

**RUSSIAN ENERGY POLITICS AND THE EUROPEAN UNION**

by

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by

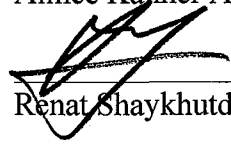
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This thesis was prepared under the direction of the candidate's thesis advisor, Dr. Robert Rabil, Department of Political Science, and has been approved by the members of her supervisory committee. It was submitted to the faculty of the Dorothy F. Schmidt College of Arts and Letters and was accepted in partial fulfillment of the requirements for the degree of Master of Arts.

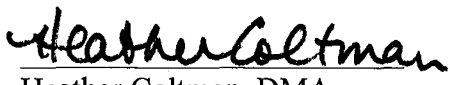
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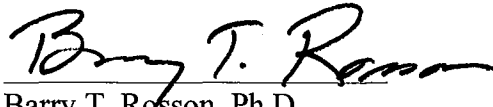
  
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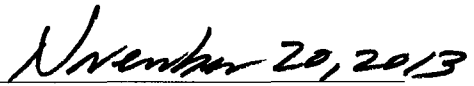
  
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## **ABSTRACT**

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In this thesis, I examine the politics of European Union (EU) and Russian energy relations. The main analysis is focused on the Russian energy policy towards the European Union and whether or not Moscow's attempts at deepening reliance on Russian's natural gas are a part of a Russian broad strategy or to gain political leverage vis-à-vis European countries. More specifically, this thesis focuses on the state-owned natural gas company Gazprom as a tool of Russia's energy policy and the extent to which Russian authorities use this company to shape the politics of EU – Russian energy relations. This study investigates whether Gazprom has become an extension of the Russian government, and whether the company has been used as a leverage tool to affect relations between the EU and Russia. Finally, this study also traces the tremendous growth of the EU – Russia energy partnership by examining several ongoing projects.

## **DEDICATION**

This manuscript is dedicated to my family. This thesis could not have been completed without the help of my wonderful parents, Ivan and Liudmila, and their love and support. I would also like to express my deepest gratitude to my amazing husband Dean, for his endless love and support, and to our sons Dylan and Preston, for completing our lives. Without you, this would have been just a dream.

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## INTRODUCTION

*“Not everyone likes the stable, gradual rise of our country. There are some who are using the democratic ideology to interfere in our internal affairs”*

*Vladimir Putin*

The Soviet Union was endowed with immense oil and natural gas reserves, which were strategically used to encourage industrialization, regional integration, and state building. The republics of the Soviet Union and East European satellite states were allotted oil and gas by the Soviet planners at prices well below those of the world market while energy exports earned much higher prices. As a result, oil and gas dominated Soviet export earnings, reaching as high as 75 percent of the total. As energy analyst Mikhail Korchemkin explains, “For nearly forty years, Soviet oil and gas export authorities operated in two entirely different markets—the world market and a separate market consisting of countries with centrally planned economies.” Undoubtedly, such energy subsidies were crucial for the process of industrialization. Natural gas was especially important for the industrial sectors of the Soviet Republics, and it eventually became the single most important resource in the regional economy.

After the fall of the Soviet Union in December 1991, it was precisely natural gas – and the miles of pipelines that were used for transport it– that continued to

tie the new states' economies together. Following the breakup of the Soviet Union, the Russian leadership led by President Boris Yeltsin, set out to find new methods of continuing to exert control over its former Soviet sphere of influence. Severe tactics, such as the 1990 energy blockade to the Baltic States, were executed in attempt to prevent their breakaway from the Soviet Union. When that failed, the Kremlin focused on the growing opposition in the former republics of the Soviet Union and in East Central Europe to its foreign and economic policies. In particular, there was a pressing demand from the former republics that Russian military forces be withdrawn from the newly independent states, which was not met favorably by the Russian Federation. As result, the Kremlin realized that short of military action, its foremost foreign policy tool was going to be the denial, or threat of denial, of access to Russia's vast gas resource and the mastermind behind this plan was soon to assume the leadership role.

Indisputably, Vladimir Putin had a vision for how energy should play a role in Russia's future (Goldman, 2008). While serving as the deputy mayor of St. Petersburg, he wrote an academic thesis that emphasized Russia flexing its "energy muscles" as a foreign policy tool. In his words,

Regardless of who is the legal owner of the country's natural resources and in particular the mineral resources, the state has a right to regulate the process of their development and use. The state should act in the interests of society as a whole and of individual property owners, when their interests come into conflict with each other and when they need the help of state organs of power to reach compromises when their interests conflict (Goldman, 2008).

When President Yeltsin selected his successor, it was no secret that Putin had specific objectives for the role of the energy sector of the Russian Federation. He brought into power former intelligence colleagues from his days in Leningrad and appointed several of



his former KGB officials to key positions in the nation's state-run energy company. As a result, Putin acquired greater control over the country's most economically and politically vital resource base. As the following research will show, once President Putin, his successor President Medvedev, and their respected governments consolidated power, the use of energy exports as a foreign policy tool increased substantially. As a result, sudden disruptions of energy supplies, political intimidation, and threats became tactics that were frequently used by the Russian government.

Such actions should have alerted the European Union, but failed to do so. The need to diversify sources of energy imports has always been a dividing subject for the European Union, as there is a clear disagreement between the member states on how it could be accomplished and whether it is feasible. As a result, Russia remains the largest supplier of natural gas to the European Union. The majority of the West European political elite display content with the immense reliance on Russia for natural gas, which can be illustrated by several completed and ongoing pipeline projects, which will only further solidify the existing partnership.

Following the collapse of the Soviet Union, the Russian government made a crucial decision of retaining majority control of its natural gas sector. Unlike Russia's oil industry, which faced privatization, the natural gas industry has since remained firmly under governmental control. As a result of this move, the state-owned gas company Gazprom was created. One of the main aspects of this study will be to examine Gazprom and the level of influence exerted by the Russian government over its operations. Assessing this entity is fundamental to fully understanding the level of government involvement in Russia's natural gas sector. Gazprom's history, leadership and ongoing

projects will be evaluated thoroughly in order to gain a better understanding of the intricate relationship it has with the Russian government.

Currently, Gazprom controls one third of the world's gas reserves and it supplies over a quarter of Europe's natural gas. Thus far, the Russian government has successfully exercised its control over Gazprom by manipulating gas supply to its transit and consumer nations. President Putin has also effectively used personal diplomacy with individual European leaders to achieve energy deals that benefit companies in individual countries (such as Germany, France, and Italy), and these direct negotiations have deterred the European Union from carrying out a unified energy strategy (Smith, 2008). This is a tactic that has been identified as "divide and conquer" (Gonchar, 2009). Such actions by the Russian government have created what scholars refer to as the "politics of gas", which is an aspect of the European Union - Russia relations that this research will investigate thoroughly (Smith, 2008; Gomart, 2008; Cameron, 2009; Truscott, 2009).

This study focuses on two interrelated questions. The first question examines whether or not Russia uses its growing supply of natural gas to the European Union as leverage in its European foreign policy. The second question investigates the nature of the relationship between the Russian government and the gas giant company Gazprom, and evaluates the extent to which Gazprom functions as an extension of the Russian government. Without gaining a full understanding of the relationship between the Russian government and Gazprom, it would be difficult to gauge *exactly* how Russia has or would be willing to manipulate its European foreign policy via natural gas supplies. Fully understanding the nature of the relationship between the Russian

government and Gazprom would allow for an analysis of whether natural gas has evolved from being an asset into being a political weapon.

The materials used in this research will be based on primary and secondary sources. Documents pertaining to the origin of Gazprom have been acquired, in their original language, from the database of the Russian Federal Assembly. Most of the secondary sources were published by the Center for Strategic and International Studies (CSIS), The German Marshall Fund of the United States (GMF), Harvard University, and the Oxford Institute for Energy Studies. Scholarly publications and journal articles were examined to understand the history behind the subject. Several Russian books on the subject were read in order to gain a better understanding from a local source (cited in the Reference section).

Newspaper articles and similar journalistic pieces were reviewed in order to provide a direction and timeline for the history of the Russian natural gas industry. As one of the most important aspects of the Russian economy, there were countless articles available to review in publications such as BBC, The New York Times, and several Russian online publications. It should be noted that several of the Russian newspapers that were used for this research are state-owned and, therefore, subject to bias.

## **I. SOVIET UNION NATURAL GAS HISTORY**

### Overview

The Soviet Union natural gas industry has often been referred to as the “bridging fuel”, mainly due to its ability to transition the Soviet Union economy from decades of oil toward the next century of fuels. Ever since its discovery, natural gas has played a crucial role in the Soviet economy. Hardly given much attention, the gas industry emerged quietly and operated on an average level. Initially, the natural gas industry was outshined by the star of the Soviet economy: the petroleum industry. However, the Soviet gas policy, which eventually emerged, has been considered one of the few success stories of the Soviet economy. Scholars have asserted that, without this discovery of natural gas, the Soviet economy would have been in serious trouble. The following chapter examines the foundation of the Soviet Union’s natural gas policy and the impact it made on Soviet Union – Europe foreign relations.

### Background

During the 1950s, Soviet economists evaluated the broad features of the existing economy and labeled certain sectors as bottlenecks to further development. The coal industry was not as profitable as it once was and additional options needed to be explored. While “in 1940 coal accounted for more than 70 percent of all mineral fuel consumption and oil and gas accounted for only 24 percent, in 1972 coal is to account for only about 30 percent and oil and gas to account for more than 60 percent” (Lydolph and

Shabad 1960, 461). As a result, the Soviet economists developed a plan with the primary goal of shifting Soviet economic dependence from coal to oil and natural gas.

The Soviet plan was ambitious and carefully calculated. The pattern that began to emerge represented a general shift of Soviet economics, which was characterized by shying away from the over-conservative policies of the past. The plan was cost-efficient, as the production of oil and gas was considerably cheaper than coal. In essence, these decisions indicated a shift in strategy. The discovery of natural gas stimulated the Soviets to begin thinking and acting based on economic principles.

Although oil had always been a viable and strong industry for the Soviet Union, it was natural gas that proved to be an exceptional asset. Remarkably, until the 1950s little or no gas was produced. It was primarily burnt off in open flares in most oil fields. According to research published in 1960, “while capital investment in the U.S.S.R. in the oil industry in 1958 increased 15 percent over 1957, in the gas industry it increased 48 percent” (Lydolph and Shabad 1960, 468). It soon became clear that natural gas began to play a crucial role in the Soviet economy and it was no longer regarded as the “humble stepchild of the oil industry” (Gustafson 1989, 138). Prompted by this success, the Soviet government began to invest heavily in the exploration for more natural gas fields, which proved successful with the discovery of countless more deposit sites.

The 1960s presented a challenge for the Soviet Union, which it took on ambitiously: expansion of its natural gas industry into Siberia. By the second half of the 1970s, it was clear that the Soviet plan was on the right track as production surpassed all expectations. Gustafson argues that it was this pivotal period, which was marked by the development of the first West Siberian gas fields and the construction of large-diameter

transcontinental pipelines, that marked the decline of petroleum and the beginning of natural gas emerging as the star performer.

As the natural gas industry began to explode, the Soviet Union started to experience the pressures of operating a major program in which domestic and foreign issues were extremely complex and fundamentally intertwined (Gustafson 1989, v). The new gas campaign required major changes in domestic policy in order to deal with the foreign opportunities and problems posed by energy. In addition, major changes in foreign relations were required in order to solve domestic energy problems (Gustafson 1989, vi). According to Gustafson, “the gas program represent[ed] the new pressures and opportunities the Soviet Union faced in the 1970s as a result of its increased participation in the world economic market” (Gustafson 1989, vi).

Upon the discovery of even more and considerably larger deposits, what followed was the addition of several world-class gas fields to their growing arsenal of production sites. Slowly, the Soviets were now operating a natural gas industry that was envied by countries all over the world. However, in 1973, concerns began to surface that inadequate oil exploration would lead to the eventual lack of oil reserves. According to several reports, there was not enough oil in either the Tiumen or Middle Ob fields, which up until then had been the highest producing oil fields in the Soviet Union, to provide an adequate base for further expansion of Soviet oil output past 1980. Despite these concerning findings, the situation did not escalate into a panic. However, 1973 proved to be a pivotal year as there were no more supergiant oil fields ever discovered in West Siberia. Eventually, as more emphasis was placed on the natural gas industry, the Soviet

energy sector found itself going from a low-cost (coal, oil, etc.) to high-cost during the 1970s (Gustafson 1989, vi).

Once the troublesome decline in oil supplies was combined with the decline of the coal industry, gas clearly became the only Soviet energy source able to meet the demands set forth by the government. By late 1977, the Soviet Union was facing an imminent energy crisis and began to turn away from coal. The initial stress on finding more oil reserves began to diminish and by 1979 a new policy emerged: a balanced approach, with an emphasis on natural gas.

#### The 1973 OPEC Oil Embargo Facilitates Soviet Gas to Reach Europe

The key moment for the Soviet Union-Europe natural gas dependence can be traced to the 1973 Organization of Petroleum Exporting Countries (OPEC) oil embargo imposed on the United States and several European countries (Goldman 2008, 46). Created in September 1960, OPEC was established to prevent private oil companies from cutting the price of the petroleum they purchased from Saudi Arabia, Kuwait, Iraq, Iran and Venezuela. These original members of OPEC attempted to do so by regulating how much petroleum each of these countries could produce and, therefore, regulate worldwide supplies (Goldman 2008, 46). But, while the rest of the world's major petroleum exporters began to curtail their production and exports, the Soviets continued to push ahead and increased their political leverage and earning power (Goldman 2008, 46).

The 1973 oil embargo imposed on the United States and several European countries provided the Soviet Union with a “golden opportunity” (Goldman 2008, 46).

The bad boy image that the Soviet Union had acquired through its actions up until that moment was now miniscule in size compared to that of OPEC. After the 1973 crisis, energy consumers around the world gained a clear understanding that reliance on energy supplies from the Middle East involved massive risks. Therefore, they asked themselves: “how much more risky could reliance on the USSR be?” (Goldman 2008, 47).

Although the 1973 oil embargo directly affected the petroleum sector, it had a major spillover effect on the Soviet Union’s natural gas industry. As the Soviet Union’s industrial output continued to soar, so did the demand to export more natural gas. And, shortly after 1973, customers across Europe no longer faced resistance to buy petroleum and natural gas from the Soviet Union. Essentially, the 1973 Oil Embargo forced customers in Western Europe to search for ways to reduce their dependence on the “now uncertain imports from the Middle East” (Goldman 2008, 47).

Even though buying natural gas from Russia certainly had its advantages, there were also serious risks (Goldman 2008, 47). As Goldman explains, “because pipelines needed to supply natural gas are very expensive to construct, no one can afford to build a second standby pipeline from some other supplier as a reserve for emergencies” (Goldman 2008, 47). And, despite the setup of the European pipeline network, which links up three major sources of supply (Russia, the North Sea, and Algeria), consumers tend to become dependent on a single dominant supply source (Goldman 2008, 47). This, in turn, makes them vulnerable. Unlike petroleum, which can be delivered to its destination by tankers from almost anywhere in the world, natural gas travels through an expensive pipeline infrastructure. And, when a pipeline is built from a supplier to a consumer, there is rarely an easily available option of backing out from an agreement and



acquiring natural gas from another source. For this specific reason, the upcoming project, the “Urengoy-Uzhgorod” pipeline, between Russia and Western Europe indicated the beginning of an escalated European reliance on Russian gas. Not surprisingly, this was not welcomed news for the United States.

The “Urengoy-Uzhgorod”, a massive pipeline completed in 1985, was what the United States had feared all along. This pipeline enabled the supply of Soviet Union natural gas, which was fairly reliable, while Western Europe began to feel comfortable with their newfound partnership (Goldman 2008, 48). The governments of France and West Germany, who were eager to reduce their dependence on OPEC following the 1973 Oil Embargo, fully supported this project. And, not surprisingly, this pipeline project emerged as a sign of what the United States, under the leadership of President Reagan, had feared all along: strong reliance on natural gas might make Europe vulnerable to Soviet political pressure.

In a February 2, 1982 report titled “Overview of the Siberia-to-Europe Natural Gas Pipeline”, the Central Intelligence Agency (CIA) warned the Reagan Administration:

Increased dependence on Soviet gas will almost certainly influence European decision-making, despite likely efforts to provide a cushion against supply cutoffs. The Soviets conceivably could exacerbate European differences with the US over future economic sanctions against the USSR or even over more sensitive issues such as NATO force modernization (Central Intelligence Agency, Office of Soviet Analysis, 2).

The CIA report investigated and proposed several tactics for stalling the pipeline from being completed. President Reagan, following the report’s recommendations, did everything within his power to prevent the pipeline from being

built. He reached out to British Prime Minister Margaret Thatcher, asking her to persuade the British firm, John Brown Engineering, not to sell the Soviets the compressors they needed to transport gas through the pipelines (Goldman 2008, 48). Similar requests were presented to General Electric (GE), another manufacturer of turbines and compressors. This became known as the “American Embargo of December 1981”, and it essentially blocked GE from exporting to its West European licensees key components for the gas turbines that the Soviets had ordered for their pipeline (Gustafson 1983, 92). This proved to be a problem for the Soviets and they retaliated to the American ban with defiance, vowing to defeat the embargo by producing domestic substitutes. In the end, as all of these efforts failed, the pipeline was completed and Europe’s reliance on Soviet gas began, with Soviet gas exports nearly doubling between 1985 and 1990.

Once the Siberia-West Europe pipeline was completed in 1985, gas began to flow steadily. The occasional setbacks and stoppage were primarily due to the cold weather. Despite fears, the Cold War never proved to be a roadblock. And, despite the hesitation among Western leaders that relying on one single source of supply might backfire, the need to distance Europe from the unreliable OPEC prevailed. OPEC had used oil as a weapon, while the Soviet Union seemed eager to welcome Western Europe as its newest and largest client. The notion was that the Soviet Union would do its best to keep its consumers satisfied. As Marshall Goldman describes, “as a good salesman, Viktor Chernomyrdin, when he was Minister of the Soviet Gas Industry, always insisted that he would never think of cutting off the flow of gas for political reasons” (Goldman 2008, 48).

## The Emerging Power of Natural Gas

During the 1980s, it was becoming clear that the future of Soviet investment policy was going to be energy, and the center of Soviet energy policy was going to be natural gas (Gustafson 1983, 1). It was with such ambition that during 1980-81, while facing a potentially disastrous energy shortage, Soviet leaders launched a grand campaign to dramatically increase the output of natural gas by 50 percent in five years. The plan centered on the concept that natural gas was going to provide most of the increment energy output in the first half of the 1980s, and subsequently was going to replace oil as the Soviet Union's main source of hard-currency income for many years to come (Gustafson 1983, 1).

The Soviet Five-Year Plan required enormous resources, which the Kremlin gladly devoted. According to Gustafson's research, "to reach their output targets on time, the Soviet leadership may have to spend as much as 45 billion rubles on gas between 1981 and 1985" (Gustafson 1983, 1). By 1984, Siberian gas fields were producing more than half of the country's gas and the Soviet Union became the "world's biggest natural gas producer" (Gazprom, History of the Russian Gas Branch). Most of the new gas output was coming from one field, Urengoy, which was located in the arctic wastes of West Siberia. As Brezhnev stated in February 1981, in his report to the 26<sup>th</sup> Party Congress:

I consider it necessary to single out the rapid development of Siberian gas output as a task of first-class economic and political importance. The deposits of the West Siberian region are unique. The largest of them- Urengoy - has such gigantic reserves that it can meet for many years both the internal needs of the country and its exports needs, including exports to the capitalist countries (Gustafson 1983, 34).

The Urengoy field would eventually supply natural gas to the USSR and Europe through six giant pipelines, which Brezhnev called “the central construction projects of the five-year plan” (Gustafson 1983, 1). Also, in 1984 a ceremony was held in France commemorating the commissioning of the 20,000 km long transcontinental gas pipeline between Western Siberia and Western Europe. This project invoked anticipation and some apprehension among those who feared that Europe’s dependence on Soviet gas might prove to be a deadly combination (Goldman 2008, 48).

The gas campaign of the 1980s was one of the most important stories of the Soviet economy and its ability to adapt to changes. It also marked the beginning of the United States displaying animosity towards West European imports of Soviet Union gas. This was a pivotal point for the United States and Europe because the growing reliance on Soviet energy was seen as a threat and the American ruling elite feared the foreign policy consequences that might arise from this growing partnership.

#### Soviet Union and Europe: Energy Relations

Russia’s current status as the world’s largest producer of hydrocarbons (oil and natural gas) is primarily the result of the massive investments the Soviet Union made in the western Siberian oil and gas fields dating back to the 1950s. As previously examined, it was during the 1950s that the Soviet Union discovered its immense oil and natural gas reserves. Shortly after, the Soviet planners began to strategically use natural resources to encourage industrialization, regional integration, and state building (Abdelal 2004, 3).

While the republics of the Soviet Union and East European satellite states were allotted oil and gas by the Soviet Ministry of Oil and Gas at efficient prices far below those of the world market, energy exports to the rest of the consumers fetched much higher prices. As a result of this tactic, oil and gas dominated Soviet export earnings, reached as high as 75 percent of the total (Abdelal 2004, 3). Undoubtedly, it was natural gas that proved pivotal for the industrial sectors of the Soviet Union, and eventually became the single most essential resource for the Soviets.

As its biggest consumer, Europe and the Soviet Union have had a long history of natural gas relations, which has managed to survive an extensive history of political upheavals. Initially, the USSR began exporting small quantities of gas to Poland in the 1940s, but high-volume exports did not begin until after the completion of the first gas pipeline from Russia to Czechoslovakia in 1967 (Lee 2009, 1). A year later, Russia expanded its reach into Europe when it signed a twenty-year contract that guaranteed the supply of Russian gas to Austria. And by 1970, the USSR had established similar long-term contracts to supply both West Germany and Italy.

During the first half of the 1970s the Soviet Ministry of Oil and Gas extended its list of European customers by adding Finland, East Germany, Bulgaria, France and Hungary. By mid 1975, Russia was exporting almost 20 billion cubic meters per year (bcm/yr) of Russian gas to Europe and within five years this figure had doubled to almost 55 bcm/yr (Lee 2009, 1). During the 1980s, the volume of gas trade with Europe continued to grow, reaching 70 bcm/yr by the middle of the decade and 100 bcm/yr by 1990, according to figures from Gazprom (Lee 2009, 2).

According to Julian Lee's research, part of the Centre for Global Energy Studies' analysis of the European natural gas relations with the USSR, even before the collapse of the Soviet Union, the Soviets were already using their energy resources and energy transmission systems to pressure their neighbors. This further solidifies the view that it did not take the Soviets long to realize the control they had over the east-west energy pipelines gave them strategic ability to block European access to non-Russian gas and oil from the Caspian Sea and Central Asian region (Smith 2010, 1). In addition, the Soviet Union's use of its energy recourses to pressure its neighbors began as early 1990, shortly prior to its collapse. The first countries, which were in line for "energy intimidation", were the three Baltic States; shortly after, Ukraine was pressured with the threat of discontinuing natural gas imports (Smith 2010, 1). What Smith's research shows is that even before the collapse of the Soviet Union signs began to emerge that natural gas can and will be used as a weapon in order to influence foreign policy.

Despite claims of using its resource as leverage, the natural gas relations between the USSR and Europe developed further during the latter stages of the Cold War (Lee 2009, 2). They have survived through the fall of the Berlin Wall, the breakup of two customer states (Czechoslovakia and Yugoslavia) and re-unification of another (Germany). Undoubtedly, the Soviet-Europe gas trade has survived and thrived even during a period of tense political relations and unprecedented instability in the region. And, despite the tumultuous period this relationship has experienced, the gas relations between Europe and the USSR have always maintained a steady level of supply and demand.

Following the breakup of the Soviet Union and the Warsaw Pact, Smith concludes that the leaders of Russia, mainly then-President Boris Yeltsin, searched for new methods of continuing to exert influence over the former Soviet-controlled region (Smith 2010, 1). According to Smith, the Kremlin first used an energy blockage to the Baltic States in 1990 in an attempt to prevent their breakaway from the Soviet Union. And, when that failed, Yeltsin focused on the growing opposition in the former republics of the Soviet Union and in East Central Europe to its foreign and economic policies, and in particular on demands that Russian military forces withdraw from the newly independent states (Smith 2010, 1). It was then that the Kremlin leadership quickly realized that short of military action, its most affective foreign policy tool was the “denial or threat of denial of access to Russia’s vast oil and gas resource” (Smith 2010, 1).

Furthermore, what is even more impressive is that following the collapse of the Soviet Union the trade remained largely unaffected (Lee 2009, 2). It thrived during the disintegration of the Soviet Union and survived the political and economic upheavals that were characteristic of the Yeltsin presidency during the 1990s. It was not until the reign of former President Vladimir Putin and his trend of growing Russian nationalism and international power projection that the gas trade, under the umbrella of the state-owned conglomerate Gazprom, morphed from a considerable revenue source into a foreign policy tool (Lee 2009, 2) (This aspect of the Russian gas industry will be thoroughly evaluated in Chapter Two).

## Fall of the Soviet Union and Emergence of Gazprom

In the chaotic environment created by the fall of the Soviet Union, senior officials within the new government fought hard to retain the natural gas industry as a single unit. This was a clear indication that the government viewed this specific industry as a significant and valuable asset. And, despite the privatization of several other industries, such as petroleum, the natural gas industry retained its specific properties and the Soviet Ministry of the Gas Industry was transformed into a conglomerate called Gazprom.

The natural gas giant known today as Gazprom has its origins in a 1956 decision by the former USSR Council of Ministers to establish a separate ministry for the gas industry, which became known as Glavgaz. This move was done in an effort to recognize the rapid emergence of natural gas as a viable energy source, independent of the oil industry. Rapid growth in demand led to the creation of numerous local, independent production enterprises and pipeline networks, technically under the control of Glavgaz, to facilitate the growing need. While this development was occurring in the USSR, export markets were emerging.

To ensure timely, uninterrupted deliveries to both domestic and export markets, the Soviet Union in 1960 began to build the Unified Gas Supply System (UGSS), which in its size and structure still has no comparison in the world (Grigoryev, 2007, p. 6). The UGSS is a technological development ensuring continuous regulation and supervising of the gas supply within a system, which covers the entire Soviet landmass. Its mass size and comprehensive design guarantee gas from the well to the pipeline and then to the consumer. According to the Gazprom official website, the UGSS



currently includes 160.4 thousand kilometers of gas trunk lines and laterals, long enough to go four times around the Earth (Gazprom Official Website).

During the late 1970s and early 1980s, due to the large gas reserves discovered in Siberia, in the Urals, and in the Volga region after the 1960s, the Soviet Union strengthened its image as a major gas producer in the world. Under the Communist rule, gas exploration, development, and distribution were centralized under a state ministry. However, President Gorbachev decided to alter the structure of the ministries of gas and oil as part of his economic reforms in 1989.

As Sergi observes, in his book titled “Misinterpreting Modern Russia”, Moscow was attempting to “build a long-term strategy and exploit export potential” (Sergi 2009, 130). In 1989, as the Soviet Union was facing a rapidly growing industry and lack of cohesion, the USSR Ministry of the Gas Industry was reorganized into a gas conglomerate named Gazprom State Concern (Gazprom Official Website). Although this was a state-owned entity, Gazprom functioned on an autonomous basis, without state participation in funding investment.

According to the Gazprom official website, State Gas Concern Gazprom was transformed into Russian Joint Stock Company (RAO) Gazprom pursuant to the Russian Federation Government Directive and following the Russian Federation President Decree. As translated from the original decree, “in November 5, 1992, ‘The Decree of the Russian Federation President on Reorganization of Gazprom Gas Concern into Russian Joint Stock Company Gazprom’ was signed”, which gave the Russian Federation single ownership (Gazprom Official Website). Under this structure, the

Russian Federation owned 85% of the shares, while the remaining balance was held by Ukraine and Belarus, through which the main export pipelines ran.

In accordance with the Russian Federation President Decree of November 5, 1992, the Company was vested with the obligations as follows: providing reliable gas supply to consumers in the Russian Federation; exporting gas under interstate and intergovernmental agreements; pursuing an integrated sci-tech and investment policy with regard to the UGSS upgrade and development; building and financing high pressure gas laterals in order to gasify rural areas; exercising control over the UGSS; and, providing other producers with access to the national gas transmission system (Gazprom Official Website).

In 1998, RAO Gazprom was reincorporated into the current open joint stock company “Gazprom”.

## **II. GAZPROM UNVEILED**

### Introduction

Following the collapse of the Soviet Union, the Russian government made a key decision of retaining fifty-one percent control of its natural gas sector. Unlike Russia's oil industry, which faced privatization, the natural gas industry was brought firmly under governmental control. Part of this strategy was to create the state-owned gas company Gazprom. In 2008, Alexey Miller, then chief executive, predicted that Gazprom has the potential of becoming the world's most powerful energy company (Ebel 2009, 9). Despite the fact that the Russian government retained a majority stake in Gazprom, there was no hard proof that it would be such an active player in the operational proceedings and decision-making. In essence, no one could even fathom to predict that Gazprom would become so closely operated by the Kremlin.

Nonetheless, speculations about the extent to which the Russian government controls Gazprom have always surrounded this company, mainly due to its close ties to the Kremlin and the level of involvement by the Russian government in Gazprom's decision making. There is no denying that since its establishment, Gazprom has been a pivotal player in securing Russia's status as a major natural gas supplier. For the purpose of this thesis and its main research question, investigating this company, including its history, leadership, current and future projects is essential to fully

understand and gauge the level of government involvement in Russia's natural gas sector and the country's energy policy.

### Restructuring

Gazprom traces its roots to the Soviet Gas Ministry, which was formed in 1965 when the USSR initially decided to place greater emphasis on gas production and consumption. In August 1989, the Soviet Gas Ministry transformed itself intact into a corporation called Gazprom and Soviet President Mikhail Gorbachev appointed Viktor Chernomyrdin as its first head (Goldman 2008, 59). At the time of Gazprom's creation, one hundred percent of the company's shares were held by the Russian Federation (Gazprom Official Website).

On October 26 1992, the Committee of the Russian Supreme Council approved a Governmental Decree, which converted Gazprom into a joint stock company. According to Marshall Goldman, this was an indication of the route that the Russian government foresaw for Gazprom. The mass privatization that soon followed did not begin until mid-1992, shortly after Boris Yeltsin took over as president. With the government committed to an economic reform, President Yeltsin authorized the conversion of Gazprom from a wholly state-owned joint stock company into a private joint-stock company, whose shares could now be owned by both state and private parties. At the same time, in December 1992, Gazprom's political influence increased significantly after the newly elected Russian President Boris Yeltsin selected the company's appointed chairman, Viktor Chernomyrdin, as his Prime Minister. Shortly after, in February 2003, Gazprom began to be privatized and this prompted foreign investors and private individuals to begin buying shares in the newly privatized Russian

entity (Sergi 2009, 131). Steadily, foreign companies began to acquire substantial amount of shares. And, as a result, Gazprom began to lose a large part of its assets outside the newly drawn up border of the Russian Federation.

As a result of the shares distribution held between 1993 and 1995, 41 percent stayed under state ownership, 10 percent were acquired by Gazprom in exchange for privatization vouchers, 15 percent were paid by the company's current and former employees in vouchers (at least 50 percent payment) in cash, 32.9 percent were acquired by the residents of 60 Russian regions in exchange for vouchers, and 1.1 percent were handed over to AO Rosgazifikatsiya (a majority state-owned company that regulates state-owned stakes in regional natural gas distribution networks within Russia) (Sergi 2009, 129). In all, 8.3 million privatization vouchers and around 17 billion rubles were paid for Gazprom's shares. In essence, 1.03 million Russian citizens became the Company's shareholders (Sergi 2009, 129).

Under this method, every Russian citizen obtained vouchers to purchase shares of previously state-owned companies. In 1994, 747,000 members of the public, mostly in exchange for the vouchers, had bought 33% of the Gazprom's shares; in addition, 15% of the stock was also purchased and distributed to Gazprom employees (Goldman 2008, 60). The state retained 40% of the shares, but that amount was slowly lowered to 38%. Strategically, trading of Gazprom's shares was heavily regulated, and the rules of the company banned foreigners from owning more than 9 percent of the shares.

Not surprisingly, the privatization of Gazprom strayed from the course ratified by the State Duma and tactics to distribute shares "privately" began to emerge.

For an example, in the early months of 1994, 15 percent of Gazprom's shares were simply handed over to chosen, unnamed employees or retired workers before any privatization auctions commenced (Sergi 2009, 130). By June of the same year, an additional 35 percent of Gazprom had been sold and traded at secretive, closed auctions in approximately 60 Russian gas-producing regions.

During the mid-1990s Chernomyrdin, under his capacity as Prime Minister, was able to ensure that Gazprom was not thoroughly regulated by the state. This enabled the company to evade taxes on a large scale, which led to tax evasion and asset stripping charges. A clear example of the degree of tax evasion can be seen in the 1995-1996 payments of \$3.5 million in taxes on \$2 billion earnings (Sergi 2009, 131). In addition, asset stripping occurred when the management and board members began a large-scale operation during which Gazprom's property was parceled out to the inner circle and their relatives.

As it was later discovered, Chernomyrdin and Gazprom's CEO Viakhirev were the leading figures in the asset stripping process. After the numerous scandals of the mid-1990s that touched almost the entire privatization process, and the eventual firing of Prime Minister Chernomyrdin in March 1998, the government demanded billions of dollars in back taxes from Gazprom (Sergi 2009, 130). As Sergi emphasizes, "this is an example of tax evasion, or rather a very friendly tax system, and the possibility of circumventing it almost legally" (Sergi 2009, 131).

Nonetheless, when tax prosecutors began to seize Gazprom's assets, the company gave in and paid in full. For the first time Gazprom began to show losses, not just profits. It was primarily due to such questionable transactions with foreign-based

companies and corrupt management that favored the inner circle, that Vladimir Putin pursued a comprehensive reform of Gazprom in the new century.

### Putin Sets Sights on Gazprom

When Vladimir Putin declared his name for the 2000 presidential election, it was not the best of times in Russia. Nearly a year had passed since the August 17, 1998 financial crisis, and the country was still recovering. Due to the government defaulting on its debt, millions of Russians had lost all of their savings, and banks had shut their doors. As Goldman evaluates, “as industrial output declined and unemployment increased, the number of Russians below the poverty level, which had fallen to 21 percent in 1997, suddenly soared to 33.3 percent, a new high” (Goldman 2008, 94). The country was visibly in distress; however, its natural resources provided a glimmer of hope.

As Goldman shows, years before Vladimir Putin began his career within the Russian government he submitted a dissertation to the St. Petersburg Mining Institute. In it he outlined a plan, an “owner’s manual”, for Russia’s recovery and return to the times of economic and political authority (Goldman 2008, 97). Putin emphasized that the Russian government needs to reassert its control over the country’s abundant natural resources and raw materials. He concluded that, “the process of restructuring the national economy must have the goal of creating the most effective and competitive companies on both the domestic and world markets” (Goldman 2008, 97). In essence, Putin believed that capitalizing on the country’s natural resources was the best way to reestablish Russia’s status as a superpower, an energy superpower.

In order for such dramatic turnaround to take place, key changes had to be implemented. Under President Yeltsin, numerous Russian assets were spun off to private

interests. But, according to Putin, instead of allowing the country's oligarch-controlled corporations to focus solely on making a profit, natural resources should be used to advance the country's national interests. It was this aspect of the economy that Putin viewed as vital to Russia's comeback. According to him, assets, which up until then, were in the hands of private interests, needed to be commanded by the Russian government and integrated vertically into industrial conglomerates. Simply stated, he wanted the state to have more control and power over those industries, such as natural gas, that were emerging as stars within the Russian economy. Putin believed that once the state acquired control, then the industries would have a better chance of competing with the Western multinational organizations such as Exxon-Mobil and Shell (Goldman 2008, 97). In Putin's words,

Regardless of who is the legal owner of the country's natural resources and in particular the mineral resources, the state has a right to regulate the process of their development and use. The state should act in the interests of society as a whole and of individual property owners, when their interests come into conflict with each other and when they need the help of state organs of power to reach compromises when their interests conflict (Goldman 2008, 98).

As Putin's argument illustrates, the state would ideally remain the primary decision maker and beneficiary. In his thesis, he does acknowledge that in order for Russia to become a competitive player in the world market it needs to end its isolationist trend and it needs to attract foreign investors; however, his bottom line remained firm: foreign investors needed to have a clear understanding that Russia would retain operating control and be the primary decision maker. As Goldman concludes, "as [Putin] saw it, if left on their own, private owners become too absorbed in pursuing their own interests and



are more interested in damaging their competitors than helping the state. They become so self-centered they ignore legitimate state interests” (Goldman 2008, 98). If the state declared control of its resource-based companies, Russia, Putin argued, has the potential to resurface “from its deep crisis” and restore “its former might” (Goldman 2008, 98).

### Putin’s Reign Begins

Undoubtedly, Gazprom is a unique phenomenon in Russia’s political and business life (Milov 2008, 4). No other corporation in Russia has such tremendous political and economic power. So, it did not come as a surprise when during the 2000 presidential campaign it became clear that Vladimir Putin had put energy resources and Gazprom on the top of his agenda. And, when Vladimir Putin became president he set his sights on Russian natural gas industry with one main goal in mind: reform Gazprom.

In May 2001, following numerous allegations of large-scale nepotism, corruption, and shifting corporate assets towards “private hands”, the resignation of Gazprom’s chief executive director Rem Vyakhirev, and head of Gazprom since 1992, was not surprising. Immediately, Putin appointed Alexey Miller, former Deputy Minister of Energy, as Gazprom’s new chief executive officer in 2001. As he clearly stated in a meeting devoted to Miller’s appointment, “Gazprom is more than just a joint-stock company. Russia’s whole economy is largely based on its gas industry” (Milov 2008, 4). Under the guidance of Miller, Gazprom began to emerge as a powerful economic instrument of Putin’s administration and the star of Russia’s economic growth (Sergi 2009, 131)

Since his first term as president, there have been numerous reports and articles that focus on the particular importance President Putin has always placed on

Gazprom. In their report titled “Putin and Gazprom”, Boris Nemstov, First Deputy Prime Minister of the Russian Federation (1997-1998) and Vladimir Milov, Deputy Minister of Energy (2002), labeled Gazprom as “Putin’s prime personal project” and examined the trends that began to emerge when Putin became president. According to Nemstov and Milov, the Kremlin had a plan to make Gazprom, Rosneft (state-owned oil company), and Sibneft (oil subsidiary of Gazprom, currently known as Gazprom Neft) one big state company. According to their investigation, one specific advantage became crucial: a majority in the boardroom.

According to the authors, once Putin seized the presidency, he began to fill the ranks of Gazprom with loyal, hand-selected individuals. Soon enough, “Gazprom’s ranks were rapidly filled with old Putin contacts from his St. Petersburg administration years” (Milov 2008, 4). Furthermore, the authors conclude that by 2008, 11 of the 18 members of Gazprom’s board were individuals who in the 1990s worked alongside or were closely associated with Putin. It was such emphasis on Gazprom, combined with clear statements made by the president himself, which indicated that the natural gas industry was going to be a top priority for Putin’s administration.

Although the Russian government held less than 39 percent stake until 2004, it enjoyed a majority on the company’s board of directors. As Putin saw it, if Gazprom was thwarted in its attempt to merge with Rosneft, then the Russian government would increase its involvement in Gazprom and become a majority stakeholder, which would make it the major state company responsible for gas production, distribution, and sales. As Putin envisioned in his previously mentioned dissertation, the state needed to remain in control and execute in the best interest of the

people, and as it deemed necessary. The plan he had constructed was now closely following the vision he had laid out in his 1997 dissertation. Every move from this point on indicated that Putin's plan to put Russia back on the map, as a key player in the world energy sector, would involve the state's majority control over the natural gas industry.

On September 14, 2004, in what could be justifiably labeled as yet another move aimed at strengthening Kremlin's reach, President Vladimir Putin gave the green light to the Gazprom natural gas monopoly to acquire the state-owned oil company Rosneft (Sergi 2009, 132). He also gave the approval to eliminate the dual-ownership system of Gazprom shares, which restricted foreign ownership of the company. The premise of this move, however, was aimed towards consolidating the state's control over the energy sector and further solidifying Putin's plan.

In summary, the natural gas sector of Russia's economy was so corruptly privatized during the 1990s, that, upon the election of President Putin, the Kremlin saw the perfect opportunity to reinforce its position and enact structural reforms. The plan worked: with Russia's immense resources and a spectacular increase in the Russian Trading System Stock Exchange (RTS) index and St. Petersburg market, "Gazprom shares soared from 78.3 rubles to 343.82 rubles in May 2006" (Sergi 2009, 132)

### Gazprom Structure

Currently, the Russian gas industry is a monopoly run by the Gazprom group, which controls over 95 percent of domestic gas production and owns the largest gas reserves in the world (Sergi 2009, 132). As of 2011, it has over 404, 000 employees and the state-controlled stake is 50.002% of the shares (Gazprom Official Website). The corporate structure of Gazprom is intricate. It consists of an extensive list of subsidiary

companies engaged in hydrocarbons production, processing and refining, and transportation.

*a. The Unified Gas Supply System*

Natural gas that is produced in Russia is pumped into the countless gas trunk lines of the Unified Gas Supply System (UGSS) of Russia and then transported to clients throughout the world. The UGSS is the largest gas transmission system in the world and it consists of a unique combination of gas extraction, processing, transmission, storage and distribution facilities. Essentially, the UGSS offers an uninterrupted cycle of gas supply from the rig to the consumer.

Built during the 1970s and 1980s, UGSS is the world's largest high-pressure trunk pipeline system. Currently, the UGSS contains 164.7 thousand km of gas trunk lines and branches and has 25 underground gas storage facilities (Gazprom Annual Report 2011, 41). As of 2011, Gazprom stated that the UGSS is working at a "fully loaded" capacity. Currently, as outlined in the 2011 Gazprom Annual Report, "demand is recovering in the gas market and gas consumption in the global markets is forecast to rise" (Gazprom Annual Report 2011, 42). The Russian Energy Strategy until 2030 foresees that 803 to 837 billion m<sup>3</sup> of gas will be produced domestically by 2020, and 885 to 940 billion m<sup>3</sup> – by 2030 (Gazprom Annual Report 2011, 42) As a result of such predictions, the UGSS capability must be increased in order to meet "solvent demand of domestic consumers and Russia's international obligations in relation to natural gas supply" (Gazprom Annual Report 2011, 42).

In 2011, Gazprom allotted over 51 billion rubles towards the upgrading and retrofitting of the gas transmission system (Gazprom Annual Report 2011, 42). As a

result of these repairs and technical condition improvements, the number of gas pipeline breakdowns was reduced nearly three times – from 32 to 12 breakdowns in 2002.

Technically speaking, fewer breakdowns stem directly from the use of progressive gas transmission system inspection techniques and scheduled preventive maintenance operations, which enable effective detection of worn out sections and aged equipment (Gazprom Annual Report 2011, 42).

*b. Leadership*

Gazprom, as any complex corporation, has an extensive list of departments and executives. At the head of the board of directors is former Prime Minister of Russia Viktor Zubkov. He has held the position as Chairman of Gazprom Board of Directors since 2008. According to Provision on Board of Directors of Gazprom, the primary duties of the Board of Directors are to “set the Company’s development strategy so as to maximize capitalization and investment appeal, to determine the Company’s asset management policy and to implement efficient controls over the Company’s financial and business performance” (Gazprom Annual Report 2011, 93). The Board consists of highly educated professionals who have, at one time or another, been either involved in governmental operations or have had a tremendous amount of experience within the energy sector. Although they all possess remarkable resumes, one trend seems to run through most of their past positions: a tie to Saint Petersburg, which one cannot help but connect to President Putin.

As expected, the structure of Gazprom is as intricate as it is complicated. According to their website:

Gazprom Group as a vertically integrated energy company is comprised of the parent company – OAO Gazprom and its subsidiaries engaged in gas, oil and other hydrocarbons extraction, transmission, processing and marketing, underground gas storage, heat and power generation and distribution as well as other activities including pipeline systems monitoring, oil and gas wells drilling, equipment supply, R&D, information processing and banking services (Gazprom Official Website).

### Gazprom Projects

Currently, Gazprom is in the midst of five *major* pipeline projects: Nord Stream, South Stream, Yamal – Europe, Blue Stream, and Pre-Caspian gas pipelines. The target market of the majority of these pipelines is Europe. These pipelines have faced scrutiny from those who oppose Europe’s continued dependency on Russian gas. EU member states, such as the three Baltic States, Poland, and Czech Republic, have repeatedly voiced their concerns that with each additional project Russia is given more and more leverage over the European Union as a whole. As Smith concludes, “unlike Western Europe, these countries have weak national energy companies that are in no position to challenge contractual violations by Gazprom” (Smith 2010, 16). Nonetheless, the consensus among the big states, such as Germany, Italy, and France is that Russia has been a reliable source of natural gas and they oppose a common EU energy strategy (See Chapter Three). In essence, the smaller states have been left on their own to fight off Russian energy pressures (Smith 2010, 16).

Those in charge within the Putin/Medvedev administration have consistently denied that Russia uses its energy resources strategically for political purposes. Nevertheless, Russia’s actions repeatedly indicate that the Kremlin leadership has plans to and will use its enormous energy wealth in an effort to increase its political

and economic influence in Europe (Smith 2008, 1) (See Chapter Three for further discussion).

*a. Nord Stream Gas Pipeline*

The Nord Stream gas pipeline, formerly known as the North European Gas Pipeline (NEGP), runs across the Baltic Sea from Russia to Western European countries. Nord Stream will represent a fundamentally new export route for Russian gas to reach Western Europe. According to Gazprom, by avoiding transit countries this new transnational gas pipeline is distinguished by low country risk and transit costs, while assuring more reliable export supplies of Russian gas (Gazprom Annual Report 2011, 65). The main target markets for gas supplies via Nord Stream are Germany, Denmark, the Netherlands, the United Kingdom and France.

In September 2005, Gazprom, and two German energy companies, E. ON Ruhrgas and BASF/Wintershall, agreed to construct the North European Gas Pipeline (Whist 2008, 5). Notably present at the signing of the agreement were Russian President Vladimir Putin and German Chancellor Gerhard Schröder, both consistent supporters of the project. In November 2005, the North European Gas Pipeline Company, which is today known as Nord Stream AG, was incorporated in Zug, Switzerland (Whist 2008, 6). Gazprom was designated as the majority shareholder (51%), while the two German companies with a 24.5% stake each. Former German Chancellor Schroder has, since March 30, 2006, been the head of the shareholders' committee of Nord Stream AG (Whist 2008, 6). Whist's research also indicates that in November 2007, the Dutch gas company Gasunie bought a 9% stake in the Nord Stream project, which meant that each of the two German companies relinquished 4.5% of their shares (leaving them with a

20% share each), while Gazprom remained the majority shareholder with its 51% (Whist 2008, 6).

This extremely expensive (various estimates range from 12 to 15 billion dollars) pipeline runs through the Baltic Sea and delivers natural gas directly from Russia to Europe (Smith 2008, 6). According to Smith, the European Union Commission had silently agreed to a German request for further inquiry into the project, despite the fact that this specific project was already strongly opposed by Poland, the Baltic States, and Sweden (Smith 2008, 6). In addition, Andris Piebalgs, then EU commissioner for energy, and EU Commission president Manuel Barroso, came out publicly in support of the project. Interestingly, they even allowed a former East German intelligence officer and close Cold War colleague of former KGB officer Vladimir Putin to come to Brussels to explain to the EU why this project was needed and should proceed (Smith 2008, 6). Their main objective was to further clarify the need to build a pipeline that would bypass any transit states and connect Russia to Europe directly.

Nord Stream is crucial to expand export routes and directly link the gas transmission pipelines of Russia with the European gas network. The project entails nearly 1,224 km of pipelines across the Baltic Sea from the Portovaya Bay (Vyborg) to the German coast (Greifswald). The UGSS elements required for gas supplies, via Nord Stream, are being constructed solely by Gazprom. According to the company's website, assembly of the first string, with the total capacity of some 27.5 billion m<sup>3</sup> per annum, was completed in September 2011. Shortly after, in November 2011, the gas pipeline's first string was contracted and commercial gas supplies to European consumers began construction. The Nord Stream's second string laying commenced in May 2011 and



completed on April 19, 2012 ahead of schedule (Gazprom Annual Report 2011, 66). The second string will increase the gas pipeline capacity from 27.5 to 55 billion m<sup>3</sup> (Gazprom Annual Report 2011, 66). Commissioning of the second string was scheduled for 2012. In May 2012, Nord Stream successfully completed full load tests.

According to the Nord Stream AG, this pipeline will be one, if not the, answer to Europe's energy struggle (Whist 2008, 9). According to a quote provided by Whist in his analysis, "it is evident that without Nord Stream, the EU will not be able to cover its gas needs. Therefore, Nord Stream is an important contribution to security of supply, as it will meet a quarter of additional import needs of Europe" (Whist 2008, 9). Whist's research further indicates that the predominant energy trend indicates a growing dependency on import. While both demand and production steadily grew until the mid-1990s, production has since stabilized, and from 2002 it has been declining, while the consumption has continued to rise (Whist 2008, 9). As Whist's research further determines, gas imports as a percentage of consumption rose from approximately 40% in 1994 to almost 60% in 2006.

Despite the fact that the Nord Stream pipeline will bring natural gas to numerous EU member states, one country in particular will benefit the most: Germany. As Whist determines, "no matter how much the EU's gas demand is to increase, one cannot escape the fact that Nord Stream will run ashore in Germany, and that the project will serve this state more than any other within the union (the bulk of the gas is earmarked for the German market) (Whist 2008, 13). Overall, Germany is Russia's main partner among the original EU member states. There are two main reasons why the relationship between Germany and Russia will remain strong (as per a research done by

Proedroe, 2007): one, the Nord Stream pipeline project, and two, is Gazprom's 2006 commitment to redirect gas from the Shtokman field in the Barents Sea to the German market, instead of to the United States (Whist 2008, 13). As Whist concludes, "the trend towards increased German dependence on Russian gas is unlikely to change" (Whist 2008, 13).

On October 8, 2012, a festive ceremony dedicated to the commissioning of the second string of the Nord Stream gas pipeline took place in Portovaya Bay, the Baltic coast of Russia. In attendance were Sergey Ivanov, Head of the Russian Presidential Administration, Alexey Miller, Chairman of the Gazprom Management Committee, as well as Gerhard Schröder, former Chancellor of Germany and current Chairman of the Nord Stream AG Shareholders Committee. Vladimir Putin, President of the Russian Federation, Angela Merkel, Chancellor of Germany, Francois Hollande, President of France and Mark Rutte, Prime Minister of the Netherlands spoke via video link (Gazprom Official Website). Alexey Miller addressed the crowd by stating that,

Nord Stream became a new link on the European energy map to increase the reliability of energy supplies. This was possible due to the alliance of the leading European gas and energy companies. The gas pipeline was constructed in no time. Gazprom took great efforts on developing the Russian gas transmission system to deliver gas into Nord Stream. In the first place, the unparalleled Portovaya gas compressor station was constructed. Now we are bringing Portovaya to its full capacity, and it is becoming the most powerful compressor station in the world (Gazprom Official Website, 2012).

In a similar statement, Matthias Warnig, Managing Director of Nord Stream AG asserted that,

Russia and the EU will be able to use the optimal modern and efficient supply route to make a direct connection between European markets and

some of the world's largest gas reserves in Northern Russia. The Nord Stream pipes, manufactured with the use of cutting-edge technologies, have a service life of at least 50 years; they will make a considerable long-term contribution to energy security in Europe. We implemented this ambitious infrastructure project on schedule, within budget limits and with no expenses on the part of European taxpayers (Gazprom Official Website, 2012).

The impact of Nord Stream can be seen throughout Europe, as the project receives a significant amount of media coverage and attracts public interest. The biggest impact this pipeline project has had on Russia-European Union energy relations has been the resurgence of the generally held apprehension that Europe will now be even more than ever dependent on Russia's gas supply. It is difficult to estimate exactly how much this project will increase the EU's already strong dependency on Russia; however, the projected completion of Nord Stream in 2015 will undoubtedly increase German dependency on Russia.

#### *b. South Stream Gas Pipeline*

According to the 2011 Gazprom official report, "for the purpose of diversifying natural gas export routes Gazprom is planning to construct a gas pipeline across the Black Sea to Southern and Central Europe – the South Stream project" (Gazprom Annual Report 2011, 64). The total length of the offshore section of the pipeline will be around 900 km, while the maximum depth will reach over 2 km. The design capacity of the gas pipeline is 63 billion m<sup>3</sup>.

Just as with its other projects, Gazprom has met its fair share of challenges, particularly from those who oppose increasing dependence on Russian natural gas; however, so far the company has signed an impressive list of cooperative agreements with Bulgaria, Hungary, Greece, Serbia, Slovenia, Croatia and Austria. These countries,

and their declared support, are crucial to the construction of the offshore pipeline sections of South Stream. In 2011, Gazprom also gained the support of Montenegro and Republika Srpska, as the leaders in these two countries expressed their interest to take part in this project.

Academics speculate that the South Stream project was a direct answer by Russia to the proposed Nabucco pipeline (Smith 2010). The Nabucco pipeline, which would run from Turkey to Austria, was intended to lessen European dependency on Russian natural gas. Several European Union members, as well as the United States have voiced their support for Nabucco. According to Smith (2010), “South Stream was clearly designed with the intention of killing the Nabucco project, thus leaving Europe with no access to Caspian or Central Asian gas except via Russia” (Smith 2010, 11). Not surprisingly, U.S. officials have made several trips to the region attempting to gather support for Nabucco. Unfortunately, as Smith explains, there has been less involvement on the part of the Europeans, and particularly absent has been significant involvement by the European Commission president and the former energy commissioner Andris Piebalgs, to gather any and all support for a non-Russian pipeline (Smith 2010, 11).

Just like Nord Stream, the South Stream gas pipeline project has faced numerous problems. Most importantly, there has been a strong opposition from the United States and its closest allies in Europe, such as the three Baltic States, Belarus, Poland, the Czech Republic, and Ukraine to building yet another Russia – Europe pipeline. However, as Smith explains, South Stream, along with Nord Stream, have gained momentum in large part due to “Moscow’s ability to recruit and pay substantial salaries to at least two former European leaders” (Smith 2010, 4). One of the most

notable former European leaders that has established a very close bond with the Putin/Medvedev administration has been Gerhard Schröder, who was the former Chancellor of Germany and current Chairman of the Nord Stream AG Shareholders Committee. In addition, in some European countries, officials have reportedly benefited from their financial ties to Russia's Gazprom; therefore, furthering European acceptance of Moscow's pipeline projects (Smith 2010, 4).

There is a perception held among political scientists who examine Russia - EU relations that projects such as South Stream and Nord Stream were primarily intended to tie Europe closer to Russia politically, while diminishing the possibility that competitive non-Russian pipelines, such as Nabucco, will ever be completed (Whist 2008; Smith 2010; Smith 2008). Although there is strong evidence to indicate that Nabucco is not, nor will it ever be commercially viable, it is not less viable than the Nord Stream and South Stream projects. Nonetheless, the powerful states within the EU, most notably Germany, have chosen to side with Gazprom's project and the inevitable dependency on Russia for natural gas will continue to escalate. According to the Gazprom website, "in the beginning of 2012, pursuant to the assignment by Vladimir Putin, Prime Minister of the Russian Federation, a detailed action plan was approved to speed up South Stream and to launch the gas pipeline construction in December 2012 instead of 2013" (Gazprom Annual Report 2011, 65).

On October 30, 2012, an article published in Financial Times titled "Gazprom pushes on with South Stream", in which Andrew MacDowall outlined Gazprom's latest plans for the South Stream pipeline. MacDowall defined Gazprom's latest contract with Srbijagas (a Serbian government-owned monopoly) as crucial to the

ultimate completion of this massive project (MacDowall 2012, np). Also, an official contract with Bulgaria is to be completed later this year. This official contract with Bulgaria is a critical step for South Stream, as the construction of the Bulgarian pipeline section is set to begin in July of 2013. MacDowall stresses the importance of the Serbian and Bulgarian contracts, because they are crucial components to the progress of South Stream.

As Gazprom pushes ahead with its project, its main competition remains to be Nabucco. However, MacDowall's article highlights a recent problem this pipeline has run into. As quoted in MacDowall's article, Tomasz Daborowski, an energy expert at the Centre for Eastern Studies, a Warsaw think-tank, has stated that Nabucco seems to be in serious trouble, however, "despite this, I do not share widespread opinion that Nabucco is dead. Most importantly, Nabucco has been redesigned into Nabucco West – a cheaper and smaller project" (MacDowall 2012, np). While the hope for this project was to diversify Europe's natural gas supply and decrease dependence on Russia, it seems as though Gazprom's plans will prevail yet again. In MacDowall's words, "while the fate of the non-Gazprom projects appears uncertain, concrete progress on South Stream may start within months" (MacDowall 2012, np).

Projects such as Nord Stream and South Stream have also highlighted the growing trend of Russia's weakening dominance of Central Asian energy producers, particularly as these countries complete new gas and oil pipelines to China. Smith's research has shown that there is a notion among scholars that this would make Russia even more financially reliant on its energy sales to Europe, thus driving Moscow to adopt a more constructive (i.e., less political) position toward the energy consuming countries

in Europe, including the ECE states (Smith 2010, 5). Lastly, and certainly regarded as one of the main components of this partnership, is the fact that geographical proximity makes Russia and Europe natural energy partners.

*c. Yamal – Europe, Blue Stream, and Pre-Caspian gas pipelines*

The multinational “Yamal – Europe” gas pipeline operates across four countries: Russia, Belarus, Poland and Germany. The current overall length of the gas pipeline exceeds 2,000 km. Currently, there are 14 compressor stations operational, of which three are in Russia, five in Belarus, five in Poland and one in Germany (Gazprom Annual Report 2011, 61). The gas pipeline construction began in 1994 close to the German and Polish borders, and first sections of the pipeline were fully operational as early as 1996.

According to Gazprom, the Blue Stream gas pipeline has one main purpose: directly supply Russian gas to Turkey and bypass transit countries. It starts in the vicinity of Izobilnoye, Stavropol Krai and ends in Ankara, Turkey. The 1,213 km long gas pipeline consists of an overland and a rare submerged section. This section of Blue Stream is unique in design and construction (Gazprom Annual Report 2011, 63).

The Blue Stream’s immersed pipeline rests on the bottom of the Black Sea at depths of up to 2,150 meters. That is one-third deeper than every known underwater pipeline in the world. According to Gazprom, construction of this section was obstructed by the unfavorable landscape of the bottom and by the forceful ground environment saturated with hydrogen sulfide. In all, the underwater section of the pipeline is 393 km long. The gas pipeline was completed in December 2002. In February 2003, commercial gas began flowing (Gazprom Annual Report 2011, 63).

The Pre-Caspian gas pipeline's main objective is to transmit gas from the fields located in the Caspian Sea, as well as Turkmenistan and Kazakhstan, to Russia. The three countries involved entered into a trilateral intergovernmental agreement on December 20, 2007, for the construction of this project. According to the Gazprom Annual Report, "Russia, Kazakhstan and Turkmenistan will consider an opportunity for building up the transmission capacity of the Pre-Caspian gas pipeline when gas consumption reaches the pre-crisis levels of 2008" (Gazprom Annual Report 2011, 19). In total, the Pre-Caspian gas pipeline will be approximately 1,700 km long, which includes a 500 km section across Turkmenistan and about 1,200 across Kazakhstan.

Combined with the massive Nord Stream and South Stream projects, these three pipelines represent the immense capacity of the Russian gas reach throughout the region. Although the emphasis is on reaching the European Union and its customers, there seems to be an emerging trend: monopolization of the natural gas sector. This can be clearly seen in Gazprom's attempt to block the execution of the Nabucco pipeline and instead replace such a route with its own pipeline project, South Stream. Clearly, Gazprom does not like competition and it would do everything within its power, whether strategically or politically, to achieve its main goal: control of gas supplies to Europe.



### III. THE TWO EUROPES

#### Overview

When Russia looks west towards the European Union (EU), it sees decades of multidimensional foreign relations with countless ups and downs. This multilayered relationship is especially evident when evaluating the natural gas partnership and the effect it has on the Russia-EU foreign relations. In Russia's eyes, the EU represents a dichotomy: partner and a roadblock. The partner side is the one that *needs* Russia's gas supplies, as it heavily relies on them. This partner does not put up a fight or try to look for different ways to bypass its partnership with Russia. Germany is Russia's best ally within the EU, and is often referred to as a trustworthy partner and reliable client. Whereas, despite the fact that this country does not possess EU membership, the thorn can be best personified by Ukraine and the tumultuous relationship between the two former comrades. Using Ukraine as an example is not ideal, mainly because it is not an EU member state; however, the support Ukraine has received from numerous EU countries that do not have cooperative relations with Russia cannot be ignore and this makes Ukraine a feasible choice for the purpose of this thesis. Also, Ukraine's position as *the* transit state for Russian gas to the EU market makes it an important player in the Russia-EU natural gas partnership. Since the collapse of the Soviet Union, the Russian government has exerted influence on its neighboring countries

by withholding or threatening to withhold natural gas supplies (Smith 2010, 1). A majority of these countries are Central and Eastern European (CEE) states, such as Latvia and Poland, and are highly dependent on Russian energy imports. The impact of Russia's tactic of withholding or threatening to withhold energy has been felt throughout the EU, as currently Russia is responsible for over a quarter of the EU's natural gas supply. This chapter delves into the dynamic relationship between Russia and the EU, and specifically, their natural gas relations. A contrast will be observed while analyzing Russia's relationship with Germany and Ukraine, specifically related to natural gas. These two countries represent two entirely different approaches that Russia has to execute when carrying out natural gas policies with each one.

There is no denying that Russia has, and most likely will continue to, use its natural gas as leverage over the EU and attempt to affect foreign policy. The goal of this chapter is to analyze specifically *how* Russia has been using its natural gas supplier role to affect foreign policy. In addition, this chapter will investigate whether the state-run Russian natural gas company Gazprom has become an extension of the Russian government, and whether the company has used its position to influence energy relations between Russia and the EU.

#### Despite Setbacks, a Relationship Predicted to Last

In his report, Smith (2010) studies an emerging Kremlin push, supported by 60 percent of Russian public opinion, to reestablish Soviet-era influence over its neighboring countries. This push originates from Russia's observable ambition to exert control over the countries it once had under its USSR umbrella. One way to achieve this

goal has been by drastically diminishing or even cutting off gas supply to the targeted countries.

Cutting off gas supplies is nothing new. The Russian government has exercised this policy since the early 1990s and as recently as the well-publicized gas cutoff to Ukraine in 2009. Up until the 2009 instance, most of Moscow's actions had been directed towards the CEE countries and current EU member states, such as the three Baltic States and the Czech Republic; in addition, it is also important to note that gas cutoffs also targeted important transit state for EU-bound natural gas such as Belarus and Ukraine (Smith 2010, 1). Cutoffs in gas supplies to the Baltic States and the Czech Republic did not have a major impact on Western Europe because *their* supplies were not directly affected. However, this all changed in early 2009 when Russia cut off gas supplies to Ukraine, which had a direct impact on the EU. Even though the cutoff was to Ukraine, a non-EU member state, this specific incident highlighted EU's natural gas vulnerability and became a topic of major concern for the EU.

The impact of the 2009 Ukrainian Gas Crisis was beyond political; it was directly felt by ordinary citizens and superseded the political consequences it was meant to carry out. Blankets and electrical heaters were sold out in hours throughout stores in Munich; and, as the degrees dropped people found themselves confronted with below zero temperatures and no means to keep warm. It soon became clear that while the cutoff was directed towards Ukraine, the impact was felt far beyond the intended target. During, and especially following, the 2009 Ukrainian Gas Crisis the question before the EU became clear: whether to continue its dependence on Russia's supply of natural gas (via transit states such as Ukraine and Belarus) or to seek other options. As it eventually

became evident, and a topic that will be addressed later on in this chapter, the EU member states were not all on the same page as to the answer.

Surprisingly, despite the interruption of service to millions of Western European consumers due to Russia's cutoff of gas supplies to Ukraine in 2009, there was a tremendous reluctance among the larger EU states to pursue any energy policy that is strongly opposed by Moscow (Smith 2010, 4). One country in particular, Germany, has been in favor of continuing EU's energy partnership with Russia (refer to "The German Factor" section for further analysis). And, as it was shown in the previous chapter the energy relationship between the European Union and Russia has become stronger and will only continue to develop as pipeline projects such as Nord Stream and South Stream (see Chapter Two) near completion. Furthermore, a majority of EU countries have displayed solidarity in the energy relation with Russia in the hopes for a larger financial stake in forthcoming energy projects promoted by Russia (Smith 2010, 6).

Another assessment of the EU - Russia energy relationship is provided in a report written by Andris Piebalgs, the former European Commission Energy Commissioner. In his 2009 report, Piebalgs presents a strong suggestion that Europe must make an effort to better diversify its energy sources and suppliers as opposed to continue to increase its reliance on Russia. As of 2011, 33% of EU's natural gas was imported from Russia, 27.8% from Norway and the rest is evenly divided among several other countries (Algeria, Qatar, Nigeria, Trinidad and Tobago, Egypt, and Lybia). However, as Piebalgs further examines evidence of ongoing and upcoming projects between the EU and Russia, he concludes that the reliance on Russian gas will continue to remain high in the next 20-25 years despite the need for diversification of energy

suppliers. The main reasons for EU's continued reliance on Russia for natural gas supplies, such as geographical proximity, existing transport infrastructure, and the energy cooperation based on long-term agreements outweigh the need for diversification (Piebalgs 2009, 5).

The main contributing factor to the sustained partnership between the EU and Russia, and its projected growth, is cooperation. This factor can be easily observed by the construction of new pipelines (such as Nord Stream and South Stream) and development of new gas storage facilities. These projects indicate that the existing energy partnership between the EU and Russia represents an important component of stable mutual foreign relations between the two entities (Piebalgs 2009, 5). The supply and demand of natural gas has become a strong link between the EU and Russia and successful projects such as Nord Stream solidify this partnership even further. Such analysis echoes the conclusions made by other scholars, who predict that energy cooperation between the EU and Russia will continue to intensify in the near future (Piebalgs 2009, 7; Smith 2010, 6).

There is a wide consensus that the energy partnership between the European Union and Russia must continue despite the need for diversification. However, one of the major challenges this relationship has encountered has been caused by insecurities that both sides have. The EU has had doubts whether Russia can sustain its reliability as a supplier, while Russia has had fears of whether the EU will sustain its demand for natural gas and continue to rely primarily on Russia or find sources elsewhere. These concerns were brought to light during the 2009 Ukrainian Gas Crisis,

which put a strain on the relationship mainly due to the interrupted gas service to Western Europe. Ever since, the security of natural gas supply has been a critical issue for the EU.

Despite the setback that the 2009 Ukrainian Gas Crises proved to be for the mutual energy cooperation between the EU and Russia, the perception held among most Western European leaders is that there has to be an even stronger cooperation between the EU, Russia and the transit states (Piebalgs 2009, 6). Most recognizable has been Germany's Chancellor Angela Merkel and former Chancellor Gerhard Schröder voicing their vehement support for continuing the natural gas relationship with Russia. Undoubtedly, in order for the EU-Russia energy cooperation to continue two factors must be met: first, the energy dialogue between the EU and Russia must continue; and, second, neither side can afford another disruption of supply such as the one that took place in 2009.

#### A Relationship Based on Interdependence

The EU – Russia energy relations can be further assessed against the backdrop of the European Foreign Energy Policy. The 2009 Ukrainian Gas Crisis highlighted the EU's energy vulnerability, and, as a result, securing EU's energy supply catapulted its relationship with Russia into a primary spot on the EU's agenda (Espuny 2009, 8). Currently, Russia is the EU's most important *single* provider of energy products, supplying about 25% of the overall natural gas consumption. More importantly, energy products represent more than 60% of Russia's overall exports to the EU, equal to more than €60 billion annually (60% of Russia's oil exports and 50% of gas exports go to the EU) (Espuny 2009, 8).

There is a consensus among scholars that Russian energy supplies to the EU will grow exponentially over the next decade mainly due to several projects, such as Nord Stream and South Stream, which are expected to increase EU's dependence on Russian natural gas (Espuny 2009, 10; Smith 2010, 6; Pieblags 2009, 7). Based on such predictions, the EU will find itself closely dependent on Russia for natural gas supplies. Therefore, it is essential for the EU to establish an even stronger and more solid energy relationship with Russia. Espuny cites the favorable pattern of relations that Russia has maintained with several major international energy suppliers, including OPEC and the Gulf Cooperation Council as examples for the EU. Espuny also examines an important aspect of the EU-Russia energy relationship, which has been highlighted by several other scholars: a true partnership must be based on the principle of interdependence (Espuny 2009, 8; Cameron 2009, 20). Complex interdependence, such as the one that Russia and the EU fall under, is defined as both sides being equal partners and putting equal effort into sustaining the existing relationship.

Interdependence, as exhibited by the Russia-EU natural gas relationship, can be best categorized under the general international relations theory of liberalism. Liberalism emphasizes that ties among states make it difficult to define national interest and, thus, decrease the need for military power. So far, there have been no military campaigns (specifically related to natural gas disputes) between Russia and the EU. Opposite of the theory of realism, which holds that states only work to increase their own power, liberalism was developed in the 1970s as scholars began to realize that realism was outdated and no longer applied to the way foreign relations were executed. With globalization, the rapid rise in communication technology, and the increase in

international trade it became evident that states could no longer rely solely on power politics to settle matters. Robert Keohane and Joseph Nye, the founders of “complex interdependence”, developed their theory especially for analyzing situations involving transnational issues (Viotti 2010, 131). It is precisely this branch of the theory of interdependence that best applies to the case of Russia’s supply of natural gas to the EU, and the level of reliance the EU has upon Russia for the supply of natural gas. According to Keohane and Nye, interdependence exists when there are “reciprocal [though not necessarily symmetrical] effects among countries or among actors in different countries” (Viotti 2010, 130).

Most of the analysis related to the interdependence between the EU and Russia has thus focused on fact that Russia is the biggest supplier of energy to the EU, and not much importance has been given to the fact that the EU is Russia’s largest energy buyer (Espuny 2009, 8). This distinction is important, because it highlights a notion that is often overlooked: Russia needs the EU even more than the EU needs Russia. Currently, Russia exports over 60% of its energy to the EU, and with the completion of Nord Stream these numbers will only escalate. Russia cannot afford to lose its partnership with the EU. And while Russia needs the EU more than the EU needs Russia, the EU cannot afford to lose its relationship with Russia either. This is where interdependence plays a crucial role, by compelling both sides to invest equally into the relationship.

Another way to examine this interdependence is to investigate the politics behind it. As Cameron had noted, the energy dialogue between the EU and Russia “does not take place in a vacuum” (Cameron 2009, 20). Meaning, the energy relationship must



be thoroughly examined against the wider backdrop of the geopolitical relationship between the West, EU, Russia and all sides' growing concerns about energy security.

When analyzing the energy relations between the EU and Russia, there are two ways to politically examine this interdependence and the impact it holds. One way is to view the nearly 500 million EU consumers as very fortunate to have Russia as their main energy supplier and neighbor. The fact that Russia has the largest supply of natural gas and its geographical proximity to the EU has always made the two entities natural partners. However, on the other side of the argument are those who claim that this exact dependence on Russia for energy is a “curse” because it allows Russia to “blackmail” European countries by threatening to turn on and off their gas and oil supplies (Cameron 2009, 21). By offering lucrative deals to European companies, such as when two German energy companies, E. ON Ruhrgas and BASF/Wintershall were offered to construct the North European Gas Pipeline, critics claim that Russia is attempting to “divide and rule” the EU by extending offers to its allies within the EU and alienating the rest. As Cameron concludes, it is precisely these concerns over energy securities that have propelled this issue to the top of the EU's foreign policy agenda.

Furthermore, the EU finds itself in an unusual position when dealing with Russia and its control over the energy supplies. Specifically, for some EU countries the energy dependency upon Russia is 100 per cent, while others do not rely on Russia for energy at all. Such a dichotomy makes it complicated for the EU to find one united stance when dealing with Russia. And, according to Cameron, there is predominant evidence that this precise lack of agreement on a united EU policy towards Russia is a major hurdle in the EU's attempts to succeed in negotiating with Russia.

The dependence on energy has created a split within the EU, which can be easily observed when analyzing the considerable difference in the reliance of EU member states on Russia for natural gas. As Cameron presents the issue, he highlights the fact that while some of the newer member states such as Latvia and Bulgaria are almost entirely dependent on Russian energy supplies, others such as Spain and Ireland receive no energy supplies from Russia. As a result of this split, it would be fair to assess that Russia will most likely continue to exert political power over its energy clients as long as the EU struggles to agree on the principles for a *common* energy policy (Cameron 2009, 22).

It is important to emphasize that despite the lack of a common energy policy, which this thesis holds as one of the major setbacks for the EU when dealing with Russia's supply of natural gas, the EU *has* implemented other ways to "protect" its member states when trading goods or services with Non-EU Member States. The Common Commercial Policy, as a primary example. A pillar for the external relations of the EU, the Common Commercial Policy is constructed on a set of uniform rules under the Customs Union and the Common Customs Tariff. Its primary function is to govern the commercial relations of the Member States with Non-EU Member countries (Europa.eu). According to the EU's official website, "the common commercial policy is one of the main pillars of the European Union's relations with the rest of the world" (Article 207 of the Treaty on the Functioning of the European Union – TFEU). The main objective of the Common Commercial Policy is to implement uniform conduct of trade relations and safeguard the European market. While certainly an effective tool, the EU's Common Commercial Policy lacks the strength of a common energy policy mainly because it is a widely operational policy and so far it has not been able to center its

attention on one particular area, such as the EU-Russia natural gas relations. In addition, the EU has at its disposal the Customs Union and the Competition Policy. Despite being strong pillars of the European Union, these measures still fail to unite the Member States to form a common energy policy. The bottom line is that until the EU unites and clearly defines a unified energy policy, to which all member states agree and adhere to, there will remain to be an opening for Russia to execute its “divide and conquer” tactic that has worked so well up until now.

It is widely argued that energy dependence on Russia has produced two separate Europes. On one side are Germany, Italy, France, and Spain who remain opposed to a common EU energy strategy (Smith 2008, 16). These countries remain firmly against a unified EU stance, whether it concerns dependency on one major import source of energy (i.e. Russia) or support for greater competition within the EU member states. On the other side are the smaller, newer member states that have been left to fend off Russian energy pressures. As Smith further examines, in 2007 the new members within the European Parliament, led by Poland, gained parliamentary approval for a resolution calling for “a common European foreign policy on energy” (Smith 2008, 16). However, despite support by many Western European parliamentarians, it is unlikely to be implemented by the Commission or by the Council.

There is currently a considerable amount of frustration and despair among smaller countries such as the three Baltic States, the Czech Republic, and Poland as they repeatedly have felt the brunt of Russian energy disruptions. The three Baltic States (Estonia, Latvia and Lithuania) have always been most vulnerable, mainly due to their historic ties to Russia and current membership in the EU. Essentially, they have no choice

but to rely entirely on Russia for their natural gas supplies while also face the impact of Russia's dislike of their new alliance. As Smith explains, these countries have weak national energy companies that cannot challenge contractual violations by Gazprom (Smith 2008, 16). In essence, these countries are left at the mercy of Russia. Although there have been speculations that the United Kingdom, Sweden and possibly Finland are quietly supporting the Central European effort to establish a stronger and better-coordinated EU energy policy, there seems to be no hope of achieving that unless the bigger member states get on board.

In order to gain a better understanding of the dynamics between Russia and the European Union, it is vital to examine whether President Putin and former President Medvedev have shown signs of willingness to use energy as a political weapon and how (thoroughly discussed in Chapter Four). Despite the fact that officials within the Putin/Medvedev administrations have consistently denied that Russia employs its energy resources for political purposes, its past actions have shown otherwise. As Smith (2008) concludes, "Russia's actions again and again demonstrate that the Kremlin leadership will use its enormous energy wealth in an effort to increase its political and economic influence in Europe" (Smith 2008, 1).

Using its role as the primary natural gas supplier as leverage over Europe is not a new tactic for Russia. This is an aspect of the EU-Russia energy debate that has been analyzed by numerous scholars and appears to be a concerning issue. In 2008, the Kremlin manifested its use of "energy weapon" when it directed Transneft, the monopoly exporter of all Russian oil, to deliberately cut supplies to the Czech Republic one day after the Prague leadership signed an agreement with the United States regarding the

stationing of an antimissile radar site in that country (Smith 2008, 3). As Smith further illustrates, a similar incident occurred in 2006 when the Kremlin cited the usual “technical difficulties with the pipeline” after it cut oil supplies to Lithuania following the sale of its oil facilities to a Polish, rather than a Russian, company (Smith 2008, 3). The fact that Russia would use its energy supplies as a political weapon has never been a secret; however, undeniably the most infamous instance of such actions was the Ukrainian Gas Crisis. That was the moment when Europe realized the exact level of its dependency on Russia for natural gas.

However, this also happened to be the moment when Russia realized that its dependence on its transit states needed to be diminished and acquiring additional routes for its gas became the primary objective for the Kremlin. As Cameron concludes, it was following the Ukrainian Gas Crisis that Russia began to actively pursue the two major pipeline projects, Nord Stream and South Stream, which aim to bypass Ukraine entirely. This step signaled to the EU that Russia, now more than ever, has plans of establishing itself as the sole energy supplier to the EU.

Energy relations between the European Union and Russia, and the tensions associated with this partnership are nothing new. Peter Truscott (2009) addresses this topic from a standpoint that energy relations between the two sides *must* be based on interdependence, as both sides have significant mutual interests and political capital invested in their mutually agreed to partnership. The Russia-EU interdependence is characterized by the complementary nature of the interests between the energy producing Russia and energy-consuming members of the European Union (Truscott 2009, 22).

Truscott examines the impact of the Ukrainian Gas Crisis and the political aftermath it caused for the EU – Russia energy relations. According to his research, it is essential for Europe to come to terms with the increasingly assertive nature of Russia. Unsurprisingly, Moscow has become incredibly proficient at pursuing the “divide and rule” strategy when addressing the EU (Truscott 2009, 23). In essence, Russia has been able to undermine Europe’s attempt to create a common energy policy by executing lucrative bilateral relations with individual member states (Truscott 2009, 25; Cameron 2009, 21).

Additionally, in his analysis Truscott examines the emergence of Russia’s state capitalism and the “Russia first” school of policy-making in the Kremlin. The term “Russia First” is a historically rooted political tradition that re-emerged after the 1995 Duma (Russia’s legislature) elections and it signaled the end of the post-Cold War honeymoon between Russia and the West (Truscott 2009, 24). As Truscott explains, this period was characterized by forming a uniquely Russian approach to political and economic development, which is based on Western skills and values but avoids “copying” the Western model of democracy and market economy.

Furthermore, Russia has gone on to develop and implement its own hybrid form of “state capitalism”, which is guided primarily by Russian perceptions of the country’s needs and historic traditions (Truscott 2009, 24). This phenomenon has spilled over into the EU energy relations with Russia. By refusing to ratify the Energy Charter Treaty and Transit Protocol (ECT), a set of international rules for investment and trade in the oil and gas sector, the Russian ruling elite has sent out a signal that it will not tolerate those international rules that it did not establish (Truscott 2009, 25). Such an attitude has

led the Russian elite to conclude, “there is no way the Europeans can get away from us” (Truscott 2009, 25). And, any attempts by Europe to do so have been unsuccessful. In essence, any effort to force Russia to operate under international rules would be denied and if Europe wanted to continue to receive energy from Russia, it would need to accept Russia’s requirements. Additionally, upon the completion of the Nord Stream and South Stream projects, Russia’s grip on the European Union’s energy consumption will only escalate.

In response to the “Russia First” attitude, Truscott examines an interesting point. He believes that given Russia’s dependence on European consumer markets, Europe’s approach should be “Russia cannot get away from us either” (Truscott 2009, 27). According to him, the events of early 2009 signaled exactly how much Russia gives superiority to commercial interests. Mainly, Truscott believes that Europe should resist falling under the spell of the argument that the “new Cold War” with Russia is imminent and instead attempt to engage in a routine and practical relationship based on shared interests and equal partnership. Overall, Truscott examines that the two sides can achieve a more stable and strategic partnership in energy relations by pursuing reciprocity. As a supplier and consumer, Russia and the European Union must accept that they are locked in a mutually dependent relationship, which they must embrace.

#### Vulnerabilities Highlighted by the Ukrainian Gas Crisis

##### *a. Russia – Ukraine Gas Relations Background*

There is no denying that the Soviet Union was endowed with immense natural gas reserves. And, as it was discussed in Chapter One, Soviet planners used this to their advantage to promote industrialization, regional integration, and state building

(Abdelal 2002, 3). Under the Soviet Union, the constituent republics were allocated natural gas by the planners at prices far below those of the world market. Natural gas was of particular importance for the industrial sectors of the Soviet republics, and “eventually became the single most important resource in the regional economy” (Abdelal 2002, 3). It was this precise relationship and the immense reliance on Soviet natural gas that eventually came back as a disadvantage for Ukraine.

Following the disintegration of the Soviet Union, the newly independent states found themselves tied to Russia via miles of existing gas pipelines. Two states in particular, Ukraine and Belarus were especially dependent on Russian gas. As explained by Abdelal, since the fall of the Soviet Union, Ukrainian and Belorussian households have lived in fear whether gas supplies would end and intolerable living conditions would take place. Most notably, Ukrainian and Belarusian industrial firms, referred to as the “energy – inefficient behemoths designed by Stalinist planners” by Abdelal, would suffer greatly if the supply of energy ends due to their enormous reliance on Russian oil and gas to continue operating (Abdelal 2002, 1). As Abdelal concludes, “the cost of energy dependence was obvious to policymakers in both states: reduced political autonomy” (Abdelal 2002, 1). But, even if these newly independent states were interested in the diversification of energy supplies, they faced an enormous undertaking: Russia’s wrath.

Following the collapse of the Soviet Union, Ukraine and Belarus inherited an enormous economic dependence on Russia. Aside from being highly dependent on Russian markets, Ukraine and Belarus depended on Russia for crucial imports. And, undoubtedly, energy was the most important of all. Where prices could have been negotiable, the supply source was not. The Eurasia energy markets were highly divided



and Russia offered the lowest prices. And, despite the disintegration of the Soviet Union, the Russian government managed the prices of oil and gas exports to the remaining 14 newly independent states and continued to subsidize their energy consumption.

Despite continuing to provide natural gas to its former republics, Russia was doing it so systematically. When the three Baltic States (Latvia, Lithuania, and Estonia) refused to join the Commonwealth of Independent States (CIS) their “subsidized” prices were increased. Another factor that influenced this decision was the Baltic States’ refusal to stay within the “ruble zone”. When post-Soviet governments began to indicate that they were considering exiting the national currency zone of their former union, Russian policymakers made it clear that “only those post-Soviet countries that remained in the ruble zone would receive energy subsidies” As Abdelal points out, “the Russian government clearly sought to link political acquiescence in its regional hegemony to energy subsidies” (Abdelal 2002, 2).

In accordance with such a pattern, Belarus was rewarded for its commitment to CIS integration with low prices, while Ukraine, despite being a member of the CIS, was punished for its assertiveness with higher prices. Political scientist Daniel Drezner, as quoted by Abdelal, argued that Russia systematically attempted to use the energy dependence of several post-Soviet states as leverage to shape their foreign policies (Abdelal 2002, 2). It was this precise use of natural gas as leverage that led to the persistent tensions between Russia and Ukraine, and the eventual gas cut cutoffs of 2006 and 2009.

*b. 2006 Ukrainian Gas Crisis*

During the 1990s, the Russia-Ukraine gas relations were highlighted by two themes: Ukraine's inability to pay Russia for its natural gas supplies and high levels of debt and unpaid bills. This led to Russia's cutback of Russian gas supplies to Ukraine for short intervals of time, which was aimed at restoring payment discipline (Stern 2006, 2).

Up until 2005, nearly 80% of Russia's gas exports to the European Union passed through Ukraine. As its biggest transit state, Ukraine provided a passage for two-thirds of Gazprom's sales to Europe. In March of 2005, Gazprom informed Ukraine that it would be raising prices to market levels, to which Ukraine agreed to, in return for increased transit fees. When it became clear that Ukraine would not be able to pay the suggested \$160 per 1,000 cubic meters, as suggested by Gazprom, negotiations began to take place.

After numerous exchanges regarding price, storage facilities and capacity, and transit fees it seemed as though Russia had enough. In an interview with the Russian national newspaper *Kommerstant*, President Putin expressed his skepticism of whether Ukraine truthfully could not afford the newly proposed prices. He also stated that Ukrainian consumers pay less for gas than Russians and as far as he understood, Ukraine has enough money to pay market price. He further emphasized that Russia subsidized Ukraine by \$1 billion a year from the Russian budget, money that Gazprom paid from its revenues (*Kommerstant* 2005, np).

Following another round of heated exchanges between the two governments, Russia presented its ultimatum. On December 13, Gazprom stated that unless an agreement was reached by January 1, 2006, it would cut Ukraine's gas off.

Gazprom also indicated its inclination to own and operate Ukraine's gas transit pipelines. Once Ukraine rejected such a proposal, Gazprom indicated that the new price would have to be \$220-230 per 1,000 cubic meters, the *actual* fair price.

The highest political levels in the Kremlin supported Gazprom's strong position on the \$230 per 1,000 cubic meters price. As a suggestion, Gazprom proposed that if Ukraine could not afford to pay higher prices, the company would extend loans to Ukraine for this purpose (Stern 2006, 7). In his final attempt to make what was regarded as a "political concession to his Ukrainian counterpart" President Putin suggested that if the Ukrainian side was prepared to agree to this gas price, the increase could be suspended for three months before the switch to market prices (Stern 2006, 7). In the final days of 2005, European countries, which had up until then stayed out of the dispute, began to advocate for a compromise. The Ukrainian side rejected both suggestions and at precisely 10:00am Moscow time on January 1, 2006, Gazprom cut off gas supplies to Ukraine.

EU member states began to feel the impact immediately. The fall in volumes caused an outcry all over the EU. By January 2, Hungary was reported to have lost up to 40% of its Russian supplies; Austrian, Slovakian and Romania supplies were said to be down by at least one third, France 25-30% and Poland by 14% (Stern 2006, 8). Almost immediately, Italy reported having lost 32 million cubic meters, around 25% of its deliveries, during January 1-3 (Stern 2006, 8). On January 2, Gazprom responded by stating that it would pump an additional 95 million cubic meters per day into the network to compensate for the Ukrainian withdrawals. By January 3, Austrian and Hungarian supplies were back to normal levels although some other countries were still experiencing

shortfalls (Stern 2006, 9). The dispute lasted a total of 4 days, during which almost all European countries experienced shortfalls in gas deliveries.

On January 4, 2006 Gazprom and Naftogaz, Ukraine's state-controlled oil and gas company, signed a 5-year contract with questionable terms. Most notably, prices were only set for six months and RosUkrEnergo<sup>1</sup> was chosen as the company that would deliver gas to Ukraine. Essentially, Gazprom decided to no longer deliver Russian gas to Ukraine, and Naftogaz will no longer export any gas that it had received from Russia.

According to Stern, the 2006 Gas Crisis was a politically motivated dispute. He supports his theory by referring to several commentaries in the European press at the time of the crisis. He states that most of the support has been for "Ukrainian President Yushchenko's position that this was a politically motivated dispute in which the Russian side was attempting to blackmail Ukraine politically by placing it under extreme economic pressure" (Stern 2006, 10). The biggest indicator of such a pressure policy was Russia's severe price demand for natural gas after Ukraine denied Russia's attempt to purchase their transit pipelines. This price demand, at \$230 per 1,000 cubic meters, was designed to sever the gas supply relationship between Gazprom and Ukraine.

### *c. The 2009 Ukrainian Gas Crisis*

In late 2007, import prices for 2008 gas supplies to Ukraine were up for assessment. Upon review, prices were set at \$179.50/mcm<sup>2</sup>, up from \$130/mcm in 2007. This price increase, along with Tymoshenko's return as prime minister, put the previous arrangements between Russia and Ukraine regarding natural gas in jeopardy. After

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<sup>1</sup> Swiss - registered venture company that transports natural gas from Turkmenistan to East European countries, 50% owned by Gazprom.

<sup>2</sup> \$/mcm: dollars per thousand cubic meters

carrying out several negotiation meetings, Prime Ministers Putin and Timoshenko could not come to an agreement. Shortly after, on March 3, Gazprom reduced the pressure in its transit pipelines. This was a direct reminder of what had taken place in January 2006. Ukraine responded by warning Russia that if Russia could not guarantee supplies to Ukraine, then it would have no choice but to reduce its transit volumes to Europe (Pirani 2009, 12).

The 2008 gas dispute that took place between Russia and Ukraine, and led to the eventual January 2009 cut off was by far the most serious of its kind. Despite numerous negotiations, the two sides failed to come to an agreement for the price of Russian gas supply to Ukraine and a tariff price for the transit of Russian gas to Europe. And, when the previous agreement expired on December 31, 2008, Russian exports to Ukraine were cut off on January 1, 2009.

The aftermath of this gas crisis was felt throughout Europe. Exports to 16 EU member states and Moldova were drastically reduced on January 6, 2009 and completely shut off by January 7, 2009. It was one of the coldest winters in Europe, and without gas millions of Europeans could not keep warm. The most serious affected countries in the Balkans experienced a humanitarian crisis, with many citizens unable to heat their homes. At the height of the conflict, gas was completely cut off to countries in south-eastern Europe, many of which are 100 percent dependent on Russian imports, and partially to the rest of their consumers, for 13 straight days (Pirani 2009, 22). As Pirani further evaluates, both sides blamed each other and neither displayed any urgency about moving towards an agreement.

On January 19, 2009, Prime Ministers Putin and Timoshenko signed an agreement to end the dispute. The heads of Gazprom and Naftogaz also signed a supply and a transit contract, both covering the ten-year period of 2009-2019.

*d. The Ukrainian View*

Despite the fact that Ukraine presented a united front when answering Russia's demands during the 2009 Ukrainian Gas Crisis, one of the major problems the country was facing behind closed doors was a deep division between President Yushchenko and Prime Minister Timoshenko. There were several reports that both parties had tried to resolve the matter by withholding information from one another, in an attempt to take the entire credit if a resolution had been reached. Neither side officially confirmed such reports and both officials were able to work past their differences and present Ukraine's proposals for resolving the dispute on January 1, 2009.

According to Pirani et al., Ukraine played a big part in provoking and prolonging the dispute by carrying out a series of actions that led to the inevitable. The most notable action was its statement that it would respond to Russian cut-offs by "diverting volumes bound for Europe" (Pirani 2009, 38). Such a tactic not only undermines the original agreement between Russia and Ukraine regarding its status as a "transit country", which does not allow for diversion of gas meant for consumers in other states, but it also shows to what lengths Ukraine is willing to go. Another factor was that Ukraine was so late with its payments for gas received in 2008, that it left Russia with no adequate time to even address the issue of alleged fines and penalties before the eventual cutoff in 2009.

After analyzing Ukraine's actions and the inevitable consequences, several conclusions can be made. The most obvious is that Ukraine's status as a reliable transit country is no longer existent. When Ukraine chose to prolong the dispute, its reputation in Europe became questionable and alternative methods for acquiring Russian gas had to be evaluated. As Pirani concludes,

One certain outcome of the dispute is that there will be an even greater determination from Gazprom – and perhaps also from European countries – to build the North Stream and South Stream transit avoidance pipelines, which will impact heavily on Ukraine's gas transit business (Pirani 2009, 39).

There are speculations that Kiev's approach to the 2009 Ukrainian Gas Crisis was a reaction to the economic downward spiral that the country had been experiencing since gaining independence. According to Pirani's research, Ukraine's economy entered a recession in the fourth quarter of 2008 and was expected to contract by 3-5 per cent during 2009 (Pirani et al. 2009, 40). In addition, the steel industry, which accounts for more than 40 per cent of Ukraine's export revenues, was experiencing a cut in production by up to 50 per cent in the second half of 2008 (Pirani et al. 2009, 40). According to Pirani, such an economic crisis seemed to have made Ukraine's politicians more willing to prolong the dispute with Russia because things could not have gotten any worse than they already were. Ukraine's thinking was based on two presumptions: they risked that industry could survive for longer with less gas, and, their need to postpone price increases became more desperate (Pirani et al. 2009, 40). However, no one in the Ukrainian government could have predicted that the dispute with Russia would carry such a dramatic impact on Ukrainian production.

*e. Impact of the 2009 Ukrainian Gas Crisis*

The impact of the 2009 Ukrainian Gas Crisis on the energy relations between the EU and Russia is a theme that dominates within this area of research and is thoroughly addressed by Gonchar, Martyniuk, and Prystayko (2009). Their analysis is primarily focused on how this conflict impacted European energy security and the future of gas relations between the European Union and Russia. They evaluate the gas crisis as a “mirror” of the level of energy vulnerability of the European Union. According to the authors, there are several factors, which contribute to the high level of concern the European Union has when it comes to energy security.

Lack of unity when dealing with Russia and its supply of gas is one of the key elements that has been seen as a problem for the EU. Mainly because Russia has been given a chance to accommodate those member states that are willing to play by Russia’s rules, while excluding the rest (Gonchar et al. 2009, 39). This has, in turn, allowed Russia to pursue a “divide and conquer” policy when negotiating gas prices and access with the European Union. By not being able to effectively interfere on behalf of those member states that were directly affected, the Ukrainian Gas Crisis highlighted the fact that the European Union lacked a common European Energy Policy and could not defend its own member states in the time of need.

According to the authors, this emphasized a major “vulnerability” for the European Union: failure to counter an outside supplier that uses commercial means to attain political goals (Gonchar et al. 2009, 39). Their report investigates that the situation has not changed drastically since the crisis and Russia continues to execute agreements with individual energy companies of the member states. Meaning, the European Union has yet to form a united voice when dealing with its major gas supplier.



The second vulnerability is that the European Union has no official agreement with Russia, as related to its role as a major supplier of gas and oil. There is not a single document that outlines the responsibilities of each player. As the authors point out, Russia signed but did not ratify the Energy Charter Treaty mainly due to its firm objection regarding the third party access to the pipelines and transit fees. Not ratifying the treaty, in turn, ended up benefiting them by avoiding any international and bilateral responsibility for actions like the Gas Crisis of 2009 (Gonchar et al. 2009, 39).

The third vulnerability stems from the different energy interests of the EU member states. The inconsistency of demand that is demonstrated by the different member states undermines the ability of the European Union to speak and act as one (Gonchar et al. 2009, 39). During the Ukrainian Gas Crisis, the cohesion and solidarity of the European Union and its ability to speak as one was put to the test and it failed. The authors present Bulgaria as an example of a member state, which called for greater agreement among the member states and sooner actions by the European Union, as a whole entity, when dealing with the crisis.

This precise inability to form a cohesive energy stance can be contributed to several factors. First, the level of dependency on Russian gas supply is drastically different between West European countries and East European countries. Second, there is also a difference in the level of consumption, the structure and openness of energy markets and geographic proximity to energy resources. The third factor is that Russian pressure is not as strong in Western Europe, which is certainly not the case in Eastern Europe where Russia historically has had a great level of influence. Hence, as Gonchar et. al. emphasize, it is crucial for Western European leaders to understand the problems

faced by the newly admitted member states, especially those neighboring Russia. The fourth and final reason is that different member states differ in their level of economic and energy cooperation with Russia, which is a contributing factor to the fragmentation and lack of cohesion that the authors highlight in their report.

The fourth vulnerability is the different levels of cooperation between European energy companies and Russia. The concern is that when big Western European companies such as Germany's EON-Ruhrigas and BASF and Italy's Eni strike deals with Russia's Gazprom, their close cooperation leads to favoritism (Gonchar et al. 2009, 40). And, when gas supply to the suffering member states is controlled either by companies with the Russian capital or lead European corporations that have close ties with Gazprom, it sends the wrong message as related to unity on the European Union front. As Gonchar et al. conclude, Russia uses this to its advantage by skillfully manipulating European internal competition in order to gain support for Russian interests and projects.

The fifth vulnerability is the absence of a real domestic energy market in the gas sector. The authors classify this as one of the main explanations for the EU energy imbalance. Their research has led them to the conclusion that there is virtually no gas market or a common approach to gas pricing in the EU. This, in turn, has allowed Russia's Gazprom to pursue and execute gas contracts separately with each EU member state. More importantly, Gazprom is allowed to execute contracts with each energy company of a separate national market under different conditions. Essentially, what this causes is each member state having their own separate gas relations with Russia. With a large entity such as the EU, and its numerous member states, being consistent is impossible under such conditions and Russia has used this to its advantage by striking

different gas policies with those member states who are willing to play by its rules (Gonchar et al. 2009, 41).

The sixth and final vulnerability is the absence of a gas transport network. They evaluate the fact that the gas pipeline of the European Union mainly runs from the East to the West, especially in the Central and East European states. Due to this lack of a gas network between the EU member states, the EU is tightly bound to gas coming from Russia (Gonchar et al. 2009, 42). And, with the construction and opening of the Nord Stream and South Stream projects, the dependence on Russian gas supplies will only deepen.

#### The “Politicization” of Energy

Thomas Gomart analyzes the topic of EU – Russia energy relations and whether the foreign relations between the two sides have entered a period of depression. According to his research, energy supply is currently being viewed by Russian elites as something “invaluable” and the key to the future of their economy (Gomart 2008, 10). What has occurred, according to Gomart, is the “politicization” of energy, which can be explained by a combination of three factors: strong global demand, liberalization of the European gas market, and renationalization of the energy sector. According to Gomart, energy has always been treated by Russia as a vehicle for projecting power. This specific concept has always put a strain on the energy relations between Russia and the European Union mainly because energy was once seen as a “factor of cooperation”, however, since Putin took the reigns energy has gradually become a “factor of tension” (Gomart 2008, 10).

According to Gomart's research, the EU imports 50 percent of the energy it consumes and it is expected to reach 70 percent in 2030. Therefore, the energy dependency on its providers, with Russia at the top of the list, will continue to increase. On the other side, even more strikingly, is that a total of 75 percent of Russia's export revenues depend *directly* on the single European energy market. Such numbers demonstrate the level of European-Russian interdependence in energy relations, a view held by Gomart and one that dominates the scholarly discussion on this topic (Gomart 2008, 11; Espuny 2009, 8; Cameron 2009, 21; Truscott 2009, 22).

Diverging from the previous scholars mentioned in this chapter, Gomart presents an interesting approach when analyzing interdependence. According to him, the energy relations between the European Union and Russia are based on mistrust. This is a notion other scholars have explored, however, none have explicitly outlined in their research. In essence, it has become evident that EU governments do not attach the same level of importance to energy security in general, or to Russia, in the overall operation. In his opinion, in order for this interdependence to function properly, the EU – Russia energy relationship should be centered around the following question: how can Russia be made not only to accept the political, commercial and legal regulations of this relationship, and, vice versa, how can the European Union actions within the energy sphere be made dependable (Gomart 2008, 11)?

Similar key aspects of EU-Russia energy dialogue are what Andrew Monaghan and Lucia Montanaro-Jankovski thoroughly investigate in their paper written for the European Policy Centre's Task Force on Russia. Their argument is direct: "energy security thinking must move from notions of 'dependence' and 'producer against

consumer' towards a more cooperative mindset" (Monaghan and Jankovski 2006, 5). Their argument rests on a three-pronged strategy for the EU: it must improve its energy efficiency, enhance its relations with key transit states and devote time to building a more effective relationship with Russia.

The EU-Russia energy dialogue, as examined by the authors, has a set of problems and differences. They all seem to stem from the fact that both sides have different interpretations of the relationship and each side's priorities. While Russia seeks to modernize its energy sector and protect itself, the authors examine that one of the key demands demonstrated by the EU is the need for Russia to reform and open its markets in order to create a more positive business climate (Monaghan and Jankovski 2006, 8).

The need for an active approach is what Monaghan and Jankovski highlight as the primary goal for a successful EU-Russia energy relationship. Both sides must make their requests clear and engage in discussions on how to achieve an agreement that would please both parties. It might sound simple, but it is far from that. Given that the EU imports more than 50% of its energy, a number that is projected to rise to 70% by 2030, the way the EU manages its relationship with Russia is crucial to its long-term energy security. The EU, simply said, cannot afford to miss the opportunity to secure a cooperative and active engagement with Russia with regards to energy.

As the authors explain, although the two sides did officially enter into a formal energy dialogue in 2000, which has led to a "true partnership, offering wider prospects which go beyond the narrow questions of energy trade and extend to transport-related problems and to the environmental impact of the energy sector", the reality is that this strategic energy partnership is often considered hollow and flawed and not many of

its plans have been executed (Monaghan and Jankovski 2006, 7). As anticipated, the authors point out that there is growing unease and concern voiced by several EU member states that as the EU becomes increasingly more dependent on Russia for energy imports, Moscow would attempt to use this as a diplomatic lever. In order to emphasize the magnitude of these fears, the authors label Russia as “triple-hatted”; meaning, it should be examined as a major energy producer, consumer and transit state. According to them, this is exactly what makes the EU worry.

In a more direct way of approaching this issue, Joseph Wood of The German Marshall Fund of the United States calls energy “a major strategic vulnerability for Europe” (Wood 2009, 36). In his analysis he emphasizes the fact that if the EU accepts an even deeper dependence on Russia for energy than it already has, it will open the door for a substantial and potentially dangerous Russian influence in central and Western Europe. An important point highlighted by Wood is the fact that while some EU countries have been exploring alternatives to Russian-supplied gas by obtaining supplies from Azerbaijan and Iran, there has been a lack of enthusiasm from big EU players such as Germany. According to Wood, by offering support to projects such as Nord Stream, German Chancellor Merkel has indicated that she sides with those who argue that European dependence on Russian gas is actually an interdependence that guarantees that Russia must play by realistic rules in energy relations (Wood 2009, 36). However, Wood concludes that the EU dependence on Russian energy as a major opportunity for direct Russian leverage and impact on EU foreign policy.

## **IV. ENERGY AS LEVERAGE**

### Overview

Despite some historical setbacks, the EU and Russia have remained steady energy partners. Geographical proximity and mutual understanding has made this partnership stronger over the years. The theory of interdependence, as examined in the previous chapter, has held strong despite experiencing obstacles such as the 2009 Ukrainian Gas Crisis. This chapter will examine the ongoing energy relations between the EU and Russia, and to what level Gazprom, as an extension of the Russian government, has used its supply of natural gas to affect the outcome of foreign policy. In essence, has Gazprom become a tool of Russia's foreign policy and how has this affected its business with Europe?

This chapter will also assess the role energy has within Russia's foreign policy towards its former satellite states and national security matters. Undoubtedly, energy brings considerable power to Russia. The question at the heart of this chapter is how much political power does Russia's vast amount of energy supplies hold and whether or not the Russian government is willing to use it as leverage.

### Manipulating Gas Supplies

Widely named "the wake up call", Russia's initial cut-off of gas supplies to Ukraine in January 2006 made Europeans aware of the level of dependency on their

largest supplier. Subsequently, twelve months later, almost to the day, Russia decided to shut off oil supplies to Belarus for three days, causing a wave of effects on supplies to Western Europe (Smith 2007, 1). Belarus is one of the two main transit states for Russian gas to the EU, the other one being Ukraine. When the Russian government decided to cut off gas supplies to Belarus, it had a downstream effect on every EU member state that relies on that Russian gas. While these actions were seen as “unacceptable” by Germany’s Chancellor Angela Merkel (Germany held the EU Presidency at the time of this incident), the condemnation of Russia was short-lived. And, despite the EU’s attempt to criticize Russia for using its vast energy resources as a political weapon, particularly in its “near abroad”, the lack of a united voice had once again failed and Russia was left unmarked (Smith 2007, 1).

As Smith concludes in his report titled “Russian Energy Pressure Fail to Unite Europe”, “although Russia’s action against Ukraine at the beginning of January 2006 led to a brief flurry of activity by EU leaders, there have so far been few signs of emergence of an effective Europe-wide policy that would reduce dependence on Russian energy” (Smith 2007, 1). In the months following the 2006 Ukrainian shut off, the EU showed a lack of cohesion and failed to utilize the momentum presented by the anger over the shut off. Quite on the contrary, as Smith concludes, European countries began to forge bilateral deals with Russia, without any consideration for the interests of their fellow EU members (Smith 2007, 1). Predictably, the Western European members have shown little consideration or concern over Russian pressure tactics against the newer, small members in Central and Eastern Europe. Immediately following the crisis, Andris Piebalgs, the EU’s energy commissioner, stated that Europe needed a more “cohesive



policy on security of energy supply” (BBC, 2006) This has been a prevalent point for discussion within the EU and the 2006 incident highlighted the urgent need for a solution.

The trend that emerged following the 2006 Ukrainian gas shut off was what Smith described as “divide and rule” tactics. Immediately, Russia began to negotiate separate deals with energy companies from Germany, France, Italy, Hungary, Slovakia, and Denmark (Smith 2007, 2). While pursuing these separate deals, Russia also began to increase natural gas prices for its transit states of Ukraine, Georgia, Armenia, Belarus, and Moldova and continued to increase its control over Europe’s gas pipeline systems. Russia’s argument was that it was simply increasing prices to market rates by removing wasteful former subsidies (Smith 2007, 2). However, such a rapid increase in prices was bound to enrage the transit states and cause disruption in customer countries later on (Smith 2007, 2).

One example of the above mentioned price increase took place at the end of 2006 when Belarus angrily succumbed to Russia’s demands to double gas prices and let Russia take control of more than half of the country’s pipeline infrastructure (Smith 2007, 2). Despite Belarus’ close political relations with Russia, Alexander Lukashenko, then president of Belarus accused Moscow of taking “unfriendly steps” against his nation. As Smith further examines, these remarks, along with the announced \$45 duty tax on Russian oil transported through Belarus, provoked the Russian cut off of supplies (Smith 2007, 2). This is just one of many examples of pressure on smaller countries to give in to the demands of Russia. And, when met with resistance, Russia simply shuts off the supply until their demands are met.

## Transit States at the Mercy of Gazprom

Aside from Ukraine, another transit state falls at the mercy of the Russian government: Belarus. Often regarded as an ally of Russia, there are tensions between the two countries, which are often overshadowed by those between Russia and Ukraine. The main source of tension has been the desire of Moscow to overtake Belarus' prized possession: its gas pipeline operator Beltransgaz (Hedenskog and Larsson 2007, 73). The process has been strenuous, but it illustrates the methods used by Russia to "acquire foreign energy enterprises against the will of its host nations" (Hedenskog and Larsson 2007, 73).

During the mid-1990s, as Hedenskog and Larsson examine, negotiations on the cancellation of the Belarusian gas debt in exchange for military concessions. By the end of the 1990s, the political significance of Belarus had diminished and Russia demanded the payment of back-taxes by Gazprom (Hedenskog and Larsson 2007, 73). As the mood between the two countries changed, Russia decided that it needed to take a tougher line on Belarus' gas debts and systematically began to decrease their supplies. Supplies were reduced three times in only one year initially by 50%, then 30% and then 40%, and no "friendship" price was offered (Hedenskog and Larsson 2007, 73). As Hedenskog and Larsson determine, "this was the starting point for the battle for Beltransgaz that came to characterize Russia's energy policy under Putin" (Hedenskog and Larsson 2007, 73).

In 2001 and 2002, Belarus caved in and agreed to provide Gazprom with a 50% stake in Beltransgaz, in return for a gas price close to the domestic Russian price. Interestingly, this process was taking place in parallel with negotiations concerning a

merger of the two states (Hedenskog and Larsson 2007, 73). Russia had previously proposed an EU-like structure or even full integration. However, these negotiations fell through, mainly because Belarusian President Lukashenko felt insulted that he would have to give up his post. It was then that the Beltranshaz deal fell through and Belarus refused to pay Gazprom's new gas price. As a result, Gazprom cut off supplies by 50% and called for a full privatization of Beltranshaz (Hedenskog and Larsson 2007, 73). Ultimately, in the autumn of 2003, Gazprom once again suspended gas deliveries to Belarus, while still demanding higher price for deliveries and "favorable terms in the potential purchase of a controlling stake in Belarus' gas-pipeline operator Beltranshaz" (Hedenskog and Larsson 2007, 73). Finally, in November of 2003, Belarus conceded and agreed to let Gazprom lease Beltranshaz for 99 years in return for increased gas deliveries (Hedenskog and Larsson 2007, 73). Despite the agreement, the Belarusian parliament refused to ratify the contract. This prompted numerous supply cut offs, which brought on turbulent times for both countries. As matters got worse, President Lukashenko even declared that "now our relations with Russia will be poisoned by gas for a long time" (Hedenskog and Larsson 2007, 73).

His statement could not have been any more accurate. Following the 2003 incident, tensions between Russia and Belarus escalated, mainly because of the denial by the Belarusian parliament to ratify the agreement between Gazprom and its takeover of Beltranshaz. Shortly after, Alexey Miller, CEO of Gazprom, admitted that the gas cut offs had been imposed on Belarus throughout the Beltranshaz negotiations had been previously approved by the Russian government (Hedenskog and Larsson 2007, 73).

Essentially, confirming that the Russian government carries out specific foreign relation objectives through the manipulation of natural gas supplies and its main player, Gazprom.

### Troubles in Georgia

In January 2006, two explosions occurred on the main and reserve branches of the Mozdok-Tbilisi on the Russian border region of North Ossetia, (BBC, 2006). An electricity transmission line was also destroyed just as Georgia began to experience extremely cold weather. Georgian President Mikhail Saakashvili told the BBC that the near simultaneous attacks were pre-planned actions orchestrated by Russia.

Speaking to BBC, Saakashvili said “there was now huge pressure on his country’s energy system, as it was experiencing its coldest weather in more than 20 years” (BBC, 2006). The explosions resulted in the cut off of all gas supplies, as well as 25% of the electricity supply. Continuing on with his speculations, Saakashvili stated that the gas pipeline was blown up in “an area fully under Russian control, with a heavy presence of Russian border guards” (BBC, 2006). The Russian government denied any and all suppositions that it was responsible for the explosion and Gazprom stated that it was doing everything within its power to restore gas supplies. Coincidentally, gas prices for Georgia were doubled in January, as part of a series of recent price hikes for former Soviet countries (BBC, 2006).

The 2006 simultaneous explosions were one of the numerous incidents that took place between Russia and Georgia, all of which led up to what became known as the Russo-Georgia War of 2008. Despite the fact that Russia had countless reasons for why it chose to enter this war, it is interesting to note that one of the main strategic goals for Russia was for Georgia to renounce its intention to integrate into the Euro-Atlantic

community, primarily NATO, and return to a Russian sphere of influence (Hamilton 2008, 1).

Despite the fact that the EU has not implemented a comprehensive and integrated policy specifically related to Russia, which would stress democratization, the rule of law, human rights, and respect for the sovereignty of neighbors, it entered the conflict in an attempt to act as a moderator. Up until the Russo-Georgian War, the relationship between the EU and Russia had primarily been driven by business interests and diplomatic partnerships and strayed away from heated political discussions (Bugajski 2010, 99). Interestingly, Bugajski concludes that “Russia’s leaders do not view the EU as a major strategic power but as a valuable twofold instrument: an economic engine from where Russia can tap investment, technology, and trade; and a U.S. partner that Moscow can help decouple and maximize its own influence to decrease the American role in Europe” (Bugajski 2010, 99). According to Bugajski, this attitude by the Russian government has led them to form a policy towards the EU built around three approaches.

First, Russia approaches EU institutions as an equal partner, and not as a candidate or even a member state. Second, it builds bilateral ties with larger EU states, such as Germany, which tend to be more accommodating. This, in turn, weakens the ability of the EU to form an “assertive common policy” (Bugajski 2010, 99). And third, the EU is considered to be a potential competitor in Russia’s “near abroad” sphere, as it might try to lure various post-Soviet capitals away from Moscow’s orbit (Bugajski 2010, 99). These three factors combined made the EU vulnerable and an easily manipulated instrument in the hands of the Russians. Essentially, as Bugajski concludes, “the August 2008 war underscored for Moscow that the EU was neither a determined ‘hard power’

nor a coordinated and effective ‘soft power’” (Bugajski 2010, 99). In the end, the actions that were taken by the EU did not convey a strong opposition to Russia’s actions in the region nor were their sanctions relevant.

Just like with energy issues, the 2008 Russia-Georgia war highlighted the division among the EU member states when dealing with Russia. As Bugajski shows,

While presidents of several CEE states, including Poland and Lithuania, visited Tbilisi during the August war to condemn the Russian invasion, French President Sarkozy was engaged in mediation efforts between Moscow and Georgia that had not received unanimous EU approval or had even been consulted with France’s new EU partners (Bugajski 2010, 99).

The actions of the EU during the 2008 Russia-Georgia war showed weakness and division. The Russians easily interpreted the EU Tagliavini Commission report on the war that eventually emerged as reprimanding Georgia for starting the war. Although there are contrasting evaluations of what the report actually meant, it showed the resistance on the part of the EU to firmly establish Russia’s faults and enforce punishments.

Following the 2008 war, Russia issued a new foreign policy doctrine, which is described by Bugajski as “an assertive document that rules out any prospect of EU membership or any surrender of Russia’s state sovereignty” (Bugajski 2010, 101). It is not a secret that Russia has no intentions of being a member of the EU, however, what was interesting about this doctrine is that it highlighted Russia’s tactic to dealing with the EU: although it collaborates with EU bodies on certain matters, Russia prefers to deal with individual member states when pursuing its political, economic, security, and energy interests (Bugajski 2010, 101). Interestingly, this is exactly the strategy that has dominated the energy relations between the EU and Russia. As Bugajski explains, “the

absence of a unified and consequential EU policy towards Russia reinforces Kremlin contentions that the country has a special historical role that places it outside of any existing political models of multinational institutions” (Bugajski 2010, 101).

### The Germany Factor

Indisputably, Germany is Russia’s main partner among the original EU member states. The tremendous amount of natural gas Germany receives from Russia is one of the main reasons this relationship has survived. Even the 2009 Ukrainian Gas Crisis did not put a dent in the strong relations between Germany and Russia. If anything, it prompted the two countries to come up with a project (Nord Stream), which would guarantee uninterrupted supply of natural gas.

For Germany, the annual volume of imported Russian gas, which was 40 bcm in 2007, will within a few years increase steadily and exceed 50 bcm (Whist 2008, 13). According to Whist’s research, the trend towards increased German dependence on Russian gas is highly unlikely to change. And, as he further concludes, it is “important to assess if, and why, Germany accepts this development” (Whist 2008, 13). According to Whist, there are several factors that contribute to Germany’s dependence on Russia for natural gas.

First, in 2000 the German government and the country’s energy utilities companies entered into an agreement to shut down all nuclear power stations and reach a complete shut down of all nuclear plants by 2022. This decision was taken mainly because several of Germany’s nuclear power stations had aged and the country was no longer interested in continuing its nuclear energy program. Also, the 2011 nuclear

accident in Japan's Fukushima Daiichi Nuclear Power Plant served as a thrust for Germany's already planned nuclear power phase out.

As of 2008, the time of Whist's report, nuclear power accounted for 12% of the primary energy supply in Germany, and over 25% of the electricity generation (Whist 2008, 13). According to a 2007 report by the International Energy Agency (IEA), as cited by Whist, "the loss of nuclear power will lead to reduced supply diversity, negatively impacting energy security" (Whist 2008, 13). In essence, as Germany began to phase out nuclear power, its energy supplies had to be fulfilled otherwise. Therefore, Germany's reliance on Gazprom for supply of natural gas would increase tremendously as a result of the nuclear phase out. The German nuclear phase out is a critical component of the Russia-Germany relationship, mainly because it explains the sense of urgency and importance that has always been given to the Nord Stream project. Securing energy deliveries, without the worry of another "transit country meltdown" such as the Ukrainian Gas Crisis, has been the main goal for Germany.

According to Whist, the second factor that contributes to Germany's energy dependence on Russia is the German strong energy lobby (Whist 2008, 14). As the author directly states, "the two second-largest shareholders of the Nord Stream consortium, E.ON Ruhrgas and BASF/Wintershall, are both German companies, and they inevitably have a strong economic interest in the project" (Whist 2008, 14). As Whist further explains, decades of strong trade and investment relations with Russia have made many German companies willing to go to great lengths to accommodate each others demands, so the relationship continues to remain strong (Whist 2008, 14). Undeniably, a "pro-Russian" attitude prevails within the German business lobby.



Both of these factors combined demonstrate why the Russia-Germany energy partnership exists. It is also evident that this relationship is built to last. And, as this research has shown in previous chapters, this relationship is not one-sided. It is based on interdependence and projects such as Nord Stream exemplify that. As much as Germany needs Russia for its supply of natural gas, Russia needs Germany just as much, if not even more, to provide its resources to. As vital as this relationship is to both sides, it is crucial to analyze the way it carries itself out.

#### German Dependence on Russian Gas: Key to EU-Russia Energy Relations

In an October 2006 interview, as cited by Whist, President Putin was asked about the growing concern many Germans have had about becoming too dependent on Russian gas supplies, to which he replied:

No, I don't understand that. It is artificially politicized. There are people that are trying to heat up this issue to gain from it politically. These people are either provocateurs or very stupid. I say this quite often, even if it sounds harsh. It is, however, the fact that when we have a common pipeline system, we are equally dependent on each other (Whist 2008, 15). President Putin emphasized that once pipelines are constructed, they are stationary; meaning, gas can go from supplier to consumer and cannot be sent elsewhere on a whim (Whist 2008, 15). So, in essence, this interdependence argument is plausible because once two countries enter into an agreement to build a pipeline to transport natural gas (such as Germany and Russia's agreement to build the Nord Stream pipeline project), they also enter into an agreement that one side will supply the gas (Russia) and the other will purchase the gas (Germany). Basically, this becomes an interdependent relationship where both sides have taken on a responsibility, which they must adhere to in order for the partnership to endure.

Another factor that adds to the interdependence argument is that currently there is a lack of feasible alternative for both sides. According to a research cited by Whist, about 50% of all Russian energy exports go to the EU, which, in turn, makes Russia its most important supplier (Whist 2008, 15). For comparison, Norway is the second-largest exporter of oil and gas to the EU and the corresponding numbers were 16% and 24% (Whist 2008, 15). According to Whist, “had Russia had the infrastructure in place to divert its energy sources to the expanding markets in Asia, the EU would have a better reason to worry” (Whist 2008, 15). However, since this is not the case “Moscow has no other option but to sustain its energy trade with the EU, [as] any other option would entail a tremendous loss of income” (Whist 2008, 16).

The interdependence between Russia and Germany has only been strengthened by the completion of Nord Stream. This project represents both sides’ efforts to reinforce the economic ties between the two entities and, as Whist concludes, promote peaceful coexistence (Whist 2008, 16). Interestingly, the completion of Nord Stream has been compared to the European integration process following the Second World War (Whist 2008, 16). In the words of the former Swedish ambassador to Russia, Sven Hirdman, as cited to Whist, “the more economic and industrial cooperation we have in Europe, the better. Nord Stream is comparable to the European Coal and Steel Community [ECSC] back in the days” (Whist 2008, 16). As such, Whist concludes that the general assumption is that economic integration with Russia will reduce the chances of a EU-Russia conflict (Whist 2008, 16).

As an original and one of the largest member states, Germany has always been regarded as one of the leaders within the EU. And, while this community has yet to

establish a way to blend the unique needs of each individual member state and to act as one unified voice, Germany is respected and widely acknowledged as a leading voice. By taking actions, such as the construction of Nord Stream, Germany has showed the rest of the EU that Russia is a reliable source of energy and a country with which it plans on establishing a long-standing relationship. In 2009, the Ukrainian Gas Crisis affected millions of Germans and the government took note. By bypassing any transit states, it decided that a direct route for Russian gas to reach Germany was no longer a luxury but a necessity. As one of the largest and original members of the EU, Germany's relations with Russia are an example of the direction that the EU needs to take if it plans on keeping Russia as its major natural gas supplier.

#### What Does Russia Want?

On June 28, 2000, according to the Foreign Policy Concept of the Russian Federation, the Commonwealth of Independent Nations (CIS) states were identified as the main priority in Russian foreign policy (Hedenskog and Larsson 2007, 19). Shortly after, however, President Putin realized that the CIS, the organization established in 1991, which embraced all Former Soviet Union (FSU) republics with the exception of the three Baltic States, poorly served his intentions of upholding Russian influence in the post-Soviet area.

As this and previous chapters have shown, a strategic goal for Russia has been to keep the former CIS area intact and as an exclusive zone of Russian influence. Energy has been one of the main ways Russia has tried to achieve this. Maintaining the above-mentioned exclusive zone of Russian influence has been an underlying driver of Russia's policies. And, as this study has shown, Russia has used its natural gas supplies

as much as it could to influence the actions of its consumer states. As Hedenskog and Larsson conclude, “denying the influence of external factors is often more important than increasing Russia’s own influence (Hedenskog and Larsson 2007, 9).

One important element, that has always kept Russia’s influence strong, is that those FSU states that are dependent on Russian energy are not just dependent on actual supplies, but also to a large extent on low prices. As Hedenskog and Larsson show, “in Ukraine, the energy-intensive and inefficient petrochemical industries rely solely on subsidized prices, as does the Belarusian economy” (Hedenskog and Larsson 2007, 72). As it was shown earlier in this chapter, the political implication of this is that presidents, i.e. Alexander Lukashenko, seek legitimacy through the relatively successful economic performance that has been afforded to them by the subsidized prices. However, when the Belarusian economy stays artificially upheld by low energy prices, the strong support base of the president hangs in the balance of whether Moscow demands higher prices for natural gas or not.

Another one of the main strategic goals for Russia, as highlighted by Hedenskog and Larsson, has been to prevent NATO expansion to Ukraine and Georgia and to “retain, regain and in some areas increase its influence, but it has failed to prevent NATO enlargement to the Baltic States” (Hedenskog and Larsson 2007, 10). One way of achieving this goal has been to retain military presence in these countries. Generally regarded as a strategic presence, and not of military-operative importance, this presence has tried to serve one goal: intimidation. As Hedenskog and Larsson explain,

The military capability is limited in the event of large-scale war, but the pressure that the forces bring work as a political bargaining chip, a lever in

local affairs and a force to prevent conflict resolution or NATO membership is overwhelming (Hedenskog and Larsson 2007, 10).

Although Russia's goals in each incident might seem different, they often relate to one strategic objective. And that is the ultimate Russian ambition to be a factor by affecting the outcomes of elections and attain control over ports, pipelines, refineries, and companies. While success is not always the case, failures have never deterred Russia from continuing to pursue its goals and objectives.

## CONCLUSION

In the aftermath of the financial collapse of 1998, Russia's position as a superpower appeared to be in jeopardy. Scholars assumed that it would require a substantial amount of time for the country to recover, but once again Russia surprised everyone. The fact that it took less than a decade was nothing short of an economic and political miracle. Russia's recovery was fast and depended on two things: strong leadership and valuable natural resources such as natural gas. Luckily, those were the exact two things that Russia had at its disposal in order to climb out of the ruins.

Natural gas wealth and ownership of an extensive network of natural gas pipelines, at a time when there is a limited amount of viable energy markets, has given Russia unprecedented political and economic power. Although naturally endowed, it took time for Russia to fully grasp the power that natural gas would eventually produce. As observed in Chapter One, Russia's current status as the largest producer of hydrocarbons (oil and natural gas) was not an overnight occurrence. It was the result of massive investments that the Soviet Union made in the western Siberian oil and gas fields dating back to the 1950s. But it was not until the 1980s that the Soviets realized that the future rested within their natural gas supplies and their most dependent client: the European Union.

As evident by the research provided in Chapters Three and Four, Russia-EU gas relations have come a long way since the first gas deliveries began flowing across the border from the USSR to Austria in 1968 and to Germany in early 1973. Friction and uncertainty in the bilateral relationship have been on the rise in the last few years. The peak of the Russia-EU gas relationship was reached when the two entities established the EU-Russia Energy Dialogue in 2000 under the leadership of Romano Prodi, then President of the EU Commission. The primary goal of this dialogue was to announce and present a plan for a very ambitious goal: doubling Russian gas imports to the EU. Ambitious it was, and it proved to be very difficult to achieve. Rising prices and realignment in leadership proved to be roadblocks for a plan that never seemed feasible. Then, came the Russia-Ukraine disputes of 2006 and 2009, which put a big dent in the relations between Russia and the EU.

The Ukraine gas crises of 2006 and 2009 were an excellent indicator of the volatile politics that have come to represent the supply of natural gas in Europe. These two incidents were quickly labeled as evidence of Russia's ability to use energy as leverage to influence decision-making among its neighbors and the EU. However, it became quite clear that it was not Russia's intention of merely teaching Ukraine a lesson about paying on time or playing along politically, but it was also Ukraine's internal political fights that, intentionally or not, contributed to the severity of the two crises. Nonetheless, it was the EU's "neutrality" stance throughout these two incidents that suggested that Russia's behavior was neither condemned nor opposed, which eventually provided Russia with an even stronger leverage over its biggest customer.

As evident by Chapters Two and Three, natural gas relations between Russia and the EU have been a widely researched topic of interest. Russia has been the most important energy supplier to the European Union, and European companies continue to be key investors in Russia's economy. As such, there is no denying that these two entities have been, and will most likely, continue on being important strategic partners. However, the 2006 and 2009 Russia-Ukraine gas crises proved that security of energy supply would be one of the EU's main challenges when dealing with Russia. Mainly, despite the fact that the EU and Russia have a joint interest in building a long-term strategic partnership, incidents such as the 2006 and 2009 crises have put the EU on alert as to *exactly* how vulnerable it truly is due to its dependence on Russia for its natural gas. In addition, while some have feared that projects such as Nord Stream and South Stream have paved the way for greater dependence, the consensus is they have provided for greater confidence, security and predictability in the long-term success of this partnership. These two projects have offered Russia and the EU a chance to transition from basic trade in energy to a wider cooperation based on joint investments, which has widely been viewed as a crucial step towards the future of energy supply from Russia to Europe.

Undeniably, at the heart of this research has been the Russian gas giant company Gazprom. Simply stated, in order to understand the complex energy relationship between Russia and the EU one must first understand Gazprom. And, as evident by the research provided in Chapter Two, Gazprom has been a crucial player in the Russia – EU energy partnership. One of the key questions that this research was guided by was the delicate relationship between Gazprom and the Russian government,



and whether the company functions as an extension of the Russian government. The answer to this question began to take shape when the research examined the leadership of Gazprom and the close ties to the Russian government. From there, past and present appointments to the Board of Directors were a good indicator of exactly how closely involved the Kremlin is within Gazprom. It was also of no surprise that Vladimir Putin has been referred to as the “Gas Emperor”, as he has always maintained that Gazprom is a key card for the Russian government.

EU and Russia have had no choice but to remain energy partners primarily based on geographical proximity and numerous completed projects that have brought them even closer together. Given the complementarity of Russia’s immense gas reserves and EU’s gas import needs, this partnership is not only natural but also necessary.

Undoubtedly, the 2006 and 2009 gas disruptions to Europe were an important, and cold, lesson that put a dent in the relations between Russia and Europe. But, it has been crucial that a dialogue remain in place because neither Russia nor Europe can afford another disruption of supply. Preventing another such disruption is what Gazprom, under the guidance of the Russian government, had in mind when it commissioned the Nord Stream project. And, with eventual support of South Stream, Europeans will no longer have to fear the freezing temperatures of a European winter without heat.

At the onset of this research, there were two things that were clear. The first thing was that Russia was the EU’s largest supplier of natural gas. And the second was that the EU was the largest consumer of Russian gas. With these two facts clearly outlined, this research commenced. With the objective clearly stated, this research delved into the history and quickly realized that it was foolish to assume that this was a

simple supplier-consumer relationship. Analyzing this multidimensional relationship between Russia and the EU, as specifically related to natural gas, has been a tremendous opportunity. Investigating Russia and the EU, and the intricate relationship they sustain within the multidimensional interdependence of being natural gas supplier and consumer, has truly been a priceless lesson in political science.

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