Central Asia-Europe gas transit business. Both of the Russia-promoted gas pipeline projects (Nord Stream and South Stream) received support from the European Commission before the necessary environmental impact studies were completed. Nor were the energy or national security interests of the East Central European states taken into account by the EU leadership.

The lack of a unified EU energy import policy was highlighted in the September 2007 European Parliament report on energy security.²⁰ Unfortunately, even though this declaration was overwhelmingly approved by the Parliament, the recommendations in the declaration were largely ignored by the European Council and Commission. The large states of Western Europe dominate those two bodies, and their construction companies are the prime Western beneficiaries of Russia's pipeline projects. Although there have been periodic EU-Russian, U.S.-Russian and EU-U.S. consultations on energy issues over the past 10 years, none of these meetings has resulted in any concrete action to confront Russia's use of its near-monopoly on energy for political advantage. G-7 and G-8 summit conferences have also failed to tackle the use by Russia of energy as a political weapon against its East European neighbors. National commercial interests and a reluctance to upset Russia's leadership have generally trumped long-term security concerns in the region.

Developments in recent years have not always gone in the direction intended by the Kremlin leadership. Only after the world economic crisis of 2008 and the ensuing drop in oil and gas prices, did Russian leaders begin to court foreign energy investors in a serious way. By then, however, the incentives for international energy firms to invest in Russian oil and gas fields had somewhat diminished as a result of the temporary drop in demand for energy imports and because of previous anti-investor policies pursued during the Putin presidency. In September 2009, in an about-face, Prime Minister Putin publicly encouraged foreign firms to join in

¹⁹ David Crawford and Thomas Catan, "Putin Threatens to Scrap Gas Pipeline as Talks with EU Leaders Approach," *Wall Street Journal*, November 13, 2008, http://online.wsj.com/article/SB122653533902022571.html?mod=googlenews_wsj.

²⁰ European Parliament, "Towards a common European foreign policy on energy," Brussels, September 26, 2007, <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P6-TA-2007-0413&language=EN&ring=A6-2007-0312>.

exploiting the Yamal gas fields, but the response from the West's private sector has up to now been tepid.²¹ Low world gas prices have also forced Gazprom and its partner firms, Total and Statoil, to put on hold development of the expensive Shtokman gas field in the Barents Sea.

It's Still Business as Usual

In spite of the economic crisis and lower natural gas prices, in addition to more cautious interest by foreign investors in the energy sector, the Kremlin continues to use its commercial leverage and other not-so-transparent tools in an attempt to gain access to more downstream activities throughout Europe. However, many of these offers designed to attract Western investors are clumsily made. Putin's offer to share the Yamal project was conditioned on Western companies giving Russian firms control over downstream facilities, hardly an attractive proposition. So far, his "offer" has not been taken up by a major Western firm.

It is also worth keeping in mind that many of the deals announced between Moscow and Western companies are more agreements in principle than solid project contracts. Some announcements are used by the Kremlin as attempts to pressure other companies or countries into climbing on board for one project or another favored by Russia. The South Stream gas pipeline project is a prime example. Gazprom succeeded in enlisting "agreements" from Italy, Hungary, Romania, Bulgaria, Serbia, and Croatia. But with a lack of an identifiable source of Russian or Central Asian gas and a glut of natural gas already on the world market, the project is unlikely to be completed.

If these dubious business practices affected only Russia, it would be of less interest to Europeans and Americans. Unfortunately, the increasing use of nontransparent energy transactions endangers the development of democracy in the new states of East Central and Southeast Europe (ECSE). These also threaten to weaken security ties between EU and NATO members. The financial incentives offered to European companies, political parties, and individuals by Russian energy exporting firms and by the Kremlin are frequently difficult to resist—even if they pose a potential danger to European or transatlantic cohesion.

Russian energy policies may have been instrumental in building opposition within some major West European countries to participation by Ukraine and Georgia in NATO's Membership Action Plan.²² It is disturbing that several key alliance countries, led by Germany, have until recently blocked a full discussion within NATO of the security implications of Russia's energy relationship with Europe. Only among Central European NATO member states is there strong support for the idea of making "energy warfare" an Article V obligation. Not even within the European Commission is there backing for a common response from EU members to politically motivated energy disruptions, particularly among the larger, influential European countries.

²¹ Gleb Bryanski, "Russia seeks partners for Arctic gas fields," Reuters, September 24, 2009, <http://www.reuters.com/article/idUSLO72948120090924>.

²² Steven Erlander, and Steven Lee Myers, "NATO Allies Oppose Bush on Georgia and Ukraine," *New York Times*, April 3, 2008, <http://www.nytimes.com/2008/04/03/world/europe/03nato.html>.

For too long, the Western response to energy coercion on the part of Russia and its supporters has been weak and ineffective. Short-term national interests among importers have outweighed the longer-term need to foster transparent business practices in Russia, Central Asia, and within Europe itself. Even though the European Union has policies that mandate the size of fruit and the labeling of cheese, it has no common energy policy. Its policies do not prevent one member state from being played off against another, or even enable the enforcement of EU competition and antitrust laws in regard to energy imports into the EU area. Member states pay a wide range of prices for Russian energy imports. The bargaining clout of Germany allows it to buy Russian gas for \$220 per TCM, whereas weaker Lithuania is forced to pay Gazprom \$320 per TCM. The European Commission has not nullified clauses in contracts with Russia that restrict any resale of unneeded supplies. This is a violation of the common market concept. The European Union began as a coal and steel community, but now, almost 50 years later, there is still no oil and gas community.

The purpose of this report is to consolidate and amplify recommendations contained in three earlier monographs.²³ It is hoped that these suggestions will in some way promote the implementation of energy policies by European and U.S. policymakers to bring greater coordination and transparency in dealing with Russian and non-Russian oil and gas exporters. The major policy burden is clearly on the European Union and the individual European countries to adopt measures to effectively counter Moscow's energy strategies, which pose a threat to Europe itself. Nevertheless, there are some key areas where the United States can assist in creating a greater degree of energy security in East and South Central Europe. The United States can also play an important supporting role to the European Union in convincing Russia that business as usual, particularly in the energy sector, will no longer be tolerated.

The Kremlin's ability to leverage its energy exports has declined temporarily, and the immediate economic threat to Central Europe may have diminished slightly over the past year. The decrease in world oil and gas prices following the financial breakdown in the developed countries, including Russia, has weakened Moscow's hand. The 2009 gas cutoff woke up many Western leaders to the need for real diversity in the sources of supply—and not simply by alternative pipelines controlled by Russia. Also significant is the substantial development in the past five years of unconventional gas resources in the United States and the prospect of bringing to market recoverable deposits of shale and methane gas in Europe itself. Central Asian producers, particularly in Turkmenistan, have diversified their gas exports, undercutting Russia's monopoly. Also, Russian price leverage has weakened with the large supply of liquefied natural gas (LNG) now entering world markets.

²³ Keith C. Smith, *Russia-Europe Energy Relations: Implications for U.S. Policy* (Washington, D.C.: CSIS, February 2010); Keith C. Smith, *Bringing Energy Security to East Central Europe: Regional Cooperation Is the Key* (Washington, D.C.: CSIS, April 2010); and Keith C. Smith, *Lack of Transparency in Russian Energy Trade: The Risks to Europe* (Washington, D.C.: CSIS, July 2010).

For this reason, Russian energy policy leaders are attempting to tie European access to Russia's mineral resources to an exchange for Russian control of downstream refining and distribution systems throughout Europe. In his September 2009 speech to Western energy companies regarding Yamal investments, Vladimir Putin made clear that participation by Western firms was contingent on simultaneous Russian access to ownership in their downstream industry. Clearly, there is no sign that the Kremlin has decided to stop using energy as a political tool or even as a coercive instrument against a recalcitrant neighbor, nor to open its own markets to greater production and price competition.

The West must more actively pursue the construction of gas pipelines linking Central Asia directly to Europe. These pipelines are not intended to replace lines bringing gas from Russia, but they will provide needed competition to the "southern corridor" energy routes. Greater competition will also have more influence on Russian energy policies than the many declarations by European leaders regarding future intentions of "energy diversification."

EU and U.S. Policies: Seeking Transparency and Good Governance

This report is not intended to depict the Russian government as a political rogue state. Coercive policies have been used in the past by energy companies from Europe and the United States. In the twenty-first century, however, it is in the interest of a Europe "whole and free" that Russia and its companies become "normal" partners within the international business community, with common norms and values in trade relations. Transparency and open competition is also in Russia's own long-term economic interests—perhaps more so—than in the interests of the country's energy trading partners.

The present system in Russia (and in Ukraine and Central Asia) confers the primary financial and political benefits from the country's oil and gas exports on a small group of elite players. By doing so, it has set back Russia's modernization and has played an important role in preventing its integration into the community of democracies. Reluctance on the part of some members of Russia's dominant class to support membership in the World Trade Organization (WTO) or Organization for Economic Co-operation and Development (OECD), or even to adhere to the Energy Charter Treaty, cannot be in the long-term interests of the average Russian citizen. The West is not helping to promote Russia's modernization and democratization by turning a blind eye to many of the Kremlin-approved corrupt or unethical practices that occur in the European energy trade. Russia's economy would expand at a faster pace if it were more attractive to Western and private domestic energy investment, and the country's integration into Europe would likely accelerate if the reforms recommended in this report were put into practice.

Sometimes it is difficult to make a clear distinction between policy actions that should be pursued by the European Union and those by the United States, although the primary responsibility lies with the EU organizations and its member states. However, both the European Union and the United States need to adopt the same or similar policies in order to curb the use of corrupt or

dubious business practices when engaged in energy trading with Russia. Western collaboration would also encourage and promote the interests of those Russians who already understand that East-West cooperation regarding resource exports is not a financial win-lose situation, but rather that both sides of a business transaction come out ahead.

Unfortunately, too many of Russia's current decisionmakers come from the intelligence or military-industrial domains, where a win-lose concept in dealing with Western business is deeply ingrained from their Soviet training. It would be naïve to believe that the recommendations below will by themselves win acceptance on the part of the current Russian leadership. Only strong and coordinated pressure from Russia's Western partners will influence the behavior of the current Kremlin leadership.

Recommendations for action must be enforced in such a way that they compel Russia's present leaders to conclude that adhering to transparent business practices and open accounting systems is the price they must pay for their country's continued access to international markets and that it is in their own personal and their country's financial interests. Over time, this author hopes that enforcement of best business practices, including the acceptance of transparent and ethical commercial standards, will become ingrained in the minds of the new generation of Russia's political and business elite. A new business culture must become standard practice among those governing in Russia. In order to have the desired effect on open markets and democratic governance, these values must also become ingrained in the commercial ethics of the leadership in Russia's major energy trading partners in Central and South Central Europe. Substantial cultural changes have to take place on both sides of Russia's western and southern borders.

Recommendations for Europe

1. The European Commission and European Council should push for full implementation of the European Parliament's September 26, 2007, resolution that called for a "common European policy on energy."²⁴ Carrying out the Parliament's recommendations would help reduce the use of energy as a political weapon by importing states, level the playing field for Western investors in Russia, reduce the existing opportunities to engage in nontransparent or corrupt business practices in East-West energy corridors, and decrease the outsized profits that stem from monopoly control of natural gas exports that flow from Caspian Sea countries through Russia to Europe.
2. The issue of energy security should be put high on the agendas of Hungary and Poland as they take over the rotating EU presidency in 2011. These two countries are both in a strong position to push forward the implementation of a common European energy market and the enforcement of existing antimonopoly rules.

²⁴ European Parliament resolution, "Towards a common European foreign policy on energy," September 26, 2007, <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P6-TA-2007-0413&language=EN&ring=A6-2007-0312>.

3. The European Council and Commission should more actively defend member states against politically motivated disruptions of oil flows from Russia. In recent years, the target countries of these disruptions have included Lithuania, Latvia, and the Czech Republic. There have also been indirect disruptions in supplies of natural gas deliveries to at least a dozen other European countries. The failure of the European Union in 2007 to effectively respond to the “temporary disruption” of oil via the Drusba pipeline to Lithuania only encouraged Russia to then move to completely stop all shipments to the Mazeikiiai refinery. The Transneft cutoff was clearly made in retaliation for the refusal of Lithuania to sell its oil facilities to a Russian firm.
4. The European Parliament and Council should hold public hearings on the question of establishing a “common energy market” in which common supply and price levels would be enforced at the border of the first member state where the energy import occurs. Take-or-pay contracts would be prohibited, as would clauses barring resale within the EU market of Russian-supplied energy. A common import price (including a formula for transmission charges) would be negotiated with importers by an EU technical authority.
5. The European Union should more actively carry through with the unbundling directive of the EU Directorate General for Competition Policy (DG COMP) by enforcing existing rules calling for energy importing firms to auction off their national distribution businesses. Unbundling is particularly important to maintain moderate prices in the smaller EU member states. The more highly developed West European states usually have their own national energy “champions” that have the economic clout to bargain effectively with the importers of energy. Unbundling would also reduce the leverage of Russian energy exporters who attempt to assume control of downstream operations through the use of either off-shore intermediary firms or those set up in the European Union, but that lack transparency regarding real ownership, which was the case with EuralTransGas and RosUkrEnergo.
6. DG COMP should also enforce the European Union’s existing antitrust and competition policies, particularly in regards to Russian state companies. Greater import competition would lower prices for consumers and for European power and refinery operators. Opening existing Russian state export pipelines (Transneft and Gazprom) to private Russian firms and allowing the building of Russian private-sector export pipelines would increase the supply of oil and gas coming from Russia and Central Asia and bring more predictability in supply. This would incentivize greater exploration and development by private energy firms in Russia and bring greater foreign direct investment and modern technology to Russia’s energy sector.
7. The European Council should consider establishing an independent regulatory agency within the European Commission with the power to monitor (but not approve or disapprove of) all major energy agreements between EU and non-EU companies and governments. Such an entity would report to the European Commission regarding the likely effect that any proposed international deal would have on the broader EU energy market. The agency should be able to enforce a minimum level of accounting and revenue transparency in international energy contracts, extending to all companies (domestic or foreign) that do business within EU member states.

8. In order to enforce the above recommendations, all member states should be required to notify the Commission at the start of negotiations with foreign entities regarding: (a) the construction of new energy pipelines; (b) when offering international tenders for energy contracts; and (c) when conducting talks for the sale of existing facilities within their national borders. This would counter the “divide-and-conquer” activities of foreign state-owned or controlled energy firms.
9. All large deals with non-EU energy importers or deals involving the sale of energy infrastructure should have a fixed time set before the contract goes into force. This would allow other member states a chance to comment on the possible economic or political impacts of the agreement on their national economies.
10. European energy companies and all EU member states would benefit if tighter enforcement of uniform reporting requirements were applied to national and foreign firms doing business within EU borders. This would weaken the present advantage held by those energy firms and governments willing to use nontransparent and/or corrupt practices.
11. More stringent reporting to the EU Directorate General for Energy (DG Energy) regarding the results of due diligence would lead to securing more reliable information regarding the actual ownership of companies registered as off-shore entities. Many are established with the intent of sheltering energy firms from tax and other transparency requirements that would otherwise be enforced in OECD member states. EU officials would also be given additional tools to combat financial crimes and tax avoidance.
12. The European Commission should prohibit firms from including confidentiality clauses in contracts with foreign energy firms that are designed to or have the effect of hiding revenue. The European Union and OECD should also encourage member firms to conduct more comprehensive due diligence procedures regarding prospective partners in countries with less rigorous accounting, financial, and ownership requirements.
13. The OECD should draw up due diligence guidelines that would help new or less experienced firms in Central and South Central Europe that are becoming more actively involved in international energy trade and investment. These guidelines could be more sharply drawn up in the *aqui communautaire* and be applied to all new applicant states.
14. All European states that have ratified the OECD’s anticorruption pledge should strengthen their ability to detect illegal payoffs or other corrupt activities on the part of their own national firms or foreign companies operating within their borders. Some of the largest OECD members have a conspicuously poor history of anticorruption enforcement.
15. All EU member states should follow the example of the United States and force their companies to disclose all payments made to foreign oil, gas, and mining sectors. These three industries are the source of most of the illegal and/or unethical payments by Western firms. This could reduce Russian pressure on foreign firms to make under-the-table payments to government officials.
16. The European Commission should provide greater technical assistance and training to the courts of the new member states in order to strengthen their judicial systems, particularly their commercial law courts. EU member states with more established legal systems and

- experience in commercial law could also provide training and advice to the newer members. The United States was very active in this area in the 1990s and should reestablish “rule-of-law” assistance programs in most of the East and South Central European states.
17. The younger democracies of East and Southeast Europe (ESEE) should take the initiative to establish an effective organization that would push for their national energy interests within EU structures. Up to the present, the larger and more powerful members are able to prevent common EU policies that would result in strengthening the energy security interests of newer member states.
 18. Greater cooperation by the ESEE states would also likely result in a more equitable distribution of funding for energy security projects, such as for electricity and gas interconnectors, storage facilities, and energy efficiency activities. The recent distribution of EU funding for energy infrastructure went largely to the more energy secure states of Western Europe, rather than to those countries most exposed to arbitrary supply disruptions.
 19. The 11 states that attended the February 24, 2010, Budapest conference on energy should each appoint a high-level official to represent them on the proposed Intergovernmental Commission.²⁵ These states could also provide a technical panel of energy experts empowered to provide advice on measures that would increase regional energy security.
 20. This same group should establish an independent office in Brussels that would assist the members in pushing through energy security recommendations in the European Parliament and in the European Council and Commission. The combined weight of the 11 countries (even if some are not yet EU members) would increase the likelihood of attention being paid by the European Union to their particular needs in the energy sector, including the goal of achieving real supply diversity.
 21. The European Commission should support an EU requirement for full discussion and disclosure of the European Council and Commission’s stand on pipeline construction proposals such as Nord Stream, South Stream, Yamal II, Amber, White Stream, and ITGI (Italy, Turkey, Greece interconnectors) and on any future plans for energy connectors. Similar requirements should apply to the energy import sector. The Commission should fund an independent calculation of the costs and benefits of each proposal.
 22. The European Union announced late in 2009 its willingness to help Ukraine upgrade its gas pipeline system, which carries almost 80 percent of Europe’s imports.²⁶ Now that the new Yanukovich government is in place, the European Union should press Kyiv to collaborate in carrying out the Commission’s proposal to help modernize the primary pipeline system bringing gas to Europe, as well as the principal branch lines that feed into the major cities of

²⁵ Ministry of Foreign Affairs of the Republic of Hungary, “Declaration of the Budapest V4+ Energy Security Summit,” February 24, 2010, http://www.mfa.gov.hu/kum/en/bal/actualities/spokesman_statements/20100224_Kozos_nyilatkozat_V4_en.htm.

²⁶ European Commission et al., “Joint EU-Ukraine International Investment Conference on the Modernisation of the Ukraine’s Gas Transit System,” March 23, 2009, http://ec.europa.eu/external_relations/energy/events/eu_ukraine_2009/joint_declaration_en.pdf.

Ukraine. Also, any future scheme that sets up multinational ownership of the east-west gas pipeline should ensure that it not result in Gazprom ultimately acquiring a majority of shares, since this would increase the monopoly power of Gazprom over European imports and Russia's economic hold over Ukraine.

Recommendations for the United States

During the past 10 years, the United States has put more effort into bringing energy security to East Central Europe than has the European Union, although this may be changing. Nevertheless, U.S. officials pioneered the effort to bring Caspian oil directly to Europe, even in the face of widespread skepticism in Europe. Until very recently, these same officials also traveled more extensively than their European counterparts to Central European capitals in an effort to secure natural gas supplies for Europe through pipelines not controlled by Russia. Up until mid-2009, the European Union's "priority" Nabucco pipeline project was promoted more vigorously among Caspian countries by U.S. officials than by the EU leadership.

The United States was also more willing to discuss Russia and energy security issues in NATO fora than were the large European member states. There has been a strong feeling among some West Europeans that the countries east of the German-Polish border were too Russophobic and should not be allowed to raise energy issues if doing so would block agreements desired by some West European states.

1. The U.S. Department of Energy should be given congressional funding earmarked for joint energy research programs with the new democracies of Central and Southeastern Europe. Several countries, including Poland and Bulgaria, would like to participate in the department's research efforts for coal gasification and sequestration and for coal and/or gas-to-liquids programs. The goal is to reduce import dependency, while attracting foreign investment, including R&D funding, into new energy technologies.
2. Both the United States and the European Union should help fund a more robust outreach program by the International Energy Agency directed at establishing energy research programs for ESEE states and for those non-EU member countries even farther east, such as Moldova, Georgia, and Ukraine. The United States should also encourage the World Bank to continue long-term funding of recently approved energy efficiency programs in the region.
3. The United States should work closely with OECD staff to assure more comprehensive reporting on suspected member violations of approved OECD guidelines on corrupt practices. The United States and the OECD could also provide increased technical assistance regarding the implementation of laws requiring greater business transparency and the enforcement of antitrust regulations in the nonmember states that aspire to join the OECD and the European Union.
4. The United States should lobby more actively within the NATO Council for the issue of energy security to be made a priority. The case can easily be made that it is crucial to the long-term preservation of democracy and economic growth in the newer member states of East Central Europe.

5. The Lithuanian effort to establish an Energy Security Center in that country should be given some U.S. seed funding.²⁷ The active participation of U.S. officials in the center's activities should be encouraged.
6. The U.S.-Russia Energy Forum should be encouraged to address more vigorously the issues of transparency and corruption in energy trade. The U.S. side should directly confront the Russian government when there are disruptions in oil and gas shipments to Central Europe, such as those that occurred in Russian deliveries to the Baltic States, Ukraine, and the Czech Republic over the past 10 years.
7. Finally, the U.S.-European Energy Forum should be given a mandate by the political leadership on both sides to implement tough and effective measures, including those listed above, in order to bring greater competition and transparency to all energy transactions with Russian, Ukrainian, and Central Asian energy producers. Past policies of the European Union and the United States have not been sufficiently proactive in dealing with energy coercion by Russia and its proxies in East Central Europe.

Conclusions

There has been a clear split both within the NATO alliance and the European Union over how to deal with Russian energy relations with the West. Countries with heavy energy sector investments in Russia have tended to dampen criticism of Moscow's use of its export power to intimidate the weaker member states. The past 10 years have also seen too much wishful thinking regarding prospects for reform in Russia. This has only reinforced the view in the Kremlin that energy coercion is a risk-free policy. Even though Russia was legally obligated to observe the rules of the European Energy Charter simply by signing the treaty, Moscow succeeded for over a decade in convincing the European Union that it was free to go its own way as long as the Duma did not ratify the agreement.²⁸

The former commissioner of the EU Directorate General for Competition was also stymied by most of the larger West European states from implementing the unbundling rules. Enforcing the rules would have countered Moscow's efforts to control both energy supply and distribution in major European markets. The Kremlin's vocal opposition to unbundling is a clear sign that this is seen by Russian policymakers as weakening Russia's economic influence in Europe. The repeated assertion by Russian government and energy industry officials that their country never uses energy exports for political gain generally goes unchallenged by Western leaders. This only adds to the perception in Moscow that the West is too weak and too divided to stop Russia's use of its "energy weapon."

²⁷ Arunas Molis, "NATO takes aim at energy," *Geopolitika*, August 16, 2010, <http://news300.info/2010/08/16/nato-takes-aim-at-energy/>.

²⁸ Energy Charter Secretariat, "The Energy Charter Treaty and Related Documents: A Legal Framework for International Energy Cooperation," September 2004, http://www.encharter.org/fileadmin/user_upload/document/EN.pdf#page=211.

Nevertheless, the European Union and the United States are now in a stronger political and economic position to effectively confront Russia. This confrontation will only come, however, if there is sufficient political will in Brussels and in Washington. The 2008–2009 financial crisis reduced demand for Russian resources. Many of the country’s economic leaders suddenly realized the degree to which they have become dependent on a globalized economy. They also learned the hard way that prices for oil and gas can go down as well as up. Calls by President Medvedev for “modernization” of Russia reflect this recognition. His push for a cleanup of corrupt practices, including in the energy trade, have unfortunately been largely ignored. Russian polling indicates that Russian businessmen and the general public have become deeply pessimistic about the ability of the president to influence positively the governmental structures.

The pricing power of Russian energy companies has weakened significantly in the past two years, as demand for energy imports has slipped in Europe and prospects for natural gas exports to the United States from Russia have almost disappeared. The world-wide glut of liquefied natural gas, coupled with the relatively new direct energy relationship between Central Asia and China has also reduced Moscow’s leverage over international natural gas prices. The robust search by U.S. companies in Poland and other European countries for unconventional gas resources has Moscow clearly worried about its ability to exercise monopoly power over its former client states.

However, as Russia’s energy pricing power has weakened, there has been no let up in Moscow’s use of its “nontransparent” power to influence policymakers in Europe. It appears as if the Kremlin is now engaged in a more sophisticated campaign using public relations firms and direct financial incentives to compensate for weaker pricing power.

The 2010–2011 period is a particularly favorable time for the West to rewrite the rules of the game in the East-West energy trade. It is in the interests of Europe and of the United States to maintain strong economic, commercial, and political ties with Russia, but only if the rules governing these relations are transparent, competitive, and in the economic interests of all members of the European Union.

Appendix

Primary Russian Oil and Gas Pipelines to Europe



Source: U.S. Department of Energy, Energy Information Administration, "Russia," Country Analysis Brief, May 2008, p. 11, at <http://www.eia.doe.gov/emeu/cabs/Russia/pdf.pdf> (March 6, 2009).

PROPOSED AZERBAIJAN-GEORGIA-ROMANIA-INTERCONNECTOR (AGRI)



Interconnection Turkey - Greece - Italy (ITGI)

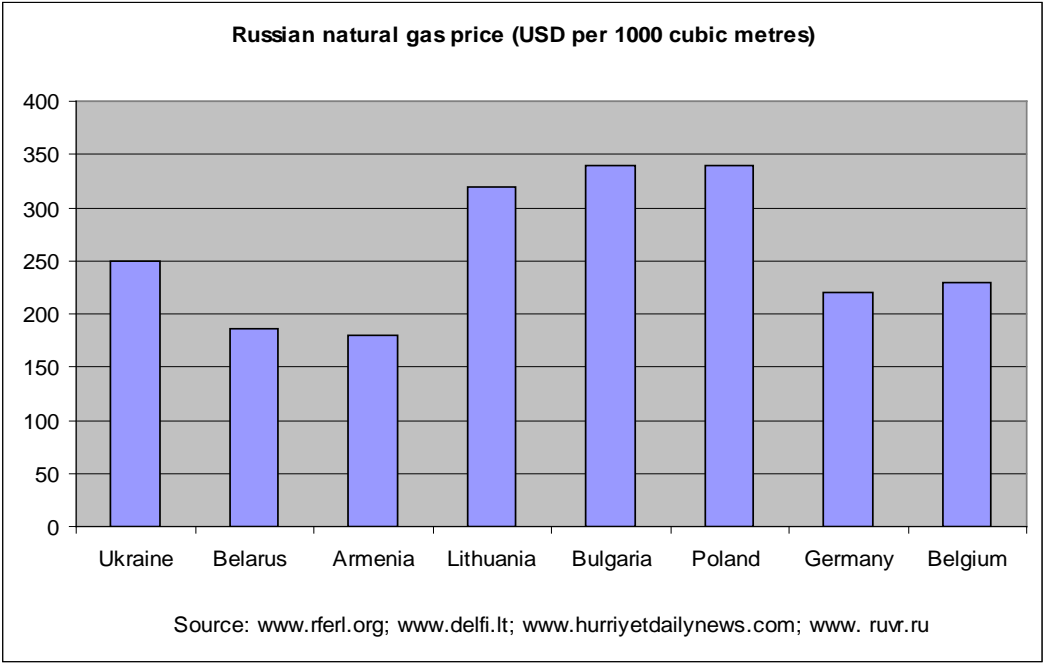


Source: http://pipelinesinternational.com/news/agreement_accelerates_turkey_greece_italy_pipeline/041564/.

**Major Recipients
of Russian Natural Gas Exports, 2006-2007**

| Rank | Country | 2006 Exports (bcf/y) | 2007 Exports (bcf/y) | 2006 % of Domestic NG Consumption |
|-----------------------------------------|---------------------|-----------------------------|-----------------------------|------------------------------------------|
| 1 | Germany | 1,339 | 1,378 | 37% |
| 2 | Turkey | 703 | 828 | 64% |
| 3 | Italy | 756 | 742 | 25% |
| 4 | France | 353 | 346 | 20% |
| 5 | Czech Republic | 261 | 247 | 79% |
| 6 | Poland | 272 | 247 | 47% |
| 7 | Hungary | 272 | 226 | 54% |
| 8 | Slovakia | 240 | 223 | 100% |
| 9 | Austria | 233 | 191 | 74% |
| 10 | Finland | 173 | 166 | 100% |
| 11 | Romania | 180 | 138 | 28% |
| 12 | Bulgaria | 113 | 120 | 96% |
| 13 | Greece | 95 | 111 | 82% |
| 14 | Serbia & Montenegro | 74 | 74 | 87% |
| 15 | Croatia | 35 | 35 | 37% |
| 16 | Slovenia | 25 | 18 | 64% |
| 17 | Switzerland | 14 | 11 | 12% |
| 18 | Macedonia | 4 | 4 | 100% |
| Total | | 5,145 | 5,105 | |
| Sales to Baltic & CIS States | | | | |
| 1 | Ukraine | 2,085 | 2,240 | 66% |
| 2 | Belarus | 724 | 763 | 98% |
| 3 | Lithuania | 99 | 122 | 96% |
| 4 | Latvia | 49 | 72 | 74% |
| 5 | Armenia | 57 | 71 | 99% |
| 6 | Estonia | 25 | 49 | 11% |
| 7 | Georgia | 49 | 36 | 99% |
| 8 | Kazakhstan | 28 | 32 | 3% |
| Total | | 3,117 | 3,385 | |

Source: U.S. Department of Energy, Energy Information Administration, "Russia: Country Analysis Brief," 2008, Table 4, <http://www.eia.doe.gov/cabs/Russia/NaturalGas.html>.



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