

GAZPROM: RUSSIA'S NATIONALIZED POLITICAL WEAPON AND THE  
IMPLICATIONS FOR THE EUROPEAN UNION

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## ABSTRACT

How has the Kremlin nationalized and politicized Gazprom, Russia's natural gas monopoly, for the purposes of using it as a political weapon? How has the Kremlin used this weapon to advance Russian interests in the former Soviet Space and the European Union? How has the European Union fought back against Russian political advancement through Gazprom? Using two case studies, Ukraine and Belarus, this study will examine Soviet and Russian energy policy and explain how energy diplomats have grown the Russian energy industry today while centralizing control of the industry under the Kremlin. The study will then focus on how the Kremlin has been able to re-gain control of Gazprom under the Putin presidency after being privatized under the Yeltsin presidency. The study will then examine Russia's relations with the EU as a result of the EU's dependence on Gazprom for natural gas supplies and Russia's use of Gazprom as a political weapon. This part of the study will focus on how the importance Russia has placed on Gazprom, in terms of Gazprom stimulating the Russian economy, has affected Russia's relationship with the EU. The study will also examine the lessons the EU can learn from Russia's relationships between Ukraine and Belarus as a result of the political nature of Gazprom. The study will also

touch on Russia's entrance in the World Trade Organization and their refusal to ratify the Energy Charter Treaty's Protocol on Transit. The study will also look at the issue of pipeline ownership and how the lack of ownership has become a security threat to Gazprom's security. The research used for the study is derived from a variety of resources including research on the Gazprom website, analysis by industry experts, including Jonathan Stern and Marshall Goldman, as well as newspapers. Conclusions derived from the study include that nationalization of Gazprom has enabled the Kremlin to politicize Gazprom's functions to the effect of using Gazprom as nationalized political weapon; Gazprom, as a monopoly, is an important institution in Russia in terms of contributing to the Russian economy and in how the Kremlin has been able to use Gazprom to infiltrate other industries, such as the Russian oil industry, which has begun to create the basis for uniting the whole Russian energy industry; that Gazprom's mission might be to provide for their client countries, but the Kremlin has used Gazprom to infiltrate the European energy market to secure Russia's own interests abroad; and also that Gazprom faces various threats including their lack of pipeline ownership and how the organization is in a state of decline, not only are its gas reserves in decline, but the organization has failed to substantially re-invest in its infrastructure and field exploration enough to halt the decline.

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## INTRODUCTION

By definition energy means power; energy resources are the means that power the modern day world, whether it be powering cars, computers, lights, etc., energy resources have molded the modern way of life. Russia, as a country rich in natural energy resources, is therefore highly valued by outsiders, especially the EU, for its energy. Russia's strategic geographical location to the EU has enabled the EU to lessen its dependence on energy from the Middle East. However, the EU is facing potential political consequences for its newly developed dependence on Russian energy because Russia has politicized its energy distributors. The purpose of this paper is to examine in depth how Russia has both nationalized and politicized Gazprom, Russia's monopolistic natural gas exporter, into a political weapon utilized by the Kremlin. By way of an Introduction, the next few paragraphs will discuss why this examination of Gazprom as a nationalized political weapon is important and what is the history of Russia's natural gas industry, and will close with an outline of the paper.

### **Why?**

After the fall of the Soviet Union, the Kremlin no longer had the option of using military might to back its policies and interests abroad. Therefore, the Kremlin had to find another way to protect Russian interests. Using energy exports to promote and secure Russian interests abroad may be perceived to be an efficient way for the Kremlin to secure these interests. Some of these interests, which will serve as examples throughout the text, include ownership of the entire Black Sea Fleet, and keeping former Soviet states out of the EU and aligned with Russia and the CIS. By

nationalizing energy giants, like Gazprom, the Kremlin was able to secure its hold over the products that could enforce their interests abroad. Without nationalizing Gazprom, the Kremlin would not be able to direct Gazprom's actions, which would therefore mean the Kremlin would be left without an important weapon through which to pursue Russia's national interests.

Studying how and why Russia has nationalized and politicized Gazprom to use its functions as a political weapon at the Kremlin's disposal is an important consideration especially for determining the European Union's future energy security. As mentioned above, Russia and the EU are geographically very close, which makes transporting energy supplies from Russia to the EU easier than transporting energy from the Middle East. However, the Kremlin seems to expect a return on their energy distribution; as the two case studies, Ukraine and Belarus, will examine, Russia has politicized Gazprom's functions for the purpose of using energy exports as a political tool. The Kremlin has infiltrated and gained control of Gazprom in order to render Gazprom's gas products as a tool to enforce Kremlin policies abroad. As the case studies will discuss, the moment the leaders of Ukraine and Belarus strayed from pro-Kremlin policies, the Kremlin would use Gazprom to threaten the leaders back into supporting pro-Kremlin policies.

The importance of the two case studies, examining Russia's energy relations with Ukraine and Belarus, lies in that fact that both of these countries were former USSR territories. As Soviet territories, both Ukraine and Belarus enjoyed paying a great deal less for gas exports from Soviet Russia than did other European nations. The

reason for this price discrepancy was that the Soviet Union wanted to increase its industrialization. By receiving inexpensive gas exports, well below the market value, both Ukraine and Belarus were able to sustain the Soviet Union's rapid industrial plans.<sup>1</sup> However, the fall of the Soviet Union brought about nationalistic movements in both countries; these movements were determined to decrease each countries' dependency on Russia by adopting a western perspective. The nationalistic movements upset Russia's predetermined post-Soviet relations with each country, which has resulted in the price increases in gas exports and a subsequent mounting issue over building an energy exportation system that purposely bypasses Russia.

While this study will examine the two mentioned case studies, Ukraine and Belarus, for the purposes of forecasting Russia's reputation as a reliable energy partner and the implications of centralization of Russia's energy sector under the Kremlin on the Russian economy, the study will also examine the issue of ownership. In this sense, the issue of ownership has two different connotations; first, is the issue of who owns the transit pipelines, and second who owns the natural resources, for example natural gas? The issue of who owns the pipelines has become a security issue for Russia because of their lack of ownership leads them to dealing with transit countries. Analyzing who or what owns energy, a natural resource, is an important consideration to understand when addressing exportation profits. Examining who owns natural resources is an important question not only for Russia, but also for the rest of the world.

## **What?**

The history of the natural gas industry in Russia actually began after the creation of the oil industry, before the Communist revolution. In 1819, gas lanterns were first used in Russia on the Aptekarsky Island in Saint Petersburg. However, it was not until 1941 that the first gas well was drilled in Saratov oblast, close to Elshanka village. This first well produced 800 thousand cubic meters of gas a day. A second well was established in June 1942, and this well had the same production as the first. As a result of the positive production from the two wells, the USSR Sovnarkom passed the Decree on Natural Gas Production of the Elshanskoye Field in September 1942, which meant that gas could be used for commercial production.<sup>2</sup>

The first gas pipeline, which was 16 kilometers in length, was completed in October 1942 and ran between Elshanka and Saratov. By 1944, experts discovered that the Saratov region's reserves had approximately 6 billion cubic meters of gas. This discovery promoted the USSR State Defense Committee in 1944 to build a gas pipeline from Saratov to Moscow, 843 kilometers in length. This pipeline passed 80 rivers and took 30 thousand people to complete. The pipeline was eventually finished in July 1946. This construction became a vital "testing ground for innovative technologies," including the "rapid-flow technique," "new construction mechanisms and route operating devices," and "gas welding equipment."<sup>3</sup>

As the paper will discuss Gazprom was born out of a Kontsern that was established in 1989 from the USSR Gas Industry Ministry. The Kontsern eventually became Gazprom, a Russian Joint Stock Company, in 1993 and then Gazprom Open

Joint Stock Company in 1998.<sup>4</sup> Today, Gazprom's mission is to "ensure a safe, efficient, and balanced supply of natural gas, other types of energy resources, and refined products to consumers."<sup>5</sup> Interestingly, Gazprom's mission only mentions delivering gas products to consumers in a safe fashion, it does not mention anything about how it will go achieving this. This paper will examine how Gazprom has delivered gas products to client countries; specifically how the Kremlin has used the nationalized politicized Gazprom to both deliver gas products and enforce Russian interests to client countries in the former Soviet space and the EU.

### **Outline**

The paper will be divided into five chapters. The first chapter will be devoted to analyzing the energy relationship between Russia and Ukraine; this chapter will examine what the Soviet energy policy was towards Ukraine, what the current energy policy towards Ukraine is, and what has been Ukraine's reaction towards Russian advances. The second chapter will be devoted to analyzing the energy relationship between Russia and Belarus. This chapter will examine the Soviet and Russian energy policies towards Belarus and Belarus' reactions to Russian advances. This chapter will also briefly compare and contrast the relationship between Russia and Belarus with the relationship between Russia and Ukraine. The third chapter will discuss how the Kremlin privatized Gazprom under Yeltsin and then how during Putin's rule, the state re-gained ownership in this strategic monopoly and subsequently nationalized the organization. The fourth chapter will examine how the Kremlin has used their ownership of Gazprom to enforce their foreign policies. This chapter will look at how

the Kremlin has re-gained ownership of Gazprom and Gazprom's European strategy as an effect of Kremlin influence and how Gazprom can be a model for the four stages of the energy weapon.<sup>6</sup> This chapter will also examine how Russia's membership in the World Trade Organization will affect Gazprom's influence as a political weapon. The fifth chapter will examine how the importance Russia has placed on Gazprom has affected its relations with the EU. This chapter will discuss: how Gazprom has contributed to the Russian economy; how Russia has refused to ratify the Energy Charter Treaty's Protocol on Transit; how the Kremlin has been able to infiltrate the European energy market through Gazprom; and how Russia's relations with Ukraine and Belarus have become an example to the EU of how to deal with Russia's use of Gazprom as a political weapon.

## CHAPTER ONE

### CASE STUDY ON UKRAINE

Russia's political relations with Ukraine have been strongly influenced by their exportation of energy to Ukraine. As one of the former Soviet Union republics, Ukraine has both benefitted and been ruined by Soviet and Russian energy exports in that Ukraine had once unlimited access to Russia's subsidized energy exports as a member of the Soviet Union; however, as an independent Ukraine, the country is finding it difficult to meet the world market prices Russia is now attempting to charge them for the exports. Ukraine also lies in Russia's strategic path towards the West; Ukraine's geographic position has made it difficult for Russia to export its energy to the West without using the pipelines running through Ukraine. Thus, the political relations between Russia and Ukraine affect energy exports to the EU. Ukraine, therefore, makes an interesting and key case study for analyzing Russia's forthcoming relations with the EU in terms of analyzing how Russia has politicized its energy exports to Ukraine to keep the former Soviet republic under Russia's influence. This chapter will first analyze the Soviet energy policy towards Ukraine and then how the collapse of the Soviet Union allowed Ukraine to develop its own energy policy based on its relations with Russia and the subsequent decentralization of the Ukrainian energy industry.

As referred to above, the Soviet Union did not charge market prices to its republic states, like Ukraine, but instead choose to enact a "...scheme of vertical fiscal redistribution between the Union budget and the republican budgets."<sup>1</sup> This system

allowed the less-wealthier republics to “receive...direct transfers” of goods, including oil and energy products, while the more wealthier republics would “donate” the goods.<sup>2</sup> The transfer of oil and gas was a primary commodity transferred. In fact in a survey taken in 1990, 61.5% of transfers were of oil and gas products, the next highest transferred commodity was “machine building [materials]” at 17%.<sup>3</sup> Transfers did not only consist of “underpriced exports” of energy, but also consisted of “overpriced imports of non-oil and gas products.”<sup>4</sup> Ukraine, along with Uzbekistan, Kazakhstan, and Kirghizia, were republics that imported subsidized energy products but also imported “overpriced” goods.

One can see the centralization of the Soviet Union by examining the “vertical fiscal redistribution” system that was in play here. In a free market system, where market value determines the commodities that are bought and sold and even traded, the Soviet Union diminished the market value only to play this role itself. Unlike in a free market system, where the market value determines what and for how much is “transferred,” in the Soviet Union, Kremlin officials determined what products were to be “transferred” for other products regardless of equal trading value or market prices. The Soviet Union therefore set its own market value, which gave it a powerful role in the development, or lack of development, in republic states while fostering a strong dependence on the Motherland.

The exportation of “underpriced goods” from Russia to the Soviet republics was balanced by the importation of some non-energy “overpriced” goods. Ukraine, however, was a crucial element of the transfer system that received more energy

imports then any other republic; in 1990, Ukraine alone imported 50% of Russia's oil and gas products.<sup>5</sup> Why was Russia practically giving away its energy resources? Because the Soviet Union was attempting to industrialize rapidly. Ever since Stalin reigned over the Soviet Union, industrialization spread rapidly throughout the republics—the Cold War was formulated on the notion that an undisclosed time-sensitive battle was mounting with the West, mainly the US, in an attempt to industrialize the military and space industries. The “transfer” of energy supplies to republic states was something that fueled this encouragement.

The Soviet Ministry of Gas, whose function has been taken over by Gazprom today, would purposely sell gas products to republic states at prices that were considerably lower than the price point at which gas was sold outside of the Soviet Union. The Ministry of Gas did this for the purpose of encouraging industrialization. By receiving gas supplies at a low rate, republic states, like Ukraine, could focus their resources on building an industry. However, the low prices did encourage the “overuse” and “wasteful” use of energy resources because they were inexpensive and republic states could afford for “waste” them.<sup>6</sup>

Giving energy supplies away for practically nothing had a enduring and damaging effect on post-Soviet Ukraine. First of all, the centralization of the whole distribution system did not prepare Ukraine, or any of the Soviet republics, for life outside of the Union. The centralization placed a heavy dependency on the Soviet Union, and subsequently Russia as the energy supplier, to the point where disassociation with Russia's energy resources in the modern day has been difficult to

achieve, although it has been attempted with great difficulty; the Nabucco gas pipeline project is an example of this. The Nabucco pipeline project has endured significant alterations as a result of Russian influence. When Bulgaria “sold some of its strategic assets in the energy industry to Russia and signed onto the Russian pipeline of South Stream,” these actions “endangered the...Nabucco [project].”<sup>7</sup>

Secondly, the relatively inexpensive energy resources did little to encourage sustainability. Not only was this harmful to the environment, but Ukraine, like other republics, did not have a sustainable energy plan that would make the most efficient use of energy resources. Therefore, when Russia began charging market prices, Ukraine could not afford their present unsustainable energy usage.

The fall of the Soviet Union did not bring tremendous change to Ukraine’s energy usage immediately but the “red directors” sustained the country’s high-energy usage for a few years. In her book, *Energy Dependency, Politics and Corruption in the Former Soviet Union*, Margarita Balmaceda explains that “red directors” were the former “...directors of huge Soviet-era factories characterized by their high energy intensity, energy inefficiency, and thus, dependency on cheap supplies of Russian energy.”<sup>8</sup> Because Ukraine was still receiving inexpensive energy supplies from Russia even after the fall of the Soviet Union, the “red directors” had no motivation or need to change Ukraine’s high energy need. It was as though Ukraine still “...lived in an energy rich state” where the energy distribution was a “Soviet-wide” matter not particular to Ukraine.<sup>9</sup>

While the newly independent Ukrainian energy policy still encouraged high imports of Russian energy at low prices, beginning in 1992, Ukrainian officials were beginning to understand the consequences of paying a low price for Russian energy in their growingly democratic world. In the article *Ukraine's Quest for Independence: The Fuel Factor*, Oles Smolansky explains how the 1992 “energy crisis” was the starting point where relations between Russia and Ukraine began to worsen and how at this point it became clear that Russia was politicizing the distribution of their energy.

Smolansky explains that the Ukrainian Soviet Socialist Republic imported about 55 million tons of petroleum a year from Siberia in the 1980s. In 1992, Ukraine found itself in an energy challenge when production from the Ukrainian energy resources and Russian energy resources were declining.<sup>10</sup> The decline in energy meant that Ukraine only had about 15-20% of its needed gas supplies and only 8% of its needed oil supplies. Because Ukraine’s energy policy up until this point had been based on unlimited inexpensive energy supplies from Russia, this decline meant that Ukraine had to search elsewhere for the needed supplies or work more closely with Russia.<sup>11</sup>

Ukraine at this point was faced with a difficult decision. Their once unlimited energy supply was dwindling as their post-Soviet energy policy was to maintain the high-energy usage level sustained from the Soviet days. Smolansky notes that many Ukrainian observers saw the solution two ways; one solution being that Ukraine should have strengthened its relations with Russia, while the other solution was to find importation sources elsewhere.<sup>12</sup> Interestingly, nothing is really mentioned about

lowering the country's use of "wasteful" energy to make their energy usage more sustainable and efficient. Perhaps no attention was paid to lowering the energy usage because Ukraine's industrial production and domestic heating sector, as was proper for a former Soviet republic, was built to depend on the Soviet Union.

As a result, Ukraine's industry was built with a heavy usage of energy, which was formerly supplied inexpensively from the Soviet Union. Because the fall of the USSR happened so quickly, Ukraine did not have the time or the resources to reevaluate their energy usage, but could only sustain the systems and industries and their subsequent energy usage levels already in place during and immediately after the fall of the Union. Therefore, the sudden collapse of the system played in Russia's favor in that Ukraine did not have the time to develop their own systems in which would make them independent from Russia.

Further on in the article, Smolansky makes a bold point explaining that Russia was slowly understanding the influence they had over Ukraine. "...Russia discovered early on that vulnerability to threats of actual reduction in fuel deliveries made Ukraine more pliant in negotiations concerning various political and military problems." The "political and military problems" mentioned above were not only referring to the issue of bilateral agreements concerning the amount and price of energy exports to Ukraine (which can be interpreted as a security concern), but also the issue of ownership of the Black Sea Fleet as well as the future of Ukraine's extensive nuclear supply. Therefore, the looming non-energy issues surrounding the Russian-Ukrainian relationship only

gave Russia the necessary motivation to use their energy exports as political leverage into Ukrainian political affairs.

In the beginning of Ukraine's independence, the country had a centralized system that would purchase energy supplies from Russia for the country's use. Working with the "red directors" at the time, the centralized state corporation Ukrhazprom would buy oil and gas supplies from Russia to sell to Ukrainian users. These energy supplies, at this time were subsidized by Russia, which in effect meant that Ukraine continued to enjoy the virtually limitless supply of energy.<sup>13</sup> While Ukraine did enjoy the inexpensive energy exports from Russia, it should be noted that these exports were not given to Ukraine for free. It should be understood that the state had little to no money to spend and the Ukrainian economy had not yet been developed. It was therefore during the 1992-1994 period that Ukraine developed a massive debt to Russia for the importation of energy supplies.<sup>14</sup>

After 1994, the centralized Ukrainian energy system started to decentralize into the hands of gas traders or *hazotreidery*. The rise of the *hazotreidery* occurred when the inexpensive energy prices charged by Russia to Ukraine stopped. Before 1994, when Russia largely subsidized their energy exports to Ukraine, Ukrhazprom would purchase the inexpensive energy not only for Ukrainian users but also for the purposes of re-selling the energy to other EU users. Therefore, Ukrhazprom was able to make a profit off the imports from Russia. Once the subsidization stopped, Ukraine continued to purchase the energy, although at higher price points, and subsidized it for the

Ukrainian users, so an average Ukrainian would have paid roughly the same price for the energy throughout this period.<sup>15</sup>

To make up for these subsidies, Ukraine had to cut money from other sources. To do this Ukraine “...exemplified...hyper-inflation,” failed to pay salaries of state workers, and depreciated their currency.<sup>16</sup> The high price for energy exports coupled with the consequences of Ukrainian energy subsidization, largely led to the rise of the *hazotreidery*. As the Ukrainian energy industry was beginning to decentralize to shed some debt, the *hazotreidery* adopted the same problem that the state had in not having sufficient monetary resources to cover the purchase of energy commodities. However, the *hazotreidery* were able to get around this problem, unlike the state, by bartering “payment schemes” and by “restructuring...non-performing gas loans.” The state also thought that the *hazotreidery* might be more willing to take a hard hand in dealing with non-paying customers (and shut off the energy source) as well as “...be more flexible in dealing with Gazprom” than the state would.<sup>17</sup> It appears as though the state hoped the *hazotreidery* would be able to operate without politics involving Russia and Ukrainian end-users.

The *hazotreidery* movement was not wholly effective in eliminating or at least relieving Ukraine’s debts to Russia. Although Ukraine awarded the *hazotreidery* the most “profitable industrial contracts” in Ukraine, the state still maintained “contracts with the largely insolvent residential customers.”<sup>18</sup> This meant that although the Ukrainian industry was being supplied with energy through the *hazotreidery*, an average Ukrainian citizen still owed Ukraine for the energy used. Ukraine therefore,

still had debt to pay for the “non-paying residential customer” and for the *hazot Reidery* who failed and left their debts to the state.<sup>19</sup> Thus making the *hazot Reidery* system not definitive of the Ukrainian energy industry as a whole and leaving the state still subject to dealing with Russian energy exports and debt.

Ukraine’s debts to Russia continued to rise due to the fact that the decentralization system did not completely over-take the Ukrainian energy industry. Early 1997 reports recorded that Ukraine’s energy debts to Russia and Turkmenistan were about \$4.205 billion. These debts became a security threat to Ukraine primarily due to Russian infiltration via Gazprom. In order to alleviate there debts, Ukraine attempted a number of measures, including the “debt-for share swap” program. This program invited “...Russian companies [to acquire] equity in Ukrainian companies in exchange for debt forgiveness.” Gazprom was the primary company keenly interested in the program and in developing ownership in Ukrainian energy capital by acquiring pipeline ownership.<sup>20</sup>

The one, and most likely only, reason why Ukraine did not have to immediately fall prey to Russia politically speaking, was that Ukraine ha one major obstacle that slowed Russia’s energy exportation plan. This obstacle was the pipelines. After the fall of the Soviet Union, Ukraine became the owner of the pipelines running from Russia through Ukraine to the EU.<sup>21</sup> Although Ukraine had to obey Russian political demands when Russia threatened to lessen the energy flow to Ukraine, Ukraine could counter-negotiate Russia by reminding them who owns the pipeline. Ukraine’s ownership of the pipeline meant that “...Ukraine can siphon off Russian gas from the pipeline and

thus make up for suspended supplies,” meaning that Ukraine could stall Gazprom’s threats of shutting off the energy.<sup>22</sup>

Ukraine’s ownership over the transit pipelines gave great power to Ukraine against Russia. Russia receives a majority of its “hard currency reserves” from selling its energy resources to the EU. As mentioned above, Ukraine’s geographic location is vital in that Russia had to use Ukrainian pipeline to transport these exports to the EU in the most efficient way possible. 95% of Russia’s exports to the EU pass through Ukraine, which makes the relations between Russia and Ukraine of strategic interest to Russia and the EU. Russia (Gazprom) is keenly interested in gaining ownership of Ukrainian pipeline due to the impending 2015 EU environmental regulations, which will limit the use of coal and will increase the use of natural gas.<sup>23</sup> Owning the pipelines when this regulation is enforced would mean that Ukraine would be removed from the exportation pipelines system.

In her article “Gas, Oil and the Linkages between Domestic and Foreign Policies: The Case of Ukraine,” Margarita Balmaceda makes an interesting point regarding the shift in Russian influence. During the Soviet Union, the main source of influence was the military or its subsidiary functions. Balmaceda notes that the Teplovoi Energeticheskii Kompleks, or the “Russian energy sector,” has adopted the role the military played in the Soviet Union. Like the Soviet military, the current Russian energy industry has been able to accrue vast amounts of revenue, it has “acted as a powerful player outside of Russia,” and it has “links with the highest levels of the Russian government.”<sup>24</sup> Russia, through Gazprom, has been able to infiltrate the

Ukrainian energy industry by gaining stake in Ukrainian corporations in order to act as “lobbies’ inside Ukraine.”<sup>25</sup> Therefore, while the Soviet military performed the Union’s imperialistic practices, in the modern age, it is the Russian energy industry, which has become the main protagonist of modern Russian imperialism.

The ascension of Yuliia Tymoshenko as Vice Prime Minister for Energy Issues in 2000-2001 transformed the entire Ukrainian energy policy from one based on Ukraine’s relations with Russia to one semi-dependent in its own internal functionality. Tymoshenko was appointed to her position by President Kuchma who had been “under pressure from the IMF and the World Bank” to reform the Ukrainian energy industry.<sup>26</sup> This pressure came in the wake of Russia’s forceful demand for “cash payments” and stalled gas deliveries. Russia at this time must have been in need for “revenue,” as Kremlin officials pressured Gazprom to “demand cash payments from Ukraine.” The environment in the Ukrainian energy industry was also complicated with other matters aside from Gazprom’s “demand for cash payments.” Ukraine was hit by “Russia’s oil embargo of winter 1999,” which accounted for the decrease in energy flow from Russia to Ukraine. Russia’s response for this embargo was that it was reacting to Ukraine’s “alleged illegal re-export and stealing of gas, and foot-dragging on its gas debt to Russia.” The tension surrounding the Ukrainian-Russian relationship before 2000, atop “Western urging,” from the IMF and World Bank, motivated President Kuchma to hire Tymoshenko to re-organize and re-mold the Ukrainian energy policy.<sup>27</sup>

Tymoshenko’s goal in transforming the energy policy was to “increase transparency and accountability” in the policy, as well as among its end-users. She

quickly issued a “state of emergency in the energy sector” which lasted for three months. The main objective of the “state of emergency” was to “reduce the role of non-monetary payments [through “barter”] and non-payments [through “unpaid bills and credits”]” throughout the energy industry. In limiting barter arrangements, Tymoshenko wanted to instead utilize “oil auctions” in place of barter arrangements used by “oil traders” or the *hazotreidery*. The use of “oil auctions” allowed Tymoshenko to both ensure that a fixed percentage of oil would be processed through them, while also ensuring that the “‘administrative distribution’ (de facto heavily subsidized distribution) of fuel” would end.<sup>28</sup>

Tymoshenko’s goal in re-molding the Ukrainian energy industry attempted to disrupt two major internal (particular to Ukraine) energy distribution systems. First, Tymoshenko sought the end, or at least limitation, of the *hazotreidery* system where “oil traders” would sell energy products aside from the state. In this respect, Tymoshenko moved to recentralize the Ukrainian energy industry. Second, Tymoshenko sought to end the state subsidization of energy, thus making energy users compliant with market prices. Although Tymoshenko’s reforms were met with a plethora of difficult issues, such as the ongoing debates on energy prices, her work in reforming Ukrainian energy policy impacted the policy for years after her removal from office in January 2001.

After President Kuchma dismissed Tymoshenko, Oleh Dubin was soon appointed to assume her role. Although the constituency surrounding Tymoshenko was highly critical of the hard reforms she processed, many of which hurt the various

political clans running energy distribution systems throughout the country, Dubin ultimately keep many of Tymoshenko's reforms, including the "war against non-payments and non-monetary payments."<sup>29</sup> Although Ukraine had attempted to reform the energy policy before Tymoshenko, the state had ultimately failed at doing so until Tymoshenko stepped in. It was therefore Tymoshenko's reforms, which marked Ukraine's first effective reform of the energy policy.

The fall of the Soviet Union eventually forced Ukraine to transform its energy policy from being dependent on Russia's unlimited supply of inexpensive energy, which was marked by Ukraine's high energy usage and the unaccountability of Ukraine's end users, to a policy that was built on the decentralization of Ukrainian energy distribution and the accountability of the end users in paying market prices for energy. Ukraine's dependency on inexpensive energy imports from the Soviet Union, and Russia, through the "vertical fiscal redistribution" system, which fostered the "transfer" and "donation" of energy supplies, enabled the Union to determine the value of exports; and in doing so, the Union eliminated the use of market value. This coupled with the pressure to industrialize, encouraged Ukraine's "overuse" and "wasteful" use of energy and their dependency on Russia in the post-Soviet age.

Although the fall of the Union did not produce immediate effects on Ukraine's energy policy, due to the work of the "red-directors" and the sheer velocity of the fall of the Union, the 1992 energy crisis forced Ukraine to see the dangerous dependency they had fostered on Russian energy exports and how Russia was able to use this dependency as political leverage into Ukraine politics. From 1992 onwards, Ukraine

made several attempts to both reduce their debt to and dependency on Russia while also trying to re-mold their energy policy. However, it was only the reforms initiated by Tymoshenko that began to positively affect Ukraine's energy industry.

The development of Ukraine's post-Soviet energy policy is a key to understanding Russia's use of their energy exports as political leverage. In analyzing Russia's relations with Ukraine, it is easy to see how Russia has manipulated their hold over Ukraine, through energy exports, for their own political gains, namely the transfer of the Black Sea Fleet and the nuclear weapons in Ukraine to Russia. Although the transfer of these commodities are not discussed in this paper in depth, it can be assumed that Russia's hold over Ukraine, due to energy exports, are the likely motivational causes that led to Russia's eventual ownership of these commodities. In terms of using the relations between Ukraine and Russia as a model for Russia's growing relations with the EU, it is rather complicated considering that Ukraine was a former USSR republic. However, this case study is key to defining what sort of relations Russia will have with the EU. In punishing Ukraine for "unpaid bills" and slowing the flow of energy running through the pipelines to Ukraine, Russia was ultimately also hurting the transmission of energy to the EU and as a result, Russia's reputation as an accountable energy partner to the EU. As mentioned above, Ukraine is the key for Russia to efficiently export its energy to the EU (geographically speaking). In punishing Ukraine, Russia has also created the evidence for which the EU can now use in viewing Russia as an unreliable energy partner.

## **CHAPTER TWO**

### **CASE STUDY ON BELARUS**

Belarus' political relations with Russia after the fall of the Soviet Union have determined the flow of energy from Russia to Belarus. In examining these relations, it will become clear that Russia has nationalized the exportation of energy for the purposes of using it as a political lever. Belarus is in an interesting situation. Geographically speaking, Belarus, like Ukraine, is in a strategic location for transmitting energy from Russia to the EU. What makes Belarus a unique case study, aside from Ukraine, is that the country (after the fall of the Union) made several attempts to re-join Russia, although as an independent state. Unlike Ukraine, which saw their energy dependency on Russia as a security threat, Belarus saw their non-alignment with Russia as an energy security threat.

The purpose of this chapter is to show how Belarus' failed Union with Russia lead to various energy disputes over pricing structures for energy exports and ownership over the pipelines running through Belarus; and how these energy disputes influenced Russia's relations with the EU. Russia's energy relations with Belarus reflect the changing political atmosphere from Yeltsin to Putin, and thus, the emerging Belarusian energy policy that began to take form during the Putin presidency. The chapter will begin with an explanation of Soviet energy policy towards Belarus; second, the chapter will examine Belarus' attempted union with Russia during the Yeltsin and Putin years and what this meant for the energy relations between Russia and Belarus; third, the chapter will then examine how the

2004 “gas war” between Russia and Belarus revealed Russia’s use of Belarus as a political ploy against Ukraine, as well as sealing its reputation as an unreliable energy partner with the EU.

Gas is a major source of energy for Belarus, more essential than other energy sources. Throughout the post-Soviet period, Belarus has relied upon Russia for over 80 percent of its energy supplies through gas imports. In 2004, Belarus utilized gas imports for 95.4 percent of its electrical energy generation and in the same year, gas imports constituted 60 percent of Belarus’ overall energy usage.<sup>1</sup> Belarus is highly dependent on Russia for its energy supply as gas is the primary energy used in Belarus. Because gas is such a major energy source for Belarus, the relationship between the countries is even more important.

During the Soviet Union, Belarus, like other Soviet republics, was part of the “...scheme of vertical fiscal redistribution” system where products, including oil and gas, were traded amongst Union republics.<sup>2</sup> Unlike Ukraine, which imported “underpriced oil and gas” and “overpriced non-oil and gas” products, Belarus imported “underpriced oil and gas” and exported “overpriced oil and gas” products. According to Lucjan Orłowski, in his article “Trade Among Former Soviet Republics,” Belarus, like the Soviet republics of Georgia, Lithuania, Moldova, Latvia, Tadjikistan, Armenia, and Estonia, were the countries that were “hit most by bringing domestic market prices closer to world market prices” after the fall of the Union.<sup>3</sup>

According to Orlowski, the economies of countries like Belarus, which imported inexpensive oil and gas and exported expensive non-energy products, were effected more by the collapse of the Union than countries like Ukraine which imported both expensive non-energy products and inexpensive oil and gas products. The reason for this conclusion was that Belarus, after the fall of the Union, would “have to accept much higher import prices for energy products...”<sup>4</sup> Because Soviet Belarus’ imported inexpensive oil and gas products and exported expensive non-energy products, the Belarusian economy should have been stable. In 1990, Belarus imported \$3,699 million rubles of underpriced energy products and exported \$2,745 million rubles of overpriced non-energy products.<sup>5</sup> Belarus’ importation and exportation of goods, allowed them to completely cover their energy costs without significant debt. Belarus’ economic stability, created as a Soviet republican state, was destroyed in the collapse along with their economy.

After the fall of the Soviet Union, the policy of energy transfers did not continue entirely. But, as referenced in Chapter One, the former USSR republic states were sold energy exports at a highly reduced rate. Since 1994, IMF officials “estimated” that “the...effect of selling Belarus gas and oil at less-than-world prices amount[ed] to 10 per cent of the country’s GDP.” In the IMF’s calculation, the 10 percent was broken down by 6-7 percent attributed by subsidized gas imports and the remaining 3 percent from subsidized oil imports.<sup>6</sup> It is therefore clear that the living standard enjoyed in Belarus was highly dependent on the subsidized energy imports from Russia. This IMF estimation also proves that gas imports constituted the

majority of the Belarusian economy as stimulated by the energy industry. Belarus' relations with Russia were by extension the determining factor behind these prices; making the livelihood of the Belarusian population dependent on Russian subsidized exports.

As mentioned above, Belarus saw their non-alignment with Russia as a security threat to their nation. In discussing how dependent the Belarusian populace was on the subsidized energy prices from Russia one can see the importance behind Belarus' continuing to promote positive relations with Russia. This proves the difference between Belarus and other countries that have utilized their own efforts to boost the support from their own populous. Unlike other countries, the government of Belarus has depended on Russia's willingness to sell subsidized energy prices to secure support from the Belarus populous. The Belarus government therefore had to work with the Kremlin and retain positive relations with Russia in order to win support from Belarus citizens.

The two former Soviet republics that took the most advantage of imported subsidized Russian energy exports were Ukraine and Belarus. Throughout the 1991-1998 period, Belarus received on average 15.3 billion cubic meters of gas from Russia annually. Ukraine and Belarus were the two republics that received the most gas exports from Russia during this period. Ukraine received an average of 57.05 billion cubic meters of gas from Russia annually, by far the highest of the former USSR republic states. The next highest importer, after Ukraine and Belarus, was

Moldova importing an average of 3.11 billion cubic meters of gas from Russia annually.<sup>7</sup>

It is very important to note the large gap between the amount of gas exports from Russia to Ukraine and Belarus, but even more interestingly to consider the gap between Ukraine and Belarus and the rest of the former USSR republic states. Ukraine and Belarus were clearly Russia's main gas importing countries at this time. The reason for this most probably stems from the fact that Russia was using Belarus, and more so Ukraine, as transit countries to export energy from Russia to the EU.

In his article "Soviet and Russian Gas," Jonathan Stern suggests that Russia, up until 1998, was looking to ease their dependency on Ukraine as a transit country byway of increasing their utilization of the pipelines running through Belarus. Stern argues that Russia was looking to "...diversify away from dependence on the Ukraine, but also...[looking to expand their] logistical" routes by building the Yamal pipeline that would run "through Belarus and Poland to Germany."<sup>8</sup> The Yamal pipeline would therefore become Russia's way of isolating Ukraine while also increasing their dependence on Belarus as a transit country. The political situation in the 1990's clearly persuaded the Kremlin that their reliance on Belarus was possible.

In the immediate post-Soviet years, Belarus was becoming more of a strategic factor in Russia's developing gas exportation industry. As discussed in Chapter One, the relations between Russia and Ukraine in the immediate post-Soviet years were filled with tensions over pricing strategies influenced by political factors such as who owned the Black Sea Fleet and the status of the nuclear arms in Ukraine.

Russia was therefore looking to diversify its options regarding gas exportation to the EU. Attempting to increase the utilization of the pipelines, and adding additional pipelines, running through Belarus was Russia's way of diversifying their exportation options.

It was not hard for Russia to use Belarus as its growing transit country to lessen the dependency they had on Ukraine. After the fall of the Soviet Union, Belarus actually sought a Union with Russia. In April 1996, Russia and Belarus signed the Russian-Belarusian Community Agreement, which was to foster "integration" and was to set-up the two countries for [the] eventual "merger of economic and legal policies." However, the Community Agreement "remained ink on paper" months after it was signed.<sup>9</sup> The Community Agreement does show Belarus' desire to establish an intimate connection with Russia, a type of connection that would be reminiscent of the Soviet Union.

From the start of Aleksander Lukashenka's presidential reign, he had made clear his desire for a Union between Russia and Belarus. And he thought that Yeltsin had the same desire. In fact in May 1997, Yeltsin clearly explained that "...he himself favored a complete merger of Russia and Belarus as the culmination of the integration process, [and thought] that the Union would be 'very close,' to the point of 'being a single state.'"<sup>10</sup> It is no wonder that Lukashenka pushed for such a Union considering his popularity amongst the Belarusians depended on it. As mentioned before, since the fall of the Soviet Union, the members of the Commonwealth of Independent States (CIS) had been issued energy imports from Russia at reduced

rates; interestingly, Belarus was issued these imports at an even greater discount. The low rates for energy enabled the Belarusian public to enjoy a high standard of living, which was attributed to the rule and work of Lukashenko.<sup>11</sup> The success of Lukashenko in Belarus was therefore tied to the low-priced energy imports from Russia and subsequent good relations with the Kremlin. A union with Russia could possibly guarantee that these low prices would continue, and as a result, fuel the continual success and popularity of Lukashenko within the Belarusian populous.

The formalization of the Union between Russia and Belarus would have indeed established permanent subsidized energy prices for Belarus. In 1999, it was agreed that the Union would have guaranteed that Belarus was charged the "...same domestic price as industrial consumers in Russia's fifth region, Smolensk." This meant that Belarus, which had been paying \$59 per 1000 cubic meters of gas, would have been charged \$35 per 1000 cubic meters of gas.<sup>12</sup> Russia was somewhat successful at enticing Lukashenko to seek a Union with Russia. Although the Union was not actually formalized as intended, Russia's guarantee of subsidized (domestic) prices for Belarus most probably aided Lukashenko in persuading the Belarusian public to agree with and support the Union idea.

Lukashenko's dreams of a Union with Russia were unfeasible. The election and rise of Putin to the presidency put an end to the idea of a Union that Yeltsin fostered (although perhaps unwillingly considering that the Union was never finalized during Yeltsin's presidency). Even in the last years of Yeltsin's presidency, the agreements formalizing the Union were unsatisfactory to Belarus. In 1999, the

Kremlin refused to reconstruct the constitution, which meant "...that the only way for Belarus to 'unite' with Russia would be to join it as one of the subjects of the Russian Federation."<sup>13</sup> Considering that one of Lukashenko's three main stipulations regarding the Union agreement was that "Belarus would retain its sovereignty and statehood as an equal partner," the Kremlin's refusal to alter the constitution would prohibit the Union formation, and retain a sovereign and independent Belarus, before Yeltsin left the presidency.

When Putin was elected President in March 2000, the possibility of establishing a union came to an end as relations between Lukashenko and Putin became very negative. At a meeting in June between the two leaders, Putin made clear his objection to Lukashenko's proposed Union Agreement, which had been supported by Yeltsin. Putin said to Lukashenko that "[o]ne cannot restore something like the USSR at the expense of Russia's economic interests, because that might weaken Russia."<sup>14</sup> Lukashenko was quick to respond explaining that he saw Putin's objective as either "absorbing Belarus into the Russia Federation" or having no accord at all.<sup>15</sup>

It was clear from the start that relations between Putin and Lukashenko would not resemble Lukashenko's relations with Yeltsin. Lukashenko wanted a Union between Russia and Belarus that would leave each country with equal power. Putin, and perhaps Yeltsin (although this was never admitted), wanted a Union where Belarus would become part of Russia, in the form of additional oblasts. Putin was firm in expressing the security of the Russian economy comes first in foreign

relations while also making clear that Russia is distinct from Belarus (economically speaking) even though the fall of the Union took place only nine years before. While Yeltsin ultimately did not agree to Lukashenko's hopes of a Union,, at least Yeltsin catered to Lukashenko's desired plan, and in a way lead him to believe that a Union with equal status for the partners was still possible until 1999. This contrasts Putin who flatly declared that a Union agreement would only be had with Belarus becoming part of the Russian Federation.

From 2000 onwards, Belarus would find itself in a precarious situation in dealing with Russian exports of energy, primarily gas, due to the tensions surrounding the relationship between Lukashenko and Putin. In the beginning of Putin's rule, he indicated the need for Russia to collect on debt payments. In reaction to Putin's announcement on debt collection, Gazprom decreased the gas supply to Belarus by 40% in retaliation for Belarus' debt of \$260 million.<sup>16</sup> However, the Belarusian debt owed to Russia did not persuade Gazprom to stop increasing their use of Belarus as a transit county. Ukraine had even worse relations with Gazprom and the Kremlin then Belarus had at the time. In October 2000, Gazprom discovered that Ukraine was illegally taking energy supplies from the pipelines running to the EU. "Gazprom estimated that it had lost over \$720 million in 1999 owing to Ukrainian theft of its gas..." At the same time, Ukraine was mounting a debt to Gazprom, and the Kremlin, of about \$1.5 billion dollars.<sup>17</sup> Compared to Belarus' debt of \$260 million dollars, Ukraine's debt of \$1.5 billion dollars was a major motivating factor that drove Gazprom, and the Kremlin, to continue to increase their

use of Belarus as a transit country despite the failed relations between Lukashenko and Putin.

Similar to Russia's quest to control the Ukrainian transit pipeline system, Russia has also sought the ownership of pipeline in Belarus. For Russia, not owning the pipelines going through Ukraine and Belarus to the EU constitutes a security threat. From the start of his presidency, Putin also stressed the need for Russia to gain ownership, or at least majority share, in the transit pipeline networks running to the EU. In April 2002, Russia and Belarus agreed that Belarus would receive inexpensive gas imports from Gazprom in exchange for the "creation of a joint venture based on Beltransgaz."<sup>18</sup> Beltransgaz, was the corporation in charge of maintaining the pipeline transit networks in Belarus. However, by the summer of 2003, Lukashenko caved to populous demands and declared that Belarus would not be selling any part of Beltransgaz to Gazprom. Lukashenko's decision was based on the opinion that "...if Belarus sold control of Beltransgaz it 'would sell control of the country.'<sup>19</sup>

In denying Gazprom the deal, Lukashenko essentially protected the Belarusian economy as an independent entity. It should be noted that Belarus, in October 2003, ultimately decided to sell "a non-controlling share of Beltransgaz to Gazprom in exchange for..." the subsidized gas prices to continue.<sup>20</sup> Key here is the "non-controlling" share of Beltransgaz; by allowing Gazprom to infiltrate a "non-controlling" portion, Belarus was essentially fulfilling the April 2002 agreement while also continuing to protect its energy industry and economy, as well as

protecting its negotiation power against Russia. Beltransgaz, being Belarus's only "pipeline operator," most probably was the foundation of the Belarusian energy economy and industry.

The fact that Lukashenko denied Gazprom access to Beltransgaz not only suggests that he protected the Belarusian energy economy, as well as the Belarusian energy industry, he also by extension revealed his failed vision of a Union between Russia and Belarus. A Union between Russia and Belarus would have included a clause on the equal ownership of resources and infrastructure in some capacity. Lukashenko's refusal to let Gazprom infiltrate Belarus' energy industry foundation (the pipelines) protected the independent Belarusian energy industry and economy. By doing so, Lukashenko also protected Belarus' negotiating power against Russia. As mentioned above, Russia saw their lack of pipeline ownership as a security threat. By denying Gazprom, and the Kremlin, access to Belarusian pipeline, Lukashenko protected Belarus' main security shield from Russia, as lack of ownership in the Belarusian pipeline was the only thing stopping the Kremlin from completely infiltrating the Belarusian energy industry.

Lukashenko's refusal to let Gazprom infiltrate the Belarusian pipeline system ignited the "gas war" between Russia and Belarus in January 2004. During this month, Gazprom announced that Belarus would be subject to market prices and that subsidized prices would discontinue. Most Belarusians believed this announcement was Putin's way of "hardening [Russia's] foreign policy course" towards Belarus. In response to Belarus, Gazprom explained that it had supplied Belarus with

inexpensive energy without receiving anything in return from Belarus. Alexy Miller, the Head of Gazprom at the time announced that “[t]he romantic period is over” in speaking of the energy relations between Belarus and Gazprom.<sup>21</sup>

In February 2004, Gazprom shut off the gas completely in the Northern Lights pipeline, which Beltransgaz runs.<sup>22</sup> This shut-off was in retaliation for Belarus “..siphoning off...Russian gas in transit to third countries.”<sup>23</sup> The shut off was also in retaliation of Belarus’ refusal to accept the higher prices for gas exports. Gazprom had wanted to increase the price of gas exports to Belarus from “\$30 to \$50/mcm.”<sup>24</sup> Gazprom wanted to increase the export gas prices by almost one third. As discussed above, because the livelihood of the Belarusian populace is dependent on subsidized energy prices, this price increase could have had a negative impact on the Belarusian economy and by extension, Lukashenko’s decreased popularity amongst Belarusians.

In response to the shut-off, Lukashenko called “the halt of deliveries ‘an act of terrorism in the highest level and increased the transit fees.’”<sup>25</sup> Because Gazprom only shut-off the gas running through the Northern Lights pipeline, Belarus was able to still obtain gas imports through the Russian independent sellers at \$46.68/mcm.<sup>26</sup> This price was still a large price increase for Belarus. One wonders why Belarus just did not agree to pay the higher price to Gazprom, but instead agreed to pay a nearly equal higher price (which was only \$3.32/mcm lower) to the independent sellers. This action shows that Belarus believed that ownership of the pipelines constituted a powerful negotiating factor against Gazprom and Russia, and that Belarus perhaps

thought, with time, they might be able to negotiate a lower price from Gazprom based on their ownership of the transit pipelines network.

During the shut off, Belarus made use of its ownership of the pipeline by extracting the gas Gazprom was still running through the Yamal-Europe pipeline. The gas in this pipeline was not intended for Belarusian use, but was only for European exportation. Because 90 percent Belarus' electricity production is created by means of burning gas, Belarus needed the gas in the Yamal-Europe pipeline. Once Gazprom discovered that Beltransgaz was taking gas from the Yamal-Europe pipeline, this pipeline was also shutdown to stop Belarus from obtaining Russian energy from Gazprom illegally. However, by shutting down the Yamal-Europe pipeline, Gazprom also shut off supplies going to Europe. By working with independent gas sellers through short-term contracts, Belarus was able to obtain enough energy to get by until June 2004, when they agreed to paying Gazprom's higher prices. The contract signed between Belarus and Gazprom lasted throughout 2004-2006. This agreement established that Belarus would pay \$46.68/mcm, ironically the same price they paid for gas from independent sellers, and established a transit price for the Northern Lights pipeline of \$0.75.mcm/100 km and the Yamal-Europe pipeline of \$0.46/mcm/100 km.<sup>27</sup>

The 2004 "gas war" demonstrates two things. First, that unlike Ukraine, where the energy disputes between Russia and Ukraine were framed by non-energy based political issues surrounding Russia's lack of ownership in non-energy entities, the energy disputes between Russia and Belarus are only framed by the political

situation surrounding Belarus' sovereignty and are actually centered around distribution and subsequent control of the pipeline network. Second, that Gazprom was willing to endure the consequences of damaging their reputation as a reliable energy distributor to show Belarus their power over them.

The failed notion of the Union Agreement between Russia and Belarus spiraled in to a security threat for both countries. Unlike the relationship between Ukraine and Russia, where politics surrounding Russia's lack of non-energy entities influenced the growing energy disputes between the two countries, the energy disputes between Belarus and Russia were hatched because of the countries' lack of political re-integration or non-alignment with each other; the non-alignment meant that greater emphasis was placed on the relationship between Putin and Lukashenko. If the Union had actually occurred, either according to Putin's or Lukashenko's desires, then the energy disputes over pricing and pipeline transit usage would have most likely been minimal if none at all. Even though Russia was keen to use their lack of pipeline ownership against Belarus, Russia did continue to increase their usage of Belarus as a transit country. The growing tensions between Russia and Ukraine did motivate Russia to increase their energy relations with Belarus, perhaps to show Ukraine that they were not the only transit country and that Russia could, if needed, transit energy to the EU without Ukraine. Belarus, in this situation became a political weapon at Russia's disposal against Ukraine, while Gazprom was Russia's weapon against Belarus.

The layering of political weapons, might lead one to inquire if, perhaps, the energy relations between Russia and Belarus were not less dependent on the lack of political integration between the two countries, but rather, more dependent on Russia's relations with Ukraine. In examining Russia's relations with Ukraine and Belarus, one can see how Russia manipulated its relations with Belarus only to use them as a political threat against Ukraine. Considering that over 95% of Russia's energy is transited through Ukraine, Russia's energy relations with Belarus was almost unnecessary, in terms of using Belarus as a major transit country.<sup>28</sup> Of course Russia could have built other pipelines through Belarus to replace Ukraine, like they announced in 2000, but that would have been tremendously expensive to Gazprom (in 2000 the additional Belarusian pipeline would have cost \$1 billion to construct).<sup>29</sup> Russia clearly needed Ukraine as a transit country, and was reluctant to admit the security threat of losing Ukraine. Therefore, Russia utilized their energy relations with Belarus as a political ploy against Ukraine.

The "gas war" also proved that Gazprom was more interested in punishing its transit countries than upholding its energy relations with Europe. In the 2004 incident, when Gazprom discovered that Beltransgaz was stealing gas from the Yamal-Europe pipeline, it simply shut-off the gas running through the pipeline which meant that Beltransgaz was no longer able to steal the gas, but that the European customers benefiting from the Yamal-Europe line did not receive the supplies. Gazprom, in shutting off this line might have punished Belarus, but perhaps punished its own reputation as a reliable energy partner even more so. This incident

shows that Gazprom's European consumers are ultimately at the will of Gazprom, and Russia's, political relations with Belarus and Ukraine.

Unlike Ukraine, whose energy policy developed after the fall of the Soviet Union, the energy policy of Belarus has been primarily dependent on the subsidized energy exports from Russia and in navigating a relationship after the failed Union between the two countries. Unlike Ukraine, which has visibly attempted to diversify its sources for energy importation, Belarus has not made such visible attempts. It seems that Belarus understands that Russia is its only feasible option for energy, and thus has accepted its energy relations with Russia. However, Belarus has used its ownership over the pipelines to leverage its energy negotiations with Gazprom, and Russia. It therefore appears as though Belarus' energy policy is not concerned with where it gets its energy supplies from but how and at what price. Belarus is careful to increase or decrease its energy transit fees in accord with the prices at which Russia sells its gas supplies. Belarus's energy policy is therefore dependent upon its political relationship with Russia at any given time, and Belarus' reactions to Russia's price points and moves to assume ownership of the pipelines.

The change in political climate from Yeltsin to Putin, and the subsequent failed Union Agreement, greatly affected energy policies towards Belarus. With the rise of Putin, Belarus found that its "romantic period" enjoyed during the Soviet Union with Russian energy exports had ended. Belarus went from thinking they might have a guarantee of subsidized energy prices as a member of a Union, to fighting Gazprom, and the Kremlin, over pricing structures and pipeline ownership.

The 2004 “gas war” revealed several things about the energy relations between Russia and Belarus; mainly that Belarus was a political ploy for Russia to use against Ukraine. Russia’s energy relations between Belarus and Ukraine seem to support the same realization: that the spontaneous shutting off of energy flowing through pipelines carrying supplies to EU countries is based on Russia’s retaliation against Ukraine and Belarus (not EU end-users) for various political reasons. This action paints Russia as an unreliable energy partner with the EU. As this paper continues, it will further analyze Russia’s growing energy relationship with the EU and what the EU can denote from Russia’s relations with Ukraine and Belarus.

## **CHAPTER THREE**

### **PRIVATIZATION OF GAZPROM**

As discussed in Chapters One and Two above, Kremlin officials acted through Gazprom to influence their relations with Ukraine and Belarus. Ironically however, from the fall of the Communist regime in 1991 and up until 2004, Gazprom was no longer wholly owned by the state, but was a private, joint-share organization split between several investing parties. However, the Kremlin was still able to act through Gazprom to determine its, and by extension Russia's, energy and political relations with other countries. The purpose of this chapter is to examine how and why Gazprom was privatized and how the Kremlin has been able to remain the unofficial dominant power in this organization despite the fact that it is now a joint-shared organization. To do this, the chapter will first explain the history of Russian privatization after the fall of the Soviet Union, including an analysis of the why the Kremlin initially relinquished control over these organizations. Second, the chapter will examine the specific privatization experience of Gazprom and how the Kremlin was able to re-gain state-ownership after Putin's 2000 election to the presidency.

The last few years of the Soviet Union paved the way for what several Sovietologists, including Li-Chen Sim and David Lane, call "spontaneous privatization." The Russian oil industry entered into a period of decline just before the collapse of the Soviet Union. While output in the oil industry "had peaked at 569 million tones in 1988," the industry fell into decline and in 1991, output was 20%

less.<sup>1</sup> Russia's use of energy products was also harmful to the state. As mentioned in Chapter One, Russia greatly subsidized their energy for domestic consumers; by the end of 1991, Russian oil was selling for US\$0.05 per tonne, while the same oil was sold for US\$1000 outside of Russia.<sup>2</sup> The inexpensive, and somewhat limitless, energy resources led to "wasteful energy consumption." During the Soviet Union, heating was built on a centralized system where a single neighborhood could be heated on one furnace. The centralization heating system led to an inefficient use of energy because consumers could not adjust the heat as needed and would resort to opening windows to release the heat instead of turning it off.<sup>3</sup> This led to Russian populace consuming energy resources at a rate five times higher than most members of the Organization for Economic Co-Operation and Development (OECD).<sup>4</sup>

The mounting problems in the Russian energy industry were exacerbated by Gorbachev's new policies introduced in the 1980's. Policies such as the Law on the State Enterprise, 1987, and the Law on Co-Operatives, 1988, were meant to decentralize the ministries including the Ministry of Oil and the Ministry of Gas. These laws and policies were meant to lessen the decision-making abilities from the state and transfer these decision-making abilities to the ministry heads. These policies were also aimed at encouraging entrepreneurial practices while also building a foundation for the operation of "fully privatized enterprises." In the oil industry, the new policies gave the managers of the "state-owned oil production and refining entities" the ability to dictate the development of production, finance, and marketing functions aside from the state.<sup>5</sup>

Gorbachev consolidated the development of “fully privatized enterprises” through his “‘anti-ministerial’ campaign” where the ministries were replaced by the *kontsern* and “holding companies.” Gorbachev’s perception that the ministries had become more dominant than the Communist political party and the Communist party heads because these ministries acted in both the political and economic fields provided the motivation for this campaign. The *kontsern* phenomenon was meant to develop “representative institutions” that Gorbachev felt could be controlled more effectively than the ministries. Therefore, Gorbachev felt that decentralization of the ministry functions into separate *kontserns* would be easier to control because the ministries had become an all encompassing power bigger than the Kremlin.<sup>6</sup>

In 1989, the first *kontsern* was created from the Ministry of Gas. Viktor Stepanovich Chernomyrdin, the former chairman of the Ministry of Gas, established this *kontsern*, which would later become Gazprom. The Ministry of Oil also attempted to follow suit, but was stopped by Ivan Silayev, the prime minister at the time, who stated that turning this ministry into a *kontsern* “would result in ‘an oil monster which would try to influence oil policies.’”<sup>7</sup> With his refusal, Silayev prohibited the evolution of the Ministry of Oil, which was rather surprising considering that the Russian oil industry at this time was in economic decline as explained above. A still unanswered question, unclear to analysts was why Silayev was keen to keep the Ministry of Oil under total state control.

The end results of the development of *kontserns* are that they enabled the ministry heads to experience “real autonomy” without state guidance while also

providing “legal grounds for *de facto* ownership over [the] enterprises that they managed.” The *kontsern* institution allowed the heads of the ministries to actually manage the ministry function under a new structure. The establishment of these policies also revealed the “weakness of the central authority.”<sup>8</sup> The fact that Gorbachev was able to initiate the establishment of the *kontserns* rather easily, suggests that the core of the Kremlin was already not in control of the subsidiary functions. Although the real purpose of the “anti-ministerial campaign” was to facilitate an easier control apparatus over the ministry functions, the campaign actually jump-started the era of privatization in the post-Soviet age.

Before examining the privatization process in the post-Soviet age, it is important to fully understand the difference between the *kontserns* and privatization. The establishment of the *kontserns* is often referred to as “spontaneous privatization.” As explained above, *kontserns* enabled the “management of enterprises” to gain control of the “enterprise” aside from the state.<sup>9</sup> *Kontserns* were the Soviet way of privatizing the ministries, but it is important to note that although the management gained control of the ministry functions, the functions were still state-owned. After the fall of the Soviet Union, privatization began to take place in Russia. According to Li-Chen Sim, in his book *The Rise and Fall of Privatization in the Russian Oil Industry*, privatization is “the process of deliberate transfer and sale, in whole or in part, by a government of state-owned enterprises or assets to private economic agents.”<sup>10</sup> Privatization was the process whereby external players were

supposed to, and given a small opportunity to, gain ownership of a state-owned entity.

The establishment of privatization in the post-Soviet age was therefore a semi-continuation of the Soviet “anti-ministerial campaign.” It appears as though after the collapse of the Soviet Union, the process of “spontaneous privatization” continued but in an exaggerated form, where the state control was taken out of the equation. In all probability, the state was taken out because the state, in the form of the Union, was no longer in formally functioning.

The privatization of the Russian energy industry, as well as several other industries, began in 1992 with the collapse of the Soviet Union and the semi-continuation of “spontaneous privatization.” At the time, many economists believed that the Shock Therapy method of transitioning an economic system was an effective method. Regardless of what economists believed at the time, Russia was in need of immediate cash. Jeffrey Sachs points out that at the time, industries were not purchasing the Kremlin’s “targeted procurement” of goods because of the black market prices. For example, “grainaries at the time had only purchased 15% of the target procurement because of the incredible and rapidly widening discrepancy between black-market and official prices.”<sup>11</sup> Perhaps to combat the effects of black-market pricing, Yeltsin hoped that the application of Shock Therapy would provide much needed revenue to the Russian economy.

The method of Shock Therapy called for the “rapid decontrol of prices, freeing of markets, and privatization of industry.”<sup>12</sup> The method was meant to utilize

a rapid pace so that it would quickly “revive the economy” and also decrease dependence on the state. Russia also had other examples of countries that had privatized state organizations in the past. Most of the examples, however, had success in privatization “through one-company-at-a-time auctions.” For Russia, privatizing each state organization “one-at-a-time” was too slow as the country had many organizations and a vastly growing debt to re-pay.<sup>13</sup>

Russia ultimately followed the Czech Republic’s example of using the “mass voucher privatization” system to both utilize the rapid ideology of Shock Therapy and to auction off several state organizations in a short period of time. The “mass voucher privatization” system called for the distribution of vouchers to citizens (mostly those associated with the organization being privatized (former managers and employees)). The vouchers could be used to purchase shares of the organization that was privatizing at auctions. In the Czech Republic, authorities constrained the amount of shares with which the managers and employees of the privatizing company could purchase. In Russia, however, this constraint was never initiated.<sup>14</sup>

Instead of combating their lack of constraint, Kremlin authorities actually awarded managers with a number of “cheap shares so they would pursue privatization voluntarily.” This appears as though the Kremlin believed that managers needed to be persuaded to agree to the privatization. The Kremlin also awarded the employees a number of “cheap shares” but only to honor the “Communist ideology of worker ownership of the means of production.”<sup>15</sup> Interestingly, even after the fall of communism, the Kremlin felt the need to honor

communist ideology. This action reflects on the very definition of socialism, which meant that the collective populous had a collective ownership over production. Thus, it seems that the notion of private property remained alien to the Russian mentality even after the fall of the Communist regime.

The award of “cheap shares” to managers and employees made it difficult for outside investors to purchase a majority share in the privatizing organizations. The distribution of “cheap shares,” however, did not achieve its stated goal—the healthy transition to an open economy. In the end, the privatizing organization came to be owned primarily by the managers and employees; a typical breakdown was that 60-65 percent of the organization was purchased by the managers and employees, 20 percent by outside parties, and the remaining 15-20 percent was still owned by the state.<sup>16</sup>

After the fall of the Soviet Union, Russian energy organizations, including Gazprom, were sold to various shareholders through the privatization process which left the energy industry in various pieces. In the last months of 1992, the Gazprom *kontsern* had transformed into the Russian Joint Stock Company (RAO) Gazprom. The RAO Gazprom was “partly a privatized joint stock company until 1993, when the company “registered as an Open Joint Stock Company (OAO). After changing the type of organization from RAO to OAO, in 1993, the shareholders of OAO Gazprom were largely left unchanged until the early 2000s when Putin became president.<sup>17</sup>

Interestingly, in analyzing the breakdown of shareholders of OAO Gazprom between 1993-2003, one can find that “aside from the Russian government, the entities that had registered ownership of more than 2% of the company’s share capital were either Gazprom affiliates or foreign investors.” In this period of time, the Russian government owned on average 35-40% of OAO Gazprom, while on average, the various Russian “legal entities” owned between 35-40%, and Russian citizens (which this figure includes Gazprom employees as well as non-affiliated Russians) owned between 15-20%.<sup>18</sup> According to Gazprom, it appeared as though the majority of OAO Gazprom owners were either the Russian government, affiliated with Gazprom, or Russian citizens; foreign parties had little to no stake in OAO Gazprom.

Thus, according to Gazprom, foreign investors, during the 1993-2003 period, only owned between 10-12%; however this was not the true case. The Gas Supply law, as well as several other similar laws passed in the late 1990s, sought to constrain the amount of shares that non-Russian’s could own. The Gas Supply Law “led to a formal separation between the shares that could be owned and traded in the Russian share market, and those owned and traded by foreigners.” The “separation” between what shares of Gazprom could be bought led to the development of the “ring fence” practice<sup>19</sup>

The “ring fence” was a practice where Russian stock firms would purchase large amounts of Gazprom stock under their own Russian names for themselves, as well as foreign customers who were barred from purchasing their own Gazprom

stock due to the Gas Supply Law. The stock that was bought for the foreign customers was represented by the Russian stock firm that bought it, making it appear as though the stock that went to the foreign customer actually still belonged to the Russian stock firm. The “ring fence” practice artificially enlarged the percentage of stock that Russian citizens owned. The “ring fence” practice was protected by the “grey schemes” practice, which ensured that the true “identity of Gazprom’s shareholders” were actually never known and recorded.<sup>20</sup>

With the ascendancy of Putin as President in 2000, the Russian government began a campaign to rid Gazprom of foreign investors. The Kremlin, among other things, had to find a means to end the “ring fence” practice without inflicting damage on the Russian economy in doing so. The Kremlin also had to find a way to re-claim a “formal majority stake” in Gazprom to keep the company out of foreign hands.<sup>21</sup> Putin clearly saw that Gazprom was a major means of re-aligning the whole Russian energy system. In a speech Putin made on February 14<sup>th</sup>, 2003, the ten-year anniversary of Gazprom’s becoming a “open joint stock company,” he commented on the importance of centralizing Gazprom’s ownership. Putin stated that “[a]s a strategic company, Gazprom had to be maintained and has been maintained as a single organism.” He went on to explain that “Gazprom today is a transnational company which provides 8 percent of [the Russian] GDP and 20 percent of tax revenues.” Putin further commented saying that “the state ‘does not support any plans to break up or divide Gazprom.’” “Divide” in this sense meant to breakup the company, not disperse its profits amongst shareholders.<sup>22</sup>

In the case of Gazprom, the process of privatization started in the early 1990s and continued strongly until about 2003. This privatization process was able to incorporate foreign investors despite the obvious attempts by the Kremlin to ward off foreign investors. However, the process of privatization decreased significantly in the early 2000s, when Putin began to increase the Kremlin's hold on Gazprom in an attempt to use Gazprom as a foundation for controlling the majority of the Russian energy industry. In the analysis below, the discussion will feature how the Kremlin began limiting and reversing the process of privatization in order to centralize Gazprom's ownership under the Kremlin.

The first year of Putin's presidency was marked by effective change in the Russian energy industry and the Russian economy. Putin's policy of "national champions" attempted to restore nationalism in several of the energy corporations that had become privatized during the Yeltsin era. The policy of "national champions" was meant to utilize "public mechanisms" to guide the Russian economy. A "national champion" was created from "state financing, ownership, and control, government orchestration of or intervention in corporate restructurings and industrial policy." Each "national champion" would become a major influencer in different levels of various industries, including the energy industry.<sup>23</sup> It was through this policy, that Putin aimed to "merge state interests with private sector capabilities" by re-introducing state-ownership.<sup>24</sup> Putin also saw the creation of Russian energy "national champions" as a way to ensure that these "champions" "would put promotion of the state's interest over profit maximization." By this, he saw that each

“champion” would greatly subsidize energy prices domestically and “suspend deliveries to countries that refuse[d] to support Russian foreign policy or advance its interests.”<sup>25</sup> As explained above, President Yeltsin did not effectively interfere in the post-Soviet privatization process, which had been largely a continuation of the *kontsern* establishment in the Soviet period, enough to stabilize the Russian economy.

Putin recognized the growing importance of the Russian energy industry. The development of both China and India as major energy consumers, put Russia in a strategic exporting position. Not to mention, Gazprom’s operations contributed to 8 percent of Russia’s GDP and 20 percent of federal budget revenue.<sup>26</sup> Identifying the strategic importance that Gazprom carried within the Russian economy, Putin aimed to make Gazprom a “national champion” by “reassert[ing] the state’s interests [towards Gazprom], [and] renationalizing [Gazprom].”<sup>27</sup>

Many observers of Putin’s policy, such as Marshall Goldman, have commented on the stark similarity between Putin’s “national champion” policy and that of the Soviet “economic imperialism” practice. Goldman sites the slight difference between the two. He states that “economic imperialism” involved companies that were either state-owned or private entities that would ask the state to “help them maintain their interests abroad after they established footholds in the region.” “Economic imperialism” therefore was driven by the companies more so than the Kremlin. Putin’s “national champions” are instead “encouraged by the state to seek domination of foreign markets.” The Russian imperialism today, is therefore

driven by the state using the “national champions” as a medium for modern Russian imperialism.<sup>28</sup>

Interestingly, in his book *Petrostate*, Marshall Goldman suggests that Putin was not the original creator of the idea of “national champions.” After careful analysis, Brookings Institution scholar, Clifford Gaddy and Igor Danchenko found that Putin’s dissertation, “The Strategic Planning of the Reproduction of the Resource Bases,” had several passages taken directly from a 1978 paper “Strategic Planning and Policy,” by William King and David Cleland of University of Pittsburgh. And perhaps the King and Cleland paper was originally inspired by Charles de Gaulle’s policies launched in the 1950’s, which had a similar take as the “national champions” policy did.<sup>29</sup>

Putin’s first objective in carrying out the policy of “national champions” was to remove the leadership in several of the leading energy corporations. In the case of Gazprom, this meant replacing the oligarchs that had become quite wealthy in transforming their organizations into *kontserns*. Viktor Chernomyrdin was removed as chairman of Gazprom in June 2000.<sup>30</sup> Interestingly however, Chernomyrdin’s “term of office” was to end in June 2001.<sup>31</sup> Chernomyrdin was the minister of the Soviet Ministry of Gas, who (as explained above) had established Gazprom as a *kontsern* in 1989 and named himself the president of the *kontsern*. Rem Vyakhirev was replaced as the CEO of Gazprom in May 2001.<sup>32</sup>

Putin replaced Chernomyrdin and Vyakhirev with Dmitri Medvedev and Alexi Miller. Both of the replacements had worked with Putin while he was working

in the St. Petersburg Mayor's office. Medvedev replaced Cheromyrdin as chairman of Gazprom. In assuming the position, Medvedev also became the "head of the Kremlin administration." Miller had replaced Vyakhirev as CEO of Gazprom.<sup>33</sup> Miller had worked in the Ministry of Energy as the Deputy Minister before Putin had selected him to become a leader at Gazprom.<sup>34</sup>

Instead of working with the existing leadership, Putin choose to replace the leadership of Gazprom with the people he had worked with before, and perhaps the people he knew would be loyal to him. This step, replacing the Gazprom leadership, was crucial to the success of Putin's plan to re-nationalize the energy sector. Without their loyalty to Putin, Putin might not have been able to successfully have Rosneft purchase Gazprom shares or Gazprom might not have purchased majority share in Sibneft, which without the combination of the two actions, would not have given Russia a large ownership in the whole Russian energy industry.

Once Putin had replaced Gazprom's leadership with Kremlin-loyal substitutes, he went about making Gazprom a state-owned entity once again; or at least having the state own a majority of Gazprom's shares. In September 2004, the Kremlin announced its plans to merge Gazprom and Rosneft. At the time, Rosneft was a state-owned entity. Putin at first favored the merger between the two companies, because it would ultimately give "the Russian government control of gas monopoly OAO Gazprom."<sup>35</sup> In September 2004, the merger plan "proposed [that] an exchange of 100% of Rosneft [would be given for] an additional 10.7% of Gazprom's shares." This "exchange" would result in the Russian state increasing its

Gazprom shares from 38.37% to “over 50%.” The Russian state’s majority ownership in Gazprom ultimately meant that the state “control[led]...20% of the world’s annual gas production, 35% of global gas reserves, 20% of federal budget revenues, and up to 8% of Russia’s GDP.”<sup>36</sup>

While the merger had Putin’s approval in late 2004, in May 2005, the merger was cancelled by the Kremlin. Medvedev and Miller accepted the cancellation to “satisfic[e] [the] behavior of rational individuals who accepted a lower-order preference because it embraced a minimum level of their self-interest.”<sup>37</sup> In other words, the pair accepted the cancellation because Putin changed his mind. In his article, “Kremlin Cancels Its Plan to Merge Gazprom, Rosneft,” Gregory White suggests that the merger was cancelled because the “president [was not] fully able to control powerful members of his inner circle.”<sup>38</sup> The inner circle members could have included Medvedev and Miller and Sergey Bogdanchiko, the head of Rosneft, who were fighting over the terms of the merger in the months preceding the cancellation.<sup>39</sup>

The cancellation of the merger did not mean that the Russian state missed its opportunity to re-gain majority ownership of Gazprom. Instead of merging Rosneft and Gazprom, Putin decided that the Russian government would buy shares of Gazprom outright. The government would buy \$7 billion dollars worth of Gazprom shares, using loans taken out from international banks. And to re-pay the loan debt, the government had planned to sell up to 49% of Rosneft shares at a later period.<sup>40</sup> Then in “mid-2005,” Putin opted for Rosneft to purchase 10.74% of Gazprom’s

shares. This purchase led to the “state or state-owned entities” to own 50.02% of Gazprom’s shares, which left various Russian businesses owning 29.482% of Gazprom shares, Russian citizens owning 13.068% of Gazprom shares, and non-Russian citizens owning 7.448% of Gazprom shares.<sup>41</sup>

With Rosneft’s purchase of Gazprom shares, the Kremlin became a major player in the Russian gas sector as well as the Russian energy industry as a whole. Putin was therefore in the position to use Gazprom as the base from which the Kremlin could overtake other privatized Russian energy corporations. In September 2005, Putin utilized the Kremlin’s stake in Gazprom to enlarge the Kremlin’s ownership of the Russian oil industry. With the downfall of Boris Berezovsky, the owner of Sibneft, Putin announced that Gazprom would purchase 72.6% of Sibneft, giving the Kremlin, byway of Gazprom, majority ownership of Sibneft.<sup>42</sup> After Putin “threatened” Berezovsky with jail time, Berezovsky “fled to London.” However before he left, he “transferred control” of Sibneft to Roman Abramovich, his “junior partner and erstwhile sportsman.”<sup>43</sup>

Abramovich actually considered selling his ownership in Sibneft to the several western companies that had made offers to him. However, the Russian government influenced his decision; the Russian government claimed that Abramovich owed the government \$1.4 billion due to “tax arrears.” As a result, in September 2005, Abramovich agreed to sell his ownership in Sibneft to Gazprom for \$13 billion. With its new purchase, Gazprom re-named Sibneft to “Gazpromneft (Gas Industry Petroleum).” The sale of Sibneft to Gazprom, ultimately “gave state-

dominated Gazprom a major stake in the petroleum sector for the first time.”

Reportedly, the sale gave the state “control of 30 percent of Russia’s total oil output.”<sup>44</sup>

Privatization in Russia has not actually led to a capitalistic based market system, due largely to the reign of Putin and the “national champions” policy. The process of privatization in Russia was transformed between the Yeltsin and Putin presidencies. Privatization under Yeltsin was largely a continuation of the *kontsern* system development by Gorbachev. This method of privatization was transformed when Putin became president and started to reform the Russian economic system to become more dependent on the Kremlin. The state take-over of Gazprom is a prime example of Putin’s objective (of increasing dependence on the state) to initiate the “national champions” policy. Once the Kremlin had control of Gazprom, Putin, through Gazprom, has been able to slowly take-over other Russian energy corporations, such as Sibneft, to give the Kremlin increased ownership of the Russian energy industry and to also increase dependence on the Kremlin. The next chapter will examine how the Kremlin has harnessed their ownership in the energy sector to secure security and stability for modern day Russia.

## **CHAPTER FOUR**

### **GAZPROM BECOMES A KREMLIN WEAPON**

After the fall of the Soviet Union, the Kremlin had to find a democratic means to pursue their policy objectives, both domestic and foreign, without relying on a strong military force as a policy enforcer. As stated in Chapter Three above, the Kremlin seemed to find this means through their majority ownership in the energy industry through Gazprom. While the previous chapter examined how the Kremlin went about re-centralizing Gazprom's ownership under the Kremlin, the purpose of this chapter is to examine how the Kremlin has used their majority ownership of Gazprom to further advance and enforce their foreign policy objectives while also influencing Gazprom's exportation strategy. The chapter will first explain how the Kremlin has infiltrated Gazprom after taking majority share of the organization; second, the chapter will explain how the Kremlin, by way of Gazprom, has used gas exports to further their foreign policy objectives; lastly, the chapter will analyze how Russia's recent membership into the World Trade Organization will affect their use of Gazprom as a political enforcer in the future.

As explained in Chapter Three, once Putin became President, the Kremlin was rather quick to re-gain majority ownership in Gazprom, and Putin was keen to replace the Gazprom leadership with two of his comrades from the St. Petersburg Mayor's office, Alexi Miller and Dimitri Medvedev. However, even before Miller and Medvedev entered the scene, Chernomyrdin and Vyakhirev were aware of how Putin and the Kremlin were the real managers and that obedience to them was crucial for the

growth of Gazprom. In 2002, Chernomyrdin and Vyakhirev attempted to re-structure the pricing system to adjust how the domestic Russian consumers were paying for gas. The pair wanted to “deregulate...[the] prices for industrial consumers. The pair began to present their idea to the Kremlin in 2002 when they “propos[ed] to create a gas exchange through which Gazprom could sell a portion of its output at unregulated prices.” In this proposal, Gazprom wanted to sell 10% of its output to test the market, unregulated price, for gas products. However, the Kremlin ultimately refused.<sup>1</sup>

Although their plan did not succeed at first, this attempt by Gazprom leadership at altering the pricing structure demonstrates how the Kremlin was the real power in control of Gazprom’s future. If Gazprom were a purely independent organization, then why did the leadership at the time have to run their plans by the Kremlin for approval? Considering that the proposal was to reform Gazprom’s own prices, something which independent organizations in market-driven economies can do themselves, further proves the Kremlin’s domination and how the heads of Gazprom understand their obligation to obey Kremlin verdicts.

Interestingly, Putin ultimately agreed to Gazprom’s proposal to adjust the domestic pricing structure in 2004 because of Russia’s imminent desire to enter the World Trade Organization. According to WTO membership rules, Russia would have to “end... its regulated gas prices for domestic industry, which amounted to [an] illegal subsidy.” Therefore, it was decided that these prices would increase to \$37-42 mcm in 2006 and \$49-57 mcm in 2010. However, the forecasted 2010 price increase was

actually lower than what the Russian Energy Strategy group had thought 2010 prices would be; therefore Putin's price increase was not as high as it could have been.<sup>2</sup>

While the evidence suggests that the heads of Gazprom remain compliant with Kremlin demands, Karen Smith Stegan, in her article, "Deconstructing the "Energy Weapon": Russia's Threat to Europe as Case Study," suggests that Gazprom actually benefits from this compliance. Stegan states that "Gazprom's decision-makers are acutely aware of the Kremlin's foreign policy goals." She continues to explain that "in return, Gazprom controls 65% of Russia's proven natural gas reserves (plus [the] reserves it controls with partners) and produces 90% of Russia's gas."<sup>3</sup> Therefore, Gazprom's management complies with the Kremlin for the guaranteed monopoly Gazprom has on Russia's natural gas resources. Business-wise this is rather smart, despite the fact that Gazprom management largely have given up their external decision-making ability to the Kremlin. Considering that Gazprom management can be replaced quickly, which explains how Miller and Medvedev came to power, Gazprom management must comply with the Kremlin, but their obedience does come with benefits.

Once the Kremlin was able to maintain not only majority ownership of Gazprom but also control over its leaders, the Kremlin began influencing Gazprom's export strategy to Europe. In her book, *Power, Energy, and the New Russian Imperialism*, Anita Orban makes several references to Gazprom's developed exporting strategy to Central Europe. According to Orban, Gazprom has a three-pronged strategy to expanding and securing exports to Central Europe. The first prong is for Gazprom to

remain “the only Russian gas company active in the region” to “prevent any attempts to diversify Central Europe’s energy supply.”<sup>4</sup> Gazprom’s goal here is clearly to remain a monopolistic player in Central Europe, similar to how Gazprom is a major monopoly in Russia and Eastern Europe. Diversification would ruin Gazprom’s monopoly based business strategies. Although diversification would actually be beneficial to the end user, in terms of competitive pricing structures, Gazprom has thwarted attempts at diversification in its own self-interest.

The second strategic prong comprising Gazprom’s Central European plan is for Gazprom to gain ownership of the transit pipelines.<sup>5</sup> As discussed in Chapters One and Two, Russia, and Gazprom, faces a major security threat in not owning the transit pipelines running through Ukraine and Belarus. It is not surprising that one of Gazprom’s major objectives in their European exportation policy is to gain ownership of the transit pipelines. Achieving this objective would also benefit Gazprom because in owning the transit pipelines, the company would “benefit from transporting as well as selling gas.”<sup>6</sup> Currently, Gazprom is a major seller of gas; however, because the company does not own the transit pipelines, they must pay fluctuating transit fees to transit countries like Ukraine and Belarus. Ownership of this pipeline would mean that Gazprom would not have to pay these transit fees and could possibly charge independent sellers of natural gas from using Gazprom’s pipelines.

The third prong to Gazprom’s exportation strategy to Europe is to gain ownership of Central Europe’s “wholesale infrastructure, meaning high-capacity pipelines and storage facilities that deliver gas to distributors.”<sup>7</sup> In other words,

Gazprom wants not only to control the transit pipelines, but also each individual country's natural gas infrastructure. Gazprom seems to want to eliminate the distributors, who deliver the gas product to the end user, and become the distributor itself; therefore forging a link between it and the end user. If Gazprom were to fully succeed in this goal, Orban suggests that the Kremlin, by way of Gazprom, could "inflict serious harm on a host country in case of a dispute."<sup>8</sup>

While there is no direct evidence that Kremlin officials have influenced Gazprom leadership to create the three-pronged European export strategy in these exact terms, it seems a plausible assumption given that Putin's loyal comrades replaced Gazprom leadership when Putin became President. All three prongs seem to have the same objective, which is to protect Russian interests by making Gazprom, and Russia, the only suppliers in the region and in doing so, eliminating the threat of competition or the possibility of alternative suppliers. The accomplishment of any or all of the three-pronged strategies would ensure that Gazprom's business goals in the region would have guaranteed success and as a result, Gazprom would further benefit Russia economically and politically.

One may wonder, however, if without the Kremlin's influence, if Gazprom would have selected to control the transit pipelines (second strategic prong). As mentioned above, in not controlling these transit pipelines, Gazprom must pay transit fees to the given country. And as discussed in Chapters One and Two, the rate of the transit fees often times depends on the Kremlin's relationship with the given transit country.

Another important consideration, not yet discussed, is the fact that a majority of the pipelines travelling to Europe are aging and are in need of repair. In his report, “Today or Not Today: Deregulating the Russian Gas Sector,” Yuli Grigoryev explains that “the [energy] infrastructure is mostly Soviet built and ailing in the majority of cases.” Considering that the “gas transportation system (pipelines)” were actually built in the 1940s and “little maintenance or replacement” has been done on it, Gazprom would have to pay a lot to secure its lifeline.<sup>9</sup> The Kremlin probably wants to acquire these transit pipelines via Gazprom not only for security reasons, but to have another layer of domination over the transit country. However, if Gazprom were to acquire ownership of these transit pipelines, it would be Gazprom, not the Kremlin who would have to pay to repair and/or upgrade the pipelines which is very expensive.

Gazprom’s three strategic prongs for energy exportation to Europe have clearly been influenced by the Kremlin. Not only is the overall objective of the three prongs to guarantee the influence and domination of Gazprom in the European market, but also, not all prongs are beneficial to Gazprom (particularly prong two), but would benefit the Kremlin more. Not only has the Kremlin dominated Gazprom for the purposes of influencing Gazprom’s exportation strategy so that it benefits the Kremlin, but the Kremlin has also been able to use Gazprom to advance and enforce its foreign policy aspirations and policies. In her article, “Deconstructing the ‘Energy Weapon’: Russia’s Threat to Europe as a Case Study,” Karen Smith Stegan discusses what an “energy weapon” is and how the Kremlin has made Gazprom their “energy weapon.”

The idea of the “energy weapon” was first conceived in the 1970s when the oil embargo was perceived to be a “threat that energy exporting countries could use their control over energy supplies to influence the political behavior of client states.” Although in the 1970s, this was called an “oil weapon,” the term evolved to include other sources of energy, and in her article, Stegan names this threat the “energy weapon.”<sup>10</sup> As Stegan points, out several westerners believe in Russia’s growing “energy weapon” and Europe’s dependence on it. According to an article in the *New York Times*, “[n]ow that Russia is seeking to reclaim the geopolitical clout it had in the Soviet days, it is wielding its vast energy resources, rather than missiles, to reassert itself.”<sup>11</sup> Unlike in the days of the Soviet Union, when the Kremlin would enforce its foreign policies by reminding its allies and competitors of its strong military arm, the Kremlin today has had to use another means to enforce its policies. In place of traditional military strength, through “missiles” and troops, Russia has essentially utilized its energy resources in place of its diminished military capacity. The Kremlin has thus harnessed a dominion over Gazprom to ensure that it can use Gazprom as a policy enforcer or weapon securing Russian interests.

Stegan wraps up her article discussing the “energy weapon model” and how the relationship between the Kremlin and Gazprom is an example of the model in progress. According to Stegan, this model details the stages that must be accomplished before a state can be considered to have transformed energy resources into political capital.” The stages are: first, that a state “must consolidate the country’s energy resources”; second, that “the state must acquire control of transit routes”; third, that “the state must

use the energy resources..[to] further its own political objectives” which can be accomplished through the use of “threatening, punishing, or rewarding” a “client state”; the fourth, and last stage, is “the *reaction* of the dependent government to the threats, price hikes or cut-offs.”<sup>12</sup>

The first stage, “state consolidation of resources,” is something that Stegan feels is evidenced in Putin’s thesis prepared for his graduate degree entitled “Mineral Raw Materials in the Strategy for Development of the Russian Economy.” In this paper, Putin observes that “the Russian government must control Russia’s raw resources to both secure its domestic economic prosperity and to rejuvenate its status as a world power.”<sup>13</sup> The “consolidation” of energy resources is discussed in detail in Chapter Three above. Gazprom is a prime example of how the Kremlin, after the rise of Putin as President, began the process to de-privatize and nationalize Russia’s energy sector. The example of nationalizing Gazprom is further evidenced by Gazprom’s take-over of Sibneft, also discussed above. With the Kremlin’s take-over of Gazprom and Gazprom’s take-over of Sibneft, the Kremlin became the largest shareholder in Russia’s overall energy super-structure.

The second stage, “state control over transit routes,” is something that the Kremlin had been striving to accomplish even before the fall of the Soviet Union. This stage “requires that the supplier state controls delivery to the customer.” Not surprisingly, “90% of Russia’s oil is transported, within Russia, by state-owned Transneft, and Gazprom dominates the gas pipeline network.”<sup>14</sup> Interestingly this fact

reveals that Russia must import some of its oil supply from a non-Russian area which would account for the 10% of oil not transported through Russia.

The Kremlin has also attempted to accomplish the second stage through the use of threats. Considering that the Kremlin has majority ownership in the transit pipelines internally, the transit routes outside of Russian borders are what stage two is primarily focused on. After all, the transit pipelines outside of Russia are the ones that actually transmit energy products to Europe and are therefore the ones that allow the Kremlin to reap a profit from the exportation of energy. The majority of the external Russian transit pipelines that concern the Kremlin, travel through the “former members of the USSR, [which] have come under pressure to transfer control of transit assets to Gazprom.”<sup>15</sup>

The primary method that the Kremlin, by way of Gazprom, has utilized to pressure the “former USSR members,” and current CIS members, into giving or selling ownership of the transit pipelines to the Kremlin is by “using debt owed to Russia (usually energy debt) as a bargaining chip.”<sup>16</sup> An example of this modus operandi was detailed above, in Chapter Two, where Gazprom was threatening Beltransgaz into giving Gazprom partial ownership of the transit pipelines running through Belarus. In April 2002, Belarus and Gazprom agreed that Gazprom would continue to deliver inexpensive gas exports to Belarus in exchange for the “creation of a joint venture based on Beltransgaz.”<sup>17</sup> Although Lukashenko ultimately denied Gazprom this access to Beltransgaz in 2003, the situation does show how Gazprom utilized Belarus’ situation (in which the country was dependent on inexpensive gas exports to ward off

accumulating debt) to attempt to infiltrate the Beltransgaz transit network.

The example of Gazprom's attempt to gain ownership in Beltransgaz, proves how the Kremlin, through Gazprom, has benefitted from the "former USSR" nations' dependency on Russian energy. The Kremlin has identified the dependency on Gazprom and harnessed this dependency into a tool that the Kremlin can use to remind these nations who is the dominant power. This is a seemingly paradoxical position considering that Putin openly declared that re-creation of a post-Soviet Union—like a federation out of the former Soviet republics—would be economically harmful to Russia, when he told Lukashenko why his Union idea would not pass in the Kremlin.<sup>18</sup> In analyzing stage two, it appears as though the Kremlin has found a way to keep the political structure of the Union intact, while at the same time keeping the Russian economy independent. Similar to the Soviet political structure where member states were subordinate to and obedient the Supreme Soviet, the post-Soviet Kremlin has been able to remain dominant due to energy exports over former Soviet member states to re-create a sense of Soviet subordination and obedience.

The third stage of the "energy weapon" model put forth by Stegan is the "threats, price hikes, and disruptions." According to Stegan, "an energy supplier...[must] also intend to convert its power into political gains...[which] can [be] expressed by the issuance of threats...or by actually instigating a price hike or disruption."<sup>19</sup> However, Stegan notes that the energy supplier needs to be prudent in instigating a price hike or disruption so as not to draw attention from the international audience. In order to avoid this attention, the supplier "may attribute disruption to

weather, sabotage, technical problems, or other causes.” However the “timing” of the incident can make it clear to observers that the price hike or disruption was actually motivated by political means. In other words, if the political relationship between the Kremlin and the import country is not going as well, and perhaps the import country is at a cross-roads in determining if they should follow a policy that would harm Russia’s own interests, a price hike or disruption usually occurs.<sup>20</sup>

An example of stage three would be the transfer of the entire Black Sea Fleet ownership from Ukraine to Russia in 1993. After the fall of the Soviet Union, Ukraine was in its jurisdiction to claim ownership to a 300-foot ship in the Fleet; due to new borders after the fall of the Soviet Union, this ship was in Ukraine’s territory. In response, the Kremlin proclaimed that Sevastopol, the location of this ship, was a Russian area. To discuss a possible merger of interests, Russia and Ukraine agreed to a summit meeting at Massandra in 1993. And in an attempt to show Ukraine the real value they would be losing if they were to deny Russia the entire Fleet, Russia decreased the gas exports to Ukraine by 25% a week before the summit, while publicly declaring that this decrease was due to Ukraine’s unpaid energy bills. Needless to say, Russia’s use of Gazprom as an “energy weapon” worked, as Ukraine ultimately agreed to give Russia the ship, and thus, the entire Black Sea Fleet.<sup>21</sup>

The fourth stage of the “energy weapon” model is “acquiescence and concessions.” According to Stegan, at this stage, the “targeted state’s responses [are that it] must modify its behavior on account of the threats or actual disruptions.”<sup>22</sup> This stage seems to be an acclamation that the energy supply country was successful in

utilizing their “energy weapon.” Because this stage involves the analysis of the “targeted” country’s reaction to the threats, the energy supply country can thus decide to either end the threats or continue them in order to push the modified behavior from the targeted country. An example of this stage was discussed in Chapter Two, where Belarus experienced a shut-off by Gazprom as punishment for Belarus stealing gas from the Yamal-Europe pipeline. Once this was discovered, Gazprom shut-off the gas running to Europe through the Yamal-Europe pipeline. Eventually the Kremlin had success in using their “energy weapon” because Belarus ultimately agreed to pay a higher price to Gazprom for the gas imports.<sup>23</sup>

While the Kremlin has undoubtedly utilized its grasp on Gazprom for the purposes of using it as a “energy weapon” to advance its own political objectives, Russia’s recent entrance into the World Trade Organization might have interesting results for Gazprom, particularly over the prices it charges to domestic consumers. In December 2011, Russia successfully was approved to join the WTO after 18 years of discussion. With its membership in the WTO, Russia became the largest economy yet to join the WTO. The WTO creates a “forum” for its 153 members for “international trade liberalization agreements, which it polices - deciding when rules have been breached and when retaliatory trade sanctions can be imposed.” The membership also means that Russia will face no trade barriers with other WTO members which will encourage “diversified trade.” Russia’s membership is expected to yield a “boost [in] its economy by tens of billions of dollars each year.” And according to Ivan Tchakarov, the Chief Economist at Renaissance Capital, a “Russian brokerage,” “[b]y

becoming a WTO member, Russia will have to import certain rules and regulations that will address the very issues that foreign investors usually complain about, like corruption, the protection of minority shareholders, the independence of judiciary.”<sup>24</sup> On the surface, Russia’s membership in the WTO suggests that it will help Russia develop into an advanced capitalistic society where business-practices and the actions of shareholders will be monitored by the WTO.

Russia’s membership in the WTO also means that Gazprom’s export prices will be watched. Back in June 2008, Germany “raised the question of Gazprom’s status as a state trading organization with a trading policy that should be regulated by the WTO.” Russia had that same year, only a few months before, enacted a law that constrained investment in “strategic sectors in Russia” by non-Russians. The leader of the drive for Russia’s membership in the WTO, Alexey Portansky, reacted to Germany’s questioning and stated:

As for Gazprom, the question is not likely to be as pressing for Europe. That is more a question for Saudi Arabia and the United States. Gas supply is the only thing that might be of interest to Germany, but the status of the enterprise is not within the sphere of Germany’s competence!<sup>25</sup>

Portansky’s reaction to Germany’s inquiry suggests several opinions regarding Gazprom. First, that the Kremlin does not see Gazprom as a “state trading organization” such as the Saudi Arabian Aramco petroleum corporation. And second, that Portansky seemed to think that Germany was raising this question only because it is a frequent importer of Gazprom gas; in Portansky’s eyes, Germany must have been

hoping to secure its energy sources. Most probably, Germany was aware of the Kremlin's politicization of Gazprom; in asking about how Gazprom should be regulated by the WTO, perhaps Germany was looking to have the WTO regulations end the Kremlin's politicization of Gazprom's energy from the Kremlin.

Even though Gazprom is "legislatively defined as the monopoly natural gas exporter," Russia does not recognize that Gazprom is a "state trading organization." According to the GATT agreement, "export prices and subsidies [are] subject to the WTO negotiations" if they are propagated by a "state trading organization." This means that these enterprises must "make imports and exports exclusively on a commercial basis."<sup>26</sup> As Chapters One and Two discussed, Gazprom sells its gas products to "former USSR" states at prices well below the market value that they price the same gas products at for European customers.

If Gazprom is forced by Russia's WTO membership to deliver uniform prices for gas exports based on the "commercial" prices, then the Kremlin's use of Gazprom as an "energy weapon" will be negatively impacted. Part of the incentive for the "former USSR" member states to obey Russian policy is to receive the inexpensive gas exports that Gazprom provides. If the WTO membership prohibits Gazprom from differentiating the prices it charges the European states from the prices it charges the "former USSR" states, the Kremlin, by way of Gazprom, will lose its blackmailing capability for the "energy weapon" model to succeed to stage four, whereby the "target country" would reform its behavior to suffice the Kremlin.

Through the use of Gazprom as an “energy weapon,” the Kremlin has been able to both advance its own foreign policies internationally and influence Gazprom’s own exportation strategy to be both beneficial to Gazprom and the Kremlin. As the chapter examined above, the Kremlin has successfully been able to influence Gazprom’s export strategy to benefit the Kremlin. At the same time, the Kremlin has also been able to utilize Gazprom as an “energy weapon” to the effect of advancing the Kremlin’s own foreign policies, even though they might be completely unrelated to energy exports. And lastly, the Kremlin’s use of Gazprom as an “energy weapon” is in limbo as their membership in the WTO will negatively impact the very pricing structure that has protected the Russian economy thus far. The next chapter will draw on all the previous chapters to determine how the value the Kremlin has placed on the Russian energy industry has influenced its relations with the EU.

## **CHAPTER FIVE**

### **THE KREMLIN, GAZPROM, AND THE EU**

As explored in the previous four chapters, the Kremlin has purposely utilized its ownership of the natural gas industry as a political tool against the former Republics of the USSR and in doing so, nationalized and politicized Gazprom. The Kremlin has also successfully re-taken ownership of Gazprom from the privatization era of Yeltsin and instituted Kremlin loyalists to head Gazprom and to guide it into protecting Russian interests. As explained in the preceding chapters, the Kremlin has both nationalized and politicized Gazprom to use as its own tool, or weapon, against countries straying from Russia's sphere of influence. While the major part of this paper has been dedicated to the nationalization and politicalization of Gazprom, this chapter will take this analysis a step further to discuss how this has affected Russia's relations with the EU. The chapter will start off with a brief discussion on how Gazprom has contributed to the Russian GDP; this is something that has been mentioned in previous chapters, but should be discussed in detail before this chapter develops to understand just how important Gazprom has become to Russia and not only to the Kremlin. Second, the chapter will examine the European Commission's energy charter and why Russia has refused to ratify the revised documents and how their recent entrance into the WTO will affect this. Third, the chapter will examine how the Kremlin, using Gazprom, has infiltrated EU politics. And lastly, the chapter will look at the reactions the EU has taken to Russian advances to infiltrate the European energy market.

While the preceding chapters have stressed how important Gazprom has become to the Kremlin's political advancement strategies, Gazprom is also important to the Russian economy at large. Gazprom, as a major monopoly in Russia, contributes a large percentage to its economic output. The whole Russian gas industry, Gazprom being the majority player, contributes 7% of the Russian gross domestic product. The gas industry also contributes to 14% of Russia's profits made on energy exports. Gazprom is the major player in the Russian gas industry in that its production and exports account for the majority of gas exports. In 2003, for example, Gazprom exported 540.2 billion cubic meters of gas products, which account for 87.6% of all Russian gas exports. The next highest exporters—various Russian oil companies—exported 40.4 billion cubic meters of gas collectively, which accounted for 12.4% of all Russian gas exports; Gazprom is clearly the largest exporter of Russian gas.<sup>1</sup> It is evident that Gazprom not only contributes a large percentage to the Russian economy, but it also accounts for the majority of the Russia gas industry's profits from exportation.

Russia itself also uses a large supply of gas domestically. The Russian population derives one half of its energy from gas products.<sup>2</sup> In her article "Containing Russia," Yulia Tymoshenko, discusses the implications of Russia's decreasing production. Tymoshenko explains that Gazprom's "three biggest gas fields, which account for three-quarters of its output, [are] in steep decline." This decline is derived from the fact that Gazprom has not used its capital to explore additional reserves or update its aging infrastructure. Gazprom has diverted some of its capital into non-

energy “activities” including “media companies, banks, even chicken farms, as well as downstream investments in Western Europe’s energy networks.” However, Gazprom has really failed to significantly invest in the things it truly needs, like updated infrastructure and the exploration of new energy sources.<sup>3</sup>

Due to Gazprom’s lack of industry investiture, Russia has faced a “steep decline” in its gas production, and as a result, has started to divert its energy production to its domestic consumers. According to Tymoshenko, “[t]he impending shortage means that Gazprom will not be able to increase gas supplies to Europe, at least in the short term...” Tymoshenko cites possible evidence of this in Gazprom’s “abandon[ment of] its plan to send gas from [the] Shtokman field, in the Barents Sea, to the US market as liquefied natural gas and diverted it to Europe instead.” Tymoshenko states that this move might have been made to punish the US for a political reason, but in “sending Shtokman gas to Europe [it] free[d] up Siberian output for domestic consumption.”<sup>4</sup>

Tymoshenko makes a compelling argument that the Kremlin, through Gazprom, has exportation priorities that become more clearly defined when energy supplies are in decline. It appears as though the Kremlin first seeks to supply its domestic consumers, then its European consumers, and then any other possible importers (like the US). However, Tymoshenko also makes a keen point in that the Kremlin instead of reserving the energy supplies for its domestic consumers, in case the decline continued, chose to supply European consumers along with its domestic consumers. Thus, it appears that the European consumers, as they pay a higher price

for energy than domestic consumers, mean the same or more to the Kremlin than domestic consumers.

In her career, Tymoshenko demonstrated why the Kremlin might actually value its European consumers a bit more than its domestic consumers. According to Russia Today, a Kremlin sponsored news channel, Tymoshenko signed a deal with Russia in 2009 that stated that Ukraine would pay more for Russian energy exports. Ukrainian protestors were rebelling against Tymoshenko's agreement earlier in 2012, demanding that Russia re-consider the high rates. Russia's response was that it would consider lowering the rates only if Ukraine would relinquish control over the pipeline transit system to Russia.<sup>5</sup>

The issue of appearances versus realities should come as no surprise considering that the Soviet Union always strove to project the appearance of a strong Union to outsiders. During the Soviet Union, the appearance of a strong, unified Union that was clean, uncorrupt, and very powerful was very important to the communist party. Similar to the Soviet times, the modern day Kremlin seeks to also uphold the image of a strong, powerful nation. Today's Kremlin would sacrifice the needs of their populous (domestic consumers) to supply the needs of others (Europe) and in doing so, continue to uphold the image of a powerful Russian nation that has plentiful resources to aid many.

While Gazprom contributes to a large share of the Russian economy, this could all change in the next few years, as Russia has now become a member of the World Trade Organization. The Energy Charter Treaty, along with the General Agreement on

Trade and Tariffs (GATT) is a tool that is thought by many Europeans to be useful in “creat[ing] an open regional energy market.” The creation of the Energy Charter Treaty began in the 1990s when it was observed that the former USSR states had enormous energy reserves but lacked the “major investments” needed to spiral these reserves into growth. At the same time, European states needed to diversify their dependence on the Middle East for energy supplies. It was the Dutch Prime Minister Ruud Lubbers who formulated these observations into what would become the Energy Charter Treaty.<sup>6</sup>

Lubbers along with other EU officials sought to “combine ‘Western’ European concerns (security of energy supplies) with ‘Eastern’ assets (abundant oil and gas reserves) by facilitating Western (primarily European) investment in the East and the transit of Eastern energy to Europe.” Therefore, the EU would pay to have the infrastructure built in the East, while in return the East would provide the West with a means of energy diversification.<sup>7</sup> Lubbers’ work paid off and in April 1998, the Energy Charter Treaty (ECT) and the Energy Charter Protocol on Energy Efficiency and Related Environmental Aspects (PEEREA) was enacted.<sup>8</sup>

The final ECT became a “legally binding multilateral instrument,” which became the only treaty that “deal[t] specifically with intergovernmental cooperation in the energy sector.” The ECT would act as a “benchmark” that would monitor and steer the energy sector reform in member states as well as create a way for protected “cross-border investment and trade.”<sup>9</sup> The main goal of establishing the ECT was to “strengthen the rule of law on energy issues, by creating a level playing field of rules to be observed by all participating governments, thus minimizing the risks associated

with energy related investments and trade.”<sup>10</sup> The ECT was therefore enacted to create a non-corrupt, protected means for the EU to establish energy security for its member states.

When enacted, the ECT also references the GATT and upholds article 29 IIa which is “the principle of equal treatment of national and foreign actors.” The combination of these two allowed the EU to use the ECT as a tool to “strengthen market principle and multilateralism in the form of equal access to markets and networks.” Therefore, the ECT not only became a tool for measuring member states’ energy reforms, the ECT also gave users the right to “equal access to markets and networks” such as pipelines.<sup>11</sup>

As mentioned in several previous chapters, control of pipelines is a major issue, especially in Russia, where the lack of pipeline ownership, in Ukraine and Belarus, has led to political trouble. It is therefore not surprising that Russia chose not to ratify the ECT’s Protocol on Transit. This Protocol gives the ECT the ability to “regulate transit issues and thus the access to export pipeline networks under the principles of freedom of transit and non-discrimination.” Because Gazprom’s monopoly is powered by its “position as operator of the Russian gas pipeline network” as well as other networks in the former Soviet space, the Kremlin opted to not ratify this protocol.<sup>12</sup>

The protocol, in addition to relinquishing Gazprom’s operator status over its defined energy networks, would also force Russia into practicing “non-discriminatory pricing.”<sup>13</sup> As explored above, Gazprom has differentiated its pricing structure between states in the former Soviet sphere (i.e. those states that are still in Russia’s sphere of

influence) and those states that are not. In fact, when Ukraine threatened to leave Russia's sphere of influence, Russia reacted by stopping the subsidized prices charged to Ukraine. If Russia had adopted the ECT's Protocol on Transit, then Gazprom would have had to drastically alter the way it does business. Not only would Gazprom have to uniformly charge market prices, but they would also lose their role as "operator" of the pipeline networks—two things, which have not only assured the success of Gazprom, but served as the Kremlin's means of enforcing their political policies. The Protocol on Transit would therefore negatively impact the way the Kremlin has secured Russian interests abroad.

Aside from rejecting the Protocol on Transit, Russia has sought to utilize the EU energy security threat to their advantage, by infiltrating the EU energy market. Ironically, the ECT was created to protect the EU energy security, the very thing Russia aims to exploit. According to the European Commission, energy security is as follows:

The ability to ensure that future essential energy needs can be met, both by means of adequate domestic resources worked under economically acceptable conditions or maintained as strategic reserves, and by calling upon accessible and stable external sources supplemented where appropriate by strategic stocks.<sup>14</sup>

The enactment of the ECT was proposed to provide the EU with energy security. And in establishing this security, the EU also looked to diversify their energy sources, something which is mentioned above. Europe's search for diversification initially gave Russia a way into the European energy market; however, in an effort to veer away

from the Middle East, Europe essentially, in enacting the ECT, legally led to Russian domination of the energy market.

Although it appears as though the EU let Russia infiltrate their energy market rather willingly, Russia has also taken advantage of the EU's need for energy diversification. Russia, in not only delivering energy supplies to the EU, which has cultivated the EU's dependence on Russian natural gas supplies, has also developed its grasp over the EU energy markets, particularly in taking ownership of the infrastructure. To develop their grasp over the EU energy market, Russia has first, planned construction of several additional pipelines running from Russia to the EU; and second, Russia, byway of Gazprom, has attempt to gain ownership of the EU's refineries and domestic distributing pipelines.

Gazprom delivers its gas products to the EU throughout pipelines and in the recent years, Gazprom has developed and launched plans for construction for several different pipelines running through different transit countries. The Yamal-Europe pipeline transfers gas products "from Russia to Poland and Germany via Belarus." This pipeline was mentioned in Chapter Two, when Gazprom shut-off the pipeline to ward off Belarus from stealing gas from it illegally. The Blue Stream pipeline transfers gas products from Russia to Turkey under the Black Sea. And a plan for a "north European gas pipeline...would bypass Poland and the Baltic states, running under the Baltic Sea from St. Petersburg to northern Germany, then across the Netherlands and the English Channel to the United Kingdom."<sup>15</sup> The construction or plans for the construction of these pipelines all further entangle Russia in the EU energy spectrum. Although the

ECT may not allow Gazprom to become the “operator” of these pipelines as Gazprom has done in Russia, the pipelines essentially permanently tie the EU to Russia.

The Kremlin’s second goal was for Gazprom to gain ownership of Europe’s energy infrastructure. As discussed in Chapter Four, Gazprom has been attempting to “acquire control over Central Europe’s natural gas wholesale infrastructure.” In doing so, Gazprom wants to own the “high-capacity pipelines and storage facilities that deliver gas to distributors.” Not only does Gazprom want control of the pipelines running through the major transit countries and into the EU, but it also wants to control the very pipelines running within countries to deliver gas products to distributors who then deliver to the end user.<sup>16</sup> Gazprom therefore wants to control the transportation of gas to European countries as well as the transportation of gas within European countries. Because Gazprom also wants to control the storage facilities, they must also want to control how and when they are used. This is a very disturbing prognosis considering that it will be the Gazprom leadership that will determine when and if the storage facilities will be used and not the country whose citizens would be using the contents of the storage facility.

It is evident from the research that Gazprom is keen to develop a firm grasp over its European consumers. Gazprom plans not only to own and control the major interstate pipelines which transport its gas to a importing country but the company also wants to infiltrate the intrastate pipelines running within each European importing country.<sup>17</sup> Similar to how Gazprom holds a monopoly over Russia’s gas pipelines, Gazprom also wants to develop a similar monopoly over Europe’s gas pipeline

network. This becomes more interestingly considering how Gazprom's exportation of gas is in "steep decline." As mentioned above, Gazprom might own the world's largest gas reserves, but their gas exportation is decreasing due to the lack of investment in their infrastructure and exploration of additional gas fields. By understanding these two facts, of Gazprom's declining gas exports and how they are infiltrating the European gas market, one might conclude that in a last ditch effort, Gazprom is attempting to secure its hold over Europe before it can securely deliver gas to Europe, possibly making Gazprom's infiltration of the European market not something wholly for the purpose of delivering gas products to Europe.

Gazprom's infiltration of the European gas market has not come without speculation on Russia's reliability as a dependable gas partner largely due to the various energy shut-offs. As mentioned in Chapters One and Two, Gazprom has shut-off its flow of energy traveling through both Ukraine and Belarus. These two chapters developed the notion that the energy relationship between Russia and Ukraine and Belarus was largely dependent on the political relationship between the three countries. In other words, Russia was very willing to use its status as energy provider to punish these two states' attempted moves out of Russia's sphere of influence.

The way in which Russia has used its energy exports to accomplish their own political agenda has raised questions in Europe concerning the security of depending on Russia for energy exports. In December 2005, Gazprom cut the flow of gas to Ukraine with the Kremlin qualifying this cut as a "purely commercial dispute between Gazprom...and Kiev." The "commercial dispute" was over the fact that Gazprom had

been delivering gas supplies to Ukraine at prices below market value (about “\$50 per thousand cubic meters”) and Ukraine refused to pay the escalated price of “\$230 per thousand cubic meters” of gas Gazprom had attempted to charge Ukraine the escalated price in order to establish a pricing structure based on market value.<sup>18</sup>

While the Kremlin and Gazprom both had a legitimate excuse for the price increase and cut of gas supplies, many US and European observers understood the event differently because of the relationship between Gazprom and Belarus.

Interestingly, the pricing structure based on subsidized prices Gazprom applied to exports to Belarus was left intact; no escalation price was charged to Belarus. Although the prices Gazprom charges to Belarus have been “threatened” from time to time, as mentioned in Chapter Two above, these prices charged to “a staunch Russian ally” (Belarus) were still subsidized and not based on market pricing. Outsiders saw this event between Russia and Ukraine as Russia’s way of “punish[ing]...the democratic victory of Ukraine’s pro-western President Victor Yushchenko a year earlier.”<sup>19</sup>

This event sparked reactions from the United States and Europe alike. The US Department of State stated “that the incident ‘raises serious questions about the use of energy to exert political pressure.’” Germany even voiced an option in “threatening to reconsider further energy imports from Russia unless it could demonstrate itself to be a responsible supplier.”<sup>20</sup> It is clear from analyzing the 2005-2006 energy dispute between Russia, by way of Gazprom, and Ukraine that both US and European states have come to question Russia’s reliability as a dependable energy partner. Based on the various disputes that Russia has staged with former USSR members over energy

exports, the EU has a right to be wary of Russian exports as they have a clear example that Russia is willing to utilize their exports to gain political capital.

The EU has reason to be suspicious of furthering their dependence on Russian energy exports due to Russia's relations with Ukraine and Belarus, they should therefore be concerned about their growing dependence on Russian energy. In 2006, the EU's energy usage was 22% gas while the world's energy consumption was 23% gas. In fact, Russia is the EU's "dominant supplier." Not surprisingly, "the EU buys 62% of Russia's total gas exports, which in turn account for 20% of the EU's overall gas consumption." Russia is looking to increase this dependence; over the next 20 years, Russia had planned to "double [its] exports to Europe."<sup>21</sup> The EU dependence on Russian energy is clearly very strong and will likely continue to increase due to Gazprom's growing ownership of the interstate pipelines and infiltration of the European energy market. Also due to the geographic space between the EU and Russia, receiving energy from Russia is the most efficient way for the EU to secure energy considering that the energy does not have to travel as far as energy from the Middle East. The question then is not will the EU look for energy elsewhere, but how will they deal with Russia to protect the EU's own energy security.

The EU has slowly started to deal with Russia's aims at leveraging its own political agenda through its energy exports in a few different ways. One way the EU has sought to deal with the Russia issue has been to ignore it. In the *Financial Times* (London) April 7, 2006 issue, German businesses and political activists were cited addressing the Russian issue. They stated that they did "not consider that dependence

on Russian gas was harming Germany's economic interest." They continued saying that "they do not want to hurt Russia's ...[feelings] by such allegation[s] since they know that Russia provides Germany with 35% of its oil and 40% of its gas..." These statements are interesting to understand, considering that the Germans who were cited in the article had personally "benefited by wide ranging economic ties with Russia including the energy sector."<sup>22</sup>

These statements can be interpreted in two different ways. First, that these German representatives really do believe that strong ties to Russia are not harmful, but in fact are beneficial considering that Russian imports account for \$47 billion in trade for Germany.<sup>23</sup> However, one must wonder if these representatives are speaking for themselves or the German nation at large considering that these speakers have personally benefited from German dependence on Russia. The second way these statements can be interpreted is that they were made out of fear—fear of Russian resentment and subsequent punishment. Given that Germany is strongly dependent on Russian energy exports, it is hard to believe that Germany's business and political representatives would make negative statements that would provoke Russian resentment and punishment. Seeing Ukraine as an example of how Russia can punish a state, it would be in Germany's best interest to let Russia believe that their relationship (between Germany and Russia) is strong and that Germany is entitled to Russian energy exports because they have continued uphold Russia's image of a strong, unified nation.

Another way the EU can deal with Russia, while protecting their own energy security interests, is to encourage Russia to expand its exports to the Far East. Russia has already begun to do this; in March 2006, Putin announced his plans to construct a pipeline under the sponsorship of Transneft and the China Natural Petroleum Corporation (CNPC). And through joint venture agreements, Rosneft and Gazprom “agreed to supply annually 80 billion cubic meters of natural gas to China...”<sup>24</sup> Russia’s expansion into the Chinese energy market can only benefit the EU. With the addition of China into its client base, Russia now has other customers it can accrue revenue from. Although this might not wholly aid the EU in preventing Russia’s political hold over the EU through energy exports, China does give Russia another substantial means of income besides the EU, Russian focus will be split between the EU and China. China also gives the EU another ally in combating Russia. If Russia begins to mount energy shut-offs, similar to the ones experienced by Ukraine and Belarus, the EU can look to China for backup in combating Russia.

Russia’s relations with the EU will continue to strengthen largely due to the EU’s dire need for Russian energy supplies. While Russia will benefit economically, and is in the position to benefit politically, from the growing connection between them and the EU, the situation is different for the EU. To address their energy security threat, the EU has looked to Russia for energy supplies; however, this move has caused the EU to develop a strong, and perhaps politically unhealthy, dependence on Russian energy. The EU, therefore, faces a conundrum in dealing with Russia. On one hand, they must work with Russia to ensure the delivery of Russian energy to the EU. Yet on

the other hand, the EU must also monitor their relationship with Russia so as not to become a political tool that Russia can use to its advantage as it has with Ukraine and Belarus. As the relationship further develops between Russia and the EU, it will be interesting to see how and if Gazprom's relationship with the Kremlin will change. As this chapter discussed, Gazprom means a lot to Russia's economy. However, Gazprom maybe forced to change how its derives its income from its ownership of the Russian pipelines due to Russia's membership in the WTO; especially if this membership will mean Russia must ratify the ECT's Protocol on Transit. Regardless of the WTO membership, Russia has been able to both infiltrate the intrastate and interstate gas pipelines in Europe, permanently tying the EU to Russia. This infiltration has forced the EU to not ask if it will continue to use Russian energy, but how to stop Russia from using their energy as a political weapon.

## CONCLUSION

Energy resources are highly valuable assets that any country in the world would be lucky to have in mass quantities. Russia is one of these countries whose inherited energy resources have allowed it to build up its economy as an energy exporting country, but whose political maneuvers to politicize Russian energy monopolies has given it a reputation as an unreliable energy partner. The goal of this paper was to examine how the Kremlin was able to infiltrate and take ownership of Gazprom, one of Russia's energy monopolies, in order to show how Gazprom has been turned into a nationalized, political weapon the Kremlin has at their disposal. In doing so, the study has also shown that energy exports from Russia come at a non-monetary cost that can only be negotiated regardless of market forces directly with the Kremlin.

Chapters One and Two demonstrated how the Kremlin has politicized Gazprom by utilizing Gazprom's products to ensure that Russian interests are kept intact in Ukraine and Belarus. These chapters examined how both countries are at the whim of Russian interests as long as they remain dependent on Russian energy exports. However, these chapters also proved the vulnerability that Russia has in not owning the transit pipelines running through these transit countries.

Chapters Three and Four focused on the relationship between the Kremlin and Gazprom. In these chapters, the study showed how the Kremlin has successfully been able to both infiltrate and re-gain ownership of Gazprom. Chapter Three especially proved how the Kremlin's control over Gazprom, combined with the organization's sheer monopoly over the Russian natural gas industry, has in a sense nationalized the

organization, making the Kremlin's interests identical with those of Gazprom. Chapter Four then proved how the Kremlin has molded Gazprom into a political weapon with which is used to enforce Russian interests abroad, similar to the function that the Soviet military played during the Soviet Union.

Chapter Five discusses Russia's problems with the European Union, which stem directly from the high importance that Russia has placed on Gazprom, in terms of stimulating the Russian economy and using Gazprom as their main political enforcer. This chapter, as well as Chapters One and Two, also showed how the EU can use Russia's relations with Belarus and Ukraine as an example of how to deal with the politicized nature of Gazprom. This chapter also concluded that due to the geographical location of the EU to Russia, the question for the EU is not if they will look for alternative energy sources outside of Russia to ease their growing dependence on Russian energy sources, but how they will deal with Russia in securing their energy needs.

Dealing with Gazprom, as a nationalized political weapon is something that the world should consider, not just the EU, because of the question of who owns natural resources. In nationalizing and politicizing Gazprom, the Kremlin has essentially sided with the view that natural resources are the property of the country in which they are found. The Kremlin is not the only government that has this view, but the governments of countries comprising the Persian Gulf also have revealed a similar stance. However, one must wonder if energy producing countries, like Russia, have a right to consider themselves the sole owners of the natural energy resources found in there country.

Should it be considered a human right to get access to needed energy resources; therefore making natural resources a property of the world's population instead of one country? And if it is a human right, shouldn't it be forbidden to use natural resources to gain a political agenda? While it is not the main crux of this study to analyze these questions in detail, this study has proven that Russia does not see access to energy resources as a human right. Russia believes that it is completely the luck of a country's geographical location that permits a country to use its energy resources as it will; therefore, Russia has nationalized and politicized Gazprom and can use its weapon as it wants.

## INTRODUCTION

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<sup>3</sup> Ibid.

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<sup>5</sup> Gazprom, “About Gazprom,” Gazprom Web Site, <http://www.gazprom.com/about/> (accessed March, 11, 2012).

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## CHAPTER ONE

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<sup>3</sup> Ibid., 1003.

<sup>4</sup> Ibid., 1005.

<sup>5</sup> Ibid., 1007.

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<sup>7</sup> Anita Orban, *Power, Energy, and the New Russian Imperialism* (Westport: Prager International Security Group, 2008), 113.

<sup>8</sup> Margarita Balmaceda, *Energy Dependency, Politics and Corruption in the Former Soviet Union: Russia’s Power, Oligarches’ Profits and Ukraine’s Missing Energy Policy, 1995-2006* (New York: Routledge, 2008), 46.

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<sup>10</sup> Oles M. Solansky, "Ukraine's Quest for Independence: The Fuel Factor," *Europe-Asia Studies* 47, no. 1 (1995): 67.

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<sup>12</sup> Ibid., 68.

<sup>13</sup> Balmaceda, *Energy Dependency*, 46.

<sup>14</sup> Margarita Balmaceda, "Gas, Oil and the Linkages between Domestic and Foreign Policies: The Case of Ukraine," *Europe-Asia Studies* 50, no. 2 (March 1998): 261.

<sup>15</sup> Balmaceda, *Energy Dependency*, 48.

<sup>16</sup> Ibid.

<sup>17</sup> Ibid.

<sup>18</sup> Ibid., 49.

<sup>19</sup> Balmaceda, "Gas, Oil and the Linkages," 261.

<sup>20</sup> Ibid.

<sup>21</sup> Ibid., 262.

<sup>22</sup> Ibid.

<sup>23</sup> Ibid., 267.

<sup>24</sup> Ibid., 265.

<sup>25</sup> Ibid.

<sup>26</sup> Balmaceda, *Energy Dependency*, 53.

<sup>27</sup> Ibid., 54.

<sup>28</sup> Ibid.

<sup>29</sup> Ibid., 58.

## CHAPTER TWO

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