

Pumping Up: Russian Energy and National Power

by

Nina J. Fahy

B.A., Political Science; Russian and East European Studies

Tufts University (2006)

Submitted to the Department of Political Science
in Partial Fulfillment for the Requirements for the Degree of
Master of Science in Political Science

at the

Massachusetts Institute of Technology

September 2007

© 2007 Nina J. Fahy All rights reserved

The author hereby grants to MIT permission to reproduce
and distribute publicly paper and electronic copies of this
thesis document in whole or in part in any medium
now known or hereafter created.

Signature of Author: _____

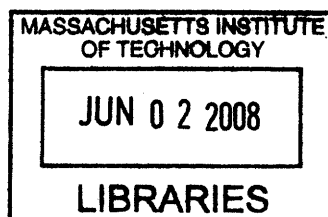
Department of Political Science
July 5th, 2007

Certified by: _____

Kenneth A. Oye
Associate Professor of Political Science
Thesis Advisor

Accepted by: _____

Roger D. Petersen
Associate Professor of Political Science
Chairman, Graduate Program Committee



ARCHIVES

Pumping Up: Russian Energy and National Power

by

NINA J. FAHY

Submitted to the Department of Political Science
on September 4, 2007 in partial fulfillment of the
requirements for the Degree of Master of Science in
Political Science

ABSTRACT

Russia has organized its energy industry similarly to a vertically integrated energy corporation. Not only does Russia possess vast oil and gas reserves, it also has capabilities at every step in the production chain. The execution of Russian energy strategy is incredibly intricate and flows from all points including the state, firms, suppliers, degrees of ownership and transit locales. This work reviews five important aspects of Russia's vertical integration strategy. Firstly, Russia is bringing the domestic industry under state control. Secondly, it has pushed out particular types of foreign investment in order to gain control of domestic reserves, their monetization and the development of important projects. Thirdly, Russia seeks to keep resource rich states in its near abroad in its sphere of influence in order to keep their supply within its grasp. Fourthly, it manages relations with neighboring states in possession of transit infrastructure to keep supply routes open to markets. Lastly, it invests abroad in order to increase market presence, cut out middlemen, and further build production chains. Russia expects to strengthen its international position, both economically and geopolitically by undertaking this strategy of vertical integration.

Thesis Supervisor: Kenneth A. Oye

Title: Associate Professor of Political Science

Table of Contents

Introduction:	page 7
Chapter 1: Russia's Hydrocarbon Wealth: A Means to Power	page 13
Chapter 2: Foreign Direct Investment in Russia: Pushing Investors Out of the Fields	page 35
Chapter 3: Supply States: Managing Relations to Maintain Reserves	page 53
Chapter 4: Transit States: Managing Relations to Maintain Access	page 68
Chapter 5: Foreign Investments: Enabling Addiction	page 79
Chapter 6: Power Potential: The Prospects for Conversion	page 94

Acknowledgements

The author would like to acknowledge the Massachusetts Institute of Technology Visiting Professor and New America Foundation Senior Fellow Flynt Leverett, the second supervisor of this thesis, for his support and role in the realization of this completed work. Participation in his course, “The Geoeconomics and Geopolitics of Global Energy,” proved to be pivotal for the insight and knowledge gained that inspired several of the conclusions presented in the following pages.

The author would also like to acknowledge Kenneth Oye for his encouragement and advice throughout the writing process.

Introduction:

This paper sets forth an argument that Russia has organized its energy industry similarly to a vertically integrated energy corporation. With rising prices of oil and gas, Russia is in a position to utilize its vast energy resources. Russia will use its energy reserves, whether monetized or undeveloped, as an instrument to enhance its international standing both economically and geopolitically. In practice, actions taken to maximize profit through economic cartelization and to secure a potential political weapon are not the same. Consequently, not all Russian actions work to satisfy both economic and geopolitical objectives. Russian steps toward vertical integration include control of the domestic industry, management of relations in its near abroad to get supply and secure transit routes and foreign investment to increase market presence while cutting out middlemen.

Chapter 1 examines the characteristics of the Russian Federation's energy industry and its importance to the state. It outlines the evolution of the Russian domestic energy industry since the dissolution of the Soviet Union. It focuses on Putin's thesis of resource nationalism and how it has been applied since he became president. Resource wealth is controlled from the embryonic stage – prior to monetization. State control of Russia's state-owned energy firms – Gazprom, Rosneft and Transnet – and state involvement with the privately owned Lukoil allows Russia to pursue an energy strategy with aspects similar to vertical integration. State-owned firms are not under total state-ownership. The state is the majority stakeholder in these firms while minority stakes are parcelized and sold in order to raise significant capital. Major private energy firms in

Russia including Mikhail Khodorkovsky's Yukos and Roman Abramovich's Sibneft have recently been absorbed by state-controlled companies and come under the state.

Chapter 2 examines the restrictions on foreign investment in Russian domestic energy projects, particularly those of specific strategic importance. Since major projects on Russian domestic soil and the development of the contents of the attendant subsoil are important for state objectives, there is a trend of contract renegotiations to give Russia full control of all steps in monetization, production and extraction. Nonetheless, certain forms of foreign investment in Russia are still possible. As is the case in initial public offerings of Russian state-owned firms, Russia has been willing to offer non-majority stakes in some projects in exchange for capital while ensuring it maintains control.

Chapter 3 and Chapter 4 examine the role Russia plays in its near-abroad, or the former Soviet republics. Russia has significant leverage over these states, specifically in relation to their oil and gas supply, and transport to market. In pursuing a strategy to keep these states within its sphere of influence, Russia aims to keep their hydrocarbon transport and development within its control. Relying on hydrocarbons from supply states will allow Russia to compensate for future depletion in its domestic in order to continue to supply its domestic market as well as world markets. Control over supply states is just one aspect of a vertically integrated entity. Maintaining relations with states in possession of transit infrastructure is important. Most of the infrastructure in transit states is a relic of the Soviet period. Without the use of infrastructure, Russia could not bring supply into the country for its own use or sell it to lucrative European markets.

Chapter 5 examines Russian investment abroad. Russian investment abroad brings the strategy of vertical infrastructure closer to realization. Significant investment in

transport infrastructure will not only allow Russia to bypass transit states and alleviate concerns of transit politics, but may also build foreign dependencies on Russian supply. These relations and potential dependencies can be further buttressed with Russia taking on a direct retail role in European markets. In essence, Russia cuts out middlemen and takes on new market power. This final retail phase brings Russian strategy from control of oil and gas in embryonic form to the opposite side of the spectrum. Retail operations afford Russia the independence to direct product after a full maturation process.

Chapter 6 concludes with the assessment of the power potential such a strategy confers upon Russia. The recent meeting of the Gas Exporting Countries Forum has raised concern about a possible gas cartel on the idea of the Organization of Petroleum Exporting Countries. However, given the characteristics of the global gas trade versus the global oil trade, it is very unlikely that a gas cartel could function as any ideal type, or similarly to OPEC. The power in a gas cartel would lie in its potential to divide market share. As the largest holder of natural gas reserves, Russia could gain ascendancy in assigning market share to GEFC countries. Russia would then be in a position to be sole supplier to the world's most lucrative markets. This evolution of GEFC seems unlikely.

It appears that Russia prefers to manage the makings of its vertically integrated energy empire on its own. It will pursue coordinating relationships where necessary, and will work to maintain dominance or secure future dominance in upcoming markets. Arguments have been made the Russia focuses too greatly on the foreign segments of vertical integration and neglects investments in its own projects. Perhaps this disregard is purposeful as the rest of the intricate strategy does indeed involve various pieces coming together as if by design. In sum, Russia appears to utilize its vast hydrocarbon resources

in the manner it deems to be most advantageous for its purposes. These purposes, given the statements of various high-ranking public officials include utilizing the state's relatively consolidated economic power to assert its power regionally and increase its military capabilities. Ultimately, the strategy of vertical integration is expected to strengthen Russia economically and geopolitically.

Portions of this paper have suffered to some extent from the non-release and unavailability of information. The non-release and unavailability of information is as intentional a part of the Russian energy strategy as the steps to vertical integration. Energy information strategy involves is more than the non-release of information. The information that is released is done so selectively. Relatedly, the degrees of accuracy and depth of the information released is purposeful.

A recent update to the law "On State Secrets" classifies "the quantity and volume of oil reserves, and the methods, locations, and amounts of extraction, production, and consumption of Russia's strategically valuable fossil fuels."¹ Several of the Russian major energy firms including Gazprom, Lukoil and Transneft previously have been designated as part of the list of "Strategic Enterprises and Strategic Joint Stock Companies," which confers upon them special status – generally one of exception attributable to their centrality to national security and defense. Although as Michael Fredholm points out certain legislative acts listing these companies are no longer intact², it can be safely assumed that even in the absence of the list, the information protected by it still is held guardedly.

¹ Fredholm, Michael. *The Russian Energy Strategy and Energy Policy: Pipeline Diplomacy or Mutual Dependence*. Conflict Studies Research Centre. Sept. 2005. p. 6.

² Fredholm, p. 40.

Additionally, degrees of state control over the Russian mass media and opacity surrounding major firms and state functions render an exhaustive analysis of the Russian energy strategy utterly impossible. For example, according to Standard and Poor's Corporate Governance Services: "Rosneft discloses virtually no information on its basic principles of corporate governance, including its Articles of Association and dividend policy. The company does not file any statutory reports to Russian or foreign regulators that are public."³ It can be assumed that this lack of public corporate disclosure is not only common practice across state firms, but also a state move to mask specific categories of information, especially financial information. For that reason, the state and state-controlled energy majors have not handily released information regarding the terms of investments in the domestic industry. Nor has information regarding the specifics of joint ventures been released. Perhaps this is the case because it allows Russia to maintain an upper hand in negotiations. Potential partners will not feel that they are being shortchanged in comparison to the terms of other deals if the terms are generally not public information.

Complete text of certain legislation on subsoil, strategic deposits and production sharing agreements was not available at the time of writing. The unavailability of exact legislation to the general public allows the state to cherry-pick from a wealth of legislation in order to call into question the legality of some projects. The abstract to Putin's doctoral dissertation, widely thought to inspire Russian energy strategy, has not been available since he became prime minister. Again, this may be the case so as to avoid specific

³ Kochetygova, Julia, Nick Popivshchy, Oleg Shvyrkov, Vladimir Todres, Christine Liadskaya. "Transparency and Disclosure by Russian State-Owned Enterprises." Standard and Poor's Governance Services. p. 4-5. June 2005. Prepared for the Roundtable on Corporate Governance organized by the OECD in Moscow on June 3, 2005 <<http://www.oecd.org/dataoecd/9/59/35175841.pdf>> Accessed May 6, 2007.

accusations with textual evidence of a state strategy to control hydrocarbon resources as a path to national power. Connections and personal relationships between the corporate energy and political worlds are only known by information released and made public. Consequently, connections between the corporate and political spheres may be much tighter than acknowledged.

Yet, not all information is classified. If there is state control over the media, as many argue, then the media can be convinced to release inaccurate information, or fed information selectively. Available information has likely been purposefully released especially considering the deliberate non-release of other forms of information. It appears that sources available to the public are those that identify information portraying the state-owned majors in favorable light in terms of production, reserves and centrality to the state. In short, information strategy, as an aspect of energy strategy, is meant to give the state a means to control the public image of the Russian energy industry, to both domestic and international observers.

Chapter 1:
Russia's Hydrocarbon Wealth:
A Means to Power

The Russian Federation holds a place of increasing importance in the world energy market. As the world's largest exporter of gas, its natural gas reserves are unrivaled. It is not only rich in natural gas. It is the world's second largest exporter of oil.

**Table 8. World Natural Gas Reserves by Country
as of January 1, 2006**

Country	Reserves (Trillion Cubic Feet)	Percent of World Total
World	6,112	100.0
Top 20 Countries	5,510	90.2
Russia	1,680	27.5
Iran	971	15.9
Qatar	911	14.9
Saudi Arabia	241	3.9
United Arab Emirates	214	3.5
United States	193	3.1
Nigeria	185	3.0
Algeria	161	2.6
Venezuela	151	2.5
Iraq	112	1.8
Indonesia	98	1.6
Norway	84	1.4
Malaysia	75	1.2
Turkmenistan	71	1.2
Uzbekistan	66	1.1
Kazakhstan	65	1.1
Netherlands	62	1.0
Egypt	59	1.0
Canada	57	0.9
Kuwait	56	0.9
Rest of World	602	9.8

Source: "Worldwide Look at Reserves and Production," *Oil & Gas Journal*, Vol. 103, No. 47 (December 19, 2005), pp. 24-25.

**Table 3. World Oil Reserves by Country as of
January 1, 2006
(Billion Barrels)**

Country	Oil Reserves
Saudi Arabia	264.3
Canada	178.8
Iran	132.5
Iraq	115.0
Kuwait	101.5
UAE	97.8
Venezuela	79.7
Russia	60.0
Libya	39.1
Nigeria	35.9
United States	21.4
China	18.3
Qatar	15.2
Mexico	12.9
Algeria	11.4
Brazil	11.2
Kazakhstan	9.0
Norway	7.7
Azerbaijan	7.0
India	5.8
Rest of World	68.1
World Total	1,292.5

Source: "Worldwide Look at Reserves and Production," *Oil & Gas Journal*, Vol. 103, No. 47 (December 19, 2005), pp. 24-25.

According to the *Russian Energy Strategy to 2020*, the expected results of Russia's energy strategy include "strengthening of its economic position and geopolitical influence."⁴ In an effort to maximize the utility of its energy resource base, Russia seeks to have command over oil and gas at all points, from the time before their monetization to their sale directly to retail customers. The Russian strategy is analogous to one of vertical integration. The state aims to reassert control of the energy industry through control of Russian firms, transport infrastructure and systems. It has squeezed out the role of Russian private enterprise in order to regain command of hydrocarbons from any third actor that could stand to profit from them. Additionally, it has limited foreign investment and participation inside its borders to non-majority stakes. To gain retail access, Russian firms have purchased strategically important downstream resources in both major and developing markets to either maintain market dominance or assert their hegemony before any other market player can do so.

State and Corporate Action: A Framework for Behavior

Vertical integration as a path to national power is a bold assertion without a framework to analyze state and corporate action. The state and energy companies can be viewed as exhibiting three distinct types of behavior. In the first type, companies are independent profit-maximizing entities. The second type of behavior is characterized by the state assuming a management and consulting role of a vertically integrated entity consisting of separate actors. The state works to maximize the profit and secure the

⁴ "The Summary of the Energy Strategy for Russia for the Period up to 2020." Aug. 28, 2003. <http://ec.europa.eu/energy/russia/events/doc/2003_strategy_2020_en.pdf>

objectives of the entire entity as it sees fit. The third type of behavior centers on the state. The state moves beyond the management and consulting role of type two and engages in realpolitik.

By the beginning of the current decade private companies such as Yukos had already taken on the first type of behavior, acting independently as a profit maximizer in its business dealings. If transition is seen as the root cause of behavior of this type, then the second type of behavior can be seen as transitional on the part of the state with the real politik state in the third as the post-transition type. The second type, or transition type, involves the state maximizing its national economic interest and its share of rents. The tension between the first type of behavior with independent actors and the second with the state as manager and consultant has essentially passed. Now, the tension is between the second type of state management and consultancy and the third type of realpolitik. The goal of Russian energy strategy of vertical integration is realpolitik.

Theories of realism and industrial organization poke through the analysis of Russia energy and national power. Given that Russia is still in the pursuit of power with a strategy of vertical integration, it is difficult to see which theory best fits the pattern of behavior. Realism predicts that actions taken in the Russian energy industry, both domestically and internationally, will be done in such a way as to pursue power. Once attained, however, power does not need to be applied. Its possession is enough to cause some alteration in the balance of power. However, realism does relate to aspects of Russia acting as a corporation as industrial organization theory does.

Although the three types of behavior provide a framework to examine action in the energy industry, they also leave room for a number of questions in analysis. The sets

of questions that arise refer to the distinction between the state and corporations, and the state's economic and military spheres. What is the maximization of power, profit, reserves or rents in a scenario where the actors are the state and corporations, who must act internationally and with various stakeholders? The next question that makes it difficult to ascertain the motivation of state and corporate action is the distinction between corporations and the state. If corporations such as Gazprom and Rosneft are state-controlled, differentiating between what role the state versus the corporation plays is difficult. Is the state different than a corporation? When are state and corporate objectives the same? When are they different? Why is the difference important?

These questions render an application of theory somewhat impractical. In its absence, the following pages contain an analysis of Russian action on the path to power.

The Rise of Putin and World Energy Prices

In comparison to its other measures of wealth and prestige, oil and gas are imminently important. Russia does not simply want to build renown as a global energy industry powerhouse. Although Russia sometimes downplays its ambitions saying it wants to be nothing more than a "reliable provider," President Vladimir Putin and the state-owned energy majors do not refrain from building their ambitions higher. In a December 2005 speech before the Russian Federation Security Council Putin publicly gave voice to these ambitions.

Energy is, at least today, the most important motive force of world economic progress. The present and future prosperity of Russia depends directly on the place we occupy in the global energy context. Claiming leadership in world energy is an ambitious task... Such a large -scale task will become a serious

catalyst for the modernization and qualitative development of the entire economy of the Russian Federation.⁵

Putin frames energy as the linchpin of Russia's future success. Vast oil and gas resources will not only endow the country with economic benefits, but will lead to a Russian transformation on the back of its leadership role in the world-wide energy trade.

Putin's view of the inherent power of hydrocarbons is obviously dependent on world energy prices. The 1990s did not offer Russia the opportunity to capitalize from its mineral wealth as the current decade has. During the 1990s as Russia was in the midst of a double transition to democracy and a market-based economy, world oil prices were on average \$17.59 in current dollars per barrel.⁶ Russia was not earning enough income from oil and gas revenues, and its level of debt was increasing. The fall of the Soviet Union coupled with the political and economic difficulties of transition resulted in a diminution of international standing and prestige. These difficulties projected a different image of Russia on the world stage. Russia no longer appeared as threatening and powerful as it had during the height of the Cold War. If anything, it seemed to be a state in decline. Russia stood in at meetings of the G-7 but was not in the same proverbial club as the seven wealthy world movers. Help from the west in the forms of International Monetary Fund loans were necessary to defend the ruble – symbolic of the west bailing out a former rather than current world power. In August 1998, as the affects of the Asian financial crisis reverberated worldwide, Russia defaulted on its domestic debt and the ruble was devalued.

⁵ Putin, Vladimir. Security Council of the Russian Federation session. Dec 27, 2005.

⁶ Price calculated from: Energy Information Administration. "Table 12. World Oil Prices, Actual vs. Forecasts." <<http://www.eia.doe.gov/oiaf/analysispaper/pdf/table12.pdf>> Accessed Apr 11, 2007.

High world oil prices have helped the economy recover. The federal budget has bounced back from a situation of debt to regular federal budget surpluses since 2001. The 2006 federal budget surplus was 9% of GDP. Since 1998 average annual growth has been 6.7%. Russian foreign reserve growth, on the back of oil exports, grew from \$12 billion in 1999 to \$315 billion in 2006.⁷ This phenomenal growth began at the end of the last decade. World oil prices tripled between September 1999 and January 2000 according to the United States Energy Information Administration.⁸

The timing of the increase in world energy prices providentially coincided with Putin assuming the office of president – December 31, 1999. His administration could reap the benefits of market conditions that fueled changes in the Russian domestic climate following the hardships of transition. By 2002 the *Financial Time's* annual FT 500 recognized not only Russia's turnaround, but its amazing growth. After a three year absence from the survey, four firms represented Russia. Not unsurprisingly, all were oil and gas companies. The *Financial Times* attributed the positive change to Russia's resource wealth. "Russia has benefited on two counts: First, its general rehabilitation after the domestic debt default crisis of 1998; and second, its preponderance of natural resources groups."⁹ Oil and gas wealth surely have factored considerably in the new rise of Russia. Russia no longer attends meetings of the G-7. It hosts meetings of the G-8. Without a doubt, this change in fortune has come largely at the helm of a global upturn in

⁷ adapted from *The World Fact Book: Russia*. CIA.

<<https://www.cia.gov/cia/publications/factbook/geos/rs.html#Econ>>

⁸ Energy Information Administration. "Country Analysis Brief: Russia."

<<http://www.eia.doe.gov/emeu/cabs/Russia/Oil.html>> Accessed Apr 11, 2007.

⁹ Fuller, Jane. "Survey – The World's Largest Companies – Russia joins the party South Africa slips out of the rankings." *Financial Times*. May 14, 2002. p. 3.

energy prices. More importantly, it has come about with the energy strategy under the Putin regime to maximize returns at a time of high world energy prices.

Putin's Energy Thesis: Mineral Raw Materials and Russia Development Strategy

The basis of a vertically integrated national energy industry in Russia is not new. The steps involved – creating energy companies under state control, vesting them with powers unavailable to private enterprise – are a means to control the development of the oil and gas sectors. Reigning in control of natural resources and putting their power potential to use has been a crucial part of Putin's thinking for sometime. Putin's doctoral dissertation at the St. Petersburg Mining Institute supposedly focused on leveraging Russia's vast raw materials reserves in order to develop its economy and position of international standing. Although it is likely that he did not write the thesis himself – in Soviet times it was common to have a dissertation written on behalf of an official of public standing – it still would have been subject to Putin's approval. The thesis provides for a course of action of state management of strategic resources and their related industries.

Although the dissertation is classified for unknown reasons, the abstract was available before Putin became prime minister. The following is an excerpt:

At the beginning of market reforms in Russia, the state let go of the nation's natural resources, to a breakdown in the geological sector that had been formed over the course of many decades, as well as a number of other negative consequences. The pro-market euphoria of the first years of economic reform has gradually given way to a more considered approach, an approach which assumes the possibility of and recognizes the need for the regulating influence of the state

on the economy as a whole and on those developing natural resources in particular.¹⁰

Even though Putin does not advocate traditional renationalization of the energy industry, he does advocate protecting Russian national interest. He supports some instances of Russian monopoly where he believes state interest and security to be involved. But, he still welcomes private investment where he believes it to be appropriate. He argues: "At the moment I consider that there are no grounds for the state to give up its control over pipeline transportation. But this does not hinder private investment, which shall be welcomed."¹¹ Nevertheless, Putin pulls a harder line for Russian dominance in the hydrocarbon sector in other interviews. In a February 2006 press conference he compared state-control of Gazprom to state control in the Norwegian energy sector. He commented that: "The oil-and-gas sector is completely monopolized by the state."¹² Albeit this is not a fair comparison on his part, it does underscore the relationship he champions between the state and the Russian energy industry.

This relationship is predicated on Russian control over resources in the ground, their extraction and production. Perhaps Flynt Leverett best sums up the consolidation of the Russian energy sector within the bounds of the state.

After several years of uncertainty and contestation, President Vladimir Putin has successfully reasserted a definitive measure of state control over Russia's upstream oil and gas sectors, with NOCs like Gazprom and Rosneft playing increasingly important roles, the country's pipeline network firmly in government hands, Russian private-sector companies operating within parameters established by Moscow, and formidable barriers in place to large-scale foreign investment.¹³

¹⁰ Putin, Vladimir. *Mineralno-syrevye resursi v strategii razvitiya Rossisskoi ekonomiki* [Mineral Raw Materials in the Strategy for Development of the Russian Economy]

¹¹ Fredholm, p. 9.

¹² Baev, Pavel K. "Putin, Gazprom and "The Other Norwegian Company." Feb. 6, 2006. *Eurasia Daily Monitor*, published by The Jamestown Foundation.

¹³ "The New Axis of Oil," Leverett, Flynt. *The National Interest*, July 2006

It is therefore, not unsurprising to have the Russian oil and gas industry dominated by state-owned firms Gazprom, Rosneft and Transneft.

Major Hydrocarbon Players

Gazprom, Rosneft, Transneft and to a certain extent Lukoil are seen as accumulating formal and informal powers at the expense of other firms. These firms' boards of directors include a significant amount of both former and current high-ranking politicians and several members with ties to the KGB and FSB. Although the significance of this political-business crosscut is not entirely apparent, it should be noted. There is a level of political-business crosscut in other major energy companies, for instance, in Norway's state-owned Statoil. However, these directors generally are former office holders, not current office holders as is the case in Russia. This could perhaps be interpreted as making the firms effective tools of policy since many of the board directors are current officeholders and can influence both political and corporate decisions. At the very least, the level of crosscut underscores the importance of these firms to the state. Transneft, Gazprom and Lukoil were all at one point in the group of "Strategic Enterprises and Strategic Joint Stock Companies" – firms that had been classified and categorized as of "strategic significance for ensuring the defence capability and security of the state and the protection of morality, health, and the rights and legitimate interests of citizens."¹⁴

¹⁴ Fredholm, p. 6.

Gazprom

In terms relative to world-wide production and reserves, Gazprom produces about 20% of gas output and holds about one-third of reserves.

Natural gas production in major world regions, 2004

Region name	Natural gas production volumes, bcm
Russia	632.7
Including Gazprom	545.1
North America	756.0
South America	131.0
Europe	362.8
Africa	155.0
Middle East	278.6
Asia – Oceania	491.0
TOTAL:	2,807.1

15

Gazprom is currently the third largest corporation in the world by capitalization and is Russia's largest earner of hard currency. According to the Russian Classification of Mineral Resources Gazprom's natural gas reserves stand at 29.1 trillion cubic meters, gas condensate reserves at 1.22 billion tons and oil reserves at 1.36 billion tons for a total valuation of \$138.6 billion. The company's 2005 operating profit was R1231.26 billion rubles. The company aims to have a \$1 trillion capitalization. "We will reach a \$1 trillion market capitalization in a period of seven to 10 years...We'd like to be the most valued

¹⁵ Gazprom. "Gazprom in Questions and Answers: Production."
<<http://eng.gazpromquestions.ru/page7.shtml>> Accessed May 10, 2007.

and most capitalized company in the world,” said Alexander Medvedev, Chairman of the Gazprom Board of Directors.¹⁶

The requisite steps in its strategy to become a global contender of such enormous magnitude are often taken in a manner generally seen as monopolistic and injurious to other players in Russia’s energy sector.

Ever since it was established in 1992, the company has been viewed as a proxy for the Russian state. Created from the Soviet ministry of gas, it has retained many features of a centrally planned economy. As the Organisation for Economic Co-operation and Development has noted, “it can at times be difficult even to identify where the state budget ends and Gazprom’s begins”.¹⁷

Gazprom is the only company in Russia allowed to export natural gas. Proponents of the July 2006 parliamentary bill, which formalized this right, said it was needed in an environment of increasing foreign presence in the Russian energy industry. This restriction severely limits the operations of foreign players in the Russian natural gas industry.

Although Gazprom is without argument a massive and powerful firm, it has two major points of weakness. Firstly, according to federal law Gazprom must provide the domestic market with highly subsidized gas supplies. The domestic market consumes over half of Gazprom’s annual production. (See Table 1.)

¹⁶ Kim, Lucian and Nina de Roy. “Gazprom Seeks \$1 Trillion Value, Twice Exxon’s, as Soon as 2014.” *Bloomberg*. Apr 9, 2006.
<<http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a4RhDV8z5Drg>> Accessed Apr 9, 2007.

¹⁷ Ostrovsky, Arkady. “Energy of the State.” *Financial Times*. Mar 14, 2006.

Table 1: Gazprom Production Volumes vs Domestic Sales Volumes¹⁸

YEAR	PRODUCTION OF GAS (BCM)	DOMESTIC GAS SALES (BCM)
2001	512.0	300.8
2002	521.9	298.0
2003	540.2	309.1
2004	545.1	305.7
2005	547.9	307.0

Gazprom export sales finance this subsidization, which depending on world prices can substantially cannibalize revenue. The situation of multi-tiered pricing to domestic industrial and residential consumers, transit state markets, and world markets allows for the potential use of pricing as a instrument to reward or punish certain behaviors.

Secondly, Gazprom will face a supply crunch in the future under a business-as-usual model for rates of growth of production and demand. In a supply crunch scenario, the situation in which Gazprom supplies the domestic market while securing profitability through export will become untenable. Consequently, Gazprom will further embark on the path of asset grabbing to fend off supply shortages. The government, for its part in helping Gazprom, will aim to reassert control in strategic projects as well as engaging in the near abroad and international markets in order to recapitalize reserves.

Rosneft

¹⁸ Adapted from Gazprom. "Gazprom in Questions and Answers." < <http://eng.gazpromquestions.ru/>> Accessed May 10, 2007.

Rosneft is the Russian state oil company. It is a vertically integrated oil firm with downstream and upstream capabilities. Its proven oil reserves stand at 14.88 billion barrels with revenues of \$23.95 billion in 2005. Originally established in 1993 as a state-owned firm, it became an open joint stock company in 1995 still wholly state-owned and controlled. The 2005 version of the company's official website provides a self-description of the firm:

It is an efficient market instrument for adjustment of Russia's fuel and energy complex. One of Rosneft's basic functions is execution of state commissions in most various areas, beginning with creation of a favorable investment climate in the country and ending with specific social tasks related to leveling out of the regional and branch disproportions.¹⁹

Up until its IPO, the firm was 100% state-owned. In July 2006 the firm had the world's fifth-largest IPO garnering \$10.6 billion. The firm is the official state representative for production sharing agreements (PSAs). It thus has significant power in controlling the development of domestic projects. It has publicly announced that it aims to be the world's largest oil producer by 2015. It, like Gazprom, makes no point to hide its ambitions.

Gazprom and Rosneft

Oftentimes the Russian state acts according to the second type of behavior as manager of and consultant to the separate parts within the vertically integrated entity. The state has acted to contain the growth of Gazprom in order to strike a balance between the firm and Rosneft. In the spring and summer of 2007, Rosneft bought most of the former Yukos assets at auction. Previously, Gazprom had gained assets through the Sibneft roll-

¹⁹ Rosneft. "State Policy." 2005 <www.rosneft.ru/english/company/state_policy/index.html>

in making it not only a major presence in the gas sector, but oil sector as well. Now the two rivals, Gazprom and Rosneft, are Russia's largest natural gas company and oil company respectively. There has been speculation that Transneft will come under Rosneft's wing. Teaming oil transport infrastructure with its current oil-producing capabilities would create a balance between Rosneft and Gazprom. If this were to happen, both companies would have their own transportation networks. Transportation infrastructure would give both companies the power to turn on and off supply. Currently, the power to block access to other companies and control supply is Gazprom's. Arguably, this current imbalance in regards to infrastructure and supply control may make Gazprom more powerful than Rosneft.

As the 2008 presidential election approaches, any competition between the firms has evolved into competition between their backers. This situation endows the state-corporate political crosscut with importance. First Deputy Prime Minister Medvedev and Deputy Chief of Staff Vladislav Surkov not only represent Gazprom, but also a Moscow power circle and presidential contender. Deputy Prime Minister Sergei Ivanov and Deputy Chief of Staff Igor Sechin not only control Rosneft, but represent a contending power circle and presidential contender -- like their title-sharing counterparts.

Transneft

Transneft is the Russian state-controlled oil pipeline monopoly. Its power, unlike the other firms examined in this chapter, is not a result of controlling oil and gas resources. Rather, its power is a result of its monopoly control of their transportation.

According to the company's website it is responsible for the transportation of 93% of Russian oil. "If Russia wishes to use any firm as a foreign policy lever, the pre-eminent mode is to turn to Transneft. The state-run Transneft is the company that takes care of crude oil transport by pipeline...In short, the Kremlin controls the oil tap."²⁰

Lukoil

Lukoil, a private firm, has not taken on the role of arm of the state in such an outright manner. At one point Lukoil, like the preceding firms, was also a state-owned energy firm. It was formed in 1991 by a resolution of the USSR Council of Ministers. It was one of ten vertically integrated companies created in the oil industry restructuring of 1991. Under a 1992 presidential edict designed to privatize and reorganize state-owned firms, it became an open stock company. In 1993 it became an open joint stock company and shares were issued. ConocoPhillips bought the last of the government's share in 2004. Since then it has amassed a 20% share – the limit set by its shareholder agreement. The strategic partnership with ConocoPhillips has helped to improve Lukoil's corporate practices and governance – characteristics that will only serve to help it in foreign markets.

Lukoil does not have the same immunity to act as the three other state-controlled firms do. Nor does it have immunity from threats that have faced other private enterprises. It has learned what it can and cannot do. It does not overstep boundaries. In effect, Lukoil maintains its position among the state monopolies. Indeed, as Paulius

²⁰ Larsson, Robert. *Russia's Energy Policy: Security Dimensions and Russia's Reliability as an Energy Supplier*. Swedish Defense Research Institute, March 2006. p. 30. <<http://www2.foi.se/rapp/foir1934.pdf>>

Kuncinas calls attention to in a report for the Economist Intelligence Unit, "...its main owner, Vagit Alekperov, is former Soviet fuel and energy minister and the company operates in a strategic sector, which keeps it on the political radar screen at home and abroad."²¹

Vagit Alekperov is an important Lukoil connection to the state. He held the position of Deputy Minister of Fuel and Energy and became acting minister during the period of privatization. While acting as minister, Alekperov oversaw the consolidation of Russia's three major oil companies into one – now Lukoil – and became its president.²² Although no longer in a political position, Alekperov likely has not lost a sense of political astuteness. As one of *Forbes'* richest people in the world, the annual listing underscores not only his business acumen, but foremost his political savvy. "... Alekperov is basically a politician, showing loyalty to Vladimir Putin on most anything, whether it be to pay more taxes or to reduce gasoline prices."²³

Robert Larsson of the Ministry of Defence of Sweden posits that firms like Lukoil can survive along side state-controlled firms by monitoring their own behavior. "Self-censorship has emerged and firms are reluctant to conduct politically incorrect activities, even if market-based actions are the norm. Rogue behavior exists, but in strategic matters, the Kremlin's wish is frequently obeyed. Marketisation and authoritarianism coexist."²⁴

²¹ Kuncinas, Paulius. "The Russians Are Coming: Understanding Emerging Multinationals." *The Economist Intelligence Unit*. p. 13.
<http://www.rusal.ru/off-line/press/white_paper_eiu/Russians%20are%20coming_eng.pdf> accessed Apr 2, 2007.

²² Frontline World. "How To Make a Billion Dollars" in "Moscow – Rich in Russia." Oct 2003.
<<http://www.pbs.org/frontlineworld/stories/moscow/alekperov.html>> Accessed Apr 20, 2007.

²³ Forbes. "Vagit Alekperov: The World's Richest People." *Forbes*. Oct 2006.
<<http://www.forbes.com/lists/2006/10/QXTX.html>> Accessed Apr 20, 2007.

²⁴ Larsson, Robert. p. 115

As a privately owned company, the state cannot control the actions of Lukoil as easily as it might with a state-controlled company. The Russian state has worked to balance the independence of Lukoil with the objectives of the state. Lukoil's loyalty has not gone unnoticed. Lukoil is exempt from a number of state-mandated actions other privately owned companies are subject to including domestic market obligations such as providing subsidized supply.

On April 2, 2007 Lukoil made an official connection with the Kremlin by signing a cooperation agreement with the Russian Foreign Ministry. Lukoil's press release for the event announced that "the parties agreed on cooperation in protecting foreign economic and geopolitical interests of the Russian Federation."²⁵ The agreement is seen as providing diplomatic support to Lukoil's foreign projects. A government connection with Lukoil in foreign projects is meaningful as the company has assets in over thirty countries. The governmental support will likely not only be predicated on the Russian economic agenda, but political agenda as well. Governmental support will be of increasing importance since Lukoil announced in 2006 that it plans to double its production by 2016.

Resource Nationalism: Russian-style

The state is dominant in the energy industry within its own borders and appears to be making an attempt to acquire whatever shares possible in energy companies operating on its soil. Foreign-owned corporations are not the only entities vulnerable to this

²⁵ Lukoil. "Lukoil and Russia Foreign Ministry Sign Cooperation Agreement." Apr 2, 2007. <http://www.lukoil.com/press.asp?div_id=1&id=2692&year=2007> accessed Apr 2, 2007

strategy; privately-owned domestic firms are just as vulnerable. The possible objectives behind such an approach are manifold, the most important being the creation of conglomerate firms able to compete with major international energy firms worldwide and the reassertion of control over strategic resources.

Yet, this reassertion of control reminiscent of resource nationalism does not entail a doctrine of 100 percent control. Gazprom and Rosneft have both conducted initial public offerings in London. They have taken a minority portion of their equity and put it on the market. They are able to raise tremendous amounts of capital while still retaining control. Indeed, the Russian government has maintained its position as the largest, and majority, stakeholder in both firms. Perhaps this can be seen as a new and more sophisticated version of resource nationalism.

New and sophisticated are not to be confused with uncontroversial. The asset grabbing undertaken by Gazprom and Rosneft has been met with accusations of opacity and destruction of private enterprise by those affected and their allies. The two most high profile takeovers have been of oligarchs Mikhail Khodorkovsky's Yukos and Roman Abramovich's Sibneft .

The 2003 Yukos affair sent signals to investors of renewed state pursuance of objectives and insertion of influence in private enterprise. Khodorkovsky, head of Russia's largest oil firm - Yukos, was arrested for \$1 billion in tax evasion and fraud. Yukos received a \$27.5 billion back tax bill. It is largely believed that Khodorkovsky's arrest was meant to be a model arrest to other oligarchs engaging in business practices that were not in favor with the Kremlin. In September 2003 during a U.S. trip, Putin learned of Exxon Mobil's intention of acquiring 51% of Yukos from its CEO Lee

Raymond. Putin was supposedly infuriated.²⁶ Khorkovsky was soon arrested. The news of Khodorkovsky's arrest caused investor confidence to fall immediately. In just one day the Russia's Central Bank paid \$500 million to support the ruble after it dived. Russia's stock exchange, the Moscow Interbank Currency Exchange Index fell 14%.²⁷ Standard and Poor's downgraded Yukos five notches anticipating a bankruptcy. Rosneft later bought Yukos's biggest production unit, Yuganskneftegaz, in an extremely controversial sale. Yuganskneftegaz was put on a forced auction for the back taxes owed to the Russian government.

In September of 2005 Gazprom bought a controlling stake in Sibneft for \$13.1 billion in Russia's largest corporate sale. The deal brought its total share in Sibneft to 75.7%. The purchase fulfilled Gazprom's ambition of securing status as a major energy company, not just a gas company. This ambition proved elusive when Gazprom had failed to acquire Rosneft earlier.

There has been speculation as to the Kremlin's role in the purchase. Abramovich, under the tutelage of Millhouse Capital, likely could have sold Sibneft for a much larger price. He had bought Sibneft with Boris Berezovsky from the state for \$100 million. The Kremlin obviously wanted no foreign player to gain control of this pivotal asset. Abramovich himself likely did not want to make himself vulnerable to a situation similar to the back tax claims and ensuing debacle at Yukos. At the time of the purchase, Chris Weafer, chief strategist at Alfa Bank, analyzed its significance. "This deal just increases the government's direct ownership in the oil sector, so that now government-controlled

²⁶ adapted from, "What does the Yukos Affair Mean for Russia?" Carnegie Endowment for International Peace. July 12, 2005.

<<http://www.carnegieendowment.org/events/index.cfm?fa=eventDetail&id=796&&prog=zru>>

²⁷ CNN. "Russia market rocked by arrest" Oct. 27, 2003.

<<http://www.cnn.com/2003/WORLD/europe/10/27/russia.magnate/index.html>>

and owned companies are responsible for pumping about one-third of Russia's daily oil output."²⁸

Weafer believes that the Russian government's control of existing energy companies and its rolling in of formerly private companies such as Sibneft is a deliberate move. "The government basically sees the fact that it is already a big energy partner with Western countries and has the potential to become much bigger as replacing nuclear weapons as the reason why it can keep a seat at the top table of global politics and why it can have an important place in organizations such as the G-8."²⁹ The government's assertion of the energy industry then, is an outgrowth of its need to prop up its international standing

²⁸ Bigg, Claire. "State Monopoly Gazprom Takes Over Sibneft" *RadioFreeEurope RadioLiberty*. Sept 29, 2005. <<http://www.rferl.org/featuresarticle/2005/09/eeb62324-d370-41ee-b403-0cdb42775a92.html>> Accessed Apr 11, 2007.

²⁹ *ibid.*

Chapter 2: Foreign Direct Investment in Russia: Pushing Investors Out of the Fields³⁰

One of the accepted meanings of resource nationalism focuses on the assertion of ownership rights over oil and gas reserves by national governments. Russia has not directly nationalized its hydrocarbon industry, but it has made unabashed moves toward strategic control of its resources. The second definition of resource nationalism focuses on the control over the pace and scope over which these reserves will be developed and the way they will be marked for political purposes.³¹ Russia has proved to be a friendly environment for both of these species of resource nationalism especially in the context of wresting control from foreign investors in projects of strategic importance and significant value.

After the collapse of the Soviet Union many firms were eager to enter the Russian hydrocarbon market. Production was declining as was domestic consumption. Russia itself was in dire need of investment. Massive capital flight followed the 1998 debt default. Russian state-controlled and state-owned firms were lacking in many of the competencies of western majors including technological expertise, experience in international markets, marketing skills and extensive capital. Furthermore, the 1990s saw a period of relatively low oil prices. Russia had not been earning significant revenues from oil and gas exports. Western firms saw in Russia an opportunity to leverage their skills and enter the market at a time that was opportune not only in the Russian context, but in the worldwide market generally.

³⁰ This chapter was adapted from the Sloan School of Management and Business Course, “Global Markets, National Politics and the Competitive Advantage of Firms,” with Professor Yasheng Huang in Spring 2007.

³¹ Leverett, Flynt. “Geopolitics and Geoeconomics of Energy.” Mar 23, 2007.

The country's double transition to democracy and a market-based economy has seemingly done little to lessen economic and political risk and corruption or to strengthen property rights, the rule of law, rights to access and corporate governance. Despite significant privatization and the transition to the market-economy, Russia's hydrocarbon industry is still largely subject to the state. It appears that those hydrocarbon projects and ventures, especially those that came into existence when Russia was in economic duress after transition and during its debt default period, not under the control of state monopolies and their peers are coming under increasing state pressure. Many analysts speculate that now that Russia has recovered significantly from the position it was in during the 1990s, it wants to profit from its wealth of reserves especially under current world prices.

The strategy of non-release and non-disclosure of information may skew the portrayal of foreign investment in Russia. Without knowing the details of foreign deals, it is difficult to ascertain what, if any, inequities are present in the business deal. This is true especially in regards to issues of equity and control, and technology and capital transfers from foreign investors.

It is important to note that state and corporate objectives are not always aligned in regards to foreign investment in Russia. For the state, profit maximization must be tempered with investment across a broader spectrum as opposed to direct, targeted investment confined to the limits of a single project. As *The Russian Energy Strategy to 2020* indicates, "the growth of capital investments in the energy sector, including the influx of different foreign investments, must spread on to the other industries of the

economy.”³² So-called Russian content, in which jobs and investments are made in other sectors and industries supporting the development of a project, is also important. Putin understands that a state seeking to build its economy overall, must create jobs and opportunities for Russian people. These considerations factor into investments made in the Russian energy industry.

The Hydrocarbon Market: Unique Investment Risks

In addition to Russian state national interest in exploiting its oil and gas, the unique nature of the energy industry compounds the risk of doing business in Russia. Investment in technology and the transfer of expertise and capital generally must occur before hydrocarbon production. Thus, western firms face the risk of investing a significant amount of resources only to have the project be unworthy of such costly investment by lower than expected yields or expropriation by the state and its state-owned and -controlled firms. To Russia, the benefit is either in the short-term in obtaining capital and technology and then pushing out the foreign investor without sharing energy profits, or in the long-term by maintaining access to capital, technology and expertise through a close relationship with the foreign investor.

In assessing what a producing country will generally bring to market in the future, there are generally three sets of risks that must be considered: resource risk, production risk and geostrategic risk. Resource risk refers to those factors that could variably affect a given country’s productive capacity. Many investors face this risk. Several of the phases of the Sakhalin project, including Sakhalin-3, had uncertain reserves. Furthermore, in

³² “The Summary of the Energy Strategy for Russia for the Period up to 2020.”

comparison to the United States where the SEC has very strict rules about how to make and report reserve estimates, Russia has no third-party monitoring system of reserves estimates. Even if third-party monitoring is present, only the rules for standardizing risk can be certain. Uncertainty will still remain. Perhaps one component of resource risk – the size of discoveries and fields in Russia – seems to balance the uncertainty about reserves.³³

Production risks are those factors that can variably affect a country's ability to exploit its reserve base. The current price of oil in comparison to the price of the producibility of reserves rendered elements of sunk cost practically inconsequential for some projects. For Russia several components of production risk would be lowered significantly by the competencies of foreign investors. The investment component of resource risk can be wiped away if foreign partners guaranteed sizable and sustainable flows of capital for oil and gas projects, which are extremely capital intensive by nature. Additionally, the technological expertise and know-how of foreign firms can help Russia manage its depletion rate. For investors, the situation is different. Their investments, like all those for strategic resources, are long term with timeframes as large as 20 years. Investors are also faced with bearing geostrategic risk. Geostrategic risk in the traditional sense of securing infrastructure against terrorist threat or internal dissidence is not a concern. Basic political stability is present. But it seems the state is extensively consolidating its control of internal security and ability to exercise authority especially vis-à-vis private domestic and foreign investors in strategic industries with controlling stakes.

³³ This and the following paragraph have been adapted from Leverett, Flynt. "Geopolitics and Geoeconomics of Energy." Lecture. Mar 8, 2007.

Russian Law: A Foreign Investment Roadblock

Russian law can be exercised in such a manner as to effectively block foreign investors. The Underground Resources Law, sometimes referred to as the Subsoil Law, has loopholes that can be used to the state's advantage over firms. Many of these concerns were addressed in the second U.S. – Russia Commercial Energy Summit held in St. Petersburg in 2003. Shortcomings of the Subsoil Law included grounds for unilateral termination of rights and no assured extension of production licenses beyond fixed limits even if justified by feasibility studies. Amendments to the Subsoil Law are scheduled that would affect foreign participation in Russian ventures as well. Additionally, companies are restricted to exporting 40 percent of their production by a longstanding quota arrangement and subject to tariff with the remainder sold on the domestic market at discounted rates.³⁴ The state has a de facto veto on all strategic projects.

Foreign investors are likely to find their presence in Russian hydrocarbon projects more restricted. A bill advocated by Putin limiting foreign investors' participation in extraction ventures for strategic deposits is scheduled to come to vote in the near future. The bill will allow classification of oil deposits over 70 million metric meters, natural gas deposits over 50 billion cubic meters and continental shelf deposits as strategic. The classification of deposit class could "potentially restrict hundreds of Russian hydrocarbon

³⁴Lawrence, Frederick J. "The Russian Oil Enigma: Balancing Vast Potential with Sizeable Risk". Independent Petroleum Association of America. <<http://www.ipaa.org/issues/international/RussianOil.pdf>>

deposits to operatorship by Russian majority-owned companies,” according to GlobalInsight analysis.³⁵

Despite these public displays of state intervention in key investments, Russia attracts more than second-, third-tier and marginal investors. Major international energy companies have also had significance presence in the Russian market.

Sakhalin II

The \$22 billion Sakhalin II project is the largest instance of foreign direct investment in Russia. The project was set up to be governed under a production sharing agreement. The original shareholders in the joint venture, the Sakhalin Energy Investment Company, were Shell Sakhalin Holdings BV, Mitsui Sakhalin Holdings BV and Diamond Gas Sakhalin BV (Mitsubishi). The three co-venturers took on development risks, financed construction and recovered costs through oil and gas sales. As of late 2006 the Russian government had received over \$600 million in royalties and taxes from the project.

Although no Russian firm was an original shareholder in the joint venture, the project was expected to bring \$45 billion to the Russian state not including taxes and royalties. Russia, nevertheless, stood to make substantial gains on the development of the second phase of the Sakhalin fields. Shell declared that seventy percent of the project was

³⁵ GlobalInsight Same-Day Analysis. “Resource Nationalism on the Rise as Russia Mulls Changes to Sakhalin Deal: Subsoil Legislation.” < <http://www.globalinsight.com/SDA/SDADetail6009.htm>>

so-called “‘Russian content’ – Russian businesses, materials, and contracts.”³⁶

Approximately \$4 billion was marked for Russian contractors in the form of services and construction contracts. Significant area improvements in infrastructure were to come as part of the development of the area’s energy resources. Over \$300 million was to be invested in the area for infrastructure including roads, airports and ports. Private Russian firms were still more directly involved in the development of the field. A consortium comprising project leaders Russian companies Starstroi and LUKoil-Neftegazstroi and European companies Saipem SA and AMEC Spie Capag were slated to build an onshore pipeline. The pipeline deal was worth an estimated \$1.2 billion.

Despite the investment and advantages Russia stood to gain from the project, the joint venture came under increasing pressure for supposed environmental damages and cost overruns. The state threatened to revoke licenses if environmental problems were not handled. It did seem, however, that the cost overrun from \$10 billion to an estimated \$22 billion was the more pressing issue to the state. It was widely speculated that these pressures were brought on by state ambitions to have Gazprom take on a controlling stake in the very lucrative venture totally absent of Russian direct stakeholders. This claim was reinforced by the then existing PSA contract which did not provide the state with any profits until all investments were recouped. Therefore, if the existing PSA framework was kept in place, the state did not stand to make any profit for quite some time.

On December 21, 2006 OAO Gazprom, Shell, Mitsubishi and Mitsui signed a protocol agreement changing the shareholder stakes in the joint venture. OAO Gazprom became lead stakeholder with a 50% plus one share for a purchase price of \$7.45 billion.

³⁶SEC Info. “Shell Transport and Trading Co PLC, et al 6-K for 5/19/03” Fran Finnegan and Co. <<http://www.secinfo.com/d13W5b.219.htm#1stPage>> Accessed Mar 3, 2007.

The shares of the original investors were reduced by 50% leaving Shell with a 27.5% stake and retaining its role as Technical Advisor , Mitsui with 12.5% and Mitsubishi with 10%. Because the partners had already invested an estimated \$12 billion in the project, the sale price to Gazprom did not reflect compensation for the estimated barrels of reserves from the project.

Marathon

In April 2003 Marathon Oil, a mid-major and the U.S.'s fourth-largest oil company reentered the Russian hydrocarbon market for the second time. In 2000 Marathon had traded its 37.5% share in Sakhalin II for 28% of Shell's share in two other projects and reimbursement of year 2000 expenses. Marathon had left the potentially lucrative Sakhalin II project because the Russian production sharing agreement framework had been not yet been finalized causing work stoppages. Nevertheless, Marathon must have thought the potential reward for serious reentry in the market outweighed the risks associated with doing business in Russia.

The acquisition of the Khanty-Manysiysk Oil Company was completed with a \$275 million cash sale including assumption of KMOC's outstanding debt obligations and transaction costs. Marathon president and CEO, Clarence P. Cazalot, Jr., saw the acquisition as an opportunity for significant growth. "This acquisition forms the basis for a new core area with substantial near and medium term growth, and is consistent with our strategy of upgrading Marathon's upstream portfolio to achieve superior long-

term value growth."³⁷ The merger would also give Marathon more attractive assets in Russia than it had received from its 2000 trade with Shell.

The relatively small KMOC purchase price may have allowed Marathon to slip into the market amidst the media blitz which surrounded the potential Yukos-Sibneft merger at the time. Marathon began to invest heavily in the project with spending exceeding the purchase price.

After the joint venture was completed, the company unsuccessfully had tried to increase its presence in the Russian market. In 2004 it was in talks with Rosneft to merge Marathon's KMOC with Rosneft's Severnaya Neft (Northern Oil). The deal never came to fruition. Talks were halted when Rosneft reevaluated Marathon's potential 50% stake in Severnaya Neft from an estimated \$330 to \$400 million. In 2006 The Marathon-KMOC venture began to face state pressure. The Federal Subsoil Use Agency threatened to revoke seven of nine licenses citing insufficient drilling and production.

During its three year presence in Russia Marathon grew the value of its investment considerably. In 2006 Marathon netted a \$243 million after-tax gain when it sold its assets to LUKoil for \$787 million and additional monies for working capital and closing costs.³⁸ "Since acquiring these assets almost three years ago, Marathon has doubled oil production to more than 30,000 barrels per day, resulting in the creation of substantial value," said Cazalot. "We have elected to monetize the value of these particular assets, while continuing to evaluate other attractive opportunities in the Russian

³⁷ Marathon Oil Official Website. "Marathon Completes Acquisition of Khanty Mansiysk Oil Corporation; Acquisition Establishes Russia as a New Core Area for Growth". May 13, 2003.

<http://www.marathon.com/News_Center/Press_Releases/2003_News_Releases/?releaseid=411778>

³⁸ Marathon Official Website. "Marathon News: Marathon Oil Corporation Reports Second Quarter Financial Results." Aug 1, 2006

<http://www.marathon.com/content/released/2006_2nd_Qtr_Earnings_Release_FINAL.pdf>

Federation."³⁹ It does not seem likely that Marathon will reenter the Russian energy industry in the near future. Monies from the sale of its assets in Russia were used to pursue projects in other developing markets.

TNK-BP

TNK-BP is the third largest oil exporter in Russia and the country's second largest company in terms of crude oil production. TNK was originally founded in 1995 as a state-owned company. Between 1997 and 1999 Alfa Group and Access/Renova Group took control of TNK. In a 2003 merger brokered by President Putin and Prime Minister Blair, BP and TNK merged their oil and gas assets to form TNK-BP with each company holding a 50% stake. Brokerage on such a high level gave the impression of the Russian state's assurance of durability of the venture. At the time the TNK-BP venture, valued at \$8 billion, was the largest instance of FDI in Russia and seen as a positive sign for the future investment climate in Russia.⁴⁰ The price BP paid was higher than that of Marathon for KMOC in terms of price per barrel: \$1.15 and \$0.95 respectively.⁴¹ The company's proved reserves stand at 8.230 billion barrels. TNK-BP is a diversified, vertically integrated firm. It has both downstream and upstream assets including refining capacity and filling stations.

³⁹ Marathon Official Website. "Marathon and LUKOIL Enter Into an Approximately \$787 Million Purchase Agreement for Marathon's Russian Businesses." May 15, 2006.
<http://www.marathon.com/News_Center/Press_Releases/2006_News_Releases/?releaseid=856893>

⁴⁰ Bush, Keith. "Russian Economic Survey: September 2006". *U.S.-Russia Business Council*.
<<http://www.usrbc.org/PDFs/Economic%20Survey/SurveySeptember2006.pdf>>

⁴¹ GlobalInsight Same-Day Analysis, *ibid*.

Although there was speculation at first as to the motives behind the sale of the company being connected to shifting assets abroad, since 2000 the firm had been looking to grow itself. It realized it would be unable to increase assets by simply acquiring oil fields. It needed to form a strategic alliance to realize its long-term goals. There was a dearth of Russian partners capable of providing the firm what it needed. Goldman Sachs was called in to act as financial advisor for the merger in TNK's meetings with energy majors.

TNK was particular about the structure of the potential merger. It was not interested in partnering with a major that would keep to a typical top-down management approach. It wanted a controlling stake in the venture and for the Russian management board to continue to run the firm. At first TNK only wanted to sell 25% of the firm to BP but they later arrived at a 50-50 arrangement. During the brokerage process, Putin was quick to point out a concern on how management would be apportioned with an even split of ownership. The management was essentially apportioned along the lines of ownership with positions going to members from the firm with relevant experience in the area. Board positions in technology, finance, international operations and the like went to BP whereas positions dealing with the intricacies specific to the Russian business environment were given to TNK. Thus, BP was also seen as being able to bring significant knowledge and experience, in addition to its capital wealth, to the deal – all of which TNK lacked⁴².

In April 2005 TNK-BP was hit with a \$26 billion back-tax bill – a figure slightly less than that of the \$27.5 billion bill Yukos was given in 2004. The \$26 billion raise

⁴² “Russian National to Western Multinational: The Challenges of Transition”
<http://www.carnegieendowment.org/events/index.cfm?fa=eventDetail&id=703&&prog=zru>

applied for the year 2001 prior to the BP merger. The figure was seen as being unusually large given that the firm paid \$10 billion in 2005 and \$6.5 billion in 2004. The timing of the back-tax hike was curious as it coincided with the Russian Business Forum in London, which annually brings together businesspeople seeking to come together for entrepreneurship opportunities in Russia. It was speculated that the tax hike was timed to send a signal to British investors. At a meeting in Germany on April 10 President Putin came to the defense of foreign firms saying his government would not act to limit foreign ownership and that steps would be taken to decrease the time period in which corporate action could be under governmental scrutiny. "Any allegations that Russia is preparing to revise the privatization results are groundless. On the contrary, we are currently considering reducing the statute of limitations on privatization deals from 10 to three years to stabilize ownership relations and not to allow any possibility of redistribution [of property]." ⁴³

The Russian subsoil agency declared TNK-BP in violation of terms of its development for the Kovykta field in Siberia. Kovykta is a field of utmost strategic importance. If Russia ever wants to become a major supplier to Asian markets, there is virtually no way to do so without production from Kovykta. It is not unsurprising, therefore, that the major foreign firm with a 50% stake in the field is coming under state pressure. TNK-BP must begin to produce according to its license agreement – 9 billion cubic meters of gas yearly – or its licenses will be revoked within 3 months. If the licenses are revoked, then they will be auctioned off. TNK-BP has been producing less than 1 billion cubic meters a year. BP has been unable to sell gas without Gazprom

⁴³Bransten, Jeremy. "Russia: Major Oil Company Hit With Large Tax Claim – Again". *RadioFreeEurope RadioLiberty*. Apr. 13, 2005.
<<http://www.rferl.org/featuresarticle/2005/04/5a2ff385-58a3-43b4-9fcf-fbe65cf374be.html>>

because the firm controls gas pipeline infrastructure. Local demand in the Itkutsk region is projected to reach 2.5 billion cubic meters in 2009. The Kovykta field is well positioned for exports to China but Gazprom has blocked construction of TNK-BP pipelines to Asia to feed export markets. Accordingly, TNK-BP claims it can produce 9 billion cubic meters yearly but that figure would far outstrip demand.

A moratorium on change of ownership for the 50-50 joint venture expires at the end of this year leading many analysts to believe that Russian stakeholders in TNK-BP are ready to sell their stakes to Gazprom,

The Prospects for Sakhalin III

Sakhalin III consists of an estimated 4.6 billion barrels of oil and 770 billion cubic meters of gas. In 1993 a consortium led by ExxonMobil and including ChevronTexaco won the tender for the project. Their tender was established in spite of no previous major exploration of the nature of the project's reserves thus necessitating exploration on their part. ExxonMobil and ChevronTexaco spent \$60 million in exploration costs. "It's highly prospective. It's certainly risky. But in our view, it's undoubtedly worth the investment and effort,"⁴⁴ said Peter Robertson, Vice Chairman of ChevronTexaco, regarding the Sakhalin-3 project as he addressed the attendees at the U.S.-Russia Commercial Energy Summit held in Houston Texas on October 1, 2002. He recognized the risks but thought it ultimately worth the future reward.

⁴⁴ Robertson, Peter. "The United States and Russia in Global Energy Markets." Chevron. Speech Archives. Oct. 1, 2002. <http://www.chevron.com/news/speeches/2002/01oct2002_robertson.asp>

The Russian government cancelled ExxonMobil and ChevronTexaco's rights to Sakhalin III in 2004 supposedly because of a change in tax laws on PSAs. Cancellation of the project was also reportedly due to the lengthy delay in development. ExxonMobil had spent considerable time trying to secure PSA status for the project's development that would result in significant tax breaks. However, the Russian parliament voted against PSA status. According to Russian Deputy Prime Minister Viktor Khristenko – who also sits on the board of directors of Rosneft and Gazprom – the original tender provided for exploration but no guarantees for development. He continued that in the absence of legal guarantees no license for the field had ever been issued which freed the state to cancel the tender, as it did on January 29, 2004, and to seek a new one.

In April 2005 Sakhalin was designated a “strategically” important deposit. Stakes in the project are set to be auctioned in 2007 after a new bill limiting foreign investment in strategic reserves is put into effect. According to Energy Minister Igor Yusufov, the state expects \$1 billion for a new tender for a project license. Any firm winning the new tender will be a minority stakeholder with the controlling share more than likely going to Gazprom, Rosneft or Lukoil.

PSA Restructure: Pushing Investors Out of the Fields

It appears that the PSA deals, including the aforementioned Sakhalin-2, penned when Russia was in economic need in the early 1990s are being renegotiated as Russia now sees itself in a position where it can make substantial profit from their production. The Sakhalin-1, Sakhalin-2 and Kharyaga PSAs were negotiated at a time when there

was no single law regulating PSAs. Each of the three projects was located in a region outside the original oil districts in western Siberia and necessitated extensive funding and technological infusions for development.

President Yeltsin signed a new law governing PSAs in December 1995 after these PSAs had been signed but before they came into effect. This law set a PSA limit of 30% of reserves. No PSAs have been granted since then. The new PSA law states that PSAs will only be concluded in the absence of regular regime auctions. Given the dozen pieces of misaligned and contradictory PSA legislation and seeming lack of public access to the specific text, the state can easily cherry-pick legislation to nullify, take away licenses or renegotiate terms. Although the state did not cancel, as it had considered in 2002, its PSA system which guarantees investors stable tax revenues over project lifetimes, each PSA has come under fire. It is likely all will be restructured. Even though it does appear the foreign investment is being limited, the Russian government still tries to position itself as being friendly to foreign investors as minority stakeholders in these projects.

An investigation of the French firm Total had begun for possible environmental violations in the Kharyaga field on March 13, 2007 according to officials from Rosnedra, the Federal Agency for the Use of Natural Resources. Total's license was also under reconsideration by Deputy Head of Rosnerda Pyotr Sadovnik on December 22, 2006 because the firm did not give proper evidence of the field's reserves. If the Total project is to go the way the other projects that have had environmental charges brought against them, then it seems Total will soon be pressured to sell shares to Gazprom or Rosneft.

As late as 2005 Exxon Mobil felt sufficiently protected under the PSA structure in its Sakhalin-1 project. Answering questions at March 9, 2005 Analyst Meeting in New

York, Rex Tillerson responded to a question regarding the firm's enthusiasm for additional large investments in Russia in an environment of tax regime and political changes.

Well the changes that have occurred in Russia over the past year, of course, let me say have no impact on our Sakhalin-1 investment because it being pursuant to a production sharing contract fixes all of the fiscal regime, tax, royalty. It also provides for any disagreements we have to be resolved in international courts outside of Russia. So the stability around that major investment is in place. And the Russian government has reaffirmed their commitment to that both by actions in the Duma and obviously actions as they have worked with us on approving what's needed to allow that project to go forward.⁴⁵

On March 1, 2007 the Russian state said it would start new environmental checks on Sakhalin-1. Because Rosneft is a partner in the project, some analysts predicted that these environmental checks, slated to begin in May, will not have the same outcome as those of other projects with foreign investors. But, prospects for ExxonMobil at Sakhalin-1 may not be that positive. As the project hit peak on February 15, 2007, the Russian state ruled out the possibility of an automatic enlargement of ExxonMobil's license territory. Exxon had wanted to increase its license territory to maintain peak production because the current territory will begin to decline in several years. Adjacent deposits will be auctioned even though they were discovered by Exxon.

Russia: The Prospects for Foreign Investors

Putin's dissertation may provide a clue as to the future prospects for foreign investors. Seen as the driver of economic development and vital to the state's standing as

⁴⁵Exxon Mobil Corporation. "Exhibit 99.1. Q & A Session. Analyst Meeting. March 9, 2005". Mar 9, 2005. <http://library.corporate-ir.net/library/11/115/115024/items/142151/xom_031505.pdf>

a supposed “energy superpower,” the hydrocarbon sector is likely to see more state-control and consolidation.

The Russian mineral raw material complex plays an important role in all aspects of the state’s vital functions...The development of the raw materials sector helps form a strong industrial base which is capable of satisfying the needs of both industry and agriculture; it makes an important contribution to the income of the country as its products remain the basic source of foreign currency.⁴⁶

The vital status of energy to the state is likely to continue. The three major candidates for the 2008 presidential race include Medvedev and Ivanov. Putin is widely speculated to sit at the head of Gazprom when he leaves office.

Recent developments, such as those at Shtokman field show that Russia will totally push all foreign investment in projects out. Shtokman is one of the world’s largest gas fields with 3.7 trillion cubic meters of gas. Originally Gazprom had started a selection process for foreign firms to help in development, which is estimated to cost between \$15 and \$20 billion. The five finalists from a September 2005 decision, Norway’s Statoil and Norsk Hydro, Total, Chevron Corporation and ConocoPhillips were told in October 2006 that none of them would be offered a stake in the project. According to Gazprom CEO Alekei Miller, “Gazprom will use 100 per cent of the Shtokman field resources on its own. Over the continuous period of time Gazprom has studied the possibility of providing foreign companies with a 49 per cent stake in the Shtokman project. International companies however failed to offer assets matching Shtokman’s reserves in amount and quality.”⁴⁷

If the Shtokman project is any indication, it seems that Russia is ready and more than willing to develop projects on its own while leaving out foreign investors.

⁴⁶ Olcott. “Vladimir Putin and the Geopolitics of Oil,” p. 18.

⁴⁷ “Gazprom Will Use 100% of the Shtokman Field Resources On Its Own” Oct. 9, 2006. <<http://www.gazprom.ru/eng/articles/article21383.shtml>>

Foreigners are not going to be allowed to take majority stakes in Russian companies and will not get controlling stakes or in some cases any stake in significant strategic oil and gas assets.

This chapter does not argue that in the future foreign companies will be unable to invest in the Russian energy industry. Foreign investment has been successful under different forms. The acceptance of foreign investors will be a matter of their necessity to any particular project and the terms of the deal.

Two recent examples of Chinese investments with Rosneft may be models for future foreign direct investment in Russia. The China Petrochemical Corporation, or Sinopec, successfully concluded a joint venture with Rosneft in the Russian Republic of Udmurtia. The parameters of the deal are somewhat unorthodox. Sinopec purchased Udmurtneft, a TNK-BP holding in July 2006. It then sold 51% of the holding to Rosneft. Rosneft paid nothing for the controlling stake. Sinopec will be reimbursed for the sale through profits from the venture. In February 2005 the China National Petroleum Corporation helped finance Rosneft's purchase of Yuganskneftegaz, Yukos's largest production unit. CNPC paid \$6 billion dollars for future years deliveries of oil. Consequently, it did not directly loan Rosneft the money to finance the deal or purchase any stake in Yuganskneftegaz, but bought many years of deliveries forward. As Sergei Oganessian, then head of the federal Energy Agency and member of Rosneft's board said, Rosneft and CNPC "have agreed on the prepayment for long-term oil deliveries."⁴⁸ Both of these deals highlight the evolution of the Russian investment climate.

⁴⁸ Arvedlund, Erin E. "China's cash and Kremlin's Yukos deal." *The New York Times*. Feb 2, 2005. p. 1.

Chapter 3:

Supply States: Managing Relations to Maintain Reserves

Russian supplier states are those states that have their own oil and gas reserves and related industries. Azerbaijan, Kazakhstan, Uzbekistan and Turkmenistan all developed their resources as part of the Soviet oil and gas industry. Therefore, most, if not all, of what became their sovereign export infrastructure once they became independent states was still oriented toward Russia. Although all supply states are important to Russia given the oil and gas they can provide, some states will be of more importance given their quantity of supply and proximity to major importers. It is important to note that in the case of supply states, the strategy of Russian energy corporations and the Russian state are the same. It is in the interest of both to keep supply states' oil and gas dominated by Russia.

For his part, Putin intends to keep supplier states oriented toward Russia. It is not in Russian interest to have these states develop their industries and markets such that the majority of their oil and gas exports are going through infrastructure that is not under Russian control. Relatedly, it is not in Russian interest to have these countries develop export markets that either undercut Russian market share in a market where it already has presence, or in which it plans to develop markets and share. Europe is a market of the first type. Russia already has a dominant position that it does not want to see diminished by the presence of a supplier state in the market.

TABLE 1: Major European Recipients of Russian Natural Gas Exports, 2004

Rank	Country	Imports (bcf/year)	Pct of Domestic NG Consumption
1	Germany	1110	44%
2	Italy	777	29%
3	Turkey	473	65%
4	France	470	26%
5	Hungary	378	72%
6	Finland	269	100%
7	Slovakia	261	100%
8	Poland	258	60%
9	Czech Republic	240	82%
10	Austria	201	63%
11	Bulgaria	184	94%
12	Romania	177	24%
13	Fmr Yugoslavia	74	-
14	Greece	74	92%
15	Switzerland	18	17%

Others: (Belarus: 98%, Lithuania 100%, Latvia 100%, Estonia 100%)

Source: EIA, BP (2005), CIS and E. European Energy Databook, 2005 ⁴⁹

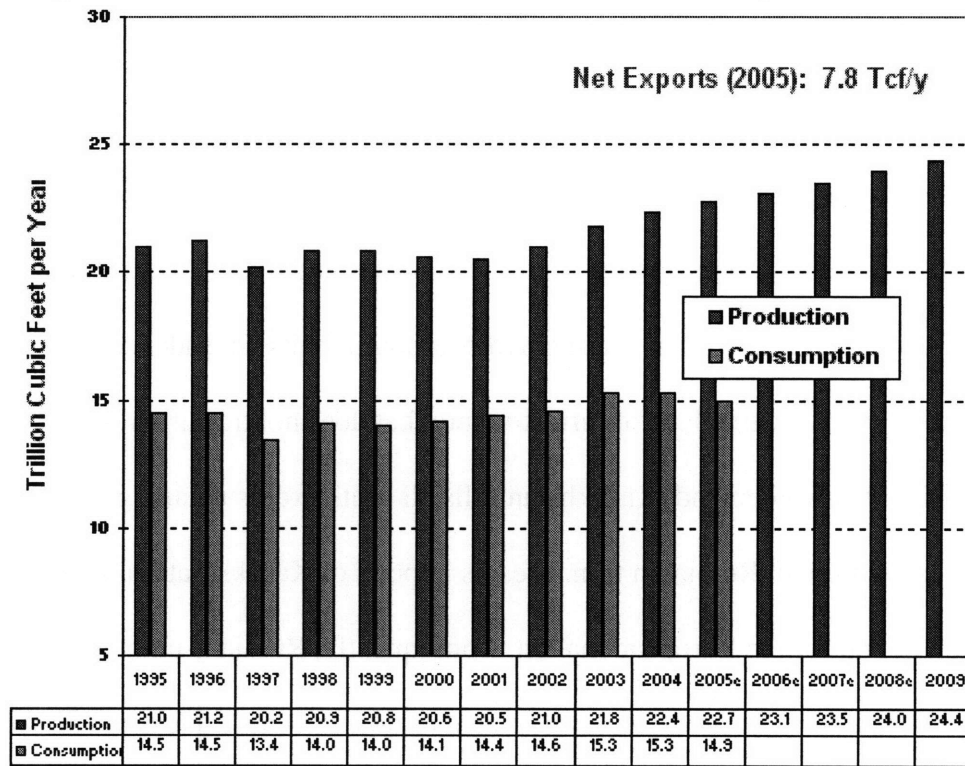
The Soviet energy industry originally developed as an important supplier to Europe and consequently all of its export infrastructure runs east to west. Asia is a market of the second type where Russia ultimately wants to emerge as a dominant supplier and does not want supplier states to move in and establish market presence first. Currently, there is no pipeline infrastructure from Russia to Asia. In effect, the Russian objective is to block supplier states from export markets; it wants supplier states to continue to export either to or through Russia.

This objective will become increasingly important in the coming years. Many analysts say that Gazprom will soon face a supply crunch in terms of its own production

⁴⁹Energy Information Administration. "Country Analysis Briefs: Russia: Natural Gas" <<http://www.eia.doe.gov/emeu/cabs/Russia/NaturalGas.html>> Accessed May 10, 2007.

and the assets it controls, and will not be able to meet both domestic and foreign consumption demands.

Fig. 5: Russian Natural Gas Production and Consumption 1992-2009



Source: 1992-2005: EIA International Energy Annual (2006). Forecast 2006-09: Gazprom (2006)

50

Consequently, it is of strategic importance for Russia to maintain relationships with supplier states in their current form. Gazprom typically buys hydrocarbon resources from supplier states at prices well below those charged to European customers. It uses these resources to fulfill domestic needs. Production is freed to export to other markets at much higher prices. The supplier states have the opposite interest. They want to establish a degree of autonomy away from Russia and to be able to maximize revenue from export of their own resources.

⁵⁰ *Ibid.*

Kazakhstan

Kazakhstan has by far the largest oil reserves of any former Soviet state. It is home to the Kashagan oil field, one of the world's five largest oil fields and the largest discovery in the past thirty years. The country has approximately 2 trillion cubic meters in proven gas reserves. Natural gas production in the country will increase in the coming years as the extraction process at major oil fields begins and overlaying gas reserves are harvested. Although Kazakhstan is quite hydrocarbon rich, its dependence on Russia has been fostered by its relative lack of infrastructure that does not transit through Russia. After meeting its own demand, Kazakhstan sells all of its excess natural gas to Russia for domestic consumption. Russia, in turn, uses its imports of Kazakh natural gas to free production bound for the European market. Consequently, Russia is uninterested in independent Kazakh infrastructure development as this will cause a loss of Russian production free for export and set up a competitor in existing or new markets.

In the case of Kazakhstan Russia has lost some ground already. The success of a number of future infrastructure projects will determine to what degree Russia can use energy as a lever against Kazakhstan. When Kazakhstan first gained independence, all infrastructure transited through Russia. Currently, only two-thirds of its infrastructure transits through Russia. This figure will decrease when, and if, new pipeline projects are completed, and will endow Kazakhstan with a level of relative energy autonomy vis-à-vis Russia.

The Caspian Pipeline Consortium, commonly referred to as the CPC pipeline, is unique among the many pipelines running through the former Soviet Union. It is the only

privately owned pipeline in Russia. This trunk pipeline runs 1,510 kilometers from the Tengiz oil field in western Kazakhstan to the Russian terminal Novorossiysk-2 on the Black Sea. Three governments, and 10 companies in seven different countries are shareholders in the project including Russia with the largest stake at 24%, followed by Kazakhstan with 19%. The CPC pipeline is also of strategic importance. It is linked to Novorossiysk from where approximately ninety percent of Russian gas is exported.

In April 2006 Kazakh president Nursultan Nazarbaev announced CPC capacity would be doubled to 67 million tons. The expansion was thought to have the seal of Russian approval when the announcement was made after Nazarbaev's meeting with Putin. Expanded capacity along pipelines is important for Kazakhstan, which has invested billions of dollars in expanding the Tengiz oil field, where production is slated to double this year. An extra 45 million tons of capacity will be needed for Tengiz production. The Kashagan field is scheduled to come online after the Tengiz production expansion is complete. Approximately 12 million tons of capacity will be needed for the project. The CPC pipeline exported approximately 30 million tons in 2005 and 2006. Investors in the project, above all Kazakhstan, are concerned that the project reach its expected capacity by 2009.

Eight days after Nazarbaev announced the CPC capacity increase the *Russia Journal* quoted Transneft Vice President Sergei Grigoriyev as saying Russia "will not allow the expansion of the CPC Pipeline to squeeze the volume of Russian crude that may currently move down the Black Sea."⁵¹ Transneft's refusal to support the CPC pipeline was contentious. Firstly, shareholders in CPC had already made concessions to

⁵¹ qtd in. Kupchinsky, Roman. "Russia: Moscow Extends Its Pipeline Web." *RadioFreeEurope RadioLiberty*. June 23, 2006. <<http://www.rferl.org/featuresarticle/2006/06/2106a51e-b8db-4682-8f23-24072fcd001b.html>> Accessed Mar 28, 2007.

Russia for increased capacity as late as September 2005. Concessions included increasing tariffs, Russian participation in the consortium's management, and protecting against cost overruns and losses for Russia. Secondly, in the same period of its statement against the CPC pipeline, Russia had begun to support another infrastructure project. It supported a pipeline running from Burgas, a Bulgarian port on the Black Sea to Alexandroupoli, a Greek port on the Aegean Sea. This proposed pipeline was seen as a counter to the Baku-Tbilisi-Ceyhan pipeline, heavily lobbied for and supported by the West. The BTC pipeline runs from the western shore of the Caspian to Azerbaijan across Turkey and from there to European markets. The BTC pipeline obviously gives Kazakhstan a large degree of autonomy in the transport and marketing of its oil. Such autonomy would effectively place it outside of the Russian sphere of influence.

It appeared that Nazarbaev was unwilling to continue to push for an expansion on the CPC that seemingly was dead in the water at the behest of Russia. He announced Kazakhstan would export some of its production through the BTC pipeline. At the official signing ceremony, Nazarbaev publicly expressed his enthusiasm for the project:

One can say that [today's agreement] is very profitable for us. As I keep saying, Kazakhstan's oil [and] Kazakhstan gas are worthless if they remain underground... Under market-economy circumstances, it is necessary to find ways to bring [this oil and gas] to world markets. With today's agreement, we have now the possibility of shipping our oil, first, through Russia, second, through China, [and] third, through the Caucasus region.⁵²

But any project profitable for a Russian supplier state and giving the state options for transport is clearly not in line with Russian interest. President Bush sent a letter to Azerbaijani leader Ilham Aliyev advocating an agreement between the two nations on the

⁵² "Eurasia: Kazakhstan Squeezes In On BTC Pipeline Project" *RadioFreeEurope RadioLiberty*. Jun 16, 2006. < <http://www.rferl.org/featuresarticle/2006/06/1662c9c5-9b2d-4612-9e45-ad8759857a7e.html> > accessed March 27, 2007.

BTC. This, to a lesser extent, may have pushed the Kremlin to take action as it is opposed not only to American unipolarity but staunchly defends its own status in the region. Russia responded to Nazarbaev's agreement with Azerbaijan for the BTC project by proposing a change in CPC ownership whereby its stake would be transferred to Transneft. The transfer could potentially kill CPC expansion. If CPC expansion is killed, Kazakhstan, despite signing on to the BTC pipeline, could be left in an extremely precarious position.

BTC capacity is almost completely taken up by Azerbaijani supply. An increase in the pipeline, which has a 50 million ton capacity, will be possible with technical adjustments. However, this will only increase capacity by 50 percent. According to Rovnaq Abdullayev, president of the Azerbaijani State Oil Company, Kazakh oil will account for 10 million tons of the capacity yearly. Thus, the BTC pipeline will still not give Kazakhstan enough capacity for production slated to come from the Tengiz and Kashagan fields.

There is a possibility for competition between BTC and the Burgas-Alexandroupoli pipelines to bring product to markets. However, if such a race for construction and expansion to bring oil to market did not ensue, Russia could effectively punish Kazakhstan. With no outlets for its increased production, Kazakhstan would be stuck with a glut of supply.

While in Brussels in December 2006 to sign a memorandum of understanding with the EU on energy, Nazarbaev was more cautious in pronouncements on independent energy activities. In speaking specifically on a possible trans-Caspian pipeline, he said "any route which is feasible and efficient for the transfer of Kazakh hydrocarbons will be

thoroughly considered.”⁵³ He added that Kazakhstan "will still probably be using the Russian network to the Baltic ports...”⁵⁴ Such comments show the caution that Kazakhstan still uses to make sure that every step it takes towards autonomy is framed in a way to still show its allegiance to Russia.

Azerbaijan

Of the supplier states, Azerbaijan has been the most open to foreign investment and the least vulnerable to the Russian energy lever. Fariz Ismailzade argues that Russia will be unable to wield its energy as a weapon to maintain Azerbaijan in its sphere of influence like it has in other countries.

...unlike in Georgia and Ukraine, where Russia is hoping to gain political victories with the help of energy tools, this policy is doomed to a failure in Azerbaijan. Due to its own sources of revenues and its limited external debt to Russia, Azerbaijan runs little risk of falling into the Kremlin’s energy trap. Extracting extra revenues from oil-rich Azerbaijan has been the only short-term gain for Russia, yet this will come with an expensive price in the long-run.⁵⁵

It seems that the energy weapon is, in fact, failing Russia in Azerbaijan.

Although Azerbaijan has proven reserves between some 30 trillion and 48 trillion cubic feet, it lacks the infrastructure to make use of its own domestic supply of natural gas. Its electrical generation capacity had been converted to a gas-based system, but it lacked terminals and pipelines and consequently flared off natural gas. Its gas imports from Russia increased four-fold since 2001. When Gazprom demanded a \$230 price from

⁵³ Kimmage, Daniel. “Kazakhstan: Democracy, Energy And Ambiguity”. *RadioFreeEurope RadioLiberty*. Dec 8, 2006.

⁵⁴ *ibid.*

⁵⁵ Ismailzade, Fariz. “Russia’s Energy Gambit: It Won’t Work in Azerbaijan” *Central Asia- Caucas Analyst*. Vol. 7. No. 2. p. 7.

Baku this January in lieu of the \$110 it has previously charged along with a reduction in supply from 4.5 bcm to 1.5 bcm, Baku ended all imports of gas. In response to Russian action, the Azerbaijani state oil company, SOCAR, ended all exports of oil to Russia via the Baku-Novorossiysk pipeline. This action, obviously, was not favorable to Russia.⁵⁶ According to the Energy Information Agency, this pipeline sends between 50,000 and 90,000 bbl/d to Russia. The diverted oil will be used to fuel thermal power stations, which had been running on natural gas since 2000.

Baku gave Russia another indication that it would not be able to claim victory with its wielding of the energy weapon: it is selling natural gas to Georgia. In the wake of pipeline explosions affecting Georgian supply, Azerbaijan together with Iran began to supply the country and ended its 100 percent dependence on Russia for the first time since it became an independent state. Thus, Azerbaijan is also supporting a degree of Georgian energy autonomy vis-à-vis Russia. According to Georgian President Mikheil Saakashvili, this is an important step for his country. "For the first time since the restoration of Georgian independence, Georgia is being supplied not just with Russian gas but with an alternative source. Of course, we will sharply strengthen our work in this direction."⁵⁷ This relationship will only be further strengthened when the Baku-Tblisi-Ezurum pipeline comes online this year.

Azerbaijani participation in the BTC pipeline was not as contentious an issue as it was in Kazakhstan perhaps because Azerbaijan has been exerting its energy autonomy

⁵⁶ Adapted from Savietz, Carol. "Russia's Energy Policy: Business or Politics or Both?" Feb 28, 2007. Presented at the Massachusetts Institute of Technology Security Studies Program Seminar Series.

⁵⁷ Parsons, Robert. "Caucuses: Georgia, Armenia Consider Options After Russia Pipeline Explosions." *RadioFreeEurope RadioLiberty*. Feb 1, 2006. <http://www.rferl.org/features/features_Article.aspx?m=02&y=2006&id=D2074170-D820-4948-812E-69551D17C950> Accessed Mar 29, 2007.

vis-à-vis Russia more openly and for a longer period of time. The BTC pipeline, which bypasses Russia, renders Azerbaijan almost completely free of dependence on Russia for transport of its oil.

In March 2007 Azerbaijani foreign minister Elmar Mammadyarov and Condoleeza Rice signed a memorandum of understanding for the construction of new pipelines from the Caspian to Europe. This instance of energy cooperation is meant to foster an Azerbaijani position as an alternative to Russian energy supply.

Turkmenistan

Turkmenistan has made attempts to move out of the Russian sphere of influence. In 1997 it started construction of Korpezhe-Kurt Kui, which links Iran to Turkmenistan and is the first Central Asian pipeline to bypass Russia. It signed a pipeline deal with China in April 2006. Although the feasibility of the project is questionable, the public move to an Asian partnership was solid.

If the deal is to be completed as arranged, Russia and Gazprom may feel the effects of the expected supply crunch more acutely. Although there is no accurate estimate of Turkmen gas reserves, a significant increase in production undoubtedly would be necessary for Turkmenistan to meet commitments to both Russia and China. It is not known if such an increase would be possible.

The agreement with China for pipeline construction sets supply guarantees gas volumes to the country. According to the text of the agreement: "If additional volumes of gas are required to build the Turkmenistan-China gas pipeline, the Turkmen side can

guarantee gas shipments from other gas fields."⁵⁸ Volumes are expected to begin at 30 bcm and increase to 50 bcm by 2010. Such an arrangement would be felt by Gazprom, since it expects Turkmen gas to be a major source of supply as its domestic supply decreases. According to Leverett, Gazprom need not worry about the Chinese agreement with Turkmenistan. The project is not likely to progress. In 2003 Gazprom signed a \$300 billion 25-year agreement with Turkmenistan for 70 to 80 bcm of gas yearly.

For its part, Russia has tried to use a positive pricing lever to keep Turkmen relations secure. On September 5, 2006 Gazprom agreed to pay \$100 per 1000 cubic meters of gas, a substantial increase from the \$65 it had been paying previously. The price increase came as a result of Turkmen threats to cut off supply if the new \$100 price was not accepted. Russia likely yielded because the \$100 figure still ensures it a profit as it is substantially below market price. Furthermore, Russia may have taken into account that Turkmenistan could use the Korpezhe-Kurt Kui pipeline to supply Iran, which has sought to increase Turkmen imports from 5.8 bcm in 2005, 8 bcm in 2006 to 14 bcm in 2007. Russia's agreement to the price increase was simply a relatively painless concession to ensure Turkmenistan remains a friendly supplier and willing state in its sphere of influence.

Turkmen relations with Russia may be facing a turning point, making the prospects for relations between the two countries unclear. In an April 2007 meeting in Moscow, Turkmenistan's new leader, Gurbanguly Berdymukhammedov, was unwilling to commit to any new projects or yield to Putin's overtures for further bilateral cooperation.

⁵⁸ Kimmage, Daniel. "Central Asia: Turkmenistan-China Pipeline Has Far-reaching Implications." *RadioFreeEurope RadioLiberty*. Apr 10, 2006. <<http://www.rferl.org/featuresarticle/2006/04/55f9574d-407a-4777-9724-944e6c2ecd7b.html>> Accessed Apr 1, 2007.

Uzbekistan

Of all the supplier states reviewed in this document, Uzbekistan is the only one that has made concerted efforts to build a closer energy and geopolitical relationship with Russia. On January 25, 2006 Uzbekistan joined the Russian-led Eurasian Economic Community. The move to join the partnership was seen as move away from the west, especially after its condemnation of the May 2005 violence in Andijon.

The EEC partnership is based firmly on the grounds of economic cooperation between the states, specifically a strategic energy partnership. Russia is well-positioned in this regard. It is the only country that receives imports of Uzbek gas and as such is free from competition over market share. Both Gazprom and Lukoil have been making investments in the Uzbek energy sector. The expected value of the investments is \$2.5 billion dollars.

Gazprom has been welcomed into Uzbekistan. Volumes sold to Gazprom have been on the rise. The 2006 contract with Gazprom provided for deliveries of 9 billion cubic meters, up from 8.15 bcm and 7 bcm in 2005 and 2004 respectively. The 2007 contract sets deliveries at 13 billion cubic meters. Instead of using pricing as a negative lever, the company has used it for positive outcomes – much like it has in Turkmenistan. Whereas countries such as Belarus, Ukraine and Azerbaijan saw their price increases as discriminatory, Uzbekistan has been receiving regular increases in the price of the gas it sells to Gazprom. Although this price is still well below the market level, it has increased substantially in the past two years. In 2006 the Gazprom contract bought supply at a cost

of \$60 per 1,000 cubic meters, a figure 25% higher than the 2005 price. The contract price was increased, once again, to \$100 for the year 2007.

Gazprom is conducting exploration in Uzbekistan specifically in the Ustyurt region. It is also expanding capacity of the section of the Central-Asia gas pipeline that runs through the country. Additionally, it plans to acquire other Uzbek assets specifically from Zeromax. Zeromax, has extremely tight but nontransparent links to Uzbek President Islam Karimov's daughter, Gulnora Karimova.

Lukoil has signed on to invest in the Uzbek natural gas sector. Under a 35-year production sharing agreement, Lukoil will invest \$1 billion with its 90% stake in the country's southern fields, estimated to hold 280 bcm. The holding of Uzbekneftegaz, the state-owned oil and gas company, in the project is dwarfed, compared to Lukoil's, at 10%. Thus, once again the relationship in which the Russian firm has more control over critical resources than the home state and its state-owned company is encountered. Lukoil also is partner in the PSA for the Khauzak-Shady-Kungrad project.

Although closer economic ties have resulted in greater economic trade – Russia is Uzbekistan's biggest foreign trade partner – Uzbekistan's debt is still growing, creating another dependence on Russia. Uzbek debt has not been serviced since 1998 and will soon exceed \$700 million. If this debt is to follow the model of transit states, then Russia may allow it to increase to such high levels that Uzbekistan will not be able to pay. If this were to happen, one might expect Russia to propose to write off the debt in exchange for a stake in infrastructure. Gazprom has already expressed interest in a 44% stake in the Uzbek pipeline monopoly Uzbektransgaz. Increased cooperation in military relations is also expected, which will serve not only to strengthen the ties between the countries, but

also to further push Uzbekistan into the Russian sphere of influence. In the years to come, Russia will likely use its influence in the region to maintain and increase its presence in the Uzbek hydrocarbon sector in order to supplement its own depleting domestic resources as well as to prevent the emergence of an Uzbek competitor in the Asian market.

Implications of Resource Nationalism in Supply States

As the above cases indicate, the goals of resource nationalism are multiple in the case of supplier states but can generally be framed in one of the two following contexts. Russia employs resource nationalism to maintain market share in important markets in Europe or prospectively to gain share in Asia. It thus seeks to secure that all supply states continue to export the majority of excess supply to Russia rather than directly to market.

Although Russia does not pay market prices for supply in these countries, the price it pays likely is calculated in a way to make it the preferred buyer. The west, specifically the United States, has supported projects to send supply out of Russian control. These projects will all need to be initiated from the principal design phase, an extremely expensive prospect. Gazprom does have the option of raising prices. Thus, it will calculate price in such a way to make supplying to Russia a much more cost-effective measure than building new infrastructure for export. Participation in organizations such as the Shanghai Cooperation Organization has also been used to push back on the United States' influence in Russia's supply states in Central Asia. Russia also is able to exert pressure to limit how large any independent or bypass projects can get in

order to ensure that over time the percentage of hydrocarbons exported in infrastructure controlled by Russia remains very high.⁵⁹

The objective of this strategy is to secure Russia's position as a dominant energy player and dominant actor in its near abroad. So far, this strategy has worked to increase Russia's standing in its near abroad. In turn, Russia will use this status, in addition to the revenues generated, as the basis for reestablishing some sphere of autonomy and international standing. It is likely that Putin's successor will continue to pursue this aspect of Russia's energy strategy.

⁵⁹ Adapted from Leverett, Flynt. "Goeconomics and Geopolitics of Global Energy." Apr 5, 2007.

Chapter 4:

Transit States: Managing Relations to Maintain Access

Russia is able to exploit its control over upstream oil and gas resources to reassert control over transit states in the geographic space of the former Soviet Union. This reassertion of control manifests itself with the variety of positive and negative levers Russia has access to vis-à-vis former Soviet states given its relative energy and economic prowess and their historical dependencies. An important step toward market dominance and sovereign autonomy is control of export and transit infrastructure for oil and gas. Thus, relations with transit states are of particular importance for Russian energy dominance and foreign policy. Supply, especially to commercially viable and important markets such as Europe, must have established and relatively secure paths to reach market.

Russia runs its export pipeline infrastructure across the territory of transit states in order to get its supplies to market. The relationship with transit states provides an interesting dynamic. Russia has a degree of leverage over transit states because they rely on Russia for energy supply and other economic measures. In theory, the transit states also have leverage; they can push back. This pushing back has manifested itself in supply cut-offs, interruptions and the siphoning of more supplies than the transit states are entitled. The dynamic of transit states pushing back on Russia has resulted in Russia employing the use of its lever to keep the states within its sphere of influence. To have these states outside the Russian sphere of influence would be drastically costly, both economically and strategically until a viable alternative to current infrastructure is present. At present, Russia will try to ameliorate the problem of transit states by

reintegrating and acquiring whatever infrastructure it can in transit states in order to have more control and decrease dependence. In this case Russia will have dominance as operator and supplier, and the transit state will be left only with its status of transit state as power potential or negotiation point.

Two recent examples of the tensions that arise when transit states push back on Russia, and Russia subsequently makes use of its energy lever, resulted from Gazprom price hikes in Ukraine and Belarus. In these instances, the objectives of Russia as a state and corporate entity are not the same. Profit maximization through increased prices is the mark of a corporation. In these two cases, there was a cost to heightening control. When Russia increased price in Ukraine and Belarus, it showed disregard for issues of regional power. Russian action in these states raises issues presented in realist and industrial organization theory. In following through with its threats to Ukraine and Belarus, Russia may have diminished its power by triggering countermeasures against itself.

Ukraine

Of the three Russian central pipeline networks for gas, all run through Ukraine. The preponderance of transit routes through Ukraine resulted in 90% of Russian gas being piped through the country.⁶⁰ Consequently, Ukraine is in a position of strength vis-à-vis Russia in regards to its infrastructure. Such a position allowed it not only to siphon off supply, but to take on significant amounts of debt as it is a net importer of gas.

The January 1, 2006 gas cutoff is perhaps the most well-known instance of Russian leverage over transit states. After Ukraine failed to agree to a price increase

⁶⁰Gazprom. "Europe" <<http://www.gazprom.ru/eng/articles/article20160.shtml>> accessed March 26, 2006

bringing the cost of gas closer to world prices than its \$50 per 1,000 cubic meters of gas subsidized rate, Russia followed through on its threat to cut off supply. Gazprom initially wanted Ukraine to pay \$160, a figure representing more than triple its then current rate, but as talks continued with no agreement and Kiev refusing to pay the increased rate outright and immediately, the Gazprom-offered price was raised to \$220, then to \$230. President Yuschenko agreed that Kiev should pay the market rate, but asked the increase to be phased in over a five-year period.

The gas dispute was eventually resolved, but different aspects of the arrangement are unclear. Russia and Ukraine set up a joint venture, UkrGazEnergo, to supply Ukraine with gas. Ukraine's state energy company, Naftohaz and the Swiss-registered representative of the Russian stake, RosUkrEnergo, are partners in the venture. The RosUkrEnergo portion of the venture is lacking in transparency. It is owned by Gazprom and what were originally unnamed shareholders equally under Centragas Holding. The shares of the unnamed shareholders, later disclosed to belong to Ukrainian businessmen Dmitri Firtash and Ivan Fursin, are held by a subsidiary of Austrian Raiffeisen Zentralbank, Raiffeisen Investment. UkrGazEnergo acts as an intermediary for gas sales from Uzbekistan, Kazakhstan, Turkmenistan and Russia in the following manner: Gazprom sells gas to RosUkrEnergo at \$230. RosUkrEnergo will then sell gas from Uzbekistan, Kazakhstan and Turkmenistan to Ukraine at \$90. UkrGazEnergo will supply the Ukrainian market.

The price war has been seen as a front for a political struggle between the Kremlin and the western-leaning President Viktor Yuschenko who rose to power after a heated race with Kremlin-backed candidate Viktor Yanukovich. Russia claimed the price

hike was based on purely economic principles. A price closer to world price was in its simple economic interest. Ukraine argued that the hike was politically motivated as retribution for what was perceived as its western-leaning political orientation. As this controversy was taking place, Gazprom announced on December 19, 2005 that its politically favored and more Kremlin friendly transit state, Belarus, would receive gas at \$46 for the year 2006. A month earlier it announced Georgia's price would increase from \$60 to \$100. The price offered to Ukraine was significantly higher. A brief history of the embattled 2004 election is necessary to understand the context of the dispute.

After a run-off election ended with Yanukovich as victor amidst allegations of far-reaching electoral fraud, a colored revolution consisting of almost two weeks of popular protest took place in Ukraine. The Supreme Court ruled in favor of another run-off election. Yuschenko was declared the winner with a 51.99% margin in an electoral system where 50% is necessary to obtain office. Since coming to office, Yuschenko has favored both NATO and EU accession. Additionally, Ukraine had not accepted all 29 of the principle accords to the four-nation Single Economic Space also consisting of Russia, Belarus, Kazakhstan. Coincidentally, or perhaps purposely, the Ukrainian parliamentary election was scheduled two months after the gas shut off. Yanokovich's party emerged victorious in the election and consequently, the Kremlin-favored party is now entrenched in parliament. If a goal of the dispute was to place the non-Kremlin party in a negative light in hopes of securing victory in the parliamentary election, than the tactic was successful. The pro-Kremlin Yanokovich has even publicly stated that "the only realistic way for resolving the gas crisis,"⁶¹ is for Ukraine to join the SES. Nevertheless, the

⁶¹ Ukrainskaya Pravda. Feb 6, 2006.

shutoff resulted in Gazprom and Russia gaining no stake in infrastructure as some analysts argued was a motivator in the shutoff.

Until recently, however, Russia still harbored hopes of gaining a share in Ukrainian infrastructure. In February 2007 Putin publicly announced that the Ukrainian government proposed to unify the Russian and Ukrainian gas pipeline infrastructure. Putin was positive about the prospects for such an unification as he has doubtlessly sought to take as much transit infrastructure as possible and place it under Russian control. Ukraine, for its part, denied suggesting any such proposal. Arguably, a unification of pipeline infrastructure with Russia would not only make Ukraine more dependent on Russia, but also reduce the bargaining power that it derives from its status as a transit state. Chairman of Ukraine's National Security and Defense Council Vitaliy Hayduk stated at a press conference that the proposal had been brought forth by a Putin aide, and therefore was not at the behest of the Ukraine. The Deputy Head of President Yuschenko's administration, Oleksander Chaliy, came forth to say that in a phone call with President Yuschenko, Putin had proposed that Ukraine receive rights to drill on Russian soil for oil in exchange for rights to Ukraine's pipeline infrastructure. Amidst the confusion, Ukraine passed legislation stating that it retains ownership of its energy infrastructure to ensure that Russia had no legal basis for any sort of asset swap.

The incident was largely seen at the behest of the Kremlin and brought back much of the political memory from the last presidential race. Yuschenko had opposed the proposal and denied any responsibility for it. "The existing gas transport artery is a strategic Ukrainian asset," said Yushchenko. "By law, the state has a monopoly over it and manages it, and everything related to modifying this model requires a very thorough

and cautious approach.”⁶² Yanukovich did not share Yushchenko’s viewpoint on the negative implications of a Russian takeover of gas infrastructure and referred to the new pipeline law as a “political game.”⁶³

Recently, Yuschenko has also been pushing back on the presence of RosUkrEnergo in the Ukrainian market. On February 14, 2007 he stated publicly that there will be no nontransparent activities in the Ukrainian gas sector. This public statement was accompanied by an order to investigate RosUkrEnergo, the presence of which has been a point of concern for various institutions including NGOs, the EU and former Prime Minister Yulia Tymoshenko.

RosUkrEnergo, a monopoly in its own right, is the sole importer of gas into Ukraine. RosUkrEnergo, furthermore, is likely an instrument of Gazprom and the Kremlin. The Ukraine intermediary and joint venture of Gazprom and RosUkrEnergo for selling to the market, UkrGazEnergo, is headed by Aleksander Ryazanov who is also Gazprom deputy head and former Sibneft CEO. RosUkrEnergo, furthermore, is now also allowed to export gas from Russia. The only other firm with this privilege is Gazprom. The Kremlin would be very unlikely to allow such privilege to a firm not in some way under its tutelage as the power to export from Russia is of extreme strategic and economic importance. According to a Global Witness report, Wolfgang Putschek, an executive at Raiffeisen Investment, has said that Gazprom effectively controls

⁶² “Yushchenko Says Too Early For Gas Venture With Russia.” *Radio Free Europe Radio Liberty*. Feb 2, 2007. <<http://www.rferl.org/featuresarticle/2007/02/2f6439fc-9d41-4b8b-9a0d-84a4caacf9b6.html>> accessed March 26, 2007.

⁶³ “Ukraine’s Prime Minister Criticizes Pipeline Law.” *Radio Free Europe Radio Liberty*. Feb 7, 2007. <<http://www.rferl.org/featuresarticle/2007/02/548cb508-e7f8-4532-878d-c3446764f11c.html>> accessed March 26, 2007.

RosUkrEnergo.⁶⁴ Thus, both UkrGazEnergo and RosUkrEnergo control gas imports to Ukraine and are heavily influenced by Gazprom, and consequently the Russian state. Officially Ukrainian co-venturer in UkrGazEnergo and state energy company, Naftohaz, has no stake in RosUkrEnergo. If this is indeed the case, Ukraine is severely limited in its power in its own market vis-à-vis Gazprom. To date, UkrGazEnergo has asserted its power by refusing to supply sixteen of Ukraine's largest industrial firms.

The 2006 shutoff was just one of several shutoffs in Ukraine timed in such a manner seen as being more than market-induced behavior, but rather as also politically expedient. With the shadowy nature of RosUkrEnergo, the new legislation on pipelines and the tension between the Yuschenko government and the pro-Kremlin parliament, it is likely that energy and politics will continue to play off each other in Russia-Ukraine relations for some time to come.

Belarus

Russia has used both the positive and the negative lever of its energy sources in its relations with Belarus. Russia and Belarus have had a traditionally strong relationship. For some time, Belarus enjoyed status as one of the favored former Soviet republics. This favored status manifested it itself, in among other things, an extremely favorable subsidized gas rate even after the rates of most other former Soviet states were raised in 2006. Russia has backed Belarus's authoritarian leader Alyaksandr Lukashenka. A

⁶⁴ Global Witness. "It's a Gas: Funny Business in the Turkmen-Ukraine Gas Trade." Global Witness Publishing. Apr 2006.

reunification of the two states was supposedly to be put to a referendum at some point this year.

The gas dispute that did occur between Russia and Belarus may be seen as coming at a time when Moscow was no longer willing to deal with Lukashenka. It has largely been financing the Belarusian economy for some time, but Lukashenka was unwilling to give Russia more control over the economy. Additionally, some have argued that supporting Lukashenka negatively impacted Russia's standing in the west and taking a firm stand against Belarus would serve to heighten it.

Gazprom threatened to shut off supply to Belarus on January 1, 2007 if it did not agree to a new price of \$105 per 1,000 cubic meters of gas. Gazprom agreed to negotiate the price with Belarus if given a 50 percent stake in its gas transit infrastructure. Belarus refused to pay the new price. In retaliation Belarus said if an agreement was not reached by January 1 it would not permit Gazprom the use of its infrastructure and would siphon any supply headed for Europe. Belarus ceded to Gazprom hours before the January 1 deadline. Gas prices in Belarus will incrementally increase from the new price of \$100 to full European prices by 2011. Gazprom, for its part, gained what it failed to secure in the Ukrainian dispute: a stake in Belarusian transit infrastructure. As part of the deal, Gazprom will acquire a 50% stake in Beltransgaz, the state-owned gas transport monopoly, over the next four years for \$2.5 billion.

Although the question of gas was largely resolved, the dispute regarding oil transit still remained. Belarus imposed oil transit fees on Russia. The transit fee, according to Belarus, was imposed because Russia, beginning on January 1 2007, levied a \$180 tax on every ton of oil imported to the country. On January 6 Russia announced its

refusal to pay the transit fee. Belarus, in reply, said it would take Transneft to court.

Russia has limited options for oil transport. The cut in supply affected Germany, Hungary, Poland the Czech Republic and Slovakia for three days. Belarus allowed for shipments to resume through the Druzhba pipeline network on January 11.

Even though the immediate energy issues were resolved, Belarus and Russia remain somewhat estranged. Following the dispute, Lukashenka did not decide to pledge allegiance to Russia once again, but rather made mention of possible closer ties with Europe and the United States. He said that "Russia has decided to trample our union."⁶⁵ However, allegiance with the west over Russia is unlikely as Belarus would have to make sweeping liberalizations. Russia is accepting of the Belarusian domestic and civic climate as it is. Russia has made steps to keep its relationship with Belarus secure. It has lowered the import tax from \$180 per ton to \$53. Additionally, it is maintaining an essential part of its relationship with Belarus that Lukashenka will be hard pressed to ignore – a \$5.8 billion subsidy, approximately 41 percent of the Belarusian budget.

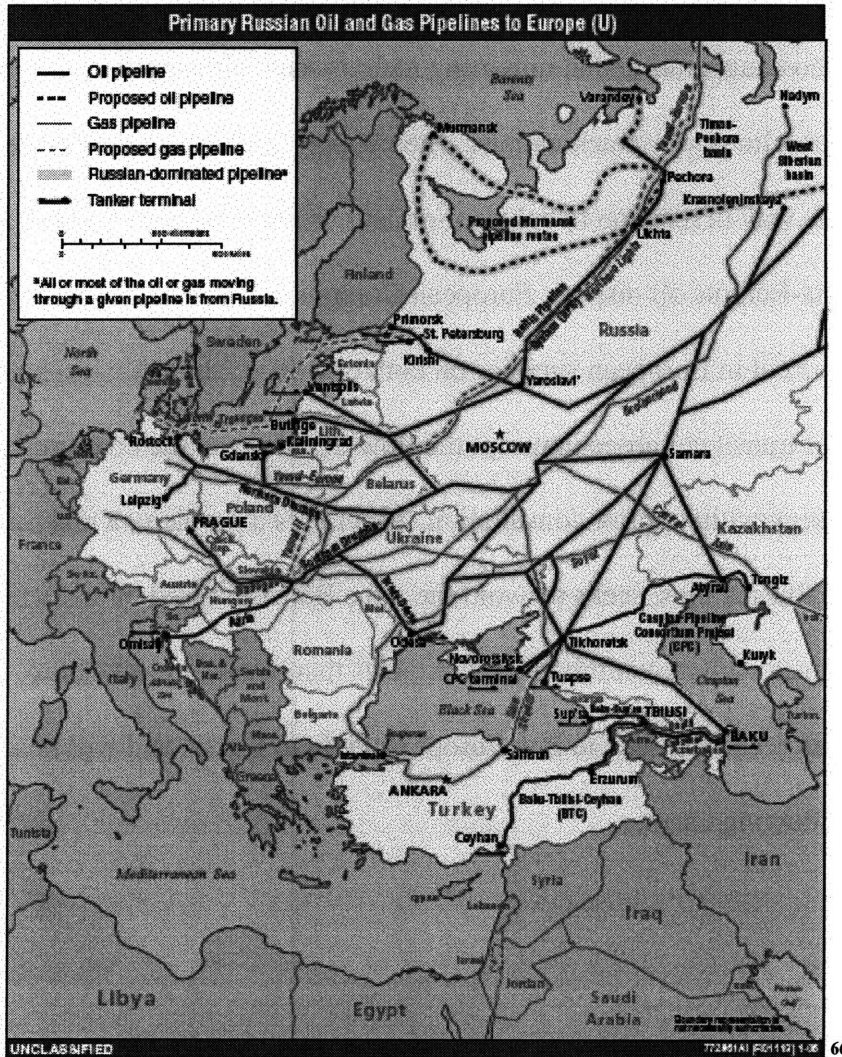
The Energy Weapon in Transit States and Its Implications

Russia currently does have the advantage when it comes to leverage over transit states. Given what seems to be the inequity in leverage, perhaps in the future transit states will band together to play their combined leverage against Russia. If transit states did combine against Russia, it could change the model of transit relations

The consequences of pursuing compliant behavior with the energy lever vis-à-vis transit states are also felt outside of the so-called near abroad. Russia's use of strong arm

⁶⁵ Buckley, Neil. "Belarus warms to the west after pipeline dispute." *Financial Times*. Jan 19, 2007.

tactics may effect its standing as a reliable supplier to other nations. Due to the nature of pipeline infrastructure, the effects of disruption are not confined to one state, but rather have a chain effect..



Pipeline structure running through Ukraine is designed such that a shutoff causes delivery interruptions in Slovakia, Hungary and into western Europe. Eighty percent of the European Union’s gas needs are piped through Ukraine. The remaining twenty

⁶⁶ Energy Information Administration. “Country Analysis Briefs: Russia: Natural Gas” <<http://www.eia.doe.gov/emeu/cabs/Russia/NaturalGas.html>> Accessed May 10, 2007.

percent is piped through Belarus. Belarus is the transit state for supplies to Lithuania, Germany and Poland. The 2006 Ukraine gas shutoff, for instance, affected European price and supply. During the time of the dispute with Belarus, European Union Energy Commission called an emergency meeting to discuss the possible impact on supply to the EU.

It is consequently no exaggeration that importing nations see their supply becoming vulnerable to Kremlin power machinations. Their supply could theoretically be disrupted in much the same way in reaction to behavior or actions not condoned by the Kremlin. During the Russia-Belarus oil dispute, European Commission President Jose Manuel Barroso blamed the cut in European supplies on both countries. "It is unacceptable that supply or transit countries interrupt the flow of energy to the countries that are consuming the energy without prior consultation. This raises a problem, a real problem, of credibility."⁶⁷ Russia, thus, seeks to avoid the issue Barroso raised by limiting its transit dependence with new infrastructure projects that bypass transit states entirely. Several of these projects will seek to link Europe directly to Russia and will be examined further in the following chapter.

⁶⁷ "Belarus Says Compromise Reached, While Russia Demurs." *RadioFreeEurope RadioLiberty*. Jan 10, 2007. <<http://www.rferl.org/featuresarticle/2007/01/37304d3c-a996-4979-92cd-fd718c87a37e.html>> accessed March 27, 2007.

Chapter 5: Foreign Investments: Enabling Addiction

Russia's energy strategy is not simply a matter of setting the rules of the game in its own market, or in its relations with transit and supply states. The import-export relationship forms the crux of the energy industry. Thus, a large part of Russian relations abroad will be based purely on supply-and-demand considerations predicated along the lines of importer consumption and attendant contracts. At the XXIII World Gas Conference in Amsterdam on June 6, 2006, Alexey Miller announced in his speech "Energy for the Planet" that "Gazprom export strategy is based on a single integrated export channel and a system of long-term contracts."⁶⁸ Such a business strategy has been clear for sometime and has been a cause for worry in net-importing countries.

For its part, the Russian Federation has steadfastly defended such a strategy as necessary for not only its own security, but for that of importing countries as well. In the same speech, Miller defended Russian strategy in relation to long-term contracts with Europe. "Long-term contracts provide for an indispensable comfort in the gas trading: constant gas supplies and predictable prices."⁶⁹ The model of long-term contracts and the integrated export channels are neither confined to Gazprom nor where the Russian energy strategy abroad ends.

Importers fuel the energy business and allow for Russia to generate and grow revenues. Russia has been making investments to allow it greater access to importers' markets and market share. One category of investments allows for Russian companies to enter the market directly. This is a well thought-out strategic move. Gazprom can value-

⁶⁸ Gazprom. "Energy for the Planet." Alexei Miller Speech for the XXIII World Gas Conference.

<<http://www.gazprom.com/eng/articles/article19731.shtml>> Accessed Oct 28, 2006.

⁶⁹ *ibid*

add by selling directly to the customer rather than just an importer entity. As Smith and Dzienkowski write in *A Fifty Year Perspective on World Petroleum Arrangements*, “By shifting into downstream activities, state oil companies invest capital in a very profitable end of the petroleum chain and protect the end market for their petroleum reserves.”⁷⁰

Another category of investments is that made in infrastructure directly linking Russia to major markets. Direct pipeline connection endows Russia with a variety of benefits.

Notably, it reduces incidence of transit dependence and deepens the influence Russia has on the country to which it is connected.

It is important to note that not all Russian investments abroad enhance power or maximize profit. The investments reviewed in the following pages are those that will eventually give Russia stronger market presence at the expense of other competitors, cut out intermediaries and strengthen dependence on Russian supply.

Gazprom and the United Kingdom⁷¹

Gazprom has taken steps to retail directly to the customer rather than simply be a wholesale supplier. In June 2006 Gazprom acquired the United Kingdom’s Pennine Natural Gas (PNG). According to Matthew Cowie of Energy Business Review the size of Pennine will not stop Gazprom from becoming a major United Kingdom presence.

“While PNG is currently one of the smallest gas suppliers in this market, the acquisition is strategically important as Gazprom has both the import infrastructure and the equity

⁷⁰ Smith, Ernest E. and John S. Dzienkowski. “A Fifty Year Perspective on World Petroleum Arrangements.” *Texas International Law Journal*. 1989.

⁷¹ This section was contained within the “European Union Energy Security and Gazprom,” written in partial fulfillment of the course “Globalization” with Professor Suzanne Berger.

gas assets to be capable of rapidly growing its customer base in the UK.”⁷² Gazprom has its share in the Interconnector pipeline that links the United Kingdom to Europe, gas reserves and will be able to pursue a price-led market entry strategy.⁷³ In contrast, Cowie asserts that the six largest UK suppliers must rely on National Balancing Point, the natural gas trading exchange for the United Kingdom, to meet their retail sales whereas

Gazprom Marketing and Trading general director Vitaly Vasilyev echoed Cowie’s views. Vasilyev met with *Kommersant*, a Russian daily newspaper, prior to defending Gazprom’s presence in the United Kingdom to parliament in the wake of the uproar surrounding the potential Centrica acquisition. When asked why Gazprom would be interested in a firm as small as PNG which only provides 31 million cubic meters per year, Vasilyev replied that it plans to grow the firm. “Gazprom never worked in the small retail sector and this will be our first experience, but the profitability here is much higher than in industry. We plan to develop Pennine and increase its client base by ten times.”⁷⁴

This inroad in the United Kingdom market was met with no major public resistance. However, when Gazprom made mention of acquisition of Centrica, the owner of British Gas and largest supplier of residential gas in the United Kingdom, London took major notice. Prime Minister Tony Blair had to make a public announcement that the British government would not stand in the way of a Gazprom bid for Centrica. The bid never came to fruition, but the idea of major Russian market presence and control of

⁷² Cowie, Matthew. “Gazprom: bearing down on the UK market.” *Energy Business Review Online*. Oct 5, 2006. <http://www.energy-business-review.com/article_feature.asp?guid=44B96D7D-CF26-494A-9CE8-1219EEB10C60> Accessed Oct 28, 2006.

⁷³ *Ibid.*

⁷⁴ “We Have to Ease the Doubts of British Society” *Kommersant*. July 19, 2006. Natalia Grib interview with Vitaly Vasilyev. <http://www.kommersant.com/p690987/r_1/%E2%80%9CWe_Have_to_Ease_the_Doubts_of_British_Society%E2%80%9D_/> Accessed Oct 30, 2006.

energy supply was enough to cause perception of possible security dilemmas in the future.

In comparison to Centrica, PNG likely did not appear to be as strategically important. Whereas Centrica was the biggest supplier through its British Gas holding that serves over 50% of the domestic market, PNG is one of the smallest and may be among the major reasons why the takeover was not met with as much controversy. Prior to being bought out, PNG only employed twelve persons.

In his interview with *Kommersant*, Vasilyev made a point to say that Gazprom's strategy was not at the then present one of taking control of major grid and distributions, but rather one of acquiring less-threatening market share in a manner that suggests building energy "brand" according to a more benign model like that of French or German firms.

We are not now talking about the purchase of companies such as Centrica that are integral parts of the British gas and electric system. First we have to ease the doubts of British society and convince it that Gazprom Marketing & Trading works on European standards and that it in no way differs from French or German companies. We have to build a system of relations with the British parliament and government like other European companies have.⁷⁵

Accordingly, one can infer that gaining downstream assets is only part of Russian energy strategy. The fuller strategy is to gain major presence while eliciting the reaction normally given to European counterparts rather than historic competitors. Gazprom has ambitions to secure 20 percent of the British gas market by 2010. Before the acquisition of PNG, it only met three percent of British demand in 2005.

⁷⁵ *ibid.*

The NordStream Pipeline⁷⁶

The reaction to investment activities in Germany has been decidedly more positive. But, as Europe's largest energy consumer this more positive attitude may be partly the result of a history of energy relations between the two states, or the percentage of Russian energy exports already in the German market. The Brookings Foreign Policy Energy Security Series: The Russian Federation terms Germany Russia's "closest Western energy partner since the 1970s."⁷⁷ According to the 1996 IEA Update on The Role of IEA Governments in Energy, Germany is Europe's largest energy consumer. Furthermore, the acceptability of Gazprom moves in the German market likely was buttressed by Putin's relationship with Former German Chancellor Gerhard Schroeder.

As Chancellor, Schroeder took clear steps to secure a German-Russian energy relationship. While still in office in September 2005 Schroeder signed the NordStream pipeline project with Putin. It allows supply to be piped directly through the Baltic Sea to Germany while bypassing transit states altogether. The pipeline will connect Russia not only to Germany, but also to the European Gas Network. Gazprom has a controlling share of 51% in the project with the remainder evenly divided by the German firms BASF AG and E.ON AG. German law does not allow third party access to gas pipelines, which will circumscribe the number of companies able to tap into gas supplies and to compete in the market. As such, Russia and Gazprom will continue to have a very strong presence in the German gas market for some time to come. Additionally, Germany will

⁷⁶ This section was contained within the "European Union Energy Security and Gazprom," written in partial fulfillment of the course "Globalization" with Professor Suzanne Berger.

⁷⁷ Brookings. "The Brookings Foreign Policy Energy Security Series: The Russian Federation." p. 13. <<http://www.brook.edu/fp/research/energy/2006russia.pdf>> Accessed Oct 30, 2006.

serve as the center of distribution for Gazprom gas in the EU. Wingas, in which Gazprom is shareholder, is owner of western Europe's largest natural gas reservoir with the capacity to hold more than 4 bcm of gas.

Shortly after leaving office in December 2005, Schroeder took on the chairmanship of the NordStream board. According to Gazprom Chief Executive Miller, Schroeder will be responsible in "reaching all strategic decisions on all areas of the company's activity."⁷⁸ Schroeder's role in the deal has met with sharp criticism as a conflict of interest. This criticism has only been exacerbated by the revelation that his government agreed on October 24, 2005 to guarantee a 1 billion euro loan to Gazprom. Schroeder claimed to have no knowledge of the loan offer. Additionally, he argued that the matter was not of substance since Gazprom did not take the loan.

Schroeder has been quick to dismiss assertions that the pipeline will negatively affect the energy security of European nations. The position of the gas pipeline is a point of major dispute with Poland, which it bypasses altogether.

⁷⁸ Whitlock, Craig and Peter Finn. "Schroeder Accepts Russian Pipeline Job: German Critics Charge Conflict." *Washington Post Foreign Service*, December 10, 2005; P A14

Nord Stream gas pipeline



Some argue that the Schroeder government decision to pursue the NordStream puts Poland in a precarious position. A fear of some nations including Poland is that once the NordStream is completed, other pipelines will close. Schroeder addressed these fears. "For more than 30 years Europe — particularly Germany — has not had the slightest reason to doubt the delivery loyalty, once of the Soviet Union and now of Russia."⁸⁰ He claims that the NordStream will not compete with those pipelines that currently supply gas to Europe and that it is meant to ensure adequate supply to Germany.

Schroeder's assertions on the maintenance of supply security have met with objections and criticisms. According to Eugeniusz Smolar, director of the Center for International Relations in Warsaw, "Germany ignored its partners and did damage to creating a common foreign and security policy for the EU."⁸¹ Matthew Bryza, the US

⁷⁹ Gazprom. "Major Projects: Nord Stream." <<http://www.gazprom.com/eng/articles/article18466.shtml>> Accessed May 10, 2007.

⁸⁰ Associated Press. "Schroeder defends pipeline project, Russia's record as supplier." *International Herald Tribune*. Nov 1, 2006. <http://www.iht.com/articles/ap/2006/11/01/europe/EU_GEN_Germany_Russia_Pipeline.php> Accessed Nov 1, 2006

⁸¹ Dempsey, Judy. "Pole wants Germans to drop claims: Kaczynski in Berlin, carrying grievances." *International Herald Tribune*. October 29, 2006

deputy assistant secretary of state for the Caucasus and southern Europe , citing weakened EU power in negotiating with Moscow and the pipeline bypass of Poland, reiterated Smolar's views in his interview with *Financial Times Deutschland*. "Very often the monopolist will work to cut a specific deal with an individual country . . . If that happens it's much harder for Europe to stand together."⁸²

Gazprom clearly has been working within Byzra's model of cutting special deals with specific nations. It has gained downstream capabilities through a swap with Wintershall, a subsidiary of its NordStream partner, BASF, a German gas distributor and retailer. The BASF-Gazprom joint venture, Wingas, is Germany's second largest retailer. In May of 2006 Gazprom swapped 35% of profits from its undeveloped Yuzhno Russkoye field, which is expected to provide supply for NordStream, for a 50% minus one share in Wingas.⁸³ This approach guarantees access to the German downstream market. Gazprom will not have to rely on middleman in its transactions. Presence in downstream markets reduces its exposure to price volatility. As the venture is a partnership rather than an acquisition, it may not seem as threatening to German interests especially with the prospect of profit as a tradeoff. But it gives Gazprom guaranteed access to the German market. According to Chris Weafer, Chief Strategist at Alpha Bank, "One of the frustrations we see and hear more and more in Russia, and from the Kremlin as well, is the fact that they feel that Russian companies are blocked from growing

⁸² Schmid, Fidelius, Wolfgang Proissl and Daniel Dombey. "US Uneasy at Germany's pipeline deal with Russia." *Financial Times*. Oct 30, 2006. <<http://www.ft.com/cms/s/dd7ae0fe-67ba-11db-8ea5-0000779e2340.html>> Accessed Oct 30, 2006.

⁸³ Greenwood, Richard. "Gazprom: Wingas swap is pragmatic route downstream" in *Energy Business Review*, May 8, 2006 <http://www.energy-business-review.com/article_feature.asp?guid=B39C8A3E-7172-4D8C-A9E1-18312DAA50DD>

internationally from accessing international markets and of course they are using energy as a lever - or more specifically a sledgehammer - to force their way in."⁸⁴

The Gazprom entrance in the German market also affords it access to other countries. Gazprom together with Wingas has made investments in storage facilities outside of Germany including Austria and England. Investments have also been made in the more than 2,000 kilometer pipeline system linking Russia throughout Europe. The BASF official website lauds the network which "provides WINGAS with access to the developing European spot markets."⁸⁵ Gazprom through Wingas will be poised with market share in emerging markets as they develop into mature consumers.

Gazprom and Italy

Gazprom has also made progress in the Italian market. Gazprom will be able to sell directly to the Italian market. In November 2006 Gazprom and the Italian firm ENI signed an agreement for a strategic alliance. The agreement resulted in ENI becoming Gazprom's largest customer. Although beneficial to both sides, it seems Gazprom may have the better end of the deal. In addition to securing ENI as its largest customer, its supply contracts extend to 2035 with increasing volumes. This move caused concern among Italian anti-trust officials as to what the net-effect would be for the Italian end-user. Given that the Italian gas market was only fully opened in January of 2003, the

⁸⁴ Simpson, Emma. "Gazprom's European Dilemma." Mar 26, 2007. *BBC News International*. <<http://news.bbc.co.uk/2/hi/business/6496555.stm>> Accessed Apr 8, 2007.

⁸⁵ BASF. "Gazexport and Wingas agree upon first deliveries of natural gas through the 'North European Gas Pipeline.'" Oct 13, 2005. <<http://www.corporate.basf.com/en/investor/news/mitteilungen/pm.htm?pmid=2009&id=V00-JTCGTAGlbc06L>> Accessed Apr 8, 2007.

market presence of a major player like Gazprom has the potential to push out the entrance of any smaller firms and thereby markedly reduce competition while increasing Gazprom power in the process.

The Gazprom entrance in the Italian market is of a somewhat different variety than the German case. Although the relationship may allow ENI to capitalize on certain synergies with Gazprom in its own market, it is likely that ENI is interested in fostering a close relationship with Russia, via Gazprom, in an effort to gain a foothold in the Russian market. Thus, ENI, for its part, has also thought strategically in its relationship with Gazprom. By forging ahead with contracts, it is building an energy relationship with Gazprom, and Russia. If this relationship is taken to the level ENI desires, it will be allowed access to Russia's reserves. Gazprom is taking full advantage of the Italian attempt to win favor. Its entry into the Italian market is only one of the benefits it has gained.

ENI has made other steps to ingratiate itself to Gazprom. It took part in a forced-auction of Yukos assets. Enineftegaz, in which ENI is majority shareholder and Enel holds a minority share, won the auction. Within an hour, ENI and Enel ceded control of the assets won at auction to Gazprom. Both firms had signed agreements with Gazprom prior to the auction that allowed the firm to take over the assets. By participating, the firms legitimized the auction. That they were willing to use their own capital in the auction, only to have the majority or all of the assets transferred to Gazprom underscores the power the Italian firms are willing to cede to Gazprom. As ENI opens up its domestic operations to Gazprom and assists Gazprom in gaining auction assets, it tries to curry favor in order to gain a foothold in the Russian market.

Gazprom and Russia are quick to utilize the potential entrance in their own market as a tool to gain advantages and concessions. Participation in the auction has allowed the Italians to have some minority stakes in Russia for an indeterminate amount of time. Leverett suspects that the Kremlin had made it known to ENI that it would be well-served to participate in the auction if it wants Russian access. Essentially a strategic bargain was brokered. The *Financial Times* hints at the governmental relationships behind the deal saying it came to fruition “following arduous talks with Gazprom, followed up by a phone conversation late on Tuesday between Mr. Putin and Romano Prodi, Italy's prime minister.”⁸⁶

Blue Stream

ENI also has presence in another major Russian investment. It is Gazprom's strategic partner in the Blue Stream pipeline. The Blue Stream will pipe gas directly to Turkey fulfilling the Russian strategy of bypassing transit states and minimizing transit dependence. Not only will the project reduce dependence on transit states, it will also allow Gazprom to maintain its presence in export markets. The pipeline will allow Gazprom to be the dominant Turkish supplier. From Turkey supply can make it to the European market. Turkey is a hub for supply from Iran and the Caspian headed to Europe. Consequently, Gazprom can maintain presence in the European market. Blue Stream is a pipeline of significant strategic importance for Russia because it will be a competitor to the BTC pipeline, which brings Caspian resources to Turkey.

⁸⁶ Belton, Catherine. “Russian bargain that comes at a price: The deal to buy prime Yukos assets follows a familiar pattern.” *Financial Times*. Apr 5, 2007.

Another connection to the European market could come by way of Hungary. The Hungarian firm MOL signed an agreement and set up a joint venture with Gazprom in June 2006 for a possible extension of the Blue Stream from Turkey to Hungary via Romania and Bulgaria. Much like the German role in the NordStream pipeline, Hungary would take on the role as the hub for supply coming from Blue Stream. Hungary is not necessarily an important market for Gazprom, as it is a transit center. Gazprom would like to build a 10 bcm storage facility there.

If this development comes to fruition, it would put Russia ahead of the competing Washington and European Union favored Nabucco pipeline. Nabucco, like the BTC pipeline, has the potential to decrease Russian market share because it would take Caspian supply to the European market via Turkey. Nabucco has been subject to delay and has had problems with financing. In seeking to extend the pipeline, Gazprom is aiming to remove a threat to its primacy before it takes form.

Refining Assets

Refining is the bridge between upstream and downstream capabilities. Russia has bridged the gap between the two subsectors with refinery investments. Although Russia has domestic refining operations, refinery ownership abroad will allow Russia to further build production chains to bring its range of capabilities from possession of raw resources to direct sales. Rosneft has teamed up with the China National Petroleum Corporation to build a refinery with a 70 million barrel annual capacity in China. Putin and Armenian president Kocharian have agreed to build a refinery in southern Armenia to process

Iranian crude oil. This project is slated to have a 7 million ton annual capacity and cost \$1.7 billion dollars. Russia has also been in talks with Kyrgyz authorities about two refineries in that country.

The Implications of Increased Presence: Gazprom in International Markets

Increased presence in European markets endows Russia with increased leverage. Consumers will continue to need Russian supply, perhaps in increased amounts, in the coming years. The use of the energy threat generally can be wielded upon Russia's customers with noticeable effect. For instance, in the case of Europe, Russia can verbalize possible intentions to supply Asian markets instead of European. Sergei Kupriyanov, Gazprom spokesman, publicly stated that Gazprom has other options for markets that it can supply. "We just want European countries to understand that we have other alternatives in gas sales. We have a fast-growing Chinese market, and a market in LNG in the U.S. If the European Union wants our gas, it has to consider our interests as well."⁸⁷ With infrastructure such as pipelines in place, it would be hard for Russia to make good on such threats in the short-term. However, just the possibility of threat can send the European Union and Brussels in a frenzy of rhetoric of diversification of supply and overreliance on Russia. For example, EU Commission President Barroso referred to EU dependence as an addiction that brings it weakness. "We have an addiction to energy, and like any addiction, it is even worse when you depend on someone else for that

⁸⁷ Buckley, Neil, Jean Eaglesham and Arkady Ostrovsky. "Gazprom in threat to supplies." *Financial Times*. Apr 20, 2006. p.1.

addiction."⁸⁸ Obviously, Russia is aware of the power it has emanating from its reserves and the dependencies of importers on its supply.

Russia aims to enable the addiction of its importers through its investments especially pipelines. The pipeline projects are of particular strategic importance for Russia. It will be able to export while minimizing transit dependence. It can protect its interests by reducing exposure to actors that could play upon weaknesses in its process to bring supply to market. Both pipelines grow the Russian foothold in the European market. Gazprom, and Russian, strategy is crafted in such a way as to bypass transit states, reduce dependence while cultivating permanent dominance and capture markets before any other source of supply can get market share. Increased presence not only is important for revenue generation, but also for the augmentation of Russia's diplomatic, geopolitical and geoeconomic presence in the states it supplies.

The European Union has made notice of its dependency on Russia for gas supplies. As member states take steps to decouple production and distribution, Russian Gazprom has been trying deliberately to bring both competencies together. This dynamic pairing of skills will give Gazprom, and relatedly, Russia, even greater power in some markets. According to Agata Loskot-Strachota of the Center for Eastern Studies in Warsaw, "In some member states, the gas market could become dominated by supplies from Russia, competition would be restrained, and freedom of access to these markets would shrink."⁸⁹ Russia, in hopes of maintaining and increasing market share in Europe, has pushed beyond investments that give it a strong presence in European markets. It is

⁸⁸ "Belarus Says Compromise Reached, While Moscow Demurs." *RadioFreeLiberty RadioEurope*. Jan 7, 2007. <<http://www.rferl.org/featuresarticle/2007/01/37304d3c-a996-4979-92cd-fd718c87a37e.html>> Accessed Apr 7, 2007.

⁸⁹ Dempsey, Judy. "Gazprom's bold moves lay bare EU's disarray." *International Herald Tribune*. Jan 11, 2007. <<http://www.iht.com/articles/2007/01/11/business/gazprom.php>> Accessed Apr 11, 2007.

also trying to establish coordinating relationships with other key gas exporters to Europe primarily Algeria, but also with Qatar, Libya, Egypt and Iran.

Chapter 6: Power Potential: The Prospects for Conversion

The Prospects For a Gas Cartel

An April 2007 study group in Doha, Qatar of the Gas Exporters Countries Forum led by Russia fueled speculation of Russia's aim to increase its power through an OPEC-like gas cartel. As of now, GECF is only an informal group of variable membership. It currently consists of sixteen states including Russia, Iran and Kazakhstan and accounts for approximately 70 percent of world supply. A grouping of gas exporting countries could work for various purposes. However, the nature of the gas market is inherently different from that of the oil market. Consequently, a gas cartel could not function or endow its members with the exact powers of OPEC, or any cartel ideal type.

To understand the power Russia could exact from such an organization, a review of the different dynamics afforded to OPEC through the characteristics of the oil trade versus that of gas is necessary. The oil market is a single-integrated worldwide market. Prices are essentially set through spot-trading activity while supply is set through term contracts. The price for oil contracts is indexed to spot or futures prices for benchmark crude plus or minus a quality differential and will be determined on a look-back basis each month. Since oil is generally shipped in tankers, cargo can be swapped. For importers, diversification of supply is a reality. Ease in real supply trading and diversification is simply not possible with natural gas trading in its current form.

The natural gas market is much less flexible and fungible than the oil market. Customers and sellers are locked into a relationship based on the nature of infrastructure. The great majority of gas is traded via pipeline. Pipelines, by definition, are fixed and

single destination with no possibility for supply swapping. Accordingly, pipeline gas deliveries are based on long-term contracts to ensure the security of both demand and supply. Fixed-term contracts of sorts prevail so that the buyer is obliged to pay some amount to the seller even if gas supply is no longer needed. At present, traditional natural gas supply rules the market. A liquefied natural gas market has the potential to act in a way conducive to an OPEC-like organization, or a cartel. But, LNG is still costly and requires major investments on the part of buyer and seller. As such, a system of long-term contracts still predominantly rules LNG although a spot market has developed.

Because the great majority of natural gas is limited by long-term contracts, an international organization of gas producers could not set quota in much the same way as OPEC. However, an organization could control other aspects of the market. Members could take a collective stand on issues facing gas exporters. For instance, a collective stand on the part of producers could work against European Union collective consumer interests. A cartel or collective could address producer-specific issues and what *Global Insight* business intelligence views as “real concerns of producers, many of whom find their positions weakened in the light of Europe's emerging collective energy policy and the abolition of destination clauses and moves to shorter-term contracts.”⁹⁰ The same report continues that in the European market in particular consumers are endowed with power while producers are left to operate alone against a collective-bargaining unit.

“European gas-market liberalisation is almost entirely geared for the benefit of consumers at the expense of producers.”⁹¹ Gazprom has already publicly announced that it finds long-term contracts to be in its best interests because they ensure it the protection

⁹⁰ Global Insight. “What About the Producers? The Other Side of the Russia-Algeria Gas Agreement.” <<http://www.globalinsight.com/SDA/SDADetail6767.htm>> Accessed Apr 8, 2007.

⁹¹ *Ibid.*

of security of demand. An organization of producers behind Russia might make it so that issues would not be framed in an EU versus Gazprom context as they often are.

Furthermore, the potential organization would gain significant market clout if other members, much like Russia currently, refuse to ratify the EU Energy Charter.

A collective stand could also be taken on what place price indexing to oil could have in the market place. However, this issue is more contentious. Several important factors will make pricing a monster of its own. The issue of price-setting is of a much different form than the international market for oil where marker crudes rule pricing. “Comparing gas prices is difficult because until recently, there hasn't been a global market for the fuel. Asian gas-delivery contracts have tended to be pegged to the price of crude oil, while in the U.S., spot gas prices are typically set by trading at a Louisiana pipeline hub.”⁹² Some have also argued that indexing to oil may be shortchanging producers. Natural gas could be much more expensive than oil in the future because countries have taken notice of the advantages of natural gas's clean burning properties. In an April meeting Energy minister Khristenko disclosed to EU Energy Commissioner Piebalgs that oil-to-gas indexing may be over.

Leverett contends that Russia is extremely interested in the possible use of a cartel so that member countries can allocate markets and market share. A collective arrangement would help Russia maintain its position as dominant supplier to the European market. This collective arrangement could be made even more secure by the coordinating relationships Russia has sought to foster with other gas exporting countries.

⁹² Gold, Russel and Gregory L. White. “Russian And Iran Discuss A Cartel For Natural Gas.” *Wall Street Journal*. Feb 2, 2007. p.1.

For now, talk of a gas cartel is enough to give Putin's Russia power. As Dmitry Butrin, a correspondent for Russian *Vlast*⁹³ argues: "Discussing a gas OPEC is an excellent means of putting pressure on consumers."⁹⁴ The next meeting of GEFC will be held in 2008 in Moscow. As such, the gas cartel remains just an idea. However, this has not stopped it from being devoured by the world press. It seems that potential uses of the energy lever previously unknown to the market make it appear that much more menacing.

Convenient Relationships: Russia and Its Gas Exporting Friends: Algeria and Iran

Russia has taken deliberate steps to cultivate relationships with its potential competitors in the gas trade. These aspects of its foreign policy fit into its energy strategy by promoting various tradeoffs with its potential rival producer that result in a form of protection of its dominance in particular markets. It has foremost struck deals with producers that could potentially provide customers in the European Union with the diversification of supply supported by Brussels.

A relationship of note is the Russian relationship with Algeria. Algeria is the world's fourth largest exporter of gas and Europe's third largest supplier. It is widely considered an alternative to supply from Russia for Europe. Russia has offered Algiers a variety of incentives to ensure cooperation in the European market. Having Algeria on its side would be a definite hindrance to the EU's plan to diversify supply. To make a friend of Algeria, Putin is willing to offer Algeria what other major players on the international scene will not: arms. Algeria will buy \$7.5 billion in arms including "40 MiG-29 fighters,

⁹³ Russian word for "power"

⁹⁴ Butrin, Dmitry. "Gas In the Face." *Kommersant*.

<<http://www.kommersant.com/pda/doc.asp?id=753021>> Accessed Apr 8, 2007.

20 Sukhoi-30 fighters, 16 Yak-130 training planes as well as 8 S-300 PMU2 Favorit rocket systems and about 40 tanks.”⁹⁵ Russia has also agreed to write-off Algeria’s \$4.74 billion Soviet-era debt. To sweeten the deal, Russia offered Sonatrach a choice of four gas explorations deals in Russia from eight fields.

Sonatrach’s exploration rights come from an asset swap under an August 2006 memorandum of cooperation. According to Gazprom,

The Memorandum opens way for deeper cooperation between the companies, identifying, among other things, the following major directions of further joint businesses in the oil & gas sector: geological exploration, production, transmission, gas transmission and distribution network development, asset swaps, natural gas and oil processing & marketing in Algeria, Russia and third countries.⁹⁶

It is joint marketing in third countries that will give Russia the power and clout to make it an even more formidable market player. Together the two countries control approximately 40 percent of the European market.

If the Moscow-Algiers relationship as well as the Gazprom-Sonatrach relationship becomes closer, transfers of technology could take place. Algeria has extensive experience dealing with LNG. Gazprom has asked Sonatrach to participate in construction of an LNG facility in Leningrad. LNG technology would help Russia in the development of its greenfields. However, the potential for such a joint project is unclear. Russia normally does not put its own money into projects with other investors. It prefers to have partners pay for expenses, while it claims project control.

⁹⁵ Faulconbridge, Guy and Hamid Ould Ahmed. “Russia Agrees to Algeria Arms Deal.” *DefenseNews*. Mar 10, 2006. < <http://defensenews.com/story.php?F=1590501&C=airwar> > Accessed Apr 8, 2006.

⁹⁶ Gazprom. “Gazprom and Sonatrach Ink Memorandum of Understanding.” Aug 4, 2006. <<http://www.gazprom.ru/eng/news/2006/08/20610.shtml>> Accessed Apr 9, 2007.

The Russian relationship with Iran is far less straightforward than its relationship with Algeria. Iran has the world's second largest gas reserves. Iran, like Algeria, has the potential to be a viable competitor to Russia in natural gas production. Natural gas could be piped from Iran to Turkey and then to European markets or northward to Armenia through Georgia and on to Europe.

Likely recognizing the possible competition Iran could bring to the market, Russia has been courting it to some extent. Russia had been assisting Iran with development of its first nuclear reactor, the Bushehr plant. This assistance, whatever it may have been in exchange for in a partnership between the two countries, would certainly fulfill any Russian goal of putting an end to the United States' place as hegemon in the current world unipolar moment.

Iran has not shied away from a coordinating relationship with Russia. Iranian Supreme Leader Ayatollah Ali Khamenei publicly suggested the idea of a gas cartel during the January 2007 visit of Russian Defense Minister Igor Ivanov to Tehran. "Iran and Russia can establish the structure for an organization of gas cooperation like OPEC, as half of the world's gas reserves are in Russia and Iran," Khamenei announced on Iranian state television.⁹⁷

The prospects of this possible coordinating relationship are unclear. Policy on the part of both states is mixed in relation to any sort of partnership. Oftentimes the relationship seems to be less one of coordination than one of competition. Iran and Armenia recently jointly opened a new natural gas pipeline. Although it had been subject

⁹⁷ Reuters. "Khamenei urges Iran and Russia to set up OPEC-style cartel for natural gas" *International Herald Tribune*. Jan 29, 2007. <<http://www.iht.com/articles/2007/01/29/business/gas.php>> Accessed Apr 10, 2007.

to over a decade's delay, the now completed project limits Armenia's dependence on Russian supply. To counteract the pipeline, and possibly as comeuppance for losing uncontested dominance in a market it previously controlled, Gazprom purchased Hrazdan-5, the power plant into which the pipeline feeds. Hrazdan-5 was supposed to provide Iran with electricity in return for the loans and capital it gave Armenia to build the plant. Furthermore, by reasserting its control of the Armenian market, Russia has effectively blocked a possible Iranian transit route to European markets. The route through Turkey similarly lacks potential for Iran in the aftermath of the Turkish gas bubble and the existing energy relationship between Turkey and Russia fostered during the crisis.

In yet another foreign policy move devoid of signs of a coordinating relationship, Russia delivered another blow to Iran when it stopped planned March deliveries to the Bushehr plant. This action may have been predicated on other foreign policy issues. Continuing with the Bushehr project would tarnish international standing. Iran had refused to cooperate with the United Nations and the International Atomic Energy Agency. For Russia to cooperate with Iran in that context would simply be foreign policy folly. It would serve to dampen the leverage and standing it has gained through its pursuit of energy strategy in other areas. It is no surprise that Russia announced it would not proceed with Bushehr as planned as the entire United Nations Security Council discussed imposing additional sanctions on Iran.

What coordination the two states will have in the future is to be determined. Russia likely recognizes that it does not need to coordinate with Iran to the extent it has with Algeria. Iran will not soon develop into a major competitor without investment in its

natural gas industry and infrastructure. Given the sanctions currently imposed on the state, the necessary capital influx will not come in the short-run. Perhaps the only coordination in the future will be dependent on the maturation of a GEFC agenda.

Neglecting Investments In Its Own Backyard: A Strategy to Demise?

Russia has been making investments in foreign projects while pushing out investments in its own domestic market. Not only does this strategy lead to a lack of reciprocity in investor relations, it has the potential to leave domestic infrastructure and projects to decay. This neglect is evidenced in the case of Gazprom investment. According to a Stratfor report the neglect of Russia's own infrastructure and projects is an investor-based issue. "Gazprom has not invested in new infrastructure while its existing infrastructure has decayed, since Gazprom wants foreign investors to provide the money."⁹⁸ But, continually denying investors any reciprocity in its markets may eventually erode the Gazprom advantage of taking control without putting forth capital. But for now, it seems that the pull of even a meager presence in hydrocarbon-rich Russia will negate the lack of vibrant reciprocity for western investors willing to hand out credit and capital.

In the days before the Group of Eight Summit in St. Petersburg Claude Mandil, head of the International Energy Agency criticized Gazprom openly for its lack of investments and its repercussions. "Gazprom has not invested enough in developing new fields or enhancing recovery in existing fields to offset the decrease in its three major oil

⁹⁸ Stratfor. "Algeria, Russia: Europe's Natural Gas Dilemma" Strategic Forecasting, Inc. Aug 9, 2006.

fields...And it has not invested enough in improving the reliability of the transport grid. That means we are not sure there will be enough gas for the commitments it has taken."⁹⁹

Russian foreign policy and energy strategy are working together to meet demand for all commitments by way of third country supplier states. Even if Russia is able to meet its export commitments, lack of investment in fields and power infrastructure would weigh heavily on a country which derives its only significant source of economic power from its hydrocarbons. If the basis for so much of its policy is, in fact, energy, then perhaps the lack of investment to bring significantly more production online in the near future is as deliberate as other policy decisions covered thus far.

Domestic investment is certainly subject to the power machinations of individual political elites interested in further personal enrichment. Furthermore, Russia, as many argue, is not thinking to the future, only to the 2008 presidential election. After the election, many investment issues may be sorted out once the new power progression is clear.

Despite these internal political factors, lack of investment may be an inaccurate portrayal of what is actually a deliberate calculation. By not monetizing all of its resources, Russian strategy may seek to grow their value by leaving them in the ground while customers anxiously await their extraction and production. The longer it takes a field to be developed, the more anxious a customer facing a supply crunch will become. Development of the field could play out in such a manner that the customer offers to finance the project – a strategy well-known to co-venturers in Russian projects. In other words, Russia may be playing the market.

⁹⁹ Dempsey, Judy. "Energy Agency Criticizes Gazprom." *International Herald Tribune*. July 7, 2006. p.1.

Russia Goes It Alone

Russia is likely unwilling to bind itself to any organization to limit its power in the market or set price. Russia has never joined OPEC, even though it is the world's second largest oil exporter. Furthermore, Russia controls the Gazprom monopoly, which holds a 20% share of gas to the world-wide export market – a figure that will grow as Gazprom tries to reach its \$1 trillion capitalization. The power seems to already be in Gazprom's hands. And if Russia does not have the power through Gazprom and its collection of state-owned and state-friendly energy companies, it certainly maintains the perception of power, which in turn gives others the perception of threat. This dynamic could either be the makings of a security dilemma or a powerful energy lever. Energy policy, as has been demonstrated, is an avenue to secure Russian interests foremost of which is to be a power to contend with. Perhaps what Dmitry Trenin, deputy director of the Moscow Carnegie Center has said is true. "Russia now has only two allies, oil and gas."¹⁰⁰

Certainly, Russia has used oil and gas as solid supporters of its strategy. The execution of Russian energy strategy is incredibly intricate involving a host of various pieces coming together almost synergistically including the state, firms, suppliers, degrees of ownership, transit points – all of which put Russia on the path to power, whether it be for the state itself or through cartelization. By controlling the domestic energy industry, pushing out foreign direct investment to gain control of assets and their monetization, entering international markets, and practicing politics to keep transit and

¹⁰⁰ Yasmann, Victor. "Moscow Intensifies Its Energy Diplomacy." *RadioFreeEurope RadioLiberty*. Mar 7, 2007. <<http://www.rferl.org/featuresarticle/2006/03/2d66bf7a-c26f-4851-be2e-0cd47e50d972.html>> Accessed Apr 9, 2007.

supply states within its sphere of influence, the Russian Federation has mimicked the steps a corporate entity would undertake to create and secure vertical integration.

Resources belong to the state and are in essence totally controlled by it. The domestic majors are either state-owned, state-controlled or state-friendly. Those energy companies that are private enterprises flourish within sectors outside the unspoken bounds of the state. They cede control to the Kremlin wherever and whenever necessary to avoid the fates of Yukos and Sibneft, two mighty corporate entities essentially rolled into the possession of state monopolies.

Russia's strategy however, exceeds the bounds of the corporate sphere. The state aims to keep its former republics, now titularly transit and supply states, within its sphere of influence in order to capitalize from the infrastructure already in place from the years of Soviet Union dominance in the region. Russia has taken special effort with supply states. It views relations with them of particular strategic importance as domestic needs increase while online production capacity decreases. Transit states are tolerated, but care has been taken to bypass them with investments abroad in transit infrastructure. Foreign markets are where Russian energy strategy will eventually come to fruition. Russia is attempting to create market dominance through significant infrastructure projects and the establishment of direct retail operations which cut out indirect, third party players while conferring additional market and monopolistic powers upon Russia. The purpose of such undertakings is to endow the Russian Federation with an appropriate vehicle to maximize its international standing economically and geopolitically and power, whether utilized or not, according to the criteria of the state.

A real increase in power and international standing would not only have an importance to the Russian Federation, but also for the world stage in general. Power increases for the Russian state would be of little impact in a vacuum absent of other nations states. The increase in power has potential for considerable impact as nations vie for status as the power contenders among the major world players. The current balance of world power places the United States as hegemon in a moment of unipolarity. More than mere speculation points to a Russian aim of bringing an end to the United States' unipolar moment. While in office former Russian Foreign Minister Yevgeni Primakov suggested the Primakov doctrine as an alternative to United States hegemonic status. An analysis of the success or follow through of such a strategy is beyond the scope of this work. However, its mere suggestion and subsequent pursuit, regardless of degree or success, is an indication of the overarching goal to which Russia hopes to apply hydrocarbon wealth capable of conversion to power, whether economically, geopolitically or militarily.

In more recent time assertions of state power have been made by Sergei Ivanov, Russia's Defense Minister. In an *Izvestiya* article published before the G-8 summit in St. Petersburg entitled "The Triad of National Values," Ivanov asserted: "Russia has fully reclaimed the status of great power -- the one that bears global responsibility for the situation on the planet and the future of human civilization."¹⁰¹ The triad encompasses the hydrocarbon wealth of Russia and its power. According to Ivanov the values of sovereign democracy, strong economy, and military might will help advance Russia's international position. A sovereign democracy was theoretically born following the collapse of the Soviet Union. A strong economy has been born on the back of oil and gas. Military might

¹⁰¹ Torbakov, Igor. "CIS Summit: Gathering Will Likely Flop But Moscow Is Intent To Continue Throwing Its Weight Around." *Eurasia Daily Monitor*. July 21, 2006. Vol. 3. No. 141. <http://www.jamestown.org/edm/article.php?article_id=2371303> Accessed May 10, 2007.

can be seen as on the rise in part from the rise of Russia's oil and gas power. There has been a noticeable rise in Russian military spending since 2000, the year which marked a turn around in world energy prices and the Russian economy. The government plans to overhaul its military infrastructure to exceed what Ivanov terms Soviet "combat readiness" at the cost of \$189 billion over eight years.¹⁰² Such increased military power will likely have the most impact on the post-Soviet space. Russia has not only worked to keep post-Soviet states within its sphere of influence because of energy concerns, but the area is also one in which it is fully capable of becoming a dominant power. Increased status in its near abroad, coupled with increased military power, serves to project a more powerful image of Russia on the world stage.

The conversion of and related power from resource wealth makes Russia a case of exception. Unlike other countries in possession of vast energy resources which simply seek to secure revenue and markets, Russia aims to move beyond the scope of worldwide business conglomerate. Building a vertically integrated system does not presuppose an end of energy corporation on the worldwide scale. Rather the means is the range of business activities and the end is that of international power politics. In consolidating its economic sphere through its energy reserves, Russia is simultaneously strengthening its geopolitical, military and political capabilities.

¹⁰² Harding, Luke and Ian Traynor. "Big rise in Russian military spending raises fears of new challenge to west." *The Guardian*. Feb 9, 2007. <<http://www.guardian.co.uk/russia/article/0,,2009339,00.html>> Accessed May 10, 2007.