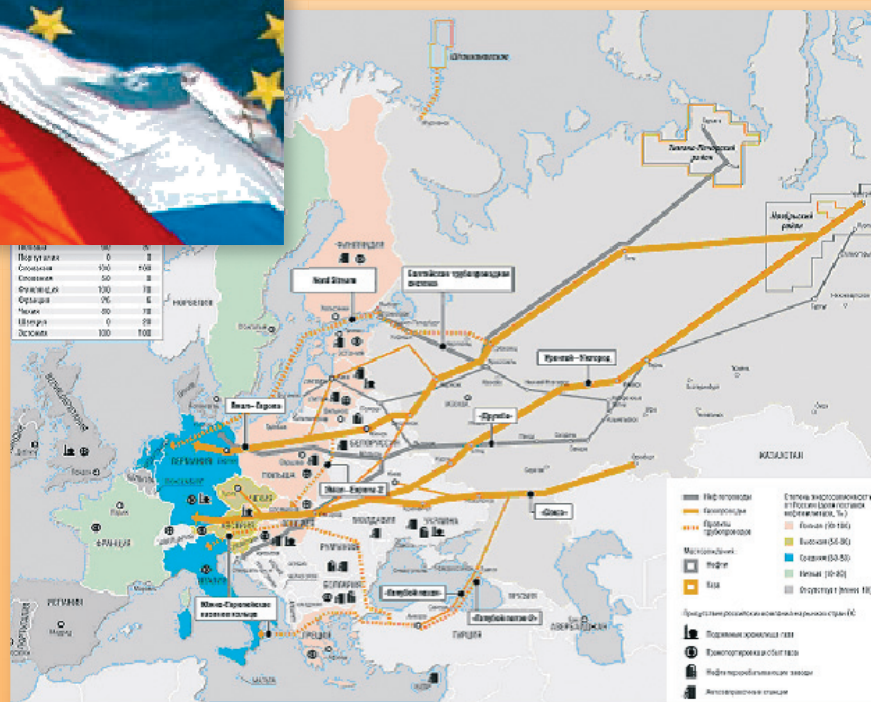


Energy as a Bond: Relations with Russia in the European and Dutch Context

Susann Handke and Jacques J. de Jong

Clingendael International Energy Programme



Nederlands Instituut voor Internationale Betrekkingen
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Clingendael

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List of abbreviations

APEC	Asia-Pacific Economic Cooperation
CIS	Commonwealth of Independent States
ECT	Energy Charter Treaty
EU	European Union
PCA	Partnership and Cooperation Agreement
PPP	Purchasing Power Parity
US	United States of America

Executive Summary

For more than 20 years, European countries have been importing large amounts of oil and gas from the Soviet Union and Russia. European energy companies have always been able to rely on their Russian business partners. The 1990s brought Russia the economic and geopolitical loss of the former Soviet republics, the collapse of the country's economy after hasty reforms, state bankruptcy due to manipulations by the new oligarchic business elite, and the extension of NATO to its very borders. During all these years, Russian energy companies continued to fulfil all contracts with their European partners and to ship the agreed oil and gas supplies to Western Europe, without any delay or extra demands. Today, however, the Russian "energy weapon" frequently hits the headlines in Western media.

This paper examines the recent policy changes in Russia. The country's economic development is assessed, as well as the state of its energy sectors. To analyse EU-Russian energy relations in a much broader context, EU policies towards Russia are discussed. Some statements are made about Dutch-Russian energy cooperation and the importance of a bilateral approach as part of an EU member state's overall external energy policy. The findings are evaluated in the context of the trends in international energy relations focussing on the role of the state and the decreasing importance of market-oriented players.

The discussion of Russia's recent policy changes shows that the current leadership has been redefining the country's political-economic system. Notions such as "managed democracy" and "bureaucratic capitalism" are indicative for the ongoing transition process. Now Russia's economy is booming. The Russian state has regained control of the country's resources and is willing to use them for its further economic recovery. Western companies saw themselves stripped of promising energy assets that they had gained when the country had to give away its energy riches under unfavourable terms. From the perspective of the current leadership, some corrections were also needed in Russia's economic relations with the former Soviet republics as well as with the West. The market structure introduced in the 1990s and the price increases for its energy exports have brought Russia robust economic development. Under President Vladimir Putin, the Russian state has regained control of Russia's internal and external policy as well as the country's most strategic assets. Some democratic achievements have been sacrificed in this adjustment process. But Russia's population favours the strong state that protects Russian national interests at home and abroad. Accordingly, it can be expected that this current system, which is closely linked to President Vladimir Putin, will be upheld in the years to come.

Oil and gas are at the core of Russia's economic recovery, the source of its regained self-confidence. The leadership asserts considerable influence on the energy sector. Yet it would be too easy to generalise and suggest that it uses energy supplies as a tool in international relations. Some of Russia's recent actions in this regard were badly communicated and gave way to heated debate and Cold War-like rhetoric in the West. In Russia and within the CIS, Russian energy prices – particularly those for natural gas – are part of the Kremlin's political and economic agenda. In Western Europe, however, the Gazprom pursues business interests as any other big energy corporation relying on government support that is not unusual for companies of that size and importance.

The energy sector is at the heart of Russian economic policies. The state is recovering its control of major companies and assets. This approach is conducted within Russia's current market economy and cannot be understood as a renationalisation. These policies are aimed at developing strong positions for the Russian energy industry in global energy markets. Economic rationale is prevailing in these policies, which are in line with modern economic theory on industrial economics. Major investments will have to be made in the Russian energy sectors in order to modernise outdated equipment and infrastructure and to keep up with growing domestic demand. Moreover, due to declining production at older fields, Russian energy companies will have to make major efforts to explore and develop new oil and gas fields. The timely beginning of these projects and the use of modern technology will be crucial for securing energy flows to all customers.

When examining EU-Russian relations, it becomes obvious that some assumptions that were held in the 1990s must be redefined. After the end of the Cold War, the same premises for cooperation as in the case of Eastern European countries determined the EU's approach to Russia. Accordingly, EU policy measures towards Russia were based on these principles. However, by the end of the 1990s it was evident that Russia would not follow the Eastern European path of development. The enlargement has changed the character of the EU. In the past, its members mainly focussed on economic integration. However, following the recent enlargement process, the EU is often seen as – and presents itself as – a community of values. This has become a problem in its relations with Russia. Furthermore, Eastern European resentments often hamper further cooperation with Russia, which is regaining self-confidence in international issues and relations. This renewed self-confidence is apparent from many statements made by Russian politicians and also from the country's increased participation in international affairs, especially in the Asian context. This approach leads its international policies in the direction of a multi-polar concept, in contrast to US policy views of a unipolar world. Energy is playing a vital role in the Russian foreign policy arena. It has strengthened Russia's economic clout and is helping Russia find new partners in Asia and elsewhere.

Energy is also the key to the EU's relations with Russia. The EU imports up to 30% of its oil and gas consumption from Russia. Due to decreasing domestic reserves, the EU will have to import an even larger share of its consumption from Russia. The EU and Russia have had fruitful and mutually beneficial energy relations for decades. Existing transport infrastructures and the complementary economies make Russia a natural partner for providing energy supplies to Europe. By signing the Energy Charter Treaty, many countries agreed to institutionalise energy cooperation. Russia has also signed the Treaty. However, it does not yet fully participate, as strong lobby groups hamper the ratification process. Moreover, populist and wrong statements about the Treaty disturb further negotiations. Nevertheless, the government is in principle willing to continue the consultation process.

The EU is facing the transition into a system of 27 member states, seeking ways and means to strengthen its institutions and to find a way to formulate a common energy policy, including a strong external policy element. The external element will be all the more necessary as external energy supplies – especially from Russia – will be critical for assuring the medium- to long-term energy security position for the EU at large. The EU common position must opt for the notion that good and workable energy relations with Russia are indispensable. In its approach to Russia, the EU must acknowledge the political transition that the country is facing, whereas its robust economic development and its energy position is giving its leadership the clout to pursue its policies in a more assertive way. The EU has to learn to live with this neighbour who is much stronger, more self-confident, and more outward bound than the crisis-struck former superpower of the early 1990s.

It is energy that has made Russia rich again, and both Russia and Europe can gain much if they are able to strengthen their mutually beneficial economic cooperation. Political conflicts are normal among countries with diverging interests, but they should not be discussed in the context of economic cooperation, especially not in the area of energy. After all, energy dependence in the case of the EU and Russia exists on both sides. Increasing economic interdependence, not only in the area of energy, will lessen fears on both sides about asymmetric dependence. In developing its energy approach towards Russia, the Brussels-Moscow energy axis should be leading, with mutual benefits, more transparency and full reciprocity as its major components. A new model for the wider European energy market, and more specifically the gas market, would further facilitate ongoing multilateral discussions in which both parties play key roles. This would include the finalisation of the outstanding issues related to the Energy Charter Treaty and the forthcoming post-Kyoto negotiations.

The Netherlands is an important energy producer in the EU. In addition, through the Port of Rotterdam it receives large amounts of oil supplies destined for other EU countries. Gasunie is keen to participate in the Nord Stream gas pipeline, which could facilitate the establishment of a European gas hub in the Netherlands. The Dutch government is actively taking part in the policymaking process at the EU level to formulate a common energy policy. However, as part of its national energy policies it will also continue bilateral projects as well as joint projects with “like-minded” countries.

In the short term, individual member states will and should be able to pursue bilateral approaches to energy relations, securing their long-term gas supplies and supporting infrastructures. There is no reason why the Netherlands would not follow such a course; to the contrary. However, as global energy policy requires a full EU approach for all its member states, integrating its three major policy goals – i.e., supply security, the environment, and the market – it will be vital to strongly pursue the further definition, development, and implementation of an integrated EU energy policy for the sake of all member states.

The discussion of Russia's recent economic policy has shown that the state has regained control of major companies and assets that are deemed vital for the country's economic recovery. Increasingly, emerging economies pursue a state-controlled path to economic and institutional modernisation. The integration of these economies into the globalised world economy has a huge impact on the character of the entire system and ever more influences the rules of the game. The "newcomers" have to adapt to the globalised system, while established players like the EU and the United States find themselves confronted with new trends in economic relations, especially in the area of energy cooperation.

On the one hand, the institutional settings and the mandate of the European Commission are sufficient to speak for the entire community. The EU can by no means act like a state in this emerging global system. Individual member states, however, are too weak to protect their interests effectively. Therefore, it is essential that the EU intensifies its economic integration process and strengthens its foreign policy tools in order to be able to protect economic interests of the entire community and remain an attractive partner for economic cooperation, and energy relations in particular.

The EU will therefore have to translate its economic power into political clout in the international system. This includes a serious attempt to limit the re-emergence of the national state as an institution among its members and beyond. The member states must be convinced to work together and not merely focus on pursuing their national interests, especially in the area of energy. Only by doing so will the EU be able to maintain its economic strength and to engage in fruitful economic cooperation with Russia. Above all, Russia's economic recovery and modernisation is an opportunity for further integration with the EU. Hence, energy should be seen as the bond that makes cooperation in many areas imperative and beneficial, following the historic vision that energy has brought about and could continue to stimulate in the wider cooperation between the peoples of Europe.

1

The stones and concrete blocks of the Berlin Wall have long been distributed as souvenirs. But we should not forget that the fall of the Berlin Wall was possible thanks to a historic choice – one that was also made by our people, the people of Russia – a choice in favour of democracy, freedom, openness and a sincere partnership with all the members of the big European family.

Vladimir V. Putin, 10 February 2007

Introduction

This section provides an overview of the topic and the outline of this paper. It introduces the main premises on which the analysis is based and which will be further developed in the evaluation section so as to find some answers to the question of the paper.

1.1. Problem definition: EU-Russian energy cooperation at the crossroads?

The topic of this paper is the current state of Europe's energy cooperation with the Russian Federation (hereafter "Russia") and its perspectives for the near future. Energy cooperation, as one aspect of the overall relations, will be discussed in the context of recent developments in Russia and the legacy of EU-Russian relations since the end of the Cold War. Finally, after an analysis of the EU's energy relations with Russia, some measure will be proposed that might be useful to solve the present problems.

Many EU member states have longstanding, trustful, and mutually fruitful relations with Russia. But in negotiations at the EU level, diverging interests of countries with different histories and experiences have to be balanced. After the 2004 EU enlargement, policy makers have found it increasingly difficult to keep the political aspects of EU-Russian relations on track with the growing economic interdependence. In fact, profound political changes in both the EU and Russia have led to a noticeable deterioration of the relations between the EU and its most important neighbour in the last few years. Due to disagreements among EU member states, negotiations between the EU and Russia on various issues have stagnated. Unfortunately, worsening overall relations have created a climate of mistrust and increasingly hamper cooperation in the field of energy.

Since the emergence of the "New Russia" in the 1990s, Western perceptions of Russia have changed fundamentally. First, there were hopeful signs of a developing civil society, a new business elite, bright young reformers and a forceful president who – standing on a tank – fought for his country's *democratic* future. Then, analysts in the West focussed on the chaos that was the result of hasty economic reform. Western media further reported on the oligarchs' incredible wealth and the system of crony capitalism these people had helped to shape. After the financial crisis in 1998, Russia was portrayed as a country with an economy stripped of "any pretence of normality",¹ and at that time doing business in Russia looked more forbidding than ever, due to bad infrastructure, corrupt officials, weak institutions, and the ever-present curse of organised crime.² Nevertheless, during these difficult years of political re-orientation and economic disaster, Russia's reliability as an important supplier of energy to the European market was never an issue. Now, the metaphor of the "Russian energy

¹ "As Winter Draws in," *The Economist*, 22 October 1998, http://www.economist.com/business/displaystory.cfm?story_id=E1_TSPQGR.

² Ibid.

weapon”³ is often used to refer to the country’s allegedly most important bargaining chip in international relations.

Undoubtedly, energy resources are above all vital for Russia’s economic development. As a result of high prices for oil on the international market, the country’s endowment with oil and gas resources could provide for Russia’s economic recovery. But is the West correct in assuming that the current leadership under President Vladimir Putin uses energy exports to achieve foreign-policy aims? Should EU policy makers consider Europe’s dependence on Russian energy imports a vulnerability, after decades of stable supplies from the Soviet Union and, subsequently, from Russia?

Since its recent expansion, the EU has direct borders with Russia. Most of the new member states were either part of the Soviet Union or in its sphere of influence in Eastern Europe. After the reunification of Germany, the 2004 enlargement of the EU was meant to be the last big step toward bringing down the remnants of the Iron Curtain that had divided the continent for decades. But before EU officials could declare “the end of European history,” new conflicts loomed on the horizon. Legitimate concerns about the course of Russia’s future development, the political orientation of other former Soviet republics, and, last but not least, the security of energy supplies became burning issues that are currently being discussed in all European capitals.

The climate of EU-Russian engagements has changed considerably. Perhaps Western policy makers and politicians are right to be worried about Russia’s recent development. To some degree, however, Western expectations in the 1990s were more than misguided and could not reasonably be based on the country’s situation at that time. Should the West admit its earlier misperceptions and redefine its approach to Russia? Should the EU position in its relations with Russia reflect the changed Russian policy preferences? Is it worthwhile adopting such a position in order to secure energy supplies and to strengthen economic cooperation?

In the 1990s, the EU and Russia negotiated and concluded various agreements, signifying the development of a new relationship. Nevertheless, this process did not lead to a common foreign policy approach to Russia that could be embraced by all EU member states. Some member states have developed closer bilateral relations with Russia, while others have remained rather indifferent. At the moment, one of the EU’s most urgent problems is how the future approach to its new (old) neighbour will be defined – not only at the EU level but also at the national level of individual member states.

From the outset, there were many signs that a Russia under Putin would no longer resemble Yeltsin’s anarchic, defeated former superpower. Yet only in early 2006 when Gazprom decided to cut off gas supplies to Ukraine did many EU policy makers and politicians in the member states conclude that the combination of increasing state power in Russia and the EU’s dependence on energy supplies from that very country should be considered a matter of concern. This crisis was a wake-up call for many in the EU, although the issue at stake was not a matter between the EU and Russia. Ever since the gas dispute, at both the EU and national levels security of energy supply issues have dominated the discussions about EU-Russian relations.

Even without the 2006 gas dispute, Europe’s energy security as part of its relations with Russia would be high on the agenda, but in another context. Due to depleting fields in the North Sea and the Netherlands and increasing demand in many member states, the EU as a whole will have to import more gas in the near future. Efforts are being made to buy gas from other regions and to build LNG facilities in several European ports. Yet many EU member states will still have to import gas from Russia and/or other countries of the former Soviet Union through already existing pipelines. Hence, good, or at least workable, relations with Russia are in the interest of all EU member states. Moreover, the geographical proximity and magnitude of interactions between the EU and Russia make it necessary to base the future relationship on a solid, mutually beneficial framework.

³ Smith, Keith, “Defuse Russia’s Energy Weapon,” *International Herald Tribune*, 17 January 2006, <http://www.ihf.com/articles/2006/01/16/opinion/edsmith.php>.

The overall political relations have more and more influence on the energy relations between the EU and Russia and vice versa. This paper argues that, considering the profound changes of propositions on which the frameworks for the EU's (energy) cooperation with Russia were premised in the mid-1990s, both parties should take these developments into account and rethink their relations. Above all, both parties should be willing to learn from the past and try to define a new common basis for fruitful future relations, especially in the field of energy.

1.2. Objectives and outline of the paper

This paper approaches the topic of EU-Russian energy relations and the position of both parties based on two orientations to the international system: (1) a focus on economic efficiency as the leading principle of governance (EU); and (2) a focus on the effectiveness of promoting national interests (Russia).⁴ The relations between the EU and Russia will be analysed in this context. The international system is still in a transitional period. At the moment it is not yet clear in which direction the international system will develop. But as of 2007, it is more than obvious that a complete globalisation with fully developed market mechanisms in the energy sector will hardly become reality.⁵ Undoubtedly, the transitional period that started with Gorbachev's *Perestroika* and accelerated after the end of the Cold War is still ongoing, while none of the current major players – US, EU, Russia, or China – has yet consolidated itself as a potential rule setter.

Based on these assessments, this paper will examine the energy relations between the European Union, the Netherlands and Russia. On the one hand, the EU's behaviour is described as being driven by the goal of more economic efficiency. The discussion of the EU's relationship with Russia, however, will show that it is increasingly difficult for this ever-growing legal and economic entity to determine a clear position in the relations with one of its most important energy supplier. On the other hand, the examination of Russia's recent policy changes leads to the conclusion that the country has embarked on a more national interest-focussed path of development. Although market mechanisms have been introduced, the energy sector in particular is once again dominated by the state. This re-orientation also affects Russia's relations with energy-consuming countries and the conduct of business by the main energy-exporting companies. EU-Russian energy cooperation will be discussed in the light of these observations, and some conclusions will be drawn for future policy approaches at EU-level as well as at national level.

Future developments cannot be predicted with any certainty, but the analysis of recent developments in EU-Russian energy relations in the context of increasing state influence in the field of energy might be helpful to keeping ongoing changes in perspective and formulate strategic future policy choices. The first part of the paper describes recent political and economic developments in Russia and assesses the current state of Russia's energy sector. The second part discusses EU and Dutch relations with Russia, focussing on issues of energy cooperation. The first two sections give an overview of recent economic and political developments that affect both the Russian energy sector and the country's policies towards consuming countries. Then, the state of the energy sector is discussed, paying special attention to the gas sector and the need to implement energy-saving policy measures. The next section provides a short summary of the development of the relations between the EU and Russia after the end of the Cold War. After this more general assessment, EU-Russian energy relations are examined. This section is followed by a brief discussion of Dutch-Russian energy relations and the opportunities for Dutch energy companies in Russia as part of the bilateral economic cooperation. Then, the findings of the preceding sections are evaluated in the light of the theoretical framework. The final section makes some concluding remarks and suggests possible policy choices that acknowledge the political and economic developments described in the previous sections.

⁴ In the 2005 CIEP study *Tomorrow's Mores: The International System – Geopolitical Changes and Energy*, which examines the possible future trends in the international system and their implications for the organisation of energy supplies. In the underlying analysis, two trends in the international system were identified: one towards more economic integration and a second that leads towards more state power. Hoogeveen, Femke, and Wilbur Perlot, eds, *Tomorrow's Mores: The International System – Geopolitical Changes and Energy*, CIEP Study. The Hague: Clingendael Institute, December 2005, http://www.clingendael.nl/publications/2006/20060117_ciep_study_hoogeveen_perlot.pdf.

⁵ Van der Linde, Coby, *Energy in a Changing World – Energie in een veranderende wereld*. CIEP Energy Paper, The Hague: Clingendael Institute, March 2006, http://www.clingendael.nl/publications/2006/20060308_ciep_paper_vanderlinde.pdf.

This paper has been inspired by two workshops that the Clingendael International Energy Programme organised together with the Department of Foreign Economic Relations of the Dutch Ministry of Economic Affairs. The first workshop, on the relations between the Netherlands and Russia, took place in November 2006, while a second workshop, on EU (energy) relations with Russia, was organised in February 2007. The authors would like to thank all participants who, through their presentations and remarks during the workshops and their comments on drafts of two background papers, have contributed to a better understanding of this complex topic.

2

Russia at the turn of the century: Safeguarding the country's interests

This section first assesses recent changes in Russia's domestic politics and describes some political and economic trends. Then it summarises the current leadership's economic and foreign policy priorities.

2.1. Re-enforcing state control after a decade of chaos

Many Western observers felt bewildered when news about the arrest of one Russia's richest men and the "re-nationalisation" of energy companies hit the headlines. The recent re-appearance of Cold War rhetoric in Western media is adding to the fear that proponents of the old Soviet regime are somehow creeping back into power. Perhaps it is correct to conclude that democracy has not (yet) consolidated in Russia. However, recent political developments and state interference in Russia's economy, especially in its strategically important energy sector, should not only be judged from a Western value- and market-focussed perspective, but must above all be judged in the context of Russia's economic crisis in the 1990s.

In 1991, it seemed that a Russia led by President Boris Yeltsin would take a firm pro-Western course, in its external as well as internal affairs. The expectations were high, but in 2000 it became clear that they had not been realised. Many analysts in the West view present President Vladimir Putin's policies as anti-democratic and anti-libertarian. These policies, however, are seemingly not being inflicted on the Russian people "but are actually supported by them".⁶ In general, Russians associate a weak government with anarchy and lawlessness. Thus far, democracy in Russia has proven "weak" and is widely viewed as "a fraud".⁷ Yet most Russians want stability and peace, which they think can only be provided by a strong leadership. Further, they are not yet ready to carry the burdens of Western-style governance and prefer to be ruled from above.⁸ Hence, Putin's victory in the 2004 presidential elections and his popularity result from the fact that he has re-instated Russia's traditional model of government – i.e., an autocratic state that relieves citizens of the responsibility for politics.⁹

For Russia's people, the country's transition has been painful in many ways. Still, the country has made remarkable economic and social progress since the end of Communism. Russia had a highly distorted and disintegrating centrally planned economy back then. Consumer goods were in short supply. The government had to support a massive military establishment. Nevertheless, Russia could end the decade as a "normal" middle-income capitalist economy with a GDP per capita of about US\$ 8.35 at PPP in 2003.¹⁰ Undoubtedly, Russia's economic and political institutions remain far from

⁶ Pipes, Richard, "Flight from Freedom: What Russians Think and Want," *Foreign Affairs*, May/June 2004, <http://www.foreignaffairs.org/20040501facomment83302-p0/richard-pipes/flight-from-freedom-what-russians-think-and-want.html>.

⁷ Ibid.

⁸ "Putin's Russia is Embracing Czarism: *Trud* Interview with Dmitri Trenin," *Trud*, 14 November 2006, <http://www.carnegieendowment.org/publications/index.cfm?fa=view&id=18861&prog=zru>.

⁹ Pipes, Richard, "Flight from Freedom: What Russians Think and Want," 2004.

¹⁰ In 2003, Russia's GDP per capita ranged between those of Thailand, Mexico and South Africa. See "Country Briefings," *The Economist*, 21 October 2006, <http://www.economist.com/countries/index.cfm>; Shleifer, Andrei, and Daniel Treisman, "A Normal Country," *Foreign Affairs*, March/April 2004, <http://www.foreignaffairs.org/20040301faessay83204-p0/andrei-shleifer-daniel-treisman/a-normal-country.html>.

perfect. But these defects are typical of countries at a similar level of economic development.¹¹ Almost all democracies in this income range are “rough around the edges”; their governments suffer from corruption, their judiciaries are politicised, and their press is almost never entirely free.¹²

After the demise of the Soviet Union in 1991, Russia embarked on a badly regulated *ad hoc* privatisation of state assets. During this process, many of the so-called oligarchs, especially those whose principal holdings were in the oil sector, could gain ever more wealth by purchasing state assets at low prices.¹³ To many Western observers, the privatisation of former Soviet state assets marked the triumph of private industry and the market. Complaints of shady dealings during the takeovers were viewed as inevitable side effects of such a far-reaching transformation.¹⁴ Still, Russia’s so-called voucher privatisation and the subsequent loans-for-shares scheme of the early and mid-1990s were conducted in a very unfair and flawed way. These reform measures created an extremely unstable business environment, making a correction of the emerged ownership arrangements almost unavoidable.¹⁵

By privatising the state’s most valuable companies, President Boris Yeltsin secured the support of the country’s richest businessmen for his re-election in 1996. Moreover, by transferring these companies to private ownership he hoped to ensure that, even in the event of his defeat, his communist opponents would face powerful opposition to any attempt to reverse the course of economic reform.¹⁶ But as a result of this “Faustian bargain”¹⁷ the president of the former superpower became a hostage to the will of a clique of businessmen. Soon the collective economic power of Russia’s 25 richest men far outstripped that of the Russian state. By the second half of the 1990s, it was impossible for the Russian president to move against these men as a group¹⁸ – even if the president had had the political will to do so.

Undoubtedly, limiting the oligarchs’ political involvement proved difficult for President Vladimir Putin, and some of his moves might be questionable. But Putin merely employed the only effective tools at his disposal. At that point, the Russian state was characterised by weak regulatory and rule-enforcement capabilities. Thus, its only excess capacity was the capability to use force.¹⁹ The steps taken by Putin’s administration against the oligarchic clique seemed appalling to many observers in the West. But to many Russians it was much more the question whether the oligarchs really had the right to claim for themselves so much of the wealth that had been accumulated over generations and had always belonged to the state or, by principle, to the people at large.²⁰

From a historical perspective, today’s Russia is back on its path of development; back at the point where things started to go wrong at the beginning of the 20th century. Russia can be compared with Western Europe, as it will also have to advance in stages. Yet Russia will not necessarily be willing or

¹¹ Shleifer, Andrei, and Daniel Treisman, “A Normal Country,” 2004.

¹² Ibid.

¹³ Martha Brill Olcott, “Vladimir Putin and Russia’s Oil Policy,” Carnegie Moscow Center, no. 1 (2005), http://www.carnegieendowment.org/files/wp-2005-01_olcott_english1.pdf, p. 6.

¹⁴ Goldman, Marshall I., “Putin and the Oligarchs,” *Foreign Affairs*, November/December 2004, <http://www.foreignaffairs.org/20041101faessay83604/marshall-i-goldman/putin-and-the-oligarchs.html>.

¹⁵ The oligarch-owned banks were supposed to act on behalf of the state. However, the auctions were rigged and, eventually, the auctioneers in almost every case ended up as the successful bidders. After obtaining the state assets, the oligarchs paid little or no taxes on their purchases. Further, those oligarchs who had obtained energy producing companies did not invest in further development of these assets but only profited from the sale of the energy resources. Goldman, Marshall I., “Putin and the Oligarchs,” 2004.

¹⁶ Tompson, William, “A Frozen Venezuela? The Resource Curse and Russian Politics,” in *Russia’s Oil and Natural Gas: Bonanza or Curse?*, ed. Michael Ellman, 199. (London: Anthem, 2006)

¹⁷ For an insightful description of Russia’s privatisation and the subsequent takeover of the country’s politics by the oligarchs its created, see Freeland, Chrystia, *Sale of the Century: The Inside Story of the Second Russian Revolution*. London: Abacus, 2005.

¹⁸ Martha Brill Olcott, 2005, p. 5.

¹⁹ Tompson, William, 2006, 208.

²⁰ Goldman, Marshall I., “Putin and the Oligarchs,” 2004.

able to opt for a Western-style market economy, democracy and rule of law. Throughout its history Russia's development has been different from Western Europe and even different from that of other Slavic peoples. Russia is at its core culturally a part of Europe. Yet due to its geography and history it forms a special subdivision of the European community of peoples. Russia's political and economic institutions have evolved differently from those of the countries in Western Europe. Thus, there is a distinct "Russian path" that does not necessarily coincide with West European and North American experiences. In addition, post-Soviet Russia has inherited a unique legacy of modernisation, which goes back to Stalin's reign. Despite the fact that it had initially taken the industrial societies of the developed West as its inspiration, Russia used quite un-Western methods in its construction, especially during the first decades of Soviet history.²¹

Analysts characterise Russia's current political system as "bureaucratic capitalism, in which the market economy is to develop under the supervision of the state",²² whereas Russian government circles often call it "a managed democracy".²³ No matter which term might describe Russia's current political system most accurately, it is true that Putin has effectively altered Russia's path of transition. In the early 1990s, Russia had begun a three-dimensional process of transformation: from dictatorship to democracy, from a centralised planned economy to a market economy, and from an Empire to a "normal" European state. Putin has blended this three-dimensional transformation process into one strategically important track: the economic strengthening of the country based on its resource riches. And indeed, the other two processes, democratisation and the retreat from the post-Soviet space, have been put on hold.²⁴

Putin has not abandoned Yeltsin's policies completely. In fact, he has tried to work with the post-communist system, which is still hampered by weak institutions and a personified leadership, capricious decision-making, and arbitrary execution of laws. This system also lacks a broad unifying ideological foundation other than establishing some sort of internal stability. Yet Putin did not infringe on the 1993 Constitution, but was still able to transform Russia's political system into what some analysts call a "bureaucratic-authoritarian regime".²⁵

Putin and the so-called *siloviki*,²⁶ upon whom the president mainly relies, argue that they need these powers in order to establish a constitutional state and a functioning market economy.²⁷ After the Duma elections in late 2003, Vladimir Putin's United Russia and some nationalist parties obtained a clear majority in the Russian parliament. Russian communism suffered a historic defeat. At the same time, the end of a power constellation was heralded in which a group of oligarchs could determine and manipulate the political direction of the country.²⁸ The clear victory of the 2004 presidential elections further enhanced Putin's power, as the *siloviki* could replace the entire Yeltsin team in his new

²¹ Trenin, Dmitri, "Russia Leaves the West," *Foreign Affairs*, July/August 2006, <http://www.foreignaffairs.org/20060701faessay85407/dmitri-trenin/russia-leaves-the-west.html>; Gvosdev, Nikolas K., "Russia: 'European But Not Western?'" *Orbis* 51, no. 1 (Winter 2007): 132, 134.

²² Shevtsova, Lilya, "Putins Vermächtnis: Wie die russische Elite die Modernisierung des Landes blockiert," *Internationale Politik* 61, no. 7 (2006): 38–9; Rahr, Alexander, "Between Reform and Restoration: Putin on the Eve of His Second Term," *CIS-Barometer*, no. 35 (February 2004), <http://www.dgap.org/midcom-serveattachmentguid-6ba15936dc3711dabac829d03b0d20192019/CIS-Barometer35.pdf>, p. 2.

²³ See, for instance, President Vladimir Putin in an interview with Steven Lee Myers of *The New York Times*, published on October 6, 2003.

²⁴ Rahr, Alexander, 2004, p. 2.

²⁵ Shevtsova, Lilya, 2006, p. 39.

²⁶ *silva* = power, strength, force. The term "*siloviki*" – roughly "power agents" – refers to "the law-and-order types from the KGB, the police, and the army" (Goldman, Marshall I., 2004). However, they usually are not proponents of Communism. Their main goal is to restore the power of the state and ensure that the security forces regain a central role in Russian politics. See Treisman, Daniel, "Putin's *Silovarchs*," *Orbis* 51, no. 1 (Winter 2007): 142.

²⁷ Rahr, Alexander, 2004, p. 1.

²⁸ Despite the democratic procedures and elections in the 1990s, in practice oligarchs were able to buy Duma deputies and, subsequently, influenced new legislation. President Boris Yeltsin's 1996 re-election was the result of massive financial support from the oligarchs. Some oligarchs even became governors and used the privileges of their position to monopolise certain sectors and natural resources.

administration.²⁹ Subsequently, Putin and his supporters could gradually increase their grip on the courts, the media, and the parliament. In late 2004, after a series of terrorist attacks in the Northern Caucasus, Putin announced a far-reaching centralisation of political decision-making. Regional governors, who were hitherto elected or free to “buy” their elections, were instead to be nominated by the president and confirmed by regional legislative bodies.³⁰

By doing so, Putin succeeded in enhancing his grip on all levels of government. Some analysts estimate that in different levels of government *siloviki* constitute about 15 to 70% of the personnel.³¹ Yet, those analysts also admit that Putin had little choice but to recruit these people for government posts. Since there were not enough other experienced and reliable candidates, the military and the secret service became Putin’s most important social pillar.³² Moreover, from attributing a mere percentage of staff to the group of *siloviki* one cannot tell how their careers in the security forces and in other civil institutions have influenced these people’s thinking. It is, therefore, difficult to assess the impact this heterogeneous group has on Russian policymaking. In addition, the *siloviki* have neither a leader nor any means to coordinate their actions and goals. Hence, the political system Putin has shaped must be examined based on the political developments, rather than the professional background, of his supporters.³³

Next to representatives of the military, the secret service, and the police, Putin’s power base also includes apparatchiks, people from the big state corporations, and some liberal technocrats. In fact, his power base cannot be viewed as a coherent group because several fractions around key persons compete for influence. At the moment, the forces in power concentrate their efforts on maintaining the system as a whole until the next Duma and presidential elections in 2007 and 2008 respectively.³⁴ At the same time, they help their favoured companies and institutions to manoeuvre for position.³⁵ Putin has repeatedly denied that he would intend to run for an unconstitutional third presidential term. Moreover, the Duma and the Federal Council will not discuss any law endorsing an amendment to this particular clause of the Constitution.³⁶ But Putin made clear that he would play an important role in choosing a candidate for the 2008 presidential elections in order to be able to further wield his influence on Russian politics.³⁷

Analysts expect that Putin’s United Russia will continue to establish itself as the “leading and guiding political force of the Russian society”³⁸ and that its policies will not change after 2008.³⁹ A managed political transfer therefore seems to be likely and might also be supported by the majority of the population, which in the past few years has been ready to sacrifice broader political freedoms for higher wages and economic stability. Putin’s popularity is still at around 80%, and almost 40% of the electorate would back his chosen successor even without knowing him. Thus far, the names most often

²⁹ Martha Brill Olcott, 2005, p. 4.

³⁰ Rahr, Alexander, 2004, p. 1; Mayr, Walter, and Christian Neef, “Die neue alte Großmacht,” *Der Spiegel*, 10 July 2006, p. 93; Petro, Nicolai N., “Russia Is Part of the West, Honest,” *Asia Times Online*, 8 June 2006, http://www.atimes.com/atimes/Central_Asia/HF08Ag01.html.

³¹ Kryshstanovskaya, Olga, and Stephen White, “Putin’s Militocracy,” *Post-Soviet Affairs* 19, no. 4 (2003): 303.

³² Kryshstanovskaya, Olga, *Anatomie der russischen Elite: Die Militarisierung Russlands unter Putin* (Anatomy of the Russia elite: The militarisation of Russia under Putin). Köln: Kiepenheuer and Wisch, 2004, p. 153.

³³ Renz, Bettina, “Die Silowiki in der russischen Politik: Politische Strategie oder Produkt des Systems?” (The siloviki in Russian politics: Political strategy or a product of the system?), *ruslandanalysen*, no. 117 (2006), <http://www.ruslandanalysen.de/content/media/Ruslandanalysen117.pdf>, p. 3–4.

³⁴ Shevtsova, Lilya, 2006, p. 39.

³⁵ See, for instance, “Ministries Battle over Gazprom,” *Kommersant*, 29 September 2006, <http://www.kommersant.com/page.asp?id=708625>.

³⁶ “Миронов предлагает увеличить президентский срок после 2008 года” (Mironov suggests that the presidential term should be changed after 2008), *RIA-Novosti*, 14 June 2007, <http://www.rian.ru/politics/russia/20070614/67182473.html>.

³⁷ “Operation Successor Postponed,” *RIA Novosti*, 26 October 2006, <http://en.rian.ru/analysis/20061026/55155011.html>.

³⁸ “Единоросс готов позаботиться о третьем сроке” (United Russia will make third term possible), *Kommersant*, 25 July 2006, <http://www.kommersant.ru/registration/registration.html>.

³⁹ Heyden, Ulrich, “Putin träumt von Macht auf Dauer” (Putin will yield power on a continuing basis), *Financial Times Deutschland*, 26 October 2006, <http://www.ftd.de/politik/international/125204.html>.

heard are those of the First Deputy Prime Ministers Dimitry Medvedev and Sergei Ivanov.⁴⁰ Mr Medvedev is also chairman of the board of directors of Gazprom, while Mr Ivanov is associated with the *siloviki* within the Rosneft top. Thus, Russia's two large state-controlled energy companies also play an important role in the country's overall power balance.

Undoubtedly, the relation between the state and the country's energy sector has become closer, and interactions between the two are an important part of Russian politics. Therefore, critics of Putin's economic policies hold that he has contributed to the emergence of a petro-state-like system where resources are controlled by the political elite and are divided among different factions of this elite. They also criticise that a considerable part of the population has not yet gained from the country's economic recovery. Arguably, over-centralisation of power leads to a suboptimal development of the economy. However, decades of misguided economic policies and a rushed privatisation cannot be overcome within a few years. Unfortunately, none of the representatives of the political opposition nor Messrs Medvedev and Ivanov have provided any clear alternative vision for the future development of the country. Hence, according to some analysts the only likely option is to continue "Putinism" and consolidate the current power structures.⁴¹

Apparently, President Putin might already have picked two potential candidates for the presidential elections in March 2008. However, he will wait until after the Duma elections late 2007 to reveal his final choice. As soon as he says he will support the one or the other, Putin will become a lame duck, as the Russian elite will immediately orientate themselves around that candidate.⁴² Further, Putin suggested that a governor who is "a decent and honest person with a high level of professional qualities and work experience and has proven himself well and positively" might also be a potential successor.⁴³ Thus, it seems that Putin and his advisors have not made up their minds yet and might eventually endorse the campaign of yet another candidate.⁴⁴ Anyway, rumours and behind-the-scenes battles will go on for a while to maintain the fragile balance of power among Russia's elite.

Judging from the recent developments within the Russian party system, it is unlikely that a candidate who is not at least suggested by Putin will be able to participate in the election process in a proper way. Political opposition has been silenced quite effectively in the last three years. The Duma and regional parliaments are dominated by two substitute parties, which were created by the Kremlin – i.e., United Russia and Just Russia. The harsh suppression of relatively small demonstrations by a strange alliance of democrats, national Bolsheviks, and radical communists in St. Petersburg, Moscow, and Nishni Novgorod in spring 2007 is illustrative of the process to diminish the space for independent movements. On the one hand, such actions show that Putin's position is not as strong and stable as he wants his enemies to believe. On the other hand, Russia's elite is still afraid of a Ukrainian-style colourful revolution in Russia. Finally, the suppression of demonstrations proves that the power of authoritarian forces within the Russian state has already gained momentum. The institutions of the state have increasingly become unable to adequately respond to even minor challenges.⁴⁵ This can be interpreted as a weakness of the system because even small demonstrations are regarded as threats rather than a healthy outlet. In fact, much will depend on whether and how "Putinism" can be stabilised and continued after its main proponent will – at least nominally – have handed over power to his successor.

⁴⁰ Buckley, Neil, "FT Report – Russia: Runners Approach the Starting Blocks," *FT.com*, 20 April 2007, http://www.ft.com/cms/s/c49eb27e-ed00-11db-9520-000b5df10621,dwp_uuid=2c9f868a-ec0e-11db-a12e-000b5df10621.html.

⁴¹ Siegert, Jens, "Über die Zerstörung des öffentlichen Raumes: Der Verlust der Politik in Putins Russland" (On the destruction of public space: the loss of politics in Putin's Russia), *russlandanalysen*, no. 132, 27 April 2007, <http://www.russlandanalysen.de/content/media/Russlandanalysen132.pdf>, p. 15.

⁴² Buckley, Neil, 20 April 2007.

⁴³ "75 Successors too Many," *Kommersant*, 12 June 2007, http://www.kommersant.com/p773140/Russian_presidential_elections_successor/

⁴⁴ "Путин готовит сюрприз" (Putin prepares a surprise), *Vedomosti*, 15 June 2007, <http://www.vedomosti.ru/newsline/index.shtml?2007/06/15/442464>

⁴⁵ Siegert, Jens, 2007, p. 14.

Politicians in the EU often see Putin's policies as an interruption of Russia's way to democracy, which might be overcome as soon as a "democratic" candidate will move into the Kremlin. People who hold such views hope that they can bridge the current difficult period on the way towards democracy by engaging Russia in close cooperation. Others compare today's Russia with the former Soviet Union and once again view the relations between the EU and the country from a Cold War perspective. They try to contain Russia in its international affairs, while supporting dissidents within the country. Analysts hold that both reactions are wrong. The complicated situation the EU is facing now can only be dealt with in a dialectical way; EU member states and the EU as a whole should cooperate with Russia on economic and security issues as if there were no violations of civil and human rights by the current ruling elite. But they should also criticise Russia for these violations as if there were no economic and security cooperation.⁴⁶ Still, EU politicians should refrain from linking economic interests with criticism of Russia's path to modernity.

2.2. Promoting economic development

For many Russians, life is indisputably better than in late 1999 when Boris Yeltsin handed his presidency over to Vladimir Putin. After a decade of coups, wars, and economic failures, many Russians lead a better life than ever before in their nation's history. After several years of high oil prices and economic growth, wealth is starting to spread across Russia, and living standards are finally improving. In 2007, almost all sectors of the economy reported wage growth of more than 15%. Together with the continual real appreciation of the rouble, current trends in wage growth suggest that the average monthly wage in Russia already exceeds US\$500.⁴⁷ In general, Russia's growth since 2000 has been strongly pro-poor. The number of people living below the subsistence level decreased from 25% in 2002 to 20.4% in 2003 and to about 15% in 2005.⁴⁸

Due to consistent economic expansion, real disposable income and wages of the population have been able to exhibit rapid growth. Therefore, surveys show that the majority of Russians are in favour of Putin's approach, despite a reverse of some democratic reforms.⁴⁹ In 2001 Yegor Gaidar, who played a major role in the privatisation of Russia's economy, already observed that the "Revolution of the 1990s" had entered its stabilisation phase. There was broad acceptance of the market among the Russian population, while the period of feeble state authority and weak government was "giving way to enhanced state power as an exhausted society allows today's rulers wider latitude for political manoeuvre".⁵⁰ According to a poll conducted during Putin's first term, 77% of Russians felt that privatisation should be either fully or partially revised and only 18% opposed re-nationalisation. Most Russians think that if privatisation had been carried out more honestly and equitably, the economic results would have been better, the country's income disparities could have been lessened, and control over its resources could have been more widely dispersed.⁵¹

In 2001, Russia adopted the most liberal economic reform plan in its history. In fact, this reform package has shown positive effects such as stable economic growth, sound state finances, and a reduction of the dependence on foreign loans.⁵² Yet with the appointment of Mikhail Fradkov as new Prime Minister in early 2004, the hopes about Putin's second term as a period of continuing with the economic reform agenda were dashed. Fradkov has not introduced sweeping new reforms, and other

⁴⁶ Ibid, p. 16.

⁴⁷ The World Bank in Russia, "Economic Review: Russian Economic Report, no. 14," June 2007, http://siteresources.worldbank.org/INTRUSSIANFEDERATION/Resources/RER14_eng_full.pdf, p. 10.

⁴⁸ The World Bank, "Russian Federation: Country Brief 2006," September 2006, <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/RUSSIANFEDERATIONEXTN/0,,contentMDK:21054807~menuPK:517666~pagePK:1497618~piPK:217854~theSitePK:305600,00.html#Economy>.

⁴⁹ About 50% of all Russians above the age of 15 think that their country is the equal of the United States again. They view Putin as the most successful Russian politician after 1917, whereas Mikhail Gorbachev and Boris Yeltsin are considered the worst. See Mayr et al., 2006, p. 90.

⁵⁰ Gaidar, Yegor, "The End of Russia's Second Revolution," *Project Syndicate*, March 2001, <http://project-syndicate.org/commentary/gaidar1>.

⁵¹ Goldman, Marshall I., "Putin and the Oligarchs," 2004.

⁵² Rahr, Alexander, 2004, p. 2.

members of Putin's administration have vocalised few ideas about how to use the hard-won control over the key economic assets.⁵³ But as Russia has destroyed enough of the vestiges of central planning, it will continue operating as a market economy, "albeit with flawed institutions and an unhealthy dose of state intervention".⁵⁴

Since the 1998 crisis, Russia's economic performance has been impressive. Russian GDP expanded by an estimated 57.6% between 1998 and 2006. The real incomes of the people grew by 65%. Furthermore, unprecedented macroeconomic stability was achieved in the context of strong budgetary and current account surpluses. The rapid development of market institutions in many areas since the early 1990s was the result of reforms of the taxation system, budgetary institutions, and the removal of administrative barriers to business. Since 2003, increases in oil and gas prices and the prices of Russia's commodity exports have contributed to further economic growth. But modernisation and productivity growth outside the oil and gas sector were also responsible for the recent expansion.⁵⁵

Table 2.1 Russia: Main macroeconomic indicators, 2001 – end of April 2007

	2001	2002	2003	2004	2005	2006	2007 (four months)
GDP growth, %	5.1	4.7	7.3	7.2	6.4	6.7	n.a.
Industrial production growth, year on year, %	4.9	3.7	7.0	8.3	4.0	3.9	7.5
Fixed capital investment growth, year on year, %	8.7	2.6	12.5	10.9	10.5	12.6	19.9
Federal government balance, % GDP	3.0	2.3	1.7	4.2	7.5	7.5	5.9
Inflation (CPI), change, year on year, %	18.6	15.1	12.0	11.7	10.9	9.0	4.0
Current account, billion US\$	35.1	32.8	35.9	60.1	86.6	94.5	21.8
Reserves (including gold), billion US\$, by April 2007	36.6	47.8	76.9	124.5	182.2	303.7	369.1

Source: The World Bank in Russia, "Economic Review: Russian Economic Report, no. 14," June 2007, http://siteresources.worldbank.org/INTRUSSIANFEDERATION/Resources/RER14_eng_full.pdf, p. 2.

Another important factor that contributed to economic growth was the depreciation of the rouble against the US dollar in the wake of the financial crisis in 1998. As a result, the rouble value of energy exports grew dramatically, while imports became much more expensive. This development considerably increased the market share of Russia's light and food industry in the domestic market.⁵⁶ Economic growth could be stabilised in the first few years of 21st century. This could be realised due to the introduction of market mechanisms in the 1990s and the consequent reforms during President Putin's first term. Tax reforms, a better protection of land property, and the simplification of application procedures for businesses helped improve the investment climate.⁵⁷ Russian investment growth of the past few years is developing into a genuine boom. In the first few months of 2007, fixed capital investment grew by 19.9%. In general, the interest of both domestic and foreign investors in

⁵³ Baev, Pavel K., "What Happened to Russia's Economic Policy?," *Eurasia Daily Monitor* 1, no. 117 (2004), http://www.jamestown.org/publications_details.php?volume_id=401&issue_id=3126&article_id=2368775.

⁵⁴ Shleifer, Andrei, and Daniel Treisman, "A Normal Country," 2004.

⁵⁵ The World Bank, "Russian Federation: Country Brief 2006," September 2006.

⁵⁶ Pleines, Heiko, 2003, "Russlands Wirtschaft im Aufwind" (The recovery of Russia's economy), *russlandanalysen*, no. 2 (2003), <http://www.russlandanalysen.de/content/media/Russlandanalysen2.pdf>, p. 2.

⁵⁷ *Ibid*, p. 3.

investment in the Russian market has steadily increased. Moreover, profit margins are high relative to those of many other countries in the world.⁵⁸

Russia's balance of payments continues to strengthen, while the pace of reserve accumulation has accelerated notably. Capital inflows have not only compensated for the decline in the balance of payments, which were caused by rapid import growth, but also led to further record highs of the balance of payments surplus. This trend, however, exerts new upward pressure on the rouble and will continue to contribute to further rapid real exchange rate appreciation. In 2007, inflation seemed largely under control. But it is still a major challenge for the government and the Central Bank to meet the yearly target of 8%. The notable fiscal surpluses are accumulated in the Stabilisation Fund, which was created as an automatic stabiliser for inflows as a result of sharp increases in oil prices. These transactions help sterilise the large inflows. In 2008 the Stabilisation Fund will be split into two funds: a Reserve Fund and a Fund for Future Generations. Apparently, the sterilisation of capital inflows through other policy measures in Russia is still quite difficult. Therefore, in 2007 the Stabilisation Fund has also been used to absorb capital inflows that were not caused by oil price increases. So far, stronger economic growth has helped to absorb additional liquidity in the Russian economy.⁵⁹

Undoubtedly, Russia qualifies as a heavily resource-based economy. In 2000, fuel and metals together accounted for an estimated 65% of value added in industry; and in 2003 oil, gas, metals, and other raw materials accounted for 76% of total exports, equivalent to 31.5% of GDP.⁶⁰ But despite its energy and resource riches, Russia cannot be considered a "typical" resource-based economy or a so-called petro-state, neither politically nor fiscally. Usually, resource-based economies are characteristic of developing countries with large agrarian sectors, low levels of urbanisation, and low overall levels of education. In fiscal terms, the state's income from resource extraction has grown markedly in recent years. However, export duties and resource taxes accounted for only about 20% of revenues in 2003. Moreover, since 1998 major efforts have been made to improve tax discipline across the entire economy. Thus, as a country with a diverse economy, Russia's situation is more analogous to that which highly industrialised economies had to face after the discovery of major new resource wealth, such as the Netherlands and the United Kingdom in the 1970s and 1980s.⁶¹

Since 2004 the structure of economic growth has changed dramatically. Finally, the reforms of the 1990s are paying off; the market is now the main place of economic activity. While oil and gas, with half of all budget revenues, still dominate the Russian economy, the energy sector is no longer the main driver of economic growth; this is now mainly driven by consumer demand. Some sectors of the Russian economy are responding well to growing domestic demand, and there is a queue of foreign companies wanting to invest and open their facilities in Russia. Domestic and foreign direct investments are still somewhat low relative to the country's needs. In 2006, Russia received US\$13.7 billion of foreign direct investment.⁶² However, investment has been growing even more rapidly than GDP in recent years. Since 2000, fixed capital investment has grown at an average rate of 9%, starting from a very low base in the late 1990s. A large share of investment – about 27% – is concentrated in the energy sector. But other sectors have also attracted substantial investment. These inflows can be attributed to the restructuring in many service industries, the food industry and in some machine-building companies.⁶³ In general, Russia is becoming more competitive with the other big emerging markets such as China, India, and Brazil. Investors stress that the particular sensitivities surrounding

⁵⁸ The World Bank in Russia, "Economic Review: Russian Economic Report, no. 14," June 2007, pp. 4–5.

⁵⁹ *Ibid.*, pp. 5–9.

⁶⁰ Tompson, William, 2006, 191.

⁶¹ *Ibid.*, pp. 191–5.

⁶² Federal State Statistics Service, "Foreign Investment in the Economy of Russia," http://www.gks.ru/free_doc/2007/b07_12/23-11.htm.

⁶³ The World Bank, "Russian Federation: Country Brief 2006," September 2006.

the oil and gas sector do not reflect the situation in many other sectors. Thus, the headlines, such as those on Sakhalin 2, create an impression of Russia that is worse than reality.⁶⁴

Despite the lack of additional far-reaching structural reforms, the Putin administration has introduced some measures to stabilise the Russian economy and to tackle some urgent social problems. In 2005 the Kremlin initiated so-called “national projects” in order to modernise Russia’s education, health services, housing and agriculture. In 2006 the Russian state allocated about €5 billion to these projects, while total government expenditures were expected to amount to about €127 billion.⁶⁵ Further, the Stabilisation Fund, which the government set up to prepare for times with fewer oil revenues, holds about US\$70 billion at the moment. Moreover, Russia’s foreign exchange and gold reserves have already risen to US\$260 billion – the world’s biggest outside Asia. In addition, Putin’s administration deserves credit for its fiscal prudence. The current government has created stability that has enabled Russia’s economy to benefit from the energy dividend.⁶⁶

Recent political changes have considerably influenced Russia’s economic system. The “bureaucratic capitalism” has replaced Yeltsin’s “oligarchic capitalism”. The oligarchs of the 1990s favoured a weak but open political system, in which their wealth could buy media coverage, political parties, and high officials as needed. The *siloviki* do not intend to rebuild institutions that they recognised had rotted by the end of the Soviet era. They want to restore order, protect the national wealth from swindlers and invest it in projects to develop Russia’s mineral riches and its industrial sectors simultaneously. They welcome foreign investors, but only as junior partners.⁶⁷ Accordingly, recent changes in Russia’s economic policy do not necessarily imply a re-nationalisation of most of the important industries. Nowadays, the Kremlin controls many assets by more elegant means – i.e., by appointing politicians who are members of supervisory boards of strategically important companies.⁶⁸ As a result, a new business elite has taken the space vacated by the departing oligarchs. They form the previously little-known cohort of executives from the network of security services and law enforcement veterans who form the backbone of Putin’s administration. Five of those “silovarchs” – a combination of the words “*silovik*” and “oligarch” – lead companies whose added assets equalled more than 30% of GDP in 2005. Thus, industrial and financial capital has fused with secret service and military networks and produced a new political and economic order.⁶⁹

The ruling political elite consider a stable domestic political situation and a robust economic development to be prerequisites for the country’s position on the international stage. All the efforts to regain state control over the most strategically important sectors of the Russian economy are befitting from such realist thinking. Putin inherited a state that had been effectively bankrupt only a short time before he became president and which was still in a precarious financial position. The task to find fiscal resources was particularly urgent. These resources could only be found in the country’s biggest potential source of wealth: the oil and gas sector.⁷⁰ The potential revenues had to be employed to develop other important sectors of the economy. Thus, Putin tried to re-establish state control of the country’s most important sectors, i.e., the oil and gas industry, the pipeline network, the military-industrial sector, and the civil aircraft industry. Hence, the Kremlin presents the restructuring of the

⁶⁴ Buckley, Neil, “Special Report Investing in Russia: Investment Climate – Rising Opportunities Push Risks into the Background,” *Financial Times*, 10 October 2006, p. 6.

⁶⁵ “Putin Pledges \$6.3Bln for Social Spending Projects in 2006,” *Mosnews.com*, 30 November 2005, <http://www.mosnews.com/news/2005/11/30/putinpledge.shtml>; “Russian Parliament Passes Draft 2006 Budget,” *News from Russia*, 22 September 2006, <http://newsfromrussia.com/main/2005/09/22/63490.html>.

⁶⁶ Ostrovsky, Arkady, “Special Report Investing in Russia: New-found Wealth Starts to Spread,” *Financial Times*, 10 October 2006, p. 2; Buckley, Neil, 2006, p. 2.

⁶⁷ Treisman, Daniel, 2007, p. 146.

⁶⁸ Shevtsova, Lilya, 2006, p. 40.

⁶⁹ Treisman, Daniel, 2007, p. 142.

⁷⁰ Tompson, William, 2006, 206.

energy sector and confrontation with the oligarchs as a necessity to overcome the political and economic chaos of the Yeltsin era and to recover Russia's position in the international community.⁷¹

In an article on the importance of Russia's mineral resources for the future of the country,⁷² Vladimir Putin states that the country's natural riches, especially its oil and gas resources, are pivotal for the development of the economy. He considers the energy sector as the "basis of the development of all other sectors of the economy".⁷³ In order to maintain the competitiveness of the Russian energy corporations, the state has to support these corporations and consolidate the entire sector. Putin acknowledges that the Russian energy sector needs considerable investment to play this envisaged role. These investments should mainly be achieved by the export of resources. Furthermore, the revenues from the Russian energy sector form the basis for the restructuring and future diversification of the Russian economy. To achieve these objectives, the state should support and guide vertically integrated energy conglomerates that are able to compete with Western multinationals on the international market. Putin concludes that market mechanisms are insufficient to achieve these objectives. Accordingly, more state interference in the energy sector is necessary, particularly in establishing a legal framework for the sector, providing sufficient financing and securing the related infrastructure.⁷⁴

Despite recent economic growth, Russia still faces serious challenges. In general, living standards have improved in the past few years. But in rural areas about two thirds of the population still has no access to public services such as water supply and central heating. Russia's public and industrial infrastructure is outdated and in desperate need of modernisation.⁷⁵ Furthermore, some critics hold that Russia's current economic system has already revealed some signs of weakness that can be compared with those of a petro-state, such as close links between economic and political power, a social layer that is dependent on revenues from the export of raw materials, corruption, predominance of monopolies, vulnerability of the economy to external shocks, the dangers of "Dutch disease", and a huge disparity in wealth between the elites and the rest of the population.⁷⁶ In addition, corruption is still widespread. Minister German Gref admits that state interference and corruption in the economy have become the biggest concerns for investors. Indeed, Russian businessmen complain that virtually no significant business deal can take place without Kremlin approval.⁷⁷ According to a recent study, about 39 million corruption deals were struck in 2005. On average about 7% of a company's turnover becomes an official's corruption profit. This "corruption tax" amounts to 1.1% of the Russian GDP.⁷⁸

These problems, as serious as the might be, are side effects of Russia's systemic transition. Moreover, they cannot necessarily be attributed to the country's resource-dependent economic structure. Analysts hold that there is little reason to believe that the Russian polity and business environment would be substantially healthier had Russia begun its market transition with less resource wealth, for its resource-poor CIS neighbours are not less corrupt than Russia.⁷⁹ The Russian economy will continue to face difficult problems in the years ahead. The non-resource sectors will push further for protection and, due to their socio-political importance and economic weakness, they will likely get it. Moreover, the dividing line between the sectors is fluid. Thus, actions taken with respect to one sector could have unexpected effects on other sectors of the economy. Finally, there is a real danger linked with the

⁷¹ Adomeit, Hannes, "Rückkehr auf die Weltbühne: Moskaus Ambitionen sind größer als sein politisches Gewicht" (Return to the world stage: Moscow's ambitions are greater than its political weight), *Internationale Politik* 61, no. 7 (2006): p. 7.

⁷² Putin, Vladimir V., "Минерально-сырьевые ресурсы в стратегии развития российской экономики" (Mineral and other natural resources in the strategy for the development of the Russian economy), in *Россия в окружающем мире: 2000* (State of Russia in the surrounding world: 2000), ed. N. N. Marfenin and N. N. Moiseeva, 1 – 11. Moscow: MNEPU, 2000.

⁷³ Ibid, p. 1.

⁷⁴ Ibid, pp. 2–5.

⁷⁵ Pleines, Heiko, 2003, p. 3.

⁷⁶ Shevtsova, Lilya, 2006, pp. 40–1.

⁷⁷ Ostrovsky, Arkady, 2006, p. 2.

⁷⁸ "Russian Companies Spend 7 Percent of their Profits on Bribes," *Kommersant*, 31 October 2006, http://www.kommersant.com/p717800/r_528/Corruption_Bribery_Statistics/

⁷⁹ Tompson, William, 2006, 190–1, 201.

notion of “strategic sectors” that are deemed vital for Russia’s recovery by the current leadership. This term seems to be rather elastic and may come to be applied to an ever-larger part of the economy.⁸⁰

Analysts point to the fact that the emerging “silovarchic” economic system has two important external components. First, “silovarchs” are eager to participate in the world market. Since their companies face little pressure to increase productivity, as they are able to lobby from inside for state favours, the weak domestic competition can partly be compensated by seeking competition in export markets. Second, the group of “silovarchs” might try to protect themselves by metamorphosing into international businessmen. Russia’s current ruling elite knows that militarised regimes cannot last long in countries at Russia’s level of development, given the high educational level of the population and no imminent external threat. Therefore, the “silovarchs” have to diversify into the global economy, mix the shares of their companies with those of Western investors, attract Western politicians onto their boards, and trade Russian products for Western ones. They hope that it would be impossible for a probable successor regime to prosecute them for corruption or expropriate their assets without international scandal. Although it might not seem morally appealing, Western policies towards Russia will have to recognise this approach of interweaving “silovarchic” companies into international business networks in order to stabilise the Russian economy and secure the country’s economic integration with the West.⁸¹

In 2005, Russian companies invested about US\$12.9 billion abroad. Nearly the same amount (US\$13 billion) had already been spent in the first half of 2006.⁸² Russian energy companies are eager to acquire shares in energy companies abroad, especially in the downstream distribution business in the EU. From Russia’s perspective, this is a matter of fair trade for which they are prepared to bargain hard.⁸³ In many European countries, however, politicians and business elites are hesitant about Russian investment in their economies. The President of the European Bank for Reconstruction and Development, Jean Lemierre, however, urges that the scepticism towards Russian investment in European economies must be replaced by long-term considerations of the value of competition and greater economic interdependence.⁸⁴

2.3. Regaining sovereignty and lost status

For centuries, the relationship with the West – today the United States and, to a lesser degree, the EU – has been central to Russia’s view of itself and of its position in the world. Therefore, any analysis of Russia’s foreign policy has to acknowledge the West’s critical significance in it. As some analysts put it, the West has been an important, powerful “Other”⁸⁵ throughout Russian history. This Other established the meaning-laden context, which has always exerted a decisive influence on the Russian “Self”.⁸⁶ Accordingly, Russian foreign policy has never been merely about enhancing power or modernising the country. Rather, it has always been about adapting to constantly changing global circumstances and, subsequently, achieving recognition by the significant Other. Hence, Russia’s leaders have always developed their strategic visions in the context of Russia’s relationship with the West.⁸⁷

The country’s geopolitical environment, size, history, and current problems prevent it from following the path of transition that the Central European countries chose when they leapfrogged over some

⁸⁰ Ibid, 209.

⁸¹ Treisman, Daniel, 2007, pp. 148–53.

⁸² Rosstat, “Платежный баланс Российской Федерации в 2005 г.” (Balance of payments of the Russian Federation, 2005), http://www.gks.ru/free_doc/2006/b06_13/24-01.htm; Beste, Ralf, Frank Dohmen, Michael Sauga, and Matthias Schepp, “Die Russen kommen,” *Der Spiegel*, 9 October 2006, p. 26.

⁸³ Trenin, Dmitri, “Russia Redefines Itself and Its Relations with the West,” *The Washington Quarterly* 30, no. 2 (2007): 99.

⁸⁴ Lemierre, Jean, “A Clear Long-term Strategy Is Needed,” *Financial Times*, 10 October 2006, p. 6.

⁸⁵ Neumann, Iver, *Russia and the Idea of Europe*, London: Routledge, 1996, quoted in Tsygankov, Andrei P., “New Challenges for Putin’s Foreign Policy,” *Orbis* 50, no.1 (Winter 2006): 153.

⁸⁶ Ibid.

⁸⁷ Tsygankov, Andrei P., 2006, p. 153.

stages in their development by becoming members of NATO and the EU.⁸⁸ Moreover, since the late 1980s there has been a marked shift in Russian attitudes towards “Western models”. At that time, the West was viewed as the norm and Russian politicians routinely promised a swift shift to “normality”.⁸⁹ But since then the popularity of pro-Western political movements in Russia has sharply declined. Further, among Russians – in particular among the youth – there is much less tolerance for Western criticism of their country’s political and economic choices.⁹⁰

Russia’s (regained) confidence in international relations rests on three pillars: energy, nuclear weapons, and the education level of Russian population. Next to its huge oil and gas reserves, the country of Russia maintains the world’s second-largest arsenal of nuclear warheads. Further, Russia has a traditionally high level of intellectual capital and a high-quality educational system that is an integral part of its rich cultural history. The Kremlin believes that education and knowledge will be the leitmotif of the new century. Accordingly, its leaders are convinced that Russia has the means to play a big role – it has got the brains to make competent use of oil and bombs and to avoid the mistakes of countries for which the era of knowledge has yet to begin.⁹¹

Although a certain legacy of the past can be found in Russia’s current foreign policy, it is also tremendously different from the Soviet and the Tsarist past. Today, Russia is one of the least ideological countries in the world. Business interests are central to the country’s foreign policy. Due to the focus on the country’s economic interests, energy prices are a matter of real importance, whereas values are only viewed as secondary or tertiary issues. In fact, under President Vladimir Putin the Russian state has turned into *Russia, Inc.* – a country ruled by people who are in control of the most important strategic industries, where corporate interests are behind most of the major policy decisions.⁹²

From this perspective, Russia’s relations with the EU are competitive but not antagonistic. In fact, in its relations with the EU, Russia wants to achieve a pragmatic business proposition that assumes the essential equality of two partners.⁹³ As the political elite still regrets the loss of superpower status after the demise of the Soviet Union, they want the West to accept that today’s Russia is not that of the early 1990s. Many Russian policy makers were disappointed by the failure of partnership with the West in the 1990s that could not bring about visible improvements in living standards or pacify military conflicts at the country’s periphery.⁹⁴ Since Russia wants to make the most of its dealings with Europe, which is its most important trade partner, it will continue to try to exploit the EU’s vulnerabilities and will further deal with the EU member states separately.⁹⁵

For the first time in its history, Russia is gradually becoming an economic power with a global reach, as it is emerging as a major player in the highly sensitive field of energy. Consequently, Russian leaders have developed a level of self-confidence that can only be compared to that of the early 1970s. By then, the Soviet Union had achieved strategic nuclear parity with the United States, while US troops suffered defeat in Vietnam. Consequently, from the current leadership’s perspective, Russia can no longer be viewed as “a poor ward of the West” as it is sovereign at last, “fiercely independent”, and

⁸⁸ Trenin, Dmitri, “Freedom, Not Democracy, for Russia,” *Project Syndicate*, 4 May 2005, <http://www.project-syndicate.org/commentary/trenin3>.

⁸⁹ Gvosdev, Nikolas K., “Russia: ‘European But Not Western?’” *Orbis* 51, no. 1 (Winter 2007): 139.

⁹⁰ Ibid.

⁹¹ Orlov, Vladimir A., and Miriam Fugufugosh, “The G-8 Strelna Summit and Russia’s National Power,” *The Washington Quarterly* 29, no. 3 (2006): 40–5.

⁹² Trenin, Dmitri, 2007, pp. 95.

⁹³ Ibid, pp. 95, 98.

⁹⁴ Tsygankov, Andrei P., 2006, p. 155.

⁹⁵ Trenin, Dmitri, 2007, pp. 95, 98.

on the way to becoming a power on par with others.⁹⁶ As a result, Russian leaders feel strong enough and can afford to quote a price for each concession they are now asked to make.⁹⁷

In his first term, President Putin showed commitment to the course of great-power normalisation or great-power pragmatism, which involved abandoning pseudo-integration at Russia's expense and the tough defence of national economic interests.⁹⁸ Yet in his second term Putin was confronted with a series of new challenges: the intensification of terrorist activities in the Northern Caucasus, the Orange Revolution in Ukraine, the destabilisation of Central Asia and the accession of Eastern European countries to the EU. The political context for foreign policymaking was thus fundamentally altered. Putin has responded to all these challenges without wavering from his course, but he was also never willing to sacrifice his country's relations with the West over these crises, nor did he let his readiness to stand for Russia's strategic interest become a direct confrontation.⁹⁹ Therefore, as long as the fundamentals of this self-confident approach remain in place, it can be expected that Russia's future foreign policy will continue to be global, assertive, and driven by the national interest as defined by the country's "silovarchic" elite.¹⁰⁰

Recently there have been symptoms of a growing rift between Russia and the West, mainly because of geopolitical rivalries in the post-Soviet space.¹⁰¹ Unfortunately, some of the present conflicts coincided with the redefining of Russia's national identity. Russia's national identity and self-esteem were lost after the demise of the Soviet Union in 1991. Currently, representatives of Russia's intellectual and political elite are struggling to find a new identity for Russia, based on a blend of elements of tsarism, communism and Stalinism. This combination may sound frightening to many in the West, but according to recent polls, Russians prefer to identify with a strong government at home and abroad and consider it central to the effort of regaining national identity. Furthermore, since many Russians still see themselves as surrounded by foes, a "strong government" also means military prowess that foreigners will respect or at least fear.¹⁰² Again, polls show that many Russians still harbour hostility towards the West, which is considered an enemy and a bearer of alien values. The United States is especially disliked, mainly because it has "usurped the global hegemony" that the Soviet Union once shared with it.¹⁰³ Consequently, after reviving the economy and securing the state's influence on strategic industries, Russians expect Putin and his successor to restore Russia's status as a military great power.¹⁰⁴

Russia's renewed self-confidence is also obvious from the development of its relations with Asian countries. Russia has reasserted its position in Northeast Asia and, at the same time, it is strengthening its cooperation with China and reviving its relations with India, and it is more actively than ever participating in regional multilateral organisations. Thus, Russia's ties with Asia are developing at three levels. They have a clear regional component, they acknowledge the rise of China and India, and they are also pursued multilaterally to cover the diverse networks of regional integration among Asian countries.

First, in recent years Putin has been pressing for a more significant role of Russia in Northeast Asia, based on the attractiveness of the country's energy resources, an image of revived state authority, and renewed military might. Subsequently, the three regional centres of diplomacy – China, Japan, and

⁹⁶ Ibid, p. 96.

⁹⁷ Ibid, p. 96.

⁹⁸ Tsygankov, Andrei P., 2006, p. 156.

⁹⁹ Ibid, pp. 157–9.

¹⁰⁰ Trenin, Dmitri, 2007, p. 98.

¹⁰¹ Tsygankov, Andrei P., 2006, p. 164.

¹⁰² Pipes, Richard, "Flight from Freedom: What Russians Think and Want," 2004.

¹⁰³ Ibid.

¹⁰⁴ Ibid.

South Korea – are also paying more attention to Russia’s intentions of influencing the region, unilaterally, bilaterally, and multilaterally.¹⁰⁵

Second, Russia is keen to engage more with both China and India. After the year 2006 was declared “The year of Russia” in China, with numerous economic fairs, cultural exchange and political statements, Russia is currently celebrating “The year of China”. Politicians from both countries frequently state that Sino-Russian relations have not been better since the late 17th century. Russia’s increased cooperation with China sprung basically from common needs and interests. Initially, it was developed as a defence against power politics and US unilateralism, but recently it has been emerging as a form of cooperation – in the field of energy in particular – that could strengthen each side’s international strategic and economic competitiveness.¹⁰⁶ Moreover, in order not to lose the Chinese market for energy exports to Central Asian countries, Russia is more and more interested in accelerating energy cooperation with China.¹⁰⁷ While fostering ties with China needed much good will and confidence building in the past, Russia’s leaders can rely on traditionally good relations with India. Under Putin, these ties have been reinforced and are now considered as “a top priority for Russia’s foreign policy”.¹⁰⁸ In the past, weapons were the main trade commodity between the two countries, but now their economic cooperation is also shifting to civil nuclear technology and Indian investments in Russia’s energy sector.¹⁰⁹

Third, Russia has a declared interest in more integration with the members of the Asia-Pacific Economic Cooperation (APEC). Russia has been member of APEC since 1998. President Putin has stressed Russia’s potential to become a transport link between East Asia and Europe. Further, the leadership views Russia’s participation in this economic forum as an important factor in the development of the eastern parts of the country.¹¹⁰ In 2012, the city of Vladivostok will host APEC’s annual summit. The emergence of Vladivostok as Russia’s regional centre in Northeast Asia coincides with the recent declaration of a development programme for the Russian Far East and Eastern Siberia, which was also cited during Putin’s visit to the city in January 2007. This development programme includes large investments in the energy sector and also envisages energy export to the Asian region. President Putin views energy as a means to integrate Russia into Asia’s regional economic network of free trade zones.¹¹¹ Judging from the dynamics of multilateral fora such as APEC and ASEAN as well as Russia’s eager participation, it is rather regrettable that the EU failed to integrate Russia into the ASEM process, as it is the biggest country in both Asia and Europe and a natural bridge between both continents.

Russia’s economic integration with its Asian neighbours and its cooperation with an ever stronger Asia will be one of the most important trends in the years to come. While political relations with the West have been deteriorating over the past few years, Russia is keen to diversify its diplomatic focus. The economic rise of Asia, driven by China and India, is a strategic imperative for Russia. In the future, relations with its neighbours in the east could balance Russia’s economic dependence on Europe, particularly in the field of energy. In the short term, any success at Russia’s eastern diplomatic

¹⁰⁵ Rozman, Gilbert, “Russia’s Resurgence in Northeast Asia: Views from the Region,” *russian analytical digest*, no. 25, 17 July 2007, p. 2.

¹⁰⁶ Voskressenski, Alexei D., “The Rise of China and Russo-Chinese Relations in the New Global Politics of Eastern Asia,” *Eager Eyes Fixed on Eurasia* 16, no. 2 (2007): 45.

¹⁰⁷ Handke, Susann, *Securing and Fuelling China’s Ascent to Power: The Geopolitics of the Chinese-Kazakh Oil Pipeline*. CIEP Energy Paper, The Hague: Clingendael Institute, August 2006, http://www.clingendael.nl/publications/2006/20060900_ciep_paper_handke.pdf.

¹⁰⁸ Quote by then Minister of Defense Sergey Ivanov; see “Russia-India Partnership Enters New Era,” *International Herald Tribune*, 24 January 2007, <http://www.ihf.com/articles/2007/01/25/news/india.php?page=1>.

¹⁰⁹ “Russia-India Partnership Enters New Era,” *International Herald Tribune*, 24 January 2007.

¹¹⁰ Putin, Vladimir V., “APEC: Russia’s Choice of Principle in the Asia-Pacific Region,” 17 November 2006, http://www.kremlin.ru/eng/speeches/2006/11/17/1236_type104017_113928.shtml.

¹¹¹ Vladimir V. Putin: “we intend to propose and carry out a number of specific infrastructure projects, namely, the construction of oil and gas pipelines to take energy resources from the eastern part of our country to the Asia-Pacific region. It is my view that APEC’s mechanisms can help resolve more effectively the task of ensuring reliable energy supplies to the region.” See Vladimir V. Putin, “APEC: Russia’s Choice of Principle in the Asia-Pacific Region,” 17 November 2006.

front will enrich Russian politicians' rhetoric and will be eagerly presented as renewed world-power prestige.

Undoubtedly, the fact that Russia's revival coincides with the economic rise of Asia and the strengthening of economic South-South cooperation makes the notion of multilateralism among Russian politicians ever more attractive. In a much-discussed speech in Munich in early 2007, President Putin demanded that the international community return to multilateral cooperation instead of US unilateralism.¹¹² In his view the unipolar model is "not only unacceptable but also impossible in today's world" because unilateral and frequently illegitimate actions conducted by "an almost uncontained hyper use of force" have not resolved any problems. Putin explicitly mentions the disrespect of international law, which is no longer "a stone wall" that protects everybody.¹¹³ Without referring directly to the 1999 NATO bombardments of Serbia, Putin definitely had in mind this watershed in the post-Cold War period with regard to the international norms about use of force. People who are regarded as "Russian liberals" in the West, such as former Prime Minister Yegor Gaidar, hold similar views. He also points to the Kosovo war as the very moment when Russians' perception of the West changed dramatically. He emphasises that there was no sense of anti-Americanism in Russia in the mid-1990s. Today, however, such views are commonly held not only among nationalists and conservatives, but also among many young educated people.¹¹⁴

The last president of the Soviet Union, Mikhail Gorbachev, also blames the United States for the worsening relations between the West and Russia. He points to the differences between the policy of former US President George H. W. Bush towards Russia and the way the current Bush Administration is engaged in "building of a new empire" by interfering in the post-Soviet space and other countries. Gorbachev stresses that, while Russia "is ready to be constructive", the US is squeezing it out of global diplomacy.¹¹⁵

Due to its economic recovery, a strong Russia is here to stay. This is what all Russian politicians envision for their country's future. How Russia's internal development will proceed will be increasingly decided within Russia, while foreign policy choices will be made according to the economic and strategic needs of the country and not to please any of the country's partners. Therefore, the EU should learn to live with this self-confident and self-assertive neighbour. This new reality might seem puzzling and uncomfortable to Western policy makers who experienced Russia's decline in the 1990s. But above all, Western policy makers and politicians should "avoid giving the impression that what they really object to is not an illiberal and undemocratic Russia but a strong and rich one".¹¹⁶

¹¹² Putin, Vladimir V., "Speech at the 43rd Munich Conference on Security Policy," Munich Conference on Security Policy, 10 February 2007, http://www.securityconference.de/konferenzen/rede.php?menu_2007=&menu_konferenzen=&id=179&sprache=en&.

¹¹³ Ibid.

¹¹⁴ "Интервью: Егор Гайдар – 'У моих американских коллег бледнеют лица и отвисают челюсти'" (My American colleagues' faces have paled and their jaws have dropped), *Vedomosti*, 16 July 2007, <http://www.smoney.ru/article.shtml?2007/07/16/3353>.

¹¹⁵ Mikhail Gorbachev in an interview with the BBC broadcast on 4 June 2007.

¹¹⁶ "Living with a Strong Russia," *The Economist*, 15 July 2006, p. 9.

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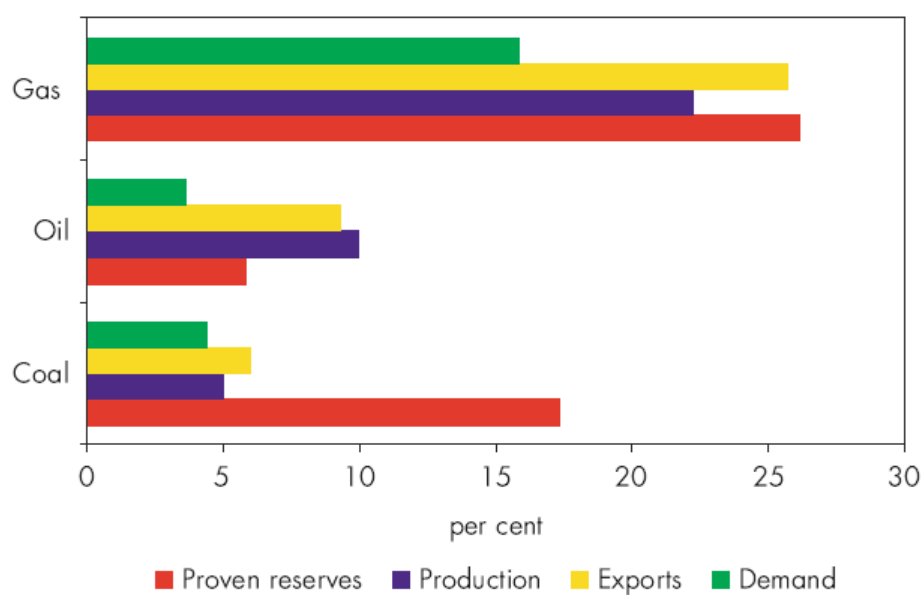
Russian energy: The state in control

This section provides a brief overview of recent developments in Russia's energy sector. First, the state of the most important sectors – gas, oil, electricity, and nuclear energy – as well as Russia's energy-efficiency policy will be assessed. Then, the current leadership's energy policy, especially with regard to gas exports, will be discussed.

3.1. Russian energy sectors

Russia is one of the world's largest energy producers and will continue to play a central role in global energy supply and trade in the near future. The country holds the world's largest natural gas reserves (about 30% of global gas reserves), the eighth largest oil reserves (9%), and the second largest coal reserves (17%). Nearly 90% of Russia's natural gas and 70% of its crude oil are produced in Siberia.¹¹⁷ The country's main centres of economic activity are located in the European part of Russia and the Urals. Moreover, most exports are directed towards Europe. Thus, the geographic location of its energy riches and the transportation to the consumers has always been a big challenge for Russia's economy. This sub-section gives an overview of the main characteristics of Russia's energy sectors.

Figure 3.1 – Russia's share of world energy, 2000



Source: International Energy Agency, *World Energy Outlook 2004*. Paris: OECD/IEA, 2004, p. 285.

¹¹⁷ Bundesagentur für Außenwirtschaft, "Energiewirtschaft: Russland 2006," 2006, pp. 1, 3, 4; International Energy Agency, *World Energy Outlook 2004*. Paris: OECD/IEA, 2004, p. 283; US Government Energy Information Administration, "International Energy Outlook 2006: World Coal Markets," June 2006, <http://www.eia.doe.gov/oiaf/ieo/coal.html> ; Milov, Vladimir, "Russian Energy Sector and Its International Implication," 30 March 2005, <http://www.energypolicy.ru/files/TokyoPaper-March30.2005.pdf>, pp. 6, 14.

The Gas sector

Russia is the world's largest natural gas producer (2005: 636 billion cubic metres) and the world's largest gas exporter (2005: 205 billion cubic metres, without transit). About 144 billion cubic metres were exported to non-CIS countries.¹¹⁸ Gazprom – the world's biggest gas company – dominates the Russian gas sector. The Russian state owns 51% of this company, which contributes a share of about 25% to the state's budget revenues. Gazprom controls 95% of Russia's gas resources, produces 86% of the country's gas, and owns a network of pipelines of about 150,000 km. In March 2006, a plan to restructure the company was presented. The restructuring aims at separating Gazprom's many subsidiaries from its core business. If this plan can be implemented, it could help increase the transparency of this vast and complex company. Gazprom's network of pipelines, however, will remain under state control.¹¹⁹

Gazprom will need to boost its production and secure reliable export routes to Europe in order to fulfil its long-term aim of increasing European sales. However, at the moment Gazprom is unable to maintain production growth, unlike private producers such as Itera and Novatek.¹²⁰ Recently, the Minister for Economic Development and Trade, German Gref, warned that the gas sector's insufficiencies could lead to gas shortages in the near future.¹²¹ Gazprom's annual investments have been in the order of US\$7 to 8 billion since 2003. In 2005, its management board approved an increase of more than 40% in its investment programme, to US\$10.8 billion. Yet much of the increase is directed to the Nord Stream project. According to IEA's estimate in its *2003 World Energy Investment Outlook*, US\$11 billion per year are required to bring on new sources of gas and to upgrade and maintain gas infrastructure. In general, the International Energy Agency is concerned about the priority Gazprom seems to be placing on foreign acquisitions and export infrastructure as opposed to its domestic network and upstream infrastructures.¹²² Gazprom will also have to make enormous investments in the near future in order to cope with the falling gas production at older fields. In addition, before gas production on the Yamal peninsula can start, an investment of about US\$70 billion will be necessary. The costs for producing on the Yamal peninsula will be seven to ten times higher than at the fields Urengoi and Yamburg.¹²³

The Russian state uses its control of Gazprom and its influence on the company's business policies to realise its own industrial and social policies. The gas price on the domestic market is still regulated by the state. Despite frequent attempts by Gazprom to force the state to increase the gas price, it is still obliged to sell more than two-thirds of its production for less than US\$40 per 1,000 cubic metres on the domestic market, compared to more than US\$200 per 1,000 cubic metres for exports to Europe. This has a very negative impact on the company's capacity to invest in the development of Russia's arctic gas fields.¹²⁴

Moreover, Gazprom wants to expand its networks of pipelines in order to ship gas directly to its customers in Western Europe, avoiding the transit fees and political risks linked to the transit through third countries. At the moment, most of the gas is transported to Europe through the pipeline system in Ukraine and the Yamal-West Europe pipeline. The construction of the Nord Stream pipeline will increase Gazprom's export capacity to Western Europe. Further, Gazprom plans to expand its

¹¹⁸ Bundesagentur für Außenwirtschaft, "Energiewirtschaft Russland 2006" (Russia's energy sector 2006), 2006, http://www.bfai.de/ext/anlagen/PubAnlage_1980.pdf, p. 26.

¹¹⁹ Ibid, pp. 27–8.

¹²⁰ Milov, Vladimir, 2005, p. 9.

¹²¹ "Через два года в России может возникнуть кризис газоснабжения" (There could be a gas crisis in Russia within two years), *RIA Novosti*, 6 September 2006, <http://rian.ru/economy/resource/20060906/53579559.html>.

¹²² International Energy Agency, *Optimising Russian Natural Gas: Reform and Climate Policy*. Paris: IEA, 2006, p. 29.

¹²³ Mitrova, Tatyana, and Yakov Pappe, "Газпром: от 'большой трубы' к большому бизнесу," *Pro et Contra* 32, nos. 2/3 (2006): 73–6.

¹²⁴ Bundesagentur für Außenwirtschaft, 2006, p. 28.

domestic network, especially in East Siberia and the Far East. Recent plans also call for the fastening of the construction of export facilities to East Asia.¹²⁵

Gazprom wants to become a global company and aims at diversifying its business and expanding into retail markets. The company views the liberalisation of European gas markets as a good opportunity to realise this strategy. The company mainly focuses on Germany, Italy, the United Kingdom, and the several Balkan countries. Gazprom is especially eager to expand into the profitable retail business in Europe.¹²⁶

The Oil sector

Russia is the world's second largest producer of oil. In 2005, it produced 469.6 million tonnes (9.43 million barrels a day). After the demise of the Soviet Union in 1991, Russia's oil production fell precipitously and reached a low of roughly 6 million barrels a day in the mid-1990s. The turnaround in oil output began in 1999. Since 2000, the production of oil has increased considerably as new technologies – provided by firms such as Halliburton and Schlumberger – have been applied. Some analysts also attribute the rebound in production to the privatisation of the industry that clarified investment incentives and contributed to more efficient production methods. In the upcoming decade, a few oil fields will contribute to most of Russia's supply growth and others will contribute to decreasing production from mature fields. New field development will have to produce almost all of Russia's annual oil growth in the next five years and will likely produce more than half of the country's oil in 2020.¹²⁷ However, the divestiture of YUKOS has caused a “strategic pause” in investment decisions. This will have a serious effect on upstream growth in the next few years.¹²⁸

In the short to medium term, inadequate export infrastructure will limit production growth. Oil production will grow from 8.5 million barrels a day (b/d) to 10.4 million b/d by 2010. However, production is expected to rise much more slowly in the next decade. Net exports of crude oil and refined products are projected to rise from 5.6 million b/d in 2003 to 7.3 million b/d in 2010. Soon after 2010, exports will start to decline gradually as domestic demand will outstrip the increase in production. In general, production and export trends will remain highly sensitive to oil prices, costs, and taxes.¹²⁹

There has been a profound shift in relations between the oil industry and the state since 2003. The private company LUKOIL is Russia's largest oil producer with about 87 million tonnes (1.8 million b/d) in 2004 and holds the largest oil reserves (16 billion barrels). The second largest producer is the Russian-British joint venture TNK-BP. After the acquisition of Yuganskneftegaz, Rosneft could increase its share in Russia's oil production from 4.5% in 2004 to 17% in 2005 and plans to further increase its share to 25% of Russia's crude oil production. Since the acquisition of Sibneft by Gazprom, about 40% of Russia's oil production has been controlled by the state. Foreign firms hold a share of about 10%. However, recently foreign oil producers complain about a less favourable business climate as authorities have rejected or are threatening to withdraw development licences.¹³⁰

Russia's main export pipeline is the Druzhba pipeline through Belarus and Poland. Other exports are realised by seaborne shipments (from Novorossiisk and some ports at the Baltic Sea) and by train to China. Crude oil exports via pipeline fall under the exclusive jurisdiction of Russia's pipeline monopoly of the state-owned firm Transneft. In 2005, Russia exported about 90% of its oil to non-CIS

¹²⁵ Ibid.

¹²⁶ Mitrova, Tatyana, and Yakov Pappé, 2006, pp. 73–6; Bundesagentur für Außenwirtschaft, 2006, pp. 31–3.

¹²⁷ Energy Information Administration, “Country Analysis Briefs: Russia,” 2006, <http://www.eia.doe.gov/emeu/cabs/Russia/Electricity.html>.

¹²⁸ Milov, Vladimir, 2005, p. 12.

¹²⁹ International Energy Agency, *World Energy Outlook 2004*. Paris: OECD/IEA, 2004, p. 300

¹³⁰ “Regierung erhöht Druck: Ausländische Ölförderer haben es in Russland schwer” (The government increases the pressure: foreign oil producers in Russia face difficult times) *Handelsblatt*, 6 September 2006, http://www.handelsblatt.com/news/Unternehmen/Industrie/_pv/_p/200038/_t/ft/_b/1132064/default.aspx/auslaendische-oelfoerederer-haben-es-in-russland-schwer.html.

countries. The main export destination for Russian oil is Europe. In the future, about 30% of total exports should go to Asia. The construction of the Taishet-Skovorodino-Nakhodka pipeline (East Siberia-Pacific Ocean pipeline) will increase Russia's capacity to deliver oil to East Asia. The planned Burgas-Alexandroupolis pipeline will increase Russia's export capacity to the Mediterranean region.¹³¹

Russian oil companies will have to make major efforts to develop new oil fields. The current exploited onshore oil fields are declining. As more than 75% of the proven reserves are already being exploited, Russian oil companies will increasingly have to develop offshore oil fields that are located beneath the continental shelf of the arctic Barents and Kara Seas. Analysts estimate that investments of up to €100 billion will be needed to realise these plans. Recent investments are insufficient to keep up with increasing domestic demand and to compensate the depletion of the old fields.¹³² Due to Russia's choice to change existing production-sharing agreements and discourage foreign investment in strategic sectors, it is unlikely that foreign oil companies will be willing or able to make up for the rest of the needed investments.

The Electricity and District heating sectors

Russia's power sector has a total electric generation capacity of 213.6 gigawatts and reached an output of about 952 billion kWh in 2005. Electricity generation declined by 18% between 1992 and 1999. Thereafter, a gradual recovery began – up 8% between 1999 and 2004. Thermal power – fired by gas (60%), coal (25%), and oil (15%) – accounts for about 63% of Russia's electricity generation, followed by hydropower (21%) and nuclear energy (16%). The share of natural gas in Russia's power generation should be decreased in the next few years in order to free up capacity for export. The share of coal and nuclear energy should be increased accordingly. Russia has about 440 thermal and hydropower plants. There are seven separate regional power systems in the Russian electricity sector: – Northwest, Centre, Middle Volga, North Caucasus, Urals, and Siberia regions. Only the Far East is not connected to an integrated power system.¹³³

RAO Unified Energy System (RAO UES), in which the Russian state holds a majority of 52.68%, owns 400 power stations and employs about 670,000 people. The electricity giant generated about 665.4 billion kWh in 2005. The company accounts for 70% of Russia's overall electricity generation. It also owns 96% of the transmission and distribution system, the central dispatch unit, and the federal wholesale electricity market. There are some independent regional electricity companies. As part of the reform of the electricity sector, new companies have been established that will gradually be privatised.¹³⁴

As part of the reform of the electricity market, a new liberalised model of the wholesale and retail electric power (capacity) markets was launched in September 2006. Additionally, earlier plans were approved to attract foreign and Russian capital (about US\$79 billion) into power generation.¹³⁵ Under the new wholesale market model, the existing power and capacity purchase-and-sale relations in the regulated market sector are to be replaced by a bilateral contract system. Moreover, the new model provides for other competitive mechanisms for power sales, such as trading at free unregulated prices under free bilateral contracts, a short-term competitive market with supplies on the following day, and a real-time market (or balancing market). The liberalisation of the market will take place by gradually reducing the power volumes (5% in 2007) traded under regulated bilateral contracts. Starting in 2007, all new generating facilities will automatically participate in the wholesale market at free unregulated

¹³¹ Bundesagentur für Außenwirtschaft, 2006, pp. 11–3.

¹³² Ibid, p. 14.

¹³³ In 1990, Russia's electricity output reached 1.080 billion kWh; such production levels will only be reached again in 2010 and 2015. See Bundesagentur für Außenwirtschaft, 2006, p. 46; Energy Information Administration, "Country Analysis Briefs: Russia," 2006.

¹³⁴ Bundesagentur für Außenwirtschaft, 2006, p. 45.

¹³⁵ "Russia Launches \$79bn Electricity Funding Drive," *Financial Times*, 5 September 2006, p. 6.

prices. The formation of a competitive electricity market is an indispensable condition for the attraction of private and foreign investments in the development of the Russian electricity sector.¹³⁶

At the moment, the chairman of RAO UES, Anatoly Chubais, is eagerly trying to find foreign investors for several large wholesale electricity companies (called “OGKs”) and more than 21 power generations companies, which have been created during a big restructuring of the electricity monopoly. The share in RAO UES that is currently held by the state will be transferred to two companies, the Federal Grid Company and the Hydro-OGK, which will both remain state-controlled after RAO UES ceases to exist in mid-2008. The wholesale electricity market will be completely liberalised. Then, the retail electricity market will gradually be liberalised. During the privatisation process, RAO UES will not only be interested in capital but also in concepts that could help enhance the efficiency of the companies. According to the Minister of Energy, Victor Khristenko, about €57 billion have to be invested in the sector until 2010. The Italian company ENEL has already acquired a stake in one of the offered companies. However, other big European companies are rather reluctant.¹³⁷

Russia exports significant quantities of electricity to neighbouring countries and plans to increase these exports, especially to China. However, Unified Energy System is increasingly unable to satisfy growing domestic demand. After severe power shortages in winter 2005/6, the chairman of RAO UES Anatoly Chubais had already warned that industrial customers in 16 regions would face power shortages in the winter 2006/7.¹³⁸ Fortunately, the warm winter could prevent the occurrence of very severe shortages this time. Still, energy demand is growing about 50% more rapidly than predicted in the documents on which the *Energy Strategy* of the Russian government was based.¹³⁹ Thus, huge investment efforts have to be made to modernise the existing infrastructure and satisfy increasing demand.

The market for heating is one of the biggest markets in the country. It has an annual turnover of about US\$30 billion. However, the structure of this market is rather dispersed as it is divided into 5,000 local markets. Estimates suggest that about US\$10 billion could be saved annually by using more efficient technologies in the district heating systems. There are a lot of district heating systems with various degrees of centralisation. About 80% of the heat in Russia is provided by district heating systems. Some centralised district heating systems even provide 100% of a city’s heat. In general, heat pipes are located underground in concrete tunnels. Currently, there are 257,000 km of heat pipes – 25,000 km heat main pipes and 232,000 km distribution pipes. About 16% of the total heat that is generated is lost annually. There is an urgent need to repair the heat pipes because average heat pipes deterioration in Russia is estimated at 55 to 65%, and in some cities at almost 100%. Some smaller projects have already been set up with the World Bank, US AID, Honeywell, and Gas de France in order to enhance the efficiency of these systems.¹⁴⁰ In spring 2005 the structures of the payments for heating and water for private consumers were reformed.¹⁴¹ However, it will still require much effort to modernise the entire infrastructure of the distribution system so as to gain from these reform measures.

¹³⁶ RAO UES, “New Liberalized Model of Wholesale and Retail Electric Power (Capacity) Markets Launched in Russia,” 1 September 2006, http://www.rao-ees.ru/en/news/pr_depart/latest_pr/show.cgi?010906new.htm; Energy Information Administration, “Country Analysis Briefs: Russia,” 2006.

¹³⁷ Wiede, Thomas, and Katharina Kort, “Russland lockt Stromkonzerne” (Russia lures foreign electricity companies) *Handelsblatt*, 27 September 2006, http://www.handelsblatt.com/news/Unternehmen/Industrie/_pv/_p/200038/_t/ft/_b/1141383/default.aspx/russland-lockt-stromkonzerne.html; Energy Information Administration, “Country Analysis Briefs: Russia,” 2006; Bundesagentur für Außenwirtschaft, 2006, p. 56.

¹³⁸ “Anatoly Chubais Makes Energy Cutoff List,” *Kommersant*, 14 September 2006, <http://www.kommersant.com/page.asp?id=704765>.

¹³⁹ Bundesagentur für Außenwirtschaft, 2006, p. 47.

¹⁴⁰ Center for Energy Efficiency, “District Heating: US Technologies on the Russian Market,” <http://www.ita.doc.gov/td/energy/gustm-1.htm>; Bashmakov, I. A., and V. N. Papushkin, “Разработка программ развития, модернизации и реабилитации систем теплоснабжения” (Study on the development programmes, modernisation, and restoration of the heating systems), <http://www.cenef.ru/info/books/HMAO.pdf>.

¹⁴¹ Bundesagentur für Außenwirtschaft, 2006, p. 45.

The Nuclear Energy sector

At the moment, Russia possesses ten nuclear power plants; eight of these power plants are located in the European part of Russia. Rosatom, the federal agency in charge of the nuclear sector, intends to expand the role of nuclear generation in the future to satisfy increasing domestic demand for electricity and to allow for greater export of fossil fuels. Currently, the share of nuclear energy in Russia's power generation is 16 to 17%.¹⁴² The government wants to raise this share to 25% by 2030.¹⁴³

At the moment, Russia has an installed nuclear capacity of 23.2 GW. However, many nuclear-power facilities are aging. The working life of a reactor is considered to be 30 years. Most of the plants, however, are already older than 20 years. Therefore, Russia plans to construct five new units at existing facilities throughout the country by 2010. According to the Ministry of Atomic Energy, nuclear generation could reach 300 billion kWh per year, doubling the level of 2003. The federal agency Rosatom considers allowing the participation of private investors, because the Russian state cannot finance the entire costs of all five new power stations. The governments of the regions are interested in participating in such projects because they would then be able to guarantee stable electricity supply in their localities. Furthermore, Gazprom also plans to invest in nuclear power stations in order to limit the increase of Russia's gas consumption, which could help fulfil the company's export obligations.¹⁴⁴

Energy Efficiency policy

Russia is the world's third-largest energy consumer. The energy intensity of Russia's economy is twice as high as in countries with similar climatic and geographic conditions. Due to the robust growth of the Russian economy, the country's energy demand will continue to recover steadily from the lows reached at the end of the 1990s. Accordingly, the government expects that Russia's energy consumption will increase by 20% by 2020.¹⁴⁵ In its *Energy Strategy*, the government states that it will triple the GDP with only a 40% increase in energy consumption. The government wants to accomplish this goal by implementing technological and organisational energy-saving measures, as well as promoting structural changes in the economy. From 2000 to 2004, the energy efficiency of the Russian economy decreased more rapidly than expected, due to the strong growth of low energy intensive sectors.¹⁴⁶

Russia has an enormous potential for energy savings. Further, it can realise much of this potential at relatively low cost; about 20% of the energy savings potential can be achieved for as little as US\$20-50 per tonne of coal equivalent. The most important measures that would help save energy are the reduction of flared gas at Russian oil wells and the subsequent conversion of this gas to energy, the prevention of losses in natural gas transmission and distribution, the promotion of efficiency of oil refineries, the modernisation of outdated power plants, and the reform of the domestic heating system. Moreover, Russia's industry still employs technologies that are far more energy intensive than modern equipment used in other industrialised countries. Finally, about one third of Russia's potential to save energy lies in the public and housing sector. However, due to institutional barriers such as ownership questions, tariffs and metering/billing issues, this potential remains almost untapped.¹⁴⁷

Gazprom as the biggest gas producer has also a great potential. On the one hand, it could benefit from energy savings on Russia's domestic market, where it must sell gas at regulated prices that are much

¹⁴² In the European part of Russia, the share of nuclear energy is about 30%. See Bundesagentur für Außenwirtschaft, 2006, p. 30.

¹⁴³ Ibid, p. 37.

¹⁴⁴ Ibid, p. 38.

¹⁴⁵ Ibid, p. 5

¹⁴⁶ Opitz, Petra, "Energy Savings in Russia – Political Challenges and Economic Potential," *russian analytical digest*, no. 23, 19 June 2007, <http://se1.isn.ch:80/serviceengine/FileContent?serviceID=7&fileid=E97C8CEF-87D1-D8C6-53EA-0991B4B6BA3B&lng=en>, p. 5.

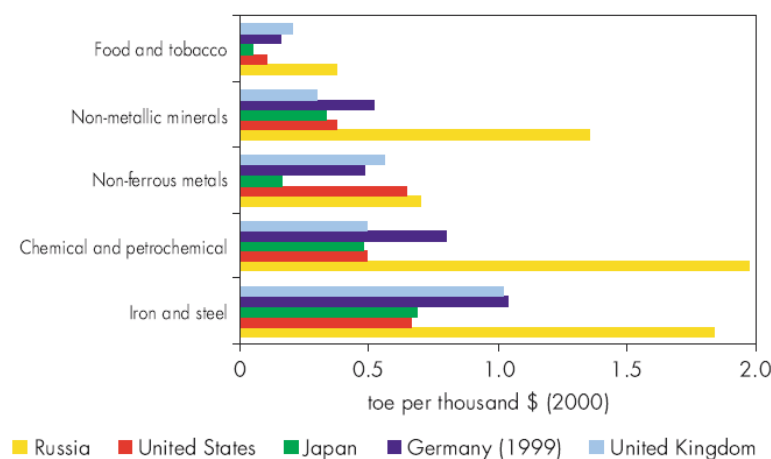
¹⁴⁷ Ibid, pp. 5–6.

lower than world prices. On the other hand, the future of its exports depends on its ability to save energy.¹⁴⁸ Greater gas efficiency would free up incremental gas for export, enhancing the security of export supply. At the moment, there is no need for Gazprom to consider energy efficiency issues in order for it to obtain additional capacity. But as soon as energy saving on the domestic market costs less than exploring and developing new fields or buying gas from Central Asia, Gazprom will have to consider this option.¹⁴⁹

The reform of gas prices is essential to increasing energy efficiency for the Russian economy as a whole. Gas prices increased by about 70% on average in real local currency terms between 2000 and 2004. However, there are considerable barriers to investments in energy efficiency, such as lack of information, technical, personnel and investment resources. More specifically, Russia's efficiency-investment barriers include low energy prices, monopolistic structures and the lack of consumer control and metering equipment, coupled with a system of billing that provides little incentive for efficiency. Due to the size of the country and the structure of the Russian electricity and heating sector, a regional approach to energy efficiency is essential for the success of energy-efficiency projects.¹⁵⁰

The energy intensity of the Russian GDP is two or more times higher than that of rich Western European countries or the United States. In fact, the sectoral makeup of Russian industry and its obsolete equipment and technologies do not meet international standards of energy saving and lead to huge fuel and energy losses. Due to the high level of its energy consumption, the Russian economy is relatively uncompetitive. The Russian economy is consuming over 0.5 kg of oil equivalent per US dollar of GDP (by PPP), compared to 0.1 to 0.2 kg in most of the industrialised and emerging countries. Additional efforts will be necessary to satisfy growing domestic energy consumption if the economy continues to grow at the current pace.¹⁵¹

Figure 3.1 – Energy intensity of industrial production in selected sectors and countries, 2000*



* energy consumption in tonnes of oil equivalent per thousand US dollars of value added, adjusted for PPP

Source: "Russian Oil and Gas Production," *russian analytical digest*, no. 18, 3 April 2007, p. 10.

¹⁴⁸ Bashmakov, I. A., "Энергетическая эффективность в России и перспективы экспорта российского газа" (Energy efficiency in Russia and perspectives for the export of Russian gas), <http://www.cenef.ru/info/books/GasExportsProspects.pdf>, p. 5; Opitz, Petra, "Energy Savings in Russia – Political Challenges and Economic Potential," *russian analytical digest*, no. 23, p. 6.

¹⁴⁹ Opitz, Petra, "Energy Savings in Russia – Political Challenges and Economic Potential," *russian analytical digest*, no. 23, 19 June 2007, p. 7.

¹⁵⁰ International Energy Agency, *Optimising Russian Natural Gas: Reform and Climate Policy*. Paris: IEA, 2006, pp. 41–3.

¹⁵¹ Volkonskii, V. A., and A. I. Kuzovkin, "Energy Intensity and Energy Efficiency of the Russian Economy: An Analysis and Forecast," *Studies on Russian Economic Development* 17, no. 1 (2006): 35.

Russia's *Energy Strategy* acknowledges the critical importance of energy efficiency and conservation in improving the competitiveness of the country's economy and in freeing up supplies for export. The potential for energy savings is huge, especially in industry, power generation, and buildings. The installation of meters and thermostats for gas and heat supplies is critically important to conserving energy and promoting the development of more efficient boilers and heat plants. All regional energy-efficiency laws include requirements for compulsory metering, but the pace of meter installation varies widely. However, these measures will only be effective after the implementation of price reforms.¹⁵²

The Russian government wants to increase the use of coal in the heat and power sector in order to lower dependence on gas in the fuel mix. Accordingly, the share of coal in the fuel balance needs to increase from about 20% in 2000 to 21–23% in 2020. This increase will be matched by a decrease in the shares of natural gas and oil in order to meet growing electricity and heat demand and increase energy efficiency.¹⁵³ Due to price reforms, changes in the structure of the economy and investment in more efficient technology, energy demand will grow much more slowly than Russia's GDP.¹⁵⁴ Additional incentives could definitely promote energy conservation in Russia and tap into the country's enormous potential. However, as Western practice has shown, improving energy efficiency requires a strong political will to implement an adequate legal and economic framework.¹⁵⁵ But there are few politicians in Russia who have such issues on their agendas.

3.2. Russia's energy policy

In 2006 Russia exported 148.4 billion cubic metres of natural gas, 4 million barrels a day of crude oil and more than 2 million barrels a day of oil products. About 65% of Russian fossil fuel exports went to non-CIS countries. Europe is still Russia's most important market. It is expected that European demand for gas imports will increase. Although demand for oil and gas on this market will not grow considerably, the demand for gas imports will grow in the near future due to declining gas production in the EU and increased use of gas in the power sector.¹⁵⁶ As Russian energy policy has an important external component, this sub-section will summarise the main features that are crucial to understand the country's energy cooperation with its foreign partners, especially the area of natural gas.

Despite the good prospects for gas export to Europe, Russian politicians and representatives of the energy companies frequently demand that Russia should diversify the direction of its oil and gas exports towards the Asia-Pacific and North America, where net imports are growing more rapidly. This is part of the often-cited notion of "security of demand". Thus far, the Eastern Siberian-Pacific Ocean oil pipeline that is now being constructed from Taishet to Perevoznaya is the only pipeline that is not directed towards Europe. But it will not significantly help oil producers in western Siberia to diversify their crude oil export markets. Oil reserves in eastern Siberia will be used to fill the pipeline. Exports of liquefied natural gas also face an infrastructure problem. At the moment, Russia is still not able to produce liquefied natural gas.

In 2030 Russia will still be the world's biggest gas exporter. In the meantime, however, Gazprom might increasingly rely on imports from Central Asia, which allow it to put off the development of its own reserves. The prospects for Russian oil production are very uncertain. Production will continue to increase. Most of the increase in the short to medium term will be available for export. But the share

¹⁵² International Energy Agency, 2004, p. 294.

¹⁵³ International Energy Agency, *Russia Energy Survey 2002*, Paris: OECD/IEA, 2002, p. 149.

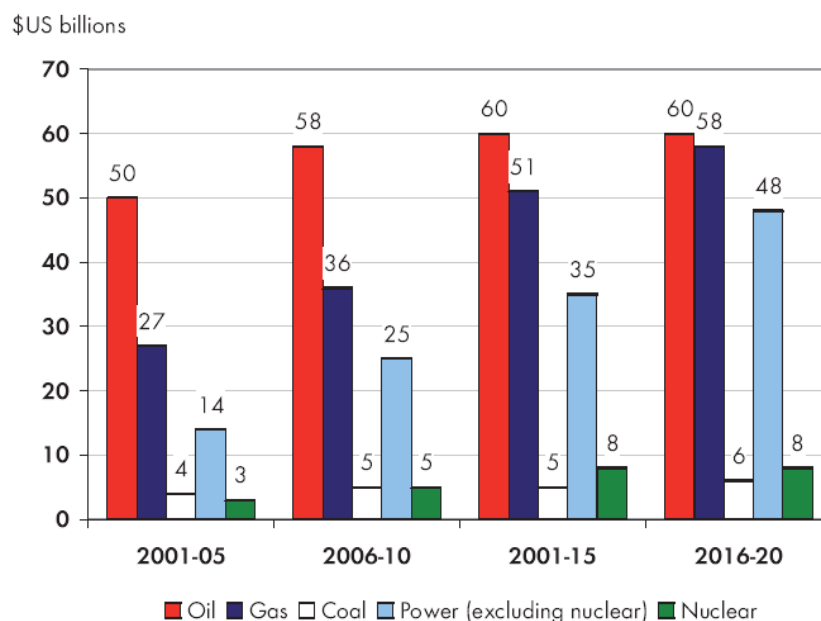
¹⁵⁴ International Energy Agency, 2004, p. 283.

¹⁵⁵ Opitz, Petra, 2007, p. 7.

¹⁵⁶ Energy Information Administration, "Country Analysis Briefs: Russia," 2006; Milov, Vladimir, 2005, pp. 6, 14; Van der Linde, Coby, and Christoph Tönjes, "Erdgas, EU-Versorgungssicherheit und Geopolitik" (Natural gas, EU security of supply and geopolitics), *DVGW Jahresrevue*, no. 12 (2004), http://www.clingendael.nl/publications/2004/20041200_art_vanderlinde.pdf, p. 5.

of Russian oil exports in world trade will fall back after 2010. In total, developing Russia's huge energy resources will call for investment of more than US\$900 billion between now and 2030.¹⁵⁷

Figure 3.1 – Investment required according to the Energy Strategy, 2003 (minimal estimate)



Source: "Russian Oil and Gas Production," *russian analytical digest*, no. 18, 3 April 2007, p. 10.

In addition to generating these huge investments, Russia faces another big challenge: the reform of its domestic energy sector. Thus far, reform has not yet seriously started, at least not in an integral way. This hampers investments in the domestic energy sector. As long as gas is subsidised, investments in the development of other energy sources will not be profitable. Gas has a share of 54% in Russia's primary energy mix. Even if nuclear and coal can replace some of the gas consumption, which is a key ambition of Russia's current energy policy, domestic demand for gas will still increase in the near future. If production levels continue to stagnate, rising demand would leave less gas available for export.¹⁵⁸

Furthermore, Russia wants to export more gas to Asia. A recent proposal by Gazprom envisions the gasification of Eastern Siberia and the Russian Far East,¹⁵⁹ which will be realised by developing new gas fields in these regions. The programme explicitly allows for the sale of the excess production to Asian countries – about 20 to 50 billion cubic metres by 2020. The realisation of the programme will

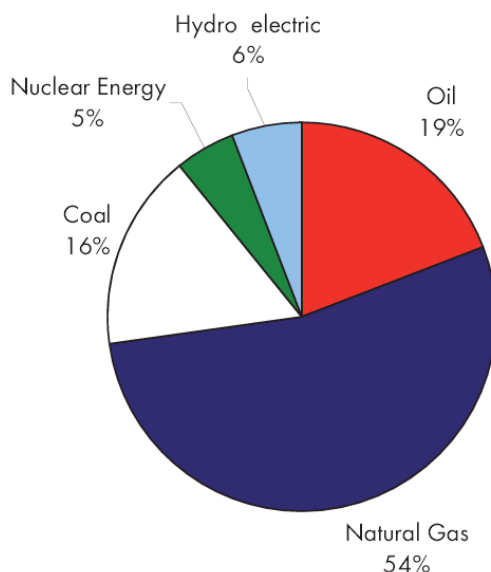
¹⁵⁷ Bundesagentur für Außenwirtschaft, 2006, pp. 1, 3, 4; International Energy Agency, 2004, p. 283; US Government Energy Information Administration, "International Energy Outlook 2006: World Coal Markets," June 2006, <http://www.eia.doe.gov/oiaf/ieo/coal.html>.

¹⁵⁸ Perovic, Jeronim, and Robert Orttung, "Russia's Energy Policy: Should Europe Worry?," *russian analytical digest*, no. 18, 3 April 2007, <http://se1.isn.ch:80/serviceengine/FileContent?serviceID=PublishingHouse&fileid=3BD26965-750E-6427-C2D9-EF15A3D54DF4&lng=en>, p. 4.

¹⁵⁹ This proposal is in line with the plans of the Ministry of Industry and Energy for the development of Russia's eastern regions, see "Минпромэнерго России направило в Правительство РФ доклад 'О формировании транспортной и энергетической инфраструктуры в регионах Сибири и Дальнего Востока'" (The Ministry of Industry and Energy has submitted the 'Report on the establishment of transport and energy infrastructure in the Siberia and the Far East'), *RosInvest.Com*, 22 May 2006, <http://www.rosinvest.com/news/197436/>; Ministry of Industry and Energy of the Russian Federation, "Миссия Дальнего Востока: Власть и бизнес призваны объединить усилия" (Mission Far East: The state and private business are called upon to make joint efforts), 25 June 2007, <http://www.minprom.gov.ru/pub/118>.

cost up to US\$95 billion before 2030.¹⁶⁰ Actual costs might even be much higher mainly because of rapidly increasing costs of materials.

Figure 3.2 – Russia’s primary energy consumption by source, 2005



Source: “Russian Oil and Gas Production,” *russian analytical digest*, no. 18, 3 April 2007, p. 10.

Another important factor in Russia’s planning is the continuing flow of gas from Central Asia. Thus far, it has been much cheaper for Russia to buy up Central Asian gas than invest in expensive fields along the coast of the Arctic Ocean. Most of the pipeline infrastructure was built in the Soviet era, connecting Central Asia’s gas producing regions with the European part of the Soviet Union. Therefore, Central Asian gas still has to go through Russia to reach export markets. Until now, the Russia-centred pipeline infrastructure compelled Central Asian countries to sell their gas to Russia. At the moment, Gazprom buys about 60 billion cubic metres a year from the region. The company pays US\$100 per thousand cubic metres from Turkmenistan, which is its largest supplier in the region. However, Turkmenistan is eager to diversify its export. In July 2007, President Gurbanguly Berdymukhammedov signed an agreement with China on the construction of a gas pipeline and the supply of 30 billion cubic metres of natural gas for a period of 30 years. Berdymukhammedov reassured Russia that there would be enough gas for both Russia and China. But with Turkmenistan having several pipeline options, Gazprom will face tough price negotiations.¹⁶¹

Russia’s energy policy touches many different issues: the country’s internal economic development, the organisation of its energy sectors, the relations with both the supplier and transit countries of the former Soviet Union, as well as those with its main clients in Europe. To lay down a comprehensive policy paper, the Russian parliament adopted the *Energy Strategy of Russia for the Period to 2020* in August 2003. The *Energy Strategy* sets out the government’s strategic thinking about the development of the energy sector and provides a framework for its future policy. This document identifies the main challenges as being mobilising investments in production and export capacity; restructuring the gas, electricity and coal industries; limiting the social impact of energy-price rises; and improving energy efficiency. Further, the *Energy Strategy* envisages large overall increases in fossil fuels and electricity output, calling for a cut in the share of gas in the power-generation fuel mix in favour of coal, hydro,

¹⁶⁰ “А. Дементьев: для реализации Восточной газовой программы требуется 2,4 трлн руб.” (A. Dementyev: 2.4 trillion roubles are needed for the realisation of the eastern gas programme), *Finmarket*, 15 June 2006, <http://www.finmarket.ru/z/nws/news.asp?id=609537&rid=1>.

¹⁶¹ “Президент Туркмении расписался за Туркменбашы – на договоре с Китаем о строительстве газопровода” (The President of Turmenistan signed the contract with China on the construction of the gas pipeline in Turkmenbashi’s place), *Kommersant*, 19 July 2007, <http://www.kommersant.ru/doc.aspx?DocsID=783641>.

and nuclear power. The *Energy Strategy* also demands measures to promote energy efficiency and conservation.¹⁶²

The *Energy Strategy* states that an “effective external trade policy must be based on the estimation of prospective energy markets, the active attendance of which will be profitable for the country. The market of Central and Western Europe remains one of the greatest markets in the forthcoming 20 years”. However, the *Energy Strategy* also projects that the share of Asian-Pacific countries in Russia’s oil exports will rise from its current 3% to 30% in 2020, while gas exports will rise to 25%.¹⁶³ The above-mentioned Gazprom proposal for the development of gas reserves in Eastern Siberia and the Russian Far East suggests that the company is eagerly trying to implement this part of the *Energy Strategy*.

Soon after Vladimir Putin had become president, he already began to implement the most important imperatives that were later elaborated in the *Energy Strategy*. He started to reorganise the energy sector and enabled state-controlled firms to take over the most important private energy corporations. Rosneft and Gazprom emerged as the two leading Russian companies in the oil and gas sectors. However, other than OPEC member states, Russia does not intend to nationalise its energy corporations. Rather, after acquisition, it plans to re-privatise a minority share and reserve a majority share for the Russian state.¹⁶⁴

In order to further preserve the role of the state, a subsoil bill was introduced in 2006 that would give the government the power to ban foreign majority investments in the exploitation of natural resources or limit their participations in certain strategic single future auctions only. Accordingly, relatively large oil and gas fields that are not being developed at the moment will likely be limited to domestic bidding while foreign investors will only be able to obtain minority shares. It is as yet unclear what this legislation would mean for the investment climate in the sector. The Kremlin intends to encourage foreign companies to invest capital and provide know-how and technology, but it still wants to retain direct ownership and control.¹⁶⁵ As a result of this policy, Shell had to negotiate to limit its equity share in the huge Sakhalin-2 project in 2006, and in first half of 2007 similar developments affected TNK-BP’s participation in the development of the Kovykta gas field. This kind of process is still ongoing as part of the YUKOS break-up, where the Kremlin has been able to bring the company in line with its energy policy agenda.

Due to the importance of Russia’s energy sector for the country’s economic development and the state’s interests in the major companies, it is not surprising that major energy deals are always part of bilateral negotiations with governments of energy-consuming countries. In general, foreign investors are still welcome to take part in the development and exploitation of the countries energy riches, if they accept Russia’s current terms. Most recently, Total was invited to join Gazprom’s efforts to develop the giant Shtokman gas field.¹⁶⁶ Initially, several foreign companies had hoped to participate in the Shtokman project that would include exports of liquefied natural gas to the United States. Conoco-Phillips and Statoil/Norsk Hydro were heavily interested in the project. The failure of the negotiations on Russia’s accession to the WTO in mid-2006 might have been a factor in the decision to continue with other partners. Subsequently, by the end of 2006 Gazprom announced a policy change on the project and declared it would continue the project without foreign equity partners. Moreover, the gas should initially be sold via pipelines to European customers. After Gazprom will be

¹⁶² International Energy Agency, *World Energy Outlook 2004*. Paris: OECD/IEA, 2004, p. 292.

¹⁶³ Ministry of Energy of the Russian Federation, *The Summary of the Energy Strategy of Russia for the Period of up to 2020*. Moscow, 2003, p. 22; a complete text of the *Energy Strategy up to 2020* can be found at <http://www.gazprom.ru/articles/article4951.shtml>.

¹⁶⁴ Brill Olcott, Martha, 2005, p. 2.

¹⁶⁵ Milov, Vladimir, 2005, pp. 13–4.

¹⁶⁶ “Газ де Франс: поможет разработать Штокман” (“Gaz de France”: Total may exploit Shtokman), *Vedomosti*, 13 July 2007, <http://www.vedomosti.ru/newspaper/article.shtml?2007/07/13/129211>.

forced to cut down its stake to 51% – the current benchmark in the Russian energy sector – Statoil/Norsk Hydro is likely to be asked to participate in the project, in addition to Total.¹⁶⁷

Other examples of recent foreign investments in Russian energy sectors are the large partly state-owned Italian energy companies ENI and ENEL. In the past few months they have gained a promising foothold in the Russian energy system, not only in oil and gas but also in the power sector. The Italian companies were successful in further extending long-term gas contracts. Further, ENEL could acquire a stake of up to 26% in one of the electricity companies that are currently being split up from RAO UES.¹⁶⁸ These investments are attracted as part of the restructuring of RAO UES, which is being unbundled and broken up into regional companies. The partial privatisation of the company should attract investments that are needed for the modernisation of the power sector. ENEL decision can be viewed as a strategic investment.

More often than not, direct interventions by heads of states precede the announcements of such deals. The participation of Total in the development of Shtokman, for instance, was made public a day after President Nicolas Sarkozy had called President Vladimir Putin to congratulate Russia on Sochi's nomination as the site for the 2014 Olympic winter games and to continue the "constructive dialogue" over a wide range of issues.¹⁶⁹ Similar political backing has also made other projects possible. The agreement to build the Nord Stream gas pipeline could not have been signed without political interventions at the highest levels in Moscow and Berlin. The pipeline will connect the Russian port of Vyborg in Russia with Greifswald in Germany through the Baltic Sea. It bypasses potential transit countries such as Poland and the three former Baltic Soviet republics.

Undoubtedly, energy cooperation is always integrated the foreign economic policy of a country. For a good understanding of Russia's energy policy, it is important to examine the relation between the country's political leadership and Gazprom, which is the sole supplier of natural gas from Russia and Central Asia to foreign markets. Further, from a European perspective, Gazprom's behaviour on the international market is more relevant than its activities in Russia and within the CIS. In accord with Russian foreign policy, Gazprom is trying to re-establish its predominance in the energy markets on the territory of the former Soviet Union. Gazprom intends to avoid the emergence of competition in the CIS space. Therefore, the company tries to preserve non-transparent trade structures to maintain its monopoly position as exporter of gas from Russia and Central Asia and is keen to reintegrate the extensive network of gas pipelines on the territory of the former Soviet Union.¹⁷⁰

In the 1990s, Gazprom tried to re-establish a common gas sector on the territory of the former Soviet Union. Transnational energy corporations under Russian leadership had to be set up, while energy supplies to CIS countries were financed by loans from Russia. Subsequently, the debts could be paid back by allowing Gazprom to obtain assets and energy companies in the countries concerned. Usually, state officials negotiated the energy deliveries, while the Russian state provided credits to finance them. As a result, the debts of the buyer states accelerated and were used as leverage for the acquisition of company shares in these countries' energy sectors.¹⁷¹

Obviously, in the CIS countries there is a principle convergence of interest and a certain level of mutual manipulation and instrumentalisation between the Russian government and Gazprom. Yet even

¹⁶⁷ "Gazprom Picks Total to Develop Shtokman," *Kommersant*, 12 July 2007, http://www.kommersant.com/p-10996/Gazprom_Shtokman_Total/.

¹⁶⁸ "Enel платит \$1,5 млрд за блокпакет ОГК-5" (ENEL pays US\$1.5 billion for a OGK-5 package), *Lenta Novosti*, 07 June 2007, <http://www.finansmag.ru/58491/>.

¹⁶⁹ "Газ де Франс: Total поможет разработать Штокман" ('Gaz de France': Total may exploit Shtokman), *Vedomosti*, 13 July 2007, <http://www.vedomosti.ru/newspaper/article.shtml?2007/07/13/129211>.

¹⁷⁰ Heinrich, Andreas, "Gazprom: Ein verlässlicher Partner für die europäische Energieversorgung?" (Gazprom: A reliable partner for Europe's energy supply?), *russland analysen*, no. 97, 2006, <http://www.russlandanalysen.de/content/media/Russlandanalysen97.pdf>, p. 1.

¹⁷¹ *Ibid*, p. 2.

in this region both parties have not always interacted in a spirit of cooperation.¹⁷² The directors of Gazprom are also trying to pursue their business interests in the CIS, but at the same time they have to acknowledge the interests of the Russian state.

When examining Gazprom's activities in the EU, no direct link can be found between its business strategy and Russia's foreign policy. Gazprom acts independently on the European market as a market player with clear economic interests, seeking cooperation with the transit countries and its customers. Further, the company increasingly accepts international standards in conducting its businesses in the EU, while support from the Russian government does not exceed certain political frameworks that are also accepted among Western multinationals.¹⁷³

Gazprom's European strategy is about market power. First of all, Gazprom wants to control the whole chain of supply – from production to transportation and distribution – and preserve its market share in Europe. To guarantee that investment made upstream will pay off, Gazprom seeks to establish dependencies via the construction of export pipelines and long-term contracts. The company seems to follow the motto “gas will not be produced until it is sold”.¹⁷⁴ In recent years, several new joint pipeline projects have been agreed upon European companies and governments – i.e., the Nord Stream, Blue Stream, and South Stream. The accumulated capacity of these pipelines by far outstrips the expected increase in demand for gas in Europe. Gazprom clearly aims at decreasing the power of the transit countries Ukraine, Belarus, and Moldova. By doing so, Gazprom hopes to be able to demand European gas prices, which are related to the oil price, for supplies to these countries and to ensure reliable supplies to Western European customers. Furthermore, Gazprom more often than not uses the Russian state agencies rather than becoming a policy tool itself. The company has considerable bargaining power in negotiations with the Russian state on domestic affairs,¹⁷⁵ such as the stalled reform of the gas sector, the enforcement of the gas export monopoly and the instrumentalisation of state agencies for the realisation of business interests in the Sakhalin and Kovykta cases.

Hence, when assessing Russia's external energy relations from a European perspective, it is important to distinguish Russia's – and Gazprom's – policies at home, their strategy in the CIS countries, and their approach to EU member states. By doing so, the discussion about energy cooperation between the EU and Russia could be reduced to its more worthwhile economic aspects.

Subsequently, the possible establishment of a real (or informal) gas cartel would primarily raise price concerns rather than supporting the notion of political encirclement by state-capitalist gas producers. To be honest, Putin's staccato of public statements on more cooperation and negotiations with gas producers such as Iran, Algeria and Qatar added to the fears of European gas consumers. However, the reality is more complex. First of all, even senior Russian officials made clear that Russia's main approach to energy policy remained the interdependence of producers and consumers. Furthermore, and even more importantly, analysts are convinced that a gas cartel is simply not feasible because of the structure of the gas market and the irreconcilable interests of the major players in this market. Thus far, the members of the Gas Exporting Countries Forum have only set up a committee that will study pricing policies and other issues, such as infrastructure and the relations with customers.¹⁷⁶

¹⁷² Ibid, p. 2.

¹⁷³ Ibid, p. 4.

¹⁷⁴ Perovic, Jeronim, and Robert Orttung, 2007, p. 4.

¹⁷⁵ Götz, Roland, “Gasproms Zukunftsstrategie: Marktbeherrschung und Expansion” (Gazprom's future strategy: Market power and expansion), *SWP-aktuell*, no. 39 (July 2007), http://www.swp-berlin.org/de/common/get_document.php?asset_id=4177, pp. 3–4.

¹⁷⁶ Fachinotti, Matteo, “Will Russia Create a Gas Cartel?,” *russian analytical digest*, no. 18, 3 April 2007, <http://se1.isn.ch:80/serviceengine/FileContent?serviceID=PublishingHouse&fileid=3BD26965-750E-6427-C2D9-EF15A3D54DF4&lng=en>, p. 14; England, Andrew, “Gas exporters launch pricing study,” *FT.com*, 10 April 2007, <http://www.ft.com/cms/s/2/7b0e6b5e-e6bb-11db-9034-000b5df10621.html>.

In fact, judging from his statements it is clear that President Putin also knows that establishing a gas cartel is not in the interest of Russia. A step like this would almost certainly push customers to diversify away from natural gas. Since natural gas competes with other fuels, the emergence of an organisation like OPEC for gas would probably tip the balance in favour of other sources for many consumers.¹⁷⁷ Picking up this issue might have been a tactical move aimed at frightening Europeans so that they – blinded by fear – would not realise that this kind of organisation does not make any sense. And subsequently, they might have allowed Gazprom to make controversial acquisition in return for an assurance that a gas cartel will not be set up.¹⁷⁸ However, playing with this kind of fears would be a very risky strategy. On the other hand, recent press reports suggest that Gazprom and Qatar Petroleum, the world's largest producer of LNG, are exploring swapping arrangements to maximise their profits in both the LNG and pipeline-gas markets.¹⁷⁹ Thus, EU politicians should be prepared to find rational answers to likely changes in the international gas business.

Whatever the Russian leadership's intentions were at that time, such moves do not contribute to the maintenance and strengthening of a fruitful and transparent cooperation. But observers in the West also knew about the feasibility of a gas cartel. Thus, Western participants in the debate about such issues definitely need to gain more self-confidence, objectivity and a better understanding of the developments in the Russian energy sectors in order to present themselves as serious players, rather than appearing guided by doom scenarios. As argued by Coby van der Linde, it could be very rational to view Gazprom's behaviour of rent maximisation as comparable to the strategies of the oil companies when they were readying themselves for a new period of expansion in already mature markets.¹⁸⁰ Accordingly, Gazprom's policies in the EU are part of the realisation of Russia's overall energy strategy. But these policies are not aimed at achieving aims other than maximising *economic* rents.

¹⁷⁷ Fachinotti, Matteo, 2007, p. 16.

¹⁷⁸ Ibid, p. 16.

¹⁷⁹ *World Gas Intelligence*, July 25, 2007.

¹⁸⁰ Van der Linde, Coby, "The Geopolitics of EU Strategy of Gas Supply," *European Review of Energy Markets*, no. 6 (2007), forthcoming.

4

The European Union and Russia

This section discusses some elements that have shaped the nature of the relations between the EU and Russia since the demise of the Soviet Union. This section describes the institutional frameworks that facilitate the EU's cooperation with Russia.

4.1. After the Cold War

When assessing the current state of EU-Russian relations, it is necessary to examine the development of the relations since the early 1990s. At that time, idealism and high expectations guided decisions on both sides. Russian politicians hoped that their country could become a member of the EU, which they saw as the Gorbachovian "Common European Home". They also thought that NATO's role in Europe would be overtaken by the OSCE. The country's new elite saw Russia's future in the international community as that of a responsible Great Power and regional leader. They signed the Partnership and Cooperation Agreement with the EU in 1994. Two years later, Russia also became a full member of the Council of Europe. In fact, the Russian leadership under President Boris Yeltsin made these steps and presented them as a strategic choice in favour of integration into the world community and, in particular, with the European Union.¹⁸¹

Europe noticed these positive signals from Russia but, in general, the Russian reality was badly misjudged. Many European policy makers and businesspeople expected that after the defeat of communism the country would become a democracy overnight. The shock therapy that worked for some East European countries was considered the best thing for Russia, too. In the 1990s, Europe's approach to Russia focussed on humanitarian issues and good-governance projects, rather than making strategic policy choices. Moreover, the implementation of these measures did not sufficiently take into account Russia's tremendous economic problems and the political consequences of the country's transition.¹⁸²

During the 1990s, the Russian state was too weak to introduce reforms that would lead to a Western-style democracy and market economy. Business people and Yeltsin's supporters dominated the political landscape, whereas the *ad hoc* privatisation led to severe social problems. In fact, after the demise of the Soviet Union many in Europe were concerned about Russia's political and economic decline, but they were not worried. When European politicians recognised the country's instability, they subsequently tried to keep Russia at arms length from the EU. To them, a Russia that was retreating from its former sphere of influence and becoming weaker definitely appeared less threatening. At that very moment, NATO jumped at the chance and moved relentlessly forward to the very borders of Russia, pushing it further into Eurasia and away from Europe.¹⁸³ In Russian eyes, some cracks had opened by then in the walls of the snug European house.

The 1997 NATO expansion had a huge impact on Russia's foreign policy establishment. A year later, at the very moment when Russia was trying to be an important player during the Kosovo crisis, the country was hit by a monetary crisis. The West could do little to improve the situation. While Russia's

¹⁸¹ Smith, Hanna, "Engaging Russia: A Major Challenge for the European Union," Conference Paper – Bertelsmann Forschungsgruppe Politik, 21 December 2006, http://www.cap.lmu.de/download/2006/2006_Engaging_Russia.pdf, p. 4.

¹⁸² Maynes, Charles William, "A Soft Power Tool-kit for Dealing with Russia," *Europe's World*, no. 3 (Summer 2006): 20–21; Smith, Hanna, 2006, p. 4.

¹⁸³ Maynes, Charles William, 2006, pp. 20–21.

economy was in the doldrums, its military started the second war in Chechnya, the conduct of which has been criticised by human rights activists both in Russia and abroad. As a result of these developments, EU-Russian relations became “very icy” despite the fact that far-reaching and promising documents, such as the Partnership and Cooperation Agreement and the Common Strategy, had been signed or approved during the same period.¹⁸⁴

From 2000 onwards, the more assertive behaviour of Russia’s leadership under President Vladimir Putin has exerted considerable influence on the further direction of Russia’s relations with the EU. His approach towards policy issues at home led to a growing dissonance – between Russia and the EU as well as among EU member states. However, at the moment, most Western European member states still prioritise stable economic relations with Russia and seek a strategic partnership. But the new Eastern European member states harbour strong historically rooted resentment towards Russia and are also more susceptible to US influence than “old Europe”. Further, and even more disturbing, their policies towards Russia exploit more normative factors, such as democratisation and human rights.¹⁸⁵ Some of these countries often raise such issues to present themselves as leading regional powers or try to take revenge for tragic events in the past. In general, the governments of the Eastern European member states hold the same perceptions as the EU-15 about Russia’s recent policies. Yet more often than not they draw diverging conclusions, mainly because of their experiences with Russia in the past.¹⁸⁶ As a result, in the future the EU’s approach to Russia could be influenced more than it was previously by historical sensitivities instead of by pragmatic considerations.

Europe and Russia are experiencing a transition process that is threefold. First, Russia is freeing itself from the remnants of its past as a planned economy and socialist society as well as the consequences of its “big bang” implementation of market structures. Second, the EU has tried to overcome the post-World War II division of the continent by accepting ever more Eastern European countries as full members, while it is pushing on with internal harmonisation on an increasing number of policy areas. Finally, as a result of these ongoing developments, EU-Russian relations are also in a phase of transition.

Since the 2004 enlargement the premises of the relations between the EU and Russia have changed substantially. First, the EU enlargement coincided with the re-focussing of Russia’s national interests in the country’s foreign policy approach. Second, the main obstacle to solving conflicts and getting along with Russia currently seems to be the new Eastern European and Baltic factor in the formulation of EU policy. Before 2004, the EU member states could be divided into two groups with regard to their Russia policy. Countries such as Germany and France were mainly interested in pragmatic economic relations. Other countries, such as Great Britain, denounced anti-democratic developments in Russia and called for sanctions against the country, though without much effect on EU policies. After all, in the 1990s none of the EU-15 viewed Russia as a security threat. Therefore, security and geopolitical concerns were not part of the debate.¹⁸⁷

Since the 2004 enlargement, especially with Poland, the Czech Republic and the three Baltic states becoming EU members, it has become difficult to focus on economic issues in the EU’s relations with Russia. Eastern Europe’s problematic and undigested history with Russia has increasingly affected and obstructed EU’s policymaking. Some Eastern European countries often pursue an uncompromising approach to the Russia and try to “contain” its political and economic influence in Europe.¹⁸⁸

¹⁸⁴ Smith, Hanna, 2006, p. 5.

¹⁸⁵ Hughes, James, “EU Relations with Russia: Partnership or Asymmetric Interdependency?,” London: LSE Research Online, 2006, <http://eprints.lse.ac.uk/archive/00000651>, p. 2.

¹⁸⁶ Geremek, Bronislaw, “Why Europe Still Lacks a Russia Policy,” *Europe’s World*, no. 1 (September 2005), 2005, p. 19.

¹⁸⁷ Fischer, Sabine, “Samara – Gipfel des Scheiterns?” (Samara – the summit of failure?), *russlandanalysen*, no. 136 (2007), p. 3.

¹⁸⁸ *Ibid.*

From an “Old Europe” perspective, however, pragmatic calculations about the costs and benefits of an interdependency of trade trump concerns over other more value-based issues.¹⁸⁹ Representatives from these countries try to focus their countries’ policies and those of the EU on the promotion and management of economic cooperation at the expense of more normative issues. In addition, the EU approach to Russia is ever more influenced by its dependency on Russian energy exports and the need for security and stability in the region.¹⁹⁰

Economically, future relations between the EU and Russia are as important as those with the United States. But they are not based on a common value system. EU officials should accept Russia’s policy approach and try to find areas for cooperation. Mentioning common European values, the rule of law and human rights are important, though. But such comments might be understood as the wish to force Russia into the position that it experienced a decade ago. At that time, Russia was only seen as a poor supplier of resources to the rich European countries. The reforms that were acclaimed in the West did not deliver the Russian people from the economic backwardness of socialism as the wealth of the country was taken away by *bisnesmeny* and corrupt government officials who used the sudden economic freedoms to enrich themselves.¹⁹¹ Today, however, Russia can pay for what it needs. Thus, it is no longer forced to accept what the West wishes to provide. Its relations with the West have become a “partner/competitor” relationship; while there is close cooperation on certain issues, others remain untouched. Accordingly, analysts suggest that the West needs an issue-based approach when dealing with the Russia, and it should not expect Moscow always to follow its lead.¹⁹²

This notion has become especially apparent when discussing Western values. In fact, one needs to be more careful in using the language of democracy when talking about Russia. Democracy has been a fairly late child of capitalism in almost all democratic countries, and it requires a self-conscious middle class to take root and flourish. Such a class can only be produced by successful and sustained capitalist development. Russia is generating this class, but this process will take time¹⁹³ and its outcome will be determined in Russia. The West should realise where Russia stands on its history’s timeline. The political gap between Russia and its Western partners can only be narrowed by indigenous capitalist development. Some analysts state that Russia’s current agenda must be more about freedom than democracy. Even now, Russia is largely free, but it needs to institutionalise this freedom by building a modern state to replace its antiquated institutions. Hence, it is fruitless for the West to try to bring the current leadership back to the kind of “democracy” of the 1990s.¹⁹⁴

Undoubtedly, Western political influence in Russia is gradually becoming a thing of the past. After the demise of the Soviet Union, Russians were frustrated by the geopolitical catastrophe of the disintegration of the Soviet Union and the loss of assets accumulated by generations. This period of national self-disparagement has now gone on far too long. Today, the “pendulum of Russian self-confidence” has started swinging back and Russia’s elites have convinced themselves that the country is able to decide independently on an increasing number of international issues. This development is part of Russia’s search for a new identity and is not primarily directed against other countries. Hence, Europe has nothing to reproach itself for “losing Russia”.¹⁹⁵

During its history, the EC/EU’s power has derived primarily from its ability to persuade, making it the most successful peaceful power in history. Yet today the EU has to realise the limitations of that power. Since the EU’s willingness to consider membership of neighbouring states is declining, EU policy makers must recognise that the EU’s soft power is substantially reduced in negotiations with

¹⁸⁹ Hughes, James, 2006, p. 1.

¹⁹⁰ Ibid.

¹⁹¹ Trenin, Dmitri, “Russia Leaves the West,” 2006.

¹⁹² Ibid.

¹⁹³ Trenin, Dmitri, 2005.

¹⁹⁴ Ibid.

¹⁹⁵ Baranovsky, Vladimir, “A Soft Power Tool-kit for Dealing with Russia: Commentary,” *Europe’s World*, no. 3 (Summer 2006): pp. 23–5.

any country that is excluded from membership.¹⁹⁶ This is particularly true for its relations with Russia. There is no option for Russia to become a member of the EU, and the government does not direct its efforts towards that aim. Nevertheless, European politicians should not create a new “devil” to the east through policies of isolation or neglect, but should try to develop some middle ground between membership and rejection.¹⁹⁷

Obviously, in its relations with Russia, the EU faces two major problems. First, it cannot offer membership to Russia, which is usually its most powerful tool of influence. Second, the EU does not have a common policy approach to Russia.¹⁹⁸ Not all EU member states have the same degree of interest in Russian issues. The resulting lack of shared concern enables Russian officials to discount the importance of individual European voices and attribute allegedly anti-Russian feelings to criticisms from some member states. Thus, for the EU it is essential to develop efficient tools and a more audible and consistent policy voice on Russian issues.¹⁹⁹

Before the EU can effectively be able to determine this voice, its member states have to realise how the rapid developments of the last one and a half decades have changed the organisation. In the 1990s, the EU-12 engaged in a process of ever-closer economic and political cooperation. From the mid-1990s onwards 15 new member states have had to be integrated into the organisation and its institutions and policymaking. Ten of these new member states were former socialist countries. Undoubtedly, the 2004 enlargement had a considerable effect on the EU’s foreign and security policy from a political as well as geographical perspective. Furthermore, the internal process of accelerated integration resulted in more emphasis on common values and norms. This growing focus on normative matters, also as part of EU foreign policy, has become an issue of real disagreement in the EU’s relations with Russia.²⁰⁰

In addition, the 2004 enlargement is also a major challenge for the EU’s internal stability. Recent political and social crises in the new member states show that so far only a minority of the population in the new member states has benefited from new freedoms and opportunities. The majority of the people still suffer from the economic and social side effects of the transition from a planned to a market economy. In the case of Poland, these problems have contributed to growing political nationalism, which also affects the country’s support for the implementation of EU policies. The Czech Republic and Hungary are other recent examples of new member states that complicate the EU’s “domestic” policies. Internal power struggles prevented the political elites in Prague from compromising on the formation of a functioning government. Violent riots broke out in Hungary after the leader of the ruling party admitted that he had lied to the people in an attempt to secure his re-election. Undoubtedly, some political instability in the new member states will continue to affect the EU’s policies in the years to come.²⁰¹ Populist attitudes and destructive behaviour among Eastern European leaders make EU foreign and security policy more unpredictable.

The 2004 EU enlargement adds also an important geopolitical aspect to the EU-Russian relations. Due to closer geographic proximity and the EU’s attempt to diversify its energy supplies, the EU and Russia have become competitors in the countries that were part of the former Soviet Union. This competition concerns the further political and economic development of these countries and the question of how energy relations with these countries should be approached. Thus, since the 2004 enlargement Russia has become a “closer” neighbour for the EU and also a more complicated one.

¹⁹⁶ Maynes, Charles William, 2006, p. 24.

¹⁹⁷ Ibid, pp. 24–7.

¹⁹⁸ Fischer, Sabine, “Die EU und Russland: Konflikte und Potentiale einer schwierigen Partnerschaft” (The EU and Russia: Conflicts and possibilities in a complex partnership), *SWP-Studie*, no. 34 (2006), http://swp-berlin.org/de/produkte/swp_studie.php?id=6623, p. 14; Maynes, Charles William, 2006, pp. 22–3.

¹⁹⁹ Maynes, Charles William, 2006, p. 27.

²⁰⁰ Smith, Hanna, 2006, p. 6.

²⁰¹ Vetter, Reinhold, “Transformationsprobleme: Krisen erschüttern Osteuropa” (Problems of transition: Crises rattle Eastern Europe), *Handelsblatt*, 2 January 2007, http://www.handelsblatt.com/news/Journal/So-wird-2007/_pv/_p/302441/_t/ft/_b/1198133/default.aspx/krisen-erschuettern-osteuropa.html.

The Russians' "near abroad" – and from an EU perspective "the former Soviet Union" – have become a "common neighbourhood" where both Russia and the EU have interests that coincide but also cross each other at times.²⁰²

The EU is interested in energy supplies from the Caspian region as part of its diversification policy. Thus far, however, EU policies towards the region have not led to concrete outcomes in this regard. At the same time, Russia is defending its economic interests in this region more assertively. Consequently, many policy makers in Europe no longer view Russia as "an object of pity but of alarm" as it is pushing back for the first time in a decade. They are dissatisfied with Russia's recent political development and feel frightened because of the perceived asymmetric dependence on Russian energy supplies. But they are undecided on how to react.²⁰³

To be sure, developments in its "near abroad" touch Russia's vital economic interests. Russia views the CIS countries as economic spaces in which it continues to enjoy some comparative advantages over third-party competitors. Accordingly, it wants to profit from this position and not necessarily share these spaces with the EU. Due to economic considerations, Russian policies towards its "near abroad" are focussed on the resource-rich Central Asian region and important transit countries to its west. Putin's policies towards the so-called post-Soviet space are not so much neo-imperialist as post-imperialist. Since the 1990s Russia's political influence has been decreasing in the western part of the former Soviet Union, but economic interests are increasing. Today's Russia is not a second Soviet Union or a revanchist and imperialist aggressor bent on absorbing its former provinces. Russia is currently adapting to changed international circumstances and seeks to construct a "greater Europe" – a loose association between the EU and a Russian-led community in the east.²⁰⁴

The new EU member states, which border this "east," are still in a transitional phase. Developments in this broader region are important for both the EU and Russia. This is particularly true in the case of the crucial energy-transit countries Ukraine and Belarus. Both the EU and Russia have to maintain good relations with these countries in order to ensure the secure transit of gas and oil to the market. Due to such vital interdependencies and other issues of international relations, Russia will inevitably play a very significant role in the EU's Common Foreign and Security Policy.²⁰⁵ Therefore, the EU should treat Russia as a major outside player that is neither an eternal foe nor an automatic friend.²⁰⁶

The EU needs to recognise that Russia's aspiration to great-power status is real and that the EU cannot talk down to it like a defeated power. The terms of Western-Russian interaction were conceptualised at the time of the demise of the Soviet Union and have remained more or less unchanged ever since. These terms, however, have shifted fundamentally. As the old paradigm is lost, it is time to start looking for a new one. Since Russia's domestic transformation will probably not follow the course of the former Soviet satellites, the EU should rethink the fundamentals of its approach to Russia and formulate a consistent strategy for dealing with Russia. Hence, the EU should no longer adopt the same attitude towards Russia that it embraced during the negotiations for EU membership with Eastern European countries, when it demanded more emphasis on human and civil rights and respect for the rule of law.²⁰⁷ The "partner/competitor" character of the EU's relation with Russia might increasingly come forward. The wisdom of the leaders will determine which theme will prevail.

The fact that Russia wants to be on a par with the EU as a global player creates tension between both entities. These challenges should be tackled through all possible kinds of cooperation: bilateral, regional, sectoral and multilateral. Most of the EU member states that have close ties with Russia do rely on their bilateral relations. Without these bilateral instruments, relations between the EU and

²⁰² Trenin, Dmitri, 2007, p. 99; Smith, Hanna, 2006, pp. 6, 14.

²⁰³ Maynes, Charles William, 2006, 21.

²⁰⁴ Fischer, Sabine, 2006, pp. 10–1, 14; Maynes, Charles William, 2006, pp. 22–3; Trenin, Dmitri, 2007, p. 99.

²⁰⁵ Trenin, Dmitri, 2007, p. 99; Smith, Hanna, 2006, pp. 6, 14.

²⁰⁶ Trenin, Dmitri, "Russia Leaves the West," 2006.

²⁰⁷ Ibid; Smith, Hanna, 2006, p. 7.

Russia would develop even slower than they do at the moment. Unfortunately, until now the EU level has not been the level where the big successes of Russian-EU cooperation could be claimed. Thus, bilateralism pursued by single member states should be taken into account in the internal policy making of the EU. By doing so, it could benefit the united line without any element of surprise and negative feelings.²⁰⁸

However, there are limits to the use of good bilateral relations to improve overall EU-Russian relations, as the German government had to realise during Germany's EU Presidency in the first half of 2007. German policy makers had revealed ambitious plans for its policy towards Russia and the CIS countries during the presidency. Germany wanted to focus on a revised energy alliance, further attempts to solve ethnic and territorial conflicts, and the promotion of European standards of the rule of law and democratic values.²⁰⁹

Unfortunately, instead of realising a considerable improvement, EU-Russian relations have further deteriorated during the German presidency. In fact, differences on a range of issues, which many thought had already been settled during the last 15 years, have resurfaced. As a result, few of Germany's ambitious goals have been accomplished. Initially, the German Chancellor Angela Merkel wanted to start negotiations with Russia on a renewed Partnership and Cooperation Agreement. But the start of the negotiations was vetoed by Poland because of its bilateral conflicts with Russia. Consequently, the EU-Russian summit in May 2007 had to also be added to the ranks of recent high-level meetings that ended without any progress. The difficult bilateral relations with Russia of some of the Eastern European and Baltic EU member states affected the mood of the participants before and during the summit. Thus, together with the gradual re-formulation of Russia foreign policy, the substantial impact of the EU enlargement on the relations is increasingly materialising and has already set the scene for difficult interactions between the two parties in the years to come.²¹⁰

Soon after the 2004 EU enlargement, Germany's interest-driven bilateral approach to Russia became a problem within the EU context because of Polish and Baltic sensitivities to German-Russian policy initiatives. The ongoing discussion about the construction of the Nord Stream gas pipeline is an example of such perceptions of the German-Russian relations by others. Yet it is important to look at the lobbying groups that are pushing German-Russian relations forward. In fact, ever since the late 1980s economic interests have shaped German policy towards the Soviet Union and Russia. Some of the most influential actors of the German energy sector and German banks are affiliated with lobby groups such as the Committee on Eastern European Economic Relations (Ostausschuss der deutschen Wirtschaft), and the German-Russian Forum. These institutions promote Germany's policy towards Russia and are close both to Chancellor Merkel's CDU and Russia-friendly quarters of the SPD. They mainly focus on the development of prosperous trade relations and a favourable investment climate. During the 1980s and 1990s, this interest-based approach created a sphere of mutual trust and also induced strong bilateral economic, political, and cultural ties between the two countries.²¹¹

In addition, Germany's continued efforts to improve relations with the Eastern European CIS countries and Russia must be viewed as a result of the legacies of the Second World War and of the changed geographic realities after the country's its reunification. In the post-Cold War period, Germany has succeeded in combining three strategic objectives. First, it has maintained good relations with Russia. Second, it was able to play a decisive role in the recent EU enlargement process on behalf of Central European countries. Finally, German politicians coordinated their initiatives with their European and transatlantic partners. In fact, Germany's geographic proximity to Russia has been responsible for its focus on economic expansion in the region as well as its tradition of driving Eastern policy within Western alliances. During its EU presidency, Germany had tried to pursue such policies, aiming at

²⁰⁸ Smith, Hanna, 2006, p. 14.

²⁰⁹ "EU im postsowjetischen Raum: Konturen einer neuen Ostpolitik" (EU in the post-Soviet space: Outline of a new Ostpolitik), *GUS-Barometer* 12, no. 41 (2006), p. 1.

²¹⁰ Fischer, Sabine, 2007, p. 2.

²¹¹ Kempe, Iris, "From a European Neighborhood Policy toward a New Ostpolitik: The Potential Impact of German Policy," *CAP Policy Analysis*, no. 3 (May 2006): 12.

more integration between Russia and the EU.²¹² Indeed, this approach seemed to be very ambitious from the outset. The German leadership might have underestimated resentments among Eastern European partners, and it might have overestimated its ability to encourage other EU member states with diverging interests to unite behind this policy.

In the end, Germany had no other choice than to accept the failure of the EU summit in Samara in May 2007 and to protect its bilateral relations with Russia from spill-over effects. To Germany, Russia is a crucial economic partner because of its energy dependence and the huge and diverse investment of German companies in Russia. Therefore, German politicians will continue to pursue its precious bilateral relations with Russia. Other EU countries with similar economic and political ties will certainly follow suit.

Analysts suggest that at the EU level relations with Russia are likely to be rocky for the time being.²¹³ They also fear that politicians in the West will not only miss opportunities but may even run real risks if they misjudge Russia's movements and subsequently – once again – overreact or react inappropriately to them. Therefore, the EU should try to deal with Russia on Russia's own terms – i.e., recognising Russia as an equal partner. By doing so, both sides could reach for an acceptable balance of reciprocity. To include more business ties would be a better way to achieve this, rather than only seeking to base cooperation on normative principles and values.²¹⁴ The imperative to work together, felt on both sides, should be the basis for all interactions.

4.2. The institutionalisation of the EU-Russian relations: A reactive process

Various policy instruments have accompanied the EU's policy towards Russia since the early 1990s. Yet, due to the complexity of the EU's internal harmonisation process and remaining intergovernmental policy areas, its approach to Russia lacks horizontal and vertical coherence. There is no uniform approach within the three EU policy pillars, within the EU institutions, and among the member states. Therefore, the EU cannot be considered as a consistent actor in its relations with Russia.²¹⁵ The EU as a party is an organisation in transition that is producing ever more new policy instruments. This inconsistency has also affected the institutionalisation of its relations with Russia and the other former Soviet republics.

The institutionalisation of the EU-Russian relations followed the political and economic developments of the 1990s. Since then, both players have been experiencing tremendous changes in their respective relative power, which were illustrated by the twin processes of the expansion of the EU and NATO into the former Soviet Union's sphere of influence. The process of shaping institutional and legal frameworks for the cooperation with Russia can be divided in three stages. It began in 1991, intensified in 1994, while in 1997 and 1999 the last significant agreements and documents were finalised. An analysis of EU policies during this period shows that they did not follow a grand strategy, but were of a rather reactive nature.²¹⁶

Brussels formulated its policy approach to post-communist Eastern Europe immediately after 1991. This approach was based on the conceptual re-division of post-communist Europe. Likely candidates for EU membership in the near term received generous aid packages (PHARE).²¹⁷ Their institutions and economies were supported in developing on a path that would lead towards integration with the EU. Countries that were not suited for membership were also offered aid and cooperation (TACIS), but substantially less than the PHARE countries. The EU's economic and political influence grew considerably in Eastern Europe and the former Baltic Soviet Republics. From 1994 onwards, the EU

²¹² "Konturen einer neuen Ostpolitik" 2006, pp. 1, 4; Kempe, Iris, 2006, pp. 5–6;.

²¹³ Trenin, Dmitri, 2007, p. 103.

²¹⁴ Ibid, pp. 104–5.

²¹⁵ Fischer, Sabine, 2006, p. 9.

²¹⁶ Hughes, James, 2006, p. 2.

²¹⁷ PHARE countries received more than double the amount of the TACIS group, and over 50% of the TACIS funds were directed to Russia and Ukraine. See also European Commission, "The EU's relations with Eastern Europe & Central Asia: Tacis," http://ec.europa.eu/comm/external_relations/ceeca/tacis/index.htm; and Hughes, James, 2006, p. 3.

tried to mask this shift in territorial balance of power in Europe by emphasising the establishment of a “partnership” with Russia. In an attempt to improve the coordination of EU policy towards Russia, new instruments were developed, such as the 1997 Partnership and Cooperation Agreement (PCA) and the 1999 Common Strategy.²¹⁸ Then, from an energy perspective Russia’s relevance was re-emphasised at the turn of the century. Due to increasing oil prices and growing instability in the Middle East, Russia was broadly recognised as an important source of reliable energy supplies for Europe and crucial for the EU’s security of energy supplies. Around that time, the Russian-EU Energy Dialogue was set up as part of the Common Strategy process.²¹⁹

Despite the importance of the issues covered by the 1999 Common Strategy, this document was largely declaratory in nature. There was no guidance how the Common Strategy should be implemented. Each EU presidency could decide on the implementation according to its own Russia policy priorities. Moreover, the document outlined only two rather vague strategic goals: maintaining both “a stable, open and pluralistic democracy in Russia” and “European stability, promoting global security and responding to the common challenges of the continent through intensified cooperation”.²²⁰ The Common Strategy did not provide any specific allocation of resources to implement the stated objectives. Hence, lacking any institutional framework and financial backing there were only some symbolic steps towards implementing the Common Strategy. Furthermore, most of the EU member states still have a general preference for bilateralism. They have their own institutional capacity for pursuing their national interests irrespective of the EU. In addition, due to economic and security considerations, it often may not be in a member state’s national interests to pool information on Russia.²²¹

In 2001, Russia and the EU established a forum for cooperation in Northern Europe: the Northern Dimension. This forum includes Russia, the EU member states Sweden, Denmark, Finland, Estonia, Latvia, Lithuania and Germany, but also two non-members: Norway and Iceland. Despite the fact that the EU has established this forum, the participating member states have more influence on the issues discussed and the cooperation within the Northern Dimension. By doing so, the unilateral approach of the EU Common Foreign and Security Policy could be overcome. Further, the documents establishing the Northern Dimension do not contain any reference to democracy and human rights issues. Thus, the Russian side can act within this cooperation forum more comfortably.²²²

As a result of the inconsistency in the presidency work plans and the lack of clarity on how the Common Strategy related to the already existing contractual PCA, Russia became uncertain about the legal precedence of the PCA.²²³ Subsequently, in October 1999 Russia responded to the EU Common Strategy by issuing its Mid-Term Strategy for the Relations with the EU, 2000–2010.²²⁴ This strategy, which was adopted under then Prime Minister Vladimir Putin, clearly states that Russia does not aspire to EU membership during this period. Further, it emphasises Russia’s special role as a large country that covers two continents. Due to its size and geopolitical environment, Russia must be able to determine its domestic and foreign policies independently.²²⁵

²¹⁸ Hughes, James, 2006, p. 2; see Agreement on Partnership and Cooperation between the European Communities and the Russian Federation of 1 December 1997, http://ec.europa.eu/comm/external_relations/ceeca/pca/pca_russia.pdf; and Common Strategy of the European Union of 4 June 1999 on Russia (1999/414/CFSP), http://ec.europa.eu/comm/external_relations/ceeca/com_strat/russia_99.pdf.

²¹⁹ Smith, Hanna, 2006, p. 8.

²²⁰ Common Strategy of the European Union of 4 June 1999 on Russia, Part I, p. 1.

²²¹ Hughes, James, 2006, pp. 4–6.

²²² Fischer, Sabine, 2006, p. 16.

²²³ Hughes, James, 2006, p. 7.

²²⁴ See the unofficial translation of the *Medium-term Strategy for Development of Relations between the Russian Federation and the European Union (2000–2010)* at http://ec.europa.eu/comm/external_relations/russia/russian_medium_term_strategy/index.htm.

²²⁵ Fischer, Sabine, 2006, p. 15.

In May 2003, the EU and Russia agreed to reinforce cooperation by creating four “Common Spaces” in the areas of (1) economy, (2) external security, (3) freedom, security, and justice, as well as (4) education, research, and culture. These Common Spaces were understood to be long-term objectives within the framework of the existing PCA and should be achieved through the institutional instrument of “road maps”. The package of road maps for the creation of the four Common Spaces was agreed in May 2005.²²⁶

The upcoming negotiations about the new partnership and cooperation agreement will take a long time, but they do provide a rare opportunity to develop Russian-EU relations in a completely different atmosphere than in the 1990s. All parties should want to focus on fewer issues but discuss every issue in more detail. Issues such as education, energy, environment, freedom of movement, and the idea of a possible free trade zone require a general framework. Cooperation on more normative issues could be discussed and developed in other more suitable fora. Thus far, for instance, the Council of Europe has demonstrated its usefulness in pulling Russia closer to the European sphere of norms and values. Therefore, the Council of Europe might be a better forum to raise concerns about human rights and democracy. As part of the Council of Europe, the EU member states should come up with a common position on these issues in order to promote civil and human rights in Russia.²²⁷ By doing so, negotiations on practical issues of EU-Russian economic and institutional relations could receive the attention they deserve.

²²⁶ See Conclusions – Four “Common Spaces” at http://ec.europa.eu/comm/external_relations/russia/summit_05_05/index.htm#1.

²²⁷ Smith, Hanna, 2006, pp. 13–5.

5

EU-Russian energy relations

This section examines the importance for the EU of promoting stable energy relations with Russia and elaborates the institutional meaning of the 1994 Energy Charter Treaty in that context. Further, some prospects for a Brussels-Moscow energy axis are discussed.

5.1. The importance of EU-Russian energy relations

The intensification of the energy cooperation between Europe and Russia is almost imperative from an economic, geographic, geopolitical, and historical perspective. In a visionary statement, shortly after the fall of the Soviet Union, Dutch Prime Minister Ruud Lubbers called for an East-West Energy Community that could facilitate the flow of Western capital and technology to the East and secure energy flows to the West. Nevertheless, energy relations have not developed smoothly in recent years, mainly because of three reasons. First, the EU and Russia hold diverging priorities and positions with regard to the regulation of the energy sector and international energy cooperation. Second, different EU member states also have diverging priorities depending on their energy imports from Russia. Third, although the institutionalisation of EU-Russian relations began in the 1990s, the process remains stalled, as it has not been able to adapt to the recent changes, especially those in Russia's energy sector.

In general, European policy makers and business people criticise increasing state interference with the energy sector. They state that these interventions hamper the development of the sector and, subsequently, disturb Russia's energy relations with its European partners. Furthermore, the frequently changing tax regulations and corrupt officials unnecessarily increase the risk for foreign investors in Russia.²²⁸

As a result of the gas crisis between Russia and the Ukraine in early 2006 and the oil blockade at the beginning of 2007, Russia's reliability has been in question in the EU. Subsequently, EU politicians have been trying to get some insurance from Russia that energy deliveries are and will be reliable. These events plus increasing state control in the energy sector have given rise to concern among Russia's customers. Repeated statements by President Putin that energy supplies to the EU member states will not be affected as a result of unreliable transit countries are heard in the EU, but seem rather symbolic. As long as Russia does not fully embrace multilateral agreements in both economic and energy policies, doubts about the country's reliability will remain, and politics will continue to play a larger role than needed and intended.²²⁹

The 2006 gas dispute had a tremendous impact on EU-Russian energy relations. Two aspects of the events are telling. First, the Russian leadership failed to grasp how Europeans would interpret the way Russia treated Ukraine. The Europeans could not fathom why the Russians would resort to such an extreme measure without prior consultation of its European customers. Second, at the time the gas conflict reached its climax Russia's overall reputation in the West was already tarnished. The West increasingly viewed Russia as an authoritarian and anti-democratic power. Thus, the political context in early 2006 was already charged negatively against Russia.²³⁰ Now many in Europe raise the

²²⁸ Tatarintseva, Marina, and Ognian N. Hishov, "Die Energiestrategie der EU und die Kooperation mit Russland," *SWP-aktuell*, no. 48 (October 2006): 4.

²²⁹ Smith, Hanna, 2006, pp. 9–10.

²³⁰ Perovic, Jeronim, and Robert Orttung, 2007, p. .

question of whether the EU wants to further cooperate with this kind of Russia.²³¹ But the real question is whether or not Europe has a choice in this.

Energy is by far the most important commodity in the trade relations between the EU-27 and Russia. Russia was the EU-27's third most important trading partner, after the USA and China, accounting for just over 6% of EU-27 exports and 10% of EU-27 imports. In 2006, energy imports from Russia amounted to €94 billion, mainly oil and gas. These two fossil fuels hold a combined share of 62% in the EU-27's primary energy mix. Imports from Russia make up 26% of the EU-27's oil consumption and 29% of its gas consumption. By 2020 the EU-27's consumption of oil will still be nearly the same, but gas consumption will increase. By then, the EU-27's overall import dependence will increase to more than 90% for oil and about 80% for gas by 2010.²³²

Table 5.1 – EU-27 trade with Russia by product in millions of euros, 2000 and 2006

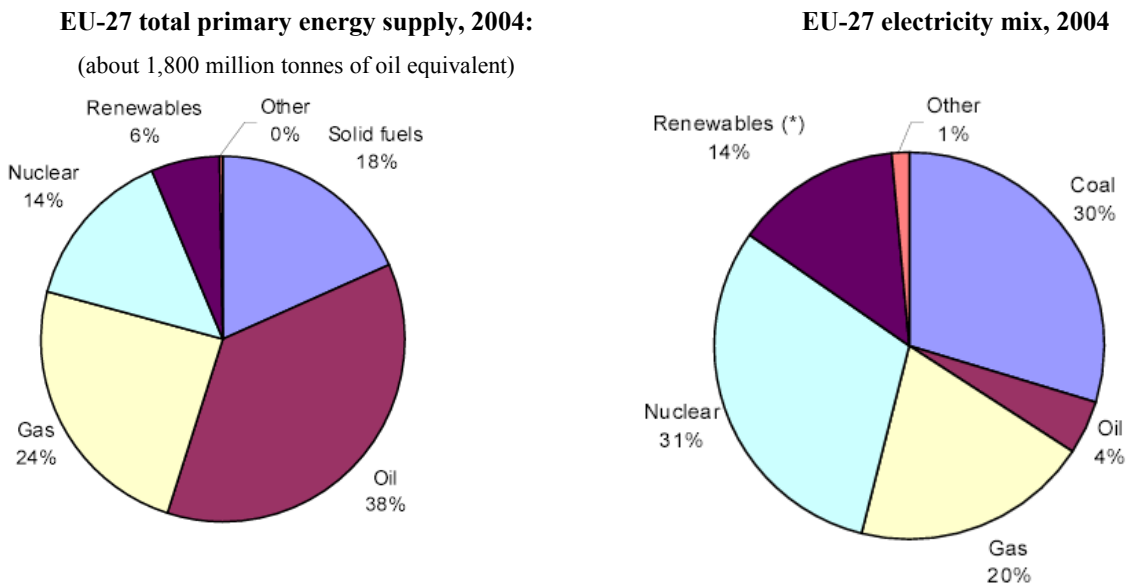
<i>in € 1,000,000</i>	Exports		Imports		Balance	
	2000	2006	2000	2006	2000	2006
Total	22,738	72,360	63,777	140,586	-41,039	-68,226
Primary products:	3,652	7,560	40,172	99,772	-36,519	-92,213
Food and drink	2,823	5,911	727	796	2,096	5,115
Crude materials	708	1,183	3,652	4,889	-2,944	-3,706
Energy	121	466	35,793	94,087	-35,671	-93,621
Manufactured goods	18,483	63,378	13,487	20,138	4,996	43,240
Chemicals	3,280	10,911	2,519	4,010	761	6,901
Machinery and vehicles	8,381	33,576	1,074	1,194	7,308	32,382
Other manufactured articles	6,822	18,892	9,895	14,934	-3,072	3,958
Other	602	1,423	10,118	20,676	-9,516	-19,253

Source: Eurostat, "External and intra-European Union trade – No. 7/2007," 15 May 2007, http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP_PRD_CAT_PREREL/PGE_CAT_PREREL_YEAR_2007/PGE_CAT_PREREL_YEAR_2007_MONTH_05/6-15052007-EN-BP.PDF.

²³¹ Ibid.

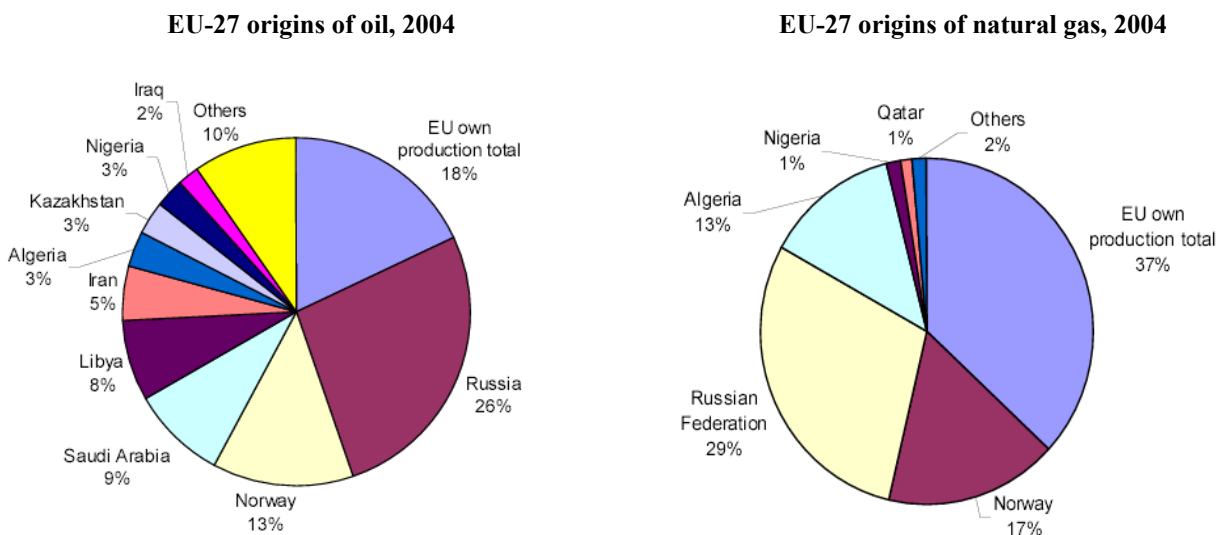
²³² Eurostat, "External and intra-European Union trade – No. 7/2007," 15 May 2007, http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP_PRD_CAT_PREREL/PGE_CAT_PREREL_YEAR_2007/PGE_CAT_PREREL_YEAR_2007_MONTH_05/6-15052007-EN-BP.PDF; EU Commission, "Commission Staff Working Document: EU Energy Policy Data," 2007, http://ec.europa.eu/energy/energy_policy/doc/02_eu_energy_policy_data_en.pdf.

Figure 5.1 – EU-27 total primary energy supply and electricity mix, 2004



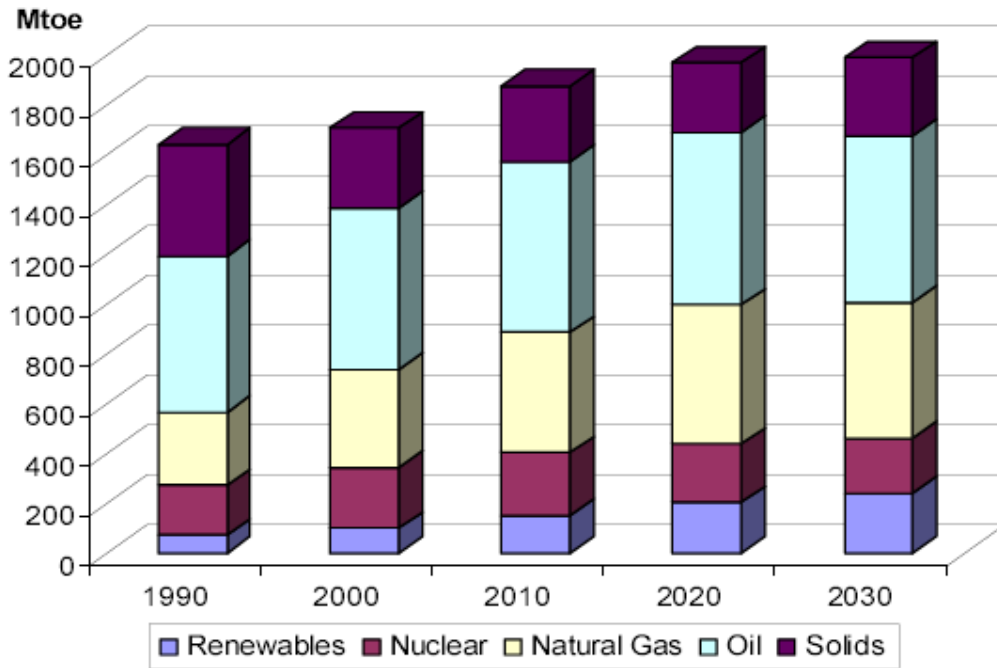
Source: European Commission, “Commission Staff Working Document: EU Energy Policy Data,” 2007, http://ec.europa.eu/energy/energy_policy/doc/02_eu_energy_policy_data_en.pdf, p. 8.

Figure 5.2 – EU-27 origins of oil and natural gas, 2004



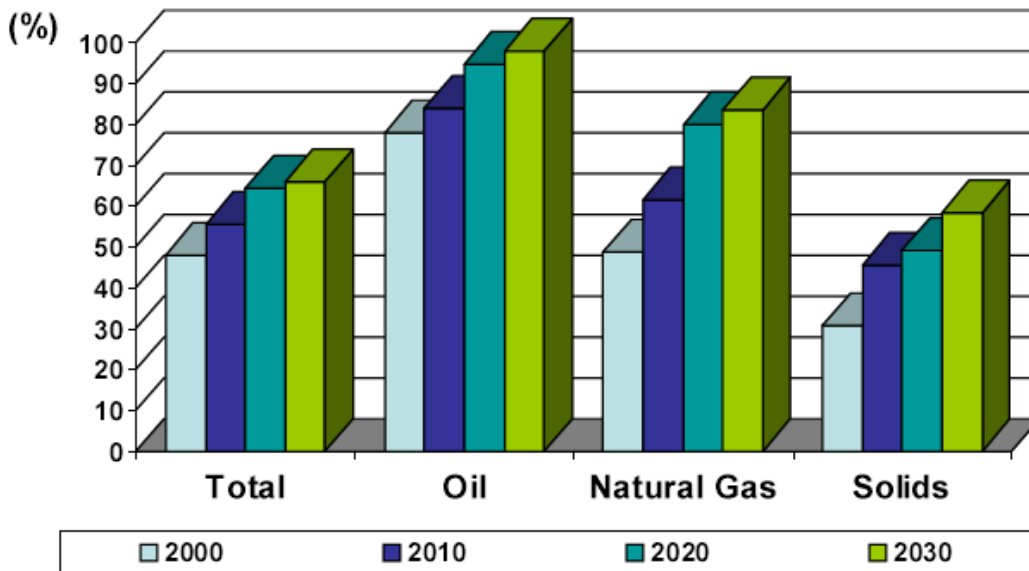
Source: European Commission, “Commission Staff Working Document: EU Energy Policy Data,” 2007, http://ec.europa.eu/energy/energy_policy/doc/02_eu_energy_policy_data_en.pdf, p. 11.

Figure 5.3 – EU-27 total primary energy supply (baseline scenario)



Source: European Commission, “Commission Staff Working Document: EU Energy Policy Data,” 2007, http://ec.europa.eu/energy/energy_policy/doc/02_eu_energy_policy_data_en.pdf, p. 14.

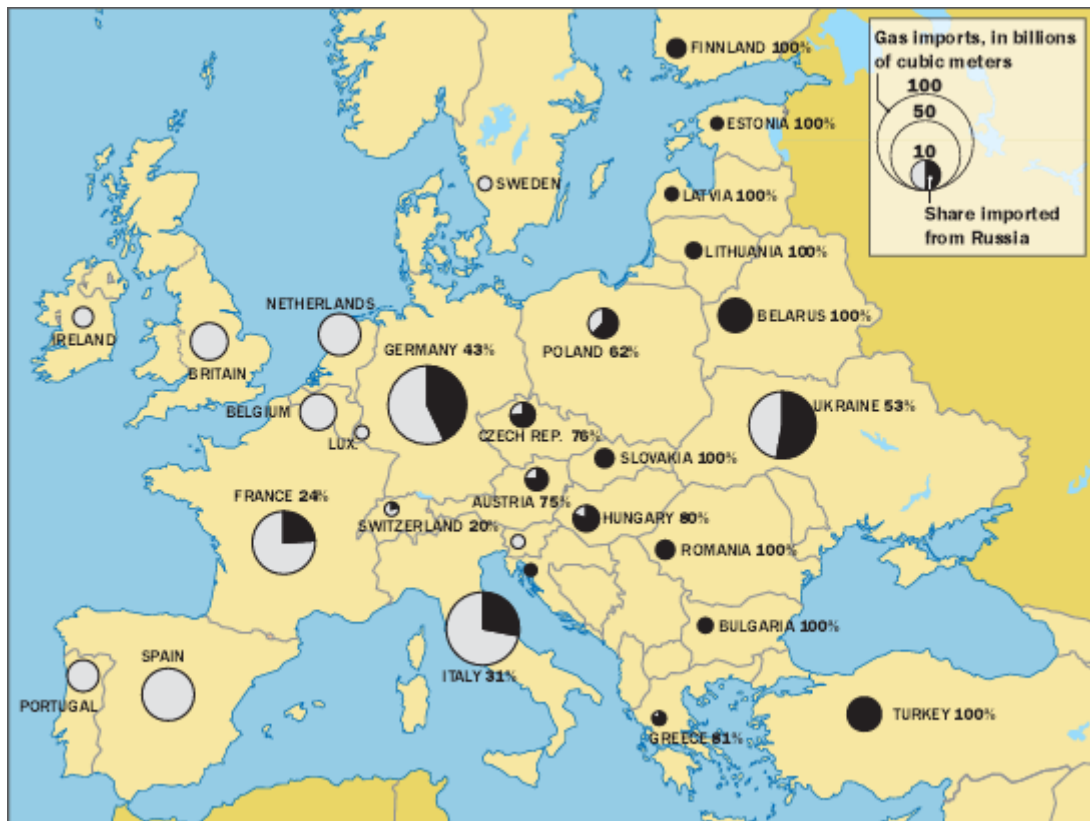
Figure 5.4 – EU-27 development of import dependence up to 2030 (baseline scenario)



Source: European Commission, “Commission Staff Working Document: EU Energy Policy Data,” 2007, http://ec.europa.eu/energy/energy_policy/doc/02_eu_energy_policy_data_en.pdf, p. 13.

The current dependence on Russian energy exports varies among EU member states. However, especially Russian gas exports are vital for Europe. The dependence on these imports is increasing. Eastern European member states are already dependent for most of their gas imports, but large economies such as Germany, France, and Italy import between 24 to 43% of the gas they consume from Russia. Due to depleting gas fields in the North Sea and the Netherlands, Russia's shares in European gas consumption will grow in the near future.

Map 5.1 – Russia's share in European natural gas imports



Source: IEA, Verband der Schweizerischen Gasindustrie, "Russian Oil and Gas Production," *russian analytical digest*, no. 18, 3 April 2007, p. 13.

From a security of supply perspective, Russia is *the* key to Europe's energy security. Since gas is increasingly being used to produce electricity, gas – rather than oil – is the priority in Europe's energy cooperation with Russia. Moreover, gas transports through pipelines are cheaper than LNG shipments. Russia has the pipeline gas that Europe needs and can influence and control some of the alternative major pipeline supply options, such as the Caspian region and the Caucasus. Thus far, other sources for European gas supply, such as Algeria and Libya, are watching Russia's moves and benefit from the higher prices.²³³ In the meantime, Russian energy companies have also approached several countries in North Africa in order to begin joint projects. Thus, either way Russia's energy companies will be vital for a large share of Europe's gas supplies.

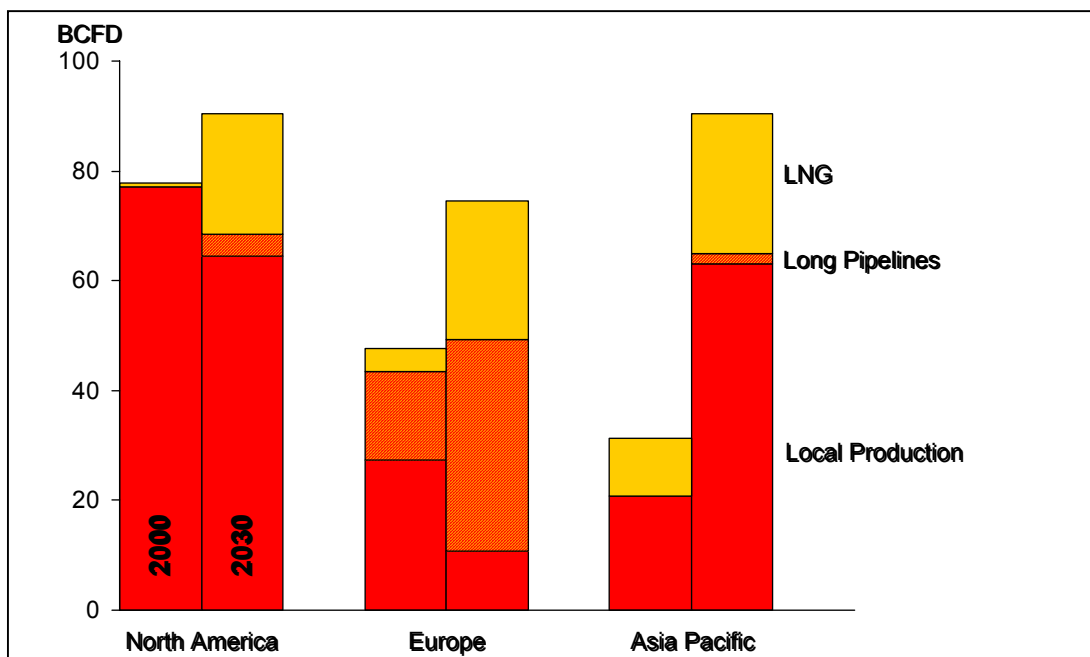
²³³ Helm, Dieter, "Russia, Germany and European Energy Policy," *Open Democracy*, 14 December 2006, http://www.opendemocracy.net/globalization-institutions_government/energy_policy_4186.jsp.

Map 5.2 – Main natural gas export pipelines from Russia



Source: IEA, Verband der Schweizerischen Gasindustrie, “Russian Oil and Gas Production,” *russian analytical digest*, no. 18, 3 April 2007, p. 13.

Figure 5.44 - Pipeline gas and LNG imports to the EU and other important consuming regions



Source: Exxon Mobil Outlook 2005.

At the EU level, few steps can be taken to change the current situation and influence future choices for energy suppliers. A country's decision about the structure of its energy mix is a sovereign right of all the individual member states. The European Commission has no mandate to interfere with the choice for the energy mix in member states. The 2007 EU Energy Package,²³⁴ however, calls for the first time in EU history for an overall integrated energy policy. But the energy mix as a national decision remains untouched. Recently, the European Council agreed to the proposed policy measures. These include commitments such as the 20% increase of energy efficiency by 2020, together with the increase of the share of renewable energy from its present level of some 7% to 20% in 2020.²³⁵ The concrete implementation of these commitments is heavily debated, including the diversification to non-carbon sources, such as nuclear and renewable energies. Implementation will take time and requires huge investments. However, all these measures cannot make any immediate impact on the amount of the gas consumption. Hence, for the time being the EU will continue to expand its gas consumption and, consequently, its gas imports from Russia and other countries.

In the past, the EU has tried to deal with the growing dependency on Russian gas imports in two ways, which both focus on the regulation of energy cooperation, promotion of competition, and transparency. First, the European Commission has been pushing on with liberalisation and competition policies within the EU, arguing towards Russia to take similar approaches. These measures, however, cannot decrease the dependence on gas imports. Second, European policy makers have encouraged Russia to participate in the Energy Charter Treaty process and still keep trying to persuade Russia to ratify the Treaty, and in particular to sign up to the Transit Protocol, in order to increase legal certainty and open up access to Russia's pipelines for international transit.²³⁶ Thus far, this approach has not been successful.

5.2. The Energy Charter Treaty

In mid-1991, Dutch Prime Minister Ruud Lubbers launched the proposal for a European Energy Community. The end of the Cold War seemed to offer an unprecedented opportunity for mutually beneficial cooperation in the energy sector in Europe. Further, there was a recognised need to ensure that a commonly accepted foundation was established for developing energy cooperation among the countries of Eurasia. The ECT has its roots in a political declaration on East-West cooperation in the energy sector. In December 1991, the political declaration on the Energy Charter was signed. In December 1994, the Energy Charter Treaty (hereafter "ECT") and the Protocol on Energy Efficiency and Related Environmental Aspects were signed. In April 1998, the ECT entered into full legal force after the first 30 members had ratified the document. As a comprehensive multilateral agreement, it covers all aspects of energy cooperation – i.e., trade, investment, transit, energy efficiency, and dispute settlement – and promotes openness of energy markets and security of energy supply, with respect for the principles of sustainable development and sovereignty over natural resources.²³⁷

The ECT obliges all parties to facilitate energy transit on a non-discriminatory basis. However, it does not oblige the signatory countries to grant third party access. Moreover, it provides for a special conciliation mechanism in the case of transit disputes. The ECT's provisions on transit are supplemented, and extended by a legally binding Transit Protocol that is still being negotiated. The ECT has become an issue of disagreement between the EU and Russia. Unfortunately, the public discussion about the Treaty is dominated by populist statements, which more than discredit the underlying goals. Therefore, it is worthwhile to explore this issue in some details.

²³⁴ Commission of the European Communities, "An Energy policy for Europe, January 2007," Com(2007) 1, 10 January 2007, http://eur-lex.europa.eu/LexUriServ/site/en/com/2007/com2007_0001en01.pdf.

²³⁵ Council of the European Union, "Brussels European Council 8/9 March 2007: Presidency Conclusions," 7224/01/07, 2 May 2007, http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/en/ec/93135.pdf.

²³⁶ Helm, Dieter, "Russia, Germany and European Energy Policy," 2006.

²³⁷ See Energy Charter Secretariat, "About the Charter," <http://www.encharter.org/index.php?id=7>; Energy Charter Secretariat, "The Energy Charter Treaty: A Reader's Guide," Brussels, 2004, http://www.encharter.org/fileadmin/user_upload/document/document1158668628.pdf#page=2, p. 7.

Russian critics of the ECT hold that the ECT is an instrument used by the EU to impose too many unfavourable obligations onto the Russian side, while Russian energy corporations will gain few advantages after the ratification and implementation of the Treaty. The Chairman of the Duma Committee on Energy, Transport and Communication, Valery Yazev, explains in a quite oversimplified way why he has been refusing to ratify the ECT for about seven years. One important reason is the fact that other important players, such as the United States, Algeria, and Norway, have either not participated in the whole process or have also not yet ratified the Treaty. He further states some more specific reasons why he is not willing to advise the Duma to ratify the ECT.²³⁸

According to Yazev, the provisions that are most important for Russia's refusal to ratify the ECT are those on the regional economic organisations,²³⁹ the right of first access to pipelines, and on the transit tariffs.²⁴⁰ First, the EU as a whole is party to the Treaty. Therefore, the Transit Protocol will not apply to EU member states. If Russia – which is a transit country with regard to gas transports from Central Asia – ratifies the ECT and the related documents, the Protocol will apply to Russia, without ever applying to any EU member state. Second, Russia does not accept that the right to access will not be reserved for the party that develops and exploits the resources and constructs the pipelines. Third, Russia does not agree to the way tariffs are determined. The EU urges Russia to apply the same tariffs for its domestic transit that are being applied to other transit countries. This would result in a considerable increase in gas prices in Russia.²⁴¹

In addition, Yazev ridicules the promise of investments in exchange for access to the pipeline network. He states that the Russia's investment climate does not depend on its ratification of the ECT, but on economic indicators. At the moment, Russia faces no problems in attracting foreign investment. On the other hand, Russia has also been promised access to the European energy customer. Yet the realisation of this promise seems increasingly difficult.²⁴²

Yazev's comments on the ECT are not those of a legal expert but of a politician. However, his views enjoy great support in the Duma. In his statements, he also plays with Russian fears of too much Western interference with the energy sector and subsequent economic loss for the country. Thus his comments should not be viewed as a correct interpretation of the ECT, but how it is used in Russian politics and how attention is being diverted from the issues.

Nevertheless, Russia is legally bound by its signature, as its government signed the ECT in 1994 and has accepted provisional application of the Treaty pending ratification. This means that Russia has agreed to apply the provisions of the ECT to the extent that they are consistent with Russia's constitution, laws and regulations. The absence of ratification does not present an obstacle to the practical and technical work of the Energy Charter process, in which Russia is an active participant. It does, however, leave ambiguity about the extent of Russia's legal rights and obligations under the Treaty.

In an interview in late 2006, President Vladimir Putin expressed his views on the issue of Russia's implementation of the ECT. He states that when Russia signed the Russian delegation expressed Russia's concern on a number of points and these are expressed in the declaration of the chairman of the Conference on the European Energy Charter. These focussed on the problem of trade in nuclear materials between Russia and the EU, which had been left out in the preparation of the ECT. It was proposed that this issue would be resolved within the framework of the new partnership agreement between Russia and the EU. A date was set for the conclusion of an agreement on the free trade of nuclear materials – i.e., 1 December 1997. Until now negotiations on this issue have been fruitless. Russia's nuclear industry is affected by the fact that the EU keeps imposing quantitative limits on the

²³⁸ “Я противник ратификации Энергетической хартии” (I am against the ratification of the Energy Treaty), *Kommersant*, 15 November 2006, <http://www.kommersant.ru/application.html?DocID=720405&IssueId=36111>.

²³⁹ Article 1 (3) ECT.

²⁴⁰ Article 7 (1), (3) ECT.

²⁴¹ “Я противник ратификации Энергетической хартии,” *Kommersant*, 15 November 2006.

²⁴² *Ibid.*

goods of the nuclear cycle. The situation has worsened even more since the 2004 EU enlargement and the creation of an Energy Community Treaty²⁴³ between the EU and the wider south-eastern European area. This Energy Community Treaty requires the full “*acquis communautaire*” in energy, therefore applying all EU energy legislation. The Energy Charter Treaty could also not change the rule on the protection of investments. This shortcoming should be removed after signing the Additional Investment Agreement, but this was blocked by the EU in 1998.²⁴⁴

Putin also criticises the state of the discussion about the Transit Protocol. Some of the issues at stake are crucial for Russia, such as the position of the EU that the transit rules are not applicable within the EU. On the other hand, the EU wants to impose on Russia transit tariffs and a regime to regulate transit disputes. Furthermore, Russia is concerned that Russian companies would be unable to prolong delivery contracts where they have priority right to renew their transportation contracts. At the time of the conclusion of the ECT, Russia expected that these issues would be resolved soon after the completion of the Treaty. Therefore, Russia started to ratify the ECT in August 1996. However, this process has been stalled because none of the aforementioned obstacles have been removed. As a result, according to Art. 45 of the ECT the provisions apply to Russia on a temporary basis, provided that they do not contradict Russian legislation.²⁴⁵

The issues that were raised by President Vladimir Putin and Valery Yazev – i.e., nuclear trade, the EU enlargement, investment rules, and the Transit Protocol – and their arguments have recurred in statements made by other senior Russian officials. These can be considered the core issues of substance that have been linked to ratification of the ECT by Russia, and each warrants some additional commentary.

The trade in nuclear materials between the EU and Russia was excluded from the scope of the ECT through a declaration, which was done in a similar way for EU trade in nuclear materials with Ukraine, Kazakhstan, Kyrgyzstan, Tajikistan, and Uzbekistan. The declaration states that trade in nuclear materials will instead be covered by the bilateral partnership and cooperation agreements. The PCA with Russia foresees a separate bilateral arrangement on this specific issue. The intention, specified in Article 22 of the PCA with, was to conclude such a bilateral arrangement by 1 January 1997. Without such an arrangement, trade in nuclear materials is covered by the PCA, which specifically allows for quantitative restrictions on nuclear materials. In 2004, the European Commission received a mandate from the Council to negotiate an agreement on nuclear trade with Russia. There has been very limited progress in these negotiations. On the Russian side, the intention appears to be to use the debate over the ECT ratification as a means to kick-start these talks in a direction that would improve or guarantee Russian access to the enlarged EU market for nuclear materials, rather than to bring this issue within the scope of the ECT.

At the 17th Meeting of the Energy Charter Conference in November 2006, the Russian delegation commented on the EU’s enlargement and the conclusion of the Energy Community Treaty, which meant that three-quarters of the ECT constituency had fallen within the legislative reach of the EU. This had an effect on the balance of the Treaty, both in terms of voting and also in terms of substance; as an example of the latter, Russia referred to the EU’s insistence that the Transit Protocol would not apply within the EU, a stance which called into question the capacity of the Treaty to balance the interests of the different parties. Nevertheless, the issue of EU enlargement cannot be taken *per se* as an argument relating to ECT ratification, but should be read in conjunction with issues of substance, such as nuclear trade (as in Putin’s interview) or the draft Transit Protocol.

The existing protection for investors under the ECT against discriminatory treatment and key non-commercial risks applies only once an investment is made. A “Supplementary Treaty” to the ECT

²⁴³ The Energy Community Treaty should not be mixed with the Energy Charter Treaty, as both treaties are using the same ECT abbreviation.

²⁴⁴ “President V. Putin: Written Interview for Mexican Publisher Marlo Vazquez Rana,” 7 December 2007, http://president.kremlin.ru/eng/speeches/2006/12/07/2211_type82916_115117.shtml.

²⁴⁵ *Ibid.*

would have extended the scope of binding Treaty obligations to the pre-investment phase, i.e., the making of investments. As pointed out by President Putin, the fact that negotiations on this instrument stalled in 1998 was largely due to the EU. From a Russian perspective, this may be a useful political point to make. At the same time, however, it might be doubted whether the Russian side is in practice interested in the substance of the Supplementary Treaty. This treaty would include provisions on non-discriminatory access for foreign investors to investment opportunities in the Russian energy sector. The current Russian leadership's position on such issues is unambiguous.

The Russian side also discussed the Treaty's investment provisions at the meeting of the Charter Conference in November 2006. The Russian delegates recalled that the Treaty was drafted in the early 1990s and that the provisions are a result of trade-offs between the negotiating parties and their wish to find a balance of interest. Since so much has changed since the Treaty was concluded, it needed to be adapted to these changes and its provisions had to be updated. The approach embodied in the original agreement – access to upstream energy resources in exchange for energy investment – had lost validity at a time when the main challenge was to encourage mutual investment among participating states. According to the Russian delegation, the Treaty needs to reflect a new balance of interests and include reciprocal obligations all along the energy chain. Although this statement clarified the Russian position regarding the ECT investment provisions, it is still not clear if and how the observation about a “new balance of interests” translates into specific legal proposals in relation to the text of the Treaty, and thus far no such proposals have been made.

The Transit Protocol aims to build on the existing Treaty provisions on transit, and to specify in greater detail the operational requirements associated with “freedom of transit” in the energy sector. The draft of the Transit Protocol covers a number of issues of substantial interest to the Russian side, and this has been reflected in active Russian participation in expert discussions on the draft text. To recall, agreement was reached on the bulk of the Protocol's text at the end of 2002. There remained some open issues to be resolved before the Protocol could be finalised,²⁴⁶ and these have been the subject of continued discussion since then between the EU and Russia. Subsequently, experts from Russia and the EU conducted an intensive round of exploratory talks in 2006 on the draft text. Clarifications and text proposals that were developed during these discussions cover transparent and non-discriminatory ways to manage congestion in networks and grids, and provisions on cost-reflective tariffs. However, it was not possible to reach consensus on all issues. The main issue requiring further consideration is how, and to what extent, the Protocol can include mechanisms to help establish long-term transit arrangements where appropriate, in particular in connection with long-term supply contracts. A related issue is the application of the Transit Protocol within the EU. Thus, it must be clarified as to how and to what extent the rules of the Protocol interact with the legislation of the EU's internal market. At the meeting of the Energy Charter Conference in November 2006, the member states reviewed the status of the draft Protocol, and invited Russia and the EU to continue their bilateral consultations and to keep other member countries informed of progress through the Energy Charter's Trade and Transit Group.

In short, of the four issues raised by the Russian side, both the first (nuclear trade) and second (EU enlargement) are not linked to issues covered by the ECT. The third issue (investment) represents a fair observation regarding the fate of the Supplementary Treaty, but there are justifiable reasons to doubt whether the Russian side is interested in pursuing this issue in practice. The only well-defined objection on matters intrinsic to the ECT relates to the draft Transit Protocol. Hence, conclusion of this Protocol – or dealing with the substantial issues of Russian concern in another form – would remove the main obstacle to ratification.

In addition, there is a less well-defined but oft-expressed sense from the Russian side that the Treaty does not reflect “current realities” in the energy sector. Insofar as this objection takes shape, it expresses the desire to incorporate “reciprocal obligations” along the energy chain in the ECT, but it is not clear that this desire is coupled with the need to amend the Treaty. In any event, the Russian side is

²⁴⁶ Energy Charter Secretariat, “Final Act of the Energy Charter Conference with Respect to the Energy Charter Protocol on Transit,” 31 October 2003, http://www.encharter.org/fileadmin/user_upload/document/CC251.pdf.

open to discussion. At the meeting in November 2006, the Russian delegation underlined that the ECT retains importance for Russia as the only document establishing international rules of the game for the energy sector. In order to ensure that this document reflects current realities, this delegation called on other parties to discuss a reform of this instrument, and indicated its readiness to participate in this process at both the expert and political levels.

5.3. Misunderstandings in relation to Russia and the Energy Charter Treaty

The substantial debate on Russia and the ECT, on the topics discussed above, has been complicated and even overshadowed by several misunderstandings regarding the Treaty. These have been repeated on occasion by senior officials on both the EU and Russian sides, and have become common currency in almost all media discussion of the Energy Charter and Russia.²⁴⁷ In practice, this “phoney war” in relation to the ECT has also become a significant obstacle to progress with ratification. The most common misunderstandings are that the Treaty imposes mandatory third-party access to energy infrastructure, obliges countries to grant foreign investors access to their natural resources, and/or that it prescribes unbundling and privatisation of state-owned assets.

First of all, the ECT does not oblige any contracting party to introduce mandatory third-party access. The Treaty includes an obligation for member countries to facilitate energy transit across their territories, in line with the principle of freedom of transit, and an obligation to secure established transit flows. At the same time, an understanding included in the Treaty makes it clear that the Treaty provisions “do not oblige any Contracting Party to introduce mandatory third-party access”.

Negotiations on the Transit Protocol aim to clarify the operational meaning of “freedom of transit” for the energy sector, on the basis of the existing Treaty provisions. The overall aim is to provide clear and transparent rules for international energy transit flows, which can encourage the efficient development and use of energy transportation infrastructure and reduce the risk of interruptions to supply.

Further, the ECT does not oblige countries to provide foreign access to national energy resources. While the ECT is based on the idea that international flows of investments and technologies in the energy sector are mutually beneficial, national sovereignty over energy resources is a core principle of the Treaty, Article 18 ECT. Each member country is free to decide whether and how its national energy resources are developed, and also the extent to which its energy sector is open to foreign investors.

Moreover, the ECT does not require unbundling or privatisation of state-owned assets. An objective of the Treaty is to promote transparency and efficiency in the operation of energy markets, but it is up to governments to define the structure of their national energy sector. There is no obligation to privatise state-owned energy companies, or to break up vertically integrated energy companies.

Russia would benefit from the ratification of the ECT, as that would clarify beyond any doubt Russia’s rights and obligations under the ECT. The Russian Federation signed the ECT in 1994 and has since that time applied the Treaty on a provisional basis. In legal terms, Russia has agreed to apply the Treaty “to the extent that such provisional application is not inconsistent with [Russia’s] constitution, laws or regulations”, Article 45 (1) ECT. In practice, while Russia maintains that it complies with the Treaty in full, Russia’s status in relation to the ECT is open to a degree of interpretation. The extent to which a state’s acceptance of provisional application of a treaty creates legal rights and obligations is not entirely clear under international law. Ultimately, this question can be settled authoritatively only in the context of relevant cases brought to international arbitration. The choice facing Russia in relation to the ECT is therefore not a straight “yes” or “no”. Even if Russia decided to terminate its

²⁴⁷ See, for instance, “В. А. Язев: Газ как фактор российской дипломатии” (V. A. Yazev: Gas as a factor in Russian diplomacy), *Mayak*, 21 December 2006, <http://www.duma.gov.ru/energy/zakon/doklad/st210606.html>; “Energy Charter Needs Reviewing, Adaption – Official,” *RIA Novosti*, 23 November 2006, <http://en.rian.ru/russia/20061123/55917471.html>; Mihailescu, Andrea R., “Russian Officials Pushing for Natural-gas Alliance,” *Alexander’s Oil & Gas Connection* 11, no. 22, 24 November 2006, <http://www.gasandoil.com/GOC/news/ntr64743.htm>.

provisional application, it would still be obliged to apply Parts III (Investment Promotion and Protection) and V (Dispute Settlement) for a further twenty-year period in relation to investments made while the Treaty had been provisionally applied, Article 45 (3) ECT. The choice is to either ratify and thereby to participate fully in the Charter process, or to continue to live with an ambiguous – and disadvantageous – status. The current situation creates incremental risks, and additional costs, that are borne by energy investment projects in Russia and by Russian investments and energy flows in other ECT countries. This is neither in the Russian interest nor in the interests of the Charter process as a whole. It runs counter to an essential objective of the Treaty: the creation of clear *rules of the game* for energy cooperation, investment security and reliable cross-border flows for all its member states. As no participant in the Russian energy sector can seriously claim to benefit from the uncertainty surrounding Russia's ambiguous status in relation to the ECT, these incremental risks and costs are not balanced by any tangible benefit to Russia.

Furthermore, ratification would enhance the security for investments in the Russian energy sector and the protection of an increasingly large volume of Russian outward investment across the ECT constituency. Russia needs large-scale investment in the oil and gas sector in the forthcoming decades. This applies in particular to new production areas such as Eastern Siberia, Timan-Pechora, Sakhalin and projects in offshore areas, which – alongside investments in exploration and production – require new transportation infrastructure in order to bring energy resources to national and international markets. While high energy prices have amplified revenues from energy exports, sources of funding for the investments of such long-term and capital-intensive projects are unlikely to come only from domestic sources. The creation of project consortia, including foreign investors, even if the latter hold only a minority stake, remains an advantageous approach. The participation in a consortium allows risks to be shared, improves access to capital, and also brings in know-how that is necessary to develop reserves in geologically difficult and offshore areas. The ECT is the best available multilateral instrument for investment protection and thereby reduces the cost of investment capital. By protecting investors against non-commercial risks, the Treaty promotes a reliable interface between an investment project and the host government; this is particularly important for long-term projects that can extend through multiple changes in government. Ratification would enhance the attractiveness of investment in all parts of the energy sector, including electricity generation and distribution, and renewable energy sources. Russia has recognised in its *Energy Strategy up to 2020* that an actual and potential shortage of investment funds is a threat to its national energy security.

All of the above considerations apply not only to investments in Russia, but also to the increasing volume of outward investment by Russian companies in other ECT countries. In some ECT countries, energy investment by Russian companies raises political and strategic sensitivities that expose these investments to a significant degree of non-commercial risk. Ratification of the ECT would provide a clear legal mechanism for protecting these investments.

The ECT provides guarantees for freedom of energy transit. During the 2006 gas dispute between Russia and Ukraine, the Russian Ministry of Foreign Affairs released a statement that the Ukrainian side, in full accordance with the international obligations specified in particular in the European Energy Charter, guarantees unimpeded transit of natural gas across its territory to the countries of the European Union and will take all necessary measures to prevent the unlawful taking of natural gas in transit and also of gas in underground storage in Ukraine. This statement underlines Russia's interest in a reliable international regime for energy transit and in the Energy Charter framework. At the same time, it also suggests some of the practical disadvantages of Russia's current status in relation to the Treaty. The statement appeared to hold Ukraine to standards which Russia itself is reluctant to apply. Ratification would bolster Russia's credibility when advocating compliance with the Treaty. Moreover, Russia's ratification would also enhance its ability to ensure compliance through the Treaty's dispute settlement mechanisms. A ratified ECT and a finalised Transit Protocol would provide Russia and all ECT member states with clear rules for international transit that would reduce the risk of future interruptions to supply and provide a framework for the resolution of transit disputes. The balanced development of a Eurasian energy market, and particularly the market for natural gas, will greatly benefit from a reliable regime for international energy transit based on common standards that are accepted by all countries on a multilateral basis.

The ECT supports some of Russia's key political priorities. A clear signal on ratification would be a visible and tangible demonstration of Russia's commitment to reliable energy supply and to energy cooperation based on common principles and values. Ratification would be fully in line with the 2006 St. Petersburg G8 Plan of Action on Energy Security, while at the same time strengthening Russia's economic security through guarantees for Russian energy investments, transit, and energy exports across the ECT constituency. In relation to the EU, ratification would give substance to the idea of a "common economic space", by confirming common rules for a critical part of the EU-Russian relationship. It would thereby provide a binding legal basis that would complement and support the bilateral EU-Russian dialogue. Ratification by Russia would also significantly enhance the benefits of the Treaty for states in Northeast Asia. Both China and South Korea have indicated that they see Russian ratification as a major benefit in relation to their potential accession. In this way, a positive decision in Moscow could build the foundations for stronger energy cooperation across Northeast Asia, facilitating the development of new oil and gas production in Eastern Siberia, of new pipeline projects and cross-border trade in this region.

The Russian State Duma has held two sets of hearings on the ECT. The first, in 1996, concluded that ECT ratification should await progress with accession to the WTO. Following the election of Vladimir Putin as President, the Treaty was resubmitted to the Duma by the Russian government, and a second set of hearings took place in January 2001. The hearings showed overall support for ratification from representatives of the government, the electricity industry and other important actors such as Transneft. However, there was also strong opposition, primarily from Gazprom. During the debate, and in subsequent contacts, Gazprom has put forward three arguments to justify its opposition to the Treaty.

First, Gazprom claims that the ECT would introduce mandatory third-party access to the Russian pipeline network. This view is unfounded, as the Understanding 1 (b) (i) to the Treaty states that "the provisions of the Treaty do not oblige any Contracting Party to introduce mandatory third party access". Second, Gazprom has claimed that ratification would threaten the system of long-term contracts for gas supplies to Europe. This concern attached itself to the Treaty in 2001, although the Treaty is silent on this issue. It was much more plausibly linked to the concurrent process of energy market liberalisation within the EU. This issue has been taken up in the EU-Russian energy dialogue. Third, Gazprom claimed that certain provisions of the Treaty's Article 7 were ambiguous and required clarification. Gazprom raised questions in particular relating to Article 7 (3) ECT, and whether this includes a requirement for national treatment of energy flows in transit no less favourable than domestic transportation. These questions have been taken up in the discussions on the draft Transit Protocol.

The conclusion of the 2001 debate was that ratification should take place, but only once certain issues had been resolved or studied in more detail. Furthermore, the debate established a political link between the completion of negotiations on the Transit Protocol and the question of ratification.

5.4. The road towards a Brussels-Moscow energy axis

The EU imports about 50% of the energy it consumes, and this share will continue to grow in the near future. This increasing dependence on energy imports generates a number of problems and is equated with vulnerability and greater power accorded to external suppliers. The geographical proximity of Russia suggests that it is logical to establish a mutually beneficial energy relationship with this country. However, concerns have been raised that the EU could find itself increasingly at the mercy of an authoritarian Russia, which might use its control over a large share of the EU's energy imports as a diplomatic lever against it.²⁴⁸ Yet the assertion of Russia using energy as a political tool is open to question. First, as most Russian oil companies are privatised, the government is not in a position to use

²⁴⁸ Monaghan, Andrew, "Russian Oil and EU Energy Security," *Conflict Studies Research Centre – Russian Series*, no. 5 (2005), <http://da.mod.uk/defac/colleges/csdc/document-listings/caucasus-publications>, p. 1.

them as foreign policy instruments.²⁴⁹ Second, there have been no clear examples of purely political use of energy cut-offs by Russia; previous cut-offs had either economic or technical reasons.²⁵⁰

From a consumer country's perspective, energy security is about limiting the vulnerability to disruption, given the increasing dependence on imported fossil fuels from unstable areas and the provision of adequate supply for increased demand at reasonable prices. Energy producing countries such as Russia favour high prices and need secure and reliable export facilities. Through its existing infrastructure, Russia is currently tied to European consumers and considers itself vulnerable to both economic and political blackmail since it has to export the majority of its oil and gas through other countries. Thus, using terms such as "dependence" could "play into the hands of easily communicated doomsday beliefs and the impending catastrophe".²⁵¹ Russia may fear that the EU will try to exert pressure on Moscow and seek other sources before Russia can develop other markets. These fears result in threats of retaliation if the EU would pursue alternative deals. Subsequently, an "energy security dilemma" will emerge as both sides become nervous about their energy security and diversify away from each other. Since the implication of mistrust will generate more problems, there needs to be a change in approach from us (consumers) vs. them (foreign producers). These terms do not reflect the complexities of the issue suggest a certain degree of polarity and imply suspicion. Further, the vagueness of the difference between energy producers and consumer countries is particularly relevant for EU-Russian relations. In fact, it is important to realise that Russia is "triple-hatted"; it is a major energy producer, consumer, and transit state. The EU must deal with Russia in a way that acknowledges this "triple-hatted" status, and risks and benefits of energy cooperation must be divided even-handedly.²⁵² This approach would leave more space for cooperation and would acknowledge Russia's economic realities instead of politicising every move.

European and Russian officials meet regularly to discuss energy issues. On these occasions, EU representatives frequently repeat the statement that Russia has always been a good supplier. Nevertheless, mutual tensions and concerns have been growing in the past few years. Although it was never a concern, Europeans are now worried about the reliability of Russian energy supplies, whereas Russian policy makers are concerned about intentions of some European countries to block Russian direct investments.²⁵³ Obviously, a series of problems and differences underlie the relationship. Thus far, the EU-Russian relationship has not been "politically securitised", and policy makers must do their utmost to prevent energy issues from emerging as a pawn in wider political and security problems between the EU and Russia.²⁵⁴

After the 2006 gas conflict between Ukraine and Russia, many European politicians called for diversifying European energy supplies. However, the notion of diversifying energy supplies should not be used easily as a way to communicate discontent with Russia's political development. This could lead to further steps by Russian energy companies to diversify energy exports, which could potentially harm long-term interests on both sides. The EU has three major gas suppliers, and Russia is its main source. The EU's oil supplies are already diversified. Furthermore, changing suppliers would involve additional infrastructure and contract costs. Finally, alternative suppliers for both oil and gas should be assessed carefully because it is doubtful whether the main alternatives – Iran, Nigeria, Venezuela, Algeria, and Libya – would be more stable, congenial, and reliable partners than Russia.²⁵⁵

²⁴⁹ The gas sector, however, is still mainly controlled by the state. But the influence of the companies on the state must also be considered in this equation. Monaghan, Andrew, 2005, p. 6.

²⁵⁰ Ibid.

²⁵¹ Ibid, pp. 3–4, 9, 16.

²⁵² Ibid, p. 9

²⁵³ Milov, Vladimir, "Energy Relations between Russia and Europe: Road Map to Sustainability from the Russian Perspective," Working Paper of the Institute of Energy Policy, May 2006, http://www.energypolicy.ru/files/russ-eur_engl.pdf, p. 1.

²⁵⁴ Monaghan, Andrew, and Lucia Montanaro-Jankovski, "EU-Russian Energy Relations: The Need for Active Engagement," *EPC Issue Paper*, no. 45 (March 2006): 7.

²⁵⁵ Ibid, p. 11.

Often timing is a crucial aspect of bilateral negotiations. European politicians should also recognise the mistakes made in previous negotiations about energy issues. In October 2003, for instance, EU Commissioner Pascal Lamy presented a package of requirements as part of the negotiations about Russia's WTO accession. The package included a set of fair and reasonable requirements – such as the increase of Russian domestic energy prices, free access to Russian gas pipelines, and the elimination of Gazprom's gas export monopoly. Yet both the timing and the manner of presenting these requirements were very unfortunate, mainly because they did not take into account the internal Russian discussion of the energy market reforms. Subsequently, proponents of these reforms have been labelled the “agents of European influence”. Thus, this package further fuelled Russian concerns that European politicians tend to demand blindfold copying of European market models in Russia without real consideration of the country's internal situation.²⁵⁶ Mishaps like this could be prevented by institutionalising bilateral energy experts meetings in order to discuss issues of concern and to better understand each other's positions.

In 2000 the EU-Russian Energy Dialogue was set up. The EU-Russian Energy Dialogue emerged from the Common Strategy. The European Commission's 2000 Green Paper on energy emphasised the strategic partnership with Russia, acknowledging the country's key dimension to the EU's future energy security and envisaged a long-term contractual relationship with Russia. The instrument to achieve this goal was the Common European Economic Space. The EU tried to establish a long-term economic relationship with Russia and to create bilateral fora and policy programmes through which it can influence Russian economic policy.²⁵⁷ Since EU and Russian priorities are very divergent, the different positions and expectations frequently result in practical limitations. During the G8 Summit in 2006, Russia agreed on more cooperation on energy issues, especially on energy security. This initiative should be supported because in the broader G8 context it could also include other important energy consumers, such as the United States and countries in Asia.

The EU expects from Russia that Western energy corporations are able to acquire stakes in Russian corporations. Several incidents, such as the Ukrainian gas crisis, the row around Shell's Sakhalin 2 project and TNK-BP's stake in Kovykta, have created a negative political atmosphere and an anti-Russian hype in Western media. Yet these cases do not reflect the level and characteristics of economic cooperation with Russia, including joint projects in the energy sector. Negotiations and contractual agreements continue with a number of other European energy companies, and there are no indications of major shifts in attitudes on either side. The Russian position on the strategic importance of the energy sector has been clarified. In general, European policy makers should try to better assess the current situation of Russia's energy sector and approach the Russian side in a more coordinated way. More understanding for the Russian position would create more space for compromises and help promote further cooperation.²⁵⁸

Some EU policy makers and representatives of Western energy corporations still hope that the Russian energy market will be liberalised. Yet liberalisation is exactly the opposite of what Putin's administration has in mind for Russia's energy sector. At the moment, efforts to liberalise the energy sector would lead to the same result as in the 1990s. EU policy makers should ask themselves whether they, at a time of high oil prices, would rather like to negotiate with a handful of oligarchs who control the entire sector. Under the current circumstances, the EU should focus on long-term agreements on energy supplies at flexible prices (determined by world market prices), which would enable Russian energy corporations to make plans for much needed investments.²⁵⁹

The EU still hopes that Russia will finally ratify the Energy Charter Treaty. On the one hand, the EU must ask itself whether enough effort has been put into establishing the legal framework of the ECT and the Transit Protocol and their possible implementation with regard to Russia. On the other hand, it

²⁵⁶ Milov, Vladimir, 2006, p. 2.

²⁵⁷ Hughes, James, 2006, p. 8.

²⁵⁸ Tatarintseva, Marina, and Ognian N. Hishow, 2006, p. 5; Perovic, Jeronim, and Robert Orttung, 2007, pp. 5–6.

²⁵⁹ *Ibid.*, pp. 5–6.

is questionable whether the legal certainty of EU-Russian energy relations really depends on this document. Genuine partnership is based on common values, norms, and mutual respect, which develop as a result of successful cooperation and not vice versa. As Russia is not willing to accept further legal obligations as part of its energy cooperation with European countries at the moment, the EU should use existing mechanisms and structures more effectively, but without dropping the demand for a ratification of the ECT.²⁶⁰ Later, the issue of the ECT could be discussed again but in a less politicised way – and should then focus on the very few remaining unsolved issues.

From an institutional perspective, the EU should also try to create something that will at first be between only Russia and the EU, and then establish a compatible regime between Russia, other CIS countries and the EU. An energy section could be included in the new partnership and cooperation agreement. Alternatively, a special energy agreement could be drawn up between Russia and the EU without the involvement of any other partner.²⁶¹ This would show the importance both parties attach to the cooperation and increase mutual confidence.

Finally, the EU should view Russia as an energy exporter as well as an energy consumer with a transitional economy.²⁶² For the time being, Russia's European partners have to be patient with regard to an increase of its internal energy prices. As there are too many Russians who currently live below the poverty level, an increase in energy prices would only help populist political forces ahead of the elections. Still, negotiations on energy efficiency and the desire to move towards a low-carbon economy might help to create an energy-related agreement. Yet it is questionable as to whether there are sufficient incentives for Russia to actively engage in the post-Kyoto process. Thus far, promotion of greater energy efficiency through the entire chain of production, transportation, and end use is often neglected as an area of cooperation. In the long term, helping to enhance Russia's energy efficiency may be an effective way to improve relations. Russia has announced plans to reduce energy subsidies for domestic consumers. Thus, by implementing energy saving measures, energy demand could be reduced, which would make higher prices more palatable for the population and politically acceptable for policy makers.²⁶³

Much efforts have already been made to establish the internal EU energy market. Now, a comparable commitment by both the EU member states and the EU institutions is required to come to a common external energy policy. The new European Commission Energy Package calls upon EU member states to speak with "one voice". But this should be based on a joint vision and a comprehensive EU strategy. It is too easy to call for this one voice approach if EU member states have not yet defined what this voice should call for in the case of Russia. Undoubtedly, it is important to establish rules for energy cooperation that apply to all member states.²⁶⁴ However, during this process the EU should not condemn member states that continue to pursue good bilateral cooperation as long as these policies do not infringe upon EU rules and norms. Some analysts correctly state that successful bilateral approaches could finally stabilise energy cooperation and contribute to the adoption of an EU-wide policy.²⁶⁵

²⁶⁰ Ibid, p. 6.

²⁶¹ Smith, Hanna, 2006, p. 10.

²⁶² Tatarintseva, Marina, and Ognian N. Hishow, 2006, p. 6.

²⁶³ Perovic, Jeronim, and Robert Orttung, 2007, p. 7.

²⁶⁴ De Jong, Jacques, "Hydrocarbon Molecules are Increasingly Asked for Their Passports," *Foreign Voices*, no. 4 (November 2006), http://www.clingendael.nl/publications/2006/20061100_ciep_art_foreignvoices.pdf, p. 3.

²⁶⁵ Tatarintseva, Marina, and Ognian N. Hishow, 2006, p. 7.

6

Dutch-Russian energy relations

This section takes a closer look at Dutch-Russian energy relations and the best way to strengthen these relations. Some options for further cooperation will be discussed in brief, such as relying on bilateral agreements, participating in partnerships with other EU member states, for instance Germany, and/or further pursuing energy policies at the EU level.

6.1. Dutch-Russian economic ties

The Netherlands has good and prosperous economic relations with Russia. Energy plays an important role in bilateral relations. The volume of Dutch-Russian trade has been increasing for a couple of years. In 2004, exports to the Netherlands accounted for 8.4% of the total volume of Russian exports. Dutch exports to Russia constituted of 3.9% of Russia's total imports, while Russia's share of all Dutch exports was 1.5%. In 2005, Dutch imports from Russia – mainly oil, gas, and coal – totalled €8.34 billion (2004: €6.11 billion), while Dutch exports to Russia amounted to €4.14 billion (2004: €3.21 billion).²⁶⁶

Figure 6.1 - Russia's trade with selected non-CIS countries, 2004

SELECTED NON-CIS COUNTRIES	NETHERLANDS	GERMANY	ITALY	CHINA
Share in Russian exports %	8.4	7.3	6.7	5.6
Share in Russian imports %	3.9	14.0	4.2	6.3

Source: Federal State Statistics Service, Russian Federation, "Foreign Trade of the Russian Federation with Non-CIS Countries," http://www.gks.ru/bgd/regl/B05_12/IssWWW.exe/Stg/d000/25-05.htm; Federal State Statistics Service, Russian Federation, "Foreign Trade of the Russian Federation," http://www.gks.ru/free_doc/2006/rus06e/25-02.htm.

In 2006, Dutch exports to Russia amounted to €5 billion, making Russia one of the most important trade partners outside the EU. Imports from Russia amounted to €11 billion.²⁶⁷ The trade deficit is created by the so-called "Rotterdam effect". Goods – in the case of Russia mainly energy supplies – that are destined for other EU countries arrive at the port of Rotterdam and then are re-exported. Thus, Dutch-Russian trade has an important energy element, with an EU-wide relevance.

The Dutch Trade Board has labelled Russia a "high-priority country" in order to help Dutch companies gain more from the country's potential economic capacity. In this scheme, public and private Dutch stakeholders cooperate closely to strengthen bilateral economic relations.²⁶⁸ The EVD²⁶⁹

²⁶⁶ In 2004, Russia's external trade turnover amounted to US\$280.6 billion. The turnover with CIS countries was US\$50.1 billion, while trade with non-CIS countries accounted for US\$230.6 billion. *See* Federal State Statistics Service, Russian Federation, "Foreign Trade of the Russian Federation with Non-CIS Countries," http://www.gks.ru/bgd/regl/B05_12/IssWWW.exe/Stg/d000/25-05.htm, and "Foreign Trade of the Russian Federation," http://www.gks.ru/free_doc/2006/rus06e/25-02.htm; EVD, "Online landenpublicatie Rusland."

²⁶⁷ Dutch Ministry of Economic Affairs, 24 May 2007.

²⁶⁸ *See* Dutch Ministry of Economic Affairs, "Dutch Trade Board: Rusland werkgroep" (Dutch Trade Board: Russia task force), <http://www.internationaalondernemen.nl/DTB/rusland.asp?bstnum=172317>.

²⁶⁹ EVD – Agency for international business and cooperation, <http://www.evd.nl/business/>.

considers investments in the following sectors in particular interesting for Dutch firms: energy efficiency, waste recovery, sewage treatment, logistics, ICT and wireless internet, as well as the car industry and transport in the north-western part of Russia. The Programme for Cooperation with Emerging Markets (PSOM), which helps Dutch companies that want to cooperate with local companies and expand into emerging markets, is applicable to Russia. Currently, it covers 51 projects in Russia in various sectors. Many projects involve technology-intensive applications in order to enhance energy efficiency and to tackle environmental pollution. Thus far, the cooperation within the PSOM framework has developed quite successfully.²⁷⁰

Renewable energies also constitute an interesting opportunity for Dutch investments in Russia. Carboncredits.nl buys emission reduction for the Dutch government as part of the Dutch contribution to the reduction of greenhouse gases. The first contract with Russian participation was signed in 2005. The Swiss company KronoStar realises the greenhouse-gas reduction by generating energy from biomass (instead of fossil fuels) at a wood factory in the north-western region of Kostroma. Carboncredits.nl, sponsored by SenterNovem, purchases this emission reduction under the Joint Implementation programme.²⁷¹ A focus on combined heat and power generation plants could be particularly effective for such projects because Russia has a huge network for long-distance heating. At the moment, several projects to enhance energy efficiency and reduce greenhouse gas emissions are underway. However, it seems rather complicated to fit these projects into Russia's administrative settings. Thus far, vague regulations hamper the progress of these projects.

The Dutch government has initiated a so-called Mixed Commission (*Gemengde commissie*) consisting of business people and government officials from both countries. This commission convenes regularly and is a useful instrument for discussing current economic affairs and for furthering personal and business contacts in a relatively informal environment.²⁷²

Dutch politicians consider good bilateral relations with Russia essential for the promotion of bilateral economic cooperation. During recent visits to Russia by the former Minister of Economic Affairs Joop Wijn in October 2006 and the current Minister Maria van der Hoeven in June 2007, energy issues played an important role in the discussion with their counterparts.

For further economic cooperation, a locally and issue-focussed approach seems to be most promising. The intensification of contacts with Russian regions and municipalities should become an important part of bilateral contacts. However, in order to identify suitable partners and the possibilities of effective cooperation, more intelligence and understanding of the situation in these regions should be built up. The Dutch government should concentrate on specific projects and cooperate closely with local governments because this could help entrepreneurs establish useful contacts. Cultural exchange and exchange between universities and cities is essential in order to increase the knowledge about each other's countries and create and strengthen local partnerships.

6.2. How to strengthen Dutch-Russian energy relations

The Netherlands is an exporter of natural gas and has an energy import dependency below the EU average. Due to its large network of gas pipelines and its geographic position "half way" from Russia to other parts of Western Europe, the Netherlands is eager to become a European gas hub. This could be realised by the participation of Gasunie in the Nord Stream gas pipeline project. This proposal is fully endorsed by the Dutch government.

²⁷⁰ EVD, "Rusland," http://www.evd.nl/business/zoeken/ShowResultsEngels.asp?rubrieken=prv&nieuws=0&sortering=titel&land=false&iaantal=25&location=%2Fbusiness%2Fprogrammes%2FProgrammaInt_psm.asp%3Fland%3Dpsm&landen=PSOM+EN+rsf§oren=als&I1.x=55&I1.y=9&I1=submit.

²⁷¹ SenterNovem, "First EUPT 5 Contract Signed with Russia," 30 September 2005, http://www.senternovem.nl/Carboncredits/news/First_ERUPT_5_contract_signed_in_Russia.asp.

²⁷² Dutch Ministry of Economic Affairs, "Bezoek van Minister van Economische Zaken aan Russische Federatie d.d. 3-5 oktober 2006," 13 October 2006, <http://www.ez.nl/dsc?c=getobject&s=obj&objectid=147176&ldsname=EZInternet>.

The Dutch government supports the call made by the European Commission to “speak with one voice” on foreign energy issues and will actively participate in EU consultations in order to formulate an EU-Russian policy that points the way ahead. In fact, there would be far more chance of influencing Russia’s position and policies through a coherent one-voiced European approach than through individual member states’ bilateral contacts with the Russian federal government. Truly, consultations within the EU include the necessity to address the concerns of Eastern European member states. Yet there are serious internal European issues that must still be solved in order to let the EU speak with one voice in negotiations with Russian partners. However, if the EU member states are unable to agree on a common policy approach, the Dutch government should not hesitate to pursue Dutch national interests in a coalition of like-minded EU member states or bilaterally.

The AIV report *Energised Foreign Policy* concluded that “the Netherlands should try to keep all its options open by selecting a ‘both/and’ approach”.²⁷³ Thus, the government “should not refrain from concluding bilateral agreements with partners where possible, but in all other cases the Netherlands will have to internationalise its energy policy. First and foremost, it should do so through the European Union. In addition, it should examine with which countries it can establish coalitions, partly for the purpose of promoting its preferred policies in international fora such as the European Union and the IEA. The European Union should be regarded as an international entity in which the Netherlands should not adopt a wait-and-see attitude, but should try to win acceptance for its policy views in an effective manner. In doing so, it should strive towards developing and deploying Community instruments. Forming alliances will prove useful in this regard”.²⁷⁴ Accordingly, projects such as Nord Stream, which are set up to enhance European energy security, should be further pursued with other partners, even in the face of temporary, short-sighted resistance by other EU member states.

In recent years, Dutch-Russian relations have developed successfully, mainly because of the good economic cooperation and frequent visits by the heads of state, ministers, and government officials. The Dutch government and companies should further try to enhance economic cooperation, especially in sectors that are not viewed as “strategic” by the Russian government. This could avoid the hazards of sudden government interference and will also help to diversify the structural makeup of the Russian economy. Economic relations that are beneficial for both parties can help stabilise Russia’s economic development and increase mutual confidence.

²⁷³ AIV, “Energised Foreign Policy: Security of Energy Supply as a New Key Objective,” December 2005, <http://www.energieraad.nl/Vertaling/Energised%20Foreign%20Policy/AIV-ER-report.pdf>.

²⁷⁴ Ibid.

7

Evaluation: Adjusting to a changing Russia

This section examines the prospects for EU and national energy policy choices in the light of changing EU-Russian relations. This analysis is based on the model of *Tomorrow's Mores*.²⁷⁵ The observations of the previous sections will be used to illustrate the shifting power of rule-setting ability and to draw some conclusions for further EU-Russian energy cooperation.

The re-emerging state and global energy flows

Globalisation has led to more economic cooperation and interdependence. When this process began, the countries that were the proponents of more economic ties – the United States and Western Europe – expected that all nations that wanted to join the process would eventually follow their development path. Liberal markets and international cooperation were viewed as the most efficient and just way to accompany the process of globalisation. In the 1990s in particular, a whole bunch of new participants in the globalising world economy entered the game. The end of the Cold War had triggered political scientists to fantasise about the “end of history” and with its end, the Western economic and political model seemed beyond any doubt and eternal in its own right. However, it turned out to not be crisis-proof.

The first shocks were felt in Asia in 1997, then a year later in Russia and once again in Latin America. In its globalised vision, the Western-dominated world community answered with the Bretton-Woods prescription package. Institution building and regulation should be the key to more stable economic development. However, institutions and regulations must always have some local content and acknowledge the characteristics of the local situation in order to become workable. Thus, at the grass-roots level Western economic institutions are adapted to and further developed according to local needs. In addition, around the globe at the national level one institution has regained acceptance that had been marginalised to a mere regulator by the processes of market liberalisation and globalisation – the state.

Undoubtedly, it is in the energy sector where the re-emergence of the state has had the most significant repercussions. Energy resources are concentrated in a few countries. The secure and reliable flows to all important economic players are a vital issue in a globalised economy. It is, therefore, essential as to what forces drive these flows and which interests are being pursued.

In the case of Russia, Gazprom is keen to become player with global reach. The company is trying to capture its economic rents throughout the gas value chain. It is also seeking strategic partnerships and ventures in gas as well as in other energy sources, like oil, coal, electricity and even nuclear energy. Further, it is using its huge market power, together with its related political, financial and technological base, to develop a strong position in European and global energy markets. It applies its business models and strategies like any other multinational industry would try to do. However, looking at it with a political perspective there can be no doubt that the Kremlin has very intense relations with Gazprom, leading to widely held perceptions that Gazprom is not only a money-maker for its shareholders, but also an important part of Russian foreign policy, trade relations and economic policy.

This development has an important consequence for the position of the EU – not because of the orientation of the Kremlin's policies, but due to the fact that a player with considerable economic

²⁷⁵ Hoogeveen, Femke, and Wilbur Perlot, eds., 2005, pp. 17–22.

power linked to a state is able to play the market game in a globalised economy. In the past, the gas industry was in the hands of the Soviet government. But its influence was confined to the borders of the Soviet Union and the revenues that were earned from gas exports disappeared in the channels of the country's inefficient socialist economy. Today, with the increasing revenues from energy sales, Russia's economy receives capital for its further modernisation. Due to the introduction of market mechanisms in the 1990s, this capital is used much more efficiently and contributes to further economic growth. As a result, Russia is becoming an ever more influential global player, which enables its leadership to continue to pursue its policy of regaining great-power status in the international community.

The use of economic power, based on the energy sector, must be seen as the current trend in Russia's foreign *economic* policy. However, it is not an aim in itself. Rather, it should be viewed as Russia's way to become a player in the globalising world economy, after an ill-fated attempt in the 1990s. Other countries, like China and India, rely on the potential of their huge populations as a cheap workforce and future market to integrate with the world economy. Russia's most-wanted assets are its energy resources. But the country's current leadership is convinced that the Russian state must ensure that these resources are used in the country's best interests. Thus, state control is indispensable to avoid the reoccurrence of developments like the oligarchic system of the 1990s. Consequently, Russia's integration with the world economy is based on its energy resources and supervised – or to some degree managed – by the state.

Russia's current position shows a political or state-driven trend with its focus on or utilisation of state power and a clear preference for bilateral approaches. State actors with such characteristics usually pursue a multilateral and state-power-focussed approach, while governmental policymaking is shaped by an orientation towards national interests and strategic manoeuvring, as well as by a focus on multilateral political and economic cooperation. The government's goal is the maximisation of the nation's welfare. Strategic thinking and (inter)national interests determine the state's behaviour. Companies and non-state actors are often extensions of state policy.²⁷⁶

The pursuit of their economic interests by China and India also exhibits the same features. Both China and India have already gained a considerable economic power in their region and beyond. As a result, their economic rise is causing a gradual shift towards the state-driven approach. This means that new rules will emerge at the global level. In the area of energy, the growing focus on state-driven activities is already apparent. State-controlled or national energy companies dominate the production of oil and gas, while state-controlled companies from consuming countries are increasingly able to secure energy supplies through government-backed deals without relying on the international market. Their approach to energy relations is solely driven by the national interests of the respective countries, focussed on security of energy supply rather than being profit-oriented.

This development does not imply that multinational oil companies are no longer able to pursue their business activities. But they, too, must adapt to the changing system, which includes more cooperation with state-owned and -controlled enterprises and the re-orientation towards new business areas. These trends are already clearly visible. After all, many home countries of state-owned and -controlled energy companies, whether they are energy exporting or energy importing, are emerging economic powers. Hence, although such a refocusing might come with a short-term loss it will eventually lead to new opportunities in the future.

In the energy system, a system is emerging that resembles the one described in the model as “No Core, No Gap” – a hybrid of free-trade mechanisms combined with politically (national-interest) determined contracts.²⁷⁷ However, future shifts towards other scenarios might still be possible. A further deepening of the current trends will show the degree to which the ongoing economic changes will influence the international political system. Within this development the EU should not only redefine its role, but also develop instruments to effectively implement its policies.

²⁷⁶ Ibid, p. 22.

²⁷⁷ Ibid, pp. 63–6.

EU – Playing according to the rules

The EU as an economic entity, and especially in its energy relations, is still strongly focussed on multilateral cooperation and market liberalisation, emphasising the importance of international institutions and economic efficiency. Players that pursue this approach aim to maximise opportunities for consumers. The adherence of a majority of players to this approach deepens the globalisation process and increases economic interdependence. As a result, economic drivers determine state behaviour.

The policy challenge the EU faces in its relations with Russia exemplifies its decreasing bargaining power in relations with countries that do not entirely embrace its approach to international economic cooperation. This is increasingly apparent in the energy sector, not only in Russia but also in other oil- and gas-producing countries as well as in economic negotiations with China and, to a lesser degree, with India. As a political and economic entity, the EU is still in a process of transition. While other players are emerging rapidly, the EU is still seeking an appropriate way to pursue its harmonisation goals in a community of 27 sovereign states. Valuable time is lost and opportunities are missed by engaging in internal conflicts and identity seeking. In the area of energy, the discussion about an integrated EU energy policy has just begun.

In the emerging system in which national states increasingly interfere in economic activities, the EU must strengthen its institutions. Thus, it is vital that the EU plays by its own rules and enforces its set goals internally by continuing the harmonisation process of the internal market. This will further strengthen the economy, which is needed in order to be a strong and attractive partner in the international system.

If the EU fails to translate its economic power into political clout in the international system, the state as an institution will re-emerge further, and individual member states will all the more eagerly try to pursue their national interests, especially in the area of energy. Undoubtedly, this danger is already obvious. Bigger economies of the EU are able to play the more state-driven game in their energy relations. However, for the EU as an economic entity, energy relations need more coordination among member states in the pursuit of not only security of supply, but also environmental and economic goals. Therefore, the EU must adapt to the emerging system by strengthening its institutions in order to play by the rules of a more state-driven international system. This can only be achieved if the EU does not lose its internal focus on both economic efficiency and solidarity among its member states.²⁷⁸

By doing so, the EU will maintain its economic strength and will also be able to engage in fruitful economic cooperation with Russia. The two economies are rather compatible. Increasing economic interdependence, and not only in the field of energy, will lessen fears of asymmetric dependence on both sides. Still, energy can and should continue to serve as the strong bond that tied the European economies together when the EU project started in 1952 – just as it has tied together the economies of the EU and Russia for years, making a strengthening of overall economic and political ties imperative.

²⁷⁸ Clingendael International Energy Programme, *Study EU Energy Supply Security and Geopolitics (Tren/C1-06-2002)*. CIEP Study, The Hague: Clingendael Institute, January 2004, http://www.clingendael.nl/publications/2004/200401000_ciep_study.pdf; De Jong, Jacques, Hans Maters, Martin Scheepers, and Ad Seebregts, *EU Standards for Energy Security of Supply*. The Hague/Petten: Clingendael Institute/Energy Research Centre of the Netherlands, June 2006, http://www.clingendael.nl/publications/2007/20070400_ciep_misc_dejong-maters-et-al_update.pdf.

8

Conclusion

Today's Russia is still a country in transition. Some in the West view President Putin's policies as an interruption of Russia's transition to democracy. Indeed, under his presidency, the country has been redefining its political and economic system, often described as "managed democracy" and "bureaucratic capitalism". Market reforms conducted in the 1990s and high energy prices on the international market have brought Russia robust economic development. Finally, the Russian state is in control of the country's wealth and can use it to improve the standard of living of the people. Due to historic experiences and the chaos of the 1990s, Russians favour a strong state that protects the country's national interests at home and abroad. Democracy, however, is linked with the robbery capitalism of the 1990s and the oligarchic system that sank the country into bankruptcy. Accordingly, it can be expected that this current system, which is closely linked to President Vladimir Putin and his supporters, will be maintained in the years to come. Russia's regained self-confidence in international relations is marked by an unambiguous preference for a multi-polar concept. Russia no longer conforms to US policy views of a unipolar world and the resulting unilateral acts by the United States. Thus, Russia is (once again) a factor to reckon with in international relations.

The energy sector is at the heart of Russian economic policies. The state is recovering its control of major assets and strategic industries, such as the oil and gas sector. But in their activities abroad, Russian energy companies rely on market forces and their assets at home. By doing so, they succeed in pursuing the government's strategy to develop strong positions for the Russian energy industry in global energy markets. Economic rationale is prevailing in these policies, which are in line with modern economic theory on industrial economics. Clearly, investments – much needed for the modernisation and expansion of the energy sector – should come from acquisitions abroad. By being able to reap revenues at the higher ends of the energy value chain, it is easier to earn the needed sums of money than by merely selling crude oil and natural gas. EU policy makers should replace their scepticism towards Russian investment in European economies with long-term considerations of security of energy supply.

The EU is facing the transition into an entity that coordinates the different views and interest of 27 member states. Moreover, it is still seeking ways and means to strengthen its institutions and to find a way to formulate a common energy policy. This common energy policy must also include a strong external policy element. In fact, the external element is all the more necessary because external energy supplies, notably from Russia, will be critical in assuring the medium- to long-term energy security position for the EU at large. The EU-wide common position on energy relations with Russia must acknowledge that good and workable relations with this country are indispensable.

In its overall approach to Russia, the EU must recognise its own difficult transition process and the transition that Russia is struggling with. This is increasingly important as Russia's robust economic development and its energy position gives its leadership the clout to pursue its policies in an ever more assertive way. The EU must learn to live with this neighbour who is much stronger, more self-confident, and more outward bound than the crisis-struck former superpower of the early 1990s. EU policy makers and politicians should realise this fact and avoid giving the impression that what they object to is not an undemocratic Russia, but a strong and rich one.

In developing its energy approach towards Russia, the EU must above all come to a Brussels-Moscow energy axis, with mutual benefits, transparency, and full reciprocity as the major components. A new model for the wider European energy sector, in particular the gas market, would further facilitate ongoing multilateral discussions in which both parties play key roles. This would include the

finalisation of the outstanding issues related to the Energy Charter Treaty and the forthcoming post-Kyoto negotiations.

In the short term, individual member states might be able to pursue bilateral approaches to energy relations, securing their long-term gas supplies and supporting infrastructures. There is no reason why the Netherlands would not follow such a course, to the contrary. Moreover, it should further strengthen its good economic and political relations with Russia to facilitate this approach. However, global energy policy requires a full EU approach for all its member states, integrating its three major policy goals: supply security, the environment, and the market. Therefore, it is critical to continue all efforts to formulate a common EU energy policy for the sake of all EU member states.

The emergence of strong economic players such as China, India, and Russia, whose economic development is state-driven and focussed on national interest, is gradually changing the rules of the game. This is especially apparent in international energy relations. The EU must somehow adjust to the changing economic system. This can only be achieved by strengthening its institutions and the solidarity among its member states. If the EU fails to translate its economic power into political clout in the international system, policies by national-interest-driven member states might ruin the integration process. Therefore, the EU and its member states must stick to the community's internal rules and goals. Only by doing so will it be a strong enough entity to remain an attractive and competitive economic partner in the changing international system. This is also the approach that should be followed in energy relations with Russia. Good relations with its biggest neighbour, not only in the field of energy, are indispensable for the stable development of the EU. Energy has been a strong bond between the EU and Russia for years; it should be further strengthened to fasten economic and political ties and stress that cooperation is imperative for both parties.

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