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7

Russian External Energy Strategy: Opportunities and Constraints

Ekaterina Demakova and Jakub M. Godzimirski

1. Introduction

Russia is an important global economic player and a major producer of raw materials. Its energy policy is shaped by various actors and by structural (mostly market-related) factors over which those actors have only limited influence. This study has two key foci: the relationship between state energy policies and international markets, which is the main theme in the study of international political economy (Gilpin 1987, 2001), and the relations between the Russian state and Gazprom as interpreted through the principal-agent theory (Eisenhardt 1989). The approach here is interdisciplinary, with elements from foreign policy analysis, strategic studies and international political economy.

Gilpin describes the relationship of state and market, and especially the differences between these two organizing principles of social life, as a recurrent theme in scholarly discourse. He underlines that 'the tension between these two fundamentally different ways of ordering human relationships has profoundly shaped the course of modern history and constitutes the crucial problem in the study of political economy' (1987: 10–11).

In the case of Russia's external energy policy, a key issue is the question of interdependence between Russia and the EU. The interdependence seems to be among the crucial factors shaping Russian energy policy, as it 'establishes a power relationship among groups and societies' and 'creates vulnerabilities that can be exploited and manipulated' (Gilpin 1987: 23).

In his more recent study analysing the situation in the post-Cold War setting, Gilpin (2001: 12) presents his views on the relationship between the economic and political goals pursued by key global actors, including

Russia. He holds that the nature of the global economy will be heavily affected by their security and political interests; further, that it is highly unlikely that these powers will leave the distribution of the global economic product and the impact of economic forces on their national interests entirely up to the market.

The principal-agent theory provides a good approach for analysing the interaction between political and economic factors in Russia. In order to understand how the state and companies operate in this energy market environment, we must grasp the relationship between the interests of the Russian state and the interests of commercial actors (like Gazprom) who operate either in their own capacity or as 'agents' of the state. As Wright et al. (2001: 414) argue, 'by narrowly focusing on the principal-agent relationship, and with a given set of assumptions, the contribution of this theory is that it provides logical predictions about what rational individuals may do if placed in such a relationship.' As a result, the agency theory 'provides a unique realistic, and empirically testable perspective on problems of cooperative effort' (Eisenhardt 1989: 72).

In order to survive in the international energy environment, Russia's energy policy makers, a group made up of key political actors and representatives of the energy business community, must possess certain adaptive skills and shape their policies accordingly. This study presents some examples of the main market-related challenges those actors have to cope with, especially when responding to the changing strategic energy environment and turmoil on the global and regional energy markets caused by the recent financial crisis.

We begin with a comprehensive analysis of Russia's external energy relationships and challenges. The second part of the chapter narrows the scope of the analysis to the gas dimension of these external energy relations, focusing on the relationship between the state and Gazprom. The third part presents a preliminary assessment of the main factors influencing Russia's external energy policy.

2. Russia's energy policy: External dimension

Russia has in recent decades developed many new energy relationships and strengthened some old ones. Two of these relationships remain crucial for the country's strategic energy designs – Russia's energy relationship with itself and its energy relationship with the EU.

In 2010, Russia increased its oil production by 2.2 per cent to 505.2 million tons. Gas production increased by 11.7 per cent to

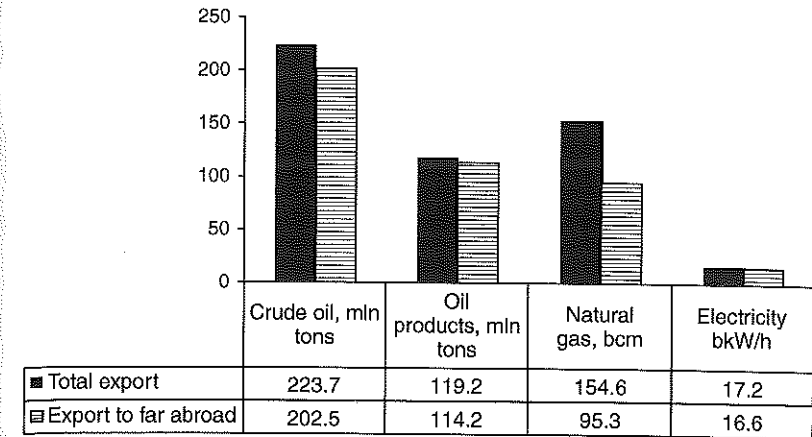


Figure 7.1 Structure of Russian export by product type

Note: Chart represents figures from January to November 2010.

Source: Russia's Federal agency for state statistics www.gks.ru.

650.3 bcm, and coal production reached 320.9 million tons (6.5 per cent more than in 2009). Some 53.2 per cent of energy was consumed in the domestic market, with the rest exported (Mitrova 2011: 3). See Figure 7.1.

In 2010, Russia exported 185 bcm of gas (10.6 per cent more than in 2009), 246.8 million tons of oil and 97.4 million tons of coal (*Prime Tass* 10 January 2001). Russian energy exports generate huge revenues – according to official data (GKS 2011), energy exports stood for 67.5 per cent (USD 267.7 billion) of the country's export revenues, and revenues were 33.1 per cent higher in 2010 than in 2009. Russia's most important external energy relationship is undoubtedly the one with the EU countries: they receive almost two-thirds of Russia's energy exports, with the remainder going to the CIS and Asia-Pacific region (Mitrova 2010: 5).

The energy relationship with Europe is a part of Russia's external energy policy in which a range of other actors, such as energy customers, transit areas and energy rivals, also play a major part. According to official sources, Russia intends to increase and diversify its energy exports (Russian Government 2009). Exports are expected to increase by 15–20 per cent in the next decade and stabilize at this higher level after 2025 (Table 7.1).

For the time being, Russia's most important external energy relationship is with the European Union. This cooperation focuses

Table 7.1 Planned increase of Russian energy exports to Asia Pacific region

Region	Level of export in 2005	Planned export in 2030
Asia-Pacific Region (APR)		
Oil, million tons	20	70–80
LNG, bcm	5.04	70–75
China, gas, bcm	0.25	30

Source: Russian government, 2009.

on enhancing infrastructure connections, general consumer–producer cooperation, business-to-business links and the facilitation of foreign investment (Youngs 2009: 81).

Over the past 30 years, this energy relationship has become heavily politicized and even securitized. The process of securitization grew, especially in the mid-2000s – mainly as a consequence of EU enlargement, as a result of Russia's energy transit disputes with Ukraine and Belarus, and due to the fact that many actors have accused Russia of using its energy resources for political purposes (Hill 2004; Saunders 2008). Others, however, have been more sanguine, noting that if Russia were to use its energy resources as a political tool it would be detrimental primarily to its own interests (Goldthau 2008).

There are certain structural economic, political, geopolitical, reputational, legal and technological factors that may impact on Russian energy strategy abroad in the short-, mid- and long-term perspective.

2.1 Factors and actors

In order to understand what those factors are and how they can influence Russia's position as an energy actor we start by looking at the current situation and at Russia's most important energy relationships today. We then go on to identify the factors that may affect Russia's situation in a mid-term and a longer term perspective.

The main factor influencing Russia's position on the international energy market today is undoubtedly that it has become a key producer, exporter and consumer of energy. Unlike many other major energy producers and exporters, Russia is also a major global consumer of energy. And that means that Russian decision makers have to find a balance between the interests of the country's producers and exporters of energy commodities, and those of domestic consumers of energy.

A central factor in recent years has been the huge volatility of prices of energy commodities (Figure 7.2). Indeed, this is listed by Keohane (2009: 41) as one of five global game-changers.

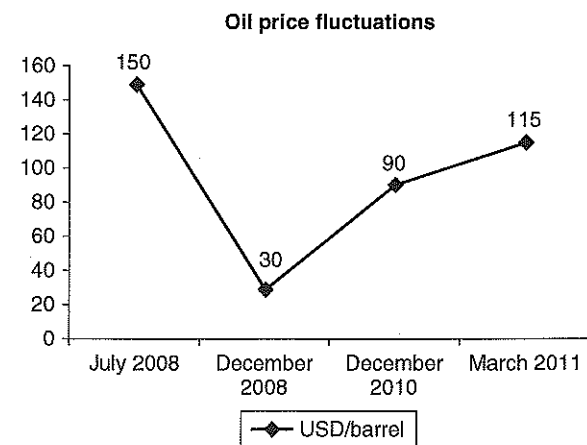


Figure 7.2 Oil-price volatility, 2008–11

The main single reason for such fluctuation in the past few years has been the global economic crisis, which has led to lower economic activity and, therefore, falling demand for energy commodities (Houssin 2009). With the economic crisis gaining momentum in the US and other Western economies in the second half of 2008, Russia entered a downward spiral. Especially Russian gas exports to Europe suffered. (Dickel 2009; Honore 2011).

The fact that the current economic crisis has had such a devastating impact on the Russian economy and energy trade is also a result of Russia's inability to diversify its energy supplies. Especially when it comes to gas, Russia's dependence on European market is seen as a major short- and mid-term factor shaping Russian energy policy. Until recently, Russia has managed to cope with this European gas challenge by embarking on a policy of bilateralizing its energy relations with individual European countries, such as Germany, Italy or France. This may, however, be about to change with the EU's decision to implement the Third Energy Package starting on 3 March 2011.

That the EU seems poised to adopt a more orchestrated approach is due to at least three factors: serious problems with energy supplies caused by Russia's quarrels with transit countries (Ukraine and Belarus), the entry into force of the Lisbon Treaty and the EU's increasing focus on energy policy in the context of the ongoing debate on climate change.

Given the strong interdependence between Russia and the EU, the new EU approach to energy cooperation must be taken into account

when strategic decisions on energy are made in Russia. However, both Russia and the EU seem to be redefining their priorities in energy cooperation. The EU's energy policy focuses on three issues – competitiveness, security of supply and sustainable development. The EU plan until 2020 is to build an energy-efficient Europe with a pan-European integrated energy market, to extend European leadership in energy technology, to protect consumers and achieve the highest level of safety and security, and to strengthen the external dimension of the EU energy market.

This, in turn, has led Russia to raise the question of overdependence on the EU market as narrowing the room for manoeuvre in shaping the country's long-term energy strategy. In particular, gas exporters have worried about security of demand in the liberalizing European market (Abdullayev 2011). During his visit to Brussels on 24 February 2011, Prime Minister Putin accused the EU of conducting a policy that could lead to higher energy prices and was detrimental to Russian energy interests, as it would limit the access of Russian companies to investments in European downstream markets. In that way, the Russian state decided to throw its weight in order to protect the interests of Russian energy companies. A few months earlier – on 26 November 2010, during his meeting with German Chancellor Angela Merkel – Putin had been even harsher, accusing the EU of preparing the legal ground for what he described as the uncivilized robbery of Russian energy assets.

Russia's increasing nervousness and lashing out at the EU is to a certain extent a result of the new emerging situation in the country's energy – and first and foremost gas – relations with its most important energy customer. Alexey Gromov has listed four conjunctural challenges that may influence Russian gas strategy in the years to come (Gromov 2010). He sees two high-degree risks – uncertainty as to export expectations and uncertainty as to export prices and contracts; one medium-degree risk (uncertainty as to transit), and one low-degree risk, which he labels as uncertainty of technologies.

2.2 Russian–German energy relations: What is in the offing?

In order to understand the impact of this combination of factors, we now look into Russia's energy relations with Germany. Germany is a highly pertinent case for examining the opportunities and challenges facing Russia (Table 7.2). Firstly, Germany is dependent on importing energy and other raw materials, and this lack of own resources is seen as an important driver in its economic and foreign policy (Kwiatkowska-Drozd 2011).

Table 7.2 Germany as a global energy player in 2009 and Russia's position

Commodity	Rank, energy consumers	Rank, energy importers (share of global imports)	Volume of imports	Russia's share in German imports (2007)
Oil	8	6 (4.4 per cent)	98.1 million tons	31.7 per cent
Natural gas	5	2 (10.4 per cent)	93.8 bcm	41.7 per cent
Coal	13	7	36.5 million tons	25.9 per cent

Although in 2009 Germany had to import 97 per cent of its oil, 84 per cent of its gas and 72 per cent of its coal, and Russia has established itself as major supplier of energy to Germany (BGR 2010), it is only Russia's supplies of gas to Germany that have been politicized in both the German and the European debate. Energy cooperation has become the backbone of the German–Russian strategic partnership, even causing some tension in Germany's relations with European and Atlantic allies.

During the two years of crisis, gas supplies from Russia to Germany dwindled from 40 bcm in 2007 to 36.2 bcm in 2008 and 31.5 bcm in 2009. However, this drop seems to have been in the short term, as in 2010 supplies reached 35.3 bcm.

In his interesting study on the energy cooperation between Russia and Germany, Khodov (2010) presents the history of this relationship, its current state and future challenges. Between 1973 and 2010, the USSR /Russia exported 1200 bcm of gas to Germany. However, in 2009, exports of Russian gas to Germany were 16 per cent lower than that in 2008, due mainly to the economic crisis which led to falling demand for energy and less demand for Russian gas on the German market, as well as lower industrial production in Germany.

There are also some important longer term factors likely to influence demand for Russian gas on the German market. The first is the new structure of the German economy, with de-industrialization, higher share of services in Germany's GDP, falling activity in the construction sector and the growing focus on energy efficiency. Further important elements include the introduction of several effective energy-saving measures, Germany's return to the nuclear option and a greater focus on alternative sources of energy. Germany is becoming the leading 'green energy power', increasing the share of energy produced from

renewable sources of energy like wind, solar and geothermal power. In addition, German companies are about to launch several ambitious energy projects that could have huge impacts on the energy situation in Europe. Khodov (2010) describes the Desertec project as an example of Germany's new approach to energy policy and claims that its realization would definitely affect the position of Russia not only on the German but also on the European energy market.

Russia is still seen in Germany as an important strategic energy partner. Especially in the gas sector, Russian–German cooperation – symbolized for instance by the Nord Stream pipeline – has been flourishing, and the Russian state seems to play a key part in the realization of Gazprom's European strategy (Godzimirski 2011). The relationship between the Russian state and Gazprom, one of the three most profitable companies worldwide, is far more complex, however.

3. Who calls the shots: The state, or Gazprom?

The relationship between the Russian state and Gazprom is one of the factors that influence Russia's external and internal energy policy. These relations could be described as a contractual interrelation that can be explained by the principal–agent theory. Principal–agent interactions occur when economic inefficiencies arise during an economic exchange between two parties (a 'principal' and an 'agent') who have different goals and different levels of information (IEA 2007: 55). The principal–agent theory highlights two important situations:

- where the goals of principal and agent differ,
- where principal and agent differ in their attitudes towards risk taking (the risk-sharing problem) (Eisenhardt 1989: 58).

Discrepancies in goals are determined by differing attitudes to the issue at hand, and the risk-sharing problem is more complex. The principal hires an agent to resolve the special case under conditions favourable to the principal at that moment. The agent, however, may have different interests in and attitudes to the case, so attitudes towards the same risk may differ.

Agency theory focuses on a contractual interrelation as well as information flows between agent and principal. Gazprom is a purely commercial actor aimed at improving its financial results, but the company may also be used for political purposes. In turn, the Russian state represents interests of various agents, which might include the Russian

foreign policy-making community, the oil industry lobby, the foreign investor lobby, and not only Gazprom. In this case, Gazprom and the Russian state are interlinked by mutual obligations and information-interest-based behaviour of both agents. Gazprom was established when the Soviet Ministry of Gas Industry was transformed into a corporation through the privatization process. The culture of interrelation between the state and the state-owned company ministry is remarkable for the relations between the two. But the new economic, social and political environment has forced the adoption of new types of behaviour. Let us take a closer look at role-sharing between the agent and the principal.

In order to understand this complex and opaque interrelation, we will examine the following areas: upstream policy, domestic market development, transforming relations with transit states, as well as supporting the diversification of gas routes and markets (the APR in particular).

3.1 Upstream policy

Upstream policy in relation to the development of new fields and associated investments is the domain of Gazprom, which owns most Russian gas fields of greatest economic significance. New fields have little likelihood of becoming commercially viable, for various reasons – location, complex geology and high investment requirements. The independent gas producers may not have sufficient financial instruments available.

The *Law on Foreign Investments in Strategic Sectors* stipulates the detailed procedures for foreign companies' involvement in sectors regulated by the Russian state. The law is intended to limit foreign investments in strategic sectors of the Russian economy in order to curb the influence of foreign owners. There are only few state-owned companies which are interested in the development of gas fields – in practice, Gazprom and Rosneft.

Russia's gas transmission system (GTS) is included among the strategic sectors because pipeline transport of gas is listed as one of the natural monopolies in Article 4 of the *Law of the Russian Federation No. 147-Fz (I) on Natural Monopolies*. Construction of the GTS started in the 1940s; it is 164 thousand km long and is now fully owned by Gazprom, indeed representing 51.6 per cent of the company's total assets (Gazprom 2009). Gazprom does not want to allow Russia's independent gas producers and foreign companies to use it to ship their gas, as it has no wish to lose control over one of its main strategic assets.

In this case, it seems that Gazprom is the principal, whereas the state is the agent that is to help Gazprom achieve the goal of control of access

to strategically important and commercially attractive gas fields and to protect its control over the transmission system. However, this situation may not necessarily be set to continue. In the mid- and longer term perspective Gazprom's monopoly may prove a disadvantage, since the lack of proper investments may result in declining gas production and problems with gas supplies on the state-controlled gas market.

Risks arising from the adoption of the *Law on Foreign Investments in the Strategic Sectors* were shared in various ways between the state and Gazprom. For Gazprom as a company, it was a matter of protecting the GTS and guaranteeing access to new gas fields, without competition from other companies. This question is important, given the decline in production from existing gas fields. But in the mid- to long-term perspective, Gazprom may face problems with access to the EU market because of its monopolistic position and the EU liberalization policy introduced with the entry into force of the Third Package in March 2011.

A monopoly also exists for gas exports, including LNG and condensate. Here Gazprom seeks to obstruct the development of independent gas producers (mainly oil companies but also some independent gas producers), whether Russian or potential foreign ones. It is illustrative to examine the situation of access to new fields and access to the export market.

The *Law on Gas Export* (adopted in 2006) may negatively influence the interest of other gas producers in exploring and developing gas resources in Russia, because those actors would be able to supply gas only to the domestic market – which still generates much lower profits than export sales.

Also here Gazprom (through the Russian Gas Society RGO) seemed to play the role of principal. The state reacted to the demand of RGO, and the law was adopted very quickly. The law represents a big commercial advantage for Gazprom, as it provides for partial compensation for loss of revenues from operations on the Russian domestic gas market. The state position was clarified by Vladimir Putin during his presidency. During a summit with German Chancellor Gerhard Schröder in October 2003, Putin presented Russia's new approach by saying: 'we are not going to divide Gazprom. [...] in the case of gas, it has to deal with the state (i.e. the Russian Federation). The gas pipeline network is the creation of the Soviet Union, and it is only the Russian Federation which can keep it in functioning order, even if we speak about its parts located outside Russian territory.' The monopoly has benefits for both parties: the state has control over exports of gas and minimizes the risk of non-controlling behaviour of other potential gas exporters; Gazprom receives compensation for losses on the domestic market.

The adoption of the *Law on Gas Export* provides Gazprom and the state with some important benefits. However, Gazprom was forced to yield to pressure from the independent producers by opening for export of LNG from the Yamal fields by Novatek. Several rounds of negotiations with Gazprom involving top Russian politicians resulted in the signing of the contract for export of LNG. One reason for that rather unexpected development was that one of Russia's most influential energy players, Gennadiy Timchenko, who had good political connections, acquired a significant portion of shares in Novatek (Russian Business 2009).

3.2 Domestic market

Gazprom monopolizes the domestic market by controlling the pipeline (Stern 2005: 20). At present, state control of gas prices on the domestic market is economically unprofitable for Gazprom. This has meant losses only partly compensated by export sales. The economic crisis of 2008–09 caused an 18 per cent drop in gas sales on export markets. For Gazprom, liberalization of domestic gas prices would be advantageous. Also oil companies (mainly Rosneft) have been pushing for internal market liberalization. They need access to pipelines and export in order to sell their own associated gas. According to recent statistics, nearly 15 bcm of associated gas is flared every year (Komkov et al. 2010). If shipped to markets, this gas could generate additional revenues for oil companies.

In April 2010, the Board of Directors of Gazprom approved a proposal on the conditions and procedure of transiting to formula-based gas pricing from 1 January 2011 (Gazprom 2010). This formula stipulates that natural gas prices will be shaped according to the principles of equal profitability between domestic and foreign gas supplies with due regard to inter-fuel competition. This pricing formula is to apply only for industrial customers; prices for the private sector will be regulated by the state.

The use of this pricing formula is to increase Gazprom revenues from sales on the domestic market starting from 2014. It will also allow the independent gas producers to participate in domestic gas trade through the electronic brokers' board Mezhrefiongas (Mezhrefiongas 2011a). Currently, the following companies participate in Mezhrefiongas cooperation: OAO Novatek, ZAO Transnafta, OAO NK Rosneft, OOO NG Itera, OOO Novourngoyskaya Gasovaya Company (Mezhrefiongas 2011b).

Russian state may consider a restructuring of Gazprom. But, according to many analysts, Russia is unlikely to shift to a UK model of asset

unbundling. Instead, Gazprom may be forced to grant independent producers access to the GTS.

In the case of domestic market and transmission of gas, it is clear that Gazprom has been pressed by the state to adapt to market rules, and the company may have to allow access to the GTS to independent gas producers. But Gazprom can be still viewed as the principal, because it is in the long-term interest of any company to get the state authorities to liberalize gas prices, as this may open for higher profits from sales on the domestic market. But the state has also been able to press Gazprom, for instance with the GTS and independent gas companies, and in the case of Mezhrefiongas.

Although the planned and partly implemented liberalization of the domestic gas market has no direct bearing on gas exports, it is important for understanding how these developments may influence Gazprom's export policies. The main point here is the question of economic incentives for the company – if it could earn as much by selling gas on the domestic market, Gazprom could be less motivated to sell gas abroad. In the current situation, Gazprom is the dominant actor on the domestic market, with a quasi-monopolist position and with good relations with the political decision makers. When operating abroad, the company has to adapt to a much less friendly environment and relate not only to gas customers but also to foreign energy-market regulators and not least to several transit countries that have already shown their ability to inflict damage on the company's strategic interests. (Detailed analysis to be provided by S. Pirani.)

3.3 Diversification of gas routes and markets

The following interests are central to the issue of diversification:

- the energy interdependence between EU and Russia and the politicization of their relations
- the shifting logic and geography of energy markets and the growing role of LNG

Technical matters between Gazprom and European companies became a political issue discussed at the top level; some of them have even become securitized. The EU wants its main supplier of gas, Russia, to accept liberalization of its gas market, to make it more transparent. The Russian authorities and Gazprom alike have rebuffed those proposals, rejecting any possibility of the EU model being introduced in Russia. Both

seem to favour strict state control of the sector. However, this unwillingness to accept the EU's rules – the lack of liberalization of the sector – may impose some restrictions on Russia's ability to participate in the European downstream market.

During the October 2003 summit with Schröder, Putin expressed Russia's approach very directly by saying that the Russian authorities would not allow Gazprom to be divided. As noted, he added that the gas pipeline network had been built during Soviet times and that only Russia could keep it running, included those parts of it located outside Russia (*ITAR Tass* 9 October 2003). This declaration clearly conflicted with the preferences of politicians in Washington and in European capitals who wanted to open up the Russian energy market for transnational companies that could then dominate Russia's energy sector.

The second issue is Gazprom's view on participation in the international gas market. The company is interested in participating in the European spot market and trading (for instance, through its Gazprom Marketing and Trading company operating in the UK). Direct access to EU markets can provide new financial opportunities impossible under the pre-liberalized system, as Russian gas was sold at the EU country border. Moreover, Gazprom has recently adopted a new strategy introducing domestic gas market trading in Russia by 2014. However, Gazprom wants to have a clear understanding about the place of take-or-pay contracts within the EU markets. Gazprom is afraid that unbundling will lead to a mismatch between supply obligation and transport capacity access, like it happened during liberalization of the gas market in the UK. But with the liberalization process and the internal Russian process, Gazprom may lose its highly profitable share in the EU gas market. The state-supported programme of opening up new opportunities in the APR market has no immediate commercial value for Gazprom, and is mainly seen as one stage in the realization of the state strategy. From the principal-agent perspective, the state, acting as principal, hires Gazprom as agent; the goal is to develop the Russian Far East and redirect gas flows to the APR. This could be seen as part of a broader strategy of national security aimed at the economic development of Russia's less densely populated regions to counter 'the Chinese demographic threat'.

4. Opportunities and constraints: Some preliminary conclusions

Having explored the factors influencing Russia's energy position at three levels – on global energy markets in the post-crisis situation, in

relation to the major collective energy customer, the EU, and with the most important bilateral energy partner, Germany – we now turn to the short-, mid- and long-term opportunities and constraints influencing Russian thinking on energy.

4.1 Strengths and opportunities

The most important strength Russia has in the energy sphere is undoubtedly the country's resource base, which provides energy self-sufficiency and secures Russia's international position. Given the resource/production ratio, we might hold that this strength should be described as long-lasting, especially as regards gas.

Also, Russia's production and export capacity seems an important strength that makes its energy sector attractive to foreign investors. The fact that two Western IOCs – BP, entering into collaboration with Rosneft and Total, establishing a collaboration with Novatek – have recently decided to strengthen their Russian engagement is a clear indication of that attractiveness. Also Russia's dominant position on two of the three most important global energy markets – Europe and Asia – is one of its energy strengths. Especially promising is Russia's increasing presence in the rapidly expanding Asian market, driven mostly by growing demands for energy in both China and India (Keohane 2009: 41).

Russia has an impressive, though partly outdated and worn-out, energy infrastructure and human energy capital with experience from the domestic and global energy sectors, especially onshore and in harsh northern conditions. Mapping the expertise of major energy players, Russian Minister of Economic Development Elvira Nabiullina (2009) identified Gazprom, GazpromNeft, Rosneft and Zarubezhneft as the key Russian technology leaders.

In recent years, Russia has also started realization of some projects that will help the country diversify its energy exports, increasing especially the share of the Asian market. However, Russia and China have to reach an agreement on prices, which may prove difficult due to greater availability of LNG and with the looming shale gas revolution in China (Amos 2011).

The seemingly quick post-crisis recovery in Germany, and rising German and global scepticism towards the nuclear option caused by recent events in Japan, will probably drive demand for Russian gas and oil on the European energy market. Also Russia's good political relations with key EU countries like Germany, France and Italy, and improving

relations with Poland, may help Russia regain some of its lost standing in Europe.

The adoption of a more comprehensive and coherent approach to energy policy on the part of the Russian political elite under Putin can also be said to be a strength – especially in Russia's relations with the EU, where some problems remain regarding designing and implementing a unified energy policy towards external suppliers of energy.

Russian authorities also claim that the country's political stability should be considered a strategic asset (Goble 2011). Deputy prime minister and head of the governmental TEK Commission Igor Sechin stressed recently that Russia has political stability, the old Soviet infrastructure having been effectively replaced; Russia has built and is about to build new gas pipelines and has created a modern banking system (White 2011a). However, this description may be too optimistic as Russia still has to cope with several weaknesses and threats.

4.2 Weaknesses and threats

The high energy intensity of the Russian economy is a key factor that hampers Russia from playing an even more important role in the global energy game. Although substantial progress has been made over the last decade, Russia still lags behind the key Western economies here.

One reason why Russia has failed to meet its energy-efficiency goals is the unsatisfactory progress of energy price reform, especially in the gas sector. Another reason why the Russian economy is still energy-inefficient is the high level of underinvestment and wear-and-tear of the infrastructure. Russian authorities, aware of the huge investment needs in the energy sector, seem to have recognized that this is an important issue, and have made several attempts at improving the investment climate so as to attract foreign investors (Odynova 2011; White 2011a).

Another factor is the country's reputational problem. Energy cooperation with Russia is perceived as challenging, and dependence on Russia as an energy supplier is politicized and even securitized (Godzimirski 2009). Fears of how Russia could use its energy resources for political purposes were summed up by Saunders (2008: 1): Russia could threaten to shut off energy supplies or increase prices to extract political concessions, exploit existing debts for energy supplies or other economic weakness in energy-consuming countries in order to buy or take over assets in those countries' energy sectors, seize the assets of foreign energy companies operating in Russia or force Western firms to sell their

assets, and that Russia's status as an energy power could encourage more assertive Russian behaviour abroad.

In addition to those political image problems, Russia must cope with very real infrastructural and geographical bottlenecks, with transit dependence, the lack of market diversification and the need to cope with new technological challenges, like the development of offshore fields. Acknowledgement of some of those problems has resulted in several strategic projects intended to help Russia address some of those issues. The construction of the Baltic Pipeline System and Nord Stream are the most important such projects in the northern part of Russia, but similar projects elsewhere – like South Stream, ESPO or the Altai pipeline – are also high on the agenda. It seems very probable that in the mid-term perspective Russia will cope with most of these issues, not least by paying greater attention to market diversification and energy cooperation with Asia (Amos 2011).

Until recently, Russia was able to control the transit of energy from Central Asia to external markets, but with the construction of the pipeline linking Turkmenistan and Kazakhstan with China, it seems set to lose this competitive advantage, which will also mean less Russian influence on the energy policies of other FSU energy producers.

As regards the lack of offshore expertise, the solution chosen by Russian policy makers was to invite Western companies with relevant expertise to join forces with one of the Russian national champions. An example here is the deal on cooperation in developing the Shtokman gas field between Gazprom and Total and Statoil. The recently announced collaboration between Rosneft and BP and Exxon Mobil is also intended to help Russia cope with that issue – as Igor Sechin recently stated, BP's experience was one of the reasons for choosing BP as a partner (Horowitz 2011; Swint and Read 2011; White 2011b).

The deal with BP was also meant to help Russian energy companies to internationalize their activities. Rosneft was to get a 5 per cent stake in BP, giving Rosneft a slice of ownership of BP's global operations, which stretch from Alaska to the Gulf of Mexico, North Africa, Azerbaijan and the North Sea. (Clark and Webb 2011).

Cooperation with Western energy companies is also intended to help Russia cope with another serious problem: the expected stagnation of gas and oil production. Developing new fields will require not only more investment but also new technology. In addition, Russia has to face the climate-change challenge as the international community focuses more and more on global warming, on CO₂ emissions and calls for 'de-hydrocarbonization' of the global economy (Mason 2011).

New technologies may indeed provide solutions to some of Russia's current and future energy problems. But the new energy technologies may also pose a serious threat to the country's quasi-hegemonic position on the European gas market. Although some Russian actors dismiss the current focus on non-conventional gas as a PR stunt, it may prove to be a real strategic challenge (EIA 2011; Mason 2011).

Also, new approaches to energy policy and new technologies may pose challenges to the Russian energy sector in the long run. According to recently presented Russian forecasts for global energy, and its impact on energy relations with the EU (Gromov 2011; Institute of Energy Strategy 2010), Russia could be affected by all three long-term scenarios. In the case of the phase catastrophe scenario taking place after 2025–30, Russia would have problems in maintaining energy infrastructure and the sustainability of its energy system and could even lose control over its own natural resources. Realization of the phase stagnation scenario would also affect Russia negatively, as its hydrocarbon resources could become marginalized and its energy sector much less profitable. And thirdly, if the phase transition scenario were to materialize, Russia could be affected, through a growing technological gap between Russia and its main partners.

How Russia's energy policy makers will cope with these challenges will depend on their understanding of their country's role as a global energy player. We see tensions growing between the more mercantilist, state-centred approach advocated by Prime Minister Vladimir Putin and the more liberal approach favoured by President Dmitrii Medvedev. Only time will tell which approach will prevail and what the consequences will be for the international energy position of Russia.

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8

Russo-Ukrainian Gas Wars and the Call on Transit Governance

Simon Pirani

1. Introduction

This chapter will argue that in the Russo-Ukrainian 'gas wars' of 2006 and 2009, the dynamics of post-Soviet transition, economic events, and shifting commercial relationships were more significant than political factors. The ways in which the 'gas wars' exposed the limitations of both international governance mechanisms (specifically, the Energy Charter Treaty) and of European Union energy policy (which was divided in its approach to them) will be discussed. Finally, factors that may influence the Russo-Ukrainian gas relationship in future will be considered.

The 'gas wars' had four groups of causes: first, mutual dependencies (Russia on Ukrainian transit, Ukraine on Russian gas imports) and, second, other legacies (including the disproportionate role of gas in Ukraine's economy) inherited from the Soviet Union; third, tensions generated by the oil boom of 2002–08, corresponding changes in Russian economic policy and the economic crisis that followed in 2008–09; and fourth, political factors and specifically the widening gap between Russian and Ukrainian foreign policies.

2. Post-Soviet legacies

The tension between Russia and Ukraine that culminated in the 'gas wars' was heightened by mutual dependencies – Ukraine on Russian gas, Russia on Ukrainian transit – that originated in the Soviet period. These mutual dependencies made conflict likely, regardless of the political relationship between the two sides. That is why Russia has fought 'gas wars' not only with Ukraine but also with Belarus, despite its political relationship with Belarus being much warmer.