

Energy Interdependence: European Union - Russian Energy Relations

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This thesis will analyze the energy relations between the Russian Federation and the European Union with a focus on the developments in the 21st century up to and including the most recent developments of 2010. The main emphasis of this thesis will be on natural gas; however when oil and gas consumption, import and export volumes are expressed as a single percentage, this paper will indicate when the data given includes both oil and gas.

The European Union's relationship with the Russian Federation in terms of energy is very complex. The relationship has reached a level of mutual dependency due to the European Union's lack of self-sufficiency in terms of energy combined with Russia's energy resource surplus. The Russian Federation is the world's largest producer of natural gas, as well as the largest exporter of energy.¹ As of 2009, the European Commission reports that the European Union relies on Russia's energy giant Gazprom for 40 percent of its total gas imports², a level which is expected to rise to 60 percent by the year 2030.³ 25 percent of all gas consumed in the European Union comes from Russia.⁴ The European Union is the world's largest gas market.⁵ There currently exists a state of energy interdependence; as one quarter of Russia's gross domestic product (GDP), two-thirds of its export profits, and half of its federal revenue comes from sales of oil and natural gas - and the largest and most profitable market for energy sales is the European Union and its Member States.⁶ European companies are also some of the largest investors in the Russian energy sector (not only in gas but in the oil and electricity sectors as well).⁷ Simultaneously, the Russian Federation (via its monolithic corporation

¹ Katinka Barysch (ed.): "Pipelines, politics and power; the future of EU-Russia energy relations." *Center for European Reform*. <http://www.cer.org.uk/pdf/rp_851.pdf> (p.1)

² European Commission > Energy > External dimension > RUSSIA, 4 June 2010. <http://ec.europa.eu/energy/international/russia/russia_en.htm>

³ "Geopolitics of EU energy supply." *Euractiv.com*, 10 January 2007.

<<http://www.euractiv.com/en/energy/geopolitics-eu-energy-supply/article-142665>>

⁴ Daniel Korski and Pierre Noël: "Russian threats are just gas." *European Council on Foreign Relations*,

2 September 2008. <http://www.ecfr.eu/content/entry/russia_threats_are_just_gas/>

⁵ Katinka Barysch (ed.): "Pipelines, politics and power; the future of EU-Russia energy relations." *Center for European Reform*. <http://www.cer.org.uk/pdf/rp_851.pdf> (p.1)

⁶ *Ibid.* (p.5)

⁷ *Ibid.* (p.1)

Gazprom) is interested in increasing its own access to the European Union's energy market (in order to raise revenues from natural gas exports).⁸

The European Union's 27 Member States display a lack of solidarity when it comes to a unified energy policy. The European Union does not have a common internal or a common external energy policy. Energy policy is a dual competency of both Union level institutions and the Member States according to the Lisbon Treaty which entered into force on the 1st of December 2009; the result of which is that energy policy cannot be fully coordinated at the Union level. Full sovereignty in energy policy has not been placed at union level because it is a sensitive policy area for Member States (especially since energy policy overlaps with foreign policy, i.e. with external policy towards the Russian Federation). Energy policy is also very important at the EU level as it affects multiple policy areas that are the full competency of EU institutions; for example the link of energy with the single market and competition policy, as well as the security of the European Union as a whole. It is, therefore, in the interest of EU level institutions to coordinate an external energy policy towards Russia based on certain basic principles of solidarity. Russia's 'divide and rule' tactics work because the European Union Member States are not willing to fully coordinate energy policy, as European companies and governments would rather sign nationally lucrative bilateral and long-term natural gas supply contracts with Russia.⁹ In order to combat this, the European Union needs first to develop an effective common internal energy policy through the integration of its gas markets, and second, define a common stance on external energy objectives (by creating a common external energy policy, especially towards Russia).¹⁰

Since the European Union still lacks one cohesive energy policy, or a common foreign relations stance towards Russia, Gazprom has been able to infiltrate the European energy market. It has done so via extensive pipeline infrastructure that indirectly supplies European

⁸ *Ibid.* (p.1)

⁹ *Ibid.* (p.1)

¹⁰ *Ibid.* (p.5)

Union Member States who have signed lucrative long-term contracts with Gazprom to import gas from Russia. Gazprom also has domestic energy distribution contracts with multiple Member States, as well as a substantial network of subsidiary companies which work for Gazprom under national energy 'brands'. Gazprom has essentially locked in European demand for Russian gas.

In turn the EU is forming new tactical partnerships with strategically key countries such as Ukraine, as well as facilitating an increase in the EU-Russian Energy Dialogue in order to increase cooperation and security of supply. The Ukrainian Gas Crises of 2006 and 2009 in particular have put severe strain on EU-Russian energy relations and have proven that a mutual dependency in terms of energy supply and demand is no guarantee of security of supply or transit.

When analyzing the extent of this mutual dependency in the energy sector, the following interrelated research questions will be analyzed with relevant case studies;

Chapter 1 will analyze how the European Union is coordinating the integration of external energy policies and the ability of European Union level institutions to facilitate and coordinate internal and external energy policies. How has the increased coordination of European Union internal and external energy policies affected EU-Russian energy relations? The lack of a full implementation of a common internal European energy policy and the complete lack of a common external European energy policy is a key component of EU-Russian energy relations. As there is no foreseeable end to European dependency on Russian gas, what cooperative steps have been taken to ensure security of supply as well as security of transit? Strategies and policies used by the EU to place energy relations with Russia on a more secure, transparent and predictable foundation will also be analyzed; including agreements such as the European Union – Russian Common Economic Spaces agreement and the European Union - Russian Energy Dialogue. What are the legal frameworks that the European Union has pursued for EU - Russian energy relations? Case studies include the EU's

promotion of the Energy Charter Treaty for Russia to ratify, and the European Commission's attempts to restrict third party companies (Gazprom and its subsidiaries) from buying into the European energy infrastructure in order to protect the internal European market.¹¹ Another key question is how EU relations with energy-important regions (i.e. members of the Eastern Partnership) affect EU-Russian energy relations? How has the EU's move towards closer relations with Ukraine been perceived by Russia? 80% of Russian gas to Europe passes through Ukraine¹², therefore the EU views energy-sector modernization investments in this neighbourhood as instrumental in guaranteeing European energy security. The Eastern Partnership may also have positive consequences for European Union energy security as it increases European cooperation with energy-important regions. The Eastern Partnership and the EU's focus on cooperation with the Ukraine's energy sector may also continue to have negative consequences on the EU's relationship with Russia. Europe's increase in interest in these regions is seen by Russia as the EU's circumnavigation of direct policies with Russia with a focus on energy-transit and producing spaces that the EU can influence. Russia's wariness of EU influence in these regions is due to Russia's traditional control over former-Soviet spaces. The European Union is well within its right to offer the benefits of attractive and lucrative partnerships to these regions, even if one aim is in order to gain greater integration and security in the energy sector.

Chapter 2 will analyze Gazprom's energy strategies and tactics and their effects on the European gas market. How does Russia's 'divide and rule' strategy undermine European Union energy security and energy policy coordination by locking in demand, through its strategies of long-term bilateral contracts with member states (such as domestic distribution

¹¹ Katinka Barysch (ed.): "Pipelines, politics and power; the future of EU-Russia energy relations." *Center for European Reform*. <http://www.cer.org.uk/pdf/rp_851.pdf>

¹² Andris Piebalgs: "Opening speech at the International Investment Conference on the Rehabilitation of Ukraine's Gas Transit Network." Europa.eu Press Release, Brussels, 23 March 2009. <<http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/09/146&format=HTML&aged=0&language=EN&guiLanguage=en>>

contracts, the use of subsidiary companies within the European energy market, fostering relationships with European interest groups and, most importantly pipeline agreements)? Gazprom's pipeline strategies have a direct effect on the European energy market, Member States' energy relations with Russia and EU-Russian energy relations as a whole. How do new pipelines such as Gazprom's new direct pipeline projects (Nord Stream, South Stream) compare with the transit pipelines (through Ukraine, Belarus, and other European Neighbourhood Policy countries) and how does South Stream compete with the EU-level supported Nabucco pipeline project. Direct pipelines have an effect on EU-Russian relations in that they single out specific EU Member States as beneficiaries of direct energy transit. Lastly, how successful has Russia been in derailing competition; using the South Stream pipeline as a political and economic rival to the Nabucco pipeline? How close is Russia to controlling the output and pricing of gas through the creation of or joining a gas OPEC? Is Russia successfully using these energy strategies to gain the upper hand in its relationship with the European Union? Is there an existence of an unequal or unbalanced interdependence in this relationship?

Chapter 3 will analyze EU-Russian energy relations in crisis. Is Russia able to use energy as political and economic leverage against the EU; or does a mutual dependency prevent it from doing so? How have energy crises made the EU and its Member States question the security of Russian energy supply to Europe? Have these crises increased or decreased EU and Russian policy towards energy cooperation? The case of the Russo-Ukrainian gas crises and their monumental effect on the European energy market is a key example of why the EU is increasingly worried about its energy dependency on Russia. These crises, however, are very costly for each actor involved; during the 2009 Russo-Ukrainian gas crisis Gazprom lost revenues totaling approximately 1.5 billion dollars (U.S.) "due to lack of

sales, plus penalties [under] European contracts”.¹³ Ukraine reportedly lost transit fees totaling 100 million dollars (U.S.).¹⁴ The crisis was thus a very expensive gamble made on the part of both Ukraine and Russia. 18 European Union Member States were directly affected by the crisis.¹⁵ Europe is the closest, largest and most valuable energy market with transit infrastructure in place linking it directly to Russia. For Europe, Russia is both geographically close and relatively reliable as a supplier. Both the European Union and the Russian Federation have a vested interest in keeping their relationship on mutually beneficial terms, which is why so many agreements and partnerships are put in place.

Russia has been an energy supplier to Western Europe even since during the Cold War, and this position of importance to the European market is not likely to change in the near future. The energy-based relationship that exists between the Russian Federation and the European Union is one of mutual dependency, the extent of which will be demonstrated through the research presented in this thesis. Energy is tied to key political, economic and security dimensions that complicate the European Union’s relationship with Russia. Since a common European energy strategy is still in the making, Member States’ varying stances on Russia will continue to cause divisions that will paralyze a centralized European Union policy on Russian energy. The mutual dependence that exists between the European Union and Russia will continue to be based on energy supply and demand – the variable dynamic is if this dependence can either be put on more stable, transparent and predictable grounds, or if the EU can successfully create a common market and diversity away from Russian gas.

¹³ Simon Pirani, Jonathan Stern and Katja Yafimava: “The Russo-Ukrainian gas dispute of January 2009: a comprehensive assessment.” *Oxford Institute for Energy Studies*, February 2009. (p. 61)

¹⁴ Andrei Nesterov: “Russia-Ukraine ‘Gas War’ Damages Both Economics.” *Worldpress.org*, 20 February 2009.

¹⁵ Leo Cendrowicz: “Russia-Europe Gas Spat Ends – For Now.” *Time.com*, 9 January 2009.

Chapter 1 European Union energy policies

1.1.1 The EU and the Member States: shared energy policy competency and the lack of a common energy policy

The background of shared competency regarding energy policy is very relevant to the issue of EU-Russian energy relations; as European Union level institutions do not have full sovereignty to make decisions regarding external energy policies with Russia, yet are able to coordinate some energy principles to a certain supranational extent and are also able to promote EU-sponsored energy projects and energy related external policies. Because European Union level institutions do not have full sovereignty on Member States' internal or external energy policy, what the Council, Commission and Parliament have been able to achieve is greater coordination of energy principles, however energy policy implementation lies with the European Union's Member States. Under the Lisbon Treaty, which entered into legislation as of 1st December 2009, energy policy is a dual competency held at both Union level and at the level of the Member States.¹⁶ The Lisbon Treaty can "enhance the EU's common energy policy"¹⁷ by setting the legislative and legal "foundations for a much needed common energy policy."¹⁸ True coordination and integration of energy policy and the creation of a 'European Energy Community', however, has not yet been achieved. The European Union's rising dependence on energy imports has had an impact on energy security, and this situation has strengthened arguments "in favour of a stronger and more coherent involvement of the EU [in] external energy questions" and as a result many national governments feel more compelled to "join forces to secure energy security" at the Union

¹⁶ European Centre for Law and Justice: "Legal Analysis of Select Provisions of the Lisbon Treaty." 12 June 2008, Strasbourg. < http://www.eclj.org/PDF/080609_ECLJ_Lisbon_Treaty_analysis_final.pdf>

¹⁷ Valentina Pop: "EU's Energy Policy a 'Big Failure'." *Business Week*, 1 June 2009. <http://www.businessweek.com/globalbiz/content/jun2009/gb2009061_310444.htm?chan=top+news_top+news+index+-+temp_global+business>

¹⁸ Jerzy Buzek: "Welcoming the Lisbon Strategy." *Spiegel Online International*, 30 November 2009. <<http://www.spiegel.de/international/europe/0,1518,664338,00.html>>

level.¹⁹ Since the Member States have diverse energy sources under various contracts, some EU Member States “are skeptical [of] forming a collective external energy security strategy and prefer bilateral agreements with producer countries”²⁰ such as Russia. These EU level initiatives are also focused on successful European energy diversification (a common European energy policy is also needed in order to make European efforts at diversification successful). Andreas Heinrich points out that if the EU were

“to liberalize its own market and unbundle its national utilities...this would cut profit margins in gas distribution, and thereby reduce Gazprom’s appetite for these assets. It would also weaken ‘special relationships’ between Russia and single [Member States] and thus strengthen a common EU energy policy. The weakened bargaining position of individual EU energy companies against energy suppliers would be offset by a common EU position presented by the EU energy commissioner.”²¹

Union level directives have focused on the full implementation of a common internal energy policy, but have more recently linked the importance of a Community level common internal policy with a common external energy policy. Within the 2006 paper ‘An external policy to serve Europe’s energy interests’, a connection is made between the EU’s internal and external energy policies; and the European Commission highlighted that “a well advanced internal [energy] policy is a prior condition for defining external interests.”²² The 2007 Communication ‘An energy policy for Europe’ from the European Commission to the Council and the Parliament suggests that the implementation of a common international energy policy would “ensure efficiency and coherence” and concludes that “it is crucial that Member States and the EU are able to speak with a single voice on international energy

¹⁹ Oliver Geden, Clemence Marcelis and Andreas Maurer: “Perspectives for the European Union’s External Energy Policy: Discourse, Ideas and Interests in Germany, the UK, Poland, and France.” *German Institute for International and Security Affairs*, Working Paper; Research Union EU Integration; December 2006.

²⁰ Manja Vidic: “The EU Institutional Capacity in Securing Energy.” *Turkish Policy Quarterly*: Vol. 6 No. 4. (p. 4)

²¹ Andreas Heinrich: “Gazprom’s Expansion Strategy in Europe and the Liberalization of EU Energy Markets”. *Russian Analytical Digest* (Research Centre for East European Studies), No. 34: Russian Business Expansion, 5 February 2008.

http://kms2.isn.ethz.ch/serviceengine/Files/RESSpecNet/46810/ipublicationdocument_singledocument/EBEB560D-319D-4A6E-BB93-25DB57792AC9/en/Russian_Analytical_Digest_34.pdf>

²² Oliver Geden, Clemence Marcelis and Andreas Maurer: “Perspectives for the European Union’s External Energy Policy: Discourse, Ideas and Interests in Germany, the UK, Poland, and France.” *German Institute for International and Security Affairs*, Working Paper; Research Union EU Integration; December 2006.

issues.”²³ The 2007-2009 Action Plan also proposes “the development of a common approach to external energy policy.”

The European Commission is also currently involved in external energy initiatives at Union level, and although these initiatives do not override Member States’ separate external policies, they show how the Union is actively involved in external energy projects. The Commission has increasingly turned to its “traditional area of responsibility” – the internal market, in order to coordinate and integrate a common external energy policy by way of an “external projection of the internal market policy.”²⁴ Examples of the Commission’s “external projection of energy market and governance rules” can be identified in various Commission initiatives including the promotion of the Energy Charter Treaty and its Transit Protocol, the Energy Community Treaty, the Baku Initiative, the Black Sea Synergy and the European Neighbourhood Policy.²⁵ In the Commission’s internal market package of 2007, the ‘third party clause’ is an example of foreign policy being included in internal energy policy; as “the European Commission proposed a series of measures to restrict non-EU companies’ access to the EU’s energy sector” so that companies from third countries would have to comply with “the same unbundling requirements as EU companies.”²⁶ These European Commission policy initiatives attempt to achieve energy security for the Union within the parameters given to Commission by the member states, and have a direct effect on EU-Russian energy relations.

²³ Europa.eu > Summaries of EU legislation>Energy>European energy policy. An Energy Policy for Europe. < http://europa.eu/legislation_summaries/energy/european_energy_policy/127067_en.htm>

²⁴ Ernest Wyciszkievicz: *EU External Energy Policy – Between Market and Strategic Interest*. The Polish Institute of International Affairs, PISM Strategic Files, #1 January 2008.

²⁵ *Ibid.*

²⁶ *Ibid.*

1.1.2 The European Union's dependence on Russian energy and the Member States varying dependence on Russian energy

As of 2009, the European Commission reports that the European Union relies on Russian energy giant Gazprom for 40 percent of its total gas imports.²⁷ Russian natural gas constitutes 25 percent of the average overall consumption of natural gas in the European Union Member States.²⁸ The Member States of the European Union have had a long history of energy-relations with the Russian Federation, and before that, the former Soviet Union. Member States such as Germany, Italy, Austria and France have held long standing contracts with the Ministry of Gas of the former Soviet Union (Gazprom's predecessor) since the 1970's.²⁹ Europe's energy diversification since the 1980's has resulted in Europe's imports of energy from Russia falling from 80 percent of its overall energy imports to (approximately) 40 percent, a significant blow to Russia as a monopoly provider.³⁰ Therefore, Europe has had success in the past of limiting its overdependence on Russian energy through supply diversification. However, the European Union's current rising demand for energy could result in an increasing dependency on Russian energy, and by 2020 approximately 70 percent of the European Union's energy could be imported, most of this from the Russian Federation.³¹ This observation is based on the fact that over the past 20 years, gas consumption and demand within the European Union's current 27 Member States has increased per annum by 2.2 percent (overall energy consumption only rises at a rate of 0.23 percent per annum).³²

²⁷ "Energy Dialogue EU-Russia: The Tenth Progress Report": European Commission, November 2009 (pp. 4-6). PDF: <http://ec.europa.eu/energy/international/bilateral_cooperation/russia/doc/reports/progress10_en.pdf>

²⁸ Andris Piebalgs (Commissioner of the European Commission on Energy Issues) and Sergey Shmatko (Minister of Energy of the Russian Federation): "Energy Dialogue EU-Russia: The Tenth Progress Report", Moscow, November 2009. <http://ec.europa.eu/energy/international/russia/doc/reports/progress10_en.pdf>

²⁹ Pierre Noel: "Beyond dependence: How to deal with Russian gas." *European Council on Foreign Relations*, Policy Brief, London, November 2008 (p. 8).

³⁰ *Ibid.* (p. 1-2).

³¹ Janusz Bugajski: "Toward an Understanding of Russia, New European Perspectives." *Council on Foreign Relations*, New York, 2002 (p. 48).

³² Pierre Noel: "Beyond Dependence: How to deal with Russian gas." *European Council on Foreign Relations*, Policy Brief, London, November 2008 (p. 7).

It is also important to note Europe's situation when considering alternatives to dependency on Russian gas; the EU is surrounded by gas-exporting countries with either pre-existing pipelines in place, or from which pipelines can be built. The European Union's 27 Member State's gas imports "at present make up 61 percent of its gas consumption of which Russia covers 42 percent, Norway 24 percent, Algeria 18 percent, and other countries 16 percent."³³ It is estimated that North African gas could account for up to 38 percent of the European Union's gas imports by 2020 (an increase of 8 percent),³⁴ whereas Russian gas imports are expected to reach over 60 percent of the EU's total gas imports by 2030 (an increase of 20 percent). The European Union's external gas dependency is expected to reach 80 percent by 2030.³⁵

The alternatives to Russian gas are equally costly – in terms of pipeline infrastructure; especially in regards to the Nabucco pipeline (which is expected to carry 31 billion cubic meters of gas per year from the Caspian Sea to Europe by 2020).³⁶ Nabucco is currently under construction, and will face problems of security since it is an indirect pipeline to Europe (it makes use of Transit countries such as Turkey and has not fully secured supply contracts). The Nabucco pipeline may also even end up carrying more Russian gas to Europe; Reinhard Mitschek, managing director of the Nabucco pipeline consortium is quoted as stating; "we did not eliminate any [gas] source...we will transport Russian gas, Azeri gas, Iraqi gas."³⁷ The alternatives have the same problems in terms of security of energy supply, transparency, stability and reliability. Russia's new pipeline projects Blue Stream, Nord Stream and South Stream will only solidify the European Union's dependence on Russian energy, when these

³³ Kirsten Westphal: "Russian Gas, Ukrainian Pipelines, and European Supply Security." *German Institute for International and Security Affairs*, Stiftung Wissenschaft und Politik, Research Paper, September 2009. <http://www.swp-berlin.org/common/get_document.php?asset_id=6381> (p. 24)

³⁴ Janusz Bugajski: "Toward an Understanding of Russia, New European Perspectives." *Council on Foreign Relations*, New York, 2002 (p. 48).

³⁵ "Geopolitics of EU Energy Supply." *Euractiv.com*, updated 29 January 2010.

<<http://www.euractiv.com/en/energy/geopolitics-eu-energy-supply/article-142665>>

³⁶ Vivienne Walt: "Why Europe Can't Abandon Russian Gas." *Time.com*, 23 January 2009.

<<http://www.time.com/time/world/article/0,8599,1873472,00.html>>

³⁷ Richard Galpin: "Energy fuels new 'Great Game' in Europe." *BBC News*, Moscow, 9 June 2009. <<http://news.bbc.co.uk/2/hi/8090104.stm>>

three new lines will pump gas to EU Member States under the sea. Construction is underway on all three pipelines; Blue Stream is expected to be completed by 2015, with promises of South Stream being completed in the same year³⁸ and Nord Stream is projected to be carrying gas in October 2011 with its second parallel pipeline potentially carrying gas by 2012.³⁹

The European Union's 27 Member States have vastly differing dependency on Russian energy. Germany imports the largest amount of Russian natural gas (38 billion cubic meters as of 2008⁴⁰, or 39 percent of total domestic consumption⁴¹), followed by Italy (22.4 billion cubic meters as of 2008⁴², or 31 percent of total domestic consumption⁴³), the United Kingdom (20.9 billion cubic meters as of 2008)⁴⁴, and France (10.9 billion cubic meters as of 2008⁴⁵, or 24 percent of total domestic consumption⁴⁶). Russian gas represents 98 percent to 100 percent of total domestic consumption of gas by EU Member States Bulgaria, Estonia, Finland, Latvia, Lithuania and Slovakia.⁴⁷ This is followed by Hungary (64 percent), the Czech Republic (77 percent), Slovenia (52 percent), Poland (43 percent) and Romania (22 percent).⁴⁸

Although Member States make separate bilateral contracts with Russian energy supplier Gazprom, it is the European Union's overall energy buying power that is central to the question of how EU-Russian interdependence is based on energy supply and demand. It is the EU's importance as a market for Russian energy that gives the Union level institutions a key position in terms of energy based agreements and partnerships with the Russian

³⁸ *Ibid.*

³⁹ Nord Stream official website: "Ten Answers about the Pipeline through the Baltic Sea." <http://www.nord-stream.com/fileadmin/Dokumente/1_PDF/5_Misc/Nord_Stream_10_Answers_Brochure_Eng.pdf>

⁴⁰ Gazprom Official Website > Gazprom in Questions and Answers > Gazprom on Foreign Markets <<http://eng.gazpromquestions.ru/?id=4#c321>>

⁴¹ Bernard Gelb: "Russian Natural Gas: Regional Dependence." *CRS Report for Congress*, January 2007 (p. 1).

⁴² Gazprom Official Website > Gazprom in Questions and Answers > Gazprom on Foreign Markets <<http://eng.gazpromquestions.ru/?id=4#c321>>

⁴³ Bernard Gelb: "Russian Natural Gas: Regional Dependence." *CRS Report for Congress*, January 2007 (p. 1).

⁴⁴ Gazprom Official Website > Gazprom in Questions and Answers > Gazprom on Foreign Markets <<http://eng.gazpromquestions.ru/?id=4#c321>>

⁴⁵ *Ibid.*

⁴⁶ Bernard Gelb: "Russian Natural Gas: Regional Dependence." *CRS Report for Congress*, January 2007 (p. 1).

⁴⁷ *Ibid.* (p. 2).

⁴⁸ *Ibid.* (p. 3).

Federation. The European Union is composed of Member States whose combined economic power is almost 15 times the size of Russia.⁴⁹ Russian energy is very important for Europe, but the European energy market is equally important for Russia's energy exports; 80 percent of Russian oil exports and 60 percent of its natural gas is exported to Europe.⁵⁰ Europe is Russia's biggest energy market.

The European Union's internal option to limiting overall dependency on Russian gas would be through the creation of a pan-European internal gas market; an integrated and competitive market could function to "de-politicize" the EU-Russian energy relationship.⁵¹ This move would also help to balance out the EU Member States extreme variation of dependency on Russian energy through European-wide infrastructure and greater coordination. The European Union is most successful when pooling the power of the 27 Member States. If a common external energy policy was in place, this would facilitate a relationship between the EU and Russia that would increase the EU's potential power and limit Russia's 'divide and rule' energy strategy; "if the EU would take a common stand as a consumer group, it would be easier to affect Russia and more difficult for Russia to set the rules of the game and exploit differences between EU members"⁵² (to be discussed further in chapter 2). However, as discussed in section 1.1.1. of this paper, a common European internal energy market and a common external energy policy have not yet been achieved, and this could become an energy security problem for the European Union if dependency on Russian energy does increase as calculated.

⁴⁹ Mark Leonard and Nicu Popescu: "A Power Audit of EU-Russia Relations." *European Council on Foreign Relations*, Policy Paper, November 2007.

< http://www.ecfr.eu/content/entry/commentary_pr_russia_power_audit/> (p. 14).

⁵⁰ Robert Larsson: "Russia's Energy Policy: Security Dimensions and Russia's Reliability as a Supplier." *Swedish Defense Research Agency*, March 2006. <<http://www2.foi.se/rapp/foir1934.pdf>>

⁵¹ Pierre Noel: "Beyond dependence: How to deal with Russian gas." *European Council on Foreign Relations*, Policy Brief, London, November 2008 (p. 9).

⁵² Robert Larsson: "Russia's Energy Policy: Security Dimensions and Russia's Reliability as a Supplier." *Swedish Defense Research Agency*, March 2006. <<http://www2.foi.se/rapp/foir1934.pdf>> (p. 186).

1.1.3 Cooperative Partnerships: the European Union –Russian Energy Dialogue and the European Union - Russian Common Spaces Agreement

What cooperative measures have EU institutions taken in order to put EU-Russian energy relations on a more firm, predictable and transparent basis? The Energy Dialogue and inclusion of energy in the EU-Russian Common Spaces agreement are two key cooperative agreement examples. The general aims of these cooperative measures are to put the energy dependency on stable and transparent grounds. It is also important to note that there is often a disparity between cooperative agreements Gazprom agrees to and the actions Gazprom takes. Although the EU-Russian energy cooperation may look good on paper, it is very difficult to say whether or not Gazprom will renege on promises of cooperative partnerships (an example of which can be viewed in gas conflicts that have directly affected Russia's most important energy customer, Europe. The effects of these gas conflicts on this relationship will be analyzed in chapter 3).

The members of the Energy Dialogue forum view the forum as an instrument to achieve the objectives of sustainability and efficiency, as well as the reliability of production, distribution and transportation of energy.⁵³ This forum has helped to facilitate an increase in cooperation between energy buyer EU and energy supplier Russia. The Energy Dialogue between the European Union and the Russian Federation was officially launched in Paris in the year 2000. This 'dialogue' is in essence a forum for the exchange of energy information. The Energy Dialogue allows for a high level of interaction between the EU Commission, the EU Member States, the European energy industry, International Financial Institutions, the government of the Russian Federation and of course, Russian and European energy experts from the private sector.⁵⁴ Those who attend these forums discuss and prepare proposals for energy related investments, infrastructure, and new energy efficiency. This dialogue "is based

⁵³ EU-Russian Energy Dialogue, "Sixth Progress Report", 2005.

<http://ec.europa.eu/energy/russia/joint_progress/doc/progress6_en.pdf>

⁵⁴ *Ibid.*

on the assumption that interdependence between the two regions will grow - from the EU for reasons of security of supply; on the part of Russia, to secure foreign investment and facilitate its own access to EU and world markets (the EU is responsible for over half of Russia's trade turnover).”⁵⁵ Although this cooperative measure has helped to facilitate an interactive energy forum, these dialogues do not create the policies of government. This is why the European Union is encouraging Russia to ratify the Energy Charter Treaty – in order to solidify energy cooperation in an international policy that is legally binding.⁵⁶

The Four Common Spaces agreement of 2003 between the European Union and the Russian Federation was the European Union’s response to Russia choosing not to join the European Neighbourhood Policy (as Russia considered itself to be an equal partner to the European Union). The Common Economic Space includes within its scope the issue of energy, with the aim of an open and integrated economic market through legislation that puts in place conditions that increase cooperation in fields such as energy. This agreement is based on the principles of transparency and non-discrimination to enhance the competitiveness of both the EU and Russian markets – through the promotion and protection of mutual energy related investments, the convergence of energy strategies and policies, the enforcement of common regulatory measures (for greater energy efficiency), and cooperation for both energy infrastructure projects and in guaranteeing safety of energy transport.⁵⁷ The EU-Russia Common Spaces Progress Report of 2008 (written in March 2009) implies that there are limits to the Common Spaces objectives; one example of failure is that the Energy Early Warning Mechanism failed to prevent the Russo-Ukrainian gas crises.⁵⁸ Agreements for cooperation can be made, but can also be broken unless they are legally binding. Moreover,

⁵⁵ Euractiv.com, EU-Russia Energy Dialogue, updated 29 January 2010.

<<http://www.euractiv.com/en/energy/eu-russia-energy-dialogue/article-150061>>

⁵⁶ Judy Dempsey: “Russia gets tough on energy sales to Europe.” *The New York Times*, 12 December 2006.

<http://www.nytimes.com/2006/12/12/world/europe/12iht-energy.3876719.html?_r=1>

⁵⁷ Road Map for the Common Economic Space, European Commission website

<http://ec.europa.eu/environment/enlarg/pdf/road_map_ces.pdf> (p. 20)

⁵⁸ EU-Russia Common Spaces Progress Report of 2008, prepared by European Commission services in March 2009. <http://ec.europa.eu/external_relations/russia/docs/commonsaces_prog_report_2008_en.pdf> (p.2)

the topics and issues outlined in the Common Spaces agreement for the field of energy are based on the principles guiding the Energy Charter Treaty⁵⁹ so in some ways the Common Spaces agreement is a way for the European Union to ensure that some of the principles of the Energy Charter Treaty can be met (as Russia has not ratified agreement).

1.1.4 Energy Charter Treaty

The Energy Charter was signed in 1991 in order to integrate the energy sectors of the former Soviet Union into the European and world-wide energy markets. The Energy Charter Treaty and its Transit Protocol create the legal framework for international energy cooperation. The legally binding Energy Charter Treaty (or ECT) was signed in 1994 by members of the Energy Charter Conference, and entered into force as of 1998.

Russia has signed but not yet ratified the Energy Charter Treaty and the Transit Protocol.⁶⁰ Russia will not ratify the ECT or Transit Protocol mainly because of the provision allowing third-party access (allowing other companies say from Central Asia to use Russia's pipeline network to transit gas to Europe) the charter would open to Russian pipelines, resulting in competition for Russia's state-owned energy monopoly.⁶¹ Currently, as the ECT and Transit Protocol have not been ratified by Russia, the only way companies in Central Asia can deliver gas to Europe is by selling it first to Russia, which then transports it to Europe. Several EU Member States have argued that by not signing the ECT and Transit Protocol, Russia has an unfair advantage in the gas market. Russia can prevent "foreign companies from gaining access to [Russian] energy grids, [yet] Gazprom is not stopped from distributing its gas in EU countries and the reciprocity of the ECT and Transit Protocol would even the

⁵⁹ Road Map for the Common Economic Space, European Commission website
<http://ec.europa.eu/environment/enlarg/pdf/road_map_ces.pdf> (p. 24)

⁶⁰ Robert Larsson: "Russia's Energy Policy: Security Dimensions and Russia's Reliability as a Supplier." *Swedish Defense Research Agency*. <<http://www2.foi.se/rapp/foir1934.pdf>> (pp. 76-77)

⁶¹ Judy Dempsey: "Russia gets tough on energy sales to Europe." *The New York Times*, 12 December 2006.
<http://www.nytimes.com/2006/12/12/world/europe/12iht-energy.3876719.html?_r=1>

access to energy grids.”⁶² In counterargument, Russia is not likely to stop European companies from investing in the Russian energy grid (although they are likely to prevent foreign controlling stakes within the network), as Russia needs foreign European investment in its internal energy grids in order to increase production and export levels.

Without Russia ratifying the ECT, the charter is weakened because of Russia’s consolidated power over pipelines and protectionist policies over Russian energy grids – the principle of reciprocity between Russia and the European Union is lacking in the energy sector unless Russia ratifies the ECT and Transit Protocol. Without a set of stable and legally binding regulations⁶³ which is signed by Russia, cooperation agreements between Russia and the European Union can be broken without legal consequence – a (possibly ongoing) example is the Russo-Ukrainian gas crises and their severe effects on the European Union. In Russia’s defense, however, other energy producing countries have also not signed the Energy Charter Treaty and its Transit Protocol (including Canada, the USA, and Norway).⁶⁴ The ECT and its Transit Protocol is thus flawed in that it is signed mainly by consumers rather than major producers, and will need revision and renegotiation to make it acceptable to both consumers and producers of energy.

Russia released an Energy Charter Treaty adaptation, entitled a ‘Conceptual approach to the new legal basis for international cooperation in the energy sphere (aims and principles)’ on the Kremlin website as of 21 April 2009.⁶⁵ Created following the Russo-Ukrainian gas conflict of January 2009 this article seems to be an attempt by Gazprom experts and the Russian government to prove a willingness to work within the ECT framework, however this article is in no way a guarantee that Russia will ratify the ECT any time soon even if the

⁶² Judy Dempsey: “Russia gets tough on energy sales to Europe.” *The New York Times*, 12 December 2006. <http://www.nytimes.com/2006/12/12/world/europe/12iht-energy.3876719.html?_r=1>

⁶³ *Ibid.*

⁶⁴ Anders Aslund: “Gazprom’s Strategy.” (Testimony before Hearing on EU Economic and Trade Relations with Russia, Committee on International Trade, European Parliament, Brussels), Peterson *Institute for International Economics*, 21 November 2006.

⁶⁵ Andrey Konoplyanik: “Russia: Don’t oppose the Energy Charter: help adapt it.” *Petroleum Economist*, July 2009. <<http://www.konoplyanik.ru/ru/publications/articles/090618-PE-ECT-final.pdf>>

suggestions contained within this ‘conceptual approach’ are considered at the next ECT review session. It has been argued by energy experts (including Andrey Konoplyanik, deputy secretary-general of the Energy Charter Secretariat from 2002 to 2008) that this document does raise important questions about updating the ECT and that this conceptual approach could provide additions that would strengthen the framework and instruments of the ECT. Andrey Konoplyanik notes that although the paper was most likely drawn up by Gazprom experts, it seems to have been created in order to provide Russian additions to the original and internationally legally binding ECT and Transit Protocol⁶⁶ (therefore the document can be viewed as a supplement rather than a Russian attempt at replacing the ECT). Konoplyanik argues that Russia is in a position to help improve the process, framework and instruments of the ECT; an example is that the text contains an innovative element that consists of the suggestion of a system of international commissions authorized to sort out threatening energy transit emergency situations.⁶⁷ At a news conference in May of 2009 following a Russia-EU Summit, European Commission President Barroso responded to the Russian adaption by stating that improvements to the ECT’s framework could be made by engaging all parties in an open international discussion of Russia’s revision.⁶⁸

1.2 European Union external policies that affect EU-Russian energy relations

European Union level institutions use external policy instruments to protect collective European energy interests. The European Neighbourhood Policy, the Black Sea Synergy and the Eastern Partnership are three initiatives created by the EU that include within their aims the diversification of energy supply and the guarantee of greater security for energy supply and transport. These initiatives cover regions that are also of interest to the EU in terms of

⁶⁶ Andrey Konoplyanik: “Energy Charter and the Russian Initiative – What should be done with the International Community’s Legal Base?” *Oil, Gas and Energy Law*, 5 May 2009.

⁶⁷ *Ibid.*

⁶⁸ President of Russia, Official Web Portal: “News Conference following Russia-EU Summit.” 22 May 2009. <http://eng.kremlin.ru/speeches/2009/05/22/1419_type82915_216713.shtml>

potential gas transit points from Central Asia (which will potentially bypass Gazprom's pipeline network). These initiatives can be seen as a response to the European Union's growing dependency on Russian energy. These agreements cover former Soviet republics – areas which have preexisting Gazprom pipeline infrastructure, Gazprom transit agreements and Gazprom subsidiaries. These partnerships are important because energy transit security through the regions covered cannot be agreed through partnerships with Russia alone. These same agreements, although they help to guarantee that Russian gas is transported safely and securely to the European Union, also are increasingly bringing these countries closer to the economic and political sphere of the EU which threatens Russia's hegemony. These policies are therefore a key dimension of the EU-Russian energy interdependence.

The competition specifically in regards to pipeline politics between Russia and the European Union will be analyzed in greater detail in Section 2.1.4 and Section 2.1.5.

1.2.1 European Neighbourhood Policy

The 2004 European Neighbourhood Policy is an important foreign relations instrument of the European Union and provides a wide framework that allows for greater political and economic cooperation for the European neighbourhood. The ENP covers Israel, Jordan, Moldova, Morocco, the Palestinian Authority, Tunisia, Armenia, Egypt, Lebanon, Algeria, and most importantly when considering EU-Russian energy relations, the policy also covers Ukraine, Azerbaijan and Georgia.⁶⁹ It is important to note that the Baku–Tbilisi–Ceyhan pipeline runs through Azerbaijan and Georgia, and the main shareholders are BP (a British energy company) and a consortium of European and Central Asian gas companies.⁷⁰

⁶⁹ Fraser Cameron: *An Introduction to European Foreign Policy*. New York, Routledge, 2007. (p. 109)

⁷⁰ Savante E. Cornell and S. Frederick Starr (eds.): "The Baku-Tbilisi-Ceyhan Pipeline: Oil Window to the West." Central Asia – Caucasus Institute, Silk Road Studies Program, 2005. <<http://www.silkroadstudies.org/new/inside/publications/BTC.pdf>> (p. 45)

Gazprom decided not to be a shareholder in this project.⁷¹ Within the ENP framework the European Union is able to facilitate an increase in cooperation in the energy sector. ENP action plans build on existing bilateral and regional initiatives including the Baku Initiative (which aims to enhance energy cooperation between the EU and the countries of the Black Sea and the Caspian Basin in particular).⁷² ENP countries play a vital role for the European Union's attempts at diversification and the security of energy supply. Russia was invited to join the ENP, but as it considers itself to be such an important partner, the Four Common Spaces agreement was created between the EU and Russia in order to cover similar spaces of cooperation.

1.2.2 Black Sea Synergy

The Black Sea Synergy is part of the European Neighbourhood Policy and is an initiative that was formally launched by Black Sea partners and the European Union in 2008.⁷³ The Black Sea Synergy initiative was created by the European Union in partnership with Black Sea governments in order to establish energy sector collaborations through joint projects, investments and the co-ownership of credible pipelines projects.⁷⁴ The Black Sea Synergy complements the Eastern Partnership of 2009⁷⁵ (for an overview of the Eastern Partnership see section 1.2.3). In terms of energy policy, the Eastern Partnership's focus is to politically and economically link and integrate Eastern Partnership members with the EU (for greater energy security), and the Black Sea Synergy will directly aid this integration via cooperative energy sector projects (and the joint funding of these projects) in this region. This

⁷¹ "Moscow negative about Baku-Ceyhan Pipeline." *Pravda*, 13 January 2004. <http://english.pravda.ru/main/18/89/357/11772_pipeline.html>

⁷² European Commission > Directorates-General > Energy and Transport > Baku Initiative. <http://ec.europa.eu/dgs/energy_transport/international/regional/caspian/energy_en.htm>

⁷³ European Parliament > Press Release: *Black Sea Synergy*. 15 March 2010. <<http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/10/78&format=HTML&aged=0&language=EN&guiLanguage=en>>

⁷⁴ *Ibid.*

⁷⁵ *Ibid.*

initiative is open to Russian involvement.⁷⁶ The launch of the Black Sea Synergy could result in strategic challenges, as the EU is encroaching on a region that traditionally is politically and economically Russian dominated, and this could result in more assertive energy policies from Gazprom. Russia's recent successful chairmanship of the Black Sea Economic Cooperation (the BSEC organization which was launched in 1992 is a regional economic initiative with eleven members; Albania, Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Moldova, Romania, Russia, Turkey and Ukraine)⁷⁷ on the other hand "suggests that the prospect of isolation can give way to a more cooperative attitude towards the European Union in due course."⁷⁸ With the growing prominence of energy issues on the European agenda, the European Union has become more pro-active in its strategic role in regions such as the Black Sea in order to prevent Russia's future political and economic domination in this area and to secure energy prospects in the region.⁷⁹ The Black Sea initiative will give the EU influence in the region and put the EU in a position of power in this strategically key region for energy security;

"Recent initiatives targeting the Eastern neighbourhood such as a European strategy for Central Asia and the ENP+ [European Neighbourhood Policy] have developed against growing concerns over the energy security and Russia's reliability as an energy supplier. The Black Sea is a major energy transit zone and the EU wants to avoid seeing this space [with which] it has already developed various bilateral cooperation ties, slip under Russia's domination"⁸⁰

The Black Sea Synergy is yet another important example of the EU's pro-active stance on energy-significant external relations.

⁷⁶ *Ibid.*

⁷⁷ Fraser Cameron: *An Introduction to European Foreign Policy*. Routledge, New York, 2007. (p. 67)

⁷⁸ Fabrizio Tassinari: *Sailing the Black Sea at last*. Opinion piece for the EU Observer by the author of "A Synergy for Black Sea Regional Cooperation", 7 February 2008. <<http://euobserver.com/9/25615>>

⁷⁹ Lili Di Puppò: "The European Union begins to think strategically about the Black Sea." *Caucas Europe News*, 15 May 2007. <http://www.caucaz.com/home_eng/breve_contenu.php?id=312>

⁸⁰ *Ibid.*

1.2.3 The Eastern Partnership

The Eastern Partnership was established in 2009 and is an external policy of the European Commission that aims to bring the countries of Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine politically and economically closer to the European Union (with the aim of gradual integration into the European Union economy)⁸¹. Due to these countries' geographical proximity to the European Union's borders, the security, stability and prosperity of these countries can have an effect on the European Union. One of the aims of the Eastern Partnership is to strengthen energy security – as these countries are strategically important for the transport of energy.⁸² The potential that these countries offer for the diversification of the European Union's energy supplies is a further example of the Eastern Partnership's importance for European energy concerns.⁸³ The Eastern Partnership has been met with strong Russian opposition. President Dmitry Medvedev has stated “We tried to convince ourselves [that the Eastern Partnership is harmless], but in the end we couldn't. What bothers us is that for some states this is seen as a partnership against Russia.”⁸⁴ Russia is critical of the European Union's Eastern Partnership because it implies an extension of the European Union's external 'sphere of influence' over territory that had previously been under the control of the Soviet Union (the Eastern Partnership includes six former Soviet states).⁸⁵ The Russian Federation is simply wary of losing its ability to influence and wield power over former Soviet territories that are strategically important for energy reasons.

⁸¹ European Commission > External Relations > Eastern Partnership.
<http://ec.europa.eu/external_relations/eastern/index_en.htm>

⁸² *Ibid.*

⁸³ *Ibid.*

⁸⁴ Karoly Benes: “Whose Sphere of Influence’? Eastern Partnership Summit in Prague.” *Central Asia-Caucases Institute Analyst*, 6 March 2009.

⁸⁵ „EU's New Eastern Partnership draws ire from Russia.” *Deutsche Welle*, 21 March 2009. <<http://www.dw-world.de/dw/article/0,,4116554,00.html>>

1.2.4 European Union – Ukraine energy relations

Although European Union – Ukraine energy relations are covered by the European Neighbourhood Policy, Eastern Partnership and the Black Sea Synergy, yet their level of cooperation in the energy sector is much deeper. Ukraine is considered to be a priority partner of the European Union as it is the main transit point for gas from Russia to Europe, and is therefore a strategically key region for European energy security.

Andris Piebalgs, European Energy Commissioner points out that;

“Ukraine is the single most important transit country for gas supplies to Europe. Around 80% of all Russian gas destined for Europe arrives through this route. The gas reaches as many as 12 EU Member States as well as Western Balkan countries and Turkey. It is in Europe's strategic interest to keep the gas coming through this route. Any other solution is economically less interesting. Additional gas imports to Europe are needed and are expected to reach approximately plus 40-150 bcm [billion cubic meters] per year by 2020 depending on different scenarios.”⁸⁶

This speech was given at the 2009 European Commission organized and initiated ‘International Investment Conference on the Rehabilitation of Ukraine’s Gas Transit Network’. This investment conference is an example of the European Union’s initiative in funding the integration of the whole of the Ukrainian gas transmission system based on “the basic principles derived from the EU energy laws.”⁸⁷ The fact that “Ukraine is already [on a] timeframe for the implementation of the complete set of EU gas laws in the framework of its negotiations for accession to the Energy Community Treaty”⁸⁸ could be worrisome for Gazprom, and could have a negative effect on EU-Russian energy relations in the near future.

Russia regards itself as an important factor of influence over Ukraine’s energy sector and it believes it has this position of advantage due to the “resources and will on its side”⁸⁹ (along with its historical connections to and political and strategic interests in the country). The European Union, however, has an advantage of an economic attraction for Ukraine; an

⁸⁶ Andris Piebalgs (Energy Commissioner): “EU-Ukraine Energy Security”. Opening speech at the International Investment Conference on the Rehabilitation of Ukraine’s Gas Transit Network. Brussels, 23 March 2009.

⁸⁷ *Ibid.*

⁸⁸ *Ibid.*

⁸⁹ Stephen Velychenko (ed.): *Ukraine, the EU and Russia*. New York, Palgrave Macmillan, 2007. (p. 176)

example being that “Ukraine’s trade turnover with the EU is greater than that with Russia.”⁹⁰ On the other hand, Ukraine remains closely interconnected with the Russian Federation; Ukraine depends upon Russia for its energy, and on the revenue it makes from the transit of Russian gas to Europe, and Russia remains influential in Ukraine’s internal politics.⁹¹ Ukraine will remain important to the EU due its geographical location; it is “the northern littoral of the Black Sea, its frontier now forms the principal eastern border of the Union after Romania’s accession, and it is the transit zone for 80 percent of the EU’s imported gas from Russia.”⁹² The EU therefore has a strategic and economic stake in its influence on and development of Ukraine for the security of its own borders and the security of its energy needs.

1.3 Conclusion

Section 1.1 analyzed the context and effects of European dependence on Russian energy and how the issue of energy has increased a need for coordinated European internal and external energy policies. The European Union’s Russian-specific energy policies were analyzed in order to determine what initiatives the EU is taking in order to place the energy-based interdependency on more stable, transparent and secure grounds. Section 1.1.1 focused on the lack of common European Union energy policy towards Russia. As EU-level institutions and Member States share competence in the area of energy policy, this creates overlapping priorities and Member States can continue to pursue their own agendas through bilateral agreements with Russia that can undermine the EU’s ability to unify internal and external energy policies. Section 1.1.2 focused on the European Union’s overall dependence on Russian energy and the issues resulting from Member States’ differing dependence on Russian Energy, especially the effect on the EU’s ability to speak with one voice when it comes to energy issues at the supranational level. Section 1.1.3 analyzed important EU-

⁹⁰ *Ibid.* (p. 176)

⁹¹ *Ibid.* (p. 176)

⁹² *Ibid.* (p. 180)

Russian energy focused partnerships and how they improve cooperation in the energy sector. The European Union – Russian Energy Dialogue and the European Union - Russian Common Spaces Agreement are important cooperative agreements that help to facilitate greater energy sector cooperation between the European Union and the Russian Federation, however, these agreements are limited because they are not legally binding and have failed to prevent gas crises such as the Russo-Ukrainian gas crises. Section 1.1.4 analyzed the importance of the Energy Charter Treaty and Transit Protocol in EU-Russian relations as a binding, international, legal document that has the potential to put the international energy sector on stable and transparent grounds. Although Russia has signed and not ratified the Energy Charter Treaty, Russia's 2009 conceptual adaptation of the ECT could prove that Russia is willing to work within its framework.

The European Union's set of agreements and partnerships that include former Soviet regions highlight the level of competition between Russia and the European Union over access to, and control over energy resources in strategically important regions. These EU external energy projects show the expanse of the European Union's sphere of influence in the international energy sector. The European Union is using new cooperative tactics in an attempt to diversify energy sources away from Russia through policies of economic integration (such as the Eastern Partnership, the Black Sea Synergy and the European Neighbourhood Policy). Russia will have to compete with the EU on shared regions of interest.⁹³ The EU's partnerships that include regions important for the energy sector, have had consequences for the EU's relationship with Russia, as Russia has its interests and concerns in these regions, which have resulted in competition (i.e. the creation of the South Stream pipeline project as competition to the EU's Nabucco pipeline project, to be discussed in section 2.1.4).

⁹³ Ecologic Institute: "European Neighbourhood Policy – Challenges for the Environment and Energy Policy." <<http://ecologic.eu/1696>>

Chapter 2 Russia & Gazprom: energy relationship with the European Union

Figure 1: Gazprom's share in the European market, 2008⁹⁴

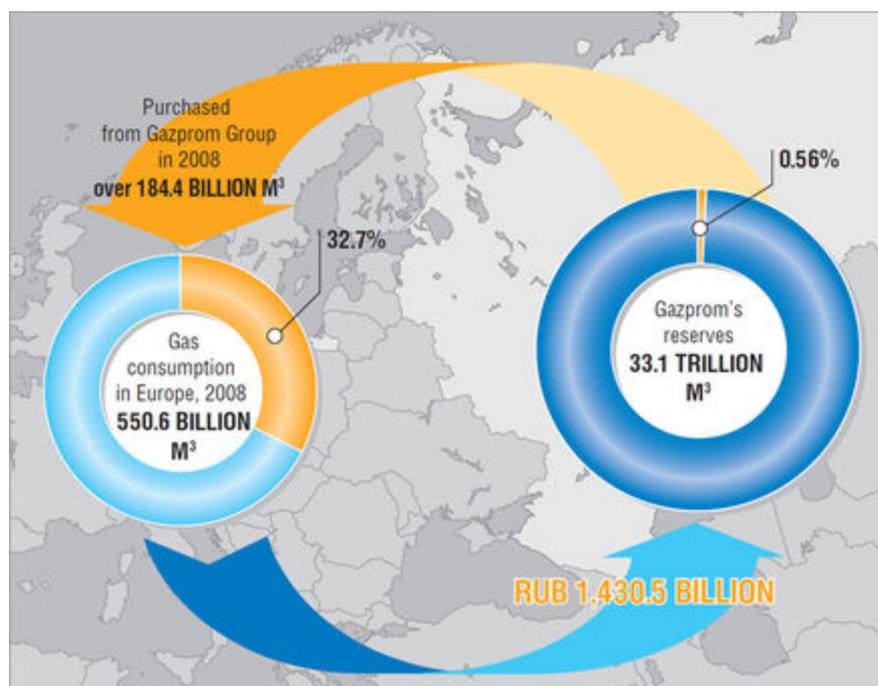
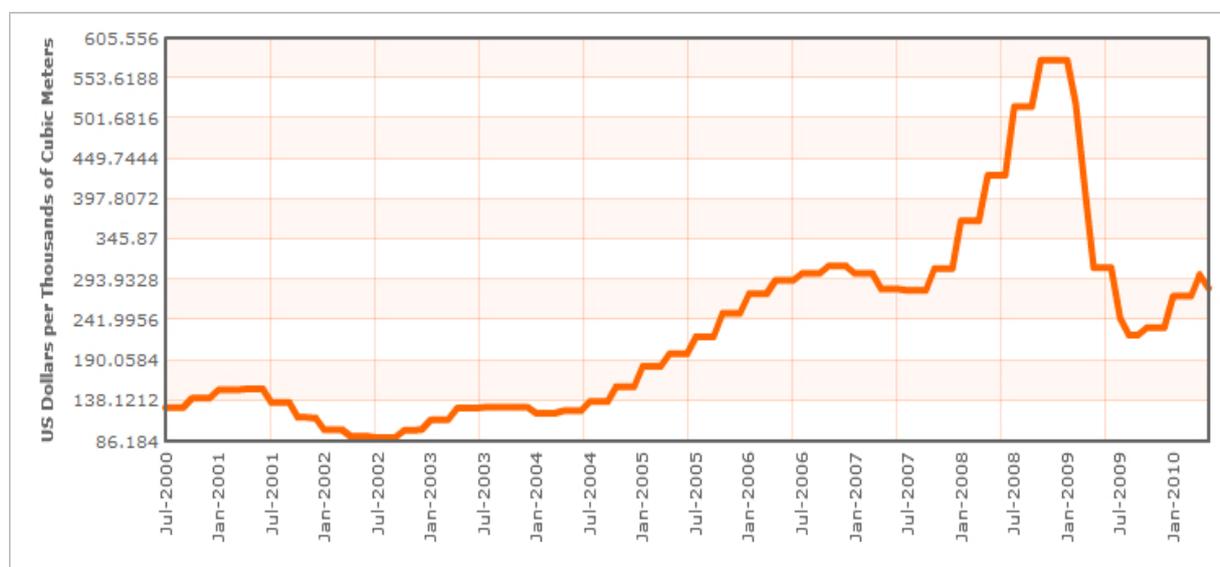


Figure 2: Russian natural gas border price for Germany, July 2000 - May 2010⁹⁵



⁹⁴Gazprom Official Website > Gazprom in Questions and Answers > Gazprom on Foreign Markets > what countries does Gazprom supply gas to?

<<http://eng.gazpromquestions.ru/?id=4#c321>>

⁹⁵ "Russian Natural Gas Monthly Price": *IndexMundi.com*, source: *International Monetary Fund*

<<http://www.indexmundi.com/commodities/?commodity=russian-natural-gas&months=120>>

2.1 Russia & Gazprom: state controlled consolidation of energy

Gazprom was created in 1989 when the Soviet Union's Ministry of Gas Industry was transformed into a corporation.⁹⁶ Gazprom was given unified control over all of the former Ministry of Gas Industry's assets, including all gas-related industries and institutions. Gazprom as a corporation thereby was given a secure monopoly over the gas sector (with control over the "production, sale, transport and export of natural gas"⁹⁷). With the fall of the Soviet Union in 1991, Gazprom was already a private company and its assets were as a result not liquidated or divided up (unlike, for example, the Ministry of Petroleum, whose assets were divided up and sold to individual private companies).⁹⁸ The company is now officially partly privatized and partly state owned; the Russian government has a controlling share in Gazprom, with ownership of 50.002 percent of the company's shares.⁹⁹ Gazprom is therefore considered to be a state-run and controlled gas monopoly.¹⁰⁰ The Russian government and Gazprom have a "symbiotic relationship"¹⁰¹ and because the state is so heavily invested in energy, as a result, Russia is considered to be a "petro-state."¹⁰²

As the Russian Federation holds a significant stake in Gazprom, Russia's internal and external energy policies and Gazprom strategies can easily be coordinated with the broader policies of the Russian Federation's foreign policy. There is often a lack of distinction between state-owned Gazprom and the Russian Federation, and the line between the two entities became even less distinguishable when Gazprom supplied Russia with its head of state in 2008 and Gazprom's former chairman of the board, Dmitry A. Medvedev, was sworn

⁹⁶ Marshall Goldman: *Oilopoly*. Oxford, Oneworld, 2008. (p. 59)

⁹⁷ Anders Åslund: *Russia's capitalist revolution: why market reform succeeded and democracy failed*. Washington D.C., Peter G. Peterson Institute for International Economics, 2007. (p. 140)

⁹⁸ Marshall Goldman: *Oilopoly*. Oxford, Oneworld, 2008. (p. 59)

⁹⁹ Nina Poussenkova: "The Global Expansion of Russia's Energy Giants." *Journal of International Affairs*, Spring/Summer 2010, Vol. 63, No. 2. (p. 103)

¹⁰⁰ "Russia Country Profile." *BBC News*, 16 April 2010.

<http://news.bbc.co.uk/2/hi/africa/country_profiles/1102275.stm>

¹⁰¹ Nina Poussenkova: "The Global Expansion of Russia's Energy Giants", *Journal of International Affairs*, Spring/Summer 2010, Vol. 63, No. 2. (p. 103)

¹⁰² *Ibid.* (p. 103)

in as the President of Russia.¹⁰³ Dr. Rawi Abdelal, a professor at Harvard Business School whose focus is on Gazprom's business strategies, correctly points out that the Russian state is "reinserting itself in the energy sector, [and] has installed a world-class, market-oriented management team to run Gazprom" thereby allowing it to control the country's single most important corporation and also its chief taxpayer.¹⁰⁴ The Russian state and Gazprom are closely interconnected and therefore energy is a highly lucrative tool that can be easily and effectively used by the state.

The gas and oil market can be extremely lucrative for the Russian state; when the market prices are high, oil and gas exports can result in up to 50 percent of the hard currency revenues for the Russian Federation.¹⁰⁵ In 2008, at the height of gas prices for the European market (see Figure 2), 10 percent of the GDP of the Russian Federation derived from Gazprom activities.¹⁰⁶ The Russian Federation's over-dependence on revenue from its natural resources is also a weakness. The Russian Federation's political and economic strength is based on natural resources (particularly natural gas) and as a result, the current economic downturn and decline in oil and gas prices since 2008 (see Figure 2) have affected the political and economic strength of Russia's energy authority.¹⁰⁷ Energy is no longer strictly a "seller's market."¹⁰⁸ Russia has, on the one hand, attempted to raise prices for its customers and transit partners; however, on the other hand has also the victim of price hikes from Central Asian producers.¹⁰⁹ Russia was previously able to powerfully dictate its terms to customers (and to Central Asian suppliers), but is now being faced with a need for more

¹⁰³"Gazprom." *The New York Times* > Business > Companies > Gazprom.

<<http://topics.nytimes.com/top/news/business/companies/gazprom/index.html>>

¹⁰⁴ Gary Emmons: "Harvard Business School Cases: The Energy Politics of Russia vs. Ukraine." *Harvard Business School*, 'Lessons from the Classroom' series, 11 March 2009.

<<http://hbswk.hbs.edu/item/6038.html>>

¹⁰⁵ Janusz Bugajski (ed.): *Toward an understanding of Russia, new European perspectives*. New York, Council of Foreign Relations Inc, 2002. (p. 47)

¹⁰⁶ OAO Gazprom brochure, "Gazprom in Figures 2004-2008." (p. 6)

<<http://www.gazprom.com/f/posts/71/879403/3se.pdf>>

¹⁰⁷ Nina Poussenkova: "The Global Expansion of Russia's Energy Giants." *Journal of International Affairs*, Spring/Summer 2010, Vol. 63, No. 2. (p. 121)

¹⁰⁸ *Ibid.* (p. 121)

¹⁰⁹ *Ibid.* (p. 117)

subtle use of energy as an extension of its foreign policy. Since the global economic downturn of 2009, Gazprom is producing 25 percent less gas (in the second half of 2009, compared to the first half of 2008 – when gas prices were at their peak).¹¹⁰ As of the first half of 2009, consumption of Russian gas has also decreased by 10 percent.¹¹¹ Russian export volumes to Europe have fallen by 40 percent, and combined with lower gas prices, export revenues to Europe are down by 23 percent).¹¹² Russia, therefore, is in a tricky position to deal with balancing production, rising domestic demands, new investments and projects with Europe (North Stream and South Stream) and within Europe, along with its current export obligations.

2.2 Russia's Energy Strategy until 2020 (& how this strategy affects the EU)

The Russian government released its official 'Energy Strategy of the Russian Federation until 2020' in 2003, and within the first paragraph the strategy defines Russia's energy sector as an;

“‘instrument for the conduct of internal and external policy,’ adding that the role of the country in world energy markets to a large extent determines its geopolitical influence. Russian analysts...have echoed the view that Gazprom has become instrumental [in] the aim of restoring Russia ‘to the capacity of a global centre of power and the establishment of a ‘sphere of predominance for Russian interests.’”¹¹³

Therefore Gazprom's systematic expansion downstream into the European Union energy market can be viewed as part of both an economic and political strategy. Russia can use its energy resources as a source of foreign policy clout. This power, however, can also be undermined by the Russian states over dependency on higher energy prices and the revenue made as a result. Lower energy prices limit the state's external and internal political and economic power.

¹¹⁰Daniel Buikema Fjaertoft: “Russian Gas – Has the 2009 economic crisis changed Russian gas fundamentals.” *Bank of Finland, Institute for Economies in Transition*, BOFIT online 10/2009 < <http://www.fni.no/russcasp/DBF-bon1009-9-21.pdf> > (p. 17)

¹¹¹ *Ibid.* (p. 17)

¹¹² *Ibid.* (p.17-18, 21)

¹¹³ Stephen Velychenko (ed.): *Ukraine, the EU and Russia*. New York, Palgrave Macmillan, 2007. (p. 179)

This strategy of the Russian government also seeks to increase production in all energy sectors (gas, oil and electricity). Russia's Energy Strategy aims for an annual natural gas production increase of 27 percent by 2020 (to 750 billion cubic meters of natural gas produced)¹¹⁴ and the Russian state will therefore need massive investments to fund this increase. Industry expansion is very expensive and "according to Russia's Energy Strategy until 2030, up to 1.8 trillion euro in investment will be needed to renew ageing capital stock and maintain energy production at forecast levels."¹¹⁵ Russia's plan is to attract investments from Europe (and investment is a key component as addressed in the EU-Russian Energy Dialogue).¹¹⁶ Even the costs of maintaining Russia's current level of gas production is very high, and in order to increase production at the rate Russia desires, Gazprom needs to increase export in order to gain much needed revenues from natural gas exports. Due to the economic downturn and lower natural gas prices, the Russian Federation has limited domestic possibilities for funding the costly expansion and upgrades to its own internal gas sector. The economic downturn coincides with the lower gas prices (since 2008), which have had a negative effect on the economic stability of the Russian state. The Russian Federation, as a result, is increasingly looking for direct foreign (particularly European) investments in its own energy sector. In order to increase production, Russia will remain dependent on revenues from long-term energy distribution contracts within EU member states in order to fund and facilitate its planned increase in production. Russia is dependent on pipeline investments from the European Union, for example, with Germany for the Nord Stream pipeline, a project in which the intention is that the Wintershall-Gazprom cooperative company Wingas will connect Russian gas through Nord Stream to the valuable internal German grid.¹¹⁷

¹¹⁴ *Ibid.*

¹¹⁵ The Delegation of the European Union to Russia > Energy > EU-Russian Energy Dialogue.
<http://www.delrus.ec.europa.eu/en/p_217.htm>

¹¹⁶ *Ibid.*

¹¹⁷ Marshall Goldman: *Oilopoly*. Oxford, Oneworld Inc., 2008. (p. 167)

The production of natural gas in Russia's present gas fields is also stagnating.¹¹⁸ Russia increasingly relies on Central Asia natural gas imports to keep up with domestic demand, but is also currently dealing with fierce competition in the region (from China, the USA and Europe).¹¹⁹ Gazprom is in need of foreign investment to develop new gas fields, as it cannot fund the infrastructure or extraction itself. Two examples are that Gazprom, Wintershall and E.ON are jointly developing the Russian 'Yuzhno-Russkoye' gas fields¹²⁰, and Gazprom along with French Total and Norwegian Statoil-Hydro are developing the 'Shtokman' field.¹²¹ Russia's need for foreign investment in order to maintain and expand its natural gas infrastructure demonstrates the limitations of Russia's sole control over its own energy industry. It is understood by the Russian Federation that it is in the government's best interests to continue to have a high level of cooperation in external relations (especially energy relations) with the European Union and its Member States.

2.3 Locking in demand: long-term contracts with EU Member States

Gazprom has been using a system of long-term contracts in order to guarantee the continuing export of Russian gas to the European Union Member States. According to Gazprom these long-term contracts are typically 25-year agreements, and are the result of intergovernmental contracts that promise the steady and reliable supply of gas.¹²² Gazprom officially argues that "only long-term deals can guarantee returns on the producer and the exporter's multibillion dollar investments in major gas export projects and [are able to ensure]

¹¹⁸ Anders Åslund: "Russia Energy and the European Union: Perspectives on Gazprom."

Peter G. Peterson Institute for International Economics, Speech before the European People's Party, European Parliament, Brussels, May 15, 2008.

<<http://peterson-institute.org/publications/papers/aslund0508.pdf>> (p.4)

¹¹⁹ Richard Galpin: "Struggle for Central Asian energy riches." *BBC News*, Moscow, 2 June 2010.

<http://news.bbc.co.uk/2/hi/world/asia_pacific/10131641.stm>

¹²⁰ Marshall Goldman: *Oilopoly*. Oxford, Oneworld Inc., 2008. (p. 167)

¹²¹ Anders Åslund: "Russia Energy and the European Union: Perspectives on Gazprom."

Peter G. Peterson Institute for International Economics, Speech before the European People's Party, European Parliament, Brussels, May 15, 2008.

<<http://peterson-institute.org/publications/papers/aslund0508.pdf>> (p.4)

¹²² Gazprom: official website > Distribution/Europe <<http://old.gazprom.ru/eng/articles/article20160.shtml>>

steady and reliable gas flow for the importer in the long term.”¹²³ These contracts, however, have not been able to guarantee a steady or reliable flow of gas during gas crises (as revealed in the 2006 and 2009 gas crises).

Although these contracts seem positive when presented by Gazprom, they also undermine the ability for the European Union to act as a single supranational actor in terms of an internal or external energy policy, as these agreements are made bilaterally between Gazprom and different individual EU Member States. These long-term contracts also put the Member States that are under Gazprom contract at a disadvantage when they do not need contracted volumes, as European customers pay in full for contracted volumes even when their gas needs are less than the volume stipulated in the contract. Due to the 2009 economic downturn, demand and consumption of Russian gas has decreased.¹²⁴ Under the long-term ‘take or pay’ contract principle, however, the European consumer and customer can be charged with fines when these contracted volumes are not taken. These contracts also limit diversification because consumers are locked into long-term contractual agreements, and as a result diversification away from Gazprom imports would be costly both in fines and in terms of new contracts with other possible suppliers. As these long-term contracts last as long as 25 years, alternative sources of gas and alternative sources of energy are not always calculated into the equation when these contracts are made, and as a result they lock in the amount of Russian gas obliged to be purchased. The bargaining power of the consumer has recently prevailed, as European firms are reported to be in negotiations with Gazprom to reduce the contractually obliged gas purchases due to collapsing demand. In a surprising show of cooperative bilateral gas relations (in the wake of the 2009 Russo-Ukrainian gas crisis), it was Russia who set this precedent with Ukraine when Gazprom allowed Naftogaz to reduce its originally contracted 2009 gas imports from 31.7 bcm (billion cubic meters of natural gas) to

¹²³ Gazprom: official website > Distribution/Europe <<http://old.gazprom.ru/eng/articles/article20160.shtml>>

¹²⁴ Fjaertoft, Daniel Buikema: “Russian Gas – Has the 2009 economic crisis changed Russian gas fundamentals.” *Bank of Finland, Institute for Economics in Transition*, BOFIT online 10/2009 <<http://www.fni.no/russcasp/DBF-bon1009-9-21.pdf>>

18.85 bcm and its 2010 volumes from 52 bcm to 33 bcm without fines.¹²⁵ Although this would cause a drop in revenue, Gazprom is increasingly ‘consumer-cautious’ and the drop in revenues is balanced against the risk of alienating and angering its customers (especially in Europe) who are already looking to diversify gas sources. In the wake of the economic downturn, Russia is also in need of foreign investments for new developments in energy resource exploitation. Gazprom is increasingly aware of the need to maintain good relations with customers and potential investors and is, as a result, demonstrating unprecedented flexibility in its ‘take-or-pay’ contracts.

2.4 Gazprom domestic energy distribution contracts with EU Member States

Germany buys the largest volume of Russian natural gas out of any European Union Member State. Russia provided Germany with 38 percent of its total gas consumption per annum as of 2008.¹²⁶ The European Union collectively consumed 526 billion cubic meters of Russian gas as of 2004.¹²⁷ The total German consumption of Russian gas was 97 billion cubic meters of natural gas as of 2004.¹²⁸ Russia therefore has an incentive in integrating itself into Germany’s domestic gas distribution infrastructure. Gazprom is connected closely to Germany’s three largest gas companies; E.ON, Wintershall, and Wingas (Wingas is jointly owned by Wintershall and Gazprom who owns “50 percent equity less one share”).¹²⁹ The Nord Stream pipeline will tie Gazprom gas exports directly to the German internal energy grid; Gazprom has a majority of 51 percent in Nord Stream equity, whereas E.ON and Wintershall each own 20 percent equity and the Dutch company Gasunie owns 9 percent equity.¹³⁰ This particular partnership including Gasunie has led to Gazprom being given the

¹²⁵ “Gazprom, Naftogaz Codify Political Agreement in Deal to Reduce Ukrainian Gas Imports.” *HIS Global Insight*, 25 November 2009. <<http://www.ihsglobalinsight.com/SDA/SDADetail17929.htm>>

¹²⁶ Gazprom: official website > Gazprom in Questions and Answers > Gazprom on Foreign Markets. <<http://eng.gazpromquestions.ru/?id=4#c321>>

¹²⁷ *Ibid.*

¹²⁸ Marshall Goldman: *Oilopoly*. Oxford, Oneworld Inc., 2008. (p. 166)

¹²⁹ *Ibid.* (p. 167)

¹³⁰ *Ibid.*

option to purchase 9 percent equity of the pipeline connecting the Netherlands and Great Britain: the Balgand-Bacton pipeline.¹³¹ Germany, yet, is also a prime example of a Member State who has a ‘mixed energy’ portfolio and is the most progressive example of diversification in terms of alternative energy options, so although they are the largest importer (by volume) of Russian gas, they also have alternatives for consumption. 39 percent of gas consumed in Germany comes from Russia, which approximately equates to the European Union’s average for Russian gas consumption (40 percent).¹³²

Italy, the European Union’s second largest Russian gas importer in terms of volume, was supplied with 22.4 billion cubic meters of Russian gas as of 2008.¹³³ Under an agreement with Eni, Italy’s multinational gas and oil company, “Gazprom Export, a subsidiary of Gazprom, was entitled to independently sell over 3 billion [cubic meters] of gas on the Italian market.”¹³⁴ Italy, however, consumes less than the European Union’s average consumption of Russian gas (40 percent); 30 percent of gas consumed in Italy comes from Russia.¹³⁵

The **United Kingdom**, the European Union’s third largest Russian gas importer in terms of volume, was supplied with 20 billion cubic meters of Russian gas as of 2008.¹³⁶ In 1999 Gazprom also became a partner, with 10 percent equity, in the Interconnector gas pipeline which connects the United Kingdom to Belgium.

France, the European Union’s fourth largest Russian gas importer in terms of volume, was supplied with 10.9 billion cubic meters of Russian gas as of 2008.¹³⁷ Gazprom and Gaz de France have had long-term energy-related cooperation.¹³⁸ 25 percent of France’s total

¹³¹ *Ibid.*

¹³² “Where Europe gets its gas from?” *BBC News*, 4 January 2006.

<http://news.bbc.co.uk/2/hi/europe/4578350.stm>

¹³³ Gazprom official website > Gazprom in Questions and Answers > Gazprom on Foreign Markets

<http://eng.gazpromquestions.ru/?id=4#c321>

¹³⁴ *Ibid.*

¹³⁵ “Where Europe gets its gas from?” *BBC News*, 4 January 2006.

<http://news.bbc.co.uk/2/hi/europe/4578350.stm>

¹³⁶ Gazprom official website > Gazprom in Questions and Answers > Gazprom on Foreign Markets

<http://eng.gazpromquestions.ru/?id=4#c321>

¹³⁷ *Ibid.*

¹³⁸ Gazprom official website > Partners > Gaz de France <http://old.gazprom.ru/eng/articles/article8927.shtml>

natural gas consumption comes from Gazprom.¹³⁹ Currently Gazprom and the state-owned French company Gaz de France are under a long-term contract until 2030; the new deal also allows Gazprom access to the retail gas market of France, and permits Gazprom to sell 1.5 billion cubic meters of gas to Gaz de France customers.¹⁴⁰ Extra gas supplies have also been negotiated to be delivered to Gaz de France via the Nord Stream pipeline.¹⁴¹ Gazprom and Gaz de France are also the co-founders of a natural gas sale and equipment procurement company, FRAGAS Trading House, and in addition, in 2002 a “consortium composed of Gazprom, Gaz de France and German Ruhrgas won the tender to purchase shares (49 percent) in the Slovak gas company SPP.”¹⁴²

Direct access to European consumers (such as in the examples given above) “allows Gazprom to earn a higher margin on its sales” and is also a way of excluding alternative suppliers¹⁴³ thus undermining the European Union’s attempts at diversification away from Russian energy. Gazprom, in addition to Germany, Italy, the United Kingdom and France, also owns directly or through subsidiary companies partial equity in the following countries domestic gas pipelines and domestic gas distribution systems; Belarus, Ukraine, Georgia, Moldova, Switzerland, Austria, Finland, Turkey, Hungary, Greece, Latvia and Lithuania.¹⁴⁴ Gazprom lists its ‘main partners’ in European Union Member States as: E.ON, Wintershall, Verbundnetz Gas and Siemens (Germany); Gaz de France and Total (France); Eni (Italy); Fortum (Finland); Gasunie (Netherlands); DONG (Denmark); OMV (Austria); MOL (Hungary); and PGNiG (Poland).¹⁴⁵

¹³⁹ *Ibid.*

¹⁴⁰ Gazprom official website > Press Centre > Gazprom News > December 2008
<<http://www.gazprom.com/press/news/2008/december/article64464/>>

¹⁴¹ Gazprom official website > Press Centre > Gazprom News > December 2008
<<http://www.gazprom.com/press/news/2008/december/article64464/>>

¹⁴² Gazprom official website > Partners > Gaz de France <<http://old.gazprom.ru/eng/articles/article8927.shtml>>

¹⁴³ Marshall Goldman: *Oilopoly*. Oxford, Oneworld Inc., 2008. (p. 168)

¹⁴⁴ *Ibid.*

¹⁴⁵ Gazprom official website > Gazprom in Questions and Answers > Gazprom on Foreign Markets
<<http://eng.gazpromquestions.ru/?id=4#c321>>

2.5 Gazprom subsidiaries in EU Member States

Gazprom subsidiary companies that function internally within EU Member States cover a range of energy industry services that include gas trading, gas marketing, gas storage, gas transport, investment companies, gas exploration, pipeline construction, petrochemicals, oil and gas equipment manufacturing, gas fired heat and power plants, gas distribution, as well as energy-related media and financial companies.¹⁴⁶ Gazprom itself owns varying shares in these subsidiary companies although generally the percentage owned is a controlling stake.¹⁴⁷ The creation of Gazprom subsidiary companies in important European countries that are key consumers of Russian energy can be seen as a move by Gazprom to gain greater control over the European Union's internal transport, storage and distribution of gas. "These subsidiaries can be seen as an attempt by Gazprom to diversify into Europe's gas transportation [and] distribution industries to gain added value and build upon its traditional business of supplying wholesale gas supplies to regional monopolies."¹⁴⁸ Gazprom uses these subsidiary companies to acquire storage facilities and distribution hubs within the EU in order to have direct access to the internal distribution networks of their largest European customers. An example of this new strategy is the establishment of "joint ventures to build large natural gas storage depots in Hungary, Germany, Belgium, Serbia, and Romania."¹⁴⁹ These storage depots are designed "to cope with unusually high demand during cold snaps and would help to ensure [a continuous supply] to Western markets in case of new disputes involving the pipeline transit countries."¹⁵⁰

The number of directly controlled Gazprom subsidiary gas trading companies in Europe has been growing, and some of these companies have also been involved in dubious

¹⁴⁶ Andreas Heinrich: "Gazprom's Expansion Strategy in Europe and the Liberalization of EU Energy Markets." *Russian Analytical Digest* (Research Centre for East European Studies), 2 May 2005. <http://kms2.isn.ethz.ch/serviceengine/Files/RESSpecNet/46810/ipublicationdocument_singledocument/EBEB560D-319D-4A6E-BB93-25DB57792AC9/en/Russian_Analytical_Digest_34.pdf> (p. 12-14)

¹⁴⁷ *Ibid.* (p. 12-14)

¹⁴⁸ *Ibid.* (p. 9)

¹⁴⁹ *Ibid.* (p. 9)

¹⁵⁰ *Ibid.* (p. 9)

activities that allegedly destabilize the European Union's energy market, possibly "criminalizing" it as well.¹⁵¹ Gazprom itself has begun to conduct auditing on its own export intermediaries (gas trading companies that are Gazprom subsidiaries) due to schemes in which companies are making special deals with countries, thereby excluding Gazprom, often by "reselling Russian fuel abroad at a higher price."¹⁵² Within the EU, it is common that natural gas from Gazprom is purchased through gas trading companies "including some in which Gazprom has a stake, such as Hungary's Panrusgaz (of which Gazprom owns 40 percent equity) and Bulgaria's Overgas (of which it owns 50 percent)."¹⁵³ The most infamous gas-trading intermediary recently was controversial Swiss-registered RosUkrEnergo, which was accused of various criminal activities, a complete lack of company transparency, and a variety of Russian and Ukrainian political connections, and "which was cut out of the gas trade last year but has yet to be liquidated."¹⁵⁴

Questions are still being raised as to why Gazprom chooses to use subsidiaries and intermediaries. William Browder, active in the Hermitage Capital Management firm (an investor in Gazprom) "has questioned publicly why Gazprom voluntarily forgoes significant profits each year by consigning a large amount of its business to murky intermediaries."¹⁵⁵

Gazprom's recent auditing of its own subsidiary companies demonstrates that Gazprom is fully aware of problems of corruption and a lack of transparency within its own business. In terms of the extent of the problem of corruption, Swedish economist Anders Aslund estimates that "50 percent of Gazprom's investments are lost through corrupt practices", an example is that the Russian funded portion of the Blue Stream pipeline cost twice as much as the Turkish

¹⁵¹ Roman Kupchinsky: "Gazprom's European Web." *The Jamestown Foundation*, February 2009.

<http://ua-energy.org/uploads/library/analitics/FULL_GazpromsWeb.pdf> (p. 4-6)

¹⁵² Yelena Mazneva, Irina Reznik and Maxim Tovkailo: "Gazprom Middlemen Face Audit On Exports." *The Moscow Times*, 5 March 2010. <<http://www.themoscowtimes.com/business/article/gazprom-middlemen-face-audit-on-exports/401007.html>>

¹⁵³ *Ibid.*

¹⁵⁴ *Ibid.*

¹⁵⁵ Keith C. Smith: "Russia and European Energy Security: Divide and Dominate." *CSIS: Center for Strategic and International Studies Publication*, Washington, October 2008. (p. 16)

portion.¹⁵⁶ Gazprom's problems with the lack of business transparency (especially amongst its own subsidiary companies), corruption and inefficient business practices and policies not only effect 'downstream' European investors and shareholders, but the company's profits as well.¹⁵⁷

2.6 Gazprom and European interest groups

The corruption and lack of transparency associated with the gas-trading business is also often linked to what Keith Smith describes as the Kremlin's

“systematically created or cultivated ‘friendly’ interest groups in both Central and Western Europe who benefit financially from their formal and informal ties to Russian state energy companies. The temptation to accept money from Russian companies too often overrides the knowledge that these firms are direct instruments of Moscow’s foreign and security policy.”¹⁵⁸

Keith Smith states that these friendships result in “corrosive effects of nontransparency in the Russian-European energy trade” and that the result is a ‘cartelization’ of the energy sector; elite energy cartels composed of “government leaders, intelligence officials and favored business oligarchs,”¹⁵⁹ and it is these partnerships favored by the elite that result in energy business contracts. One important example of Gazprom ties with EU politicians are recent claims that members of Germany’s SPD (Social Democrat Party of Germany) have ties to Gazprom; these claims are not unfounded as former Chancellor Gerhard Schröder signed Germany into the controversial Nord Stream pipeline agreement, and when he lost the following 2005 German election he was hired into a position at Nord Stream AG as Chairman of the Shareholders' Committee.¹⁶⁰ The question of a conflict of interest was raised due to the fact that Schröder had pushed that the Nord Stream deal be signed while he was in office. It is

¹⁵⁶ *Ibid.*

¹⁵⁷ Hans-Martin Tillack: “A tale of *gazoviki*; money and greed.” *Stern Magazine*, 13 September 2007 <http://www.robertamsterdam.com/Stern%20article_Tillack.pdf> (p.3)

¹⁵⁸ Keith C. Smith: “Russia and European Energy Security: Divide and Dominate.” *CSIS: Center for Strategic and International Studies Publication*, Washington, October 2008. (p. 14) <http://csis.org/files/media/isis/pubs/081024_smith_russiaeuroenergy_web.pdf>

¹⁵⁹ *Ibid.* (p. 15)

¹⁶⁰ Nord Stream AG official website > Our Company > Management <<http://www.nord-stream.com/our-company/management.html>>

more than likely that Schröder gained a position at Nord Stream in return for securing the Nord Stream contract. A second example of Gazprom ties with one of its three main partners (commonly considered to be Germany, France and Italy) is the ‘special friendship’ which Russian Prime Minister Vladimir Putin has fostered with Italian Prime Minister Silvio Berlusconi, a friendship that contributed to “forging new links between Gazprom and Eni.”¹⁶¹ In 2008 these two new friends met again and Berlusconi remarked that “Putin... has shown himself to be a great friend by coming [to Sardinia]. This shows a close relationship that has never been interrupted. The Russian Federation is very important for us. We get 30 percent of our oil and gas from them.” After Gazprom signed the South Stream pipeline contract with Italian gas giant Eni, Prime Minister Putin hosted Prime Minister Berlusconi at Sochi to celebrate the occasion.¹⁶² In these situations it can be said that natural gas resources are being used as an important feature of diplomatic relations between those with a stake in Gazprom and leaders of important European energy markets. It is these energy-based ‘friendships’ that can also impair the European Union’s chances of forging a common European Union wide energy policy towards its own internal market.

¹⁶¹ Pavel Baev: *Russian Energy Policy and Military Power*. London, Routledge, 2008. (p.123)

¹⁶² “Putin and Berlusconi seal ‘South Stream’ pipeline deal.” *Euractiv.com*, 18 May 2009.

<<http://www.euractiv.com/en/energy/putin-berlusconi-seal-south-stream-pipeline-deal/article-182435>>

2.7 Locking in supply: pipeline infrastructure to and within Europe

Figure 3: Projected gas routes for supplying the European Union¹⁶³



Overview of the three main projected gas routes for supplying the European Union¹⁶⁴

NORD STREAM:

Connection: Russia-EU (via Baltic sea)

Transport capacity: 55 billion cubic metres per year

Partners: Gazprom (51 percent), BASF/Wintershall (20 percent), E.ON Ruhrgas (20 percent), Gasunie (9 percent)

Scheduled for operation: 2 Lines: first scheduled for 2011, second for 2012

SOUTH STREAM:

Connection: Russia-EU (via Black sea)

Transport capacity: 63 billion cubic meters per year

Partners: Gazprom (50 percent), ENI (50 percent)

Scheduled for operation: End of 2015

NABUCCO:

Connection from: Caspian region, Middle East to EU

Transport capacity: 31 billion cubic meters per year

Partners: BOTAS, BEH, MOL, OMV, RWE, Transgaz (each 16.67 percent)

Scheduled for operation: End of 2015

¹⁶³ Europe's Energy Portal > Projected Gas Routes (main page)

<http://www.energy.eu/images/pipelines_nabucco_nord_south_stream.gif>

¹⁶⁴ *Ibid.*

2.7.1 Nord Stream AG

The Nord Stream AG pipeline project is funded by Gazprom (Russia), E.ON and Wintershall (Germany), and Gasunie (the Netherlands). This project aims to directly supply Germany with Russian gas via two parallel pipelines which run under the Baltic Sea. This pipeline is an important example of Gazprom locking itself into the European market with a pipeline infrastructure that will give it direct access to the German market.

The construction of the Nord Stream pipeline project has angered the Baltic Sea countries for several reasons, as the pipeline threatens their own energy security. One security reason for Baltic reservations about Nord Stream is that if gas crises continue to plague the EU-Russian relationship, Germany is in a special position to continue to receive a steady and direct flow of gas from Russia. The Nord Stream project was also opposed by many countries because since the pipeline runs under the Baltic Sea, they will lose significant transit fees that they would have made if the pipeline was constructed over land. Baltic countries will also lose a guarantee that Russia will continue to supply them with enough gas, as there is no longer a dependence on over-land Baltic transport downstream to Germany.¹⁶⁵ Environmental issues are also a concern for countries in the Baltic Sea region. The Russian government's decision to choose a more costly sea route for the pipeline rather than to build a new pipeline that would run alongside the preexisting overland pipeline has caused diplomatic problems between Germany and its Baltic and Central European neighbours. These countries perceive Nord Stream as politically threatening, because

“the Baltic Sea pipeline could allow Russia, a country that has made political use of its energy resources, to cut off gas to Central Europe and the Baltic states while still delivering gas to Germany.”¹⁶⁶

The Nord Stream pipeline can also be viewed as a very practical move by Gazprom to have a direct way of transporting natural gas to Germany, without the worries and economic losses

¹⁶⁵ Marshall Goldman: *Oilopoly*. Oxford, Oneworld, 2008. (p. 159)

¹⁶⁶ “Gerhard Schroeder's Sellout.” *The Washington Post*, 13 December 2005.

<<http://www.washingtonpost.com/wp-dyn/content/article/2005/12/12/AR2005121201060.html>>

involved with transit. Even though it is a controversial pipeline project, Nord Stream has still been able to achieve the approval of all the countries whose Baltic Sea territory will be traversed by Nord Stream.¹⁶⁷

Nord Stream has announced that its schedule for completing the first pipeline in 2011 and the second in 2012 “remains valid” although production from one of its main potential sources, the Shtokman gas field, has experienced a delay in development.¹⁶⁸ Gazprom has delayed the start of the Shtokman gas field development until 2016, due to a slump in revenues from natural gas because of lower exports and consumption levels from the recent economic downturn.

2.7.2 South Stream AG

South Stream AG is a pipeline project funded by Gazprom (Russia) and Eni (Italy), which, in addition to Italy, involves transit across the following EU Member States; Bulgaria, Greece, Hungary, Slovenia, and Austria. This particular pipeline will result in the signing of more long-term transit contracts directly between Gazprom and six European Union member states. This pipeline can be considered controversial because these contracts will undermine the European Union’s own gas pipeline project Nabucco. South Stream also undermines the EU’s attempts at energy diversification away from an increasing dependence on Russia as the main source of supply for natural gas. The South Stream project is very important because it will connect Russia to the Italian market (Italy is the second largest importer by volume of Russian natural gas in the European Union) with two legs of the pipeline supplying the north and south of Italy. Eni, which is Italy’s largest energy company, controls a 50 percent share of this joint Eni-Gazprom venture.¹⁶⁹ South Stream is an example of Gazprom’s ‘European

¹⁶⁷ *Ibid.*

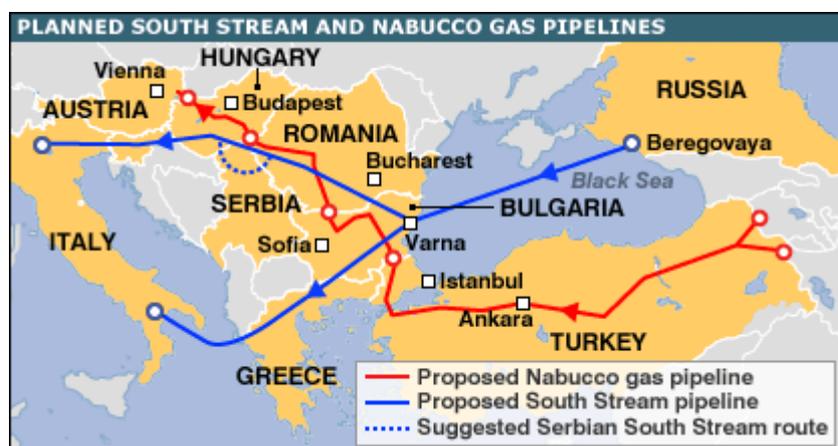
¹⁶⁸ Vladimir Soldatkin: “Nord Stream says schedule intact despite Shtokman.” *Reuters*, Moscow, 8 February 2010. <<http://www.reuters.com/article/idUKLDE6171JW20100208>>

¹⁶⁹ Europe’s Energy Portal > Projected Gas Routes (main page)
<http://www.energy.eu/images/pipelines_nabucco_nord_south_stream.gif>

Strategy' via joint partnerships; this gas pipeline, like Nord Stream, will directly connect Gazprom to the European Union's domestic energy market. Direct pipelines from Russia to the European Union, like Nord Stream and South Stream, which connect Gazprom directly to the European Union's domestic energy market, will greatly complicate the European Union's goal to solidify a common internal energy policy.

2.8 Derailing competition: South Stream as political and economic rival to Nabucco

Figure 4: Map showing the planned routes of both Nabucco and South Stream¹⁷⁰



The South Stream pipeline is widely considered to be a rival to the EU (and American) supported Nabucco pipeline. South Stream uses a similar route to Nabucco, as it makes use of EU Member State Bulgaria as the first European transit hub on its route to the European market.¹⁷¹ Nabucco will potentially reduce Europe's dependence on Russian resources by diversifying the EU's gas supply. Through the Nabucco project, Europe hopes to gain access to potential suppliers in Iran, Iraq, Kazakhstan, Turkmenistan¹⁷² and Azerbaijan.¹⁷³ The Nabucco project has been unable to guarantee supply contracts from these potential sources

¹⁷⁰ "Balkan boost for Russian gas plan." *BBC News* > Europe, 18 January 2008.

<<http://news.bbc.co.uk/2/hi/europe/7195522.stm>>

¹⁷¹ *Ibid.*

¹⁷² "Europe gas pipeline deal agreed." *BBC News* > Business, updated 13 July 2009.

<<http://news.bbc.co.uk/2/hi/8147053.stm>>

¹⁷³ Marshall Goldman: *Oilopoly*. Oxford, Oneworld, 2008. (p. 155)

and has a projected annual need of 31 billion cubic meters of gas.¹⁷⁴ The European Union remains surprisingly optimistic about Nabucco being a successful, stable and secure alternative to Russian gas and South Stream. The very real lack of stability in the region's potential suppliers leaves some serious area for concern. The European Union had rested its hopes "on the flimsy chances of persuading two dictatorships, ultra-cautious Kazakhstan and impenetrable Turkmenistan, to take the risk of snubbing Moscow and sell their gas westwards."¹⁷⁵ Europe's chance at a foothold in energy in this region has been minimized by Russia's 'diplomatic' power; as of May 2007 Mr. Putin "signed a deal with the leaders of Kazakhstan and Turkmenistan to build a new gas export pipeline [which] skirt[s] the northern shore of the Caspian and [thereby] tak[es] the region's gas riches to Europe via Russia."¹⁷⁶ This region is also an area of energy competition not only between the European Union and Russia, but also between other Western companies, Central Asian producers, China and the United States. The stability of the Caspian Sea region is an ongoing and unresolved issue for the Nabucco pipeline, as Caspian Sea's legal status also remains unresolved; Russia, Iran, Azerbaijan, Kazakhstan and Turkmenistan all claim under-water rights to the Caspian Sea (until 1991, Caspian Sea rights were held solely by the USSR and Iran).¹⁷⁷

Another problem for the Nabucco project is that Russia's Blue Stream pipeline is also a competitor in this region. The Blue Stream pipeline has been supplying Turkey with Russian gas since 2005, and Nabucco is dependent on Turkey as its transit hub for Central Asian natural gas.¹⁷⁸ Nabucco, therefore, not only has to compete with South Stream to supply Europe with natural gas, but also with Blue Stream, which can potentially supply Europe with natural gas via Gazprom's South European Gas Pipeline (SEGP).¹⁷⁹ A potential problem is

¹⁷⁴ Yigal Schleifer: "Caspian Energy: The End of the Beginning for the Nabucco Pipeline." *Eurasianet.org*, 12 July 2009. <<http://www.eurasianet.org/departments/insightb/articles/eav071309a.shtml>>

¹⁷⁵ Edward Lucas: *The New Cold War*. London, Bloomsbury, 2008. (p. 229)

¹⁷⁶ *Ibid.* (p. 229)

¹⁷⁷ Marshall Goldman: *Oilopoly*. Oxford, Oneworld, 2008. (p. 160-161)

¹⁷⁸ *Ibid.* (p. 155)

¹⁷⁹ *Ibid.* (p. 155)

that the market may not be able to support all of these pipelines, and Gazprom has worked hard to attract European Union Member States such as Hungary, by offering its own gas sooner and cheaper through an attractive long-term supply contract.¹⁸⁰

South Stream also promises the potential to supply the EU with twice as much gas as Nabucco, and both are slated to open in the year 2015 (Nabucco's opening date, however, will most likely be pushed back again, as it was initially slated to begin transporting gas as of 2011).¹⁸¹ The European Commission's spokesman on energy, Ferran Tarrandellas Espuny argued that "the South Stream deal will not dent Nabucco's prospects and in the worst case scenario, the two pipelines will be complementary."¹⁸² This is an overly optimistic opinion and realistically the worst case scenario for those in the EU dependent on and investing in the success of Nabucco, would be that Nabucco fails to provide Europe with a stable and secure alternative and Russia's South Stream proves to be the more stable project of the two pipelines. It is also highly unlikely that the two pipelines will be complimentary, as only one of the two will be able to secure the amount of natural gas needed to run at full capacity.

Some of Nabucco's European partners are also unsure of its potential, and continue to support both projects (Nabucco and South Stream) in order to keep their options open. A good example of this support of both projects is Hungary, who initially was an important member of the Nabucco project, then supported South Stream (based on lucrative Gazprom promises), then decided it would also continue to work with the Nabucco consortium, most likely because of the uncertainties of each project's success, and possibly because Hungary (as a new Member State) does not wish to undermine the European Union's great natural gas project.¹⁸³ Another good example of this pipeline game is made by the actions of partly state-owned Austrian energy company OMV. OMV was an initiator of the Nabucco project;

¹⁸⁰ *Ibid.* (p. 155)

¹⁸¹ *Ibid.* (p. 154)

¹⁸² "Balkan boost for Russian gas plan": *BBC News* > Europe, 18 January 2008.

< <http://news.bbc.co.uk/2/hi/europe/7195522.stm> >

¹⁸³ Marshall Goldman: *Oilopoly*. Oxford, Oneworld, 2008. (p. 156)

however when Nabucco's difficulties made the project appear doomed to failure, OMV made a deal with Gazprom to make Vienna a gas hub of South Stream.¹⁸⁴

A recent EU summit for Nabucco in Prague also "considered plans for an Inter-Connector pipeline linking Turkey to Italy via Greece, and White Stream, which would run from Georgia to Romania via the Black Sea."¹⁸⁵ These future pipeline projects, however, depend on the success of the Nabucco project and on how much investors are willing to support expensive future projects when Nabucco is not nearing completion. Europe has arrived late to the natural gas 'game' of Central Asia in that China and Russia have already been involved in this region for decades prior to EU interest. Central Asia is already supplying China with natural gas via a pipeline network. Issues of security continue to be significant in the Central Asian and Middle Eastern regions where the European Union seeks an alternative to Russian natural gas. In the long term the most dependable supplier of natural gas will continue to be Gazprom.

2.9 Controlling the output and pricing of gas – a Russian OPEC?

The original Organization of Petroleum Exporting Countries (OPEC), created in 1960, was set up to "prevent private companies from cutting the price of petroleum purchased from Saudi Arabia, Kuwait, Iraq, Iran and Venezuela"¹⁸⁶ by regulating how much petroleum each country could produce in order to reduce worldwide supplies and thereby control the output and pricing of gas. Russian Prime Minister Vladimir Putin had made references to creating a gas-OPEC, or what Jonathan Stern labels "some sort of cartel which could operate to the detriment of gas importers."¹⁸⁷ This possibility worried the international community. At a press conference when the BBC questioned Putin about a proposal made by the Iranian

¹⁸⁴ *Ibid.*

¹⁸⁵ Oana Lungescu: "Deal to boost key EU gas project." *BBC News*, updated 8 May 2009. <<http://news.bbc.co.uk/2/hi/europe/8039587.stm>>

¹⁸⁶ Marshall Goldman: *Oilopoly*. Oxford, Oneworld, 2008. (p. 46)

¹⁸⁷ Jonathan Stern: "Gas-OPEC: a distraction from important issues of Russian gas supply to Europe." *Oxford Energy Comment*, February 2007. <http://www.oxfordenergy.org/pdfs/comment_0207-1.pdf>

president to create or join a gas-OPEC, Putin responded that it was “an interesting idea and we will think about it.”¹⁸⁸ The general impression from Russia, however, is that “rather than [the] control of export prices and volumes, what is under discussion is the possibility of cooperation and coordination between gas exporters principally to prevent competition.”¹⁸⁹

It is more than likely that Russia will not create or join an OPEC, as Gazprom wants to develop and expand its natural gas infrastructure into Europe, and in doing so needs to increase both production and export. The Soviet Union decided not to join the original OPEC because they wanted to expand rather than reduce production and exports, and as a result of this decision, “they increased their political leverage as well as their earning power” and became the world’s largest producer of petroleum by 1975.¹⁹⁰ This seems to still be the trend that Gazprom and the Russian government wish to continue. The European Union should therefore not be concerned about rumors of Russian interest in a future gas OPEC agreement. Russia, in addition, by not being involved in an OPEC arrangement, will continue to hold its position as the best alternative to OPEC countries for the major importers of energy (especially for Europe and also China).

2.10 Gazprom: dependence on the EU energy market?

The European Union is the biggest market for Russian natural gas, and a significant portion of Russia’s GDP comes from gas sales. Therefore, Russia is currently relying on the European energy market to purchase their natural gas reserves. Gazprom is itself to a certain extent locked in and dependent on the European market because they are connected to the European market via their web of infrastructure in Europe, along with their investments in and partnerships with European Union Member States (especially their current pipeline projects and European investments in developing Russian gas fields). There are, however, always

¹⁸⁸ *Ibid.*

¹⁸⁹ *Ibid.*

¹⁹⁰ Marshall Goldman: *Oilopoly*. Oxford, Oneworld, 2008. (p. 46)

other potential markets for natural gas (the example of China as a market for Russian gas is made in Section 2.11). Gazprom has increasingly linked itself in multiple ways to the EU in the energy sector, especially through the creation of subsidiary groups, joint ventures (gas hubs and depots), and of course through an extensive network of natural gas pipelines. Gazprom's extensive investment in the natural gas infrastructure between Russia and Europe is proof that they are counting on a long term and prosperous relationship with the European Union. Although the relationship can be unstable, less than transparent and in geo-political terms can become very strained, the European Union and Russia are tied together because of their mutual dependency in terms of the import/export of natural resources and the level of infrastructure that currently exists between the two actors. Who has the upper hand in this relationship is unclear; Europe is continuing along a path towards a common internal energy market, the success of which could eventually unite European Union Member States under a common external energy policy – thereby giving a united European Union gas market enormous bargaining power. In the meantime however, Gazprom still has the ability to make lucrative long term deals and joint ventures with European Member States separately, which gives Gazprom important advantages.

2.11 China as a potential rival to the EU (as a market for Russian energy)

Russia may have another significant market option for its natural gas in China. In 2006 Putin announced that “Russia’s energy exports to Asia would increase from 3 percent of [Russia’s] total energy exports in 2006 to 30 percent by 2012.”¹⁹¹ The question is, if China is Gazprom’s new focus, will Europe receive enough natural gas if Russian energy exports to China are to increase to this extent? If this were the case, Russia would most likely only be able to support one of these two markets. Russia’s new focus on the Chinese market is most likely a strategy to play on Europe’s fear that Gazprom would abandon the European energy

¹⁹¹ Marshall Goldman: *Oilopoly*. Oxford, Oneworld, 2008. (p. 162)

market. It has been suggested that this is strategic maneuver on the part of Gazprom. Gazprom may assume that the EU would be less negative about its control over their energy market if Gazprom threatens to develop a new main market. This gamble could also backfire for Russia, and result in both China and the EU diversifying away from Gazprom due to the potential problem that Russia would only be able to realistically supply one of the two markets.

Although China could be a potential rival to the European Union as an energy market for Russian gas, it is more than likely that the European Union will remain Russia's principle focus as an energy market. The threat of a new energy-based partnership between Russia and China does not look serious, and can be considered to be a "bluff with [Gazprom] flashing the unplayable 'China card.'"¹⁹² The 'China card' could be construed as 'unplayable' first, because the sale of petrol and natural gas depends on price agreements and China is described as a very difficult negotiator in this area.¹⁹³ Separate European Union Member States are much easier for Gazprom to negotiate with for stable, secure and lucrative partnerships. Second, agreements on the construction and operation of pipelines, and especially on who would hold controlling equity shares in China-Russia gas pipelines would potentially involve a very difficult and lengthy negotiation procedure. Russia also views China as its legitimate competitor in Central Asia, especially in the field of energy. Central Asia was an area that Russia had traditionally held within its sphere of influence, and Beijing has recently been focusing on major investments in energy in Central Asia (for example, a new pipeline is currently under construction that will connect Turkmenistan's natural gas fields to western China).¹⁹⁴ It may not be in Russia's best interest to supply its rival competitor over influence in the Central Asian energy industry. The relationship between Russia and China has been

¹⁹² Pavel K. Baev: *Russian Energy Policy and Military Power*. London, Routledge, 2008. (p. 125)

¹⁹³ Marshall Goldman: *Oilopoly*. Oxford, Oneworld, 2008. (p. 162)

¹⁹⁴ Stephen Kotkin: "The Unbalanced Triangle, what Chinese-Russian Relations mean for the United States." *Foreign Affairs*, Sept/Oct 2009, Vol. 88, No. 5 "Climate Countdown". (p. 132)

labeled as an unsteady “axis of convenience - an inherently limited partnership.”¹⁹⁵ This partnership is furthermore undermined as it is clear that Russia and Europe are more “central to the other’s concerns” than China and Russia (in 2007 Russian - EU trade exceeded 250 billion US\$, and Chinese - Russian trade reached only 48 billion US\$).¹⁹⁶

2.12 Conclusion

Chapter 2 analyzed Gazprom’s tactics and strategies and their effect on the European gas market. In conclusion Russia has a strong foothold in the European Union energy market through long-term contracts, pipeline agreements, special friendships with European interest groups, and through a complex web of subsidiary companies that cover all energy-related industries. Gazprom has been very successful in the bilateral agreements and partnerships it has made with specific European countries. This strategy is much criticized at the European Union level, as it undermines the European Union’s attempts to coordinate Member States’ energy policies into a common internal policy and a common external policy. Part of Gazprom’s strategy towards the European energy market is to integrate itself into the domestic energy markets of European Union Member States, which it has been able to accomplish successfully through long-term contracts, pipeline agreements and other partnership deals.

One of Gazprom’s key strategies in integrating itself into the domestic energy market of the EU is through direct pipelines that link the most important energy purchasers of the EU Member States directly to Russian gas. The Nord Stream and South Stream pipeline projects are two examples of Gazprom’s strategy to increase infrastructure that will directly connect Russian gas supplies with the European market (Nord Stream to Germany, and South Stream through Bulgaria to Italy). Gazprom’s direct pipelines not only have an effect on EU-Russian relations, but also have an effect on the relations between EU Member States, as these

¹⁹⁵ *Ibid.* (131)

¹⁹⁶ *Ibid.* (pp. 130-132)

pipelines single out specific and strategic EU Member States as beneficiaries of direct energy transit. The direct pipeline Nord Stream links Germany to Russia, and has created controversy first, because Nord Stream bypasses the Baltic EU Member States who would have benefited from transit costs and second, because these Member States worry that if another gas crisis were to occur, Russia would still be able to directly supply Germany. South Stream is an important example of a pipeline that will be in direct competition with the European Union's own pipeline project (and the EU's attempt at diversification from Russian gas) the Nabucco pipeline. The South Stream pipeline is both a political and economic rival to the Nabucco pipeline and both pipelines are slated to open in 2015. Nabucco, however, has encountered numerous problems especially stability and security of supply in the Black Sea region, and it seems more than likely that South Stream will be the 'winner' in this pipeline competition. This would solidify Gazprom's position in the European Union's domestic gas market through Italy.

Gazprom also uses an EU-wide network of subsidiary companies that function within almost every European Union Member State. These Gazprom related companies cover almost every energy-related service that Gazprom needs to use to be successfully integrated into the European energy market. Some Gazprom subsidiaries companies (in particular gas trading companies) that function within Europe use corrupt business practices outside the control of even Gazprom. As a result, corruption and a lack of transparency plague Europe's internal energy market. Gazprom's business strategies considered to be potentially dangerous to the European Union's supranational abilities to control the influence Gazprom has over the EU's internal energy market. Until a common internal and external energy policy can be solidified by the European Commission, Gazprom will be able to continue to use its current business strategies within the European energy market.

It is also important to note that it is unlikely that it would be in Russia's strategic energy interests to join, or create a gas OPEC – as the Russian strategy in the field of energy

is to increase exports, production and expansion; Russia will continue to make a fortune in the energy field if it continues to link the European Union's domestic gas markets to its gas supply. Russia's stated intention to supply China was an initial concern for the European Union, however, this seems to be a Russian strategy based on a "China card"¹⁹⁷ they are unable to play. Fears of a new energy partnership between Russia and China have encouraged Europe to greater diversification.

¹⁹⁷ Pavel K. Baev: *Russian Energy Policy and Military Power*. London, Routledge, 2008. (p. 125)

Chapter 3 Russia – European Union: Energy Relations in Crisis

3.1 European fear of energy being used as a political weapon by Russia

Europe's fear of Russia using energy as a political weapon is based on Russia's recent history which includes a multitude of crises where energy 'blackmail' has been used for political gain. The Russian government has used energy as a political weapon since 1990, when it cut energy supplies to the Baltic States in a futile attempt to prevent their independence. In 1992 the Baltic States urged the Russian Federation to remove their remaining military force from the region, and Russia responded by cutting energy supplies. In 1993 and 1994 Russia used energy to put pressure on Ukraine, in order to maintain its control over the energy sector and the Black Sea Fleet. In 2004 Belarus, Poland and Lithuania were affected by politically motivated supply reductions.¹⁹⁸ According to a study made by Robert Larsson there have been 55 incidents of cut-offs, explicit threats or coercive price actions that have been taken by Russia since 1991, and only 11 incidents involved no political motivations.¹⁹⁹ This chapter will focus mainly on two recent gas crises; the 2006 and 2009 crises between Russia and Ukraine, and their effect on European Union - Russian energy relations. Christophe-Alexandre Paillard goes so far as to say that these two gas crises in particular prove how oil and gas are used by Russia as "part of a game of blackmail, lies, and fear between Russians and Europeans."²⁰⁰ Russia does use energy as an instrument for political pressure and as an extension of its foreign policy (as explicitly stated in Russia's Energy Strategy to 2020). When Russia uses energy as an implement of foreign policy in other regions for political domination, economic threat and blackmail, then energy is no longer merely a tool of foreign policy but a weapon. Russia does not use energy as a weapon

¹⁹⁸ Keith Smith: "Defuse Russia's energy weapon." *The New York Times*, 16 January 2006.
<<http://www.nytimes.com/2006/01/16/opinion/16iht-edsmith.html>>

¹⁹⁹ Robert Larsson: "Russia's Energy Policy: Security Dimensions and Russia's Reliability as an Energy Supplier." *FOI: Swedish Defense Research Agency*, March 2006.
<<http://www2.foi.se/rapp/foir1934.pdf>> (p. 267)

²⁰⁰ Christophe-Alexandre Paillard: "Russia and Europe's Mutual Energy Dependence." *Journal of International Affairs*, Spring/Summer 2010, Vol. 63, No. 2. (p. 73)

directly in its relations with the European Union; however when it does use energy in this manner in other regions, the European Union can be seriously affected indirectly (for instance, during the Russo-Ukrainian gas crises).

The 2006 and 2009 Russo-Ukrainian gas crises made European fears over the instability of Russian gas supplies a reality. The Russo-Ukraine gas conflict of 2006 resulted in the victimization of both Ukraine and the European Union due to Russia's political energy blackmail tactic, in which Russia used elevated gas prices in a move to punish Ukraine's new pro-Western government under President Viktor Yushchenko.²⁰¹ The less-politically motivated 2009 Russo-Ukrainian gas crisis also had an especially severe effect on the European Union, as the energy supplies of 18 European Union Member States were directly affected.²⁰²

In the aftermath of the 2009 crisis, the power and effectiveness of Russia's energy leverage could decline, due to the fact that European countries are now more wary of being too dependent on Russian natural gas for which Gazprom cannot guarantee security of transport or supply. Russia's dependence on revenues from natural gas exports has limited its ability to use the withholding of energy supplies as a threat.²⁰³ Daniel Treisman argues that Russia is overly dependent on its natural resources, and in a "classic case of the resource curse, oil and gas are at the core of Russia's political economy."²⁰⁴ Russia, therefore, must be cautious not to overuse energy as a foreign policy threat because it remains dependent on natural gas revenues, and should be careful not to scare away the European Union, its biggest customer and market. The European Union's Member States are becoming increasingly cautious of depending on Russian gas in the future, and there is a planned move towards a

²⁰¹ Keith Smith: "Defuse Russia's energy weapon." *The New York Times*, 16 January 2006.
<<http://www.nytimes.com/2006/01/16/opinion/16iht-edsmith.html>>

²⁰² Leo Cendrowicz: "Russia-Europe Gas Spat Ends — For Now." *Time.com*, 9 January 2009.

²⁰³ Edward Morse: "Low and Behold, Making the Most of Cheap Oil." *Foreign Affairs*, September/October 2009 (p. 49)

²⁰⁴ Daniel Treisman: "Is Russia cursed by oil?" *Journal of International Affairs*, Spring/Summer 2010, Vol. 63, No. 2 (p. 85)

coordinated diversification at Union level (one example of this is the attempt by the European Commission to get the Nabucco pipeline underway). In the wake of the 2009 gas crisis, the European Union is more than ever aware of the instability of their Russian supplier – and is focusing on new supply alternatives (in Norway, Algeria, the Middle East, and Central Asia). Russia is also extremely vulnerable to fluctuations in oil and gas prices. Russia is in a fragile position and is dependent on its stake in the European energy market in order to make the revenue upon which it is so dependent. Russia has proven its need of the European market through its web of investments, infrastructure (pipelines and subsidiary companies) and contracts within European domestic energy markets. The 2006 and 2009 gas crises also highlighted the fragility of Russia – and the desperate nature of the tactics used to maintain control over the revenue from energy resources and the transit of these resources to Europe.

3.2 The 2006 and 2009 Russo-Ukrainian gas crises and their effect on Europe

3.2.1 The 2006 Russo-Ukrainian gas crisis

The 2006 Russo-Ukrainian gas crisis occurred during a serious deterioration in Russia's political relations with Ukraine, a time which also coincided with a rise in oil and gas prices. By late 2006 the \$50-80 per mcm (million cubic meters) which the countries of the former Soviet Union were paying for Russian gas contrasted sharply with European border prices of 3-4 times that level.²⁰⁵ Russia and Ukraine had for some time been unable to agree on a multitude of serious energy-related issues such as debt settlement for gas supplies, and Ukraine's demands for an increase in gas transit tariffs to European levels, this then resulted in a counter-attack by Gazprom to suggest a move towards European market prices for Russian gas (Russia argued that since the gas was bound for Europe, Ukraine should pay European prices which would amount to payments between \$160-230 per million cubic

²⁰⁵ Jonathan Stern: "The Russian-Ukrainian gas crisis of January 2006". *Oxford Institute for Energy Studies*, January 2006. <http://www.oxfordenergy.org/pdfs/comment_0106.pdf> (p. 6)

meters).²⁰⁶ On the 1st of January 2006, Russia cut natural gas supplies to Ukraine, and in response, Ukraine diverted a portion of the natural gas bound for Europe for its own domestic use.²⁰⁷ European companies immediately reported falling natural gas pressures and were forced to deal with a supply emergency, as only a portion of the usual natural gas deliveries were arriving at their European destinations.²⁰⁸ Russia was accused of politically motivated actions against Ukraine including using energy as a tool of revenge and political blackmail in the aftermath of the Orange Revolution and the Ukrainian presidential elections.²⁰⁹ The rash decision to cut gas to Ukraine resulted in a domino effect, in which Russia's largest market, Europe, was affected.

The direct effect of the 2006 crisis on the European energy market was significant: Hungary reported losses of 40 percent of its Russian gas deliveries.²¹⁰ In Austria, Slovakia and Romania deliveries were down by one third.²¹¹ In France, Russian gas deliveries were down by between 25-30 percent, and in Poland deliveries were down by 14 percent.²¹² Italy also reported a loss of 25 percent of its deliveries.²¹³ German deliveries were also affected.²¹⁴ The 27 EU Member States were affected very differently by the crisis due to an EU-wide variation on the level of import and consumption of Russian gas. In Eastern Europe there is a high dependency on Russian imports and a lack of a diversified energy mix, whereas in Western Europe there is a more diversified energy mix and Russian gas therefore “constitutes

²⁰⁶ Jonathan Stern: “The Russian-Ukrainian gas crisis of January 2006”. *Oxford Institute for Energy Studies*, January 2006. <http://www.oxfordenergy.org/pdfs/comment_0106.pdf> (p. 6)

²⁰⁷ Simon Pirani, Jonathan Stern and Katja Yafimava: “The Russo-Ukrainian Gas Dispute of January 2009: A Comprehensive Assessment.” *Oxford Institute for Energy Studies*, Issue XVIII: Fall 2009. <<http://energypolitics.org/18a.pdf>> (p. 20)

²⁰⁸ *Ibid.* (p. 8)

²⁰⁹ *Ibid.* (p. 29)

²¹⁰ Jonathan Stern: “The Russian-Ukrainian gas crisis of January 2006”. *Oxford Institute for Energy Studies*, January 2006. <http://www.oxfordenergy.org/pdfs/comment_0106.pdf> (p. 8)

²¹¹ *Ibid.* (p. 8)

²¹² *Ibid.* (p. 8)

²¹³ *Ibid.* (p. 8)

²¹⁴ *Ibid.* (p. 8)

a smaller percentage of overall consumption.”²¹⁵ According to Pierre Noel, in terms of overall gas consumption, “only 5 percent of Western Europe’s primary energy needs are met by Russian gas, compared to [an average of] 15 percent for Eastern European countries.”²¹⁶

The crisis lasted four days, and by the January 4th 2006 Gazprom, Naftogaz and RosUkrEnergo signed an agreement which stopped the crisis and as a result, the full volume of gas delivery was resumed. This agreement, however, did not resolve many issues other than the immediate crisis, for example the price for natural gas beyond June 2006 was not agreed upon.²¹⁷ Due to the fact that the 2006 Russo-Ukrainian gas crisis was resolved in four days, it was assumed by some that this was evidence which confirmed that Russia was “as dependent upon the European consumer as the EU is upon the Russian supplier.”²¹⁸ Gazprom’s concerns for “supply security and [the] desire to earn money from gas exports to Europe”²¹⁹ were thought to prevent future crises that would impact the European market. The following crisis in 2009, however, proved that this economic variable would not guarantee stability and security of supply through transit countries such as Ukraine.

The International Energy Agency had voiced a common opinion that “the [2006] dispute risked doing fundamental and lasting damage to Russia’s reputation as a reliable supplier of energy to Europe.”²²⁰ Russia, however, did not face immediate repercussions for its inconsistent and sometimes volatile actions as a supplier. Russia’s damaged reputation in the aftermath of the 2006 crisis did not, and realistically could not, result in the EU purchase and consumption of less Russian gas. After the 2009 crisis, European countries are still looking for alternatives. A long-term effect on Russia’s tarnished reputation could result in a reduction of their current stake in the EU energy market if energy diversification increases

²¹⁵ Mark Scott: “Russian Gas Crises seeps into Europe.” *Business Week*, 7 January 2009.

<http://www.businessweek.com/globalbiz/content/jan2009/gb2009017_910865.htm?campaign_id=rss_daily>

²¹⁶ *Ibid.*

²¹⁷ Jonathan Stern: “The Russian-Ukrainian gas crisis of January 2006.” *Oxford Institute for Energy Studies*, January 2006. <http://www.oxfordenergy.org/pdfs/comment_0106.pdf> (p. 10)

²¹⁸ Stephen Velychenko (ed.): *Ukraine, the EU and Russia*. New York, Palgrave Macmillan, 2007. (p. 162)

²¹⁹ Jonathan Stern: “The Russian-Ukrainian gas crisis of January 2006.” *Oxford Institute for Energy Studies*, January 2006. <http://www.oxfordenergy.org/pdfs/comment_0106.pdf> (p. 8)

²²⁰ *Ibid.* (p. 12)

within the European Union. The European Union is not yet in a position to ‘say no’ to Russian gas and punish Gazprom for inconstant business practices.

The European Union level institutions are realistically and actually very limited to the actions they can take as a united front against gas crisis. In 2006 energy was a competency of the separate Member States. In 2009 energy became a dual competency at both the European Union level and at the level of the Member States under the Lisbon Treaty (as discussed in Chapter 1, Section 1.1.1) – a move which allows for some coordination of the energy sector. The actions and energy policies of the EU’s own Member States, however, still limit the European Union’s ability to act as a unified force on energy issues, as preferential bilateral agreements with Russia are perceived to be more lucrative and beneficial in the short term. Germany is a good example of a Member State with both a diversified energy mix (making it less affected by crises) and a preference for striking bilateral deals with Russia (an issue that is even more important now that construction of the Nord Stream pipeline is underway). Many EU Member States profit from energy policy not being fully coordinated at EU level, and are less likely to agree to give up energy policy competency, as their current command of energy policy gives individual Member States greater energy ‘freedom’, rather than forcing them to fully coordinate policy and action at EU level.

3.2.2 2009 Russo-Ukrainian gas crisis

List of European Countries: percent delivery of Russian gas cut, diversification, and emergency supplies²²¹

Bulgaria:	100 percent cut, no diversification, minimal short term reserves to cover 35 percent demand
Slovakia:	97 percent cut, no diversification, minimal short term reserves to cover 76 percent of demand
Greece:	80 percent cut, liquefied natural gas diversification, reserves in liquefied natural gas terminal
Austria:	66 percent cut, imports from Norway and Germany, gas storage reserves that last several weeks
Czech Rep.:	71 percent cut, imports from Norway, gas storage reserves last 40 days
Slovenia:	50 percent cut, gas imports from Algeria via Italy and from Austria, gas supplied from storage facilities in August (available for one week)
Hungary:	45 percent cut, increased imports from Norway, gas storage reserves last 45 days
Poland:	33 percent cut, increased imports from Norway, gas storage reserves for several weeks
Romania:	34 percent cut, no diversification, reliance on storage facilities
Germany:	60 percent cut (southern Germany) and 10 percent overall, increased imports from Norway and the Netherlands, gas storage reserves will last several weeks
Italy:	25 percent cut, increased imports from Libya, Norway and the Netherlands, Gas storage facilities filled up to 79 percent and cover 50 percent demand
France:	15 percent, diversification for industry secure, gas storage filled up to 80 percent

The 2006 gas crisis could be labeled as a politically and commercially motivated emergency that was of very short duration (by the 4th of January 2006, the crisis was over and the full flow of gas returned to Europe). The 2009 gas crisis, on the other hand, was almost purely commercially motivated and once more highlighted the troubled relationship between Russia and Ukraine in terms of ongoing non-payment issues, debt problems and unpaid bills. This crisis lasted much longer; and by the 4th of January 2009 it was evident that a more serious and longer lasting conflict would be a harsh reality for those dependent on Russian gas supplies for their winter fuel. It was on the 4th of January 2009 that Gazprom accused Ukraine

²²¹ Kirsten Westphal: "Russian Gas, Ukrainian Pipelines, and European Supply Security." *German Institute for International and Security Affairs*, Stiftung Wissenschaft und Politik, Research Paper, September 2009. < http://www.swp-berlin.org/common/get_document.php?asset_id=6381 > (p. 22-23)

of stealing 50 million cubic meters (mmcm) calculated that day.²²² During the first few days of the crisis, a small volume of gas continued to be delivered. By the 7th of January, however, the conflict escalated and the flow of gas stopped completely, which had a serious effect on the countries in eastern European who were 100 percent dependent on Russian natural gas imports for consumption.²²³ The grim situation was exacerbated by Russia and Ukraine who continued to blame each other for the stoppage (Russian blamed Ukraine for blocking the gas deliveries and Ukraine blamed Russia for not delivering gas).²²⁴ The situation was worsened due to a lack of urgency from Russia and Ukraine to agree to move towards ending the crisis. Gazprom was very publicly adamant (compared to their relative silence in 2006 when accused of political motivations) that they were not to blame for the halt in the transit of gas to Europe through Ukraine, and held Ukraine responsible for diverting gas meant for European delivery. Russia and Ukraine were in fact both at fault for failing to settle their problems before a crisis and cutoff occurred, both were also responsible for letting the crisis last so long by refusing to come to an agreement together. Ferran Tarradellas Espuny, the spokesman for EU Energy Commissioner Andris Piebalgs, stated that Europe would not take sides and that both parties were to blame for failed obligations and unresolved solutions.²²⁵ There was limited action that the European Commission could take in this situation; however an attempt was made by the Commission to facilitate the signing of an agreement between Russia and Ukraine which included the conditions for EU observers to monitor gas-transit at stations at the border between Russia and Ukraine.²²⁶ EU attempts at successfully coordinating an agreement to end the crises were stalled at numerous times by both Russia and Ukraine.

²²² Simon Pirani, Jonathan Stern and Katja Yafimava: "The Russo-Ukrainian Gas Dispute of January 2009: A Comprehensive Assessment." *Oxford Institute for Energy Studies*, Issue XVIII: Fall 2009. <<http://energypolitics.org/18a.pdf>> (p. 16)

²²³ *Ibid.* (p. 20)

²²⁴ *Ibid.* (p. 21)

²²⁵ Kostas Geropoulos: „Gas Crisis: Both Russia and Ukraine to blame says EU". *NewEurope*, Issue: 816, 7 January 2009. <<http://www.neweurope.eu/articles/91797.php>>

²²⁶ "Monitors key to Russian gas deal": *BBC News*, 8 January 2009. <<http://news.bbc.co.uk/2/hi/europe/7817043.stm>>

The chaotic international situation, however, was finally diffused. On the 19th of January 2009, after Prime Ministers Putin and Timoshenko signed a declaration to end the dispute, both Gazprom and Naftogaz Ukrainy immediately signed a supply and transit contract covering the period 2009-2019.²²⁷ The gas flow to Europe resumed by the 20th of January and the flow of gas returned to normal levels by the 22nd of January 2009.²²⁸ The economic damage from the crisis was felt across Europe, and significant damage has been done to perceptions of the reliability and security of Russian gas transported through Ukraine.²²⁹ The transit of Russian natural gas to Europe through Ukraine has been fraught with difficulty due to pricing and payment disagreements between Russia and Ukraine during the entire post-Soviet period.²³⁰ It is no surprise that Russia is investing in direct natural gas pipelines to Europe such as Nord Stream and South Stream, rather than depending on problematic transit countries.

3.2.2.1 Consequences for the EU and Member States affected by the 2009 crisis

The result of the 2009 gas crisis was an overwhelming realization for EU Member States that they needed to plan for alternative sources of energy in order to reduce dependence on Russian energy in the event of another crisis, and to increase the storage volume of emergency energy reserves. The crisis's short-term impact on Europe's Russian gas dependency may not be great, but the long-term impact will determine how this crisis in particular has changed European views on Russian energy dependency. The long-term effects of this crisis could be an increase in the European Union's diversification efforts away from Russian gas. During the next decades the European Union hopes to diversify by obtaining additional gas supplies from other sources, as well as to encourage a reorientation from gas to

²²⁷ *Ibid.* (p. 23)

²²⁸ *Ibid.* (p. 16)

²²⁹ Simon Pirani, Jonathan Stern and Katja Yafimava: "The Russo-Ukrainian Gas Dispute of January 2009: A Comprehensive Assessment." *Oxford Institute for Energy Studies*, Issue XVIII: Fall 2009.

<<http://energypolitics.org/18a.pdf>> (p. 60)

²³⁰ *Ibid.* (p. 26)

non-gas alternatives. The impetus for new energy opportunities and sources is partially a sequel to Russia's unreliability due to the gas crises that have affected Europe.²³¹

The serious ramifications of this gas crisis on the European Union has called attention to the major political and economic reasons for the need of a common European gas market which, as an "integrated and interlinked internal market would bring additional value to supply security [for] all the EU member states."²³² In theory, during the 2009 crisis, enough energy was on hand in the European market from alternative sources and emergency reserves; however the lack of infrastructure prevented it from being re-routed to areas experiencing major natural gas shortfall.²³³ The coordination of energy issues at the European level as well as an integrated and interconnected European market would put Member States in a position of collective strength. The EU believes that "a well functioning internal market" will eventually lead to more coherent structures and coordinated actions which would encourage the creation of an external energy policy among the EU's Member States,²³⁴ and in the wake of this crisis in particular, this would be the strongest move for the European energy market as a collective whole.

The EU Commission has reacted to the crisis by drafting a new Regulation Proposal to improve the European Union's energy independence.²³⁵ This proposal aims to facilitate effective and collaborative energy management by improving emergency measures that will support the EU in times of energy crisis. Plans include the building of more commercial gas storage facilities, the expansion and unification of Europe's gas pipeline network, and an increase in the internal gas network capacity.²³⁶ The facilitation of "reverse flows in transit

²³¹ *Ibid.* (p. 61)

²³² Kirsten Westphal: „Russian Gas, Ukrainian Pipelines, and European Supply Security.” *German Institute for International and Security Affairs*, Stiftung Wissenschaft und Politik, Research Paper, September 2009. <http://www.swp-berlin.org/common/get_document.php?asset_id=6381> (p. 28)

²³³ *Ibid.* (p. 27)

²³⁴ *Ibid.* (p. 28)

²³⁵ Mark Scott: "Russian Gas Crises seeps into Europe." *Business Week*, 7 January 2009.

<http://www.businessweek.com/globalbiz/content/jan2009/gb2009017_910865.htm?campaign_id=rss_daily>

²³⁶ *Ibid.*

pipelines” has also been suggested by the Commission in order to integrate the network of pipelines between Member States, thereby limiting the effects of any future cutoffs (by allowing gas flows to be redirected to Member States in need of emergency supplies).²³⁷ The plan to adopt a common European negotiating stance towards Russia, however, will remain unrealized in the near future.²³⁸

3.2.2.2 The losses and effects of the 2009 Russo-Ukrainian Crises on Russian and EU policies

During the 2009 Russo-Ukrainian gas crisis, Gazprom “lost around \$1.5bn of revenues due to lack of sales, plus penalties [under] European contracts.”²³⁹ The affected EU countries could require Gazprom to pay penalties up to “\$4 million for each day the gas was cut off.”²⁴⁰ Ukraine suffered from the crisis as well and reportedly lost “\$100 million in transit fees because of the cut-off.”²⁴¹ 18 EU Member States were directly affected by the 2009 Russo-Ukrainian crisis in terms of energy supplies.²⁴² The wide-scale effect of the crisis on all energy partners shows the extent of their interdependency, and the need for greater cooperation and coordination in the energy sector. The economic losses due to the gas crisis of 2009 reiterated to Russia and Ukraine that greater collaboration with the European Union on the issue of energy security is in their best collective economic interests. In a statement made by Dmitry Medvedev in the summer of 2009, Russia’s desire to cooperate with the European Union in the energy sector was declared;

“the energy sector has been shaken by conflicts...we can only respond by working together, coordinating and adopting regulations that reflect the views of all participants in the energy sector. Participants involved in energy procedures are

²³⁷ Kirsten Westphal: “Russian Gas, Ukrainian Pipelines, and European Supply Security.” *German Institute for International and Security Affairs*, Stiftung Wissenschaft und Politik, Research Paper, September 2009. <http://www.swp-berlin.org/common/get_document.php?asset_id=6381> (p. 27)

²³⁸ Mark Scott: “Russian Gas Crises seeps into Europe.” *Business Week*, 7 January 2009. <http://www.businessweek.com/globalbiz/content/jan2009/gb2009017_910865.htm?campaign_id=rss_daily>

²³⁹ Simon Pirani, Jonathan Stern and Katja Yafimava: “The Russo-Ukrainian gas dispute of January 2009: a comprehensive assessment.” *Oxford Institute for Energy Studies*, February 2009. (61).

²⁴⁰ Andrei Nesterov: “Russia-Ukraine ‘Gas War’ Damages Both Economies.” *Worldpress.org*, 20 February 2009.

²⁴¹ *Ibid.*

²⁴² Leo Cendrowicz: “Russia-Europe Gas Spat Ends — For Now.” *Time.com*, 9 January 2009.

not satisfied with current relationships between producing countries, transit countries and consumer countries.”²⁴³

In the aftermath of the 2009 crisis, Russia seemed more aware of the need to listen to European concerns and began to show signs of an improved understanding of the European Union’s worries about the security and stability of Russian natural gas.²⁴⁴ The best example of this awareness was the unveiling of the Russian Federation’s project entitled ‘Conceptual Approach to the New Legal Framework for Energy Cooperation’. This public attempt at supplementing, and in some ways improving, the Energy Charter Treaty and Transit Protocol (as outlined in Chapter 1, Section 1.1.4 of this thesis) was a surprising move by Russia towards repositioning its place in the international energy sector onto more predictable and stable ground.

The European Union’s response toward both the Ukraine and Russia in the aftermath of the crisis was an increase in energy-sector cooperation and partnership. After the January 2009 crisis, the EU has continued to actively pursue partnerships in an attempt to secure and stabilize the energy sector. These partnership include multiple EU-Ukraine agreements (such as the Joint EU-Ukraine Modernisation of Ukraine’s Gas Transit System, and the new Eastern Partnership), as well as the continuation of energy-related agreements between the EU and Russia, which, as discussed in Chapter 1, include the Common Spaces agreement (based on the “mutual interdependence of [energy] supply, demand, investment and know-how”)²⁴⁵ and the Energy Dialogue for the establishment of an EU-Russia Energy Partnership.²⁴⁶ It is the value of the EU energy market that is the impetus for Russia’s interest in maintaining a good energy relationship with the European Union. The EU’s substantial energy requirements mean that Russia has access to a large, stable and attractive energy market which remains

²⁴³ President of Russia Web Portal, Dmitry Medvedev, “Meeting with Chief Executives of Energy Companies”. 5 June 2009.

²⁴⁴ Christophe-Alexandre Paillard: “Russia and Europe’s mutual energy dependence.” *Journal of International Affairs*, Spring/Summer 2010, Vol.63, No.2. (p.75)

²⁴⁵ European Commission Website > External Relations > Russia > Common Spaces > Common Economic Space.

²⁴⁶ Europa.eu Press Release, “EU-Russia Energy Dialogue”, 19 March 2009.

Gazprom's key source of sales income.²⁴⁷ The Russia state, with its controlling stake in Gazprom (and its dependence on natural gas revenues), is ever more aware of the consequences which follow any action that makes the European market uneasy at the prospect of future reliance on Russian gas.²⁴⁸

The gas crisis of 2009 also resulted in determination on the part of the European Union to strengthen its friendship with Ukraine through long term partnerships aimed at securing, stabilizing and financing the energy sector. Ukraine is the transit corridor for 80 percent of Russian natural gas to Europe.²⁴⁹ The European Union will invest in and modernize the Ukrainian energy sector in order to stabilize this energy corridor and to secure its energy needs from Russia. Ukraine will benefit economically due to its gas transit importance. President Yushchenko pointed to "the importance of uniting European and Ukrainian energy systems through [the] investment plans on the modernization of Ukrainian gas transport systems."²⁵⁰ The Ukrainian government believes that the solution to the energy security issue is in the strengthening of Ukraine-EU energy relations through agreements on reunification of energy systems, a treaty on energy partnership, and in the integration of Ukraine's transport capabilities into the European gas market.²⁵¹ Obviously the Ukrainian government is interested in the economic benefits that the EU has to offer their energy sector. Energy Commissioner for EU-Ukraine Energy Security Andris Piebalgs argues that "it is in Europe's strategic interest to keep the gas coming through this route. Any other solution is economically less interesting."²⁵² And for the time being, this statement holds true. The

²⁴⁷ Simon Pirani, Jonathan Stern and Katja Yafimava. "The Russo-Ukrainian gas dispute of January 2009: a comprehensive assessment." *Oxford Institute for Energy Studies*, February 2009. (34).

²⁴⁸ *Ibid.* (31).

²⁴⁹ Europa.eu Press Releases, Andris Piebalgs: "Opening speech at the International Investment Conference on the Rehabilitation of Ukraine's Gas Transit Network." Brussels, 23 March 2009.

²⁵⁰ Victor Yushchenko, President of Ukraine, Official Website, Press Office Statement; "Gas dispute should not be considered economic or financial – President", 28 January 2009.

²⁵¹ Victor Yushchenko, President of Ukraine, Official Website, EuroNews Interview. "Viktor Yushchenko: «The gas conflict has unified Ukrainian society»." 29 January 2009.

²⁵² Andris Piebalgs (Energy Commissioner, EU-Ukraine Energy Security), Europa.eu Press Releases, "Opening speech at the International Investment Conference on the Rehabilitation of Ukraine's Gas Transit Network." Brussels, 23 March 2009.

European Union has strengthened energy partnerships between itself and both the Russian Federation and Ukraine in order to facilitate a more “positive interdependence.”²⁵³ In terms of energy, the EU however is also cautious enough to know that an increase in diversification away from Russian gas is also needed in the future. Russia, on the other hand, would prefer not only to maintain its valuable share of the European energy market, but also to “keep its zone of influence in its near abroad.”²⁵⁴ This will be problematic if the European Union continues to bring Ukraine closer to its own influence using the promise of greater integration.

3.3 Conclusion

The 2006 and 2009 Russo-Ukrainian gas crises were serious tests of Russia’s energy relationship with the European Union and its Member States. These recent gas crises have put pressure on energy issues that have been on the European Union’s agenda for some time. The crises highlighted the need for both an internal European energy market and an external energy policy. In her analysis of the 2009 crisis, Kirsten Westphal argues that it gave “new impetus to the debates about a common EU energy policy.”²⁵⁵ The 2009 Russo-Ukrainian gas crisis, in particular raised very serious doubts that Russia could be considered a long term reliable supplier of gas to the European market. The 2009 crisis worried the European Union and gave impetus to arguments for a common European energy market, as well as for the diversification away from Russian gas in the future. The 2009 crisis also increased European Union investments, programs and projects in an attempt to secure the transit of European bound Russian gas via Ukraine’s vital transit corridor. The crisis also encouraged Russia to push forward its strategic Nord Stream and South Stream pipelines, a move which will

²⁵³ President of Russia, Official Web Portal, “News Conference following Russia-EU Summit.” 22 May 2009, Khabarovsk.

²⁵⁴ Christophe-Alexandre Paillard: “Russia and Europe’s mutual energy dependence.” *Journal of International Affairs*. Spring/Summer 2010, Vol. 63, No.2.

²⁵⁵ Kirsten Westphal: “Russian Gas, Ukrainian Pipelines, and European Supply Security.” *German Institute for International and Security Affairs*, Stiftung Wissenschaft und Politik, Research Paper, September 2009. <http://www.swp-berlin.org/common/get_document.php?asset_id=6381> (p. 27)

potentially supply Europe directly with Russian gas and avoid transit countries. The European Union is also continuing to move forward with its own Nabucco pipeline; in the hope of diversifying natural gas imports away from Russia by connecting the European market with Central Asian produced gas. The Nabucco pipeline (as discussed in Chapter 2, Section 2.3) may turn out to be an empty investment if Europe is not able to secure enough gas for export through this route. The 2009 crisis also confirmed that the European Union needs to be able to coordinate and manage crises that affect the internal market. The internal European natural gas infrastructure needs to be more transparent, and there also needs to be an improvement in the interconnection and organization between the Member States.²⁵⁶ The European Union's response to the 2006 and 2009 Russo-Ukrainian gas crises point out how limited the abilities of the European Union are in energy conflict resolution; "Europeans are cautious when responding to any crisis in Ukraine or around the Black Sea, as they want Russia to continue [to supply] them with oil and gas."²⁵⁷ Until the European Union can act in a united front as a single energy market with a single voice on internal and external energy policy, they will remain weak in their ability to resolve energy problems that affect their own Member States. These crises, particularly the 2009 Russo-Ukrainian gas crisis, prove that the EU is only as strong as its weakest link, such as Member States who are 100 percent dependent on Russian gas, without alternatives for diversification or emergency reserves.

²⁵⁶ Kirsten Westphal: "Russian Gas, Ukrainian Pipelines, and European Supply Security." *German Institute for International and Security Affairs*, Stiftung Wissenschaft und Politik, Research Paper, September 2009. < http://www.swp-berlin.org/common/get_document.php?asset_id=6381 > (p. 27)

²⁵⁷ Christophe-Alexandre Paillard: "Russia and Europe's Mutual Energy Dependence." *Journal of International Affairs*, Spring/Summer 2010, Vol. 63, No. 2. (p. 73)

Final Conclusions

This thesis has analyzed the complex issue of the energy relations of the early 21st century between the European Union and Russia. The European Union and Russia experience a mutual dependency in terms of the Russian energy supply and the European energy market. The three main chapters and their subsections outline the major components of, and issues for this relationship.

The **first chapter** outlined the European Union's overall dependency and the differing dependencies of the Member States. The energy interdependence that does exist between the EU and Russia is undeniable, and European dependence on Russian energy will continue in the near future. The European Commission's 'Second Strategic Energy Review' of 2008, recognizes that "Europe will continue to rely on oil and gas imports until 2020, despite efforts to switch to a low carbon economy".²⁵⁸ The European Union is also aware that it should work to limit its collective dependency on Russian natural gas. Diversification both in terms of alternative sources for natural gas as well as alternatives to natural gas continues to be a central aim for EU Member States. The EU has also actively recognized the need for a common internal and external energy policy in order to deal with Russia as a united market. After the Russo-Ukrainian gas crises of 2006 and 2009, the European Commission recognized an urgent need to integrate and interconnect internal European energy networks. The precedent for future coordination has been set by a European Union level effort toward a common internal European energy market, as well as through the legislation put through by the 2009 Lisbon Treaty, which places energy policy as a dual competency at both Union and Member State levels.

The European Union has actively negotiated policies that secure and stabilize regions that are either sources of gas or important areas of transit for natural gas. These policies include, as outlined in Chapter 1: the European Neighbourhood Policy, the Black Sea

²⁵⁸ Christophe-Alexandre Paillard: "Russia and Europe's Mutual Energy Dependence." *Journal of International Affairs*, Spring/Summer 2010, Vol. 63, No. 2. (p. 65)

Synergy, Eastern Partnership, and a multitude of EU-Ukraine agreements made in the wake of the Russo-Ukrainian gas crises. The European Union continues to pursue cooperation with the Russian Federation through the EU-Russian Energy Dialogue and the Common Spaces agreement. The European Union's desire that the Russian Federation ratify the Energy Charter Treaty and Transit Protocol has been unsuccessful. The Russian Federation showed new initiative in 2009 by creating a supplement to the ECT entitled 'Conceptual approach to the new legal basis for international cooperation in the energy sphere (aims and principles)'. This document, however, does not guarantee that the Russian Federation will ratify the ECT in the future, and could be viewed as a stalling technique to avoid signing the ECT, by suggesting the renegotiation of a new and improved version. The Energy Charter Treaty is flawed in that it has mainly been signed and ratified by consumers rather than major energy producers.

The **second chapter** analyzed the Russian state's relationship with Gazprom, the use of Gazprom as a tool of Russian foreign policy, Gazprom strategies toward the European market, and the effect which these strategies have on the European Union both as a whole, and for the separate Member States. The strategies overviewed in this paper include long-term contracts with EU Member States, domestic energy distribution contracts within EU Member States, the creation of subsidiary companies to have access to domestic networks, and the locking in of demand for supply through direct pipelines to key Member States. Gazprom has also successfully used tactics such as friendships with particular EU heads of state and interest groups in order to secure energy-related contracts, such as the Nord Stream and South Stream pipeline projects. The Nord Stream and South Stream pipelines will potentially link Russian natural gas directly to the European market. If completed, both pipelines will more securely bring in essential natural gas directly to Europe by avoiding transit countries. In terms of the importance for energy diversification, however, Nord Stream and South Stream should not be the only future options for increasing Europe's natural gas supply. The European Union's

current alternative, Nabucco, aims to increase diversification by supplying Europe with Central Asian gas. Nabucco, however, has been suffering ongoing problems with construction and sources of supply. It is unlikely that both Nabucco and South Stream could co-exist; the planned pipelines are in constant competition over completion dates, as well as over stable and secure contracts for Central Asian gas producers, and over which European Union countries will sign on to financially support (and potentially sign contracts with) each pipeline. European Union Member States have remained divided over which pipeline to support, a situation which has been highlighted by the European competition for the right to be chosen as a transit hub for each pipeline's final destination within Europe. Russia's new interest in the Chinese market should not be a serious concern, in terms of competition with European consumers for Russian gas. Russia's interest will most likely be short-lived. The Russian Federation, in terms of resources and production, would only be able to fully supply one of the two markets. Russia would be unable to create the same interconnected network and cooperation with China as it has with Europe. Furthermore Russia is unlikely to come to lucrative agreements with China on the ownership of potential pipelines as well as on gas prices. As Russia and China are competing in Central Asia for energy resources, they are even less likely to forge a key partnership based on natural gas with each other. The European fear of Russia creating or joining a gas OPEC is also unlikely, as Russia plans on increasing production and export in the next decades to come.

The **third chapter** analyzed the effect that the 2006 and 2009 Russo-Ukrainian gas crises had on Russian – European Union energy relations. These crises called attention to the major weaknesses in the energy sector for the European Union as a whole and the Member States individually. These gas crises highlighted major issues in terms of the lack of security, reliability and transparency between the supplier (Gazprom), transporter (Ukraine) and market (the European Union). The crises also reiterated the need for the European Union to have a stronger, more unified and interconnected internal gas market in case of future crises. These

crises may in fact strengthen the European Union by encouraging greater internal cohesiveness in the European energy sector. These energy crises confirmed that internal coordination and integration in the energy sector is needed in order to ensure energy security and stability for the European Union.

Russia and the European Union Member States are interlinked in what can be characterized as a symbiotic relationship due to their mutual dependence on energy supply and demand. Natural gas will remain a central feature of Russian – European Union relations in the foreseeable future. The European Union remains committed to the facilitation of a higher level of cooperation and partnership between itself and energy producers and suppliers in an attempt to increase the level of stability, security and transparency for its energy market. The Russian Federation's policies toward the European market vis-à-vis Gazprom demonstrate a high level of commitment to and dependence on the European energy market due to essential natural gas revenue which the Russian state depends on for its own internal economic stability. The Russian Federation's most valuable asset is energy, and this factor can also be inherently politically and economically limiting for Russia. Europe's rate of import and consumption of Russian natural gas varies, and is by no means permanently tied to the Russian supply. The European Union may have the greater position of flexibility in this relationship, especially if there is a future emphasis on greater diversification and alternative non-Russian and non-gas energy supplies. The European Union and its Member States, nevertheless, remain at present connected to and reliant on the supply of Russian natural gas.

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