WESTERN VALUES AND THE RUSSIAN ENERGY WEAPON

A Thesis
submitted to the Faculty of
The School of Continuing Studies
and of
The Graduate School of Arts and Sciences
in partial fulfillment of the requirements for the
degree of
Master of Arts in Liberal Studies

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Washington, D.C.
November 8, 2010
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ABSTRACT

This thesis explores the competition between Russia and the West for the oil and gas resources of the Caspian Sea region, an area where far more is at stake than simply acquisition of new energy supplies. Ultimately, the “winner” of the competition for Caspian Sea energy resources will determine whether Russia will become the primary energy supplier for Europe in the future, or whether there will be alternative, non-Russian energy routes from East to West. The thesis uses a qualitative approach, drawing on scholarly books and articles, current affairs publications, energy firm websites, and other sources to compare the ethical aspects of the strategies used by Russia and the West, to determine whose strategy has been more successful, and to analyze what this means for the political, economic, and security future of Europe.

As this thesis demonstrates, Russia recognizes the importance of energy as both an economic and foreign policy tool. To secure access to the resources of the Caspian Sea region, Russia has used bribery and strongman tactics to secure
arrangements and contracts favorable to Russian interests. When a country does not capitulate to these tactics, Russia applies other measures to influence these countries’ policies. This thesis draws on two recent examples, Ukraine and Georgia, to demonstrate how Russia has used its position as a supplier of energy resources to influence countries to adopt policies complementary to Russian interests, or to punish them for failing to do so. The effectiveness of these Russian tactics is an important precedent for the countries of the Caspian Sea region to keep in mind as they make decisions that will determine their economic and political future for decades to come.

In contrast, the western strategy of promoting quality products and services, while ensuring safety and conducting business according to western ethical norms, has been less successful than western firms originally envisioned. Undoubtedly western firms have become heavily involved in oil and gas extraction projects in the region, in particular in Kazakhstan. Yet, efforts to transport that energy to western markets without Russian involvement have met with strong resistance. This thesis demonstrates that part of the reason western firms have been less successful than they hoped to be is because western firms, in
particular American firms, are so bound by western ethical norms and the statues that codify them, that they have lost their competitive advantage.

The thesis concludes with a discussion of the current day balance of energy resources in Europe, noting that Europe is rapidly growing heavily dependent on Russian oil and gas resources. Given the precedents shown in Georgia and Ukraine, it is only a matter of time before Europe grows so dependent on Russian energy that the individual countries will lose their political and economic independence and in turn, their ability to project western values and values-based ideas throughout the world with impunity.
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INTRODUCTION

With the fall of the Soviet Union in the early 1990s, new economic and political prospects emerged for several countries that formerly lived under the Communist regime. In particular, three former-Soviet republics with coastline on the Caspian Sea - Azerbaijan, Kazakhstan, and Turkmenistan - found themselves in possession of natural gas and oil resources that were of great interest to other countries. Eager to develop and sell these resources to bring in much-needed capital, the countries looked for outside investors. They soon found themselves in a tug-of-war between newly independent Russia and firms from Western Europe and the United States.

In the years that followed, Western firms competed with the Russian government to secure exclusive access to the resources of the Caspian Sea region. It soon became apparent that the resources of this volatile region, while not overly voluminous, were quite important. For the West, the resources of the Caspian Sea region represented an alternative source of energy to Russian or Middle Eastern fuel that would help balance market fluctuations and keep Europe from growing too dependent on any one supplier. For Russia, maintaining control over the flow of energy out of the region would allow Russia to preserve its authority over its
former satellite states, as well as expand its important role as a supplier of energy to Europe. This thesis will examine the competition between Russia and the West, and the competing strategies and ethical approaches used by both sides, to determine which side “won.” The thesis will also explain why the resources of the Caspian Sea are so important, both to the countries of the Caspian Sea region themselves, and to Russia and the West.

The first chapter examines the Soviet legacy, and highlights how the end of the Cold War changed the dynamics of the energy market in Europe and Central Asia alike. The second chapter outlines the vastly differing approaches that Russia and the West used, in particular, the distinction between the western corporate and government approaches, versus the much more disciplined strategy of the Russian government.

As a major supplier of oil and natural gas, Russia is in a fundamentally different position when it comes to new energy markets than the West, which is primarily a consumer of energy. To demonstrate the relevance of this distinction, chapter three examines how Russia interacts with its neighbors, such as Georgia and Ukraine, and what role Russian energy plays in these relationships. This chapter demonstrates how Russia uses its energy, and the ability to cut off energy
supplies, to achieve its policy objectives. Understanding how Russia has used its energy supplies to influence other countries’ policies in the past gives the reader an understanding of how Russia may use its resources in the future as well.

Chapters four and five delve into the ethical aspects of the two strategies to show that part of the reason the West has not been particularly successful at securing exclusive access to the resources of the Caspian Sea region has to do with its decisions to conduct business in a manner consistent with Western ethical norms, while its opponents do not. Chapter four examines the culture of corruption so prevalent in Russian business dealings, pointing out how bribery and strongman tactics, while unethical in a western context, have brought Russia much success in this part of the world. In contrast, chapter five explores the role of ethics in Western business strategies. This chapter examines the role of conflicts of interest and statutes preventing bribery, including the Foreign Corrupt Practices Act of 1977. This chapter analyzes why the Western insistence on conducting business in the Caspian Sea region ethically has had the unfortunate effect of hindering Western efforts.

The final chapter reviews the current balance of energy supplies in Europe, emphasizing the Continent’s growing dependence on Russian gas. This
dependence, which I argue is unhealthy for Europe in the medium to long-term, emphasizes the ever-greater importance of the resources of the Caspian Sea region. The thesis concludes with a discussion of what this changing energy dynamic means for Europe, and ultimately for America as well, in the years to come.
CHAPTER ONE
THE SOVIET LEGACY AND THE END OF THE COLD WAR

With the breakup of the Union of Soviet Socialist Republics (USSR) in the early 1990s, the energy market in Europe began to develop in ways that would eventually reshape power politics for decades thereafter. Prior to the 1980s, Western Europe had primarily acquired its energy from the Middle East, North Africa, and various resource pockets in the North Sea. With the fall of the USSR, the vast resource potential of the former Soviet Union states was suddenly open to outsiders. Many western companies fixated on the Caspian Sea region as a new El Dorado, promising vast resources and opportunities to enter into agreements with newly-formed states that would grant advantageous concessions to their new-found western counterparts. This chapter examines the energy policies of the USSR and Europe during the Soviet period, the role the resources of the Caspian Sea basin played in shaping the Soviet energy policy, and how the dynamic with the West began to change in the late Soviet period and into the 1990s.
Energy Sources in the USSR

The Soviet Union, which lasted from 1922 to 1991, had vast energy resources, but the Caspian Sea region was far from being one of its top producers. Locations such as West Siberia, the North Caucasus and the Ural mountains contained resources that were much easier to extract and transport to Western Russia and the neighboring bloc countries.¹ By the 1970s, Siberia was the USSR’s main source of energy.² In contrast, there were numerous challenges involved in exploitation of Caspian Sea region oil. For example, the Mangyshlak Peninsula in the Kazakh SSR had a paraffin problem and required injection of hot water to assist in the extraction of oil. Other parts of the Caspian Sea region had high tar and low sulfur content, compounding the difficulties of resource extraction.³ Thus geophysical problems made it a difficult area to explore and establish productive wells.

³ Stein, The Soviet Bloc, 18.
Poor-quality infrastructure made it even harder for the Soviet engineers to overcome the geophysical problems. In the 1920s and 1930s, Azerbaijan had served as an “energy colony” that supplied the bulk of Soviet oil, but by the end of World War II (WWII) technological innovation in the region had ceased.\(^4\) By the 1970s, production had stagnated, leaving behind challenges caused by a lack of funding, old infrastructure, and decades without innovation.\(^5\) In fact, by the late 1970s and 1980s, the entire Soviet Union had shoddy energy infrastructure that was in constant need of repair. According to a November 14, 1980 article in the Soviet newspaper, \textit{Pravda}, 30 percent of the employees in the energy sector in the Tyumen region of Siberia - one of the most productive energy supply regions in the Soviet Union - spent all of their time repairing and servicing equipment, factories and installations.\(^6\) The Soviet energy industry was plagued by personnel shortages, low productivity, and inadequate housing and services infrastructure.\(^7\) As Thane Gustafson observed, the Soviet leadership “was always spending time


\(^5\) Van der Leeuw, \textit{Oil and Gas in the Caucasus & Caspian}, 104-108.

\(^6\) Stein, \textit{The Soviet Bloc}, 15.

\(^7\) Ibid., 15-16.
and capital fixing the problems neglected in the past.\footnote{Gustafson, \textit{Crisis Amid Plenty}, 11.} This meant that despite its vast resources, the Soviet Union was barely capable of meeting the needs of the bloc, let alone becoming a world energy powerhouse.

The emphasis on heavy industry in the USSR and the bureaucratic pressure to meet arbitrary state-imposed production quotas led to waste and inefficiency, and stifled innovation.\footnote{Stein, \textit{The Soviet Bloc}, 3.} The lack of improved technology and waste in the Caspian Sea region also resulted in horrific environmental disasters. The drilling rigs set up in the waters near Azerbaijan were so poorly constructed that oil spills were common. The pollution, especially in the 1980s, resulted in severe deformities in a significant percentage of the children born in the nearby coastal towns.\footnote{Van der Leeuw, \textit{Oil and Gas in the Caucasus & Caspian}, 113.} In 1990, Baku Bay had 14 times the limit of permissible concentration (LAC) of oil residues, and 10 times that of phenol.\footnote{Ibid., 112.}

Another challenge for the energy sector resulted from the centralized, politicized, and bureaucratic nature of Soviet economic planning. In Central Asia,
the Soviet-mandated economic plan emphasized agricultural production. Thus, despite the abundance of natural resources, the tools necessary to extract those energy resources were not developed in any mature form.\textsuperscript{12} In the Kazakh SSR, despite its ability by 1989 to produce 22 million tons of crude and 6.7 billion cubic meters of gas annually, the Soviet design to increase interdependence between the republics and the center left the republic with little to no infrastructure to refine the raw product.\textsuperscript{13} As Van der Leeuw observed, by the end of the 1980s, “the Kremlin’s ‘Russia-first’ policy had left the USSR’s offspring in a deplorable state.”\textsuperscript{14} This dire state of affairs would plague both the Newly Independent States (NIS) and the new Russia for years following the collapse of the USSR.


\textsuperscript{13} Van der Leeuw, \textit{Oil and Gas in the Caucasus & Caspian}, 115.

\textsuperscript{14} Ibid., 118.
Energy as a Political Tool

Energy played an important role in the diplomacy and power politics of the Soviet Union. In the late Soviet era, the Union produced more than 12.5 million barrels of oil per day (mbd), an amount representing one-fifth of global oil production, and one-third more than Saudi Arabia produced at its peak in 2000.15 The abundance of oil and gas reserves thus made energy an important factor in Soviet policy. Moscow exported its energy resources to the neighboring bloc countries to power their economies and industries, as well as to heat homes. This allowed Moscow not only to provide for its fellow bloc members, but also to maintain control over an essential element of their industries.

Moscow also supplied oil to Communist client states, such as Cuba and Vietnam. In the 1980s, for example, Communist Indochina imported 80 percent of its oil from the USSR at the heavily reduced rate of US$5-7 per barrel.16 With world oil prices ranging from US$15 to US$30 per barrel, these Communist

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satellites found trading with the Soviet Union to be highly advantageous. Thus Moscow learned quickly how oil diplomacy could achieve results favorable to Soviet interests in areas far outside its immediate sphere of influence.

Despite its vast resources, however, energy consumption in the USSR was grossly inefficient. The bloc consumed oil, gas and coal in massive quantities, inhibiting the USSR’s ability to use its resources to produce wealth for the state. Most Soviet bloc economies were energy intensive due to Soviet emphasis on heavy industry, as over three-fifths of total Soviet consumption of energy went toward industrial development. Moreover, grossly inefficient economies such as Poland’s consumed one-tenth of Soviet oil production – oil that Moscow would have preferred to sell to Western Europe in exchange for hard currency.

Efforts to diversify the energy supply or become more energy efficient were largely failures. By the early 1980s, Moscow recognized this great inefficiency and hoped to impose “stricter consumption norms” that it could

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17 Gustafson, *Crisis Amid Plenty*, 56.
19 Ibid., 48.
21 Ibid., 44.
reinforce with heavy surcharges in cases of overconsumption. Unfortunately for Moscow, the Soviet central planners had designed the system in this way and surcharges were unlikely to result in much conservation, as areas in which people could conserve, such as individual household use, were not the culprits of the massive waste. Gustafson explains that in the end, “political aims superseded commercial aims regarding energy exports to the bloc countries.”

The Soviet Union had its greatest success in using its energy as a tool for leverage over other states prior to the mid-1980s. As late as 1980, world oil prices were US$30 per barrel, while the marginal cost of Soviet oil was US$7 per barrel. This meant the USSR could supply client states at cost, and even export some energy to Europe, which paid the world price, thereby making profits. After the mid-1980s, however, due to geopolitical shifts in the Middle East, prices dropped to US$15 per barrel. However, due to the growing cost of inefficiency and low-productivity in the USSR, the marginal cost of Soviet oil nearly

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24 Ibid., 56.
doubled. Supplying client states to buy political favors became a losing deal financially for the Soviet leadership, and the high level of consumption within the Union made it difficult to sell oil for a profit outside the bloc.

The severe inefficiency of the Soviet bloc remains an important factor even today. Once the Soviet Union collapsed, both Russia and the countries surrounding the Caspian Sea would require massive investment of western technology and capital to bring their oil and gas extraction, processing, and transportation industries into the 21st century. Moreover, the hugely inefficient Soviet republics would need major economic overhauls to lessen their dependence on heavy industry as the backbone of their economies. The economies most reliant on cheap energy from Russia would find themselves in an awkwardly dependent state following the collapse of the USSR.

**Western European Energy Consumption and the USSR**

In the 1970s and 1980s, Western Europe consumed energy from a variety of sources. The Netherlands utilized energy reserves off its coast, while the North Sea provided natural gas for the United Kingdom. Norway exported oil and had prospects off its northern coast for natural gas extraction. European countries

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relied on US steam-coal imports, domestic reserves, and nuclear power. The primary sources of oil, up to 45 percent, were the Middle East and North Africa, sources Europe found highly unstable given the overturned governments, price disputes with Algeria, the Iran-Iraq War, and other troubles in this period.

By the early 1980s, Europe was actively working to partner with the USSR to diversify its oil and gas supply. Working with the USSR was nothing new for Europe. Except during the “hottest years of the Cold War,” there had always been trade in oil and gas between the West and the Soviet bloc at some level. By the late 1970s and early 1980s, however, Europe sought to increase the amount of energy it purchased from the Soviet Union. In return, the USSR needed to sell oil and natural gas to Western Europe to earn the hard currency necessary for its purchases on the world market, including grain imports. The leadership of the USSR realized that the country needed to have at least some exchange on the world economy in order to earn the hard currency reserves it

27 Ibid., 71.
28 Van der Leeuw, *Oil and Gas in the Caucasus & Caspian*, 107.
needed.\textsuperscript{29} Between 1975 and 1985 there was huge expansion in the Soviet economy largely due to energy exports.\textsuperscript{30} This partnership between Europe and the USSR expanded in the 1980s, and by 1989, the USSR supplied one-quarter of Western Europe’s oil and gas needs.\textsuperscript{31}

This growing trade in energy served both sides well. Neither had too much leverage or advantage over the other, and both achieved their economic goals. Indeed, this partnership with Western Europe paved the way for the changing energy dynamic following the collapse of the Soviet Union.

**The Race for Resources in the 1990s**

When the Soviet Union collapsed, western oil and gas firms were eager to explore the vast resource potential of this previously-closed part of the world. In particular, the Caspian Sea region, which had been seemingly underutilized by the Soviet Union in favor of other, more resource-abundant areas, was suddenly the new El Dorado. Unaware of the challenges the USSR faced in extracting oil, western firms, investment banks and even policymakers rushed to form

\textsuperscript{29} Stein, *The Soviet Bloc*, 50-53.

\textsuperscript{30} Gustafson, *Crisis Amid Plenty*, 263.

\textsuperscript{31} Van der Leeuw, *Oil and Gas in the Caucasus & Caspian*, 116.
partnerships with the new governments. For these western groups, the resources of the Caspian Sea were a great alternative to Middle Eastern oil and a source of potentially huge profits. European firms such as British Petroleum and Norwegian Statoil, as well as “singleton high-flyers” affiliated with small firms in a variety of countries were eager to get in on the action. By May 1997, the US Department of State claimed the Caspian Sea region contained almost 200 billion barrels of oil and nearly 8 trillion cubic meters of gas, which Maureen Crandall described as “adding to the euphoria.” It seemed the possibilities for exploring the resources of the region were unlimited.

Yet western investors soon found that efforts in the Caspian Sea region would not be as easy as they thought. The governments in the newly-formed republics were authoritarian states with no checks on power and rigged elections. Crandall describes the governments as “one bullet regimes,” easily plunged into chaos in a crisis. Poverty levels were high, corruption was rampant,

33 Van der Leeuw, Oil and Gas in the Caucasus & Caspian, 124-125.
35 Crandall, Energy, Economics, and Politics in the Caspian Region, 3.
infrastructure lacked, there was no real legal system, and the economic rules changed frequently.\(^{36}\) This litany of problems, combined with the legacy of the Soviet era, the environmental disasters, and the geophysical obstacles involved in energy extraction presented serious challenges for western firms.

Another problem the west faced was the competition with the new Russia. While Russia’s lack of infrastructure and dated technology kept it from being a major player in the early 1990s, the state nevertheless did everything in its power to derail western deals, force pipelines to transit through Russian territory, and coerce the leaders of the republics to adopt pro-Russian policies. As scholar Adam Stuhlberg writes, by the late 1990s “Policymakers and strategists from across the Russian political spectrum were in rare agreement over the strategic importance of protecting the nation’s ‘special interests’ and dictating the course of energy policies in the Caspian basin.”\(^{37}\) It was thus directly in opposition to Russian interests to allow western companies to partner with the republics if it meant Russia would be excluded.

\(^{36}\) Morse, “The Battle for Energy Dominance,” 2.

Yet there was too much promise in the region for the western firms to simply retreat, resulting in a struggle between Russia and the West to secure oil and gas resources in the region. This struggle continues even today, and has both economic and strategic implications for Europe, Russia, and the countries of the Caspian Sea region. Although the amount of oil and gas in the region is comparatively small (2.8 percent of world oil production as of 2005), it nevertheless matters because it provides its consumers - primarily European nations - with an alternative energy source to Russia or the Middle East. It also gives the countries of the Caspian Sea region an opportunity by which to expand their economies and move their countries forward independent of Russia.

The following chapters will explore this struggle for energy resources in greater depth, comparing the western and Russian strategies in the region.

38 Crandall, Energy, Economics, and Politics in the Caspian Region, 14.
CHAPTER TWO

COMPETING STRATEGIES FOR CASPIAN SEA RESOURCES

In the early 1990s, it seemed every company or government interested in Caspian Sea oil and gas resources was looking for riches alone. Indeed, while fortune was a motivating factor, firms and states alike had other aims as well. By the mid-1990s, it became clear that involvement in energy projects was also a way for foreign states to exert their influence over the nascent governmental structures and policy priorities of Azerbaijan, Kazakhstan and Turkmenistan. This chapter explores the differences in strategy between the Western corporations, Western governments, and the Russian state, and examines how each strategy served the interests of the respective governments and citizens in the three former Soviet republics.

The Western Corporate Strategy

Western energy firms were eager to explore the Caspian Sea region following the collapse of the Soviet Union in 1991. Business executives recognized the unique investment opportunities, the quality of the oil in the region, and the benefits of an alternative to oil produced by the Organization of
Petroleum Exporting Countries (OPEC) for their home countries.¹ The strategy of western business executives involved negotiating fair and enforceable contracts with the new Caspian Sea states, much as they did with other western or Middle Eastern partners, and then carrying out the activities specified in these contracts. They did not anticipate the difficulties that they would encounter with dated infrastructure, an absence of the rule of law, pervasive crime, political instability, and corruption – all a legacy of seven decades of Soviet Communism.²

Contract law, in particular, was not enforceable in the Caspian region as it was in the West. For example, starting in 1990, British Petroleum negotiated and established contracts with the new Azerbaijani government and had begun its parts of the business ventures when, in 1993, much of what they had accomplished evaporated when a more pro-Russian government took power in a coup. At the same time, Azerbaijan became embroiled in a war with neighboring Armenia over the Nagorno-Karabakh region. The newly installed leader, former chairman of the Communist Party of Azerbaijan, Heydar Aliyev, sought to end the conflict on Azerbaijani terms and requested Russia pressure Armenia for a


settlement to the conflict favorable to Azerbaijan. In exchange, Russia required all deals between the State Oil Company of Azerbaijan (SOCAR) and western firms also grant a stake to the Russian energy firm LUKOIL. In the end, despite the capital and resources invested, British Petroleum found it had no recourse in enforcing the earlier agreements. In order to do business in Azerbaijan, the firm had to forego its earlier investments and restart the negotiation process.

Companies likewise found the new governments eager to change the rules to get a better deal when it suited them. In the late 1990s, Kazakhstan tried to renegotiate the terms of the contracts it had agreed upon with western firms once the western companies had invested the money up front for the exploratory efforts. Although this legal ambiguity was frustrating for Western governments used to dealing with more reliable foreign partners, many persisted in their efforts in the hopes that the gain would outweigh the risks.

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3 Andrei Shoumikhin, “Russia: Developing Cooperation on the Caspian,” in Oil and Politics in the Caspian Sea Region, ed. Michael P. Croissant and Bulent Aras (Westport, CT: Praeger, 1999), 135.

4 Ibid., 135.

Other difficulties included ethnic conflicts, corruption, and heavy bureaucracy. Western firms tried to work around such problems and contributed to the local economy in the areas they operated, including investing hundreds of millions of dollars in health clinics, schools, social infrastructure projects, and small businesses to provide jobs and services for the local population.\(^6\)

Although western firms tried to insist upon contractual agreements, many were nevertheless subjected to various forms of corruption and bureaucracy. In Kazakhstan, for example, foreign firms found themselves hounded by tax authorities and environmental interest groups levying fines, while the Kazakh government constantly sought ways to challenge western firms’ legal rights in production sharing agreements (PSAs).\(^7\) Yet despite the problems with corruption and ethnic conflicts, for larger multinational corporations, access to the giant oil and gas reserves in the Caspian was “too attractive an opportunity” to miss.\(^8\) Most western oil and gas firms continued their business endeavors despite

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\(^7\)^Adams, “Caspian Energy Development,” 95.

\(^8\)^Ibid., 96.
setbacks from corruption, competition from Russia, or other logistical and bureaucratic hurdles.

**The Western Government Strategy**

The strategy of the US and European governments was somewhat more complicated than the western business strategy. The US and Western Europe alike realized the value of promoting diversity of oil resources for the European market, and consequently recognized the potential of the Caspian States to fulfill this important role. Yet western governments also understood that cooperation with the newly-independent Caspian Sea states would not always be easy. Experience with other resource-rich governments had taught western governments the pitfalls associated with the so-called “resource curse.” To counter this trend, official government entities strove to create policies aimed at helping the Caspian Sea states avoid these problems while simultaneously promoting a good business climate for western firms. As Svetlana Tsalik explains, “It [was] in the long-term economic and security interests of the United States, the European Union (EU) member states, and other major oil importers to see Azerbaijan and Kazakhstan

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evolve into stable, prosperous, and friendly allies.”¹⁰ To achieve this goal, starting in 1992, the US government worked to promote a successful transition to democracy in Azerbaijan, and advocated greater transparency, and respect for human rights.¹¹ The US and Western European governments alike also participated in efforts with the Organization for Security Cooperation in Europe (OSCE) to find a solution to the stalemated Nagorno-Karabakh dispute. The goal of such efforts was to assist in the transition to democracy and promote greater transparency, which benefited both western business interests and the interests of the general population in these countries.

Western governments also wanted to ensure that the states of the Caspian would not be bullied by stronger neighbors such as Russia and Iran, two states intent on using their influence to shape the newly-independent states’ policies with the West. To achieve that end, the US, Turkey, and some European allies encouraged the Caspian states to choose pipeline routes that diminished Russia’s post-imperial claims over Caspian Sea resources, while avoiding the export of the

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resources via Iran.\textsuperscript{12} This policy benefitted western firms and gave the new governments of the region a chance to solidify their economic independence.

Yet the western strategy was not entirely altruistic. In the mid-1990s, the US in particular faced competing priorities in that it wanted to help Azerbaijan and Kazakhstan to develop their resources but did not want to overextend its obligations or provoke a conflict with Russia.\textsuperscript{13} The US found itself balancing efforts to promote western business interests while still maintaining pressure on the governments of the region to avoid human rights abuses.\textsuperscript{14} This meant the US strategy periodically led to mixed signals and inconsistencies, giving the regional governments varying degrees of negotiating leverage.

US policy in particular became even more complicated following the terrorist attacks on America on September 11, 2001, when the US government introduced a new element into its strategy with the states of the Caspian region: fighting terrorism. Now that the US needed allies in the war on terror, the

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\textsuperscript{13} Shoumikhin, “Developing Cooperation on the Caspian,” 142.

\textsuperscript{14} Ibid., 142.
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governments of the Caspian region had a new bargaining chip. They could leverage their cooperation against terrorism against western business interests, meaning that if the US became too outspoken against human rights violations, the lack of transparency in business, or respect for the democratic process, the governments of the Caspian Sea region could curtail their cooperation on the counterterrorism front and give their business to the west’s competitors. Indeed, Azerbaijan and Kazakhstan have steadily clamped down on media freedoms and political opponents in the wake of September 11, knowing that to some extent western governments have their hands tied.

The ultimate goals of the West, as a whole, were to promote western business interests, encourage transparency in government to overcome corruption and Soviet-era bureaucracy, and to promote democracy and freedom for all of the citizens of the region. By accomplishing all three objectives, the West believed the states of the Caspian region would ultimately become self-sufficient, independent of their neighbors, and in turn, cooperative allies. Yet even with these mutually-beneficial goals, western governments and western businesses did not deliberately coordinate their efforts.

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15 Tsalik, *Caspian Oil Windfalls*, 11.

16 Ibid.
The Russian Strategy in the 1990s

The dissolution of the Soviet Union created an identity crisis for the newly-independent Russian state. Accustomed to its world power status, Moscow suddenly found itself ruling over markedly less territory and wielding greatly diminished influence in world affairs. Yet despite its demotion from the status of superpower, Russia believed it should continue to play an important role in world affairs - especially in its former sphere of influence. One way for Russia to assert its special status was by controlling events in the former Soviet states of the Caucasus and Central Asia, an area known to Russians as the “near abroad.”

That the newly-independent governments in the Caspian region did not welcome Russia’s efforts to exert its influence only added to Russia’s frustration. As Oksana Antonenko writes, “The reluctance of the Caspian states to accept Russia’s post-Soviet influence, and their efforts to deny it economic benefits were seen as a threat to Russia’s lingering great-power ambitions.” Intent on maintaining its influence, Russia devised a strategy to insert itself into the politics

\[17\] Shoumikhin, “Developing Cooperation on the Caspian,” 146.

\[18\] Ibid.

\[19\] Antonenko, “Russia’s Policy in the Caspian Sea Region,” 244.
and business affairs of Caspian Sea states, and to limit competition from the West by using Russian economic leverage to pressure the governments of the Caspian region to involve Russian firms and infrastructure whenever possible.

The first part of the strategy involved keeping western companies out of the Caspian Sea region altogether. In the early 1990s, Russia attempted to accomplish this through diplomacy. In 1994, the Russian Foreign Ministry protested the right of Azerbaijan to pursue independent policies in the energy sector with the West.20 By the mid-1990s, the media and political establishment in Russia had convinced much of the Russian public that “most Russian problems [were] still being caused by the quintessential Western ‘machinations,’ just like during the Cold War.”21 A sense that the West was determined to plunder Azerbaijan, Kazakhstan and Turkmenistan took hold in Russia, even among political leadership and elite classes.22 The Russian government saw any independent decision on the part of the new governments as evidence of Russia’s loss of influence over them.

20 Shoumikhin, “Developing Cooperation on the Caspian,” 137.

21 Ibid.

22 Ibid.
By the late 1990s, western influence in the Caspian had become a topic of serious concern for Russian policymakers. When the United States signed a treaty with Azerbaijan in 1997, Russian President, Boris Yeltsin, declared, “The United States is already claiming that [the Caspian] is in their zone of interest. Our interest is decreasing, but the Americans are, on the contrary, beginning to infiltrate the zone….“23 This type of Cold War era rhetoric and hysteria signaled a growing divide between western and Russian interests in the region. Whereas western companies advocated transparency and sought advantageous energy deals, Russia assumed the West intended to colonize its former sphere of influence, something Russia would employ all means necessary to prevent.

In the early 1990s, Russia was unable to take full advantage of the economic opportunities in the Caspian region due to a lack of funds and the limited capabilities of the newly privatized Russian oil and gas sector. It was not because the Russians had no interest in the region.24 To overcome this weakness and achieve its policy goals in the region, Russia employed three important leverage mechanisms.

23 Shoumikhin, “Developing Cooperation on the Caspian, 147.

24 Antonenko, “Russia’s Policy in the Caspian Sea Region,” 245.
First, Russia owned the only existing pipeline infrastructure to transport oil and gas produced in the Caspian region in a safe and cost-effective way.\(^{25}\) As Adam Stuhlberg explains, “The residual Soviet pipeline network constitut[ed] a ‘steel umbilical cord’ that [bound] the SCAA [South Caucasus Central Asia] energy suppliers and customers to Russia.”\(^{26}\) Without using Russian pipelines, the countries of the Caspian would have to invest years in building new infrastructure to transport their oil and gas to the West, time that would cost them a great deal of money. Second, heavy equipment for oil extraction could only be delivered by Russian waterways.\(^{27}\) This meant that if Kazakhstan or Turkmenistan refused to allow Russian participation in any given venture, Russia could block transport of the infrastructure necessary to carry out the project. In sum, if Russia’s neighbors wanted to carry out business in an efficient and cost-effective way they had no choice but to involve Russia.

\(^{25}\) Shoumikhin, “Developing Cooperation on the Caspian,” 137.


\(^{27}\) Shoumikhin, “Developing Cooperation on the Caspian,” 137.
Third, Russia had “residual power projection capabilities” that could influence the military-political situation in a particular country, such as military bases in Georgia and joint armament projects with some of the other Central Asian states. Having troops and military equipment on the ground in several countries of the region gave Russia extra political muscle. This combination of economic and political-military leverage allowed Russia to adjust its arm-twisting strategy as necessary, serving Russian interests against its neighbors quite well, despite its lack of capital.

**Changes in the Russian Strategy under Vladimir Putin**

Following Vladimir Putin’s accession to power in 2000, the Russian government shifted its strategy in the Caspian Sea region to reconcile Russia’s security and economic interests. The new strategy emphasized exploitation of Russian economic influence to gain benefits for the overall Russian economy, and by extension, the Russian state. Russian oil and gas firms were “strongly encouraged” to follow the official government policy in exchange for the

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28 Shoumikhin, “Developing Cooperation on the Caspian,” 137.

29 Antonenko, “Russia’s Policy in the Caspian Sea Region,” 247.
government’s efforts to lobby for their interests. Significantly, unlike in the West where corporations and governments operated independently of one another, in Russia, government and business interests served as one, united policy tool.

Indeed, only a few months after Putin took office, the Russian Security Council revisited Russia’s policy toward the Caspian region and issued a statement in October 2000 that declared, “The scale of Russia’s interests in the Caspian region determines the necessity of its comprehensive presence in the region and the need to pursue a more vigorous policy there.” To justify this new and comprehensive presence, Russia cited threats to its national interests emanating from the region such as drug trafficking and illegal economic migrants. With a greater presence in the region, Russia could simultaneously pressure the states to enact policies favorable to Russian strategic and business interests, and protect itself from security threats.

With Russian oil and gas firms now following the guidance of the Kremlin, the strategy of forcing the Caspian Sea states to involve Russian

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30 Antonenko, “Russia’s Policy in the Caspian Sea Region, 255.
31 Ibid., 247.
32 Ibid., 260.
interests by leveraging the necessary economic resources proved especially effective. By the end of Putin’s presidency in 2008, nearly all of the oil and gas projects in the region involved Russia in some way.

Priorities and Challenges for the Caspian Sea Countries

Managing the demands and expectations of so many foreigners was no easy feat for the governments of the Caspian region. Azerbaijan, Kazakhstan and Turkmenistan had to strike a balance in their policies to preserve the interests of their respective states while not becoming alienated - and economically marginalized - by Russia. The strategy of each government has therefore been to work with the foreign elements to bring in necessary technology and revenue, while simultaneously trying to solve some of the more pressing domestic problems such as poverty and high levels of unemployment.

One challenge for the oil producing states was finding a way to export their products to the consumer market since much of the transit infrastructure ran through Russia. While Azerbaijan was able to build a pipeline through neighboring Georgia, the countries of the Eastern Caspian had no such option. Kazakhstan faced several choices, each with its own set of problems. Routing its oil through Russia made Kazakhstan dependent on Russian whims. Routing it
through Iran could lead to restrictions because of US sanctions and regulations. Afghanistan was too unstable to serve as a viable transit partner, and China, although a vast energy market, required a long pipeline and heavy investment in entirely new infrastructure before the oil or gas could ever reach the ocean. Turkmenistan was even more dependent on Russian infrastructure than its neighbors. This meant finding an economically and politically viable transport solution was a top priority for the three republics, one that potentially involved innovative new projects with western entities to avoid Russian involvement.

A second priority involved gaining access to oil revenues as soon as possible, since energy rents were the key to maintaining their fledgling economies. This question could sometimes cause difficulties with foreign partners when the governments became overly demanding. Foreign firms favored contractual mechanisms such as production sharing agreements (PSAs) because they provided a solid legal basis for oil and gas exploration. In contrast, the regional governments preferred other mechanisms of payment, including large signing bonuses, believing PSAs contributed to a delay in delivering revenue to

33 Shoumikhin, “Developing Cooperation on the Caspian,” 144.
the state. In reality, however, delays in revenue delivery had more to do with the difficult conditions in the region and the resulting delays in construction. As energy projects began to produce revenue, the governments grew increasingly dependent on the income. In Kazakhstan, for example, oil revenue accounted for one-third of total government revenue in 2005, compared with just six percent in 1999.

A third priority involved maintaining order and stability in the face of growing unemployment and rising poverty rates. As often occurs with countries rich in natural resources and little else, the governments of the Caspian were slowly growing overly-dependent on the energy rents, especially in the 2000s, once fields began producing oil and gas. This led to Dutch Disease, a condition when “exploitation of natural resources raises the value of the local currency, thereby discouraging exports and increasing imports, and simultaneously leads to

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the deindustrialization of the local economy.”

The lack of development in other sectors of the economy exacerbated the high levels of unemployment and poverty in the region because the government was bringing in enough revenue from energy exports alone, and therefore had little incentive to create jobs or invest in other industries.

In her pamphlet on ways for states to avoid the resource curse, Svetlana Tsalik emphasizes good management of oil revenue, meaning investment of that income in education, health services, poverty eradication, in strengthening public sector institutions, and improving the business climate for small and medium-sized businesses. Yet despite western pressures to carry out the aforementioned reforms and investments, the governments of the Caspian Sea region have done very little in this regard. Azerbaijan, a country with a poverty rate over 50 percent at the time of independence, insisted on using oil revenue to “enhance the autonomy of the president, enriching his family and associates.”

Corruption

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37 Tsalik, *Caspian Oil Windfalls*, 9.

among the leadership and a failure to reinvest the oil rents in other sectors has contributed greatly to the growing poverty levels in Azerbaijan, whose unemployment rate is estimated to be 15 to 20 percent even today.  

Similarly, in Turkmenistan, the government encouraged foreign investment in social projects while avoiding complete social turmoil by heavily subsidizing water, gas and electricity until hydrocarbon rents could “flow to the rescue.” While surely more effective than Azerbaijan’s policy, Turkmenistan’s solution to the poverty situation did not involve fixing the underlying problems by diversifying the economy and creating more jobs, but instead focused on avoiding total social chaos with payoffs and handouts.

The Kazakhstani government chose to address the widening income gap between ethnic Kazakhs and ethnic Russians by ignoring the problem entirely and instead moving the country’s capital several hundred miles away to the northern city of Astana, where the financial center was located. With its new location in

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39 US Department of State, “Background Note: Azerbaijan.”

40 Auty, “Natural Resources, Governance and Transition,” 120.

41 Shoumikhin, “Developing Cooperation on the Caspian, 123.
the north, the government did not have to address social unrest from its unemployed ethnic majority, most of which remained in the south. 42

The challenging situation in the Caspian region illustrates the competing priorities of the players involved and the high stakes of the oil and gas resources in question. If the Caspian states had no energy resources, such as their neighbors Armenia and Georgia, democratic reforms and diversification of the economy might indeed have taken place. Instead, the countries found themselves caught in a geostrategic competition between Russia and the West.

By the late 2000s, it was clear that Russia had gained a significant foothold in the region, participating heavily in nearly every energy project with the exception of the Baku-Tbilisi-Ceyhan pipeline, a transit project running from Azerbaijan, through Georgia, to Turkey that opened in 2006. 43 This heavy involvement of Russia represents a dangerous precedent, as allowing Russia too much control could endanger the independence of the Caspian Sea states. The next chapter will investigate the role Russia has played in the energy sectors of other former Soviet states, including how it has used its energy resources as

42 Auty, “Natural Resources, Governance and Transition,” 123.

43 Crandall, Energy, Economics, and Politics in the Caspian Region, 15.
political leverage in the affairs of other countries in order to demonstrate the risks that the Caspian States could face in the future.
CHAPTER THREE

RUSSIA’S USE OF THE ENERGY WEAPON AGAINST ITS NEIGHBORS

Russia’s use of energy resources to exert its authority over its neighbors and shape their policies in favor of Russian interests is not a new trend. Since the collapse of the Soviet Union, Russia has worked to protect its interests in its former sphere of influence. Two powerful weapons that Russia wields are its vast energy resources and its control over much of the transit infrastructure for those resources. This allows Russia to essentially blackmail its neighbors when they step out of line with Russian policy objectives. This chapter examines two countries, Georgia and Ukraine, against which Russia used the provision or withdrawal of energy resources to win disputes and shape policies. These examples demonstrate the dangerous precedent that exists for the states of the Caspian Sea basin as they make decisions about whether or not to involve Russia in their energy industries.

The Russia-Georgia Dynamic

One former Soviet republic with whom Russia has ongoing grievances is the Republic of Georgia, located due south of Russia in the Caucasus Mountains.
Due to its strategic location and numerous ports on the Black Sea, Georgia is ideally suited to serve as an economic and cultural bridge between Central Asia and Europe.¹ Yet Georgia has not prospered as much as it could have, in large part because Russia resents having lost this waterfront section of its former empire, and works tirelessly to thwart Georgia’s ambitions.

A country with numerous ethnic minorities, including separatist elements in the autonomous regions of Abkhazia and South Ossetia, Georgia has struggled since independence to preserve its territorial integrity. Meanwhile, the Russian government has consistently supported separatist elements in Georgia’s two autonomous regions in an effort to both reclaim them for Russia, and to destabilize independent Georgia. Starting in the early 1990s, Russia provided Abkhaz separatists with weapons, troops, guidance and moral support.² In South Ossetia, Russia has supported a government that one scholar describes as “a puppet-theatre of Russian thugs and ex-security men.”³ These efforts to sow instability in the region served Moscow’s ends in that if it could not control

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² Ibid., 81-83.

Georgia’s actions, the instability and constant threat of ethnic conflict would at least discourage foreign investment and make it difficult for Georgia to prosper economically.

Lacking in natural resources itself, Georgia has marketed itself as an energy transit country. The prospect of a non-Russian transit route to Europe was appealing both to western investors and Caspian Sea governments trying to lessen their dependence on Russia. As a result, the governments and oil firms of the Caucasus region constructed the Baku-Tbilisi-Ceyhan (BTC) oil pipeline, a 1,100 mile-long route starting in Azerbaijan and terminating in Yumurtalik, Turkey. From Turkey, the oil is loaded onto supertankers and delivered to Europe.4

The prospect of an energy transit route through Georgia angered the Russian government, which actively sought involvement in all regional energy projects. In 1996, in an attempt to force Georgia to abandon its efforts with the West, Russia offered to “restore” Georgia’s territorial integrity in exchange for allowing Russia to control any pipelines running across Georgian territory.5 Such an offer illustrates Russia’s strategy of exploiting the separatist causes to

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5 Karagiannis, Energy and Security in the Caucasus, 84.
destabilize Georgia, while bullying Georgia into accepting a greater role for Russian interests. As one journalist explains, “Russia…views the Caucasus as its own sphere of influence and wants Central Asian oil to be exported via its own territory.” Georgia ultimately refused the Russian demands, remaining economically independent but also unable to solve the separatist issues.

The Russian government fomented ethnic tensions as a way to pressure Georgia into the mid-2000s. Then, in late 2003, Russia altered its strategy after a pro-Western politician, Mikheil Saakashvili, came to power in Georgia in a bloodless change of government known as the “Rose Revolution.” Saakashvili sought to align Georgia with the West politically, with the eventual goals of Georgia joining the North Atlantic Treaty Organization (NATO) and the European Union. Russia found the prospect of a NATO state directly on its border threatening to its national security, and took additional measures to choke Georgia economically to prevent such a scenario. In 2005, Russia suddenly

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7 Karagiannis, Energy and Security in the Caucasus, 90.

doubled the price of its natural gas shipments to Georgia, reaching a new price of US$110 per thousand cubic meters (tcm).\textsuperscript{9}

To compensate for the shock this price increase caused to its economy, Georgia immediately began looking for ways to diversify its energy supply. Although Georgia purchased most of its oil through contracts with Azerbaijan, consumption of Russian remained a troubling vulnerability.\textsuperscript{10} In 2006, the BTC pipeline opened officially. It supplies one percent of the world’s oil, up to one million barrels per day to Turkey, and is 30 percent owned by BP.\textsuperscript{11}

In November 2006, the Russian state-controlled natural gas monopoly GAZPROM announced that it would cut off supplies of gas to Georgia by the end of the year unless Georgia agreed to a 100 percent price increase, or sold its main gas pipeline to Russia.\textsuperscript{12} This economic blackmail demonstrates Russia’s

\textsuperscript{9} Guide to Russia’s Energy Key Energy Clients,” under “Georgia.”

\textsuperscript{10} Ibid.


willingness to use its energy resources as a foreign policy tool, withdrawing supplies without warning when it served Russian interests.

In 2007, Georgia began to diversify its gas imports when the Baku-Supsa pipeline opened, transporting 2.2 billion cubic meters of Azerbaijani gas to Georgia and Turkey.\textsuperscript{13} While this gave Georgia increased energy independence, Georgia nevertheless remained far from secure because the pipelines transiting its territory received periodic threats from various separatist elements.\textsuperscript{14} The decision to bury the BTC pipeline underground helped mitigate the sabotage threat to some extent, although the pipeline would never be completely safe.\textsuperscript{15}

In August 2008, tension between Russia and Georgia boiled over in a several-day war, in which Georgia was soundly defeated by Russia. Russia seized and kept Georgia’s two autonomous regions, one-fifth of Georgian territory.\textsuperscript{16} Georgian leaders claimed that during the fighting the Russians had dropped aerial bombs near the BTC pipeline, although the bombs ultimately missed their target.\textsuperscript{17} It is unclear whether these alleged attacks were simply poorly planned,\textsuperscript{18}


\textsuperscript{14} Pagnamenta, “Analysis: Energy Pipeline That Supplies West.”

\textsuperscript{15} Ibid.

\textsuperscript{16} Rayfield, “The Georgia-Russia War, A Year On,” under “The Two Territories.”

\textsuperscript{17} Skarbo and Petre, “The Pipeline War.”
aimed at something else, or missed their target deliberately. Nevertheless, the attacks highlight the great importance of the energy transit route for Georgia.

It remains too early to fully evaluate the long-term effects of the war on Georgia’s aspirations toward greater relations with the West, although it appears initially that this quest has stalled somewhat. In the months following the war, European and American leaders slowly distanced themselves from the Georgian cause, fearful of having to choose between supporting Russia, a supplier of European gas, and Georgia, a fledgling democracy with no natural resources and an unpredictable leader.¹⁸ This isolation of Georgia politically serves Russian interests, as Russia knows its actions in the region will face no serious challenge from the West.

Georgia also suffered great physical and economic damage that will likely take years to repair. During the war, the Russians bombed the strategic port of Poti on the Black Sea, and inflicted severe damage on the Tbilisi airport.¹⁹ The war devastated Georgia’s economy and infrastructure, destroyed much of its military equipment and physical capital such as bridges, roads, and buildings, and


¹⁹ Skarbo and Petre, “The Pipeline War.”
displaced about 20,000 citizens.\textsuperscript{20} It resulted in political turmoil domestically with opposition groups questioning Saakashvili’s leadership, and shattered the confidence of international investors, who now viewed the republic as potentially too high-risk for further investment.\textsuperscript{21} Finally, the war showed what happens when a country followed a political and economic course contrary to Russian interests, sending a loud signal to both Georgia and its neighbors that challenging Russia had consequences.

**The Russia-Ukraine Dynamic**

Russia’s relationship with its southern neighbor, Ukraine, a country of 46 million inhabitants, has shifted from quite close through the 1990s to somewhat contentious toward the end of the 2000s. By 2009, Ukraine’s population included 17 percent ethnic Russians, and most of the country spoke Russian fluently.\textsuperscript{22} Russia and Ukraine historically share many cultural similarities and are often viewed as natural allies or brother Slavs. During the Soviet era, Ukraine not only grew vast quantities of crops for the Union, but also housed much of the energy-intensive, heavy industry that powered the USSR’s military-industrial

\textsuperscript{20} Rayfield, “The Georgia-Russia War, A Year On.”

\textsuperscript{21} Ibid.

complex. After the fall of the USSR, the two countries maintained a close cultural and economic bond.

As a legacy of the Soviet era, independent Ukraine continued to purchase Russian oil and gas at prices well below the world market average. According to an International Monetary Fund (IMF) report from 2008, Ukrainian consumers only paid 10 to 40 percent of world market prices for their energy. This heavy subsidy gave Ukraine no incentive to alter its highly inefficient consumption practices. In the late 2000s, Ukraine consumed “more energy per unit of GDP [gross domestic product] than almost any other nation in the world and more than two and a half times as much as the average of the OECD [Organization for Economic Cooperation and Development] nations.” In 2006, 66 percent of Ukraine’s natural gas came from Russia, while Russian oil imports accounted for 78 percent of Ukrainian consumption. Thus Ukraine’s historical energy partnership with Russia placed it in the awkward position of near total


25 Ibid.

dependence on Russian goodwill. As long as Ukrainian policy did not counter Russian interests, this relationship was not a problem.

In 2004, however, Ukraine began taking steps counter to Russian interests when the pro-Western, pro-EU political candidate, Viktor Yushchenko, emerged as the forerunner in the nation’s presidential election. Despite his popularity, in the fall 2004 elections the pro-Russian candidate Viktor Yanukovych claimed victory, albeit with widespread fraud. The US Department of State observes:

The November 21 runoff election was marred by credible reports of widespread and significant violations, including illegal expulsion of opposition representatives from election commissions, multiple voting by busloads of people, abuse of absentee ballots, reports of coercion of votes in schools and prisons, and an abnormally high number of (easily manipulated) mobile ballot box votes.27

The pervasive election fraud angered Ukrainian voters and resulted in hundreds of thousands of people taking to the streets to protest the results and voice support for the pro-western candidate in demonstrations that would later be called the “Orange Revolution.”28 A re-vote held on December 26, 2004, led to Yushchenko’s victory and a shift westward in Ukrainian politics.

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27 US Department of State, “Background Note: Ukraine.”
28 Ibid.
Once Yushchenko took office in early 2005, he began to advocate for reforms to prepare Ukraine for EU and NATO membership. Shortly thereafter, GAZPROM demanded an increase in the price Ukraine paid for natural gas. By late 2005, GAZPROM had increased its price from the heavily discounted US$50 per tcm to US$230 per tcm.²⁹ When Ukraine balked, GAZPROM ceased gas deliveries on December 31, 2005, resulting in an outcry from European countries whose supplies were also disrupted.³⁰ While doubtless GAZPROM needed to increase its own revenue and was surely losing money on gas sales to Ukraine, the tactic it took – a sudden price increase in response to political events rather than a gradual ratcheting up of the pay schedule - was highly suspect. Not only was this move financially beneficial for GAZPROM, it also suited the interests of the Russian government, which wished to convey its dissatisfaction with Ukraine’s choice of political leaders. Ultimately the two sides settled on an average price of US$95 per tcm.³¹

Yet this was only a temporary solution. Pro-Russian candidate Yanukovych, who had been elected to the Ukrainian Parliament in 2006, found


³⁰ Ibid. 7.

³¹ Ibid., 8.
himself once again ousted by the voters in fall 2007. Once it appeared that the pro-Western candidates would win the election, GAZPROM announced that it would either reduce gas supplies to Ukraine if outstanding debts were not paid, or forgive the debts in exchange for Ukraine turning over its shares in the gas pipeline system to GAZPROM.\footnote{Congressional Research Service, \textit{Russian Energy Policy}, 8.} Again, Russia appeared to be using its energy resources to pressure Ukraine when it chose a path contrary to Russian interests. In fall 2007, Ukraine agreed to a 38 percent price increase, bringing the price it paid for natural gas up to $179.50 per tcm starting in 2008.\footnote{Ibid., 8.} Although GAZPROM always cited payment disputes as its reason for changing the pricing scheme for Ukraine, the timing of the price increase immediately following a major Ukrainian national election made it hard to argue that the increase was merely a coincidence. Moreover, since the price paid by Ukraine starting in 2008 was double the amount paid by Russian ally Belarus, it seemed unlikely that GAZPROM’s motives were entirely financial.\footnote{Ibid., 9.} As Kyle Atwell observes, “Moscow [was] likely using the cover of a seemingly straight-forward business

\footnotesize{\textsuperscript{32} Congressional Research Service, \textit{Russian Energy Policy}, 8.\
\textsuperscript{33} Ibid., 8.\
\textsuperscript{34} Ibid., 9.}
dispute to do some good ol’ fashioned arm twisting of its Ukrainian and European neighbors.”

On 1 January 2009, Russia again cut off gas supplies to Ukraine over payment disputes that arose after world energy prices fell dramatically in the aftermath of the world financial crisis that began in October 2008. Russia argued that Ukraine had not paid alleged debts, while Ukraine argued with GAZPROM’s proposed price increases for 2009. As Andrew Kramer writes, “The shutoff at the peak of the heating season carried more than financial overtones; it is the most confrontational move by Russia toward a neighboring country since the August [2008] war in Georgia.” By this time, however, Ukraine and Europe alike had learned their lesson and had abundant gas reserves available to cover the stoppage in supply until the dispute could be resolved. On January 20, 2009, gas supplies

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resumed. By 2010, Ukraine was scheduled to be paying full world market rates for its gas.

Yet this arrangement did not last too long. In April 2010, following the election of pro-Russian leader Viktor Yanukovych in Ukraine, Russia offered to waive the export taxes Ukraine paid on Russian gas, meaning Ukraine would pay up to 30 percent less for Russian gas for the next nine years. In exchange, Russia asked the new Ukrainian government to extend the lease of Russia’s Black Sea Fleet for another 25 years. This clever negotiating ploy allowed the Russian Black Sea Fleet, which was scheduled to move back to Russian territory in 2017, to stay in Ukraine, preserving the Russia’s strategic foothold in the Black Sea into the middle of the 21st century. While Yanukovych saw this deal as a solution to Ukraine’s energy woes, his critics, including opposition candidate Yuliya Tymoshenko, called it “the systematic destruction of the independence of our state.” Russia clearly had more to gain from the arrangement, as it no longer had to worry about what to do with its ships or where to find the revenue to build

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39 Ibid., 10.


41 Ibid.
an entirely new base in Russia. By using its energy as policy tool, Russia could preserve its foothold in Ukraine, making it easier influence Ukrainian politics and policies toward NATO for years to come, as well as continue to project its power throughout the Black Sea region.

The continual tension between Ukraine and Russia over gas supplies illustrates the power of Russia’s energy weapon, and the utterly dependent state in which it places Ukraine. Moreover, the fact that disputes over Ukrainian political outcomes unfavorable to Russia can influence Europe’s energy supply should be troubling to those European states so eager to consume Russian energy.

**The Russian Perspective**

Following the worldwide economic downturn in October 2008, Russian energy firms lost a great deal of money. This in turn affected the Russian state, since tax revenue from Russian oil and gas firms account for approximately 60 percent of the Russian government’s annual budget. Likewise, many of the current leaders of Russia have personal ties to the oil and gas sector. Even current Russian president, Dmitriy Medvedev, was formerly in charge of overseeing

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42 Atwell, “Europe’s Very Cold War.”
GAZPROM. This means any loss in revenue for the oil and gas firms not only affects those controlling the government at a personal level, but also diminishes Russia’s ability to achieve its domestic and foreign policy goals.

Russian energy companies argue raising energy prices represents sound business strategy, since subsidies to former client states rob them of profits. Russia has raised prices on even its close allies Belarus and Armenia in recent years, although not to the degree that it has on Ukraine or Georgia. From the Russian perspective, price increases are fair and are simply part of a changing business dynamic.

Part of the reason behind Russia’s decision to terminate supplies to Ukraine in 2009 pending a new agreement on prices certainly was a result of GAZPROM losing a lot of money after the financial crisis of 2008. Andrew Kramer explains, “Plagued by the sharp fall in oil prices, Russia has been scrambling to make up the revenue as prices have slipped below US$40 a barrel. GAZPROM, too, is heavily in debt and sinking along with the energy market.”

When Russian energy firms lose revenue, the Russian state also loses important

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44 Ibid., 5.

45 Kramer, “Russia Cuts off Gas Deliveries to Ukraine.”
income from taxes. It was therefore in the interests of the Russian state and the energy firms alike to work to recuperate as much revenue as possible.

Yet the good business argument has a serious flaw. Russia’s sudden price increases started well before the economic crisis of late 2008, and tend to follow immediately after elections or other events that represent policy directions contrary to Russian interests. The price hikes are generally surprises to the countries in question, rather than part of a gradual price increase plan negotiated with, and agreed to, by both sides. In this way the Russian argument that it is simply promoting sound business practices rings hollow. Following the January 2009 price dispute, GAZPROM ultimately required Ukraine pay more for its gas than Germany, and four times the amount that Belarus pays.46 In short, while economic considerations do play a role, manipulation of the energy markets is also a way for Russia to pressure neighbors who do not keep Russian interests in mind when setting their policy priorities.

**Precedents for the Caspian Sea States**

The relationships between Russia, Georgia, and Ukraine provide a critical example for the Caspian Sea states of what happens when states become overly vulnerable to Russian pressure. The Caspian Sea states have a limited timeframe

46 Atwell, “Europe’s Very Cold War.”
in which to solidify their independence from Russia. As ideas and preliminary agreements become actual working projects, decisions will be made that will ultimately shape the course of these countries’ policies for decades to come. The challenges the Caspian states face are great, including geographic distance from their energy markets, dilapidated infrastructure, high levels of poverty and unemployment, an underdeveloped judicial system and rule of law, and significant corruption at all levels of government. Yet despite these challenges, the leadership of the Caspian Sea countries can still make decisions that will bring their products to market either completely without or with minimal Russian interference.

The examples of Ukraine and Georgia also serve as a warning to the Caspian states of what might happen to them if they allow themselves to become too economically intertwined with Russia. Unlike Georgia and Ukraine, who as energy transit countries have historically been heavily dependent on Russia for critical energy resources, the Caspian Sea states do not have this vulnerability. They still have time to heed this precedent and follow a different course in their dealings with Russia and the West.

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CHAPTER FOUR

THE CULTURE OF CORRUPTION AND STRONGMAN TACTICS

IN RUSSIAN BUSINESS

One of the most important factors shaping Russian economic relations with the former Soviet republics today involves the role of bribery in business. Whereas Western entities see bribery as inherently wrong because it gives one party an unfair advantage, bribery is an essential part of life in the former Soviet Union. The Moscow-based Information Science for Democracy Foundation (INDEM) found that since the mid-2000s, Russian citizens have paid more than US$300 billion in bribes annually, an amount equal to more than one quarter of Russia’s GDP.1

This chapter will explore some of the ethical peculiarities in Russian business practices by first examining of the role of bribery in Russian culture, and then reviewing Russia’s use of strongman tactics to solidify business relationships. This chapter will demonstrate how corruption, in particular bribery, gives Russian businesses a competitive edge in their relations and negotiations with the Caspian Sea oil and gas producing countries.

Bribery in the Soviet Era

In the Soviet Union, bribery was a part of everyday life because often it was the only means people had to acquire what they needed. Scholar George Neimanis observes that, “The old Soviet system had the peculiarity that having money was not enough for obtaining goods and services. In addition to rubles, one needed authorizations procured through personal connections.” If an individual did not have a sufficient personal connection, that individual could offer some type of incentive payment to assist in obtaining the coveted item or service. Because in the Soviet Union everyone was paid the same amount regardless of their job, ability, or work ethic, everyone had the same low standard of living and difficulty acquiring necessary or desired goods and services. Working hard or exhibiting creativity was essentially worthless because individual success was not rewarded. As a result, a culture evolved in which people with authority could use their positions to reward themselves, since there was no other way to do so by working within the Communist system. Over the years, bribery became a standard feature of Soviet culture. Neimanis writes:

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The Soviet system thoroughly corroded the work ethic of its people….Above the subsistence level, acquisition of goods and services depended on connections or blat [bribes]. The official dogma of equality dictated equal remuneration independent of the quality and quantity of one’s work. Empty stores, the limited availability of consumer durables, and the severe curtailment of homeownership did not stimulate effort. Why bother? Habits acquired during a lifetime are hard to break.3

By the late 1970s, daily business was so inefficient in the USSR that people routinely brought “gifts” to those in positions of authority who could help them get things done.4 The higher one’s social status, the more important bribery and connections became. Those in positions of authority did not punish others for taking bribes since they too were taking bribes. With no consequences for paying bribes, the system expanded. As Wilson and Donaldson point out, “corruption and inefficiency flourished within the ruling elite at all levels.”5

While bribery was certainly not unique to the Soviet Union, the Communist tradition helped institutionalize the practice in that geographic area. Neimanis explains that the Communist party “was a collective where practically nobody bore any real responsibility for anything because each decision required

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5 Ibid., 20.
approvals numbering in dozens and sometimes in hundreds." Over time, the absence of personal responsibility led to an absence of communal responsibility as well. Citizens did not require government officials to be accountable for their actions and eventually corruption became rampant at all levels. With a populace accustomed to those with authority using their positions for personal advantage rather than service to the people, it could hardly be expected that following the collapse of the Soviet Union in the early 1990s, the population would instantly morph into capitalists following western codes of ethics. And so, the practice of bribery at all levels of government persisted in the post-Soviet era.

**Business in the Post-Soviet Era**

The transition of Russia and the former Soviet republics from state-run, command economies to free-market societies has not been easy. Formerly state-run industries were sold off to a select few elites for bargain prices, creating a tiny class of wealthy oligarchs, and leaving everyone else with no way to participate or invest in the economic future of their countries. This led to a wide gap between exorbitantly wealthy oligarchs and top government officials, and the rest of the population, which survives on a few hundred dollars per month. Although

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eventually a middle class began to develop in capital cities, it remains small even as of 2010. Meanwhile, the influx of oil and gas revenue has filled the coffers of the former Soviet states that produce oil and gas, allowing the leaders of these states to rule as they wish without having to answer to a public that demands accountability in exchange for its tax revenue. The absence of a consistently applied rule of law, coupled with high unemployment and poverty have resulted in a business culture lacking in transparency and rife with corruption.

Following the breakup of the USSR, Russia and the Soviet republics of the Caspian Sea region found themselves with many layers of bureaucrats, all of whom were “empowered to authorize or deny while earning very modest salaries themselves.”\(^7\) Whereas before the fall of the Soviet Union everyone was paid the same, in the new states there was a suddenly a large disparity in wealth. Presented with the opportunity to augment low salaries, and little social stigma for doing so, bureaucrats continued the tradition of bribery from the Soviet days but with more gusto. Bribery soon became a standard part of all business dealings.\(^8\) As one Russian businessman explained in 2005, “If you want to be competitive

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\(^7\) Neimanis, “Business Ethics in the Former Soviet Union,” 358.

\(^8\) Ibid., 359.
you have to play the game. It used to be called bribery. Now it is just called business.”9 A World Bank survey conducted in 2005 revealed that 78 percent of businesses in Russia reported having to pay bribes as part of doing business.10

The prevalence of bribery continues in part in many Soviet States, especially in Central Asia and the Caucasus, because the legal systems function poorly and are ineffective at reining in corruption. There is likewise no social stigma attached to accepting bribes, another legacy of the Soviet era. As Neimanis reminds us, in the Soviet Union, “theft from state enterprises was a socially-accepted form of behavior that has survived in the sense that no stigma is attached to pilfering [by] workers because they are poorer than the owners of businesses.”11

The prevalence of bribery in the former Soviet Union frustrates many western firms, democracy advocates and scholars alike because it runs so contrary to the principles of capitalist, merit-based competition. Western firms accustomed to success based on traditional free market forces such as supply and

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10 Ibid.

demand, good products and customer service, efficiency, or best value find doing business with Russia and the Caspian Sea states challenging. Instead of choosing the best product or service, the bribe-taking entity in these areas – be it a government actor or major firm – generally selects whichever product comes with a bonus on the side. In a small business setting, bribery is a costly nuisance. When the leader of a country chooses the direction of a country’s main industry or political policy based on how much he is being compensated on the side, this can have disastrous consequences for the general population, potentially for generations thereafter.

In the West, bribery is seen as inherently wrong because it gives one party an unfair advantage. In Russia and the former USSR, however, bribery is a societal norm. Although in recent years the Russian government has made statements encouraging an end to corruption, there has been little improvement. It is this ubiquitous culture of bribery that led to Transparency International ranking Russia 146 out of 180 countries for corruption in 2009.12

12 Kelly, “Multinationals Pledge No Corruption in Russia.”
Bribery in the Oil and Gas Sector

With high stakes at play in the oil and gas sector, it is no wonder that bribery and other forms of corruption are rampant. It is hard to document all of the instances of bribery since it is by definition a discrete activity. However, the few cases that have come to light reveal how significant a problem it is, and how much money is involved. For example, a 1997 audit of the Azerbaijani oil industry revealed that since 1990, an average of 1.3 million tons of oil per year had been kept out of the production records and sold on the black market.\(^{13}\) After the fall of the Soviet Union, the Azerbaijani government’s revenue intake crumbled to one-fifth of its former GDP, yet despite this setback, the government still used oil revenue to enrich the president and his family and associates.\(^{14}\) It was said that then-president Heydar Aliyev “receive[d] a cut from every business ranging from construction through trade.”\(^{15}\) His son, Ilham took over the presidency following his father’s death in 2003.

\(^{13}\) Charles Van der Leeuw, *Oil and Gas in the Caucasus and the Caspian: A History* (New York: St. Martin’s Press, 2000), 123.


\(^{15}\) Ibid.
Also in 2003, American businessman James Giffen was charged with paying US$78 million in bribes to Kazakh President Nursultan Nazarbayev and Prime Minister Nurlan Balgimbayev. Having violated the US Foreign Corrupt Practices Act, Giffen found himself in court facing charges, fines, and jail time for activities that violated US laws against bribing foreign governments in exchange for business concessions. During the trial, Giffen argued that bribery was a necessary part of business in the former Soviet Union and without it his company would have no chance to establish a foothold in the market. Giffen said, “This is no market for the faint of heart. It takes time to develop it. You have to have patience, you have to have perseverance, you have to have a strategic plan. And it takes some money to penetrate the market.”\textsuperscript{16} Clearly the money required to successfully conduct business amounted to tens of millions of dollars in payoffs to the leadership of the country in question. Whereas this practice was illegal for the American businessman, it is perfectly standard practice for Russians and other businessmen from the former Soviet Union.

The role of bribery in the oil and gas industry in the Caspian Sea region helps to explain why the leaders of Caspian Sea countries make seemingly illogical economic and policy decisions. In Kazakhstan, for example, the leadership recognizes that the basis of its economy is oil, yet it still relies nearly exclusively on Russia to transport that oil, giving Russia huge leverage over its most important economic sector and by extension its freedom as a country.\(^\text{17}\) If Kazakhstan were to enact a policy contrary to Russian wishes, Russia could simply cease to transport Kazakhstan’s oil, crippling its economy in short order. No responsible leader would agree to such a policy, yet efforts to build alternative routes that bypass Russia are minimal. This suggests that the best interests of ordinary Kazakhs are not the top priority of the Kazakh leadership. Based on the amount Giffen was caught trying to pay in bribes, it is not a stretch to suspect that some individuals in the Kazakh leadership accepted similar bribes from Russian firms to approve and implement a policy so contrary to Kazakh national interests, rather than try to work with a western firm to develop an economic alternative.

\textsuperscript{17} Vladimir Babak, “Kakakhstan: Big Politics Around Big Oil,” in \textit{Oil and Politics in the Caspian Sea Region}, ed. Michael P. Croissant and Bulent Aras, (Westport, CT: Praeger, 1999), 195.
When governments are party to bribery, the consequences can be long-lasting. In 2010, Transparency International issued a statement saying the excessive role of government in the economy and business sector [in Russia] helped spur corruption and aggravated the problem.” 18 When the state is corrupt, the award for a properly-placed bribe can be tremendous for a business—concessions for long durations, contracts for huge amounts of money, changes in a state’s policy even. A state signing over its entire oil or gas industry to one particular company, for example, has a huge impact on that company’s profits and market share. For the country in question, such a decision can potentially alter its relations with neighboring states, change its status in the world market, and even reshape its domestic and foreign policies depending on the nature of the industry in question. Thus bribery of a government official with real decision-making capacity can have far more significant consequences than bribery in a regular business-to-business transaction. In the competition for oil and gas resources in the Caspian Sea, therefore, the entity that pays the most bribes can affect the policy of that country, and influence relations with neighboring oil-producing and consuming states.

18 Kelly, “Multinationals Pledge No Corruption in Russia.”
Corruption in business, especially when one party in the transaction is a government entity, leads to even greater corruption in other aspects of governance and society. As Maureen Crandall notes, the Caspian Sea republics tend to be mostly authoritarian regimes, with no checks on power, and rigged elections. She calls them “kleptocracies governed corruptly” [with] “abjectly poor majorities.”

Dictators who retain at least part of the oil and gas industry profits for themselves generally have little interest in developing new industries, investing in civil society building measures, promoting democracy, or working to better enforce the rule of law. Scholar Joseph Stiglitz explains, “Control over natural resource wealth provides leaders with little incentive to share power, and gives leaders the means with which to buy legitimacy rather than earn it through elections.”

For these leaders, maintaining the status quo is all that matters. The last thing they need is an effective judiciary to stop the flow of bribes or oust them from their positions of power. Indeed, twenty years after the fall of Communism, the oil- and gas-producing states of the Caspian Sea basin are rife with corruption and far from being democratic states.

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Unfortunately for the majority of the population in such countries, there is little recourse to counter the corruption of the leadership. Crandall explains, “Oil money permits governments to spend with little questioning or accountability, thus weakening any incentives to reform their economies and stifling any nascent democratic participatory processes.”

Because the regimes are flush with oil profits, and the leaders themselves well taken care of on the side, they do not need to collect tax revenue elsewhere to fund the activities of the state. With the requirement to responsibly spend taxpayer funds alleviated, government officials become less accountable to their citizens. At the same time, because ordinary citizens pay hardly any tax, and the institutions of civil society are underdeveloped, citizens have no way to effectively demand accountability from their government and thus do not challenge their leadership in any meaningful way. This lack of opposition allows government leaders to continue their corrupt practices, institutionalizes bribery from the top of the bureaucracy on down, and to some extent puts the state at the mercy of the bribe-payer.

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22 Ibid.

**Strong-Man Tactics**

A second Russian business strategy involves the use of strong-man tactics. If bribery is the carrot in a “carrot and stick” business strategy, strong-man tactics are the Russian stick. Such tactics have a unique history originating in Soviet culture and serve as another effective method Russia uses to influence the outcome of a business transaction in its favor.

In the early days of the Soviet Union, one of the primary Bolshevik goals was to eliminate the gap between rich and poor, successful and unsuccessful, so that all people were equal in every way. To accomplish this goal, the Bolsheviks introduced the idea of *uravnilovka*, roughly translated as “equalization,” encouraging Soviet citizens to make sure their neighbors did not get ahead, including denouncing them to the Committee for State Security (KGB) if necessary. After the fall of the Soviet Union, new Russian businessmen continued this tradition by using every means necessary to stop competing firms or political opponents from succeeding while simultaneously working to consolidate their own power and influence. Wilson and Donaldson explain:

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In today’s business climate, a Russian businessman not only desires to continually build his own power base, accumulating money and connections – he also tends to work hard to stop others from gaining power. Competitors or political opponents have traditionally been destroyed by a wide variety of methods, from malicious rumors to brute force.\(^2^5\)

This strategy is evident in the way the state-run gas monopoly, GAZPROM, has eliminated its competition, both within Russia and in the greater Caspian Sea region. For example, in 2004, GAZPROM’s Russian competitor YUKOS was suddenly charged with “tax evasion” and had to sell its assets to the state-run firm ROSNEFT.\(^2^6\) Shortly thereafter, GAZPROM bought another Russian competitor, SIBNEFT, at a cut-rate price, bringing its market share up to 30 percent control of the Russian oil market.\(^2^7\) GAZPROM and the Russian state have worked together to likewise eliminate much of the foreign competition. In 2006, GAZPROM bought out much of the interest in the Sakhalin-2 oil project, owned by Shell and other foreign firms, at a very low price after the Russian government “found

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\(^2^7\) Ibid.
alleged environmental problems in Shell’s management of the project.”\(^{28}\) In 2007, the Russian-British firm TNK-BP was forced to sell its Kovytka gas field in Siberia at a heavily discounted price after GAZPROM refused to approve its plans for the gas export route.\(^{29}\) This type of pressure could only be possible for a state-run firm with bureaucratic and legal assets at its disposal. Such pressure represents the Russian strong-man tactic.

Russia employs these tactics in its business dealings with the Central Asian republics as well. In 1993-1994, Kazakhstan brokered an agreement with the Western firm Chevron to develop Kazakhstan’s Tenghiz oil fields.\(^{30}\) While development of the field and the influx of western technology went well, efforts to develop a pipeline transit route through the Caspian Sea – a route that would bypass Russia – soon stalled. Russia claimed that until the boundaries in the Caspian Sea were demarcated between the five littoral states, there could be no development of the sea.\(^{31,32}\) Western plans to establish alternate routes crumbled


\(^{29}\) Ibid.

\(^{30}\) Babak, “Kazakhstan: Big Politics Around Big Oil,” 194.

and, as of 2010, Kazakhstan remains dependent on Russian pipelines to transport its oil to markets in the West. Remarkably, Russia eventually resolved its dispute with Kazakhstan over demarcation of the Caspian Sea and is currently developing an oil field beneath the sea in partnership with that country. By partnering with Russia in some capacity, Kazakhstan is able to successfully move its products to market and reap the reward thereof.

When a country does not include Russia in its energy extraction and export plans, and bribery alone has not succeeded, Russia deploys its strong-man tactics. As discussed in chapter three, Russia’s relationships with Georgia and Ukraine are two poignant examples of the measures Russia will employ to secure cooperation or ensure suffering if they do not. By employing the strategy of bribery and strong-man tactics in its business dealings, the Russian state has ensured that the leadership of the Caspian Sea states will remain loyal to Russian interests, even if those interests counter those of their own people.

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32 Andrei Shoumikhin, “Russia: Developing Cooperation on the Caspian,” in Oil and Politics in the Caspian Sea Region, edited by Michael P. Croissant and Bulent Aras (Westport, CT: Praeger, 1999), 133.

In May 2006, then US Vice-President Richard Cheney “criticized Russia’s tactics of ‘supply manipulation or attempts to monopolize transportation against vulnerable countries in the region as ‘blackmail’ and ‘intimidation.’” Looking through the western optic it was clear to Cheney that ethical competition between firms and countries for the resources in the Caspian Sea region was not the Russian business strategy. Yet despite the ethical shortcomings of this strategy, by 2010. Russia had succeeded in securing at least a share in nearly every single energy project in the region. The following chapter will explore why the West’s attempts to be ethical in their business dealings with the states of the Caspian Sea region has proven to be a losing strategy.

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CHAPTER FIVE
ETHICAL ROADBLOCKS AND THE WESTERN STRATEGY

The greatest challenge western energy firms face in working with the countries of the Caspian Sea region is not dated infrastructure or geological challenges, but rather the ethical differences governing business traditions in the two cultures. In the West, entities competing for business generally must do so based on the quality of their product or service with the best business plan, service, or opportunity, “winning” the competition. Bribery and corruption are not supposed to play a part in influencing business decisions because these practices are considered ethically wrong, and therefore “dirty.” This is not to say that corruption never occurs; surely it does prevail from time to time. Yet by and large, bribery and other forms of corruption are less present in western business because such practices are seen as morally wrong.

This chapter will explore two key areas where business ethics differs between western and former Soviet cultures, and will analyze how this western tendency to conduct business in a manner consistent with western ethical norms may in fact be hurting western firms in the long run.
Conflicts of Interest and the Role of the State

A fundamental difference between some of the former Soviet governments and western governments involves the role the state plays in assisting its national corporations. In western countries, elected officials and political appointees who have authority to affect foreign or domestic policy must carefully consider any conflicts of interests that they may have. Elected officials generally must resign from corporate boards or other organizations with which they were previously affiliated so that their decisions as elected officials do not also benefit them personally. The goal is for government officials to operate as objectively as possible to serve the greater good of their constituents. In doing so, they must forsake their personal interests to avoid compromising their decision-making process and the integrity of the political and legal system as a whole.

That elected officials are supposed to avoid conflicts of interest is so ingrained in western business and political tradition that exceptions to the norm are widely viewed as scandals. As an example, Italy’s Prime Minister Silvio Berlusconi owns the three largest television channels in Italy. Berlusconi is frequently criticized by the rest of the western media and a large part of the Italian population for acting above the law in refusing to declare his $12 billion in
publishing, insurance and real-estate holdings to a conflict of interest oversight agency, and not giving up chairmanship over the three channels.\textsuperscript{1} Berlusconi’s case is inflammatory because it represents such an egregious deviation from the western, and in particular, the American ethical standard. Similarly, it would be simply unfathomable for a sitting American president to concurrently serve on the board of a major energy company, defense contractor, pharmaceutical firm, or any other business, as this would violate a fundamental tenant of American ethical standards.

In contrast, Russia and the countries of the Caspian Sea region have no such prohibitions on conflicts of interest among government officials. The Russian government is filled with former high-level energy industry executives and officers of the state security services who maintain extensive financial and personal ties back to these sectors.\textsuperscript{2} Whereas in the west proximity to these sectors by elected officials would be highly scrutinized, in Russia it is viewed as perfectly normal. As Steven Woehrel notes, “the personal and political fortunes


of Russia’s leaders are tied to the energy firms, as Russia’s economic revival in the past decade has been due in large part to the massive revenues generated by energy exports.\(^3\) The leaders of the other Caspian Sea states are dictators, many of whom are holdovers from the Soviet KGB, or their appointed successors. They too profit substantially from the oil and gas industries of their countries.

With such prominent connections to the energy and state security complexes, it is no wonder that one function of the Russian state is to further the interests of Russian corporations in the world market. In return, the state expects its share of revenue from the corporations – both in the form of tax receipts and dividends for the shareholders, many of whom are elected officials in the government. With such an arrangement, the state has the benefit of being able to use its national corporations, in particular the energy firms, to exert its influence over neighboring states. As Oksana Antonenko reminds us, “When Putin came to power, Russian oil companies were strongly encouraged to follow government policy in exchange for government efforts to lobby their interest more actively.”\(^4\)

The Russian policies toward Georgia and Ukraine discussed in Chapter Three


show just how effectively the Russian state uses its national corporations to achieve favorable political results. The energy firms likewise recognize that cooperation with the state is hardly a conflict of interest or an area of ethical concern. Rather, it is a requirement for success. This relationship serves both sides well and represents a fusion of effort that is simply not seen between Western governments and their national corporations.

Instead, western governments often have seemingly schizophrenic policies. The US policy in the mid-1990s in Azerbaijan and Kazakhstan involved advocating for US business interests and democracy, as well as promotion of human rights.5 In the former Soviet Union writ large, the US policy was even more complicated. Edward Morse and James Richard explain as follows:

Until September 11, the United States pursued two often conflicting goals: encouraging Russia to better protect US corporate investments in the Russian energy sector, and assisting the Caspian countries in developing and exporting their own hydrocarbons, thereby avoiding pipeline routes through Russia.6

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5 Andrei Shoumikhin, “Russia: Developing Cooperation on the Caspian,” in Oil and Politics in the Caspian Sea Region, ed. Michael P. Croissant and Bülent Aras (Westport, CT: Praeger, 1999), 142.

Following the September 11, 2001 terrorist attacks, however, these issues became secondary to prosecuting the war on terror, which meant construction of civil society institutions and promotion of democracy stagnated. Encouragement of US business interests waned as well. No longer did the dictators have to worry about losing power in democratic elections or being forced to make reforms to keep the Western powers happy. As they consolidated their power, these leaders grew closer to the Russian state and its national energy corporations who kept them in power with lucrative payoffs. Meanwhile, Russian companies who had missed out on the competition for resources in the early 1990s asserted themselves into this new market, working to partner with Western firms wherever possible to establish a foothold.

Thus, while promotion of pro-western business policies may have been a convenient byproduct of US diplomatic efforts in the Caspian Sea region, it was far from the US government’s top priority. Issues such as human rights, democracy, and the war on terror took precedence. The same philosophy generally held for Western European governments active in this region. Western

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governments do not use the investments or projects of their national corporations - or the threat of cutting off funding through these projects - as a way to blackmail the Caspian Sea governments into promoting pro-Western policy goals. Such activity would represent the complete antithesis of the freedom, democracy and free-market enterprise that Western governments hope to promote in this strategic region.

Such restraint on the part of Western governments is not bad; it is in fact part of what makes the West so unique in the world. What it does mean, however, is that western companies are self-reliant when it comes to securing contracts for exploitation of energy resources in this region of the world. When competing with firms who have their state’s backing, self-reliance can serve as a disadvantage to Western corporations.

**Why Stay in the Market?**

With such serious competition from Russian firms, and the formidable legal, ecological, safety, and cultural challenges that Western firms face in the Caspian Sea region, it might seem as though competition in this area is not worth the trouble. Yet that notion assumes that the only motivation of Western firms is
profit, and this is not true. Western oil firms promote sustainable development and diversity in energy suppliers as well. ConocoPhillips, for example, operates in 30 countries, including Kazakhstan. Many other western firms have similar operational plans. These firms recognize that having one supplier is a bad idea; anything from a coup to a weather-related disaster can cause a major upset for both the business and the receiving market.

Whether the companies recognize it or not, these policies are good for the West because they help promote energy independence by keeping western nations from growing too dependent on one particular supplier. Maintaining energy independence is important for Western nations because it allows these nations to maintain and continue promoting western values, policies, and the western lifestyle. Western countries value liberty, individual freedom, free speech, the ability to worship any faith, democratic elections, and the like. Western countries also pursue foreign policies that promote western ideals such as equal treatment for women, the dignity of human life, protection of children throughout the world from trafficking, sex-slavery, forced labor, an end to human rights abuses, and so forth. Western countries periodically become engaged in conflicts far from their

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borders due to a values-based belief in assisting what they view as downtrodden or oppressed peoples from various government-imposed afflictions. Whether right or wrong, Western countries, and western-dominated institutions such as the United Nations, advocate many policies based on the Judeo-Christian ethic.

The ability to advocate and promote such values in the world requires political muscle. Western countries have vibrant economies, serve as valuable trading partners, maintain excellent educational institutions, and have many other benefits that other countries are often not willing to forego to defend a policy or practice highly contrary to western values. Western countries also have well-trained and powerful armies that give them the military muscle necessary to both defend their values and beliefs against enemies, and to promote the resulting policies throughout the world. Such muscle requires energy. The Caspian Sea region may not be the El Dorado that was predicted after the fall of the Soviet Union, but it is a new source of energy. Access to its resources could have a lasting impact on the West’s ability to muster the muscle it needs to preserve western values. Therefore, staying in the market is indeed a priority for western firms and countries alike, even this is not the official government policy.
To Bribe, or Not to Bribe?

A second challenge that western firms face in the Caspian Sea region involves the role of ethical business practices. In a western business context, following western ethical norms is not a challenging task because all parties in the business transaction are starting from essentially the same ethical baseline. Everyone knows what to expect. It is when the western ethical business paradigm shifts to a non-western business context that the clarity of principles begins to break down. Western firms find it difficult to compete in the Caspian Sea region in part due to the incompatibility of Western ethical standards with the business practices of the region, which include corruption. Specifically, bribery and “grease payments” are often essential components of business transactions. Failure to bribe means western firms are often unable to acquire or keep long-term contracts.

Arguably, one way western firms could be more competitive involves adjusting their business practices in the Caspian Sea region specifically to mimic more closely the prevailing culture. Such adjustments might involve an agreement to pay the necessary bribes to foreign leaders to stay viable in the energy market. Although this contradicts western ethical principles, occasional
bribes or grease payments could potentially make a huge difference in keeping western energy companies competitive in this market. Such an adjustment of ethical practices calls for pragmatism, that is, acceptance of the fact that the world is not ideal, and thus looking for a practical approach to problems and affairs. In this scenario, the pragmatic approach calls for making an exception to the western prohibition on bribery in order to remain competitive in the market. That would not make bribery suddenly ethical; but it would keep western corporations at least viable players in the regional market. The pragmatic approach recognizes that the practice may not be ethically sound, but also acknowledges that the alternative approach of refusing to pay bribes on principle alone is having an adverse effect on western companies and their consumer base in the west.

Despite the obvious advantages to paying bribes to stay in the market, actually doing so remains ethically troubling for western firms, which pride themselves on their ethical business practices. By paying bribes, the western firms would be violating the very ethical standards they claim to uphold. Western governments advocate transparency, democracy, and an end to corruption in the Caspian Sea region. Bribery by western corporations would undermine much of the efforts of diplomats, scholars, and non-governmental organizations to achieve
those ends, which are the implementation of western values in everyday life. Thus, it would be highly hypocritical for firms representing the values and morals of the west, even if such representation is unofficial, to sacrifice those values in order to secure energy contracts.

The answer to this dilemma requires an evaluation of the long-term consequences from the utilitarian point of view, that is, what actions can be taken by western corporations so that the outcome will result in the greatest good for the greatest number of people? Securing energy resources so that western countries can power their societies in the future is critically important to preserving western values and policy goals. Without energy, western countries will not have the political and military muscle to maintain the western way of life, and thereby avoid being economically or politically blackmailed by stronger neighbors with energy supplies. This, in turn, means those ethnic, religious or other groups living outside the west whose causes or plights are championed by the West will no longer have advocates if such advocacy threatens one of the energy-controlling nations. In the long-term, the consequences of the West not having access to energy supplies, whether from the Caspian Sea region or from other world suppliers, are indeed severe.
Yet rejecting western values by bribing dictators seems an odd way to go about preserving western values for the future. Paying bribes would likely further entrench the level of corruption and cronyism in the governments of the Caspian Sea region, which counters the western interests in helping these countries to become more democratic, transparent, and self-sufficient. However, there is nothing to indicate that failure to pay the bribes by the West alone will magically transform these governments into transparent democracies. The West’s current refusal to pay bribes has not diminished the level of corruption or improved transparency in the region. Instead, western companies simply find their options more limited than their Russian competition.

Ultimately it is not the governments of the Caspian Sea region that will view the west as hypocrites, but the individual citizens and grass-roots leaders in these countries who may look to foreign governments to provide leadership when their governments fail to do so. People in this situation will see the west as an entity that keeps corrupt governments in power to secure necessary energy resources for themselves. This is a high price to pay, but for future energy independence for the entirety of the western world, it may arguably be worth it. Using the utilitarian argument, it is still better for a greater number of people to
have western governments attempting to maintain and promote western values, than to have every country dominated by dictatorships which use their energy resources to pursue ends that are not compatible with western values. Thus, while bribery remains morally wrong, it may be a less evil alternative to the consequences of not bribing and finding western firms even more excluded from this important energy market.

**Statutes Against Bribery**

Yet the question of whether or not to bribe is not one that an individual corporation can decide because bribery is prohibited by law in many western countries. In 1977, in response to exposure that the aerospace firm Lockheed had paid bribes to sell its aircraft to foreign countries, the US Congress passed the Foreign Corrupt Practices Act (FCPA).\(^{10}\) This act prohibited US firms and other US entities from paying bribes to foreign governments or foreign government officials to “assist in obtaining or retaining business.”\(^{11}\) According to Mark Pastin and Michael Hooker, this act came about in part because, during the 1970s, US


firms had been “reluctant to bring public attention to the fact that in a very large
total number of countries, payments to foreign officials [were] virtually required for
doing business.”12 Although this was the standard business practice, it conflicted
with the Carter Administration’s policies of compassion, human rights, and
greater morality.

To an American public that believed strongly in upholding American
values and principles, the idea of paying bribes to foreign officials seemed
repulsive.13 Especially in light of the corruption exposed during the Watergate
era, Congress was eager to put an end to corruption and return to an era of
principles and ethical behavior. The FCPA demonstrated this commitment to
American values by legislating morality and promoting the idea of the American
business as an ethical role model for the world to see.

The FCPA reflects a uniquely American, and unfortunately naïve,
perspective on world affairs that suggests non-western states will admire western
states for behaving ethically, and will somehow reward them over other less-

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13 Ibid., 49.
ethical parties for their ethical behavior. This type of world view does not reflect reality in the non-western context. A majority of the countries in the world do not follow western principles of justice, equality and liberty for all, democracy, human rights, and so forth. These value-based principles require a functioning legal and judicial system with equal application of the law to all parties. Most countries do not have legal systems that function equally for all people, or the judicial and bureaucratic structures to enforce this equality for all. Instead, money and power status open doors, secure contracts, and absolve from prosecution those individuals with special connections. While it is nice to believe that behaving with ethical self-restraint will encourage others to do so as well, history has also shown time and again that the strongest man wins.

The FCPA has been criticized since its passage because of its stringent policies, including prohibition on payments that are not even technically bribes but rather “grease payments to get bureaucrats to do a job they are supposed to do anyway, but in a more timely fashion.”14 In the late 1970s, western corporations may have been the major players in the world market but since the end of the Cold War this has changed. East and South Asian, former Soviet, and other

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companies are now competing in the world market. In cultures where bribery or “gifts” to officials are the business norm, American firms are at a clear disadvantage. Despite these disadvantages, however, the FCPA has been hard to repeal because it is viewed as a law that “protects morality in forbidding bribery.”\textsuperscript{15} It is politically inexpedient to advocate a return to less ethical business standards, even if the law may actually be hurting US corporations.

The goal of ending corruption in the world is indeed a noble endeavor and one toward which western companies should actively work. The approach that the Organization for Economic Cooperation and Development (OECD) countries of Western Europe plus Argentina, Brazil, South Africa, Estonia and Israel have taken involves a similar but slightly more flexible alternative to the FCPA. In 1997, members of the OECD and five other countries signed the Convention on Combating Bribery of Foreign Officials.\textsuperscript{16} The convention includes “non-criminal rules for prevention, overall transparency, and cooperation between countries.”\textsuperscript{17} The incentives for not paying bribes include a requirement that the

\textsuperscript{15} Pastin and Hooker, “Ethics and the Foreign Corrupt Practices Act,” 49.

\textsuperscript{16} Sanyal, “Determinants of Bribery in International Business,” 140.

\textsuperscript{17} Ibid.
signatory countries deny tax deductibility of bribes. Of note, the signatories to this convention do not include Russia or the Caspian Sea states. This means that while the convention strictly prohibits bribery within the borders of the signatory countries, it does not prohibit “facilitation payments” and other necessary steps in non-signatory countries. This convention, while establishing a legal framework to prevent many of corruption, does not completely handicap companies within the OECD countries in the same way that the FCPA handicaps American firms.

Supporters of the FCPA believe it is more important to practice moral behavior than to merely secure a profit for shareholders. Kenneth Alpern argues that because American investors are not in a state of dire need, “the moral weight of their financial interests is small compared to the moral weight of moral principles.” In the context of the competition for resources in the Caspian Sea region, this would certainly be true if there was no greater consequence for refusing to pay bribes than perhaps losing some contracts and forcing western

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19 Ibid., 15.

companies to invest elsewhere. In such a scenario, western values, promotion of democracy and transparency, and investment in the countries of the region is of greater moral value than corporate profits. However, this interpretation fails to account for the potential long-term consequences of losing the competitive advantage.

While it may be acceptable to follow a certain set of ethical principles when competing for something that is considered nice to have, what happens to the moral imperative when the object of the competition suddenly becomes essential? In the world energy market, this scenario is not merely a theoretical argument but indeed something that could happen in the coming decades. With vast expansion in the number of energy consumers in the world, and the growing number of dictatorial regimes that control the world’s energy supplies, it is only a matter of time before a shortage arises. Whether the shortage is simply due to an overabundance of consumers or is created by unscrupulous politicians, remains to be seen. Regardless, someday there may be a shortage of energy. Arrangements made today will likely have a serious effect on the energy market in the future.

Despite Western aspirations to the contrary, there is currently no way to power society without oil and natural gas. If the West suddenly loses its access to
oil and gas, there will be pandemonium as people quickly find their lifestyle collapsing around them. Recriminations will abound. The citizenry of every state will demand an explanation from their government as to why life as they know it has come to a standstill, or why gasoline costs US$25 per gallon. When Americans realize that US companies conducted their business ethically but were excluded from participation in key world oil and gas transactions by doing so, it is sure to cause outrage, not pride in American values. Further, what steps will western governments have to take to secure oil and gas resources? Threats? Sanctions? Total war? Faced with prospects such as these, people may reconsider whether paying a $100 million bribe to a foreign government official to secure a steady energy supply was truly so morally abhorrent.

**The Uneven Playing Field**

This examination of the Russian and Western business strategies highlights two crucial differences. First, the Russian state uses its influence to advance the business interests of its national corporations, while western governments generally do not. Second, Russian corporations have no compunction about using bribery to advance their interests, while western governments view this practice as highly unethical and do so to a much lesser
degree. In the case of the United States, bribery of any sort is outlawed completely, regardless of the culture in which the business is taking place.

The US government’s legislation of a values-first approach to world business is leaving many western firms at a disadvantage when they compete with companies and countries subject to different standards. While American businesses executives and their attorneys are busy trying to determine just what measures they can take in a foreign country to advance their interests without violating US laws; their competition is winning the contracts for energy resource exploitation through corrupt practices. Western firms may offer better training, safer work environments, better health benefits, domestic infrastructure investment and many other incentive programs to encourage foreign countries to choose them as a partner. Unfortunately for the western firms, when the decision-makers are being compensated under the table by the competition, such incentives, which clearly would be better for their own citizens, are irrelevant. As a result, western firms, in particular American firms, have great difficulty competing in this environment.

It is no coincidence that nearly every oil and gas extraction and transport arrangement, with the exception of the Baku-Tbilisi-Ceyhan pipeline, involves the
Russian government. When the USSR fell, the Russian government was hardly involved in the Caspian Sea region. By the time Vladimir Putin became president of Russia in 2000, Russian firms had partnered with foreign firms, including Conoco, BP Amoco, ExxonMobil, Royal Dutch Shell, as well as Halliburton and Schlumberger. Carefully capitalizing on the technical expertise of these firms, the Russian companies overcame their challenges with infrastructure and dated equipment to become serious players in the region. By 2010, western firms remained involved in exploitation and extraction of resources, but Russia solidly controlled all of the major transport routes out of the region. A decision by Russia to cut off access to transport would thus leave western companies with highly limited options to move their investments to market. This newfound dependence on Russia is dangerous for both the western consumers of energy and the producing countries in the Caspian Sea region.

What this shift in the western energy firms’ roles means politically for the West has yet to be seen. However, western governments must recognize that the choices they make about energy prospects over the next five to ten years will be critical in determining whether or not Europe will be subject to a new era of

energy dependence on Russia. The answer to this question will then determine what role America has in the western world in the decades to come.
CHAPTER SIX
A NEW ERA OF RUSSIAN ENERGY DOMINANCE IN EUROPE

For the West, acquisition of energy resources has historically been a question of market forces. Russia, Iran, the Caspian Sea region, and the Middle East have the supplies; the West has demand. In theory, it should be simple to establish a business transaction favorable to all parties. In practice, however, there is more involved than simply business. Suppliers of energy know they have unique leverage; OPEC’s effort to control prices over the past few decades is a testament to the power of this leverage. Russia too recognizes that control over energy supplies is the means by which it will be able to reassert itself in on the post-Cold War stage. In contrast, Western countries continue to wear metaphorical blinders, insistent that in the post-Cold War world everyone is healthily interdependent.¹ Over the past two decades, Western governments and energy firms have pursued policies that have increased their dependence on Russian energy. This dependence is unhealthy, and yet remains on track to grow even greater in the next decade. This final chapter will examine what the

changing energy relationships signify for Russian-Western relations in the future, and what role the resources of the Caspian Sea region will play in resolving this great challenge.

**Ever Greater European Dependence on Russian Energy**

In the Soviet era and during most of the 1990s, Western European countries relied on Middle Eastern or Nordic energy supplies to fuel their societies. In the 2000s, this trade balance shifted when Russian energy exports to Europe, in particular exports of natural gas, increased dramatically. By the end of the decade, the EU depended on Russia for nearly one quarter of its entire natural gas supply, 80 percent of which was pumped through Ukraine.”

Each country has a varying degree of dependency on Russia. France, the Netherlands, Spain, Portugal, and the Scandinavian countries use domestic resources or purchase their energy from other parts of the world. In contrast, Germany currently buys more natural gas from Russia than any other country,

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amounting to nearly 40 percent of its total consumption.\textsuperscript{3} Germany is such an important client for Russia, and Russian gas is so essential to the German economy, that the two countries partnered in 2005 to establish the Nord Stream (North Stream) pipeline project. This project, controlled by GAZPROM, was designed to transport gas directly to Europe through the Baltic Sea, bypassing the transit countries in Eastern Europe.\textsuperscript{4} Construction on the project began in April 2010.\textsuperscript{5} The first pipeline is expected to be complete in 2011, the second in 2012. Nord Stream will deliver up to 55 billion cubic meters of gas per year to Europe.\textsuperscript{6} This monumental effort has the potential to reshape the way Northern European states consume energy, and may, over time, give Russia enormous leverage over states such as Germany, which stands to benefit greatly in the short-term from this new pipeline.


\textsuperscript{6} Nord Stream AG, “The Pipeline.”
Italy too has grown increasingly dependent on Russian gas. Whereas formerly the bulk of Italy’s energy came from North Africa and the Middle East, by 2005, approximately one-third of Italy’s gas imports came from Russia. This number was expected to rise to 40 percent by 2010.\(^7\) Italy’s state energy firm ENI is currently looking for new ways to partner with GAZPROM to secure deliveries to Southern Europe, demonstrating Italy’s commitment to increasing the amount of gas it imports from Russia in the future.\(^8\) While this may alleviate some of Italy’s historically rocky relations with North African energy suppliers, it is a risky long-term move.

Many countries which are not terribly dependent on Russia for oil find themselves almost completely dependent on Russia for natural gas. Countries in this category include Finland, Estonia, Latvia, Lithuania and Slovakia, all of whom receive 100 percent of their natural gas from Russia. By 2006, Central European countries were particularly vulnerable to alterations in the Russian energy policies, including price increases, due to their high level of dependence on Russian energy. For example, as of 2006, the Czech Republic relied on Russia


\(^8\) Ibid.
for 78 percent of its natural gas and 65 percent of its oil, Hungary relied on Russia for 65 percent of its natural gas and 87 percent of its oil, and worst of all, Bulgaria relied on Russia for 90 percent of its natural gas and 87 percent of its oil.9

Even the United Kingdom, which used to export most of its gas, will be importing 75 percent of its gas by 2010. GAZPROM hopes to fulfill 20 percent of the United Kingdom’s total gas needs by 2015.10 With this massive shift in Western consumption of Russian energy, and so many countries becoming heavily dependent on Russia to keep the oil and gas flowing, it follows that any Russian policy shift could potentially have a tremendous impact on Europe.

Learning the Wrong Lessons from Past Russian Behavior

The prospect of oil and gas cutoffs due to Russian whims, annoyances, or disputes with transit countries is not unknown for European nations. Yet such events are a reality, usually occurring during the coldest of the winter months. For three days during the winter of 2006, Russia cut off energy supplies to

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Ukraine over a price dispute. Ukraine quickly ceased shipments of gas to Europe, a move that impacted several other countries. Instead of a massive public outcry or any kind of punitive measures, most of the countries impacted simply responded by stockpiling enough oil and gas reserves to weather any future disputes.\textsuperscript{11} What they did not anticipate were medium to long-term disputes. In January 2009, another dispute between Russia and Ukraine lasted two weeks, exhausting most countries’ reserve supplies. There were several major European cities with heating only a few hours per day. The timing of these cutoffs showed that Russia had little regard for the well-being of its customers, and no moral or ethical qualms about asserting its will when it best suited its agenda. For Eastern Europeans in particular the energy cutoffs during freezing winter days illustrated just how vulnerable their countries had become to Russia’s political and economic decisions.

Following the January 2009 cutoffs, some Eastern European countries felt betrayed by Russia. Bulgaria, for example, had only recently renewed its contract with GAZPROM - a contract which included a steep price increase.\textsuperscript{12} The cutoff

\textsuperscript{11} Charter and Naughton, “Furious EU Protests after Russian Gas Supplies Cut Off.”

showed that even paying higher prices for energy did not guarantee that supplies would remain steady. Bulgarian government officials spoke publicly of the need to lessen Bulgaria’s dependence on Russia. Yet, when presented with the option to work with GAZPROM to potentially route a major new pipeline through its territory, Bulgaria readily agreed, lest it lose ground to neighboring Romania.\footnote{Alexey Druzhinin, “Bulgaria, Serbia, Decide on South Stream Onshore Route,” \textit{RIA Novosti}, August 7, 2010, http://en.rian.ru/world/20100807/160109633.html (accessed August 21, 2010).}

For Bulgaria, the risk of dependence on Russia did not outweigh the advantage of having the pipeline run through its territory en route to other European nations. At least if the gas supplies were interrupted in the future, Bulgaria would be closer to the source and might be better off than its neighbors further down the pipeline route. Similarly, the Czech Republic recognized the extent of the problem, but unfortunately had no immediate solution. As Czech expert on Russian affairs Oldrich Bures said in a radio interview during the January 2009 energy cutoffs: “The Czech Republic and Europe as a whole have been sort of taken hostage by this feud between Ukraine and Russia about gas prices.”\footnote{Dominik Jun, “Current Affairs-Russia Cuts off Gas Supplies to Europe,” \textit{Radio Prague}, January 7, 2009, http://www.radio.cz/en/article/111962 (accessed August 31, 2010).}
many Eastern countries, especially the landlocked republics, there seemed little choice to prevent future cutoffs but to avoid upsetting Russia in the future.

While the governments of Eastern Europe are acutely aware of their predicament of dependency on Russian gas, and the threat this poses to their independence and well-being, Western European countries often seem blissfully unaware of this growing problem. It appears as though the governments of Western Europe believe energy cutoffs could only happen to Eastern European transit countries, not to highly-developed, western European states that pay full market prices for Russian gas. European leaders advocating this point of view argue that Russia needs the profits from European energy consumption just as much as the West needs Russia’s oil and gas.\(^{15}\) Therefore, both sides are mutually dependent.

To some extent, this is true. Russia cannot fuel the modernization of its economy and society, and the rebuilding of its military-industrial complex, without energy revenue. As Steven Woehrel points out, advocates of Russian energy imports note that two-thirds of the Russian state budget comes from oil.

and gas exports. To acquire this revenue, Russia must sell its energy to someone, and the west is an attractive consumer. Western states need energy, so why not purchase it from Russia? If the West simply refused to purchase Russian energy, Russia’s economy would quickly fall into a state of disarray. However, based on the level of dependence already in place, Europe would be unable to sustain a boycott of Russian energy for long. To some extent, this energy partnership is a win-win situation for all parties involved. In speaking about the Nord Stream pipeline in April 2010, German Chancellor Angela Merkel explained, “Our shared goal is an energy partnership based on equality geared to the long term. It is to offer businesses on both sides opportunities for cooperation and growth.”

It is convenient for both parties to have the mutually beneficial economic relationship today, and revenue from energy to sales to Europe has undoubtedly been a critical factor in promoting the tremendous growth Russia has experienced over the last decade. However, while Europe becomes ever more dependent on Russian energy supplies in the future, the Russian government will continue to diversify its consumer base, increasing demand from other parts of the world.

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17 “Nord Stream AG, “The Pipeline.”
Projects to build pipelines to Asia are a very real possibility, especially if the Russian state views them as strategically advantageous. As Woehrel reminds us, “Russia has… hinted that the bulk of Russian energy exports could be provided to Asia or even the United States instead of Europe in the future, once new pipelines to Asia are completed and new liquefied natural gas facilities are built.”

Moreover, if all the pipeline projects envisioned are actually realized, Russia will not be able to fully supply all of them due to limitations on its energy extraction and transport infrastructure. Such a situation would necessitate a decision about which countries most deserved Russian supplies. European countries might find themselves coerced into either paying ever increasing rates for energy, or complying with Russian demands to avoid a loss of precious energy supplies - or both.

This long-term view is what the Western European countries fail to see. Although newspaper columnists and academics periodically point this out, governments have been slow to make any policy changes to lessen this risk. Instead of advocating the interests of the transit countries, or working to punish

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19 Ibid.
Russia collectively in some other capacity for its treatment of these countries, some Western European countries are instead looking to build energy routes that bypass these troublesome spots.

There are currently two major, Russian-sponsored projects in varying stages of development. The Nord Stream pipeline, which runs from Russia to Germany, entered the construction phase in early 2010. The proposed South Stream pipeline would run from Russia, beneath the Black Sea, to Bulgaria, and then onward to Southern Europe. This latter proposal, which still has not been fully approved, competes directly with the EU-supported endeavor, Nabucco. The Nabucco pipeline would run through Turkey into Southern Europe, transporting energy from both the Caspian Sea region and Russia. The EU favors Nabucco because it does not run through Russian territory, and thus can be open to energy contributions from several countries. Another advantage to the Nabucco project is that it would not be controlled by GAZPROM, like the rest of the land-based energy transit routes to Europe. Neither option has been formally approved, although Nabucco is currently awaiting a final decision on financing before the go-ahead is given. It is highly unlikely that both pipelines will be built.

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The Western European decision to “solve” its energy problems by bypassing the troublesome energy transit countries and building new routes to receive Russian gas highlights a significant problem for the EU: there is no united energy policy. The EU has asked Russia to open its pipelines to western firms, and to provide stronger protection for foreign investment in Russian energy endeavors. In both cases, Russia has refused. The EU demanded Russia ratify the 1994 Energy Charter Treaty, which contains these policies, and Russia again refused. Russia has refused other such measures designed to encourage free market policies, foreign investment in Russian infrastructure and energy firms, and other measures to diversify ownership of energy infrastructure. Yet instead of looking to purchase gas elsewhere until Russia agrees to the EU’s terms, the individual European countries have instead followed their own national interest. Czech energy expert Oldrich Bures explains as follows:

...If Europe was able to act in concert, it would have a strong voice in enabling Russia to see that this is a strong market that they cannot afford to lose….the farther west we go, shall we say, the less immediate concern there is. And while there is solidarity, there is not a sense of urgency. This experience may be helping to push the EU to consider alternative

22 Ibid.
pipelines in the long-run, but it will remain difficult to have a common united front in Europe.\textsuperscript{23}

Without a unified energy strategy, the various European countries continue to grow increasingly dependent on Russia – some at more alarming rates than others. Russia in turn recognizes this lack of a unified strategy and is working to exploit this fragmentation to promote greater dependency, not only as means to guarantee future political leverage, but also because it is great for Russian business.

**Russia Knows the Energy Weapon Works**

Russia has learned over the past decade that its ability to control energy supplies is indeed a highly effective policy tool. As Ukraine leaned toward NATO candidate status, Russia cut off its energy supplies. Although Russia claimed the cutoff was due to a price dispute, the move forced Ukraine to reconsider its desire to join NATO, lest, as a consequence, it lose its highly subsidized energy rates. As Kyle Atwell explained, “Pressuring Ukraine …[was] a blatant attempt to destabilize one of the few former Soviet republics that [was] not a one man, president-for-life police state, and [had] real prospects for

\textsuperscript{23} Dominik Jun, “Current Affairs-Russia Cuts Off Gas Supplies to Europe.”

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eventually becoming a NATO member.”  

Such a policy sent a clear signal to the neighboring NATO states that Russia did not want NATO encroaching any further into its sphere of influence.

Similarly, during the war between Russia and Georgia in August 2008, the Georgian leaders claimed that the BTC pipeline had been attacked, although the Russian bombs missed their target.  

Russian jets also bombed the “strategic Black Sea port of Poti, a staging post for oil and other energy supplies.”  

It is noteworthy that the Russians attempted to destroy Georgia’s major economic lifelines to the West, and the West’s only energy route from the former Soviet Union that avoided Russian territory.

If Russia did indeed bomb the BTC pipeline, as Georgia told the international press, such a move would serve Russia’s goals very effectively by damaging Georgia’s infrastructure during the war, punishing European energy


26 Ibid.

27 Skarbo and Petre, “The Pipeline War: Russian Bear Goes for West’s Jugular.”
consumers for their efforts to draw Georgia closer to NATO, and eliminating GAZPROM’s competition. Notably, Western European nations were hesitant to condemn either Georgia or Russia during and after the conflict, suggesting their desire to avoid further provoking Russia.

The Russian government recognizes what a powerful tool it possesses. With investment in its domestic infrastructure, including energy extraction and transit equipment, it will continue to flourish as an energy powerhouse for the coming decades. Likewise, Russia occupies a central location between the West and Asia. The market for energy is currently in the West. GAZPROM has taken important steps to ensure that its gas will be shipped to Europe directly, via the Baltic Sea and potentially via the Black Sea as well, so as to avoid troublesome transit countries such as Ukraine. Diversifying transit routes helps GAZPROM function as a more reliable supplier to the customers who matter most - the high paying Europeans. It also enables the Russian state to more effectively target its displeasure toward neighboring countries who do not act in accordance with strategic Russian objectives, cutting off their energy, while not affecting the European customers who remain in favor with the Russian state.

Many European states argue that Russia and the West are mutually dependent when it comes to energy. This may be true today, but in the future Russia could easily build the infrastructure necessary to ship its gas to other markets since supplies are limited but demand continues to grow around the world. In June 2009, GAZPROM Deputy Chairman Alexander Medvedev commented, “Only three countries can be suppliers of pipeline gas in the long term – Russia, Iran, and Qatar. So there is no other choice than to deal with these suppliers…Europe should decide how to handle this situation…and if Europe doesn’t need our gas, then we will find a way of selling it differently.” Russia recognizes that in the future, as Europe’s dependence on Russian energy grows, and markets in Asia become increasingly lucrative, Russia will have the absolute advantage.

Why the Resources of the Caspian Sea Region Matter

The states of the Caspian Sea region recognize the dilemma they face in growing too dependent on Russia. Turkmenistan realized the danger in relying too heavily on Russia in April 2009, when the two states quarreled over

responsibility for an explosion in a gas pipeline. In late 2009, Turkmenistan opened a pipeline to China that was expected to delivery 30 bcm of gas per year. Turkmenistan’s plans to build a pipeline beneath the Caspian Sea to Azerbaijan have been thwarted by Russia’s insistence that all projects beneath the sea be approved by all five littoral states. Intent on pressing forward independent of Russia, Turkmenistan equipped itself with two tankers and is now able to move 5,000 tons of oil every two days to Baku. This Turkmen oil is transported to the West via the BTC pipeline. While this amount of oil constitutes only 4-5 percent of the oil moving through the BTC pipeline, it is still an important way for Turkmenistan to move one of its few resources to a lucrative market without having to rely on Russia.

The Caspian Sea region may not be the El Dorado of the 21st century, but it does contain substantial resources. The BTC pipeline, likewise, is a vital conduit for energy supplies to Europe that circumvents Russia. In the future, it may even be possible for Iranian energy resources to travel through the BTC pipeline, or for the pipeline to expand its capacity, in addition to transporting

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energy from the Caspian Sea littoral states. The BTC pipeline will give Europe a
counterbalance to Russian dominance in the energy arena, and more importantly,
will ensure that the countries of the Caspian Sea region, many of which are rather
isolated, have a chance to support their economies and retain their fiscal and
political independence from Russia. Thus, the resources from the Caspian Sea
region may indeed have great influence on the Western-Russian political and
economic dynamics in the future. The Western efforts to compete with Russia to
help the Caspian Sea countries develop and export their energy resources in a
manner beneficial to both the West and the respective states has been a good
investment of time and energy for the West, and will be a relevant factor in
shaping the European-Russian energy dynamic in the years to come.
CONCLUSION

The competition between Russia and the West for the energy resources of the Caspian Sea region during the 1990s and 2000s, and the vastly different strategies each side has used to promote its interests, illustrates the importance of energy in shaping the political, military, and moral future of the West in the decades to come.

As a prominent supplier of oil and natural gas, Russia recognizes the importance of energy as both an economic and foreign policy tool. With the revenue it earns from energy exports, Russia has been able to rebuild its dilapidated military, reliably pay its civil servants, and bring stability to a country that endured much economic uncertainty during the tumultuous post-Soviet transition years. Additionally, by adjusting the price of its energy exports, or withholding supplies completely, Russia can influence other countries to adopt policies complimentary to Russian interests, or punish them for failing to do so. Russian state energy monopoly GAZPROM’s numerous energy cutoffs to Ukraine at the coldest time of year, when Ukrainian citizens were most vulnerable to such economic blackmail, shows that Russia understands how effective the energy weapon really is, and has no ethical qualms about using it.
In contrast, the Western strategy of promoting quality products and services, while ensuring safety and conducting business according to western ethical norms, has been less successful than Western firms originally envisioned. Undoubtedly Western firms have become heavily involved in oil and gas extraction projects in the region, in particular in Kazakhstan. Yet, efforts to transport that energy to Western markets without Russian involvement have met with strong resistance. This thesis demonstrated that part of the reason Western firms were less successful than they hoped to be is because Western firms, in particular American firms, are so bound by Western ethical norms and the statutes that codify them, that they lost their competitive advantage in the Caspian Sea region. Western firms simply could not effectively compete with Russia, which does not follow the same rules, and instead bribes and bullies its way into nearly every business arrangement. In all cases but one, the BTC pipeline, Russian pressure to include Russian interests has prevailed over Western interests. This means the goal of having a new energy source for Europe, free from Russian involvement or pressure, was not achieved.

This failure on the part of the West was Russia’s goal all along. This is because Russia and the West maintain fundamentally different views of the world.
For Russia, everything is a competition with the West to see who will emerge as number one. Whereas many Western countries believe this Cold War mindset disappeared with the Cold War itself, for Russia, the end of the Cold War was merely a setback in an ongoing struggle. The competition for Caspian Sea energy resources illustrates exactly how Russia views world affairs as a zero-sum game. Put simply, whatever is good for the West is bad for Russia. There is no such thing as real partnership. Russia realizes that energy is the tool by which it will win back its dominance over the West, and with it, its return to world superpower status. As the Russian foreign minister in 2000, Sergey Ivanov stated:

…the international aspect of the oil and gas business will gain an increasingly prominent place in Russia’s foreign policy strategy. This is not only one of the most considerable means of defending our foreign policy and foreign economic interests, but also an effective geopolitical factor and a tool for strengthening national security in all its dimensions.¹

For Russia, loss of its superpower status at the end of the Cold War resulted in great humiliation. The chaos of the 1990s further motivated many Russian officials, especially those leading the government today, to take the necessary measures to restore Russia’s prestige in the world. While the Russian people do not necessarily advocate a return to Communism, they do long for the days when

Russia’s opinion, decisions, and policies had an impact on other parts of the world. Russia realizes that energy is the key to regaining its great power status. The involvement of Western firms and governments in the Caspian Sea region threatened this Russian goal, and Russia took the necessary measures to prevent Western success.

As this thesis shows, Russia used a multi-faceted strategy to promote its interests in the Caspian Sea region. Russia compensated for its dated technology and lack of infrastructure in the early 1990s through well-placed bribes and payoffs, ensuring by the late 1990s that Russian firms were represented in nearly all of the extraction and transport projects in the region. Meanwhile, it used strongman tactics to forestall the efforts of the other three former-Soviet Caspian Sea littoral states to develop their own export initiatives. Russia blocked demarcation of the Caspian Sea and forbade any new projects, such as subsea transport pipelines, until all parties agreed on any proposals - and then refused to agree to any proposals. Russia welcomed Western investment in its domestic extraction and transport industries, but then used its wieldy bureaucracy to keep the firms from making much profit on their investments or, in the case of TNK-
BP, from exporting the gas they had worked so hard to extract, eventually driving them out of the market.

By the late 2000s, confident in its position as an energy supplier to the European continent, Russia was able to effectively deploy its energy weapon against Ukraine and Georgia when their interests aligned too closely with those of the West. These maneuvers should have served as a wake-up call to all of Western Europe, warning them that dependence on Russia could have far-reaching consequences. Yet most of Western Europe remains convinced that the Cold War is long over, and that the new Russian government is only interested in peace and partnership. Yet rather than ushering in a new era of energy cooperation, the Nord Stream pipeline, and potentially the South Stream pipeline project as well, will plunge Europe into a new era of heavy dependence on Russian gas. At the rate these projects are progressing, this dependence is likely to be established before the end of this current decade. As Harvard University energy expert Marshall Goodman notes, “The Europeans have to have a better appreciation of just how powerful a weapon energy is. Anybody who links up
with that gas pipeline and becomes dependent on Russia is very much at their mercy.”

The consequences of a new era of European energy dependence on Russia are enormous for both Europe and America. If Russia cuts off the gas to Europe every time they pursue a policy contrary to Russian interests, Europe will be far less willing to do anything that challenges Russia. This may include voicing objections to Russian slaughter of civilians in the breakaway republic of Chechnya, to Russian efforts to supply Iran with fuel for its nuclear reactors, or to Russian weapon sales to “rogue states” whose interests conflict with America’s, just to name a few examples. In the Russian zero-sum game mindset, anything America promotes is automatically bad for Russia. As such, Russia will use its energy resources to ensure that Europe does as little as possible to help America achieve its goals in the world.

As a consequence, America will find its influence in Europe greatly diminished. When America seeks NATO support for an international military action, it may find its European partners unwilling to participate if their participation means they will suddenly have to pay double or triple the price for

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their gas. American efforts to use force to prevent the spread of radical Islam, fight terrorism, protect oppressed populations, or stop humanitarian disasters may be thwarted if Russia views such actions as a threat to its interests. With few European allies able to assist in these global struggles, America will have a more difficult time promoting its interests and values in the world. Likewise, Europe may soon find it too is unable to advocate the values-based policies it holds dear, if such policies contradict Russian interests in any way. As Russia continues to backslide on democracy, persecute journalists who publish anything negative about the state, and crackdown on dissent of any kind, European nations will increasingly be at its mercy. The last thing Europe needs is a powerful dictatorship wielding enormous leverage by virtue of its energy resources.

These are not far-fetched scenarios. Russia’s actions against Georgia and Ukraine have demonstrated that Russia is willing and able to use its energy supplies to further its own goals regardless of how this impacts other countries. Europe is on the brink of a new era of decline in its independence and influence in the world, and its own short-sighted policies are accelerating this decline. It is imperative that European leaders recognize the threat of overdependence on Russian oil and gas, and work to stop it. They must diversify their supplies
immediately, so as to maintain the independence necessary to continue life as it is today, with a society based on Judeo-Christian values, freedom of ideas, and the security to express and live out the values that Europeans consider so fundamental to their way of life. It is ultimately in America’s interests as well to keep Europe free from ever greater dependence on Russia, if America is to maintain its prominence in the world in the decades to come.
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