

University of Macedonia

**Department of Balkan, Slavic and Oriental Studies**

# **Reinventing Power Politics in the Eurasian Energyland**

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Hellas

## **Declaration**

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## Περίληψη

Η παρούσα διδακτορική διατριβή, “Reinventing Power Politics in the Eurasian Energyland” («Επαναπροσδιορίζοντας τη Πολιτική Ισχύος με Βάση την Ενέργεια στην Ευρασία»), εξετάζει την επίδραση της Ρωσικής ενεργειακής ισχύος στον επαναπροσδιορισμό της Ρωσικής πολιτικής στην ευρύτερη γεωπολιτική περιοχή της Ευρασίας καθ’ όλη την πρώτη δεκαετία της νέας χιλιετίας (2000-2010). Υπό αυτό το πρίσμα διερευνώνται οι ενεργειακές της σχέσεις με την Ευρωπαϊκή Ένωση (ΕΕ) και τη Λαϊκή Δημοκρατία της Κίνας (ΛΔΚ). Ωστόσο, κομμάτι του γεωπολιτικού αυτού χώρου αποτελεί και η περιοχή της πρώην Σοβιετικής Ένωσης, η οποία όχι μόνο μοιράζεται βαθείς ιστορικούς και πολιτικούς δεσμούς με τη Ρωσία, αλλά αποτελεί και αναγκαίο «πέραςμα» για τη διακομιδή ρωσικών ενεργειακών πόρων στην αγορά της ΕΕ. Συνεπώς, ένα *Ευρασιατικό ενεργειακό τρίγωνο* προκύπτει θεμελιωμένο πάνω σε τρία δίπολα, Ρωσία-πρώην σοβιετικός χώρος, Ρωσία-ΕΕ και Ρωσία-ΛΔΚ. Το κάθε δίπολο αναπαριστά και μια διαφορετική μορφή διμερούς συνεργασίας με *ασύμμετρες, συμμετρικές και απλής συσχέτισης* μορφές να συνθέτουν ένα πλήρως *διαφοροποιημένο* γεωπολιτικό τρίγωνο. Μέσα στο πλαίσιο αυτό εξετάζεται η θεωρητική διαμάχη μεταξύ Νεορεαλισμού και Νεοφιλελεύθερου Θεσμισμού, κλασσική για τις Διεθνείς Σχέσεις, με σκοπό να απαντηθούν ευκρινώς οι τρεις ερευνητικές υποθέσεις της διατριβής. Τα ευρήματα ωθούν σε νέες διαπιστώσεις και μεταβολές. Σε ακαδημαϊκό επίπεδο, αρχικά, η εξεταζόμενη θεωρητική διαμάχη *συγκεκριμενοποιείται* και *εμπλουτίζεται* με τη προσθήκη μιας νέας, «ενδιάμεσης» θεωρίας, έτσι ώστε να γίνει περιεκτικότερη και ικανή να εξηγήει ένα ταχέως μεταβαλλόμενο διεθνές περιβάλλον. Σε επίπεδο πολιτικών προεκτάσεων, εν συνεχεία, η έμφαση, για πρώτη φορά, στην ευρύτερη περιοχή της *Ευρασίας* επιτρέπει να γίνει η διακρίβωση των κινήτρων της Ρωσική ενεργειακής συμπεριφοράς εντός ενός *δυναμικού* πλαισίου, με τη *ταυτόχρονη* εξέταση της τόσο απέναντι στην ΕΕ όσο και τη ΛΔΚ. Ως εκ τούτου, διορατικές και επαρκώς τεκμηριωμένες πολιτικές προτάσεις και προεκτάσεις προκύπτουν για όλα τα εμπλεκόμενα μέρη στη παραπάνω τριγωνική σχέση.

## Abstract

The present PhD thesis, “Reinventing Power Politics in the Eurasian Energyland”, examines the Russian foreign energy policy in the wider geopolitical context of Eurasia throughout the 2000s. On these grounds, Russia’s energy relations are being scrutinized *vis-à-vis* both the EU and China. However, part of this geopolitical context is also the Former Soviet Union (FSU) region, which not only shares deep historic-political ties with Russia, but also constitutes the necessary “crossing” for the Russian energy supplies earmarked for the EU. Consequently, a *Eurasian energy triangle* emerges, founded upon three dipoles, Russia-FSU region, Russia-EU and Russia-China. Each dipole represents a different type of bilateral cooperation, with *asymmetric, symmetric and balanced* types forming an utterly *differentiated* geopolitical triangle. Within this context it is tested the classic for the IR scholarship theoretical debate between Neorealism and Neoliberal institutionalism (the so-called ‘Neo-Neo’ debate) so as to address the three research hypotheses of the thesis. The findings point to new directions and highlight emerging implications for further research. To begin with the academic level, the aforementioned theoretical debate acquires *specificity* and *predictability*, since a scholar may now expect certain outcomes given the type of bilateral cooperation. Furthermore, it is also *enriched* with the addendum of a new, ‘middle-ground’ theoretical branch that aims to upgrade its overall explanatory capacity in a rapidly changing international environment. Finally, as far as the policy implications’ level is concerned, the emphasis, for the first time, in the wider region of Eurasia allows for the verification of Russia’s foreign energy policy rationale within a dynamic context, with both fronts (the EU and China) being *concurrently* examined. Therefore, insightful and well-substantiated policy proposals and implications emerge for all the involved parties in this triangular relationship.

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## Abbreviations

ABM	Anti-Ballistic Missile Treaty
APEC	Asia Pacific Economic Cooperation
ARF	Asia Regional Forum
ASEAN	Association of South East Asian Nations
BCM	Billion Cubic Meters
BMD	Ballistic Missile Defense
BP	British Petroleum
BTC	Baku-Tbilisi-Ceyhan
CAGP	Central Asia Gas Pipeline
CAP	Common Agricultural Policy
CCP	Chinese Communist Party
CDB	Chinese Development Bank
CEO	Chief Executive Officer
CFSP	Common Foreign and Security Policy
CIB	Comprehensive Institution-Building
CIC	China Investment Corporation
CIS	Commonwealth of Independent States
CMEA	Council of Mutual Economic Assistance
CNOOC	China National Offshore Oil Company
CNPC	China National Petroleum Company
CSTO	Collective Security Treaty Organization
EaP	Eastern Partnership
EBRD	European Bank of Reconstruction and Development
EC	European Community
ECSC	European Coal and Steel Community
ECT	Energy Charter Treaty
EDF	Electricite de France
EIB	European Investment Bank
EMS	European Monetary System
ENP	European Neighborhood Policy
ESPO	East Siberia Pacific Ocean
ETG	Eural Trans Gas
EU	European Union
EWG	Energy Working Group
EWM	Early Warning Mechanism
EXIM	Export Import
FDI(s)	Foreign Direct Investment(s)
FSU	Former Soviet Union
FTAs	Free Trade Agreements
G	Government Spending
GdF	Gaz de France
GDP	Growth Domestic Product
GSU	Gazprom Sbyt Ukraine
GTS	Gas Transmission System
IEA	International Energy Agency
IMF	International Monetary Fund
IPE	International Petroleum Exchange

IPO	Initial Public Offering
IR	International Relations
ISO	Independent System Operator
JV	Joint Venture
KMG	KazMunaiGaz
LDC	Local Distribution Company
LNG	Liquefied Natural Gas
LTC	Long Term Contract
MC	Marginal Cost
MCM	Million Cubic Meters
MMG	Mangistau-MunaiGaz
MoU	Memorandum of Understanding
MR	Marginal Revenue
NAPF	North Asian Petroleum Forum
NATO	North Atlantic Treaty Organization
NYMEX	New York Mercantile Exchange
OPEC	Organization of Petroleum Exporting Countries
OSCE	Organization on Security and Cooperation in Europe
OU	Ownership Unbundling
PCA	Partnership and Cooperation Agreement
PD	Prisoner's Dilemma
PM	Prime Minister
PPC	Permanent Partnership Council
PRC	People's Republic of China
PSA	Production Sharing Agreement
QMV	Qualified Majority Vote
RATS	Regional Anti-terror Structure
RFE	Russia's Far East
RUE	RosUkrEnerg
R&D	Research & Development
SC	Small Customer
Sci-tech	Science and Technology
SEA	Single European Act
Sinopec	China Petroleum & Chemical Corporation
SKV	Sakhalin Khabarovsk Vladivostok
SPEC	Symposium on Pacific Energy Cooperation
SPR	Strategic Petroleum Reserve
SSR	Soviet Socialist Republic
T	Tax
TCE	Treaty Establishing a Constitution for Europe
TCM	Thousand Cubic Meters
TCM	Trillion Cubic Meters
TFEU	Treaty on the Functioning of the European Union
TPA	Third Party Access
TSO	Transmission System Operator
UESU	United Energy Systems of Ukraine
UGS	Unified Gas System
UGS	Underground Gas Storage
US	United States
USSR	Union of Soviet Socialist Republics
VMP	Value of Marginal Product
VNG	Verbundnetz Gas AG

W	Wage
WIEE	Wintershall Erdgas Handelshaus Zug AG
WTO	World Trade Organization
XUAR	Xinjiang Uyghur Autonomous Region

# *Introduction*

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The dawn of a new era in the Eurasian energy diplomacy has been marked by the natural gas cutoffs to European supplies in January 2006 and January 2009. No sooner had these events happened, great concerns emerged with regard to the European Union (EU) growing dependence on Russian gas. Specifically, in 2008, 24% of the imported natural gas (and 31% of oil) originated from Russia (IEA, 2008). Therefore, Russia's possible operationalization of natural gas as to either politically coerce Former Soviet Union (FSU) states like Ukraine and Belarus or just economically rationalize the bilateral gas trade, has generated heated debate amongst the EU member states over the former's true intentions (Bilgin, 2009).

However, as early as on December 22<sup>nd</sup>, 2005, the President of the Russian Federation, Vladimir Putin, stated during a meeting of the Russian Security Council that "Energy is the most important force of world economic progress. It always was and will be for a long time...In fact, Russia has no other area in which to claim leadership" (Yasmann, 2006). Since then, Russia, through its state gas monopoly 'Gazprom', has pursued a strictly pro-market pricing policy not only for the EU, a fact which was *inter alia* expected, but also for the FSU states which were used to receive their energy supplies and especially gas at 'preferential' prices. But still, is "market rationality" the sole aim to be pursued or is something more hidden behind the term of "(economic) leadership" as phrased by Putin in the Security Council?

In January 2009, Putin, having then assumed the Prime Ministership, reiterated his belief in market principles governing all the energy transactions (RIA Novosti, 2009). In line with this, gas prices had already started to follow an upward trajectory for all the former Soviet allies even for the closest ones so as to reach gradually the level of the average European price. To exemplify, critical is the case of Belarus, a 'sister-country' known for its traditional adherence to the Kremlin's policies, which according to Gazprom's pricing formula would be required to pay 67% of the average European price in 2008, 80% in 2009 and 90% in 2010<sup>1</sup>. The reason beyond this

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<sup>1</sup> Both Russia and Belarus, nowadays, pursue a more distinct and diversified policy. In the words of the former Russian President, Dmitry Medvedev (2008-2012), "Belarus is not the younger sister to us, it is just our sister...I do not think the relations have been worsening. There are issues we have been discussing openly" (RIA Novosti, 2009a). In the same vein, his Belarusian counterpart stated that

gradual adjustment was, as Gazprom's spokesperson Kyprianov put it, "not only to set the price but also get the money" (Interfax-Ukraine, 2008; RIA Novosti, 2009a).

Even more striking is the case of Ukraine which was required to pay after the January's 2009 cut off a price of \$450/thousand cubic meters (tcm), up from the \$179.50/tcm it was paying in 2008 (Xuequan, 2009). At this point, some analysts claimed political reasons beyond these developments. Concretely, Roman Kupchinsky argued that the political dispute between Russia and Ukraine was to be blamed for the price of \$450/tcm, given that in December 2008, just before the cutoff, the negotiators were discussing a price around \$250/tcm. He even went further as to characterize Alexei Miller, the Chief Executive Officer (CEO) of Gazprom, as the Premier Putin's alter ego (Kupchinsky, 2009). His argument may hold specs of truth but whether Russia occasionally instrumentalizes its natural gas supplies as to forestall a possible westernization of the FSU states, is a rather difficult argument to be substantiated only by reference to a gas pricing incident. Until now, Russia seems to seek the maximum possible gains from its natural resources trade. Whether these gains are absolute or relative is open to further research<sup>2</sup>.

As mentioned above, the natural gas cut offs in January 2006 and January 2009, resurfaced the EU urgency for energy security (principally in the form of supply diversification). Since 1994, when the Energy Charter Treaty (ECT) acquired its final form, the EU has been trying to institutionalize its partnership with Russia. Although the latter signed the Treaty in 1994, it is yet to ratify it, forswearing, in this sense, any legal binding which would both dictate its obligations towards the EU member states and legitimize the latter's 'penetration' into its resource-rich territory.

Nonetheless, Russia did not deny a type of looser bilateral cooperation such as the Energy Dialogue (2000- up to date). Also, it did eagerly cooperate in establishing a new Partnership and Cooperation Agreement (PCA) with the EU, since the last one signed by Russia's first President, Boris Yeltsin, in 1994 in Corfu, expired in December 2007 and was extended for one more year till 2008 (Borko, 2008). Under the new PCA, Russia strove to make ends meet by attempting to fit an extensive

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changes in the economic relations with Russia are part of a policy of diversification. In his words, "we did this purposefully, so as to move away from dependence on just one country, even one that is near and dear to us" (RIA Novosti, 2009b).

<sup>2</sup> The term 'absolute' is used to signify that economic gains are the sole aim pursued, while the term 'relative' signifies that besides economic gains may be other strings attached. Both terms are being substantiated in Chapter 2, when the research design of the current research is presented.

partnership within a flexible implementation framework<sup>3</sup> (Fedyashin, 2008). Reading between the lines, in both cases Russia eschewed any form of legally-binding institutional cooperation. This policy, or better tactic, led the spokesman of the then Energy Commissioner of the EU, Andris Piebalgs, to state that while “We’re confident that Russia will continue to be a reliable supplier” the EU wants a “real market of reciprocity” with Russia. This term of ‘reciprocity’ is the one that has been alarming the EU officials and raising issues of energy security and growing dependence on Russian energy imports.

Upon the same pattern, Russia, as a Eurasian power, engaged in the Asia-Pacific region and particularly China. As far as regional cooperation is concerned, at first, the Shanghai Cooperation Organization (SCO) makes a critical case. While at the beginning it was formed with the aim of ‘stabilizing’ the region by military means, later on, it was reset to focus more on economic development and trade cooperation (energy included). This institutionalized, not legally-binding form of cooperation predicated on many principles which have, *inter alia*, been sovereignty, the national interest and the non-interference in the internal affairs of the contracting states. Furthermore, China and Russia signed on July 16, 2001, a 20-year Treaty of Neighborliness, Friendship and Cooperation that too provides for the aforementioned principles (Bakshi, 2002, p.101). Thus, attempting a preliminary summarizing remark, it is made apparent that Russia has been in pursuit of its gains-maximization and international (institutional) cooperation but not at the expense of its autonomy.

Thus far, Russia, has presented a rather interesting profile in its affairs in the Eurasian energyland. Acting upon the pattern of gains-maximization from the natural gas trade, Moscow engaged the FSU region, the EU and China, with different terms of cooperation in each case. Consequently, the fundamental issue pertains to the strategy beyond Russia’s natural resources management in Europe and Asia. In the form of question, what is the strategy beyond Russia’s natural resources management in the Eurasia during the 2000s?

This thesis aims to examine Russia, as a Eurasian energy power, in its affairs with the two geopolitical ends of the region, the EU and China, throughout the 2000s. Part of this geopolitical space is the FSU region which not only shares deep historical-political ties with Russia, but also constitutes the necessary crossing for the latter’s

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<sup>3</sup> Both sides would have the flexibility/freedom to implement the clauses of the partnership in the most suitable way to their aims.

natural gas and oil supplies earmarked for the EU market. In this manner, an energy triangle is established with fragile balances and delicate diplomatic practices in the sphere of energy politics. Expressing this triangle in geometric terms, there is an isosceles triangle with Russia at the top angle, the EU in the left angle, China in the right angle and the FSU region the median. Consequently, three bipolar relationships emerge from this scheme which are examined as follows: Russia-FSU region, Russia-EU and Russia-China. Even more interesting is the different types of bilateral cooperation that exist. Symmetric, asymmetric and balanced relationships form a diversified triangle. Within this triangle, the classic, for the International Relations (IR) scholarship, theoretical debate between Neorealism and Neoliberal Institutionalism (the so called 'Neo-Neo' debate) is tested, so as to provide a clear and sound answer to the main research hypotheses. During the research, limitations and needs for revision are brought to the fore, with both having academic and policy implications. It is not only the revision and more concrete substantiation of the theoretical debate, but also the disclosure of the rationale beyond Russia's natural resources management in the Eurasia, first time examined to that extent.

Viewing the structure in brief, in **Chapter one**, Mackinder's theory of the 'Heartland' offers a valuable geographic account according to which Russia is defined as a Eurasian power and a longstanding inhabitant of the 'Energyland', a term constructed paraphrasing Mackinder's 'Heartland'. The term signifies both the natural resources-rich Russian subsoil and the regional competition for resources, especially, nowadays, where intensive growth is interlinked with sufficient oil and gas supplies. Then, having placed Russia as the main actor at the core of Eurasia, we proceed with forming the geopolitical triangle by examining whether and to what extent such a thing exists. How does Russia perceive its place in the region? Does it covet a Eurasian *status*? If it does, what happens with the other two geopolitical ends of the region, the EU and China? Do they also perceive Russia as a major partner in their (energy) policy agendas? While addressing these issues of geopolitical connectivity in the region, a major point that is clarified is the EU, and particularly its 'awkward' political ontology<sup>4</sup>. Specifically, the latter makes the EU a *sui-generis* case. What the EU actually is? Is it a state so as we are able to adopt a classic interstate analysis just like in the Russia-China case? Or, is it some kind of a political hybrid that merits

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<sup>4</sup> The term 'awkward' has been inspired by Stephen George's book, *An Awkward Partner: Britain in the European Community*, Oxford University Press: London.

special treatment, especially when analyzed within an IR context? Certainly, the EU is an entity that surpasses the classic books of political science, calling for a combined and more informed analysis on the issue. Therefore, the scholarly work on the EU integration is briefly visited before we proceed to the main issue, namely the Russia-EU energy (natural gas) affairs. Having addressed these issues, a geopolitical (energy) triangle, indeed, exists with its main bilateral energy relationships being, Russia-FSU region, Russia-EU and Russia-China. On these grounds, it is critically assessed the existing literature, which for the first time is placed within a single explanatory framework (Eurasia), so as to reach better substantiated and informed conclusions. All things considered, Chapter one sets the scene of the present research.

Moving on to **Chapter two**, the research design explains how the energy dynamics in Eurasia are explained. Specifically, the theoretical debate between Neorealism (relative gains argument) vs. Neoliberal Institutionalism (absolute gains argument) is presented with the addendum of the ‘middle-ground’ of Institutional Balancing. This revised version is currently adopted so as to make the classic debate more informed and able to explain situations of interdependence and relative gains considerations from cooperation. Up to now, the two schools in the ‘Neo-Neo’ debate have been presenting either a situation where the states’ concerns of the others’ rather than their own gains (relative gains argument) make cooperation less likely, let alone the role of institutions in facilitating this cooperation, or a situation where (economic) interdependence and the states’ concerns of their own rather than others’ gains (absolute gains argument) make cooperation likely, with the institutions being facilitators to deepening further the bi-/multilateral ties. But what happens when states share interdependence and care about the relative gains (power) from cooperation? To address situations like this, we present the branch of “Institutional Balancing” as the ‘middle-ground’ in the afore said debate. In this manner, the scientific groundwork is laid, opening-up also the way for the exact formulation of the 3 research hypotheses. Finally, in the last section of the chapter, the Methodology explains the methods of both the research analysis and the data collection.

**Chapter three**, constitutes the necessary ‘antechamber’ before the research proceeds with the examination of the three main case studies. In this chapter, the sphere of energy is linked with that of politics, showing which natural resources and under which circumstances one actor/state can dictate politics to the other actor(s)/state(s). Not all natural resources are eligible for doing politics with. The

form of trade and the relationship between the commercial partners constitute respective realities that can either be connected with the sphere of politics, not to mention power politics, or not. Being more specific, oil is a fungible commodity, which means that because it is traded internationally the chances of a single actor to impose heavy burden on another are slim. But with the natural gas things are different. Its main form of trade not only today but throughout the 2000s, has been via natural gas networks (pipelines). The peculiarity of this form is that, each time, connects two specific actors that may relish two different statuses, supplier-consumer and supplier-transit state/consumer. Moreover, this direct connection, entails, most of the times, a power relationship. The two actors are either interdependent (symmetric relationship with both actors having equal means, in terms of energy trade, to press, if needed, the other), interconnected (balanced relationship with the two 'free' actors just trading with no dependence involved), or unilaterally dependent one on the other (asymmetric relationship with the one actor being overly powerful, in terms of energy, to impose its conditions, economic and political, on the other. Consequently, natural gas is a resource with which politics can be done, let alone power politics.

Once the scene for Russia's energy (natural gas) power politics in the Eurasian energyland is set, the following Chapters (four, five and six) specialize in the examination of the three bilateral relationships, Russia-FSU region, Russia-EU and Russia-China.

In **Chapter four**, the FSU region is at the center. Constituting Russia's near abroad -ближнее зарубежье- and the necessary crossing in the Russia-EU energy trade, this region is a rather interesting and also different from the rest, case since we encounter an asymmetric (unilaterally dependent) energy (natural gas) relationship between a powerful and resources-rich actor (Russia) versus two weaker actors (Ukraine and Belarus). To assess the implications of this asymmetry within the theoretical framework of the 'Neo-Neo' debate, we draw on Albert Hirschman's analysis, as presented later, on the means-indicators used by a strong and powerful nation (A) against its weaker neighboring trading partners (B,C,D, etc.) in pursuit of maximizing its power. Therefore, the analysis covers a spectrum of Russian tactics towards rationalizing, in economic terms, its energy affairs with the region, underlining concurrently, the menace an asymmetric relationship may pose for the sovereignty of the weaker side, starting from the energy sphere, then expanding to the domestic affairs and finally reflecting to the indirect 'de-legitimization' of its status in

the IR field. One of the tactics that is examined is Russia's pipeline diplomacy that played a key role not only in undermining the overall bargaining power of the FSU region but also in bringing the former much closer to its main and most lucrative, as of the time of writing, trading partner, the EU. However, this rapprochement, no matter promising it may at first seemed, more 'mine-planted' than accommodated the bilateral relationship. This is due to the fact that Russia's positive assessment of these networks did not dovetail the EU concerns over energy (supply) security, since the latter appeared skeptical and overly uneasy with the issue of excessive dependence on the former.

These developments introduce us to **Chapter five**, where the Russian energy policy is examined *vis-à-vis* the "awkward partner", the EU<sup>5</sup>. In this chapter, we experience a '*permeable*' symmetric (interdependent) energy relationship (Russia-EU), with the EU being heavily exposed to Russian supplies and Russia being heavily dependent on the EU hard currency. Both have been relishing equal bargaining power with the dynamics of the relationship to be determined by ongoing developments such as a future turning of Russia to the Asia-Pacific region and particularly China. Certainly, such a prospect added to Russia's bargaining weight, without however being capable of causing major changes in the short-term (the 2000s) negotiations. Consequently, the symmetry remained but not without an undercurrent of uncertainty.

The analysis of this chapter is predicated upon the following three indicators: a) International Trade Flows, b) FDI's and c) Legally-binding inter/supra national energy institutions and legislation, that in the end prove the limited explanatory capacity of the 'Neo-Neo' debate and the need for the initiation of the pro-realism theoretical branch of 'Institutional Balancing'. However, this update is a not-so-simple case. As it is explained in the main research body, in cases of symmetric (energy) relationship and unavoidable international institutional cooperation (such as those in this chapter), the once '*compulsory*' Institutional Balancing strategy becomes powerful when one side (e.g. Russia) has one of equal-importance to its main trading partner (e.g. the EU) alternative (e.g. China), which it may use as diplomatic leverage against the former in order to seize the maximum out of the negotiations. Of course, this works also vice versa, in the sense that one side may use its main trading partner as a diplomatic chip against the alternative option. It is a triangular relationship among equals that can be

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<sup>5</sup> For the term "awkward partner", see footnote 4.

manipulated according to the occasion and the aims pursued. Needless to say, the faster a side becomes autonomous or approaches autonomy, the greater its chances to lead the triangle.

Therefore, the role of a third partner is *sine qua non* prerequisite. Thus, China enters the current analysis (**Chapter six**), establishing in this manner the third pillar of the energy triangle (Russia-FSU-EU-China). As becomes apparent, this empirical section serves a dual purpose: a) a ‘supplement’ to the analysis of the previous Chapter 5 and b) a separate case, like the previous two, where the ‘Neo-Neo’ debate is tested. To begin with the latter, the Russo-Chinese energy affairs first come to the analytic forefront. Contrary to the previous two chapters (4,5), at present, we deal with a balanced (“interconnected”) energy partnership, since no side is either submissive (Chapter 4) or dependent (Chapter 5) on the other. Both are just connected, exploring the prospect of further deepening their cooperation. Within this framework, the Russo-Chinese relationship is examined upon the same as previously indicators against a series of events such as the East Siberia Pacific Ocean (ESPO) pipeline project, the Central Asia Gas Pipeline (CAGP) project and the antagonism over the central Asian resources. Finally, the ‘Neo-Neo’ debate provides an answer regarding Russia’s energy policy towards China.

But this chapter holds China also as an external balancer to the Russia-EU energy affairs, necessary for the successful Institutional Balancing strategy of Russia vis-à-vis the EU. Russia and the EU have been experiencing a symmetric relationship that empowered each side to ‘drag’ the other into concessions that otherwise would be inconceivable, or less likely to be made. Such a case is the prospect of a legally-binding international institutional (energy) cooperation. As earlier mentioned, the EU has been trying to institutionalize its partnership with Russia within the framework of the ECT since 1994, but the latter, although it initially endorsed it by signing it, is yet to ratify and thus grant it with legally-binding status. Certainly, the incumbent symmetry between the two powers is a sound explanation, but the role of China has been the one to determine dynamics in the Eurasian energyland, *substantiating* any institutional balancing strategy and opening the door for harder politics (as those defined by the Neorealist extreme of the ‘Neo-Neo’ debate), once the time is ripe. Institutional Balancing is a pro-realism ‘middle-ground’ strategy in occasions of symmetric relations in the IR field. The existence, however, of an external balancer is the one to possibly turn ‘inescapable’ concessions (once made by the ‘compulsory’

institutional balancing strategy) into areas of friction and conflict where cooperation falters, as Neorealism predicts. In this manner, China has been an arrow in Russia's quiver, with this also meaning that the latter would have been very delicate in its energy diplomacy towards the former if it was for the positive prospects of an external balancer of that importance not to sink. Obviously, readjusting the triangle in another formation where the EU would approach China in an effort to sideline Russia is a far from possible scenario, since the latter has been the major natural gas producer and supplier in most of the Eurasian region. Of course, this is not to say that the other two sides have been powerless to its maneuvers. Certainly, they have had their own means of pressure, with some of them extending beyond the scope of the current research. However, the bottom line is that there has been a delicate energy diplomacy unfolding in the Eurasian energyland throughout the 2000s, with its prospects surpassing the context of the present analysis and laying the groundwork for further research.

Overall, the former case-studies make possible a vertical, as well as horizontal approach to the case in point. While the formal analysis is actually premised on within-case empirics (vertical approach), the fact that three parallel case studies are concurrently employed enables us to across-case comparisons (horizontal approach), therefore, better substantiating our initial quest (Gerring, 2001; Lijphart, 1971).

Now as far as the academic and policy implications of the current research are concerned, these are presented in **Chapter seven**. With regard to the former, prime attention should be paid to the 'Neo-Neo' debate, which is enriched and upgraded not only with the addendum of the 'middle-ground' pro-realism theoretical account of "Institutional Balancing" but also with its testing against three different types of international cooperation, namely "unilateral dependence" (asymmetry), 'interdependence' (symmetry) and 'interconnectedness' (balance)<sup>6</sup>. In this way, the debates' explanatory validity is tested in depth and re-established to fit modern IR. With reference to the latter (policy implications), the disclosure of Russia's strategic thinking as a critical natural resources supplier not only to the EU but also to the whole Eurasian region, should be assessed as a finding of no lesser importance. This is because energy diplomacy, as earlier shown, is of so versatile character that there are many paths to follow: from deepening and expanding bi/multilateral cooperation to

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<sup>6</sup> It is of high importance to mention that in the research body, the terms 'symmetry', 'asymmetry' and 'balance' are substituted for 'interdependence' 'unilateral dependence' and 'interconnectedness'. At present, we do not use this terminology because it would be senseless without an earlier brief analysis on the basics of the oil and particularly natural gas trade/politics (for this see Chapter 3).

stifling and dictating policies of actors proved vulnerable in the inhospitable environment of international politics.

### *Synopsis*

In the present chapter has been provided the outline of present research, which focuses on the energy diplomacy among three main actors: Russia, EU and China, with Russia in the “driver’s seat”. The FSU is currently perceived as a region of special status for two reasons: a) it is a *necessary crossing* for the Russian supplies earmarked for the EU and b) shares deep historic-politic relations with Russia. Therefore, we incorporate it, in terms of analysis, into the main actor, Russia. In this manner, a Eurasian energy triangle emerges with multiple and delicate balances being struck. Russia, as the major natural gas producer and supplier in the region, is in the spotlight with emphasis placed on the hidden logic beyond the 2000s management of its natural resources (particularly natural gas) *vis-à-vis* the FSU, the EU and China. Is it politics? Is it economics? Or is it a mix of the two depending on the occasion?

Linking energy diplomacy with the fields of political science and International Relations, this triangle is premised upon three different types of bilateral cooperation- a) asymmetry/ unilateral dependence b) symmetry/ interdependence and c) balance/ interconnectedness- which help enlighten some aspects of international cooperation by anticipating certain outcomes given certain conditions. Thus, the theoretical debate which is employed as a solid explanatory base it is not only enriched but also becomes more concrete to match a rapidly changing international environment. In fact, today’s world politics of intense economic integration and unavoidable international institutional cooperation become all the more correlated and indiscernible, causing many scholars to lose bearing. Therefore, the present analysis serves a humble attempt to suggest solutions, both in the academic and the policy-making levels.

# Chapter 1: Exploring Eurasia

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## 1.1 Introduction: the strategic implications of Eurasia

In the previous chapter we referred to Russia as a “Eurasian power” and we committed the present effort in examining its energy (natural gas) diplomacy in the “Eurasian energyland”. But on what grounds did we designate Russia a “Eurasian power”? How did the term ‘energyland’ emerge at the present context? An answer to these questions should be sought by the geographer/geo-strategist Halford Mackinder and his concept of the ‘Heartland’.

In his memorable study, Mackinder holds that there is an ocean that covers the 9/12 of the globe. A continent –the World Island- covers the 2/12 of the globe. The rest 1/12 is covered by lots of smaller islands, two of which are North and South America<sup>7</sup>.



Map 1.1: Illustration of Mackinder’s ‘Heartland’ and its paraphrasis to ‘Energyland’<sup>8</sup>

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<sup>7</sup> Specifically the islands are North and South America, Great Britain, Japan, Australia and Malaysia, while the World Island consists of Africa, Europe and Asia. It follows that the World Island is the largest, most densely populated and resource rich compared to any other possible land combination.

<sup>8</sup> The initial format of the map is retrievable at:

[http://img.brothersoft.com/screenshots/softimage/g/global\\_satellite\\_map-28827-1.jpeg](http://img.brothersoft.com/screenshots/softimage/g/global_satellite_map-28827-1.jpeg)

As illustrated in the map, 'Heartland' is called the northern and inner part of Eurasia. It stretches from the Arctic coast to the central deserts and has as its western borders the diode between the Baltic and the Black Sea (Mackinder, 1943). Mackinder having experienced most of the *Pax Britannica* of the 19<sup>th</sup> century, when naval power itself could determine realities in remote places of the world (e.g. India), considered that an inaccessible land by the sea could alter the balance of power. For in his era a transition from the naval to land means was only in its infancy, every state inaccessible by the sea could become the invincible power of the world. Geographically speaking, 'Heartland' assembles three prerogatives that place it at the helm of geopolitics. First, it contains the biggest valley of the globe. Second, it is crossed by big floating rivers that end up either in the icy Arctic sea or the landlocked Caspian sea, thereby boosting the trade of the riparian population without being susceptible to foreign invasion by naval powers. Third, there is a vast pasture that facilitates the mobilization of the locals (Mackinder, 1943).

At the time of his latest writings, Mackinder associated the 'Heartland' with the then USSR but for one direction. Setting the river Yenisei as the border line between the Soviet 'heartland' and the Lenas region (dubbed after the river Lenas), Mackinder claimed that westwards from Yenisei to Romania there is the Soviet 'heartland', comprising a land of 4.250.000.000 square miles and the overwhelming majority of the population<sup>9</sup>. Eastwards from Yenisei (the Lenas region) there is a rich in resources expanse of 3.750.000.000 square miles, sparsely populated, that stretches from Irkutsk to Vladivostok (Mackinder, 1943). Although today this Lenas region is part of Russia, in Mackinder's analysis it was excluded from the Soviet 'heartland'<sup>10</sup>.

What is apparent from the previous lines is both the Eurasian identity of today's Russia as well as the overwhelming European feature in this identity. With a significant part of the population gathered, from a demographic perspective, in the Eastern Europe area (the FSU region included) it becomes clear not only why Russia has been mostly affected by the West than any other Eastern power (e.g. China), but also why Eastern Europe has been of great importance to the 'Heartland's' conceptualization. Possession of the former would result in domination of the latter,

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<sup>9</sup> In his era, the population equaled to 170.000.000 habitants.

<sup>10</sup> Traditionally, the 'Heartland' was ruled by the Russian Empire and subsequently by the Soviet Union with the exception of the Lenas region or the area around Vladivostok.

the size and central position of which would qualify any power in command to control the World Island plus over 50% of the world's resources<sup>11</sup>.

Regardless of the numerous critics that the theory has been through, -it did not foresee the rapid rise of China to a great power status but instead aspired to a "Sino-Japanese empire", it also did not predict the speedy pace of technological progress and its consequences that have rendered the US, albeit an insular power, at the helm of today's international affairs as well as the role of asymmetric warfare<sup>12</sup>-, it managed to capture the geopolitical fears of the two world-level sea powers, Great Britain and U.S., *vis-à-vis* the prospect of a Russo-German alliance mastering the world<sup>13</sup>. Therefore, although, Mackinder's theory is, nowadays, considered obsolete, a contribution no one can deny is to understanding international relations through geopolitics. It really explained how and why certain regions, the 'Heartland', have the potential to shape the world affairs.

To recap in the present analysis we singled this theory out for two reasons: a) designate, geographically/demographically, Russia as a "Eurasian power" with a predisposition towards the West while reluctant and suspicious towards the Eastern neighbors and especially China and b) since energy as well as natural resources are at the analytical forefront, then, if not for anything else, 'Heartland' could be a synonym to 'energyland', considering the richness of the subsoil in natural resources<sup>14</sup>. Therefore, nowadays, in an era where intensive growth is interlinked with sufficient oil and gas supplies, competition and struggle for supremacy in the region, albeit less strategy-laden than in Mackinder's perception, remain as present as it was in his time<sup>15</sup>.

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<sup>11</sup> In Mackinder's own words: "whoever rules East Europe commands the Heartland, whoever rules the Heartland commands the World Island, whoever rules the World Island commands the World" (Mackinder, 2006, p.316).

<sup>12</sup> For example the Vietnam War.

<sup>13</sup> At this point someone could recall the Molotov-Ribbentrop pact, an officially titled Treaty of Non-aggression between Germany and the Soviet Union, that resulted in the division of the Eastern Europe to spheres of influence between the two powers. Although this treaty (alliance formation) signed in August 1939 and breached in June 1941 with Hitler invading the USSR, it was too short-lived to provide a solid falsification of Mackinder's theory.

<sup>14</sup> For a detailed account see: Chapter 3.

<sup>15</sup> Mackinder mostly referred to the first quarter of the 20<sup>th</sup> century.

## ***1.2 Setting the scene: the making of the (energy) triangle***

### ***1.2.1 The Russian perspective: from a pro-western Zeal to a Eurasian pragmatism***

The Eurasian potential has long been present in the Russian political thinking. While with occasional vacillations, the Russian foreign policy, either inspired by the Westernist, the Statist or the Civilizationist school of thought, has always set its eyes in the geopolitical space of Eurasia (Tsygankov, 2006). The latter has been a strategic crossroad which entailed serious bargaining power for Russia's leaders.

However, as earlier said, there have been occasional vacillations that narrowed down the scope of Russia's geopolitical thinking. The early post-Soviet years, found the President, Boris Yeltsin, and his foreign minister, Andrei Kozyrev, being overoptimistic about the positive prospects an identification with the western *modus operandi* would entail (Tsygankov, 2006). The bitter disillusionment would not take long to come, while the realization that for the exodus from the tumultuous early 1990s much more sober thinking was required, would become as pragmatic as very few times before.

The Statist thinking and traditional geopolitics rapidly saw their way up to the political agenda. In 1996, Primakov was appointed by Yeltsin to the foreign ministry of Russia till 1998. During his tenure of office, the principles of 'statehood' ('gosudarstvennost') and "great power" status ('Derzhava'), both critical tenets of the Statist school of foreign policy thinking, became central. Geopolitics of power balancing within a politico-military context resurfaced, with Primakov arguing that "Russia is both Europe and Asia, and this geopolitical location continues to play a tremendous role in formulation of its foreign policy" (Tsygankov, 2006, p.91). Thus, he borrowed elements from the Civilizationist tradition while moderating the Westernists' obsession with integration<sup>16</sup>.

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<sup>16</sup> Civilizationists identified Russian values as completely alien to those of the West and claimed their cultural superiority versus the West. To them, the best way for Russia to ensure its security is by constantly expanding in the Eurasian landmass at the expense of the West and particularly the U.S. However, this expansionism is of responsive rather of offensive nature, due to the constantly imperial expansion of the West (Tsygankov, 2006; Kozyrev, 1992, p.2). A branch of this school, the 'Eurasianists', is fond of resorting to traditional geopolitics and, concretely, to Mackinder's theory of the 'Heartland' as springboard to global domination. To them, Russia should aim for the creation of a state similar in all respects (frontiers and centralized political system) to the USSR that would constitute the natural habitat of Eurasia's unique civilization (Mankoff, 2009). While, at first sight, these tenets may seem obsolete and inapplicable, the fact is that the USSR was a type of political entity that challenged traditional assumptions about empires. In fact, it was quite adept at presenting the

During Primakov's era, military considerations took precedence over economic, with the military industries, army and security services relishing the prospect of generating "revenue through the development of new technologies and exportation of conventional weapons" (Tsygankov, 2006, p.94).

In international affairs, the Statist approach under Primakov embraced traditional realism as the leading paradigm. Power relations shape and shove states' policies. Strong states with limited, if any, cooperation sway in a power equilibrium. Therefore, politico-military control in the geographic area of Eurasia was a principal objective. Particularly, in the post-soviet area he was fond of integration on political grounds at the sacrifice of any economic prospects the Russian private sector might, otherwise, relish. "In the Statist spirit, Primakov reasoned that the state interests were superior to those of private sector, and therefore one had to be prepared to invest in projects with the potential to facilitate the reintegration of the former republics" (Tsygankov, 2006, p.115). Political affiliation with the FSU was atop the foreign policy agenda.

However, the Eurasian potential would not be fully realized only with the successful integration of the FSU states in some kind of resuscitated USSR. It would take also its proper management with the establishment of alliances with rapidly developing East Asian states such as China and India. Thus, Primakov brought China in the equation in an attempt of counterbalancing the U.S. and shifting the international structure from a uni-polar to a multi-polar pattern (Rangsimaporn, 2009; Tsygankov, 2003). Moreover, the inclusion of China in Primakov's worldview signaled a major tipping point in Russia's foreign policy thinking. For the first time,

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illegal and nonconsensual control in terms of consent and approval. In Mark Beissinger's own words "it cloaked nonconsensual control in the language of self-determination and utilized norms of self-determination and sovereignty to blur the line between domination and consent" (Beissinger, 2005, p.29). Therefore, the USSR, instead of being the last empire, as many traditional theorists of empire argued, was the archetype of a new form of empire that loosened the boundaries between multinational states and multinational empires, making the term "imperial" seem rather fuzzy. Historically placed in the aftermath of the World War I and the rise of the principles of *statehood* and *self-determination*, the USSR and particularly its early leaders Lenin and Stalin were quick to realize that any connotation with the label 'empire' in an era of statehood would bring them to the same end-point as the Tsarist, Habsburg and Ottoman empires. To avoid that, they employed the principles of self-determination and sovereignty, as "a way of disarming non-Russian nationalism after numerous nationalist movements during the Civil War had attempted to construct their own national states" (Beissinger, 2005, p.28). Upon these principles the Soviets built an ethno-federal system that allowed for territoriality, political representation and cultural empowerment (Beissinger, 2002, p.50; Heywood, 2006). Consequently, using the past as guiding light to the future, the tenets of the 'Eurasianist' branch should not be dismissed lightheartedly, given the capacity of the Russian leadership to make its politico-economic objectives seem compatible with the international environment of its age.

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Russia perceived its geographic position as a 'bridge' between the East and the West, which could exploit to its strategic advantage (Shakleina, 2010).

Sharing a border of 4,300 km, the Sino-Russian relations got a new lease of life. In April 24-25, 1996, Presidents Boris Yeltsin and Jiang Zemin publicized their desire for setting up a strategic partnership, based on equality, mutual confidence and mutual coordination towards the 21<sup>st</sup> century. Likewise, in April 23, 1997 they signed a "Joint declaration on a Multipolar World and the formation of a new International order"<sup>17</sup> (Garnett, 1998, pp.9-11; Buszynski, 2010, p.266). These developments indicated the succession of the Cold-War bipolarity of suspicion and mistrust by an era of multipolarity and great power balancing. In Yeltsin's own words:

"China is very important state for us. It is a neighbor, with which we share the longest border in the world and with which we are destined to live and work side by side forever. Russia's future depends on the success of cooperation with China. Relations with China are extremely important to us from the global politics perspective as well. We can rest on the Chinese shoulder in our relations with the West. In that case the West will treat Russia more respectfully" (Kutchins, 2010, p.35)

This statement makes no secret of China's instrumental role in Russia's perception of world affairs. While an alliance was not the optimal policy to be pursued, both Russia and China saw the prospects of their cooperation in magnifying their power status and bolstering their balancing strategy in a multipolar international order.

Regardless of the resonance of the Statist school in the Russian foreign policy thinking, Primakov's policies encountered insurmountable hurdles. The objective of "great power" status and how this would be built remained rather nominal and loose, thus, leading one Western analyst to conclude that the foreign policy under Primakov "is difficult to define. It is difficult even to detect" (Mandelbaum cited after Mankoff, 2009, p.30). Moreover, the decision to pursue internationally the realist paradigm "of building a counter-hegemonic bloc among countries hostile to or distrustful of the

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<sup>17</sup> Beginning in the 1990s, Jiang Zemin relegated to the margins issues that had strained the Sino-Soviet relations such as military confrontation, border disputes and ideological disparities and decided to set forth the liberal principles of mutual trust, mutual benefits, equality and cooperation as the guiding light in dealing with the post-Soviet Russia (Wishnick, 2010). This light was crystallized and defined in the aforementioned partnership of 1996, in the form of denial of any formal alliance by both parties, qualification of multipolarity in world affairs as opposed to the US 'hegemonism' and support for each other on an array of issues ranging from domestic politics in Chechnya and Uyghur Region to NATO expansion.

United States, including Iran, Libya, North Korea, Cuba, and China” added little to his foreign policies’ efficiency<sup>18</sup> (Mankoff, 2009, p.30; Ambrosio, 2005). Therefore, Tsygankov’s analysis that “if one has no special tools to make an elephant move, trying to do it anyway is not a smart strategy” is rather apposite (Tsygankov, 2006, p.122).

Putin’s ascent to power, first as prime minister in August 1999 and then as President in March 2000, concurred with the resolution of the economic dead-end. Putin, contrary to his predecessors, has been very conscious of the fact that economy was the key for an independent and effective foreign policy. Therefore, he was quick to break the economic shackles of the previous decade and rebuild Russia’s great power status upon economic premises. Taking advantage of the high oil prices, he first sought to reduce foreign debt as a means of reducing foreign leverage over the official policy of the Federation. The service of the loans received by the International Monetary Fund (IMF) and the Paris Club of sovereign creditors proceeded rather apace, so as in 2003 the IMF loan had been repaid in full and in 2004 the depository had foreign reserves equal to \$476 billion (Mankoff, 2009).

Without breaking with but rather reinterpreting the Statist thinking, Putin also differed in his perception of what Russia’s international behavior should be. While Primakov’s great power balancing was indeed a potent strategy that could strike respect and recognition on behalf of the West for Russia, the way it was pursued could not yield any results. The “Balancing” strategy should be viewed as a result of a robust state and not as Siloam’s Font in which a weak state could be re-baptized strong and powerful. Therefore, Putin qualified “great power pragmatism” as the best-suited strategy for restoring Russia’s robustness and power status and eventually

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<sup>18</sup> To make things worse, domestically, from 1995 to 1998, the downturn of the Russian economy limited the maneuverability of the officials while it led to the crisis of 1998. The faulty privatization of the early 1990s, the unreformed banking sector, the fiasco of the business restructuring, pictured an economy heavily burdened with structural fiscal deficits and rocketing debt, both domestic and external. According to estimates, the total external debt while equal to 42,5% of the GDP in 1995, it climbed to the 70% of the GDP in 1998. The public external debt relished the largest share of the total external debt, approximately 80%, while the service of the latter as a percentage of the exports revenues tripled the period from 1995 to 1998. In 1998, the service of total external debt was absorbing more than 1/3 of the export revenues (Kirkilis, 2010, p.92)<sup>18</sup>. This picture, if combined with the monetary crisis in Asia in 1997 plus the plummeting oil prices in 1998, clearly depicts the economic imbroglio in which Russia had got into. Export revenues were diminishing in an astonishingly rapid pace while the fiscal situation, beset with structural deficits resulting from both the inability of the Russian state to collect taxes and the favorable treatment of certain groups with political connections, was sending no signal of recovery. Such distortions and deficiencies suffocated the Russian economy whose political leadership at that time was following an overly-ambitious and semi-confrontational foreign policy with major economic centers and trading partners such as the U.S. and the EU.

provide his country with true balancing capabilities in its international affairs. Economy, international institutions, interdependence, cooperation create an inescapable globalized reality within which Russia has to interact with other states in pursuit of its “great power” status.

## ***1.2.2 The European Union***

### ***1.2.2.1 The awkward partner<sup>19</sup>***

Engaging now the awkward partner of the currently examined energy triangle, special emphasis should be placed, first, on its ontology, in James Caporaso’s words “*what the EU is*” (Caporaso, 1996, p.49). Is it a state like Russia and China so as to adopt a classic interstate analysis and fit it in the currently examined triangle as such, or is it a *sui-generis* case of political entity that merits special treatment? Furthermore, how is it to be dealt with when it comes to issues of energy policy/ diplomacy with third partners? Is there a common EU energy policy?

After the end of the Second World War, “grand theories” of European Integration claimed their place in the IR field, next to the dominant theoretical schools of Realism and Liberalism. Without juxtaposing their hypotheses against those of the dominant schools, they sought to explain the steps of a post-war devastated Europe towards a ‘war-averse’ federal endpoint. Since the 1960s, European integration had started to gain momentum, fact that presented them with a fertile empirical ground upon which they could test their key assumptions (Rosamond, 2000).

‘Neofunctionalism’ and ‘Intergovernmentalism’ “have been the two great monoliths at the gate of the study of European integration”, with the former belonging to the “liberal family” of the IR scholarship and attributing the momentum towards further integration (the “spill over” effect) to non-state actors, domestic social interests and the tendency of the European institutions to claim more powers under their command so as to strengthen their position in the decision-making procedure, and the latter siding with the “realist camp” and claiming that “integration is driven by the interests and actions of the European nation states” (Hix, 2005, p.15). Moreover, ‘Intergovernmentalism’, contrary to ‘Neofunctionalism’, perceives the decision-

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<sup>19</sup> For the term “awkward partner”, see footnote 4.

making at the European level as a *zero-sum* game, where one's gains are the other's losses. There is no trade-off to compensate for a prior loss (Hix, 2005). So, summarizing this logic in the words of Hoffman, "in areas of key importance to the national interest, nations prefer the certainty, or the self-controlled uncertainty, of national self reliance, to the uncontrolled uncertainty of the untested blunder" (Hoffman cited after Hix, 2005, p.15). In between these two monoliths, other explanatory approaches have diachronically emerged, adjacent either to the Neofunctionalist camp ("supranational governance") or standing as hybrids ("Liberal Intergovernmentalism" and "Rational Choice Institutionalism") (Hix, 2005).

While the momentum for 'game-changing' constitutional reforms had started to flare already since the 1984 (when the draft Treaty on the EU by the European Federalist Altiero Spinelli came to the forefront), only small steps had been made until the enactment of the Lisbon Treaty<sup>20</sup>.

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<sup>20</sup> The Maastricht Treaty had, at first place, initiated the European Citizenship, established the co-decisional procedure between the Council of Ministers and the European Parliament, while, most importantly, it had initiated the pillar system, according which, the future "European Union" would be founded upon three pillars; the first, focusing on issues of the European Community (EC), the second, on issues of Common Foreign and Security Policy (CFSP) and the third, on issues of Justice and Home Affairs. Striking and noteworthy difference among the pillars is the adopted decision-making pattern. While in the last two, all decisions obeyed to the *intergovernmental* paradigm, in the first, the "Community method" remained intact, illustrating the logic of cohesiveness and Europeanization. In the same logic, all three pillars shared common institutions, forming in this sense a single institutional framework (for the "community method" see footnote 21) (Mousis, 2001).

Regardless, however, of this purported cohesiveness, it is important to note that the only pillar that did have legal personality was the first one, laying the ground for heated debate over the EU ability to get contracted with third parties and international organizations as a unit. Undeniably, the absence of a single legal personality among the three pillars kept the issue of the EU ontology in international politics blurred. Therefore, so far, the concept of the Confederal Consociation seems to better fit the facts in construing the entity "European Union". Neither a Confederation nor a Federation. A conceptual hybrid, dubbed "Confederal Consociation" (Chrysochoou, 1994).

Although subsequent treaties (Amsterdam, Nice) further ameliorated many of the provisions established by the Maastricht treaty, no major shifts occurred towards a federal Europe until the European Council issued the "Laeken Declaration" in December 2001. This declaration-initiator of the "Treaty establishing a Constitution for Europe" (TCE) set the course for a more democratic, transparent and effective Union. In particular, the issues that were brought to the table could be classified into four main categories; a) the division of powers, b) the simplification of the treaties, c) the institutional refinement of the pillar system along with the upgrading of the role of national parliaments and d) the drawing up of a Constitution for the European citizens (Europa, 2007; Bradbury, 2009). The sailing from a Confederal Consociation to a pro-federal arrangement had just gained momentum. Notwithstanding the rough ride that the TCE, initially, had with the French and Dutch referendums blackballing it in 2005 and the Irish in 2008, the momentum stayed in place and when the aforementioned Treaty was presented with a different name, namely the "Lisbon Treaty", it was ratified and put into effect as of December 2009. Advocating the phrase "different name", Bradbury notes that despite the fact that "all of the key institutional reforms relating to the Council, Council, Council of Ministers and Qualified Majority Voting remained...the Lisbon Treaty was presented much less as a consolidating constitutional treaty and much more as simply another treaty" (Bradbury, 2009, p. 30). Therefore, it would not, at all, be an exaggeration to argue that the "Lisbon Treaty" mirrored the "Laeken Declaration" *per se*, since the only point missing was the label 'Constitution'.

The Lisbon Treaty markedly tipped the balance towards a more federal-like set-up. To begin with, it is provisioned a President of the European Council for 2,5 years and a High Representative of the Union for Foreign Affairs and Security Policy. The jurisdiction of the renamed Court of the European Union is expanded to all the sectoral activities of the Union, except those that deal with issues of Common Foreign and Security Policy (CFSP). The role of the European Parliament is augmented, given that the procedure of co-decision with the Council is extended so as to cover a wide range of legislative and budgetary issues (The Lisbon Treaty, 2007, p.17). Moreover, the inter-parliamentary cooperation between the national parliaments and the European Parliament is further strengthened. The role of the citizens is also advanced, since “no less than one million citizens who are nationals of a significant number of member states may take the initiative of inviting the European Commission, within the framework of its powers, to submit any appropriate proposal...for the purpose of implementing the Treaties” (The Lisbon Treaty, 2007, p.16).

The pillar structure, introduced by the Maastricht Treaty, is abolished, with the third pillar being integrated to the first and the second retaining certain characteristics (e.g. the intergovernmental pattern in the decision making) in a separate chapter. The first pillar, namely the European Community (EC), is merged with the EU and is renamed “Treaty on the Functioning of the European Union” (TFEU) (De Zwaan, 2007). The Union shall negotiate and conclude any potential withdrawal of a member state (The Lisbon Treaty, 2007, p.40). Finally, the Article 46A provisions that “the Union shall have legal personality” (The Lisbon Treaty, 2007, p. 38).

A point, however, that remained unchanged by the Lisbon Treaty, is the issue of competences and how they are allocated between the Union and the member-states. As Article 4B stipulates, the “limits of the Union competences are governed by the principle of conferral” (The Lisbon Treaty, 2007, p. 12). Following this, the Union competences are classified into three categories: Exclusive, Shared and Supportive. At present, we focus on the second category, since energy, transport and trans-European networks, which are the cases in point, fall into this category. A shared competence means that “The Member States shall exercise their competence to the extent that the Union has not exercised its competence” (The Lisbon Treaty, 2007, p.46). Therefore, both the Union and the member states are responsible for hatching out the EU energy strategy, if any. However, it is noted that each member-state has the “right to determine the conditions for exploiting its energy sources, its choice between different

energy sources and the general structure of its energy supply” (The Lisbon Treaty, 2007, p.88).

In this framework energy policy is not as a clear-cut case as it seems *prima facie*. Quite the opposite: the EU energy policy is a hybrid falling in both the Foreign and the Competition Policy domains. Reasoning that, when energy policy is perceived as exploiting energy sources, choosing between different energy sources and the general structure of energy supply, member-states retain every right to act as if they were adopting a Foreign Policy, i.e. totally independent, without any supranational constraints imposed by the EU institutions. On the contrary, when energy policy is perceived as a part of the internal market, then it falls in the domain of the Competition Policy of the EU, this meaning that the governing rules of the once first ‘pillar’ (mainly the “Community method” and the arbitration of the Commission vs. member-states’ disagreements over the Community Law by the Court of the EU), are adopted<sup>21</sup>.

Therefore, when it comes to issues of energy diplomacy, we see that the hitherto Federation-inspired EU integration finds certain stumbling blocks that cause us to make a U-turn. Currently, we hold that “Liberal Intergovernmentalism”, as developed by Andrew Moravcsik, may provide us with a better understanding on the within EU developments with regard to a common energy policy, if any.

Andrew Moravcsik, seeking an explanation for the evolution of the EC, advanced a theoretical framework that stressed the intergovernmental logic of the whole edifice. Specifically, beyond the EC, he identified a series of intergovernmental bargains, the only purpose of which was to “set the agenda for an intervening period of consolidation” (Moravcsik, 1993, p. 473). Substantiating his argument, Moravcsik first begun by bringing to the foreground the role of preferences in shaping a state’s behavior in world politics. To prove that, he qualified Liberal theory, and particularly its insights into state-society relations, as the needed platform for understanding how domestic shape international politics. State-society relations, “-the relationship of states to the domestic and transnational social context in which they are embedded-”,

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<sup>21</sup> The “Community method” of decision-making stipulates that following the procedure of co-decision, the European Commission has *the right of legislative initiative* and the European Council along with the European Parliament are responsible for transforming this initiative into law. During this procedure, the Council decides by Qualified Majority Vote (QMV) after having incorporated the Parliament’s consent on the issue.

shed light on the way that societal ideas, interests and institutions configure state preferences and direct governmental action (Moravcsik, 1997, p. 513).

Advocating the supremacy of Liberalism vis-à-vis the two dominant theories in IR scholarship, namely Realism and Institutionalism, Moravcsik resorted to the formulation of three assumptions which denote that “research into domestic preference formation is unavoidable” (Moravcsik, 1997, p. 544). In particular, he first acknowledged the primacy of societal actors, namely individuals and interest groups, in trying to forge state preferences through intense interaction, acting, however, within the range of their capabilities. This last point led him to the second assumption, where representation as well as state preferences illustrate only a subtotal of the domestic society, on the basis of which state officials align their actions in world politics. These actions, however, according to the third assumption do not “imply that states always get what they want”, since interdependence in the international system is to decide the balance between state preferences and state behavior in world politics<sup>22</sup> (Moravcsik, 1997, pp. 516-523). Upon these assumptions, Moravcsik aspired not only at restoring the reputation of Liberalism as a systemic theory, but also at reasoning its priority in “multicausal models of state behavior” (Moravcsik, 1997, p. 544).

While the domain of domestic preference formation has been previously addressed, now what calls for further elucidation is the link that exists between the determined national preferences and the interstate bargaining, what is called in the theory ‘Intergovernmentalism’. Resorting to Moravcsik again, national preferences are those to define a “‘bargaining space’ of potentially viable agreements, each of which generates gains for one or more participants” (Moravcsik, 1993, p. 497). Then, during negotiations, irreconcilable differences at first sight, find their balancing point and international cooperation becomes possible. Of course, the negotiation procedure alludes to the abovementioned 3<sup>rd</sup> assumption, according which interdependence, and particularly the incumbent asymmetries are to determine the balancing point between each state preferences and behavior in world politics<sup>23</sup>. Thus, in this pro-realism theoretical framework of international cooperation, the last question that plausibly

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<sup>22</sup> For the sake of inclusiveness it is stated that Moravcsik formulated the three assumptions by jointly analyzing the core tenets of Ideational, Commercial and Republican Liberalism.

<sup>23</sup> As Moravcsik notes “in this relatively benign environment, relative power matters. Bargaining leverage stems most fundamentally from asymmetries in the relative intensity of national preferences, which reflect...the relative cost and benefits of agreements to remove negative externalities” (Moravcsik, 1993, p. 499).

arises revolves around the role of international institutions and particularly the supranational structures of the EC.

International institutions are of marginal significance to facilitating international cooperation. States, when operating in world affairs, get, more or less, what they deserve. International institutions may help at reducing some of the transaction costs by mediating alternative agreements or adjudicating disputes, but, in general, they cannot alter a state's destiny, which, as prior said, is determined by the relative power and intensity of domestic interests *vis-à-vis* foreign ones<sup>24</sup>. Consequently, a 'two-stage' model emerged that shows how governments, first, become identified with a specific set of preferences and, second, how they promote these interests when negotiating with other states in an effort to realize them.

Overall, this theory, by explaining the evolution of the EC via the primacy of national preferences during interstate negotiations, makes a rather critical case in informing us on how we should deal with today's EU when it comes to issues of energy diplomacy. Following the proposed 'bottom-up' approach, we accept that developments at the domestic level of EU member-states shape and direct the "European collective" in energy policy. Additionally, the more relative power an EU member-state has, the greater the distributive outcomes and the influence it relishes and exerts during negotiations within the supranational bodies of the EU.

All things considered, the key issue is how the Russia-EU energy (gas) diplomacy of the 2000s is to be dealt with? Is there a common energy policy at the EU level? What analysis is the most proper to be pursued? At present, aligning with the *unchanged* by the Lisbon Treaty provisions on the *shared* competences, the institutionalized by the same treaty EU legal personality and the 'hybrid' nature of energy policy, we hold a negative position as far as the existence of a common energy policy is concerned and, thus, qualify the "Liberal Intergovernmentalism" approach as the necessary groundwork for our analysis. In particular, we pursue a *two-level* analysis: Russia- EU member-states (national level) and Russia-EU (supranational institutions level).

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<sup>24</sup> Following Moravcsik, when referring to transaction costs, particular importance should be placed on those of negotiating bargains and codifying agreements plus monitoring and enforcing compliance (Moravcsik, 1993, p. 508).

Having explained the awkward political ontology of the EU as well as how it will be dealt with in its energy affairs with Russia, we now turn to analyze how these two actors come together.

Since 2002, the EU has been in search of a policy towards its immediate vicinity. The “European Neighborhood Policy- ENP” captures the very essence of the various EU policies with regards to its different neighbors, Eastern and Southern (Ganzle, 2009). In particular, it refers to 16 states in Eastern Europe, the Caucasus, North Africa and the Middle East (Sasse, 2008). This policy is “a form of externalized EU-centered governance in order to partially integrate third countries of the immediate vicinity into ‘policy-taking’ rather than ‘policy-making’ processes of the EU...fact which renders it as ‘politics of the half-open door’” (Ganzle, 2009, p. 1716; Timmermann cited after Sasse, 2008, p.297). Its operability extends into three directions: a) the incumbent bilateral relations (PCAs, Association Agreements) between the EU and the ENP partners, b) the “joint ownership of the process, based on the awareness of shared values and common interests (with) the EU not seek(ing) to impose priorities or conditions on its partners” and c) the monitoring procedure to assess the progress on commitments made by both the EU and the ENP partners (European Commission, 2004, p. 8; Ganzle, 2009, pp. 1715-1716).

Under the rubric ENP have sprouted out, throughout the 2000s, more concrete initiatives, such as the former French President’s, Nicolas Sarkozy, “Barcelona Process: Union for the Mediterranean” on July 13<sup>th</sup>, 2008, and the Polish-Swedish “Eastern Partnership” (EaP), earlier that year (Ganzle, 2009, p. 1722). In fact, Poland has been a fervent supporter of the establishment of the EU Eastern Policy since 1998, with the idea getting serious thinking during the Spanish Presidency of the EU in January 2002, when the then British Foreign Minister, Jack Straw, in a letter to the presidency suggested that Ukraine, Belarus and Moldova should be “offered ‘clear and practical incentives’ for proceeding with political and economic reform and be granted the status of ‘special neighbor’ based on a firm commitment to democratic governance and free market principles” (Ganzle, 2009, p.1720). Finally, in December 2008, the European Commission, following the European Council’s proposal for an “Eastern Partnership” (EaP) which was supported by the Polish Foreign Minister’s pressing statements such as “to the South we have neighbors of Europe, [whereas] to the East we have European neighbors...that all have the right one day to apply [for EU membership]”, presented a communication on the EU “Eastern Partnership” aiming at

reinforcing the Union's relations with Belarus, Moldova, Ukraine, Georgia, Armenia and Azerbaijan (European Commission, 2008, p. 2; Sikorski cited after Goldirova, 2008; Ganzle, 2009, p. 1722).

As stated by the Commission, "the ENP has already been successful in forging closer ties relations between the EU and its neighbors. The EaP should go further" (European Commission, 2008, p. 2). On these grounds, multiple measures aimed at the establishment of a secure political-economic environment. Special emphasis deserves the field of energy security, where the EaP has been directed towards strengthening "the energy security of the EU and of the partners with regard to long-term energy supply and transit" (European Commission, 2008, p. 7). Even more important is what has been agreed with Ukraine and Belarus; in the first case, support for the full integration of Ukraine's energy market with that of the EU, and rehabilitation of its oil and natural gas networks have been prioritized, whereas in the second case, the finalization of a declaration between the Commission and the Belarus on energy has been considered as the necessary sign for further deepening the cooperation in the field (European Commission, 2008, p. 8). In the same vein, it has also been assessed that energy security could be achieved via diversification of supply and transit routes. Therefore, the "strengthening of the Baku process as a genuine energy partnership, with a full participation of countries of Central Asia as a key energy producing region,... including.. the development of the Southern Corridor (and) the Transcaspian" have been considered *conditio sine qua non* (European Commission, 2008, p. 11).

Atop the previous targets, however, stands the Commission's firm commitment that the "Eastern Partnership will be pursued in parallel with the EU's strategic partnership with Russia" (European Commission, 2008, p. 2). Indeed, the EU, aside from the PCA with Russia, which had initially been signed in 1994 and was extended in 2007 for one more year until 2008, has been cooperating with it under the ECT and the Energy Dialogue, with the latter to have been launched by the Russian President Putin, the French President Chirac and the then head of the EU Commission Prodi during the EU-Russia summit on October 30<sup>th</sup>, 2000 at Paris (European Commission, 2011, p. 6). Within these institutions, there have been made efforts to address various 'grey-zones' in the bilateral energy trade.

As becomes clear from the, *hitherto*, analysis, the EU has approached both Eastern Europe (the biggest part of it comprising FSU states) and Russia in an effort

to cultivate a secure, stable and prosperous vicinity. Nevertheless, it proceeded with its effort in a very cautious manner, acknowledging the special geopolitical weight this region has for its major trading partner, especially in energy terms, Russia.

### ***1.2.2.2 Russia-EU: the energy game***

Central Asia and particularly the Caspian Sea region have been ranking high in the EU energy security plans. The adequate oil and natural gas supplies that could be transported to the EU via multiple routes have been fulfilling both energy security targets of diversification of supplies and transit routes. Thus, the energy affairs in the region have been key themes in numerous analyses. Concretely, the export routes to the EU, the Russian preponderance in the region due to its ownership of the export pipelines and its tactics of bilateralism and divide and rule in the process of demarcating the lake, constituted focal analytical points (Lynch, 2001; Saivetz, 2003; Kalyuzhnova, 2005; Mavrakis et al, 2006; Dorian, 2006; Bahgat, 2007). From these research efforts, stand out those by Bahgat and Saivetz due to their focus on Russia's tactics towards guarding its dominant position in the resource-rich Caspian Basin after the demise of the USSR. Both examine the two major hurdles in the region (the lack of consensus on the legal status of the Sea and the disagreement over the most cost-effective networks), while they expose the Russian tactic of bilateralism as a means of rendering the solution of "the median line" the governing principle in the affairs among the littoral states<sup>25 26</sup>.

The energy chain between Russia-EU comprises also big Russian companies, responsible for energy contracts and supplies to the EU consumers. Thus, a multitude of research efforts revolves around the Russian oil and gas industry. These efforts cover a broad spectrum, addressing a lot of issues. To begin with the purely descriptive, special importance is placed on approaches that view the prospect of total reformation of the Russian oil industry as *conditio sine qua non* for development (Locatelli, 1999). Similarly, other approaches stress President Putin's determination to alter Yeltsin's legacy of dilapidation by vigorously curtailing the power of both oil

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<sup>25</sup> The littoral states are: Azerbaijan, Russia, Kazakhstan, Turkmenistan, Iran.

<sup>26</sup> The solution espoused by Russia stipulates the division of the Caspian sea by a median line which runs across the seabed at the same distance from both opposite shores (Bahgat, 2007, p.162). For more on the issue see: (Janusz, 2005).

barons and regional governors and sidelining them from the central political scene<sup>27</sup> (Rutland, 2000).

More detailed approaches go a step further to highlight that Putin, acknowledging energy as the primary domain in which Russia could claim leadership in the world affairs, was not eager to hand it over to a group of oil barons which was identifying its profits with the national interest<sup>28</sup>. Such arguments have been well substantiated by articles on the Yukos affair<sup>29</sup> (Aron, 2003; Shlapentokh, 2004; Tompson, 2005; Puffer and McCarthy, 2007). Likewise, other efforts, having as starting point the Yukos case, highlight the seizure of the central political scene by a closely affiliated to the presidency network of security service and law enforcement veterans, known as *siloviki* (“power agents”), whose intransigent views on state’s supremacy raised questions relevant to etatization, democratic rule, civil society, property rights and the business’ *laissez faire* (Hanson, 2004; Hashim, 2005; Treisman, 2007). No doubt, the Yukos affair is indicative of Putin’s philosophy towards big business and market liberalization.

Parallel to the Yukos affair, other research attempts strive towards disentangling the role of state monopolies like the natural gas company ‘Gazprom’ in the Russian foreign policy. Concretely, Walsh questions whether Gazprom is driven by politics or profit. In his own words “Gazprom is a really liberalizing company or a dangerously large and powerful arm of the Russian government?”. In further substantiation, he stressed that given the government’s lion share in the company (51%), Gazprom could easily be used as “a blunt instrument of Kremlin foreign policy” (Walsh, 2005). Similarly, Gazprom’s opaque pricing policy mostly towards the FSU states as well as the intimacy of many energy companies’ executives with the official governmental structure have been at the crux of various other analyses (Hill and Fee, 2002; Kryshtanovskaya and White, 2005; Kupchinsky, 2009). Finally, some scholars, motivated by this ‘intimacy’, asserted that “Gazprom likes to advertise itself as the guardian of Russian interests while LUKoil prefers to be identified as a more of a huge, Western style oil co-operation driven by commercial than political goals” (Gorst and Poussenkova, 1998, p.4).

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<sup>27</sup> In some cases an oil baron could also be a regional governor.

<sup>28</sup> In bibliography is also used the term ‘oligarchs’ instead of “oil barons” to provide a wider context.

<sup>29</sup> This case exemplified the dramatic struggle between the Russian President Vladimir Putin and the oil baron Mikhail Khodorkovsky, whose ballooning wealth posed great threat to the former’s desire for political centralization.

In the front of the Russia-EU institutionalized energy cooperation, one initially comes across approaches that discuss, the “*Energy Action Plan*” of the EU, adopted in the 2007 Spring summit, and the 2<sup>nd</sup> *Strategic Energy Review* adopted in 2008 (Umbach, 2009). Further on, other approaches deal with issues such as the ECT as well as its provisions and clauses; the convergence of interests among the signatories and the decision by some major powers like the US and Canada to abstain from signing it, have been at the core of these research efforts (Axelrod 1996; Andrews-Speed, 1999). Striking is the fact, however, that none of the aforementioned attempts tried a possible explanation for Russia’s refusal to ratify the ECT while it had initially signed it in 1994. This gap was finally bridged by subsequent analyses (Konoplianiuk, 2002; Fomenko, 2005). Both Konoplianiuk and Fomenko held that Russia denies the ratification of the Treaty so as to preserve Gazprom’s dominant position (monopoly) in exporting natural gas to Europe. In particular, the thorny clause around which the Russian opposition has been entrenched is the one which provides for Third Party Access (TPA) to the Russian pipeline system, currently owned by the state monopolies Gazprom and Transneft.

Other analyses detour the ECT, assessing ways and means for the EU to achieve energy (supply) security *vis-à-vis* its major supplier, Russia.

Focusing, first, on Goldthau’s thesis, someone can easily understand the author’s intention to provide an alternative, economized view to the widespread politicized thinking on the issue. Therefore, he qualifies investment in the burgeoning production of the Russian gas sector among the crucial, albeit neglected, aspects of the European supply security. To him, the state monopoly Gazprom should follow a more conciliatory stance towards other private producers, if the European energy security is to be guaranteed. In the author’s words “Gazprom, which controls the entire pipeline system, has restricted access to the grid despite legal obligations to provide third party with access...Without more incentives for private producers to invest in production, this output will not materialize<sup>30</sup>” (Goldthau, 2008, p. 689).

Unequivocally, this political economy argument holds true but in the case in point, seems to be untenable. As shown above, Russia refuses ratification of the ECT due to the latter’s provision for TPA in the network owned by Gazprom. Consequently, if the Russian government denies access to its natural gas network, on what grounds could

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<sup>30</sup> 105-115 bcm in 2010 and 140-150 bcm in 2020, in order to meet demand. See: (Goldthau, p. 689).

private producers invest in projects whose profitability is uncertain? Even if Goldthau's argument refers to private Russian and not European produces, still the Yukos affair speaks for itself. The new millennium's administration has been in favor of centralization and vertical control, especially in areas such as the energy trade that can provide Russia with a cash windfall.

The same line of reasoning accounts also for the following argument, according which Goldthau claims that "moves to exclude Western companies from promising Russian upstream projects leave Gazprom with the burden of developing these fields without foreign capital and managerial and technical expertise...European households could in fact remain cold during one of the upcoming winters; this however will not be the result of Russia's use of a "gas weapon", but rather due to a serious lack of upstream investments" (Goldthau, 2008, p.691). Again, here, the argument lacks the political perspective according which even if Russia does not use gas entirely as an instrument of political coercion, it does not forget that energy is the only domain that it can claim international excellence. Therefore, any attempt at liberalization should not come at the expense of its sovereignty and autonomy to exploit its money-making natural resources as it pleases.

Other theses that deserve special emphasis are those that aim at analyzing the interdependent relationship between Russia and the EU with regard to gas (Finon and Locatelli, 2008; Proedrou 2012). Finon and Locatelli develop a theoretical framework according which the EU pursues a policy towards extending its multilateral market regime for energy while Russia uses its natural resources to restore its geopolitical power. Particularly, the theories employed are "Market and Institutions" for the EU policies and "Regions and Empires" for the respective Russian. Both theories represent, in a sense, the classic in IR scholarship 'Neo-Neo' debate between Neorealism-relative gains argument and Neoliberalism-absolute gains argument. The authors acknowledge that "Russia wants to establish a position of leadership and ensure that it is a key player with control over the terms of sale in the various markets and influence in their long-term developments" (Finon and Locatelli, 2008, p. 426). Thus, it is of utmost importance for the EU member-states to give their consent to the establishment of a "common negotiator", as suggested in the Green Paper of March 2006, that would allow the EU to express itself at the supranational institutions level with a "single voice", and also intercept the Russian assertive gas diplomacy, which has been carried out at the bilateral level (EU member-states-Russia) by the state

monopoly 'Gazprom', favoring, in this manner, Russia and diminishing the EU total energy security.

Aside from this, their argument that Gazprom is being encouraged by the Putin administration "to invest in Central Asia, to install its own routes from this region,..to redefine preferential terms for gas sales to countries in its own sphere of influence... (and) to regain control over countries attempting to distance themselves from Moscow (Ukraine and Georgia in particular)" calls for anew research (Finon and Locatelli, 2008, p. 426). This is because despite the Russian gas pricing brackets according which domestic sales are priced very low, sales to the FSU higher and sales to Europe the highest, Russia has lately, not only markedly raised the prices for most of the FSU states up to the European levels but also has moved one step further to the construction of new pipelines that bypass problematic transit-states such as Ukraine, aiming at establishing itself as a trustworthy supplier of the EU (Spanjer, 2007).

Consequently, if Russia is to reassert its political influence in the FSU via close economic integration, it will certainly not do it at the expense of its gains from the gas sales (preferential prices). Moreover, by bolstering up Gazprom status following a law passed by the Duma in July 2006 which clearly confirms the former's monopoly on Russian gas exports and transit, the FSU states, given their immense dependence on Gazprom natural gas, will have no alternative but to succumb to Russia's will<sup>31</sup>.

Finally, another thesis that also pertains to the Russia-EU natural gas relationship is that by Spanjer which examines whether the application of a unified gas pricing on behalf of Russia would strengthen the EU supply security or not. The scholar conceptualizes, first, the term "security of supply", advocating its division in two parts: system security, namely the existence of a gas network able to deliver supplies to the costumers, and the quantity security, namely the adequate quantity of gas for now as well as for the future (Spanjer, 2007, p.2890).

With regard to the former, Spanjer upholds the creation of new pipelines that will circumvent problematic transit-states, guaranteeing, in this sense, supplies for all the contracted European/EU customers. As far as the latter is concerned, he advocates that the solution of a unified gas pricing will definitely render the supplies much more expensive in the Russian as well as the FSU markets, compelling buyers to better and

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<sup>31</sup> For this law see: (Finon and Locatelli, 2008, p. 436).

more efficient use. Therefore, there will be an increase in the available quantities for the European/EU demand.

However, he is quick to note that no one can be sure that these extra gas quantities will indeed be diverted to Europe. For the time being, Europe is considered “a premium market for obvious reasons<sup>32</sup>. This situation makes Russia dependent on supplying Europe and significantly lowers Russia’s incentives to cut off supplies to Europe” (Spanjer, 2007, p. 2891). If a unified gas pricing policy was actually realized, the Russian market along with the FSU states would encounter immense social problems, while the beneficiary of the extra quantities would be decided by the location of production as well as by the competition of major powers such as China and the U.S. (Spanjer, 2007, p. 2896). Indeed! Spanjer’s claims share solid ground, given recent events such as the commencement of the government-backed Eastern Gas program—“Восточная газовая программа”- and the construction of the Sakhalin-Khabarovsk-Vladivostok (SKV) gas pipeline (Gazprom, 2009a). Parallel to these projects, other developments in the Russian Far Eastern region bring China apace in the Eurasian energy equation, despite the unresolved, as of the time of the writing, issue of the price of the Russian natural gas supplies to China<sup>33</sup>.

### ***1.2.3 China’s response to Russia’s ‘Eurasianism’***

#### ***1.2.3.1 A convergent course***

Undoubtedly, China has been a critical card in Putin’s economized perception of World affairs. Contrary to Primakov that perceived it solely as a ‘handy’ alternative for counterbalancing the US hegemonism, Putin saw the economic-political potential in the bilateral cooperation. Acknowledging the common grounds that both states have been sharing as far as domestic development and international behavior are concerned, he sought to capitalize on this convergence. China presented the “Beijing consensus” which held that its successful socioeconomic development model differed from “the Washington Consensus as promoted by the US government and multilateral organizations like the IMF and the World Bank” (Kutchins, 2010, p.45).

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<sup>32</sup> The often subsidized gas supplies to the FSU states make the European/EU high-priced sales indispensable for the sustainability of the Russian gas industry, let alone the entire economy.

<sup>33</sup> For more on the issue as well as on the SKV gas network see Chapter 6 and pp. 242-244.

The Western *modus operandi* with the ‘intrusive’ multilateral institutions and organizations, certainly, has not been endorsed by both Russia and China. To them, the boons of a global economy should not come at the expense of their sovereignty, independence and international self-standing. For China the international extension of the “Beijing consensus” has been the concept of “Harmonious World”. A “harmonious world” involved “encouraging multilateralism to ensure common security, aiming for common prosperity through mutually beneficial cooperation, and democratizing international relations by respecting the diversity of civilizations and each country’s right to choose its own development path” (Wishnick, 2010, p.69). This concept, clearly, epitomizes what has been previously discussed. Cooperation and boons of a globalized economy but not at the expense of a civilizations’ uniqueness and sovereignty<sup>34</sup>. In this manner, both nations publicized their inalienable right to choose an individual, independent and autonomous path in a multipolar world.

Since the founding of New China in 1949 and specifically the economic reforms introduced in 1978, each administration placed great emphasis on the principles of peace and development. Deng Xiaoping, the initiator of the opening-up policies in the late 1970s, qualified the concept of “peace and development” to characterize the national policies pursued either domestically or internationally (Wishnick, 2010, p. 57). Similarly, Jiang Zemin elaborated on the concepts of “win-win diplomacy”, “mutual trust”, ‘equality’ and ‘cooperation’, while Hu Jintao endorsed the concept of “peaceful development” aiming at a “Harmonious World” (Wishnick, 2010, p. 57; Wang, 2011).

Economic integration in the form of economic globalization has diachronically been the main interest of the Chinese administration and, particularly, how could the country benefit the most from such an interdependent reality<sup>35</sup>. The currently examined Hu Jintao administration, that dominated the national political scene for the best part of the 2000s, had overemphasized the role of economic globalization in accomplishing a wide range of objectives under the rubric “peaceful development”,

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<sup>34</sup> For the Russian perception of ‘uniqueness’ (‘specifica’) see: (Karagiannis, 2010, p.32).

<sup>35</sup> As mentioned by the information office of the State Council, since the economic reforms of the late 1970s, China has taken an active part in economic globalization. The total import and export volume grew from US\$20,6 billion-worth in 1978 to US\$2,974 trillion-worth in 2010, while the FDI from 1979 up to 2010 amounted to US\$1,04838 trillion (Wang, 2011). China has set up also business ties with 163 states while in an effort to align with its WTO commitments, it has reduced its total tariff rate from the before-WTO 15,3% to the present 9,3% (Wang, 2011). China has entered the WTO in 2001 and ever since its trade volume has multiplied considerably, benefiting both China and the global economy. For more on the issue see: (Wang, 2011).

expanding “from ensuring people’s basic living needs to building a society of initial prosperity and then to reaching the level of the medium-developed countries” (Wang, 2011). However, the terms under which these objectives would be accomplished are of high importance, since they are indicative not only of the Chinese leadership’s mind-set but also of the prospects for Russia being part of the former’s developmental equation.

*En route* to a “harmonious world”, concerted efforts at the political, economic, cultural and security policy spheres are required, with these taking specific meaning in China’s determination not allow “any external forces to interfere in (its) internal affairs,...practices of the big bullying the small,...strong oppressing the weak,...hegemonism and power politics” (Wang, 2011). “State sovereignty, national security, territorial integrity and national reunification, (preservation of the) political system established by the Constitution and overall social stability (are) the basic safeguards for ensuring sustainable economic and social development” (Wang, 2011).

Upon these principles, China engaged also regional cooperation trying to establish good-neighborly relations. Renouncing any aspiration towards regional hegemony or spheres of influence and sidelining any potential area of friction and instability (e.g. border dispute, territorial claim, maritime rights, etc.), China called for mutually beneficial cooperation and promotion of the regional economic integration (Wang, 2011).

Consequently, to the extent that the former principles would be respected by the international community, a world view of “unity without uniformity” would emerge providing all the necessary for China’s “peaceful development”. The Hu Jintao administration highlighted the role of economics for the sustainability and prosperity of the Chinese society while it also revealed that economic globalization should move in parallel with the principles of sovereignty, independence and non-intervention in the internal affairs of the other states. In a word, Economics and Autonomy. This is exactly the intersection that Jintao’s China found Putin’s Russia and vice-versa. Undeniably, there has been a convergence between the two throughout 2000s without, however, this meaning a complete identification of interests.

### *1.2.3.2 Russia-China: the energy relations*

Russia and China, leading actors in Eurasia, got on intimate terms mainly after the demise of the Soviet Union. In 1992, both governments announced that they were officially 'friendly' just to redefine their rapprochement in 1994, when it was characterized as "constructive partnership". Finally, from 1996 onward, the Russo-Chinese rapprochement acquired its latest and enduring form of "strategic partnership" (Jingjie, 2000; Bakshi, 2002; Li, 2007; Dittmer, 2001).

A handful of research efforts focuses on the economic and political dimensions of this partnership (Blank, 1998; Bayarsaikhan, 2003; Portyakov, 2007). Remaining largely descriptive with few political implications, Portyakov portrays Russia and China as strategic partners "that contribute to the preservation and strengthening of their independent foreign policy course" (Portyakov, 2007, p. 13). Further on, he holds that the Russian trade and the overall economic ties with China constitute an important alternative to the European direction. This allegation remains rather speculative and if it holds true needs further elaboration<sup>36</sup>. Besides, the Russia-EU partnership is not a lopsided case where only the EU depends extremely on Russia. Russia as well, has important stakes in its commercial (energy) ties with the EU. Therefore, the extent that China can serve as a substitute to the EU calls for further research. Likewise, predictions that "The Sino-Russian partnership's economic dimension is unlikely to transcend its current relatively low level, in which case will spawn not a stronger entente, but considerable disappointment and resentment" have been falsified by the official turn of the Russian government to China, especially after the commencement of oil and gas pipeline projects in the late 2000s<sup>37</sup> (Blank, 1998, pp. 348-349).

Departing now from the economic dimension of this partnership, the respective political has been equally explored. Concretely, the Russo-Chinese rapprochement has

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<sup>36</sup> In Soviet times, China and the Soviet Union were very close trading partners with the former to have built much of its defense and manufacturing sector on latter's exports. However, after the collapse of the USSR, China called for full modernization and often started many enterprises from scratch without Russian contribution. This resulted in crystallizing a trade relationship where Russia exported mainly oil and gas and imported machinery. Such a situation certainly contradicted Putin's desire for diversification of the economy since many Russian manufacturers did not relish "security of demand" from a sizeable and thirsty economy such as the Chinese (Garnett, 1998; Sutter, 2008).

<sup>37</sup> See the ESPO oil pipeline and the SKV gas pipeline projects that are expected to be 'land-bridges' to new market openings. See also Chapter 6.

been explained as an offshoot of worry and concern over the US supremacy in the world affairs. China, on the one side, renounces American hegemonism accusing the US of supporting the secession of Taiwan from China and using the human rights to do the same with Tibet (Blank, 1998, p. 350). The Chinese authorities perceive the human rights ‘language’ and democracy as a western pretext aiming at the delegitimization of the established political system. Therefore, Russia’s abstention from complaining about China’s violations of human rights or authoritarian rule has brought the two powers closer<sup>38</sup> (Blank, 1998, p.350). On the other side, Russia, being stranded by a constantly expanding NATO, has no other way to turn to but to China if it is to play a major role in the international affairs. More laconic, “Moscow won support for its opposition to NATO while Beijing won support for its ‘One China’ policy” (Hansen, 2008, p. 219).

In spite of the aforementioned, other research efforts revolve around the “grey zones” in the Sino-Russian relations. Moving down the ladder of abstraction, the Russian Far East (RFE) or the “Lenas region” to recall Mackinder’s analysis constitutes one of the major ‘roadblocks’ in this partnership. The collapse of the USSR unveiled lots of weaknesses in the region as economic subsidies disappeared and high costs and shortages surfaced. As Garnett highlights it, there is a “fundamental disparity between a vast, resource-rich Russian region of about 8 million next to the 120 million Chinese across the border”<sup>39</sup> (Garnett, 2001, p. 49). This picture clearly depicts the indisputable dynamics for a *de facto* change in the *status quo*, contrary to policies and intentions of statesmen in Moscow and Beijing. Furthermore, Central Asia is another potential “point de friction”, given its natural resources as well as its geo-strategic position. Up to now, both states’ policies have been aiming at the Caspian Sea oil fields, since they could yield significant benefits

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<sup>38</sup> In the aftermath of the Tibet insurrection in 2008, accusations over human rights breach were again leveled at the Chinese authorities.

<sup>39</sup> A major stumbling block even today for the Sino-Russian cooperation is the RFE. Russia is an Asian power only in terms of geography, military and politics but not in terms of demography and economy. The RFE is sparsely populated and if compared with the densely populated Chinese provinces, then a major disparity arises. Siberia as well as the RFE are critical for the Russian exporting industry given the production of over 90% of the country’s gas and oil output, the exclusiveness in mining diamonds and a large share of various other natural resources (Garnett, 1998). To add fuel to the fire, while in the Soviet period the economic life of the region had been heavily subsidized by the government, after the demise of the USSR the Russian Far East came to realize market realities with no governmental aid. This resulted to a steady outmigration of the region and a rising Sino-phobia, with Russian residents starting to perceive the Chinese of the Northeastern borders as the “yellow peril” (Garnett, 1998). Therefore, no matter the prospects and the profitability of an emerging Sino-Russian rapprochement, especially after 2000 during the Putin/Medvedev era, fears and suspicions of a yellow invasion have never left the scene.

for their economies. China, on the one hand, has set ties with Kazakhstan over the recently constructed oil network from the Caspian oil field ‘Atasu’ to Eastern China, ‘Alashankou’<sup>40</sup> (Fishelson, 2007). On the other hand, Russia sees Central Asia as a part of its traditional sphere of influence. Both countries pin great hopes on the region for their development and hence care a great deal for stability, cooperation and mutual respect (Garnett, 2001; Bayarsaikhan, 2003).

Consequently, what emerges from the previous analyses on Central Asia is the need for both China and Russia to guarantee regional security. Any Islamic rise could destabilize not only the Central Asian states *per se*, but also touch off a chain reaction enmeshing the Muslim minorities in both China (Uyghurs) and Russia. Therefore, in April 1996 it was established the Shanghai Five in order to handle issues of border delimitation, creation of demilitarized zones and terrorism<sup>41</sup>(Hansen, 2008). For China, an immediate concern was to control and win support for the developments in the Xinjiang Uyghur Autonomous Region (XUAR) which shares borders with all the Shanghai Five members. In the words of Hansen “By offering to normalize relations with Russia and the neighbors in Central Asia, Beijing could hope to win their active support as it continued its struggle to impose full control over the XUAR” (Hansen, 2008, p. 218). For Russia as well, the Shanghai Five organization was a tool for bolstering its influence in the region<sup>42</sup>. Thus, once the regional stability have been assured from a political perspective, both Russia and China sought to extent the range of bilateral cooperation, comprising also energy issues.

The search for supply security on behalf of China and demand security on behalf of Russia came at the forefront, prompting, in this manner, the existing literature to follow a similar course.

At first, there are research efforts that focus on the domestic level, assessing the energy situation in China (Lewis, 2008; Downs, 2004, 2006; Cheng, 2008). Downs attempts to shed light on “the parallel debate unfolding inside China over how to ensure the country’s oil needs are met without undermining national security” (Downs, 2004, p. 21). In her quest she identifies participants to the debate and analyses the energy security decision-making procedure as well as some measures

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<sup>40</sup> For an inclusive account on the central Asian energy projects with Chinese involvement see: Chapter 6.

<sup>41</sup> The Shanghai Five comprised: China, Russia, Kazakhstan, Kyrgyzstan and Tajikistan.

<sup>42</sup> In 2001 the Shanghai Five acquired its institutionalized form and renamed Shanghai Cooperation Organization (SCO). For more on the issue see: Chapter 6.

under consideration aiming at enhancing energy security (Downs, 2004, p.21). Lewis, in a similar manner, shows the allocation of power (decentralization) within China's political scene as far as energy security strategies are concerned (Lewis, 2008).

Attuned with the former, Cheng clearly states that his study mainly relies “on published data from China to reflect a Chinese view” (Cheng, 2008, p.298). Useful data are presented according which China's dependence on imported oil will reach 76,9% by 2020 and 82% by 2030 while the dependence on imported natural gas is expected to reach 30% by 2020 and 50% by 2030 (Cheng, 2998, p.301). In light of these, the Chinese authorities are expected to adopt a policy-mix to guarantee China's supply security; from upgrading the industrial structure and introducing energy conservation measures (that will allow the country to reduce the energy consumption by 13.5% of the 2005 total) to developing new supply sources such as the renewable and engaging a new fangled energy diplomacy (Cheng, 2008). While these policies may be feasible, the analysis remains in the superficial level of official documentation, released by the Chinese authorities. There are aspects of China's energy security that are largely disregarded. First, no pipeline diplomacy is analyzed. The pipeline politics play a crucial part in China's energy security<sup>43</sup>. Second, Cheng has also disregarded the role that Russia actively plays in China's energy security. Atop stands the absence of any reference to how the international affairs impact on China's energy security.

This gap is bridged by other research efforts that place China's energy security within an international context. Focusing on the East Asian region, they address the problem of energy security either on a bipartite or tripartite base. As far as the first case is concerned, Liao studies the Sino-Japanese energy affairs only to conclude that the relationship has been closely influenced by political and strategic factors. The author detects that the mutual political distrust serves as a considerable impediment in their fertile cooperation. Therefore, regional energy institutions, or at least institutions that comprise energy, such as the Association of South East Asian Nations plus three (ASEAN+3) or the North Asian Petroleum Forum (NAPF), or the Symposium on Pacific Energy Co-operation (SPEC), have been of limited capacity to ameliorate their relationship (Liao, 2007). A critical argument is made when he draws the parallel between the Sino-Japanese relationship and the EU and examines whether the former

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<sup>43</sup> To exemplify, the oil pipeline from Kazakhstan or the Russian ESPO and SKV projects, that all aim at supplying the Chinese market. See also: (Karagiannis, 2010a).

could follow in the latter's footsteps. He holds that "the EU experience was not simply a process of 'co-operation' that had little to do with state sovereignty, but rather one of 'integration' that achieved through the 'spill-over' effect and required partial transfer of the sovereignty" (Liao, 2007, p. 43). Thus, unless China and Japan rekindle their energy cooperation through political trust-building, "the EU experience would never be applicable to Asia, and the regional stability might always be dominated by power politics" (Liao, 2007, p. 44).

In stark opposition to Liao, Choi overstates the emerging prospects for energy security in the Northeast Asia via intergovernmental institutional cooperation (Choi, 2009). China, Japan and South Korea should seek to ameliorate their energy relations through institutionalized cooperation. Concretely, intergovernmental institutions such as the Asia Pacific Economic Cooperation (APEC) or the Energy Working Group (EWG) or the ASEAN+3 could contribute to the regional energy security. According to the author, a regional institution building under the US guarantee offers a sound solution to the problem of energy security (Choi, 2009).

Assessing now the two efforts, the absence of Russia as both a major supplier and a key factor to the regional energy security is striking. Although it is understandable that these analyses are case studies focused on specific states, their validity is at stake since a key player is missing. Furthermore, both authors adopt the two extremes. While Liao qualifies neorealism and the relative gains argument to disentangle its case study (China-Japan), Choi follows a more neo-liberal path of cooperation and 'win-win' tactics. Although their arguments may hold true in the examined cases, they do not stop being rather limited and narrow. What would be the best-suited theoretical approach for cooperation among major powers such as Russia and China that evidently share great power ambitions? The assessment by Choi that "institutions that succeed in facilitating co-operation make defection less likely by reinforcing the norm of reciprocity between states" can it retain its analytical validity in cases where cooperation revolves around great powers such as Russia, China and the EU? A wider analytical scope is surely required for more far-reaching assessments.

In the same continuum, 'cooperation' remains the key to regional energy security for several other research endeavors (Lee, 2005; Kreft, 2006; Dadwal, 2007; Pant 2007; Fengying and Jiejun, 2008; Zhao, 2008;).

To begin with, Fengying and Jiejun argue that the real risks are not "below ground" (a lack of resources) but "above ground" (political instability). Particularly,

the rise of the world oil prices is attributable to many “above ground” factors, *inter alia*, the business cycle, the rising demand and low spare capacity both upstream and downstream, speculation, geopolitical instability in sensitive regions such as the Middle East and terrorist activities (Fengying and Jiejun, 2008, p.52). Therefore, the authors suggest as possible solutions the strengthening of cooperation and dialogue between energy exporters and consumers, the establishment of a system for research and development aiming at advanced energy technologies, the maintenance of a sound political climate and the commencement of a high-level strategic energy dialogue among energy consuming nations. As they point out “rapid readjustments are under way in bilateral relations (Russia-China, Russia-European Union, Russia-India, United-States-China, United States-India, India-China), trilateral relations (China-Russia-India and the United States-Russia-China) and other similar relationships with a pattern of rivalry amid co-operation” (Fengying and Jiejun, 2008, p. 50). What remains open, however, to further elucidation are the terms under which this suggested cooperation is taking or will take place. As it has already been shown in the current research, major powers such as China, Russia covet a “great power” status. Thus, the terms of cooperation are the issue at stake. Besides, in a globalized reality, cooperation is an inescapable reality. No state is an island and cooperation is a given.

Likewise, other research efforts, highlighting the gloomy prospects for China’s unilateral policies and strategies in search for supply security leading to heightened competition among major importing states and geopolitical tensions in the Asia-Pacific region, qualify cooperation as the only viable solution (Dadwal, 2007; Zhao, 2008). These unilateral policies and strategies comprise: bilateral relations with energy-producing countries with poor human rights such as Sudan, Iran and Venezuela, construction of Strategic Petroleum Reserves (SPRs) outside the purview of the International Energy Agency (IEA) and the “Going Abroad” strategy by the three main national oil companies (CNPC, CNOOC, Sinopec)<sup>44</sup>. Specifically, the latter have used shrewd diplomacy to create such a tight nexus of interdependence with producing states that would render any unilateral disruption to oil supplies to China economically nonviable (Dadwal, 2007; Zhao, 2008; Lewis, 2007; Xu, 2007; Downs, 2009). Elaborating a bit more on the “Going Abroad” strategy, it is crucial to mention that China, exploiting the need of some states for FDI (Foreign Direct

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<sup>44</sup> China National Petroleum Corporation (CNPC), China National Offshore Oil Corporation (CNOOC), China Petroleum & Chemical Corporation (Sinopec).

Investment), ‘bought’ access to their energy resources (“equity oil”)<sup>45</sup>. As Zhao summarizes this strategy, “the state-centered approach is based upon a neo-mercantilist thinking that relies on bilateral diplomatic contacts with oil producing countries to beef up energy security by the use of national resource and state-owned enterprise investments in overseas energy assets” (Zhao, 2008, p. 207). Consequently, the emerging dilemma revolves around the officially endorsed Chinese policy of “peaceful rise” aiming at the enhancement of international cooperation, on the one hand, and the neo-mercantilist approach of locking up energy supplies and endangering international instability with the aim of unilaterally resolving its energy security problem, on the other (Zhao, 2008).

Undeniably, these research efforts present an assertive China that adopts a self-satisfying *modus operandi* at the expense of abiding by the rules and norms of the international community. The fact that the authors (Zhao and Dadwal) assess in the end cooperation as panacea to competition and potential international instability strips their approach off any wider political implication. This is because cooperation *per se* does not mean that states, especially those that share “great power” ambitions, will unconditionally consent to cooperative international relations. How could major players of the IR field such as Russia, the US, the EU, that each has either the same, more or less, energy needs as China or wants to take advantage of its energy resources to become a world-class power, coordinate their policies with a natural resources thirsty and suspicious towards the international community, as proved by the aforementioned (neo-mercantilist) strategies, China? What would it take for cooperation to flourish under these circumstances? To answer these questions, we need, first, to research the terms of cooperation in order to identify the governing rationale.

Qualifying, still, cooperation as the one and only solution to energy security in the Asia-Pacific, other research pieces gradually turn to Russia (Lee, 2005; Kreft, 2006; Pant, 2007; Seaman, 2010). Without disregarding the incumbent Chinese strategies, as previously described, they maintain that China, in light of its growing dependence on imported oil and natural gas, will seek to fulfill its needs from Russia, provided that an extensive network is in place (Kreft, 2006, p.107). The straits of Malacca, through

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<sup>45</sup> Specifically, China could exploit the energy resources of the producing states according to its percentage (shareholding) at the local upstream/extraction projects.

which almost 80% of China's oil imports is transited, have become rather vulnerable sea lanes, especially after the 9/11 attacks (Kreft, 2006; Downs, 2010a).

In view of this situation, Russia is a key player to the regional energy security (Itoh, 2011). But, for Russia too, Asia, and particularly China, has been a promising option. Moscow, assessing, first and foremost, the benefits for its far eastern regions, has admitted its growing interest in the Asian market as a means of diversifying its energy exports besides Europe. In particular, close to three quarters of Russian oil exports will go to Asia and particularly China (Pant, 2007, p.531). In the words of Vladimir Frolov, an official from the Russian Ministry of Development and Trade, "We need to think how to develop and pull up Siberian and the Far East regions so that they are at the same level as the central regions of Russia. How can we do this? Via Europe? No, of course not" (Frolov cited after Pant, 2007, p.531). On these grounds, the Russian concern for "security of demand" meets the Chinese quest for "supply security" (Kreft, 2006; Pant, 2007).

However, the Russo-Chinese energy relationship (particularly the network aspect) is still in the offing. In 2008 the construction of the SKV gas pipeline has commenced, while in the oil sector, the ESPO project, which has been developed in consonance with the Russian energy strategy up to 2020, has been recently put on track (Energititseskaia strategii Rossii, 2003; Watkins, 2009). These facts command anew interest in a region with strong and constantly changing energy dynamics.

### ***1.3 Conclusion***

In this chapter, we first begun by defining the geopolitical space of Eurasia and rendering today's Russia as its long-standing inhabitant. The theory of the 'Heartland' by the geographer Halford Mackinder has been a useful tool in our effort, since it provided us with the necessary geographic, demographic and natural resources insights. Without endorsing or disregarding the power struggle which Mackinder's theory entails, we paraphrased 'Heartland' to 'Energyland' and indentified Russia as a leading actor in the Eurasian energyland.

Thus, having our main actor in place, we, then, proceeded with the geopolitical connectivity in the region, identifying three states/actors: Russia-EU-China. Adopting the Russian perspective, we resorted to the Russian foreign policy to explain the shift towards Eurasia and what has been anticipated from this turn. The EU, as the one end

of the region, has been a critical factor in this geopolitical maneuver. However, examining the Russia-EU energy (natural gas) relations is a not-so-simple case. The latter has been a *sui-generis* case due to its awkward political ontology. Thus, we, first, elaborated on the issue, claiming that a ‘two-stage’ analysis would be the most suitable approach to disentangling its relationship with Russia and, then, examined whether this actor shares the same interest as Russia in strengthening their cooperation. The ENP, and the EaP as part of the former, showed that the EU has been, since the early 2000s, keen in developing its (energy) ties with Eastern Europe (emphasis placed on the FSU states) without, however, undermining its strategic relationship with Russia. Consequently, a stage for brinkmanship (energy) diplomacy between Russia and the EU has been set throughout the 2000s. The existing literature has covered a wide spectrum of the bilateral energy game, starting from Central Asia and the Caspian Basin, in particular, as the main sources of the EU plans towards diversification of supplies and transit routes, and reaching the examination of specific policy suggestions towards tightening the Russia-EU energy bond and enhancing the latter’s (supply) security. China, as the other end of the region, has also ranked high in Russia’s geopolitical maneuver, fact that made the assessment of China’s response towards Russia’s ‘Eurasianism’ equally important. The analysis highlighted that for China too, Russia has been an important regional player, not to mention the primacy of economic globalization coupled with the energy complementariness that laid common ground for Putin’s Russia and Jintao’s China. The scholarly work has highlighted various aspects of the bilateral energy relationship, with emphasis placed both on the “grey zones” and the promising (energy) prospects.

Taken together, the previous chapter highlights the formation of a Eurasian energy triangle with delicate balances and mutual interests, whose thorough and synchronized, for the first time, examination could lead to better substantiated and more informed conclusions.

## Chapter 2: Research Design

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### 2.1 Introduction

The analysis, *hitherto*, has established an energy triangle in Eurasia within which Russia, the EU and China have been interacting in pursuit of their energy priorities. In the previous chapter we clarified that, currently, we adopt the Russian perspective, thus interpreting the energy (natural gas) diplomacy in the region via Russian lenses. Nevertheless, the solidity and rigidity of any interpretation requires its examination via the filter of an unwavering theoretical framework.

Below, the Eurasian energy triangle is premised upon the theoretical debate between Neorealism and Neoliberal Institutionalism (the so called ‘Neo-Neo’ debate). This theoretical framework is the indispensable ‘tool’ for detecting and matching policies with motives and, thus, unraveling the rationale, or better said the strategy, beyond the Russian energy policies *vis-à-vis* both its geopolitical vicinity of the FSU region as well as the two geopolitical ‘angles’, namely the EU and China. The widely tested premises of the debate, and particularly the “relative versus absolute gains” argument, lay an impartial and solid ground for illuminating the case in point. Thus, what is mentioned in the Introduction of the present research about the terms of (bilateral) cooperation becomes possible. Moreover, the conclusions to be drawn surpass the Eurasian energy diplomacy and the current context of energy politics, providing useful insights into the tendencies of the examined actors when cooperating under certain conditions (e.g. symmetry/interdependence, asymmetry/unilateral dependence, correlation/interconnectedness)<sup>46</sup>.

Once the theoretical framework has been presented, the analysis takes on a more specific format by stipulating the causal mechanism (what explains what) and formulating the research hypothesis. Up to now it has, more or less, been provided a research contour. But with the clarification of both the causal mechanism and the hypothesis, this contour is ‘embodied’ in specific parameters, thus making the analysis firmer and easier to follow. Certain policies are identified with explicit actors

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<sup>46</sup> For a thorough understanding of these types of interstate cooperation see the ensuing analysis (chapter 3 onward).

and mind-sets. A direct causality is established, testable and open to falsification by further research.

Finally, for the current argumentation and support of any findings, a series of evidence and data is required. Thus, in the methodology section we refer, in detail, to both the structuring of the analysis as well as to all the research methods employed in order to collect and analyze the necessary sources of the present effort.

## ***2.2 Neorealism vs. Neoliberal institutionalism and the ‘middle-ground’ of Institutional Balancing: the debate***

### ***2.2.1 Neorealism***

The main theoretical framework of this research is that of Neorealism versus Neoliberal institutionalism. The ‘Neo-Neo’ debate, as it is often termed in the literature of the IR, traces its start back in 1986 when Professor Robert Keohane edited a volume, dubbed *Neorealism and Its Critics* (Keohane, 1986). This volume hosted a revised version of the traditional realist thinking by Kenneth Waltz as well as the associated critics (Baldwin, 1993). Waltz tried to systemize classical realism by recasting all of its tenets. Therefore, before entering the ‘Neo-Neo’ debate *per se*, it would be illuminating to delve, first, into these tenets so as to unveil slight differences between classical realism and Neorealism.

Two classic works of traditional realism are the *Peloponnesian War* by Thucydides and *Politics Among Nations* by Morgenthau. In both works one can find that in world politics the main players are territorially organized groups (tribes, city states or modern states) which interact as unitary rational actors seeking the maximization of their utility under conditions of uncertainty. This uncertainty forces them to seek out power “whether as an end or as necessary means to a variety of other ends” (Keohane, 1986, p.165; Platias, 2002; Morgenthau, 1973).

Above, we cited the principal axioms of classical realism quite epigrammatically, leaving, in this manner, a series of critical issues unaddressed. Principally, where does this uncertainty derive from? What are the repercussions of this uncertainty on the behavior of states? The richness of the realist tradition that starts from Thucydides and reaches up to Kenneth Waltz and Robert Gilpin provides us with a cogent account. For Thucydides, as for all subsequent realists, the international field lacks an order or

a law compared to the organizational structure of the states. Particularly, while in the states there is a prototype of governance, in the international field there is no such prototype to enforce the law (maintain order). Therefore, what governs international relations is anarchy. In anarchy there is no bigger imperative than “take care of yourself” (Waltz, 1986, p. 103). Self-help constrains states’ behavior since they have to rapidly come to terms with the fact that security and subsequently survival are always at stake. States sense the fear of survival in an anarchic state of affairs. Yesterday’s ally can be tomorrow’s enemy. Under these conditions power is a critical issue since it is the only means which can assure a states’ position in the international field. Thucydides bluntly expressed the magnitude of power arguing that “the strong do what they can and the weak suffer what they must” (Thucydides cited by Strassler 1996, p. 352; Platias, 2002, p. 27; Kauppi, 1995).

Indeed, power, defined as capabilities, constitutes a focal point for explaining a states’ international behavior. However, the content of the term remains rather fluid, depending on the historical context in which it is embedded. To explicate, Thucydides in the years of the Peloponnesian War treated ‘power’ in its totality. He took into consideration every aspect, namely the economic, diplomatic and military power. The economic, as control over resources and accumulation of wealth, is encapsulated in the words of the Spartan King Archidamos, when he stated that “the war is conducted less with arms and more with money” (Platias, 2002, p. 48). No doubt, according to the ancient Greek historian, money and power are closely linked. Thus, accumulation of wealth is the prime mover of power and prosperity (Gilpin, 1984). Narrating part of the Greek experiences under the dominion of Minos, Thucydides delineated the role of economics in structuring power relations:

“The coast populations now began to apply themselves more closely to the acquisition of wealth (*chremata*), and their life became more settled;.....For the love of profits (*kerdos .pl*) would reconcile the weaker (*hoi hessous*) to the dominion of the stronger (*hoi kreissous*), and the more powerful (*dunatoteroi*), because they possessed a surplus of wealth (*periousia chrematon*), were able to reduce the smaller towns to subjection” (Thucydides cited after Crane, 1998, p.65).

This hegemonic structure on the grounds of economic power has also been addressed by other scholars such as Albert Hirschman. Specifically, foreign trade is conducive “to relationships of dependence and influence between nations”

(Hirschman, 1969, p.15). Prerequisite for such a situation is the existence of a powerful nation that engages in trading relations with weaker, neighboring states.

Providing a more refined explanation of the foreign trade's function, the weaker and dependent states will try to diversify their supplies so as to enfeeble the unique and powerful state-supplier. In light of this, the powerful state will resort to interruptions of trade and tariff wars, aiming at bringing the weaker states to their knees. Hence, the powerful state will be in position to "test its influence and to shape the policy of the weaker" (Hirschman, 1969, p.16).

Reframing the aforementioned approach, a strong and powerful nation (A) seeks to increase its national wealth and relative gains while maintaining its influence over the weaker neighboring trading partners (B,C,D, etc.). By doing that, it has to consider five things:

- The total net gain to B,C,D, etc., of their trade with A
- The length and the painfulness of the adjustment process which A may impose upon B,C,D, etc. by interrupting trade (cutoff)
- The creation of a monopoly by the powerful nation A by implementing both tactics of interruption of trade (cutoff) and Bilateralism
- The enfeeblement of any transit country which could serve as an impediment to its national wealth and relative gains (Hirschman,1969, p.18)

In addition to this economic perception of power, Thucydides equally elaborated on the other two aspects. The diplomatic power entails the quest for allies that could in the mid-long term enhance the wealth and military power of a state. Finally, when referring to military power he initially acknowledged two types, naval and land forces, only to assert in the end that the former is the leading one (Platias, 2002).

Despite Thucydides' account of 'power', modern realists such as Waltz, Morgenthau, and Henry Kissinger seem to have prioritized the military aspect over both the diplomatic and economic one. Strongly influenced by the Cold War era and security concerns, these scholars took heed mostly of military build-ups, as a definite means towards assuring survival and security. However, this emphasis-shift from the 'soft' conception of power (economic) to the 'hard' (military), does not mean that the former has never or will never exist. On the contrary, as Gilpin acutely responds to one liberal critic by Ashley that economic concerns only lately appeared under the

neorealist version, the role of economic factors in the realist tradition has always been present and its recurrence in today's world politics should be treated as 'rediscovery' rather than as 'patchwork' (Gilpin, 1984, p.294).

What has, so far, been discussed about traditional realism could be roughly condensed in the following theoretical scheme:

Anarchy → Self-Help → Power → Survival

Waltz, the architect of Neorealism or Structural Realism, while espouses all the foregoing realist tenets, breaks with the latter in four interlinked points. First, he tries to systemize realism, introducing the concept of 'structure' that "emerges from the interaction of states and then constrains them from taking certain actions while propelling them towards others" (Waltz, 1990, p.74; Keohane, 1986). To explicate this interaction he resorts to the dual understanding of the concept 'dynamics'. On the one hand, 'dynamics' are defined as "energy in motion" that occurs among states. On the other hand, 'dynamics' are treated as in physics; "the action of forces on bodies in motion or at rest" (Waltz, 1986, p.342). Through this viewpoint, Waltz inserts states in a structure and establishes a 'feed-back' status between these two levels.

Second, "Structures shape and shove. They do not determine behaviors and outcomes, not only because unit-level and structural causes interact, but also because the shaping and shoving of structures may be successfully resisted" (Waltz, 1986, p. 343, emphasis added). The fact that structures may be successfully resisted reveals the flexibility of this theoretical edifice, thus sending liberal indictments about determinism crashing to the ground. The structure is characterized by both the governing principle of anarchy and the distribution of capabilities (power) across states. As Waltz shrewdly notes, "in a structural theory, states are differently placed by their power, and differences in placement help to explain both their behavior and their fates" (Waltz, 1990, p.31). This is why states exclusively care about the relative gains from a cooperation, since uneven returns are translated in changes in power and ultimately in changes in their place in the system. However, this case is addressed later on.

Third, for Neorealism the structure signifies the international environment (supranational level) as opposed to its integral part, the community of states (the national level). So, there are two units interacting. On the contrary, for traditional

realism this distinction is blurred. The two levels are merged in one, with all the effects a state may receive when operating in the international field attributable to its own synthesis and choices. In this sense, a foreign policy theory would be enough to explain international behavior; a certain choice brings about a certain outcome. A totally linear relationship. But for Waltz and Neorealism an IR theory is about functionally autonomous units/states that determine and be determined within an anarchic structure (unit ↔ structure level analysis) (Waltz, 1990).

Finally, the last major rift between Neorealism and traditional realism is the way that they treat power. According to Waltz, realists view power as “an end in itself” (Waltz, 1990, p.35). Given the Hobbesian perception of human nature as sinful and wicked, constant war and conflict is the *ultima ratio* in world affairs (Kegley, 1995). As put in the thirteenth chapter of Hobbes’ *Leviathan* there is “a war of all against all” (“bellum omnium contra omnes”) (Serafetinidou, 2006, p.77; Kitromilidis, 1996, p.23; Horkheimer, 1989, p.52). Therefore, the attainment of “a maximum of power is universal” (Morgenthau, 1973, p. 208). On the contrary, Neorealists view power in a more ‘instrumental’ way. To them, it is a useful tool that could facilitate statesmen’s efforts towards various ends. It is a means towards an end and not an end in itself. In Waltz’s words “In anarchy, security is the highest end. Only if survival is assured can states safely seek such other goals as tranquility, profit and power. Because power is a means and not an end, states prefer to join the weaker of two coalitions. They cannot let power, a possibly useful means, become the end they pursue. The goal the system encourages them to seek is security” (Waltz, 1986, p.127).

The analysis hitherto, has covered the basic tenets of traditional realism as well as the major rifts between traditional realism and Neorealism. A careful reader could infer in this point that the fundamental axioms of realism, namely anarchy, power, positionality and survival have remained intact, as Neorealism only tried to *systemize* and not change them (Keohane, 1986).

Now we enter the core of the ‘Neo-Neo’ debate examining how the foregoing axioms affect the prospects of international cooperation.

States in any form of cooperation care about the relative gains that may emerge. Certainly the absolute gains matter but what counts the most is the gap in the gains, or in other words “who will gain more if we cooperate” (Grieco, 1993, p.319; Lamy, 2001, p.187). Why? In anarchy, where self-help is the motto beyond any international behavior, “one state may use its disproportionate gain to implement a policy to

damage or destroy the other” (Waltz cited after Grieco, 1993, p. 319). Survival and security are atop of a state’s concerns, therefore it accepts to cooperate only in the certainty of guarding and promoting its own relative advantage. The profits of the other participants are of great concern and can be crucial stumbling blocks to any type of cooperation. In a mathematical illustration of the relative gains argument, Joseph Grieco’s equation makes a critical case. His terminology is as follows:

U= State’s utility

V=Individual payoff

W=The individual payoff plus the partner’s payoff (overall payoff)

k=The state’s coefficient of sensitivity to gaps in payoffs

$$U=V-k(W-V)$$

(Grieco, 1988, p.500)

Grieco’s equation exemplifies the difficulty that exists between two states in cooperating. As long as the individual payoff (V) outweighs the partner’s payoff (as this is included in W), the state utility (U) increases and then and only then the prospects for cooperation are positive. In any other case, where absolute gains certainly would emerge but not necessarily relative cooperation becomes unattainable. Overall, as Waltz put it, “the first concern of states is not to maximize power but to maintain their position in the system” (Waltz, 1979, p.126).

In the same line of reasoning, independence is another imperative that states take into consideration when cooperate. Being aware that the high level of imports as well as exports entails vulnerability to any possible turmoil, states embark on an attempt to regulate and then limit the extent of their dependency. High interdependence involves various risks for their security. As described above, in an anarchic international structure the only imperative is “take care of yourself” otherwise no one else will. Independence must be preserved, if a state is to be unsusceptible to risks or dangers threatening its security. Anarchy once more constrains states.

But how can the status of state be guaranteed before or during a cooperation? Neorealists argue that balance of power is the high-strategy pursued. To this aim, states may exploit various means that can be categorized in a) internal efforts such as increases in the economic and military capabilities or b) external efforts such as the formation of alliances in order to empower further their own status or wane the rival

one. As Waltz argues, states which will do less effectively than others will confront gloomy conditions that raise the stakes of their survival. Therefore, “fear of such unwanted consequences stimulates states to behave in ways that tend towards the creation of balances of power” (Waltz, 1986, p.117). So, the amount of power is the key to a successful balancing strategy. But what kind of power: soft (economic) or hard (military) power?

Waltz experienced mostly a world dominated by the Cold War. The international structure was bipolar, hence, it is all but striking the fact that he attributed much less importance to economic than militaristic means. To him “economic interdependence is always a marginal affair”, since the smaller the number of great powers, the lower the interdependence among them (Waltz, 1970, p.206). A large country relishes the prospect of producing a big proportion of goods within its borders, being in this sense self-sufficient. Therefore, trade and interdependence are trivial. Counterfactually, however, things would be different in a multipolar setting (Ruggie, 1986).

Not to put too fine a point on it, in today’s multipolar world, economics do play a role. Economic interaction is running high while institutions seem to gain, day by day, more ground in international affairs. In our case, Russia cooperates with both the EU and China, while many times this cooperation takes place within the structures of international institutions. The Eurasian energy triangle portrays a reality of increased economic interaction and intense cooperation, even up to the point that it is rather difficult for one of the involved actors to avoid or break free. This scenario is certainly different and more challenging for everything that has been discussed up to now. What does Neorealism have to say? How can Grieco’s correct observation that Neorealism “has not offered an explanation for the tendency of states to undertake their cooperation through institutionalized arrangements” be amended? (Grieco, 1993, p.335). A possible solution could be offered by the model of ‘Institutional Balancing’ which is discussed later on, but even in this case there are certain conditions that have to be met<sup>47</sup>.

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<sup>47</sup> For example, the type of cooperation (interdependence, unilateral dependence and interconnectedness) plays a key role in examining the possible expansion of the ‘Neo-Neo’ debate towards the direction of ‘Institutional Balancing’. It is once more reminded that the aforementioned terms are employed in the current analysis only after having been clarified and tied to energy politics in the following chapter (3). Thus, for the time being, we use their ‘substitutes’, namely ‘symmetry’, ‘asymmetry’ and ‘balance’.

### 2.2.2 Neoliberal Institutionalism

The other side of the ‘Neo-Neo’ coin is usually termed Neoliberalism or better Neoliberal Institutionalism<sup>48</sup>. It is a mixed concept that merges three distinct theoretical strands, ‘Liberalism’, ‘Neoliberalism’ and ‘Institutionalism’, into one. Elaborating on this, ‘Liberalism’, the corner stone, has, first and foremost, to be briefly examined.

As a child of the Enlightenment, ‘Liberalism’, is “multifaceted, and what is or is not at its core can be disputed” (Stein, 1990, p.7). Leading scholars of the IR tradition such as Michael Doyle have mentioned that “there is no canonical description of liberalism” (Doyle, 1986, p.1152). Throughout the centuries, this concept has appeared in a multitude of variants, following the theoretical thinking of the age. Briefly noted, John Lock’s *laissez-faire liberalism* envisioned a small government limited only to the protection of property, life and liberty. A minimal set of rules would characterize this night-watchman state (Heywood, 2006). Another variant, *interventionist liberalism*, saw the state from a more positive perspective, emphasizing its role in education and the wealth redistribution (Zacher and Matthew, 1995).

The shift to IR, however, occurred in the late 18<sup>th</sup> and 19<sup>th</sup> century with Immanuel Kant placing prime importance to the role of cooperation and interdependence in the sustainability of world peace. Cooperative relations among states would cross the Rubicon to a world where power politics and force would have lost prominence. Like Kant, many liberals espoused the idea of free trade diminishing the possibility of war and power politics at large (Zacher and Matthew, 1995; Richardson, 1995). While the discussion about the liberal theory runs deep, our main focus at present, is to highlight the breaking points with Neorealism, staying tuned with the ‘Neo-Neo’ debate.

Contrary to Neorealists that view IR as circular and teleological, liberals uphold a linear course where a cumulative process is taking place. The benign and rational character of the human nature paves the way for individual progress and the formation of an ever improving civilization that is able to stand the test of time (Kegley, 1995). Of course, the role of international cooperation to this progress is more than essential, since it strengthens ties among states and multiplies the deriving benefits for each

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<sup>48</sup> For the exact meaning of this concept in the IR scholarship see, parallel to the analysis, also Table 2.1

side. While for Neorealists cooperation is a secondary issue, less likely to happen mainly due to relative gains concerns, for liberals, cooperation is one of the prime concerns. To them, IR are experiencing a process of modernization which is brought about by “liberal democracy or republican government, international (economic) interdependence, cognitive progress, international sociological integration and international institutions”<sup>49</sup> (Zacher and Matthew, 1995, p.110).

Embedded in this broad context, states are seen as pluralistic actors within which many groups interact in shaping policies. The recognition of the individual as the primary level of analysis makes more fundamental our understanding about how a state’s international behavior is formed. This insightful perspective is also stressed by Keohane when he notes that “liberalism is an approach to the analysis of social reality that begins with individuals as the relevant actors” (Keohane cited after Zacher and Matthew, 1995, p.118, Heywood, 2006). Moreover, catalytic concepts for Neorealists such as ‘survival’ and ‘autonomy’ are of lesser concern to Liberalists, because what counts in a cooperative relationship are the absolute and not relative gains (Lamy, 2001). A state, acting as a rational egoist, qualifies absolute gains atop its priorities while playing apathetic to advantages favoring other states (relative gains). Drawing on Grieco’s previously analyzed equation on cooperation, liberals hold that  $U=V$ <sup>50</sup> (Grieco, 1988, p. 497).

At this point, there are certain inferences to be drawn from the previous analysis. Anarchy is not necessarily the governing principle of international affairs. Other factors such as interdependence, democracy, international institutions etc. serve as domestic and international conditions eligible to alter the international structure, thus, overthrowing ‘anarchy’ and endless “power-seeking” from their Neorealist ‘thrones’. Of course, this is not to say that these two concepts stop affecting the IR. They continue to play a role but not the dominant one, as Neorealists contend. Moreover, Liberals refuse to recognize the positional character of states that forces them to view international affairs from a *zero-sum* perspective. To them, states are rational egoists that engage in ‘win-win’ tactics<sup>51</sup>.

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<sup>49</sup> All these variables gave rise to respective research fields, dubbed “Republican liberalism”, “Interdependence liberalism”, “Cognitive liberalism”, “Sociological liberalism” and “Institutional liberalism”.

<sup>50</sup>  $U$ =state’s utility and  $V$ =individual payoff. See also p.49.

<sup>51</sup> Caring only for the absolute and not individual gains.

Now that this preliminary presentation of Liberalism has been completed, the analysis calls for the clarification of Neoliberal Institutionalism as a bit differentiated and concrete branch of Liberalism. What grounds do they share? On what terms do they differ? How is, finally, the ‘Neo-Neo’ debate formed? To address these points with precision and accuracy, we again resort to Grieco’s analysis, and concretely to the following table.

**Table 2.1: Compare and Contrast: The ‘Neo-Neo’ debate<sup>52</sup>**

<i>Proposition</i>	<i>Liberalism</i>	<i>Neoliberal Institutionalism</i>	<i>Neorealism</i>
<i>States are the only major actors in world politics</i>	No. An amalgam of supra and sub national actors co-act	Yes (with international institutions being the protagonists).	Yes
<i>States are unitary-rational actors</i>	No. States are permeable	Yes	Yes
<i>Anarchy is the governing principle of international affairs</i>	Not necessarily. Areas of the sub-national level such as technology, knowledge etc. can curb anarchy	Yes	Yes
<i>International Institutions are facilitators to cooperation</i>	Yes	Yes	No
<i>Positive/Negative prospects for cooperation</i>	Positive	Positive	Negative

This table portrays the points of convergence and divergence in the ‘Neo-Neo’ debate. What becomes crystal clear is that cooperation prospects within international institutions are viewed from polar opposite angles, with Neoliberal Institutionalism holding the optimistic view.

Reasoning that, in an anarchic international field, the existence of common interests, though it may facilitate cooperation, it does not absolve states from the problem of cheating. Therefore, any cooperation looks like a Prisoner’s Dilemma (PD) in which actors’ dominant strategies qualify an equilibrium far from Pareto’s optimal (Lipson, 1984; Snidal, 1991; Powell, 1991; Stein, 1982; Georgakopoulos et al, 2002). Elaborating on the PD, there are a few preliminary remarks that deserve special elucidation: (a) *Pareto optimal outcome* is a situation in which it is impossible to make one actor better off without necessarily making another worse off. This is because a perfectly balanced equilibrium has been struck, where all involved parties prosper. For this situation to occur (or for Pareto’s criterion to be fulfilled), consent

<sup>52</sup> Source: (Grieco, 1988, p. 494).

and cooperation among actors are required<sup>53</sup>, and (b) *Dominant strategy* is the one adopted when taking the other actor's (unknown) strategy as granted. In our case, states, having to interact within an anarchic international context, qualify 'cheating' as their dominant strategy.

Below, it is illustrated a two-actor PD with the available strategies to each actor:

**Table 2.2: The Prisoner's Dilemma**

		ACTOR A	
		A1	A2
ACTOR B	B1	PRISONER'S DILEMMA Abide by the Agreement	Abide by the agreement Payoff A: 2 Payoff B: 2
	B2	Break the Agreement	Break the agreement Payoff A: 3 Payoff B: 1
			Payoff A: 1 Payoff B: 3

The Pareto Optimal strategy is the A1B1 which yields the maximum payoff 2. Knowing, nevertheless, that in an anarchic environment each player acts as rational egoist seeking the maximization of its absolute gains through cheating, it plausible to conjecture that the qualified dominant strategy is the A2B2, forming, in this manner, a final equilibrium (Nash equilibrium) that is deficient for all<sup>54</sup>. However, cheating from the very beginning is to no avail for anyone. Therefore, actors will initially accept to cooperate, aspiring to the A1B1 equilibrium, but this will be neither "individually accessible nor stable...since each actor can make itself immediately better off by cheating" (Stein, 1982, p. 306). Consequently, the remedy for such a situation, if Pareto's optimal outcome is to be achieved, dubbed "international institutions". Institutions guarantee that no state will drop another "like a hot brick" only to satisfy its rational ego through cheating. But how? How can an international institution preclude cheating? How does neoliberal institutionalism conceive their international effects?

<sup>53</sup> The Pareto criterion is used in political science and economics to show that the market strikes perfect balance when self-regulated. Any state intervention drives to sub-optimal results. In the IR scholarship, however, and, specifically, along the lines of the 'Neo-Neo' debate, this criterion is employed to show that for the international community to better off, consent and cooperation is needed.

<sup>54</sup> The Nash equilibrium is the one naturally struck without any supervision.

Neoliberalism's understanding of Institutions is provided through the lenses of Rational Choice Theory. Neoliberal Institutionalism or Rational Institutionalism is constrained to the normative power (impact) institutional arrangements have on the behavior and policies of actors. In the words of Weingast, "how institutions constrain the sequence of interaction among the actors, the choices available (and)...the payoffs to individuals and groups" (Weingast, 2002, p. 661; Risse, 2002). The analysis solely focuses on how the behavior of rational egoist profit maximizers can be shaped. It does not go any deeper to unravel how interests and strategies are defined and most importantly altered via institutional cooperation<sup>55</sup>.

Elaborating further on the functioning of international institutions, Thomas Risse employs the term "in the sense...of communicative practices and rules defining appropriate behavior for specific groups of actors in specific situations of international life" (Risse, 2002, p.604). Risse clearly refers to the obligatory or coercive context an institution has. He acknowledges the potency of institutions to implement practices and propel behaviors via rule-building. In the same line of reasoning, other scholars highlight the same coercive aspect of institutions. Axelrod and Keohane uphold that international regimes enforce and institutionalize reciprocity, because by clarifying its meaning "in the relevant issue area, they make it easier to establish a reputation for practicing reciprocity consistently" (Axelrod and Keohane, 1985, p. 250). Moreover, Krasner tells apart principles, norms, rules and decision-making procedures only to stress the potency of international regimes towards shaping practices and behaviors (Krasner 1983). Finally Göhler defines a political institution as a nexus of rules that produces and implements binding as well as organizational structures on all participants (Göhler, 1998). Overall, rules, legal bindings (obligations) and reciprocity are the means through which international institutions align a state's behavior with the long-term, mutually beneficial, Pareto's optimal outcome.

Overall, (international) institutions serve as facilitators of international cooperation, alleviating the problem of cheating and reducing the transaction costs. Moreover, Neoliberal Institutionalism, streamlined with Liberalism, claims that common interests and economic interdependence lead to more stable and safe international regimes within which states interact solely on the basis of their absolute

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<sup>55</sup> This is the research field of Constructivism that makes a rather insightful and far-reaching case when it discusses the construction and reconstruction of interests and strategies through the process of mutual constitutiveness (Adler, 1997, pp. 324-325). Structure and agents define and be defined in a similar manner to Waltz's Neorealism, when the anarchic structure constrains and alters states' behavior.

gains maximization. Given these, neorealist concerns over relative gains and survival fall on deaf ears<sup>56</sup>.

### ***2.2.3 The ‘middle-ground’: institutional balancing***

Contemporary world affairs seem to be somewhere between the two branches of the ‘Neo-Neo’ debate. Anarchy is not as absolute as Neorealism holds, whereas its politicization via international institutions, as Neoliberal institutionalism argues, is yet to come. Hedley Bull’s concept of an “anarchic society” surely delineates a situation where while there is no formal government above states (anarchy remains), economic interdependence, international institutions and overall cooperation gain ground day by day (Bull, 1977). Henry Kissinger, a strong proponent of classical realism has stated that “Now we are entering a new era. Old international patterns are crumbling; old slogans are uninformative; old solutions are unavailing. The world has become interdependent in economics, in communications, in human aspirations” (Kissinger cited after Keohane and Nye, 2001, p. 3). Consequently, the gist of the above lines is that interdependence shapes a new reality. Economics and international institutions are certainly part of the game. But what does this mean in turn? Has Neoliberal Institutionalism blown a hole in Neorealism? Has ‘power’ stopped being at the top of the interstate agenda, as Kant would argue? Or is there another explanation to be pursued?

A critical insight to these questions is offered by Keohane and Nye. To them, where “there are reciprocal costly effects of transactions, there is interdependence” (Keohane and Nye, 2001, p. 8). This becomes apparent through two main channels. First the joint gains and losses and second the relative gains and the distribution of capabilities (Keohane and Nye, 2001). The first channel is being well taken care of by the economists, who, given the comparative advantage that each state relishes, argue that free trade may serve to the benefit of all participating members (Georgakopoulos et al, 2002). Thus, Neoliberal ‘win-win’ tactics are taking place. Nevertheless, this is one side of the coin. The other has to do with the classical question “who gets what?”.

As Keohane and Nye formulate it “it is important to guard against the assumption that measures that increase joint gain from a relationship will somehow be free of

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<sup>56</sup> Neorealism holds that even if institutions, common interests and economic interdependence do exist, still cooperation is hard to achieve.

distributional conflict” (Keohane and Nye, 2001, p. 9). Interdependence does not turn the international society from traditional ‘*zero-sum*’ to utterly ‘win-win’ tactics. In fact, international relations can be sustained on a mutually complement basis, with the “Balance of power”, however, being the key to a stable environment. In the authors’ words “if most or all participants want a stable status quo, they can jointly gain by preserving the balance of power among them” (Keohane and Nye, 2001, p. 9). But since “getting the best of both worlds” is achievable, what meaning does the term ‘power’ acquire in such an interdependent reality<sup>57</sup>?

Following Keohane’s and Nye’s analysis, ‘power’ is founded upon two pillars, that of sensitivity and vulnerability<sup>58</sup>. To make the argument less abstract, I resort to an example from the current research field. Ukraine is dependent on Russia for its energy needs (oil and gas). Suddenly, the latter, due to political or economic reasons, unilaterally decides to cut off supplies to the former, exploiting its dominant position as an energy supplier and the incumbent asymmetry of power as expressed by the heavy dependency of Ukraine on Russia. Ukraine, immediately, finds itself in a sensitive position. But this does not necessarily mean that it is equally vulnerable. It may have foreseen or anticipated such a unilateral action by Russia and therefore invested in its own resources (e.g. nuclear energy) or tried to diversify its energy imports, aiming at substituting, temporarily or permanently, the imposed cut off. Consequently, Ukraine is sensitive but not necessarily vulnerable<sup>59</sup>. Vulnerability depends on its own strategy while sensitivity goes beyond its own sphere of jurisdiction or decision-making.

The analysis, so far, has established the “middle ground” in the ‘Neo-Neo’ debate by re-defining “(economic) interdependence” (and the at times inescapable cooperation within international institutions) and ‘power’ in today’s “anarchic society”. Both concepts, representing key tenets of the respective theories in the ‘Neo-Neo’ debate, have risen in importance, calling for an updated theoretical model,

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<sup>57</sup> By the phrase “getting the best of both worlds”, we refer to Neoliberal Institutionalism and Neorealism, as they are illustrated in the ‘Neo-Neo’ debate.

<sup>58</sup> Such a conceptualization of the term ‘power’ is not at all new, considering Thucydides’ and Hirschman’s earlier approaches, see pages 45-46.

<sup>59</sup> Later on the analysis we see that the Russo-Ukrainian energy relations have been far more complex than the present example. This solely aims at clarifying the terms ‘sensitivity’ and ‘vulnerability’ and nothing more. In any case, while Russia has been the main and major energy supplier of Ukraine, the latter has also had a leverage on the former given its transit status. As a result, this relationship has, indeed, been a rather complex one whose delicate diplomacy is analyzed, in detail, in Chapter 4.

applicable when needed. Therefore, the critical parameter to be addressed now is to incorporate these concepts in a testable model.

Such a model is found in He's "Institutional Balancing" approach. He begins with the fact that for Neorealism, institutions are 'epiphenomenal' in international politics (He, 2008, p.490). However, "if institutions do not really matter, why do states devote resources and energy to them?" (He, 2008, p.490). Thus, in light of the expansion of institutional arrangements in the post-Cold War era, He employs the mechanism of "Institutional Balancing" to inform initially the 'Neo-Neo' debate and then turn this update to Neorealism's favor.

Reasoning the model, "it specifies that (1) high economic interdependence makes states choose a new realist balancing strategy –institutional balancing- other than traditional military alliances to cope with threats or pressures from the system (2) the distribution of capabilities in the regional system indicates how states conduct institutional balancing"<sup>60</sup> (He, 2008, p. 492). For He it is important that traditional power politics of hard balancing and military build-ups have been rendered secondary to the soft balancing of economics and interdependence. Nevertheless, he does recognize the possibility of soft balancing turning to hard when competition runs high and powerful states loom menacing (He, 2008). Consequently, it becomes apparent that 'power' is perceived more on economic (sensitivity/vulnerability) than militaristic terms. Thus, there is a re-invention of the concept "power politics" with emphasis primarily placed on the economic side.

As He notes, when constantly growing economic interdependence takes place, military balancing, evaluated on a cost/benefit basis, is not a choice to be picked. On the contrary, states accept institutions, not as Keohane and Nye define them as "situations characterized by reciprocal effects among countries or among actors in different countries"<sup>61</sup>, but as "empty shells" towards enhancing their economic power, easily transformed to military, when necessary.

To explicate, the following figure illustrates a situation where the states A and B cooperate within an institution as long as they get power, mostly defined in economic terms, without losing their sovereignty and independent international standing (this is what the term 'balancing' stands for). Loss of sovereignty or independence emerges

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<sup>60</sup> It is reminded that "economic interdependence" is an issue that remained largely unaddressed by Neorealists and became part of the neoliberal criticism (Ruggie, 1986; Keohane, 1986).

<sup>61</sup> See: (Keohane and Nye, 1989, p.9).

when an international institution can dictate national policies on a number of issues<sup>62</sup>. This model is mainly applicable to occasions where equal, major and (economically) interdependent powers of the international field with great expectations for their international standing cooperate<sup>63</sup>. The terms of their cooperation are rather loose, far from stylized, since as earlier noted, today's economic gains might be translated in tomorrow's military (comparative) advantage in a possible occasion of confrontation.



**Figure 2.1 Model of Institutional Balancing**

It plausibly emerges that for He to set his model in motion, first, needs to prove the existence of economic interdependence. Therefore, he qualifies two indicators, (a) FDI and (b) Flows of international trade. As previously said, He aims at bringing the two extremes together only to show how supposedly neoliberal ‘bunkers’, such as economic interdependence and institutions, can be addressed within a neorealist theoretical framework. On these grounds, he argues that the “institutional balancing model does not predict, as neoliberalism does, cooperation among states through institutions. Instead, it predicts institutional struggle, confrontation, bargaining, negotiation, compromise, and balance among states within institutions” (He, 2008, p. 497). Overall, this model gives the ‘Neo-Neo’ debate a new lease of life by placing it in today’s “anarchic society” of intense economic interdependence. It certainly provides solid propositions to be tested only to alleviate Kissinger’s concerns over ‘uninstructive’ and ‘unavailing’ old patterns.

<sup>62</sup> A rather recent example is the IMF and the rules it imposes in order to finance states close to bankruptcy. However, this is an extreme case that emerged lately due to the rigors of the international economic crisis. Another case where states are bound to provisions of international institutions is the EU. Take as an example the obligation of the member-states to align their legislation and policies with the EU regulations and directives on various policy areas.

<sup>63</sup> This model proves its analytical validity and becomes better understood when the energy relations between Russia-EU come to the forefront. In parallel, check also the analysis in Chapter 3, regarding the three types of international cooperation, namely interdependence, unilateral dependence and interconnectedness.

### **2.3 Research Hypothesis**

The era of globalization and intense interaction has signaled major readjustments not only in states' attitudes *per se* but also in the theoretical frameworks that seek to explain them. World affairs have entered a state of flux where a modicum of cooperation is not enough for states that crave for a prominent role in the international scene. International institutions and economic interdependence do play a major role, inducing, in this manner, states in the adoption of new "soft balancing" strategies towards assuring their superiority and security. Economics and power have become very intimate. The former substantiates the latter, while the latter presupposes the former. Military build-ups have lost supremacy over economics. There is a shift from 'high' to 'low' politics.

In this international context, the possession of the Eurasian energyland as the necessary springboard to global recognition is not an easy objective to accomplish. Russia has to play by the international rules in such a way that will allow it to be an active and equal member of the international community without sacrificing its sovereignty and autonomy. Energy certainly is a powerful tool in the hands of everyone with the ability to use it properly.

Justifying, earlier, the energy triangle among Russia-EU-China with Russia in the "driver's seat", we witnessed the gradual transition from the "western illusionism" of the early and mid-1990s to the Eurasian pragmatism of 2000s with Putin at the helm of the power structures. Influenced by all three schools of foreign policy thinking, Putin accustomed Russia to the international context of its age by re-establishing the inherited by Primakov "Russia-EU-China" triangle on economic and particularly energy premises.

Specifically, Putin, first turned to domestic politics altering the power structures. Engaging in a process of "strengthening the power vertical", he attempted to subdue all the levels of power (local, regional and federal) to the central authority of Kremlin. By doing so, all the governors were appointed by the Kremlin instead of being elected by the electorate (Karagiannis, 2010; Mankoff, 2009, p. 55). As a result, Putin managed to seize absolute control of the domestic political affairs while leaving no room for political opposition. This 'top-down' approach became also apparent in the foreign ministry where Putin, having realized how the strong-willed Yevgeny Primakov had undermined President Yeltsin in the conduct of foreign policy,

appointed career diplomats with no political affiliations and unbending views on the direction of the official foreign policy. To put it in Lenin's terminology, Putin picked ministers that could serve as "transfer belts" of his policies to the international arena<sup>64</sup>.

Also, knowing very well that his turn to political centralization could easily be associated with claims about authoritarianism and even dictatorship, thus harming his legitimacy and international profile, Putin along with his close associate, Vladislav Surkov, came up with the concept of "Sovereign democracy" (*suverennaya demokratiya*) (Karagiannis, 2010, p.31). Grasping the genealogy of the term, one must first identify the decade of the 1990s as a modern-day "Time of Troubles", with Russia domestically dilapidated and internationally subdued, unable to pursue its national interest (Kutchins, 2010, p.44). This embarrassing situation, however, would be reversed in favor of a sovereign state capable of pursuing and defending its national interest against foreign pressures (Mankoff, 2009).

Putin's presidency would establish a sovereign and strong state with the consent of the Russian people<sup>65</sup>. Therefore, the other half of the term "sovereign democracy", be it 'democracy', implies the inalienable right of the Russian electorate to define itself as well as the policies pursued on its behalf by a decisive and strong President. Putin, portraying himself as the "impersonated desire" of the Russian electorate, claimed that "for Russians, a strong state is not an anomaly to be got rid of. Quite the contrary, it is a source of order and main driving force of any change" (Jack, 2004, p.336; Karagiannis, 2010). By this argumentation, Putin reversed the 'top-down' to a 'bottom-up' procedure. The political centralization was not an authoritarian practice but an authentic expression of the genuine desire of the Russian people for a strong state domestically and internationally. In this manner, Putin altered the criteria by which legitimacy should be assessed. A threaten to legitimacy would only be posed by not fulfilling the intrinsic Russian desire for a "strong state" with "great power" status. The aim and the means were clear. Putin had only to enforce them<sup>66</sup>. The

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<sup>64</sup> This term was used by Lenin to characterize the role of the Bolshevik party during the transformation of the Soviet society into a classless one.

<sup>65</sup> A necessary fact since otherwise Putin's regime would be characterized as dictatorship rather than as democracy.

<sup>66</sup> These principles are so deep-rooted in Putin's mind-set, that stand little chance of change even after his third re-election to the Presidency on March 5<sup>th</sup>, 2012. For an inclusive account see: (Rogoza, 2012).

parallel here with the Soviet practice of wrapping control in peoples' consent seems to be still present and unequivocal<sup>67</sup>.

Having established a stronghold in the domestic political scene, Putin's foreign policy gave prime importance on the Eurasia, insisting on the Russian culture being something different from both the American and the British<sup>68</sup> (Jack, 2004; Lo, 2003). Understanding the world more in terms of geoeconomics and institutions rather than military struggle and security concerns, Putin perceived the world as a mix of threats and opportunities with the latter outweighing the former<sup>69</sup>. In his own words "The norm of international community and the modern world is a tough competition-for markets, investments, political and economic influence...nobody is eager to help us. We have to fight for our place under the economic sun" (Tsygankov, 2006, p.130). Additionally, he stressed the need for Russia to learn to defend itself by economic means, thus, it had to be reasonable with the use of its resources, avoiding to "bite off more than it could chew".

In this light, Putin strove towards complete integration with the global economy. The final accession to the World Trade Organization (WTO) in 2012, nurtured hopes for increased foreign direct investments making the Russian industry more efficient and profitable (Guardian, 2012). However, the alarming prospects for the competition harming the domestic industry, led Kremlin to negotiate and, finally, succeed in gaining a phased-in opening up of markets, mainly because the Geneva-based body of the WTO has also been in dire need of presenting the accession of Russia as a proof of functionability, especially in light of the stalling of the Doha round of trade liberalization talks (Guardian, 2012). This fact clearly shows that Putin's Russia found a rather loose international institutional environment within which it did interact. The same argumentation also holds for international (EU-initiated/backed) energy institutions such as the Energy Charter Treaty, the Energy Dialogue, etc. The loose nature of these institutions along with their need to incorporate Russia into their frameworks, granted the latter an extra negotiating power. Parallel with the former, Russia sought to promote the diversification of exports in favor of information and technology, a fact which became rather evident in the bilateral trade with China.

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<sup>67</sup> See footnote 16.

<sup>68</sup> Putin upheld the Eurasian identity of the Russian nation, visiting in the late 1999 early 2000 principal states of central Asia such as China and India (Tsygankov, 2006)

<sup>69</sup> Geoeconomics: A term to signify that economic factors affect politics over a given territory.

All things considered, Putin initiated an utterly economized perception of its affairs with both the West and the East on the principles of profit-maximization and flexibility. Confrontational issues such as the NATO expansion, the Balkans, the missile defense system, the Russian Far East and the ‘colored’ revolutions had been purposefully played down<sup>70</sup> (Deng, 2007). However, this lenience should be seen more as a tactical maneuver rather than as admitting defeat to a powerful and unchallengeable equal, either the US, China or the EU<sup>71</sup>.

In this context, Putin’s Russia constitutes an appropriate case for testing the revised ‘Neo-Neo’ debate. The political centralization at the domestic level and the loose international institutional environment as presented by the WTO negotiations, the signed but not ratified on behalf of Russia ECT and the elastic nature of the Energy Dialogue, provide us with a fertile ground for the testing.

Putin’s Russia engaged a diversified set of strategies in a differentiated, as far as the types of bilateral cooperation are concerned, Eurasian energyland. While in the FSU region it has been more assertive, in its affairs with the two ends of the triangle, the EU and China, it has been rather diplomatic and flexible, aiming at attaining the maximum possible gains but not at the expense of its sovereignty and autonomy. If in the former is also added the concept of “great power” status with which ‘Putinized’ Russia has been beset, then it becomes apparent why its Eurasian energy diplomacy is a great testing ground for the revised ‘Neo-Neo’ debate.

It is not only the first (Russia-FSU region) and the third (Russia-China) cases where Neorealism’s “relative gains” argument is expected to qualify as the best explanation, given the types of the bilateral cooperation (asymmetry and correlation respectively) and Putin’s political thinking, but also the second case (Russia-EU), where the economic (energy) interdependence, the EU insistence on (energy) cooperation via ‘behavior-shaping’/legally binding institutions and Putin’s emphasis on flexibility and autonomy, opens the door for accepting institutions into the examined ‘Neo-Neo’ debate. But this development perceives institutions as a

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<sup>70</sup> Even in cases where Russia’s opposition was rather vehement, take as an example the US desire to abandon the ABM treaty that proscribed any unilateral action in building a nuclear missile defense system, Putin played down the issue for fear of sacrificing the more lucrative prospects for the Russian economy.

<sup>71</sup> To substantiate the case, take as an example the gas cut-offs in FSU republics such as Ukraine in 2006 and 2009 and Belarus, the nationalization of the west-oriented Yukos and the imprisonment of its founder Khodorkovsky, the strong opposition against the establishment of NATO anti-missile systems in the Czech Republic and Poland and finally the August 2008 invasion in Georgia that ceased with the mediation of the EU French Presidency.

“necessary evil” or “empty shells” for keeping indispensable partners in the picture, rather than as ‘behavior-shaping’ normative arrangements. It is an ‘on-off’ procedure of cooperation via institutions up to the point that the latter can be *usurped* by the (state) actors to extract as much power as possible/or conform with an incumbent state of affairs without committing further so as to impair their relative power (see Figure 2.1, p.57). Certainly, this is a pro-neorealism account, which the *mentalité* of Putin’s Russia, on the one hand, and the EU insistence on institutional, legally binding (energy) cooperation, on the other, help substantiate. Of course, the examination of ‘Putinized’ Russia’s energy diplomacy in the wide geopolitical space of the Eurasia, enables us to go the revised ‘Neo-Neo’ debate one step further, by arguing that the positive prospects of the Russo-Chinese cooperation may turn the once *compulsory* Institutional Balancing strategy employed by Putin’s Russia in its affairs with the EU into a *powerful* negotiating tool, with the former pressing for more and deeper concessions on behalf of the latter.

To reiterate, the current theoretical debate is first tested in the FSU region against an asymmetric energy (natural gas) relationship, where a powerful, always assessed in energy terms, Russia interacts with the neighboring less powerful Ukraine and Belarus. The pattern, however, changes when the symmetric energy relationship with the EU comes to the forefront. This is the most challenging case, since the coexistence of international (energy) institutions, economic interdependence, along with Russia’s great power ambitions and concerns over sovereignty and autonomy, constitute a rather antithetic blend. Finally, the research effort completes its cycle by turning to the Asian end of the triangle and testing the revised ‘Neo-Neo’ debate against the Russo-Chinese balanced energy relationship<sup>72</sup>.

Overall, considering Putin’s political thinking, the loose nature of international (energy) institutions, and the different types of bilateral energy cooperation in the Eurasia, the research hypotheses of the present effort appear in a threefold manner: a) in the ‘Russia-FSU’ case, it is expected the testing of the debate to qualify Neorealism’s argument of “relative gains” as the best explanation, b) in the ‘Russia-EU’ case, it is anticipated the limited explanatory capacity of the ‘Neo-Neo’ debate

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<sup>72</sup> It is critical to mention here that in Chapter 3, after some basic but absolutely necessary for the understanding of energy politics facts have been explained, the terms ‘symmetry’, ‘asymmetry’ and ‘balance’ are substituted for ‘interdependence’, ‘unilateral dependence’ and ‘interconnectedness’. We did not use this terminology at present because it would be senseless without an earlier brief analysis on the basics of the oil and gas trade. This chapter aims solely at presenting the research design, without getting any deeper to the oil and gas politics.

and its update by the ‘middle-ground’ of Institutional Balancing and c) in the ‘Russia-China’ case, it is expected Neorealism’s “relative gains” argument to qualify again as the best explanation.

## **2.4 Methodology**

As becomes apparent, the whole analysis is structured according to a ‘case-study’ approach, where three case-studies are examined within a specific time-frame. Thus, elements of both a synchronic (or cross sectional) and a diachronic (or longitudinal) dimension of analysis are employed, aiming at comparisons across space and through time (Gerring, 2001, p. 222). In this manner, the research not only widens and becomes more solid but also stands better chances of unraveling and substantiating causality. The ‘case-study’ methodological approach qualifies the scholar “by watching the progress of a single unit (a country, a city, a person) over time and by paying attention to variation within that case...(to) often observe, or at least intuit, a complex causal relationship at work” (Gerring, 2001, p. 215). Of course, this is not to say that this method is absolved of any criticism.

It does often come under criticism with regard to the small, literally speaking, one case (the *N* dataset) that each time examines. This, indeed, challenges one of the criteria (plentitude) that characterize a sufficient research design<sup>73</sup>. But, still, while “the formal analysis maybe limited to within-case evidence (case within case), most case studies devote some attention to across-case comparisons as well” (Gerring, 2001, p. 215). This implies a larger *N* given that more case-studies are concurrently examined. Nevertheless, this does not immunize the method against criticism of the kind, but simply it does render it in a respected position after measured against the aforesaid criteria.

In the case in point, it is examined the 2000s Russia’s energy (natural gas) diplomacy *vis-à-vis* the FSU region (and particularly Ukraine and Belarus), the EU (in two levels; national and supranational institutions) and China.

In the first case, the ‘Neo-Neo’ debate is tested on the Russia-Ukraine and Russia-Belarus relationships. In both cases, a classic, but absolutely consistent with

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<sup>73</sup> In brief, the criteria are: Plentitude, Boundedness, Comparability, Independence, Representativeness, Variation, Analytic utility, Mechanism, Replicability, Causal comparison. Also, for a thorough analysis on the issue, see: (Gerring, 2001, p. 202).

the current theoretical paradigm, interstate analysis is applied, with no methodological peculiarities and the regional power game to unfold over a number of cases; the Russo-Ukrainian 2006 and 2009 natural gas trade standoffs and the subsequent agreements that restored order in the bilateral energy relationship, the April 2010 agreement which stipulated the lease of Sevastopol's Naval base from the Russian navy in exchange for cheaper Russian natural gas, and the Russia-Belarus Custom Union as well as its impact on the bilateral energy (natural gas) relations.

With regard to the EU, its awkward political ontology led the present analysis to follow a 'two-stage' model, national and supranational. As a result, Russia's natural gas relations are first examined towards specific member-states; Germany, France, Italy and Poland constitute the selected sample. Justifying the selection, it is stated that, while according to the EU functioning in the Foreign policy (CFSP) each decision obeys to the intergovernmental logic of Unanimity and, thus, each state holds the same power during the decision-making, the same does not entirely hold for energy policy. The latter, as earlier said, stands as a CFSP and Competition Policy hybrid. Member-states and supranational EU bodies maintain a shared competence, a fact which means that both levels (national and supranational institutions) may interact, with the former always taking precedence over the latter according to the principle of subsidiarity (Mousis, 2001). Therefore, energy policy, to the point it falls into the Competition Policy of the EU, obeys to the Qualified Majority Voting (QMV) pattern in the Council of Ministers ("Community method") (Hix, 2005).

Keeping this in mind, we also recall that the more relative power an EU member-state has, the greater the distributive outcomes and the influence it relishes and exerts during negotiations within the supranational bodies of the EU. To measure this strength, the voting pattern in the Council of Ministers is of utmost importance, since it is the body without its consent no decision is reached at the EU (or supranational institutions) level.

**Table 2.3: Voting power in the Council of Ministers**

	Pop. (mil.)	Unanimity		Qualified Majority EU27 (Nice rules/Lisbon Treaty)	
		Votes <sup>1</sup>	Power <sup>2</sup>	Votes <sup>1</sup>	Power <sup>2</sup>
<i>Germany</i>	82.5	1	100.0	29	8.7
<i>France</i>	59.6	1	100.0	29	8.7
<i>Italy</i>	57.3	1	100.0	29	8.7
<i>Un. Kingdom</i>	59.3	1	100.0	29	8.7
<i>Poland</i>	38.2	1	100.0	27	8.0
<i>Spain</i>	40.7	1	100.0	27	8.0
<i>Romania</i>	22.5	1	100.0	14	4.0

Notes: 1.The table contains only the first 16 member-states, measured in terms of votes and power. An inclusive account on the EU27 is accessible at the sources right below.

2.Power = proportion of times a member-state is pivotal (as reported in Hix’s analysis).

Sources: Hix, 2005, p. 85; The Lisbon Treaty, 2007, pp. 160-161.

As shown in Table 2.3, Germany, France, Italy and Poland not only hold the maximum possible votes in situations where QMV is required, but they also exert the maximum influence on the remainder of the member-states with their voting pattern, as illustrated in the column where power/influence is measured<sup>74</sup>. Thus, having the national level established, then, the supranational institutions level comes at the forefront, examining the Russia-EU partnership within institutions such as the ECT, the Energy Dialogue and the 3<sup>rd</sup> Internal Energy Market Package (“Third Energy Package”). Once the analysis on both levels has been accomplished, the research quest takes the following form: if Russia managed to establish a strong presence inside these EU member-states’ gas-markets, if not dominant, then its relative gains would be mirrored in the supranational structures of the EU, obeying to the Liberal Intergovernmentalist logic.

Finally, the Russo-Chinese relationship completes the cycle, with this chapter serving as both a ‘supplement’ to the analysis of the Russia-EU relations and a separate case, like the previous two, where the ‘Neo-Neo’ debate is tested. The dominant *mentalité* in Asia with regard to (interstate) cooperation, the brinkmanship energy diplomacy over the Central Asian resources as well as energy projects such as the ESPO, the CAGP, the SKV and the Eastern Gas Program constitute the pillars of the chapter. These three case-studies (with the associated within case variation)

<sup>74</sup> It is clarified that the United Kingdom, although it ranks higher than Poland in the Table 2.3, it is excluded from the present research since it has been a natural gas exporting state.

represent different types of cooperation, providing useful insights. All things considered, a Eurasian energy triangle emerges with multiple and delicate balances being struck.

Yet, this dataset is small, thus, not satisfying, *prima facie*, the criteria of Plentitude, Boundedness, Representativeness and Variation. But, if considered the nature of the topic (energy-natural gas diplomacy), the extent (Eurasia) and the actors involved (Russia-EU-China), then one could argue in the exactly opposite way. Moreover, if we also consider the academic implications (the updating of the ‘Neo-Neo’ debate and its testing under certain types of cooperation), it becomes even more striking that the main framework of the present research, aside from the energy diplomacy, could also be reemployed to address various challenging fronts of the IR field, thus satisfying the criterion of Replicability. Consequently, the bottom line is that, although the aforementioned criteria may not be fulfilled in absolute terms (judging from a natural sciences perspective), in the present research, *mutatis mutandis*, they are well taken off.

Eventually, the data collection is founded upon multiple primary and secondary sources such as documents of either institutionalized or non-institutionalized energy cooperation (e.g. the ECT, the Energy dialogue), annual reports from energy companies either EU (e.g. Total, ENI, E.ON Ruhrgas AG, GdF SUEZ, BP, etc.) or Russian (e.g. Gazprom, LUKoil, Transneft, Rosneft) or Chinese (e.g. CNPC), trade agreements or policy papers coming either from our main actor, Russia, or other states and political entities (e.g. Energititseskaia strategija Rossii, The Lisbon Treaty), statistics from well-established and recognized institutions and energy firms illustrating trade flows and FDIs (e.g. the United Nations Conference on Trade and Development-UNCTAD, IMF, IEA, BP), and, finally, various internet sources (news sites, policy-analysis sites), serving to cover every aspect that could possibly remain loose if only examined under the scope of the previous sources. In this way, a solid and thorough, as much as possible, database emerges, where a mix of primary and secondary sources aims to support and substantiate, in the best possible way, the carefully-built argumentation.

A point that calls for further clarification is the distinction between primary and secondary sources, especially in light of the absence of interviews with key actors. As previously presented, many sources come from the archive of energy companies that have been directly involved in the Eurasian energy diplomacy. Prime focus is placed

on Russia's state natural gas monopoly 'Gazprom', which is the pillar of the present research. Its well-classified archive has been of great help in the effort to gather sources as primary as possible. Specifically, its documents have been rather catalytic in substantiating the current quest; memoranda of Understanding, Production Sharing Agreements, Joint Ventures agreements, etc. have all been pillar (hard) evidence, published in the official archive. This 'archive-focused' *modus* of research and its intimacy to/identification with primary sources has also been adopted with other Russian or not, state or not, energy companies such as LUKoil, Transneft, Rosneft, Total, ENI, E.ON Ruhrgas AG, GdF SUEZ, BP, etc. It is interesting to mention that even in the case where Chinese national energy companies have been involved (CNPC), their archive has been accessible, at least to the extent it was needed for the present research, a fact that made the current analysis as inclusive as possible. Consequently, the 'archive-focused' *modus* of research has been realized in the whole scope of Eurasia, comprising EU, Russian and Chinese energy firms and making the argumentation solid and perfectly balanced, as far as the quality of the data is concerned. Of course, parallel with the companies, the accessibility of (supranational) political institutions such as the European Commission, the Russian and the Chinese governments, further contributed to the 'archive-focused' research method. Moreover, in cases where supportive statistics were required, the widely respected in the energy sector, BP's "Statistical Reviews of World Energy" and IEA's "World Energy Outlook(s)" have been among the critical primary sources to provide us with valuable insights and data.

Overall, the present research, following institutions/companies-guiding lights in the energy business and not only, assembled an impartial and well-substantiated dataset so as to shed light on Putin's Russia Eurasian energy (natural gas) diplomacy throughout the 2000s.

## ***2.5 Conclusion***

In this chapter, the Eurasian energyland has been placed in a specific research framework. The main theoretical debate, Neorealism vs. Neoliberal Institutionalism, has been presented and extended with the addendum of the 'middle-ground' of Institutional Balancing. It was made apparent their dichotomy over the prospects of international cooperation, much more within international institutions. In the case of

Neorealism, the concern of the actors for the relative gains from a cooperation limit the prospects of such an even occurring, whereas the institutions cannot play any role in facilitating the situation. The international field is dominated by limited interaction between actors and anarchy prevails. On the contrary, Neoliberal institutionalism, stands in exactly the opposite end. In today's world affairs, interdependence is a given, while institutions may serve as facilitators to cooperation. This is due to the fact that the actors care about the absolute gains from a cooperation, limiting their vision to their own gains, and disregarding the gains, bigger or smaller, of the other side(s). In sum, both strands uphold key positions that may share common grounds as far as international cooperation is concerned.

Nowadays, economic interdependence is growing apace while international institutions stand as guarantors of further deepening this interdependence. Multiple examples attest to this assumption. But what happens when two interdependent actors care about the relative gains (power) from cooperation? To address such cases, we enriched the incumbent 'Neo-Neo' debate with the 'middle-ground' of Institutional Balancing. Interdependence, no doubt, forces actors to cooperate within international institutions, but the latter are deprived of the power to shape and shove, as they should do under normal circumstances, the actors' behaviors. Consequently, institutions are "empty shells", which actors engage only to maximize their relative power, according to the Neorealist tenets.

In this revised theoretical framework is embedded the Eurasian energy diplomacy of Putin's Russia. Having, at first, briefly visited Putin's political thinking in both domestic and international affairs, we set up the triangular but differentiated in terms of status (symmetry, asymmetry, correlation) relationship in the Eurasia according to specific research hypotheses so as to predict certain outcomes. Consequently, in the first case where the asymmetric energy relationship between Russia and the FSU region is presented, it is expected that the testing of the revised 'Neo-Neo' will qualify Neorealism's argument of "relative gains" as the best explanation. In the second case, the symmetric energy relationship between Russia and the EU is anticipated to prove the limited explanatory capacity of the incumbent 'Neo-Neo' debate and open the way for its revised version with the addendum of the Institutional Balancing branch. Finally, in the last third case, where the balanced energy relationship between Russia and China comes to the forefront, it is predicted that Neorealism's "relative gains" will again qualify as the best explanation.

Finally, in the last section of the chapter it has been mentioned that the research is structured according to a 'case-study' approach, in which there are elements of both a synchronic (or cross sectional) and a diachronic (or longitudinal) dimension of analysis. In this manner is achieved the analysis of a triangular relationship within a dynamic theoretical framework. Because, its update or revision, as earlier defined, is a not-so-simple case. As it is explained in the main research body, in cases of symmetric (energy) relationship and unavoidable international institutional cooperation, the once '*compulsory*' Institutional Balancing strategy becomes powerful when one side (e.g. Russia) has one of equal-importance to its main trading partner (e.g. the EU) alternative (e.g. China), which it may use as diplomatic leverage against the former in order to seize the maximum out of the negotiations. Of course, this works also vice versa, in the sense that one side may use its main trading partner as a diplomatic chip against the alternative option. It is a triangular relationship among equals that can be manipulated according to the occasion and the aims pursued. As a result, the analysis aside from presenting a simple revision of the 'Neo-Neo' debate, it also gives it a dynamic form, exhibiting the full extent of its operability and tying it with specific statuses of international cooperation. Consequently, parallel with the operability, there is also predictability. Needless to say, the faster a side becomes autonomous or approaches autonomy, the greater its chances to lead the triangle.

## *Chapter 3: Energy politics and the Russian energy locomotive*

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### *3.1 Getting to the inner of oil and natural gas trade*

The current study on geoeconomics in the Eurasian energyland would certainly find no better starting point than clarifying realities shaped by the oil and natural gas trade. These realities involve, at times, both political and economic considerations whilst others only economic. But upon what does this depend?

As a matter of fact, oil and gas are two commodities of totally different nature. Principally, oil is fungible while natural gas is not (Shaffer, 2009)<sup>75</sup>. Thus, the latter necessitates ‘personal’ or better said, directly linked supplier-consumer relations, fact which, in turn, paves the way for politics to intermingle easier with this form of trade than with oil. However, a thorough understanding of these dynamics, certainly, calls for a broader presentation on the basics of both commodities’ trade.

To begin with oil, it is an internationally traded commodity (fungible) with its price set by an average in the global trading centers. Specifically, it is mainly traded in the New York Mercantile Exchange (NYMEX) in the US and in the International Petroleum Exchange (IPE) in London, with thousands of brokers setting the tone for its price (Falola and Genova, 2008). While, periodically, many different forms of contractual trade have been employed, the spot market has finally prevailed, with buyers and producers conducting direct exchanges.

Elaborating on the price setting, oil prices tend to be of cyclical nature. Following Shaffer’s analysis, “low oil prices lead to high demand, accompanied by low investment in oil production and refining and low interest in conversion and use of other fuels (such as natural gas, nuclear energy and renewable energy sources)” (Shaffer, 2009, p. 15). Such a situation soon constricts oil supplies, increases prices and, ultimately, curbs demand. Consequently, the “market tightens” with the high oil prices stimulating investments in production and, eventually, boosting supply. But

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<sup>75</sup> Explaining oil’s fungible nature, the producer and the consumer do not have to be directly linked, fact which comes in sharp contrast with the natural gas trade, where vacillations in supply and demand entail global repercussions (Shaffer, 2009).

this boost causes prices to fall again and demand rise. Thus, there is a cycle going on where “a rise in oil prices is followed by a decline, which may manifest as a price crash: earlier investments in production lead to additional supplies becoming available at the time demand is dwindling” (Shaffer, 2009, p. 15). Of course, in the meantime, because each cycle lasts for a few years, when the prices are high, many governments consider a wide spectrum of policies, ranging from consumption taxes to adjusting their economies’ structures to other sources of energy, cheaper to use.

We have, so far, explained how oil prices fluctuate according to the supply-demand cycle. However, at times, price shocks (both upwards and downwards) may occur as a result of exogenous factors such as political crises, discovery of new oil deposits, security threats that discourage people from travelling etc. (Shaffer, 2009). Particular emphasis should be placed on the political crises, or even the rumors of such crises, that are more than sufficient to skyrocket oil prices. An example could be found in the recent uprisings in North Africa. The upheaval in Libya, the biggest oil exporter of Africa, triggered rumors over possible reduction of the production to the half and gave room to speculations over an oil barrel exceeding \$220 by the end of 2011 (Vedomosti, 2011; Abdulaev, 2011; Kykol and Tsitskin, 2011). Nevertheless, even in such occasions, due to oil’s fungible nature, other producers (OPEC members and non) are to step forward, filling the supply gap and keeping the commodity’s global preponderance afloat.

Moreover, governments have also initiated other policies against price spikes of that kind. Acting within the framework of the International Energy Agency (IEA), which was established in 1974 in the wake of the 1970s price shocks, they prioritized energy security by systematizing oil stocks against future shortages. Thus, first the US and then other states (e.g. China), created their own Strategic Petroleum Reserves (SPRs) to cushion all the severe consequences a tight oil market may inflict on their domestic development (Shaffer, 2009, p.17).

So, oil is a rather internationally integrated commodity with plenty of options at the hands of the national governments. Price shocks certainly exist but sufficient policy alternatives outdo their initial dynamics. Therefore politics, although initially potent to affect the terms of trade, seem to finally succumb to the logic of market economy.

Natural gas on the other side, is a commodity that shares little common ground with oil. Notwithstanding environmentally friendly, it faces major logistical

deficiencies that affect its fungibility. While oil can be traded internationally with no need for the supplier and the consumer to be directly linked, the same does not hold true for the natural gas. Today's technological *niveau* does not allow for its transportation as widely as for oil. The main means of transport remains the pipeline trade, with no more than 5% being traded via Liquefied Natural Gas (LNG) tankers (Shaffer, 2009). LNG is mostly traded in Asia that already has a total of over 60 LNG re-gasification facilities while similar investments have also been made in Australia, Malaysia, Indonesia and Papua New Guinea (Deutch, 2011). Finally, a recently discovered form of unconventional gas, dubbed "shale gas", is only in its infancy and despite its world-scale presence, its chances of challenging pipeline trade, according to current estimates, are rather limited. Thus, for the time being, the producer and the costumer are directly linked<sup>76</sup>.

This, in turn, gives the natural gas market a specific form. Long-term contracts (LTCs)(usually 15-20 years) guarantee a return on the costly investments made in the pipeline construction. Moreover, most LTCs are accompanied by a "take or pay" clause that commits the customer to the purchase of a fixed amount of gas, regardless of the actual consumption (Shaffer, 2009). So, all this 'inflexibility' has given rise to three (separate) natural gas markets globally, namely North America, Asia and Europe, which may differ one another in the terms of trade (Deutch, 2011). Therefore, economics may be interwoven with politics.

Explaining this economic-political "*bras de fer*", in the best-case scenario, the supplier and the consumer are symmetrically dependent or interdependent. The former needs a profitable market while the latter needs the commodity. Nevertheless, this relationship may change its status from interdependent to interconnected. If the supplier finds another, equally lucrative market and the consumer other sources for imports aside from the incumbent pipeline network (e.g. LNG or shale gas), then the

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<sup>76</sup> A point that is critical for the current analysis is the distinction made in the gas and oil business between the *upstream*, *midstream* and *downstream* sector, with the midstream, however, incorporated into downstream sector.

***The Upstream sector*** refers to the search for underground or underwater gas and oil resources and to the subsequent drilling and development of these wells/resources.

***The Midstream sector*** falls both in the upstream and the downstream sectors and refers to the gathering system which collects at first the wet natural gas from the well heads and transports it to a gas processing plant. Then, when the natural gas is purified and thus becomes dry and of "pipeline quality", it is transported to the final consumers. In sum, this sector refers to the transportation of the resource and focuses on the pipeline network. Parallel procedure is followed for the crude oil pipeline trade.

***The Downstream sector*** refers to the selling and distribution of gas as well as of the products derived from the crude oil.

More information accessible at: [http://naturalgas.org/naturalgas/processing\\_ng.asp](http://naturalgas.org/naturalgas/processing_ng.asp)

relationship becomes interconnected. In both scenarios, the supplier and the consumer sides balance. Neither is stronger than the other. Each side has at its disposal the same means (balance of economic-political means)<sup>77</sup>.

Conversely, in the worst-case scenario, if the once interdependent relationship does not change concurrently, the prospect of unilateral dependence of one side on the other sets the stage for politics taking precedence over economics. The powerful and independent side can dictate its terms to the weaker and dependent side of the relationship. Thus, the latter becomes *sensitive* and *vulnerable* to the trade terms of the former. Meanwhile, the former, if anything, becomes sensitive in the sense that it may lose a lucrative market but it is not vulnerable since it can recover its loss from the equally profitable substitute market it has started doing business with. Expressing the aforementioned as an equation:

**Interdependence** (A-B) = Sensitivity (A-B) + Vulnerability (A-B)

**Interconnectedness** (A-B) = Sensitivity (A-B) – Vulnerability (A-B)

**Unilateral dependence** (A→B) = Sensitivity (A-B) + Vulnerability (A)

\*\*\* where (A-B) symbolizes the two sides of the relationship, while (A→B) symbolizes the unilateral dependence of side A on side B.

What stands firm from the previous analysis is that the natural gas trade, in its present form, leaves an open door for politics to step in the energy equation and tamper with economic considerations that should otherwise, govern every commercial relationship.

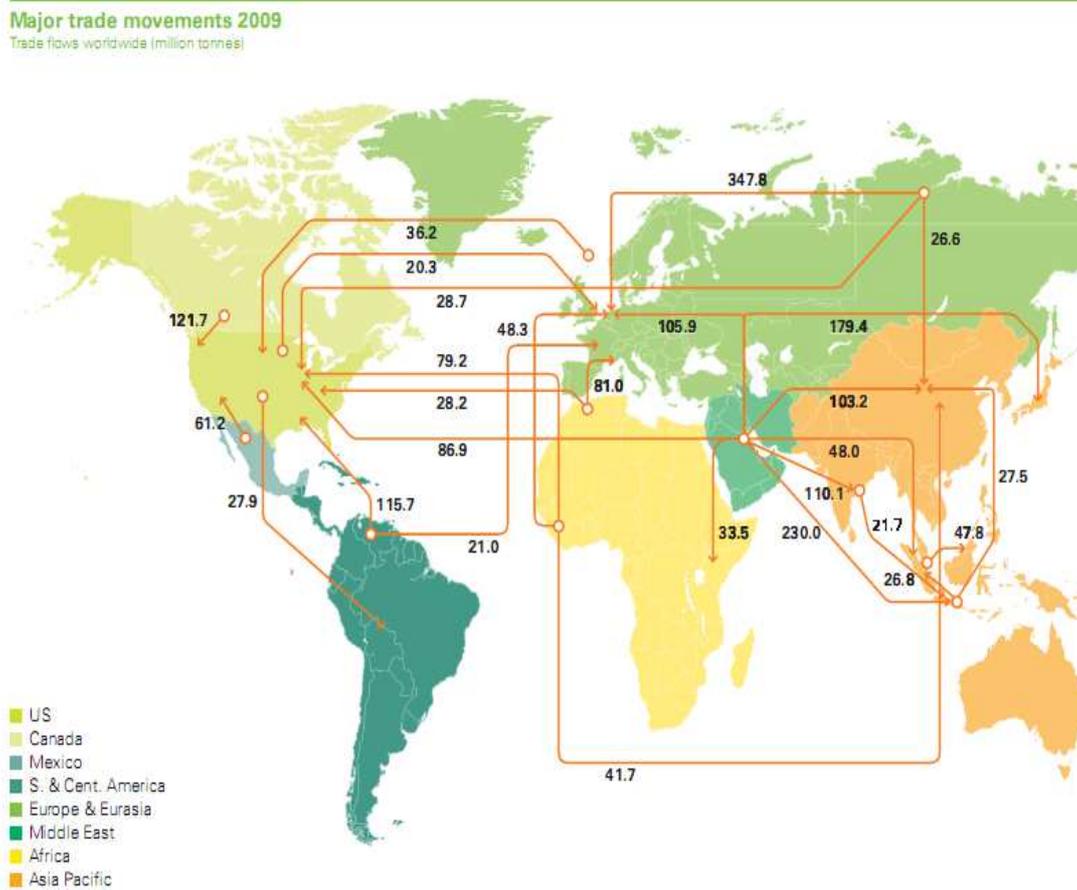
Of course, this brief presentation on the basics of oil and natural gas trade cannot claim analytical depth. However, since we, currently, focus on power relations that emerge from the energy trade, the link between these two commodities and politics has become sufficiently clear.

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<sup>77</sup> It is reminded, here, that the earlier used terms of ‘symmetry’, ‘asymmetry’ and ‘balance’ have now been substituted for ‘interdependence’, ‘unilateral dependence’ and ‘interconnectedness’, since the brief presentation on the basics of oil and gas trade has substantiated their meaning in the current context.

### 3.2 The Russian energy status

So, the previous analysis introduces us now to the core quest. Where does Russia stand? What is its energy status? Does it claim resource supremacy in either gas or oil sector? And if yes, does the form of trade, especially in the natural gas sphere, allow it to pursue political parallel with the commercial interests? As a preliminary remark it is stated that Russia, as an energy superpower, is overly abundant in both natural gas and oil resources.



Map 3.1: Major Oil trade movements 2009 (million tonnes)<sup>78</sup>

<sup>78</sup> Source: (BP, 2010, p. 21).

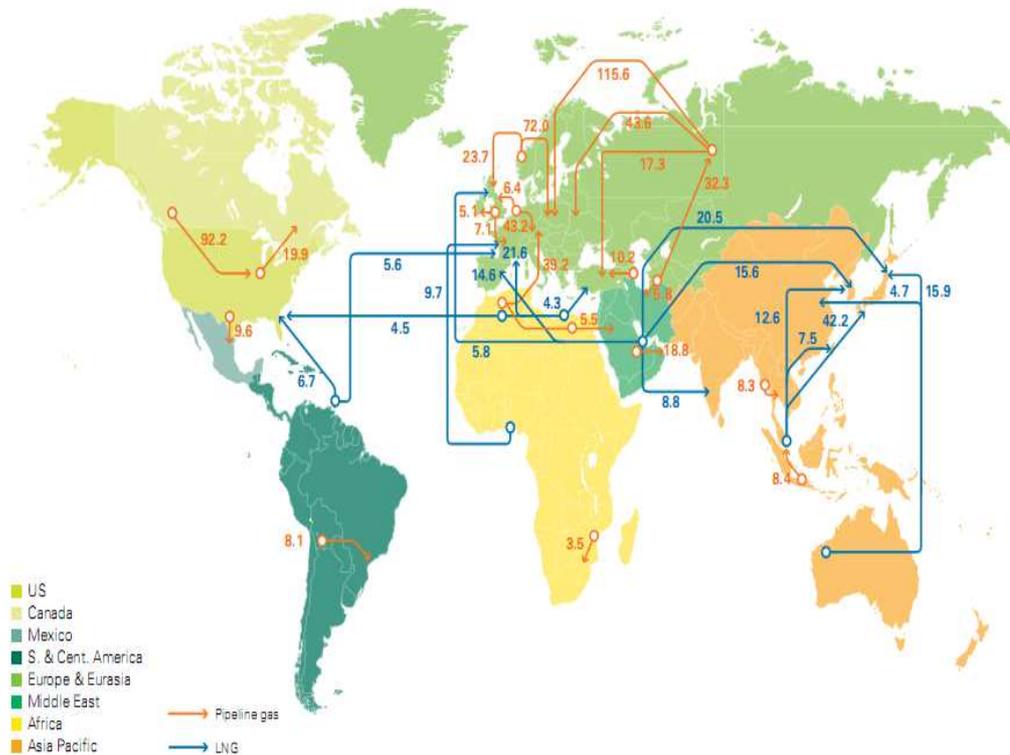
**Table 3.1: Russian Imports and Exports in 2009<sup>79</sup>**

Imports and exports 2009	Million tones				At Thousand barrels daily				
	Crude Imports	Product Imports	Crude Exports	Product Exports	Crude Imports	Products imports	Crude exports	Product exports	
	US	442,8	122,0	2,2	89,5	8893	2550	44	1871
Canada	39,1	15,3	96,5	25,7	785	320	1938	538	
Mexico	0,5	21,0	63,8	8,0	9	439	1282	168	
S. & Cent. America	25,1	41,3	128,9	54,4	504	863	2588	1137	
Europe	513,3	152,0	23,1	72,9	10308	3177	464	1523	
Former Soviet Union	0,9	3,2	342,0	105,1	18	67	6868	2197	
Middle East	7,0	10,5	822,1	91,6	140	219	16510	1916	
North Africa	18,4	10,0	111,1	25,3	369	209	2232	528	
West Africa	†	12,1	212,3	5,3	1	254	4263	110	
East & Southern Africa	21,9	5,7	14,8	0,3	439	119	297	6	
Australasia	22,8	17,1	12,8	2,0	458	358	258	42	
China	203,5	49,8	4,7	29,4	4086	1041	94	614	
India	145,8	10,4	0,1	35,4	2928	217	1,9	740	
Japan	176,5	35,3	–	16,5	3545	738	–	345	
Singapore	46,3	79,8	2,3	72,0	930	1668	47	1505	
Other Asia Pacific	228,6	127,6	40,2	59,9	4590	2667	807	1252	
Unidentified*	–	0,9	15,5	20,6	–	18	311	430	
<b>Total World</b>	<b>1892,5</b>	<b>714,0</b>	<b>1892,5</b>	<b>714,0</b>	<b>38005</b>	<b>14925</b>	<b>38005</b>	<b>14925</b>	
*	Includes changes in the quantity of oil in transit, movements not otherwise shown, unidentified military use, etc.								
†	Less than 0.05.								
	<b>Note:</b> Bunkers are not included as exports. Intra-area movements (for example, between countries in Europe) are excluded.								

<sup>79</sup> Source: (BP, 2010, p. 21)

### Major trade movements

Trade flows worldwide (billion cubic metres)



**Map 3.2: Major natural gas trade movements 2009 (billion cubic meters)<sup>80</sup>**

Following the figures in the previous maps, it is easy to ascertain that Russia relishes a large share of the global oil and gas exports. With regard to oil, major quantities are shipped to the US, Europe and China, while in the natural gas sphere, Russia seems to rule the roost. Its exports reach mainly the EU via the transit states Turkey, Ukraine and Belarus. Although the pipeline routing as well as its implications are analyzed further on where each FSU transit state is examined as a necessary link for the Russia-EU gas trade, currently, we emphasize two important factors for better understanding power relations in the Eurasian energyland: a) Pipeline gas has been dominating the market and it is set to expand further (for instance, Russia, as a part of its “Eastern Gas Program”, has commenced since 2007 the construction of a new, eastern-oriented gas network to cross Siberia with additional export branches to China and the rest of the Asia-Pacific region<sup>81</sup>) and b) LNG and shale gas are far from substituting pipeline gas (although these two new forms of gas are on the rise to shape

<sup>80</sup> Source: (BP, 2010, p. 33)

<sup>81</sup> See: (Gazprom, 2011;2011a); see also Chapter 6, pp. 242-248.

new realities<sup>82</sup>). Thus, at present, Russia appears to control the commanding heights in the natural gas business, since its current form of trade (via pipelines/networks) allows for strong involvement of political parallel with commercial interests.

### ***3.3 Energy ‘statism’: the Russian case***

Being a natural resources economy, Russia sought, especially after Vladimir Putin’s ascent to the Presidency in March 2000, to tighten the bond between the state and the major natural gas and oil companies. Gazprom, LUKoil, Rosneft, became either directly or indirectly linked to the state, while the biggest Russian oil company of its time, YUKOS, crumbled as a result of its opposition to state directives<sup>83</sup>.

To begin with the oil sector, state presence could be characterized as mixed. While in Rosneft the state has been literally running the company with almost 85% of the shares belonging to it<sup>84</sup>, the same does not hold for LUKoil. The latter, having been fully privatized since 2004, it has been indirectly supervised and guided by the state so as its interests to be always taken into consideration. To put it in a simpler way, the company should not act to the detriment of the state interests.

The most evident case to attest to that is the construction of the Baku-Tbilisi-Ceyhan (BTC) oil pipeline. That project met US support and it would carry Azeri oil from Azerbaijan through Georgia to the Turkish port of Ceyhan. Initial negotiations found LUKoil with a 10% stake in the end of 2001. Although LUKoil, at the very beginning, pushed for the old Soviet route from Baku to the Russian port of Novorossiysk to remain the main export route for the Azeri oil, no changes were made to the plan. The “Azerbaijan via Caucasus to Turkey” option had been finalized. The project attracted many conglomerates such as British Petroleum (BP), Unocal, Statoil, and ENI, while according to a study conducted by BP, the expected profits would be ample for all the participants involved (Lelyveld, 2002). Given that, the reason that LUKoil dropped the project in May 2002, claiming low profitability, led many analysts to the assumption that political reasons outdid the respective economic

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<sup>82</sup> For more on the issue see Chapter 5, pp.156-159.

<sup>83</sup> At the present analysis, we focus on energy companies that have a strong presence both domestically as well as internationally. No doubt, there are also other companies (e.g. Novatek) which operate in the domestic market but have marginal foreign presence, if any. Thus, they are excluded from our focus.

<sup>84</sup> For the exact shareholder structure see: [http://www.rosneft.ru/Investors/structure/share\\_capital/](http://www.rosneft.ru/Investors/structure/share_capital/)

(Guardian, 2002; Lelyveld, 2002; Pravda, 2003). More concrete answers, however, should be sought to the Kremlin's severe opposition to the project and in the influence it could exert on the company's managerial board, considering that its president, Vagit Alekperov, along with other leading figures, such as Alexander Shokhin and Sergei Mikhailov, had previously a political profile<sup>85</sup>.

Parallel to these indirect means of influence, the Russian state had also plenty more 'weapons' in its arsenal to 'manipulate' the energy business, such as the oil transport state-monopoly 'Transneft' as well as the legislation. Specifically, the Subsoil Law (1992) stipulates that the right of exploration and production is granted jointly by the Federal government and the regional powers "on the basis of sales by auction through invitation to tender"<sup>86</sup> (Locatelli, 2006, p. 1081).

However, no matter the tight pressure exerted by the state on oil business, there are hardly any international ramifications, since the fungible nature of the commodity (the internationalization of its trade) enfeebles any possible link with national foreign policy priorities, always speaking in relative and not absolute terms.

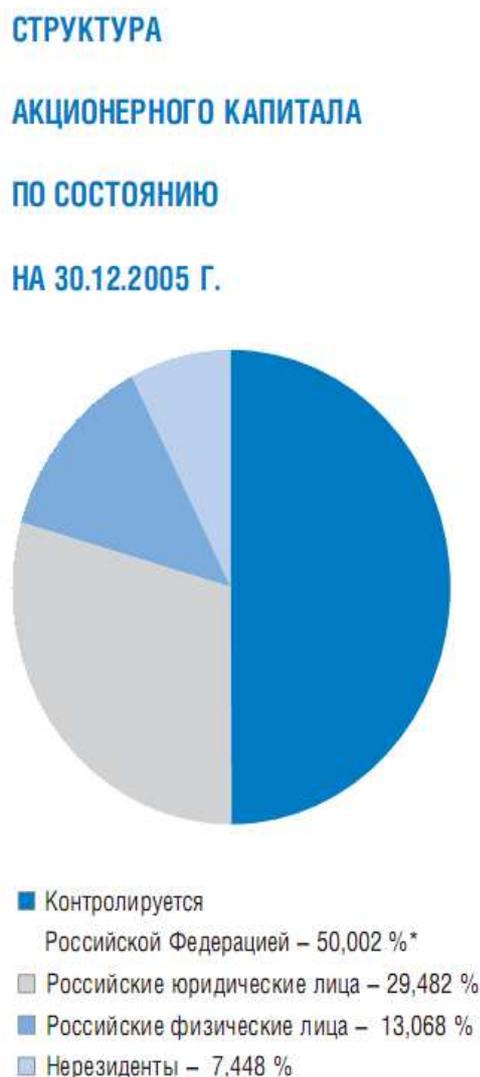
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<sup>85</sup> Reading between the lines of LUKoil's withdrawal from the project, someone should prioritize the following reasons: a) Kremlin's fear that the project would sideline Russia from Western markets, since, up to that time, Azeri oil was shipped mainly through Russian routes (Baku-Novorossiysk) (Guardian, 2002), b) Vagit Alekperov's appointment in 1991 as the first deputy to the minister of oil and gas industry in the Soviet Union (RFE/RL, 2002) and c) the overwhelming shareholding of LUKoil by Russian non-governmental entities. Thus, it may have been privatized but the control remained in Russian hands (LUKoil 2005).

<sup>86</sup> The link, here, to a possible exclusion from the domestic energy fields is clear and threatening to every energy company.

In the gas sector, things are of much different scale. The demise of the Soviet Union brought turmoil to the restructuring of the sector. Early presidential decree, transformed the Soviet Ministry of gas (which had been established in 1965 as a means of centrally controlling the exploitation of gas) into a joint stock company under the name ‘Gazprom’. Gazprom (“RAO Gazprom”) was then to be privatized over the next three years, forming an open joint stock company (“OAO Gazprom”) with state shareholding to less than 40% and more space for other investors (Victor and Victor, 2004). Thus, state presence trimmed to 38%, a share that remained intact from 1993 till 2005, when Putin’s anew decree repositioned the state at the commanding heights with 50,002%<sup>87</sup>.

Gazprom, as of today, owns 60% of total Russian reserves, produces 94% of the domestic natural gas production while its export activities largely cover the Eurasian landmass, mostly the EU and the rising Chinese market (Rosner,2006; Gazprom 2011b)<sup>88</sup>. Having inherited most of its assets (land, natural resources, pipeline network etc.) from the Soviet Gas Ministry, it has acquired an influential position domestically as well as internationally. As it is shown



**Figure 3.1: Shareholding Structure in Gazprom**

later on, Gazprom, capitalizing on its magnitude, has grown ever more ‘extrovert’, pursuing vertical integration in both near abroad (the FSU states) and the EU market,

<sup>87</sup> For the Figure see: (Gazprom, 2005, p. 68).

<sup>88</sup> The ownership of the 60% of the total Russian reserves equals to the 30% of world natural gas reserves (Rosner, 2007).

with the acquisition of mid and downstream assets<sup>89</sup>. This tactic, however, has raised many doubts over the company's independent and market-oriented commercial interests, given the state's shareholding. It should be reminded, here, that the natural gas cutoffs to European supplies in 2006 and 2009 generated heated debate amongst the EU member states over Russia's true intentions concerning the operationalization of its resources. More specific, is it also politics to account for its behavior towards Ukraine and Belarus or is it just economics? Because, if it is just economics, then, Gazprom's 'extrovert' profile does not really fit the picture. Or maybe it does, given the company's significance for the Russian state in total. The bigger the better, with no political (foreign policy) strings attached. It remains to be seen.

As the analysis has, so far, demonstrated, Gazprom has been essential to the Russian state not only for reasons tied to the external dimension of the national interest (foreign policy), but also for reasons tied to its internal dimension (every day economics). Specifically, the company generates the 25% of the state tax revenue while it accounts for the 8% of the nation's GDP (Rosner, 2006). Thus, Russia is heavily dependent on Gazprom's tax revenues to finance a multitude of policies. At this point, the question arises as to whether it would be an exaggeration to use Skocpol's term of "rentier state" to describe the Russian case; a state like Iran in the mid-1960s where its dependency on petrodollars was so immense that it did not even wrest taxes. It was an economy solely based on the oil and natural gas exports that employed a trivial percentage of the domestic workforce (Skocpol, 1982, p. 269).

### ***3.4 The 'Dutch Disease' and the way to autonomy***

The scenario of a "rentier state" is one that Russia should guard against if it is to avoid being excessively dependent on the constant influx of hard currency so as to ensure the sustainability of its economy. Because such a situation would entail grave limitations on its autonomous international standing, let alone pursuit its objectives (economic and political) according to its national interest.

But, how could a nominally powerful natural resources economy forfeit its *autonomy* and become dependent on exogenous factors? The answer lies to the term "Dutch Disease" that employed to explain the inauspicious effects of the 1960s

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<sup>89</sup> The term "vertical integration" refers to a situation when a company controls all the supply chain, from production to distribution.

natural gas discoveries on the Dutch manufacturing due to the appreciation of the real exchange rate (Corden, 1984).

Following Corden's core model, in an economy are identified three sectors, the Booming Sector (B), the Lagging Sector (L), and the Non-Tradable sector (N). The products of the first two are traded internationally, thus facing world prices, while those of the third not<sup>90</sup>. In each sector, output is produced by a specific factor and by labor that is mobile among sectors, leading, in this way, to wage equalization (Corden, 1984, p.360). Preliminary, it is noted that the Dutch Disease shows how the traditional lagging export sector (L) gets crowded out by the other two.

This happens as follows. At first, it is assumed that oil and gas discoveries in an economy boost exports. Foreign exchange flows into this economy, resulting to the appreciation of the real foreign exchange rate<sup>91</sup>. Now the traditional lagging export sector loses in competitiveness and shrinks. At the same time, the extra income in sector (B) is spent either directly by the factor owners or indirectly by the government (since it has earlier collected taxes from this sector) (Corden, 1984, p. 360). Provided that the *income elasticity of demand for the Non-tradable sector (N) is positive*, then the prices of the products of this sector rise. So, the appreciation of the real exchange rate, plus the *spending effect* (that resulted from the income-increase of the booming sector), lead to the polarization in an economy between the booming and the non-tradable sectors.

This polarization, however, is established out of the resource re-allocation ("*The Resource Movement Effect*"). As earlier argued, the bloated incomes of the booming sector with positive income elasticity for products of the sector (N), push the demand and raise the prices of these products. The resources (capital and labor) in view of such a promising situation for income-increase, shift into the production of domestic non-tradable goods, just to meet the increased demand and profit from the raised prices. There will be a labor outflow from sector (L) to sector (N), with mid-long term severe repercussions on the traditional lagging export sector (L) (Ebrahim-zadeh, 2003). This labor outflow is referred to as *indirect de-industrialization* since it is brought about by the spending effect of the booming sector (B) and not by the direct movement of resources from the lagging sector to the booming sector. If the latter was

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<sup>90</sup> The third sector might include retail trade, services and construction.

<sup>91</sup> The present analysis refers to the current foreign exchange rate regime that is flexible not fixed.

happening it would constitute a case of *direct de-industrialization*<sup>92</sup> (Corden, 1984). However, the reason that such a case is not occurring in occasions of an energy boom, is that the energy sector requires a minimum amount of labor. In reality, it is an ‘enclave’ (Corden, 1984, p. 362; Corden and Neary, 1982).

So, a polarized economy emerges. Two sectors, one tradable and the other not, dominate the economy of a natural resources/rentier state. Of course, the level of dependence of a “rentier state” on international energy trade is enormous. This state, albeit inherently rich, remains not only sensitive to the international demand but also vulnerable, given that if a temporary plunge in demand becomes protracted, issues of economic survival come at the forefront. Therefore, this “natural resources” state has limited capacity of independent decision making, much less, use its natural resources as a ‘weapon’ to coerce other actors to political concessions. The “shooting range” of such a ‘weapon’ will only be limited and temporary, up to the point that it will not jeopardize the state’s reputation as a reliable supplier. If it is for energy to become an indeed coercive diplomatic chip, then the “natural resources” state has, above all, to make its exports diversified and modernized, if not innovative, and thus limit its lopsided dependence on oil and gas export revenues. But this is neither an easy nor a short-term objective to accomplish. So, this bring us to the final question, how can a state, at least, minimize the adverse effects of the “Dutch disease” and gain an autonomous international standing?

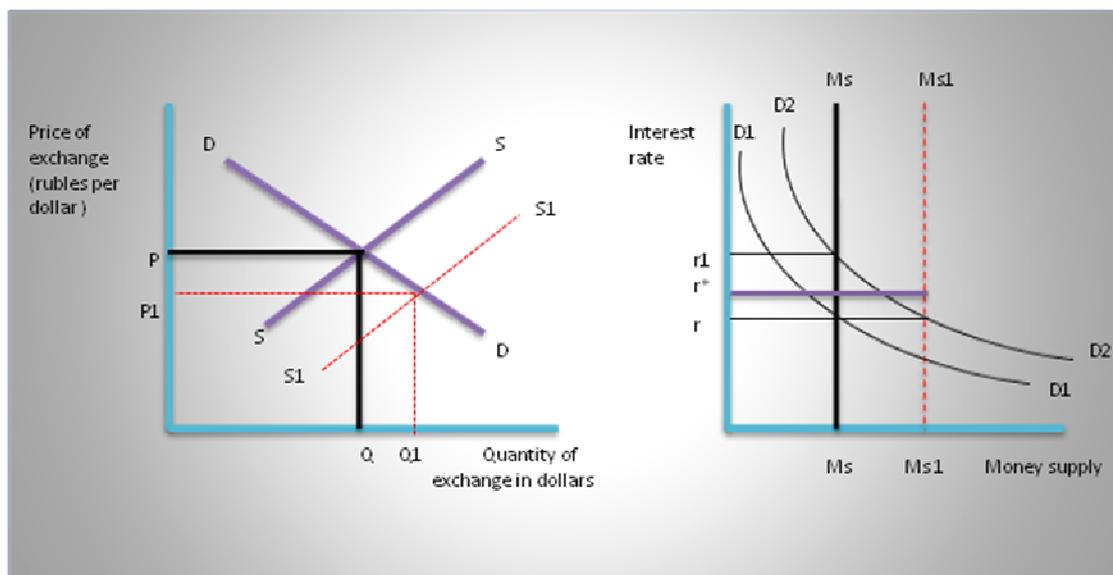
The key answer to this is by keeping the fluctuation of the foreign exchange rate at bay. This may happen via: a) sovereign wealth funds, b) boosting the competitiveness via a market-rational national income policy, and c) restrictive fiscal policy. All three points pave the way for the ultimate cure of the “Dutch Disease”, provided the political leadership adopts the proper policies as far as the allocation of resources in the economy is concerned.

The slowing of the appreciation of the foreign exchange rate can first be achieved with the ‘sterilization’ of boom revenues (i.e. the gradual repatriation of the revenues

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<sup>92</sup> For the sake of inclusiveness, here it is noted that the core model as developed by Corden refers to the “Resource Movement effect” via two supplementary stages, the *direct de-industrialization* and the *indirect de-industrialization* (Corden, 1984, p.361). In the first stage, as the booming sector starts to generate bloating incomes, there is a movement of labor from sector (L) to sector (B) in pursuit of income maximization. This lowers the production in the traditional lagging export sector (L), thus bringing about a direct de-industrialization. Additionally, the incomes of the booming sector with positive income elasticity of demand for products of the sector N raise prices thus creating a labor movement from sector (L) to sector (N). This movement has been brought about by the spending effect and constitutes the indirect de-industrialization (Corden, 1984, p.361).

which are kept in special funds abroad). The reference, here, is made to sovereign wealth funds. Major “natural resources” states such as Norway (Government Pension Fund), Russia (Reserve Fund and the National Welfare Fund) and Azerbaijan (State Oil Fund of Azerbaijan) maintain sovereign wealth funds. As said above, the gradual repatriation of revenues allows the slow appreciation of the exchange rate ( $P \rightarrow P1$ ), thus, minimizing the spending and the resource movement effect and keeping the competitiveness of the non-booming traditional export sector ( $L$ ) afloat.



**Figure 3.2: (a) The Foreign Exchange Market, (b) The money market**

Parallel to that, another way for slowing the foreign exchange rate appreciation is by boosting the competitiveness of the manufacturing sector, if it is for a restrictive fiscal policy to be avoided. Why and how?

Briefly describing, first, the operation of the economic system, the initial inflow of foreign exchange in the booming sector would increase incomes and consumption. An increased consumption in a period of given money supply ( $M_s$ ) would raise prices of products and services (inflationary pressures), causing higher demand for money ( $D_2$ ) and interest rates ( $r_1$ ) so as for the balance in the domestic market to be maintained. High interest rates, however, limit investments, stall business activities and widen the trade deficit. Therefore, the Central Bank needs to intervene in the money market by adopting expansionary monetary policy. This policy, would increase money supply ( $M_s \rightarrow M_{s1}$ ), lower interest rates to the previous, if not lower level and depreciate the initially appreciated foreign exchange rate ( $P \leftarrow P_1$ ). Obviously, for the latter to happen, it is necessary for the Central Bank to have the

margin to lower the interest rates below the level of the international interest rate ( $r^*$ )<sup>93</sup> <sup>94</sup>.

So, here is exactly where increased competitiveness of the manufacturing sector enters the equation. Following the compass of productivity in the national income policy ( $W < VMP$ ), the products will have the same quality, if not better, with lower price<sup>95</sup>. That is because if the previous inequality is abided by, the productive factors will produce more with the same salary. Therefore, businessmen will have the margin to lower the prices since the cost of labor (Fixed cost) will be reduced due to the increased quantity produced. Consequently, a product's competitiveness will be upgraded and the Central Bank will be able to adopt expansive monetary policy without inflationary pressures *ante portas*.

However, if readjustments in the national income policy face certain socio-political impediments (a quite frequent scenario), then direct-effect policies of budget surplus (i.e. restrictive fiscal policy) should be pursued in order to increase saving in the economy<sup>96</sup>.

Of course, as prior said, the ultimate remedy of the “Dutch Disease” is the establishment of an economy of knowledge with diversified, innovative and of high added value products, whose competitiveness will endure low (appreciated) foreign exchange rates. However, this a long-term scenario, conditional to many factors, domestic and international.

Russia, being very well aware of the risks that its natural resources endowment may bring about, has been pursuing a path of decoupling its development from the price of oil. A first step towards shielding itself from the Dutch Disease is the establishment of two funds, the Reserve Fund and the National Welfare Fund, managed by the Ministry of Finance (IEA, 2011, p. 332). As earlier noted, such funds procrastinate the appreciation of the foreign exchange rate, thus keeping the lagging traditional export sector afloat.

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<sup>93</sup> For an expansionary monetary policy to take effect, it is necessary the absence of any inflationary pressures. Otherwise, there will be no capital flee from the economy in pursuit of better prospective yields and the national currency will remain overly-appreciated.

<sup>94</sup> See also: (Cohn, 2009; Georgakopoulos et al, 2002).

<sup>95</sup> In the inequality  $W < VMP$ ,  $W$  refers to Wages while  $VMP$  refers to Value Marginal Product which is the Marginal physical output of a factor input multiplied by the unit price of the output. See: (Georgakopoulos et al, 2002, p.249). Check also: <http://www.businessdictionary.com/definition/value-of-marginal-product-VMP.html>

<sup>96</sup> Nevertheless, a restrictive fiscal policy will not succeed in averting the currency appreciation as formed by the initial foreign capital inflows. It will only keep inflationary pressures at bay. Thus it is a short-term strategy against the transforming of the state to a rentier one.

Parallel to that, modernization and diversification of the economy has come atop the agenda. Hence, cooperation with the West plus influx of foreign capital has been considered catalysts for this transformation. However, for this cooperation to flourish, Russia, should overcome major stumbling blocks such as corruption, lack of transparency and judicial inefficiency that all severely affect the investment climate (Kouzmin and Cidibe, 2011). Even in the relatively recent case of the oil tycoon Mikhail Khodorkovsky, who was jailed for tax evasion even though rumors widely held his opposition to the Kremlin as the prime cause of imprisonment, Prime Minister (PM) Medvedev, in a bid of good will and openness consented to a team of legal experts examining the case as to note legal deficiencies and structural problems (RFE/RL, 2011).

Transformations and reforms, nevertheless, should go much deeper, aiming at structural changes. According to Medvedev, development should divert from the old soviet path of merely introducing new technology to the existing industry to that of diversification. Therefore, progress has been made in many new sectors like pharmaceuticals, telecommunications, digital models and other hi-tech products, in order to increase their share in exports. Alongside this transformation, administrative changes have also been underway to strengthen political competition and ameliorate representation (Lisova and Kostenko, 2011). Finally, under consideration has been the establishment of a \$10 mln state fund which would co-invest with foreign funds in projects aiming at the modernization of the economy. This fund constitutes an effort to alleviate foreign investors' fears over forfeiting their money once invested in a project (Leonov, 2011). Common denominator to all these reforms is the adjustment of the economy to a high-tech developmental pattern that would maintain its competitiveness even in lower prices of exchange rate. This, given the adherence to the inequality  $W < VMP$ , would allow for more export revenue inflow to raise national wealth and living standards.

However, as we have recognized before, the 'roadmap' to the previous long-term economic modernization and increased competitiveness has to be combined, especially in "natural resources" states, with direct-effect restrictive fiscal policies. Such was the case in the recent economic forum of Krasnoyarsk where the former minister of finance, Alexei Kudrin, referring to the forecasts of socio-economic development till 2030, opposed any scenario allowing for budget deficits. According to him, the innovative scenario of a 2% deficit along a 10-15 years perspective is not

sustainable (Tovkailo, 2011). This is because the debt would disproportionately increase as well as the dependence on oil for paying back this debt. On the contrary, a balanced budget would stimulate development out of its own resources. Albeit at a slower rate, the balanced budget is linked to a series of steps leading to a market-rational development. Holding the expenditures (G) to the same level as revenues (T), no inflationary pressures would be felt imminent. This, in turn, would further encourage the influx of FDIs given that low interest rates would regulate the money supply<sup>97</sup>. Thus, direct investments, seeking profit while not creating debt to the host economy, would contribute both to the modernization of the productive structures and the international competitiveness of domestic products (Lapavitsas et al, 2010). Export earnings would flow to the economy boosting state revenues and productive factors' incomes. An upward trend would be initiated, the preservation of which would depend upon investments in key sectors such as technology, education, research and development (R&D) (Mitsos, 2008; Giannitsis, 2008). This monetarist path, while feasible by market rewards, would allow for an autonomous and self-sustained course.

On the contrary, if the strategy of a protracted budget deficit is to be followed instead, the long-term threat of a “rentier state” stricken by “Dutch Disease” lurks in the shadows. While for rebooting an economy after recession a deficit strategy would certainly yield results, in the long term (10-15 years) such a strategy would pose a major impediment to economic modernization and diversification. The argument is as follows: When an economy reaches *potential output*, if government spending (G) is increased disproportionately to revenues (T), then the expansive fiscal policy encourages prices (inflation), increases the demand for money and ultimately leads to a higher interest rate. As a result, private investments as well as FDIs are crowded out, while domestic demand, exploiting the appreciated foreign exchange rate, diverts to cheaper imported products and services<sup>98 99</sup>. The trade deficit widens and the debt follows an upward trend<sup>100</sup>. Kudrin, stressed that danger, saying that, given the inflation rates already at high levels (8,8%), a budget deficit policy for a protracted period of 10-15 years would further boost inflation to 12% (Kykol 2011).

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<sup>97</sup> Aside from interest rates, the Rule of Law is equally important for FDIs into the economy.

<sup>98</sup> The increased interest rate will attract foreign capital thus increasing the price of foreign exchange and making the imports cheaper (Georgakopoulos et al, 2002).

<sup>99</sup> The government spending will shift resources away from the private sector, thus shrinking the latter even more. This could be paralleled to the *resource re-allocation* earlier referred to.

<sup>100</sup> This argument refers to the Twin Deficits hypothesis (Kearney and Monadjemi, 1990).

In the same line of reasoning, he stressed that accumulating debt is not a viable option either (Tovkailo, 2011). While for the developed, modernized and diversified western economies a debt ratio of 60% / GDP is manageable, for Russia, such a percentage remains rather high, given its immense dependence on natural resources exports<sup>101</sup>. By these statements, Kudrin expressed his disbelief for the rapid transformation of the economy so as to be able to repay its debts. Notwithstanding borrowed public spending could be oriented to key sectors such as education, sci-tech and research and development (R&D), Kudrin keeps low on the prospect<sup>102</sup>. To him, inflation rate signals the need for a watchful course. In 2009, Russia saw the darkest side of the global financial crisis. Oil prices plunged along with prices of other major export commodities, such as metals (IEA, 2011, p. 332). Capital flows and investments were assessed of high risk, especially in the emerging markets, thus they were grimly decreased (IEA, 2011, p. 332). According to IEA's estimates, Russian revenues "from oil and gas exports fell by 40% in 2009 compared to the record levels of 2008" (IEA, 2011, p. 332). In terms of GDP, the experienced losses equaled 8%, while the budget deficit amounted to 6,3%, a fact starkly opposite to the recent past, where from 2000 onward, the Russian economy has been appearing successive budget surpluses (IEA, 2011, p.332).

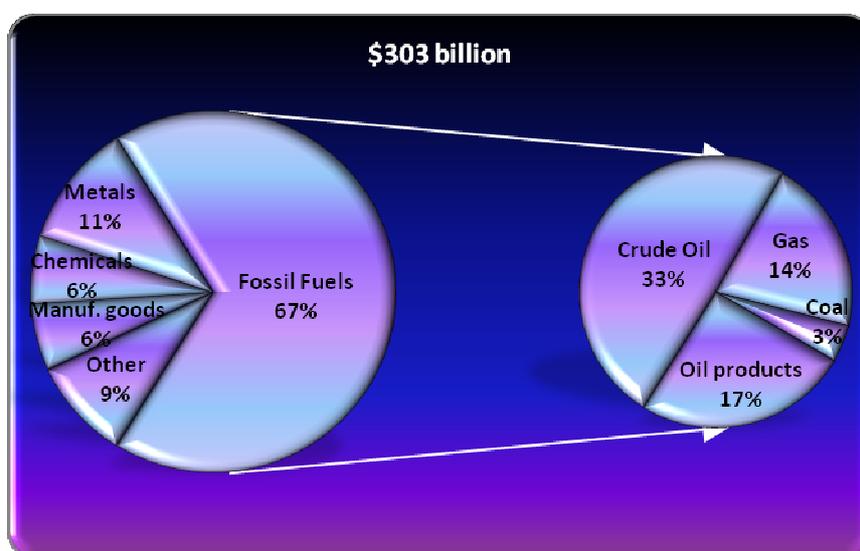


Figure 3.3: Structure of the Russian exports by value, 2009<sup>103</sup>

<sup>101</sup> Particularly the price of oil.

<sup>102</sup> Being under the protective umbrella of the Stabilization Fund, Russia currently prefers to cover its budget deficits borrowing from the international markets and keeping the fund's reserves intact (Nikolaev, 2011).

<sup>103</sup> This Figure has been remodeled strictly abiding by IEA's archetype, (IEA, 2011, p. 331).

Reading between the lines, the nebulous prospect of a “rentier state” suffering from “Dutch Disease” is still possible. The overly-emphasized issue of ‘inflation’ could easily be linked to the appreciation of the foreign exchange rate and the adverse affects for the competitiveness of the Russian products (Ebrahim-zadeh, 2003). Of course, the ‘damage’ and the irreversible course towards a “rentier state” would emerge when the national interest rate stood above the level of the international interest rate. This would deal a death blow to the traditional lagging export sector. All in all, a *protracted* budget deficit could crowd out private investments, widen the trade deficit and skyrocket debt. Development, if any, would come within a rather interdependent global context, where *autonomy*, no matter highly appreciated, would remain a rather elusive virtue.

In any case, the previous discussion shows that *autonomy* is equally important to modernization and diversification. Although PM Medvedev has been pushing ahead efforts for investment to innovative industries and research hubs such as Skolkovo, accession to the WTO, etc., at the same time, he has clarified that mutual respect and recognition of the other’s freedom (*-yvazat svobodny drougava-*) should be the governing principles of IR (Kouzmin and Cidibe, 2011; RIA Novosti, 2011; Panina, 2011).

All things considered, Russia has been very well aware of the dangers its natural resources endowment may hide. To buffer itself against those, it has been approaching western structures and developmental patterns seeking modernization and diversification, but not integration. High level of interdependence limits the *autonomy* of decision making. This point has been well exhibited in the debate over the budget strategy. A long-term reckless government spending may turn Russia into a “rentier state”, utterly dependent on the price of oil for repaying emerging debts. Therefore, it has been appearing determined to dispel the natural resources curse, maintain its autonomy and set its hands free in the energy trade. This would grant it the opportunity to use its natural resources as it has been seeing fit to each occasion. Consequently, the interplay between politics and economics should not be excluded in any occasion until proved otherwise.

### 3.5 Conclusion

This chapter serves as the necessary ‘antechamber’ before the research proceeds with the examination of the three main case studies. This is because it is explained how one actor/state can do politics *vis-à-vis* another actor/state using its natural resources/energy. More specific, there are explicit conditions which can render the conduct of energy politics feasible; first, it is the form of trade of a natural resource and subsequently, second, the power relations which are forged between the main trading partners. Focusing on the principal natural resources for the functioning of the global economy, we ascertained that natural gas is more susceptible to do politics with than the oil. In contrast to the latter which is fungible, the former is mostly traded via gas networks (pipelines), linking two actors, the supplier with the consumer -which could also be a transit state-, directly, and, thus, forming power relationships. These relationships fall into three categories, ‘Interdependence’, “Unilateral dependence” and ‘Interconnectedness’. The first implies a symmetric relationship where both actors are equally sensitive and vulnerable since they have equal means, in terms of energy trade, to press, one another. The second refers to an asymmetric relationship where while both actors are sensitive, only one is vulnerable to the actions of the other; the overly powerful actor is the one to impose its conditions, economic and political, on the other. Last but not least, the third denotes a balanced relationship with the two ‘free’ actors equally sensitive but not vulnerable, since they trade with no dependence involved.

In this manner, we substituted the terms ‘symmetric’, asymmetric’ and ‘balanced’ relationship that we referred to in the previous two chapters plus the introduction, for ‘Interdependence’, “Unilateral Dependence” and ‘Interconnectedness’, since the latter are currently considered much more apposite when analyzing energy politics.

However, conducting energy politics is a not-so-simple case, depending solely on the form of trade and the *de facto* power relationships. Russia, is the world’s leader as far as the natural gas reserves are concerned, while it also relishes a large share of the global oil and gas exports. Thus, it holds a key position in the Eurasian energyland, which if combined with the fact that the network (pipeline) form of natural gas trade dominates the region, make it a rather strong actor in the region. Nevertheless, all these could result in Russia being nothing more than being a paper tiger, unless the authorities guard against the menacing prospects of the ‘Dutch Disease’.

The latter underlines the fact that the natural resources endowment of a state can be a gift as well as a curse if not managed properly. The key-remedy to this disease is by keeping the fluctuation of the foreign exchange rate at bay. This may happen via: a) sovereign wealth funds, b) boosting the competitiveness via a market-rational national income policy, and c) restrictive fiscal policy. Russia has moved to all three directions and has showed its eagerness to adopt a restrictive fiscal policy which in combination with targeted and insightful investments in key sectors of the economy could lead, in the mid-long term, in the establishment of an economy of knowledge with diversified, innovative and of high added value products, able to endure, in terms of competitiveness, low (appreciated) foreign exchange rates. Consequently, a full-fledged economy would diminish the dependence on natural resources, opening-up the way for an autonomous international standing.

This perspective, while promising for Russia itself, it is alarming for its Eurasian energy partners, currently the FSU states, the EU and China, since it could allow the former to engage in an all the more assertive energy diplomacy, the less dependent it would become on energy export revenues. In light of this, it is now examined Russia's energy (natural gas) trade with its near abroad FSU states that form the nucleus of the Eurasian energyland.

## *Chapter 4: Russia in the FSU region: the cases of Ukraine and Belarus*

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### *4.1 The “near abroad” as “the lands in between”*

The term “near abroad” -ближнее зарубежье- was forged after the dissolution of the Soviet Union as an attempt to signify the special weight the newly-independent former Soviet republics would have in the Russian foreign policy at large and in the energy policy in particular <sup>104</sup>. Critical to the veracity of the aforementioned is the 1992 confidential document by the head of the parliamentary committee on foreign affairs, Yevgeny Ambartsumov, describing Moscow’s role in the FSU as “Russia’s Monroe Doctrine”. In particular:

“As the internationally recognized legal successor to the USSR, the Russian Federation must proceed in its foreign policy from the doctrine that proclaims the entire geopolitical space of the former [Soviet] Union the sphere of its vital interests (along the lines of the USA’s “Monroe Doctrine” in Latin America) and secure from the world community the understanding and recognition of its special interests in this space” (Solchanyk, 2001, p. 69).

As a result, Russia sought from the early years après the Soviet disintegration to reinstate its clout across the FSU in a way that would ‘finlandize’ their foreign policy while increasing its maneuverability (Tsakiris, 2010).

At present, considering the Eurasian energy triangle, the focus, at first, shifts to those FSU states that relish the status of the “lands in between” Russia and the EU, i.e. Ukraine and Belarus<sup>105</sup>. However, before engaging in the energy relations *per se*, it would be accommodating to view briefly the Russian political sensitivity towards these two states via a socio-historical perspective.

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<sup>104</sup> To be precise, the term “near abroad” was forged in the early 1990s by the then Russian Foreign Minister Andrei Kozyrev to designate a special “droit de regard” for Moscow in Central and Eastern Europe” (Martinsen, 2002, p. 2).

<sup>105</sup> The term “lands in between” signifies the Slavic states that had been integral part of the Soviet Union while geographically being European, fact that certainly added to their gravitation between their Soviet past and the lure to take part to the political-economic-military institutional arrangements of the West (White et al, 2010, p. 345).

Until the Soviet disintegration, neither Ukraine nor Belarus had ever existed as independent states within these borders while there was no tradition of consensus on what constituted their national identity (Stent, 2007). By-products of the Molotov-Ribbentrop pact that partitioned Romania and Poland, both Ukraine and Belarus developed intimate relations with the USSR first and subsequently Russia. However, the cultural imbroglio between Russia-Ukraine and Russia-Belarus runs deep in history. Always subjects of volatile geopolitical shifts, these states had been levitating between the East ('souther Rus') and the West ('Ruthenians') since 16<sup>th</sup> century.

Ukraine, having experienced only two brief periods of independence, in 1648 and 1917-1918, had always been absorbed by a neighboring empire. Between 1654 and 1795 "what are now Ukrainian lands were progressively absorbed into the newly-dominant empires of Central and Eastern Europe, namely the Russian and Austro-Hungarian empires" (Stent, 2007, p. 4). Likewise, in the beginning of the 20<sup>th</sup> century, even though Ukraine made an attempt to declare an independent People's Republic in January 1917, it finally ended up being liquidated by the Red Army and shortly after divided again between the then newly-formed USSR and Poland (Stent, 2007). Ultimately, as prior said, today's Ukraine, in geographic terms, has been drawn up only after the Molotov-Ribbentrop pact. To many Russians, Ukrainians do not constitute an alienate ethnic group but "little Russians" who descend from the Rus. This argument traces its roots back in the 1187 epic poem *Lay of Ihor's Host*, written in the old East Slavic language, and substantiates even today's struggle for the legacy of the Kievan Rus (Stent, 2007)<sup>106</sup>. Therefore, any Ukrainian attempt to redefine its historic past away from Russians is met with suspicion, if not distrust.

Belarus, although it followed the same, more or less, levitation between the East and West as Ukraine, its identification with the Russian *modus vivendi* was more fervent and fanatical. A striking example of that is the late dispute over the Belarusian language being either a self-standing verbal group or just a dialect of Russian (Stent, 2007). In any case, drawing on the recent Soviet history one could observe the level of the Belarusian assimilation to the Russian socio-political thinking. That fact lead to the assessment that "Belarus was less well prepared for independence than either Moldova or Ukraine and Russians are even less inclined to accept Belarus as a separate nation than are Ukrainians or Moldovans" (Stent, 2007, p. 7). In the same

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<sup>106</sup> The first Russian kingdom was established in the 9<sup>th</sup> century at the region of today's Kiev by Scandinavians who had come to intermarriage with Slavic tribes (Karagiannis, 2010, p. 19).

line of reasoning, traces of this interstate socio-political amalgamation can be spotted in a handful of integrative projects of the 1990s, atop of which is the treaty of 1996 creating the community of the sovereign states Belarus and Russia, based in Moscow (Deyermond, 2004). The implications of that as well as other projects are extensively visited further on, when the Russo-Belarusian energy relations come at the forefront.

Generalizing now on the developments après the dismemberment of the USSR, Ukraine and Belarus, as indeed the “lands in between”, have been transformed into a theater of diplomatic ‘wrestling’ between the EU and NATO, on one side, and Russia, on the other. While the EU has been pushing ahead with its “neighborhood policy” and NATO coveting extension of its activities to the East by membership of the FSU region, Russia begun to feel more and more alienated from a geopolitical space that it considered its own. Thus, it has been regularly accused by western states of trying to intercept the “western invasion” by flexing its energy and military muscles (e.g. gas cutoffs and the short-lived conflict with Georgia). Indeed, these accusations might not lack solid ground. Traditionally, Russia considered Eastern Europe a “security buffer” or a “cordon sanitaire” against the Western-Capitalist ‘invasion’ (Zubok and Pleshakov, 1996, p. 131; Tsakiris, 2010). Consequently, “high politics” dominated policies in the region with “low politics” holding a rather marginalized role, if any. Not until the collapse of the USSR and particularly the ascent of Vladimir Putin to the Presidency (2000) did economic-energy concerns start to be detectable in the Russian (foreign) policy making. However, this shift did not signal the sidelining of erstwhile politico-security concerns in favor of economic rationality.

On these grounds, currently, the ‘Neo-Neo’ debate seeks to explain the Russian energy policy at the FSU region and particularly in the state-linkages of the Eurasian energy triangle, Ukraine and Belarus. Examining, first, the dependence of these states on Russia and vice-versa so as to understand the relationship, we, then, proceed with the assessment of the means via which Russia has been seeking to guard and maximize its gains in the bilateral energy (natural gas) trade. Whether, however, these gains have been relative or absolute is shown in the end of the section, after the facts have been tested upon the ‘Neo-Neo’ theoretical platform<sup>107</sup>.

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<sup>107</sup> The indicators for the ‘Neo-Neo’ test draw on Albert Hirschman model, presented in page 46, that shows how a powerful nation (A) seeks to establish and guarantee its dominant position and relative gains in its commercial affairs with weaker neighboring states (B,C,D, etc.).

#### ***4.2 Russo-Ukrainian relations: interdependence at first***

To begin with Ukraine's energy status, striking is the high level of dependence on imported gas. With domestic production at 18-20 bcm/year, its overall consumption of 69-78bcm/year remains to be covered by Russian and Central Asian (Turkmenistan, Uzbekistan, Kazakhstan) imports (Pirani, 2009, p. 93).

Today's gas dependence traces its roots back in the early second half of the 20<sup>th</sup> century, when the development of the Soviet Union economy was primarily based on gas coming from Ukrainian fields (Pirani, 2009). In the 1950s, Ukrainian production equaled to a second of the overall Soviet output of 5-6 bcm/year, percentage that grew bigger in the 1960s with the tapping of the 'Shebelinka' deposit, only to culminate in 1975 at the optimum of 68.7 bcm/year (Pirani, 2009, p. 95). However, that over-exploitation soon exhausted the Ukrainian deposits, leading whole production to stagnate at the historic low of 20bcm/year. That was exactly the point that the Siberian fields gained prominence in the Soviet gas production, forging, at the same time, the Ukrainian dependence upon Siberian supplies. Therefore, when the Soviet dissolution became a *fait accompli*, Ukraine found itself overly dependent on imported gas. Indicatively, in 1992, the imported gas was as high as 81% (Pirani, 2009, p. 95). Ever since, the situation has roughly remained unchanged, with Ukraine transforming into the largest FSU gas importer, linked to Russian and Central Asian supplies. It would not be much of an exaggeration to tag the latter as 'Russian', given that the state natural gas monopoly Gazprom, owns the pipelines from the region and subsequently has a strong leverage on Ukraine's gas trade, if not the dominant<sup>108</sup>. So, hitherto, Ukraine has been portrayed as a unilaterally dependent consumer on Russian gas (directly or indirectly).

But, as earlier shown, Ukraine is also "the land in between" the Russo-EU natural gas relationship. Therefore, given the way that gas is traded, certain realities come in support of its bargaining with Russia<sup>109</sup>. Most of the gas pipelines from Russia to the

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<sup>108</sup> Elaborating on the Russo-Ukrainian natural gas trade, Ukraine has three sources of supplies: a) central Asia and mostly Turkmenistan (35-37bcm/y), b) Russia (20-25bcm/y) and c) domestic production (18-20bcm/y) (Pirani, 2007, p. 28). Turkmen gas can only reach Ukraine via Gazprom's pipelines (see also: Map 4.2 p.104).

<sup>109</sup> For the specifics on natural gas trade see pp.73-75.

EU, that built during the 1970s and 1980s, cross Ukraine<sup>110</sup>. These transit pipelines share the same storage infrastructure with those that supply the domestic (Ukrainian) market (Gotz, 2007, p. 152). Thus, a very strong link exists between the gas *en route* to the EU market and that for supplying the domestic market. Logically extrapolated, a cut off to the latter due to, for example, payment arrears could result in fluctuations of pressure in the gas destined for the EU market, since national authorities may have laid their hand in the common storage infrastructure to offset the missing gas at the expense of the EU customers (Gotz, 2007). Such was the case in the recent gas disputes between Russia-Ukraine in 2006 and 2009 and Russia-Belarus in 2004.

Ukraine's network carries about four-fifths of the Russian exports to the EU, let alone it has the biggest storage infrastructure after Russia (Pirani, 2009). Particularly, storage capacity reaches that of 34 bcm, while its location (in the western border of the country) near the 'heart' of the EU market, makes it an indispensable asset. On these grounds, Ukraine seems to have been standing in an advantageous position, able to exploit Russia's need for export revenues in order to keep its gas debt burgeoning. Therefore, its gravity in the wider context of the Russo-EU natural gas business is beyond any doubt.

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<sup>110</sup> Belarus and Poland, notwithstanding cheaper routes, had been marginalized as transit alternatives until 1999, when the Yamal-Europe pipeline was actually constructed (Gotz, 2007). Other pipelines via Belarus are examined in the following section.



Map 4.1: Existing oil, natural gas transport networks<sup>111</sup>

All things considered, Russia and Ukraine have been experiencing a high level of interdependence. The former needs the latter to reach lucrative markets (EU), while the latter needs the former to fulfill its domestic gas needs. However, this level of interdependence, had been proved rather detrimental all along the 1990s to both the economic interests of the Russian gas industry as well as the national wealth at large. Consequently, with Putin’s ascent to power in 2000 and the shift of energy business to pragmatism and economic rationality, Russia has put on a rather assertive face.

<sup>111</sup> Source: (EIA, 2010)

Determination to plough an energy furrow away from interdependence to unilateral dependence of Ukraine on Russia has been solid. Thus, the de-legitimization of the former's transit status as a leverage became the common denominator in a policy spectrum. Briefly, Kremlin moved to end the 1990s cycle of debts and barter swaps while pursuing, in parallel, price-adjustments according to the "European netback" principle<sup>112</sup>. Attuned with that, the, so far, highly politicized intergovernmental gas agreements have been sought to be replaced by pragmatic market deals, so as in the mid-long term the Kremlin to gain a position in the Ukrainian market and ultimately claim ownership of the domestic Gas Transmission System (GTS)<sup>113</sup> (Pirani, 2009).

So, the common denominator in the Russian energy policy *vis-à-vis* Ukraine since the 2000s has been: (a) demoralize Ukraine as a transit state, thus making it unilaterally dependent on Russia and (b) serve the relative gains and policy priorities of Russia, which, at times, involved political concessions in exchange for cheaper gas. Below, we elucidate the Russo-Ukrainian "*bras de fer*" as far as the natural gas trade is concerned.

#### ***4.2.1 Moving against interdependence***

##### ***4.2.1.1 The 1990s: a damaging era to the Russian interests***

Viewing interdependence from a financial perspective, certain asymmetries had plagued the Russo-Ukrainian energy trade since the early years of independence. The subsidy mechanism led to major financial disequilibria mostly at Russia's expense<sup>114</sup>. Specifically, according to Krasnov & Brada's analysis on the CMEA trade, this mechanism functioned as follows: "whenever trade prices diverge from those established by market forces, the trade flows include a transfer element. (Thus), if a certain import is underpriced relative to world market prices subsidization by the exporter of the importer results" (Krasnov and Brada, 1997, p. 827). Building on that logic, Krasnov & Brada estimated that the Russian subsidies to Ukraine via oil and

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<sup>112</sup> This principle refers to the European border prices minus transport costs, see Mitrova et al., 2009.

<sup>113</sup> Provided, of course, that Ukraine would not have diversified its gas supplies, remaining overly-dependent on Russian gas, fact that actually happened.

<sup>114</sup> This mechanism had been established by the CMEA (Council of Mutual Economic Assistance-COMECON) for the intra-Soviet trade and, *inter alia*, stipulated the underpricing of raw materials and energy and the overpricing of machinery. This practice of subsidization continued almost all the first decade (1990s) *après* the dissolution of the USSR.

gas prices at a fraction of the world prices for the period 1992-1995 amounted to \$10.625,93 million, whereas the Ukrainian subsidies to Russia via the charged transit fee for gas and oil exports to Europe for the same period amounted to \$2464 million (Krasnov and Brada, 1997, p. 830-831). Extrapolating these estimates, the Russian net gain from that subsidy mechanism amounted to:  $\$2464 - \$10.625,93 = \$ -8161,93$ . Therefore, the energy trade between the two states of the FSU region had been overtly contacted at Russia's expense. To make things even worse, Ukrainians, taking advantage of the transit leverage and the politicized nature of the gas trade in the 1990s, accumulated huge debts, mostly due to the non-payment of the deliveries<sup>115</sup>.

A U-turn on this damaging for Russia interdependence would have been the once and for all ownership of the Ukrainian GTS. Embedded within a "debt to equity" framework, Russia's policies sought from the early post-soviet years for strategic concessions as repayment for energy debts. While ownership of the Ukrainian GTS never ceased to be Russia's great expectation, this proved a rather difficult objective to accomplish. Severe domestic opposition posed an insurmountable stumbling block in any arrangement providing for concessions. Typical on the issue were the negotiations in 1993-1994 between the Russian government and the Ukrainian President Leonid Kravchuk over swapping the gas debt for Ukrainian gas assets. Particularly, the 1994 intergovernmental agreement stipulated, *inter alia*, that Gazprom could "participate in the privatization of enterprises in the gas and other sectors in Ukraine, in accordance with Ukrainian legislation" (Pirani, 2007, p. 20).

Aligned with this were also the following two intergovernmental arrangements, in March 1994, granting Gazprom 51% stake in the Ukrainian GTS and in 1995, providing for the formation of a Russo-Ukrainian Joint Venture (JV) (Haztranzit) to own and handle the transit of Russian gas via Ukraine (Krasnov and Brada, 1997).

All these *political* arrangements met, as earlier said, with such a fierce domestic discontent and mistrust that, in November 1995, took the form of a legislative ban against any attempt towards privatization of oil and gas assets (Pirani, 2007). Therefore, given that irremovable obstacle of the Ukrainian parliament ("Верховна Рада України"), Russia confined herself to the pursuit of strategic concessions not

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<sup>115</sup> For the debts of this period see: Krasnov Gregory V. and Brada Josef C. (1997), "Implicit subsidies in Russian-Ukrainian Energy Trade", *Europe-Asia Studies*, Vol. 49, No.5, pp. 825-843.

directly linked to the energy sphere, such as the naval base at the black sea port of Sevastopol<sup>116</sup>.

However, these trade-offs did not add much to Russia's priority towards curbing interdependence. As long as no ownership of the Ukrainian GTS was accomplished, economic losses for the Russian side grew bigger. Consequently, other ways had to be employed which would 'oxidize' Ukraine's bargaining position as a transit state. The role of natural gas intermediaries was crucial to that direction. The hidden logic behind gas intermediaries was to have (central Asian) natural gas shipped by a *prima facie* not affiliated to Gazprom private company, capable of cutting off supplies to Ukraine without risking retaliation like Gazprom did<sup>117</sup> (Guillet, 2005). To put it in a more laconic way, dissociate gas supplies for Ukraine's domestic market from European transit.

The first such scheme to emerge in the bilateral natural gas trade was the offshore company 'Itera' in 1994, headed by the Turkmen Igor Makarov<sup>118</sup>. Theoretically, Itera was an independent Turkmen gas producer, which was supposed to deliver its gas to Ukraine and pay the transit fees to Gazprom<sup>119</sup>. Such a 'tale' was an easy case for Gazprom to make up, given Turkmenistan's weak bargaining position once export dependent on Russian pipelines<sup>120</sup> (Guillet, 2005). That figment, however, served well

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<sup>116</sup> The first time in the post soviet years that such arrangement was conducted was in the summit conference of Massandra at Crimea, when the then Russian President Boris Yeltsin proposed a swap of the gas debt for control of the Black Sea fleet and Ukraine's nuclear warheads, see: Pirani, Simon (2007), *Ukraine's gas sector*, Oxford: Oxford Institute for Energy Studies, p.19.

In April 2010, it was the second time that similar arrangement was signed between the Russian President Dmitry Medvedev and his Ukrainian counterpart, Viktor Yanukovich. This case is visited later on.

<sup>117</sup> Intermediary companies had usually emerged from scratch, having their ownership structure hidden behind sophisticated networks of offshore holding companies, trusts and nominee directors (Global Witness, 2006, p. 5). Therefore, the disclosure of any official link to Gazprom was nothing more than an elusive dream. Their main task was to ship Turkmen gas via Gazprom's pipelines to Ukraine, paying probably to Gazprom the transit fees. It is also reminded, here, that Ukraine has had three gas supply sources: a) central Asia and mostly Turkmenistan (35-37bcm/y), b) Russia (20-25bcm/y) and c) domestic production (18-20bcm/y) (Pirani, 2007, p. 28). Turkmen gas can only reach Ukraine via Gazprom's pipelines.

<sup>118</sup> As Makarov put it in an interview "The agreements were win-win for all parties, as Turkmenistan needed a market to export its natural gas, Gazprom preferred to sell its natural gas to more profitable markets in Europe and the FSU region was in need of a reliable energy resource. Itera was able to fulfill the region's needs and provide energy security at a critical period of economic and political development" (ARCCI Business Report, 2002, p.12).

<sup>119</sup> Itera was also assigned part of Gazprom's FSU region gas trade, i.e. Uzbekistan, Kazakhstan, Belarus, see: Pirani, Simon (2007), *Ukraine's gas sector*, Oxford: Oxford Institute for Energy Studies, p.38.

<sup>120</sup> The reason for the use of the word 'tale' has to do with the illogically gigantic enlargement of the company's assets from 1994 that was registered by Makarov in Florida to 2001 when the Itera Holding, part of the Itera Group was occupying 8,000 employees in more than 130 subsidiaries (Global Witness, 2006, p. 34). A tangible explanation for this enlargement should be sought in the gluttonous

only to the benefit of the few, disregarding the public interest of the people of the two states. On one side, Gazprom indeed reduced its deliveries to Ukraine to 25-30bcm/year, volume that equaled to the transit tariff for the EU-destined gas exports payable in kind (barter) and did not incur new Ukrainian debts, while it collected the transit fees for the transport of Turkmen gas to Ukraine by ITERA<sup>121</sup> (Global Witness, 2006; Guillet, 2005). On the other side, nevertheless, ITERA had heavily profited at the expense of Gazprom, if considered special concessions made by the Russian state and company<sup>122</sup>. Therefore, with ITERA at play, the extra value of Gazprom gas had been siphoned off from its coffers as well as the state budget. So, what finally Gazprom achieved with the 'ITERA' strategy, if anything, was highly questionable. That is because the lessening of Ukraine's transit leverage, came at the illogical cost of giving away not only the Ukrainian gas market at large but also more than 50% of its own gas markets in the FSU region (Global Witness, 2006, p. 35).

Now ITERA *per se*, exploiting the barter payment method of the time, stood to gain a lot from its involvement in the natural gas trade<sup>123</sup> (ARCCI Business Report, 2002, pp. 12-13). Earned loots, either money, goods or ownership of local production assets, were to be shared by the parties involved, i.e. Ukrainians, ITERA's owners, Russians and Turkmens (Guillet, 2005).

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concessions made by the Russian state and the company during the period of its employment, see footnotes 118-119.

<sup>121</sup> According to the 1998 agreement between Gazprom and the then newly fangled state gas company Naftogaz Ukrainy, the two sides had consented to tie together supply and transit, stipulating that Gazprom would pay for the transit of Europe-destined gas with volumes of gas (barter trade), while gas prices and transit tariffs would be in sync (Pirani, 2007, p.21).

<sup>122</sup> To many pundits, Itera's affiliation to Gazprom was to be attested by a series of events typical of the period, i.e. the nebulous offshore ownership structure, special concessions by Gazprom and the Russian government such as cheap production assets, a share of the central European export market, prerogative access to the Russian-owned central Asian transit pipelines, etc. (Pirani, 2007, p.39; Guillet, 2005). Particularly, according to Hermitage Capital it is estimated that from 1996 to 2002 Gazprom surrendered over 50% of its gas markets in the former Soviet Union to Itera (Global Witness, 2006, p. 35). All these were more than enough to give ground to suspicions on Itera used to strip state assets in favor of well-connected unnamed owners, possibly including Gazprom managers. The latter stands on solid ground if considered that when the once President of Gazprom Viktor Chernomyrdin (1989-1992) and subsequently Prime Minister of Russia (1992-1998) inaugurated his own political party under the name "Our home is Russia" (1995), many analysts resorted to puns substituting the world 'Russia' for the world 'Gazprom', thus making "Our home is Gazprom" (Aris, 1999). This paraphrasis served to underline the economic-political imbroglio during the 1990s that functioned only to the benefit of the few, well-connected individuals.

<sup>123</sup> When Makarov asked how ITERA managed to make profit from the cash-strap FSU region of the time, he replied that "Through a sophisticated and highly developed barter structure, Itera managed to solve a number of hard currency problems characteristic of these countries. We managed to arrange profitable business in struggling markets. It is ITERA's "know how", if I may say so" (ARCCI Business Report 2002, pp.12-13).

As obvious, in this type of business, it “takes two to tango”. Natural gas intermediaries would not have flourished if it was not for the Ukrainian corruption as well. Therefore, ITERA, cashing on the rife corruption during Leonid Kuchma’s presidency (1994-2005) and the ‘half-done’ reform attempted with the Gas Trading Concession System, established trade links with private gas companies controlling downstream business, while since 1996, it served not only as shipper and importer but also as major domestic wholesale trader<sup>124 125</sup>. This potent presence in the Ukrainian market (the industrial sector included) enabled it to capitalize subsequently on debt-for-equity swaps, operating as “Trojan horse” to the benefit of its owners. Industrial assets and mega-profits soon accumulated in the coffers of the offshore company.

#### ***4.2.1.2 The 2000s and the assertiveness of ‘putinized’ Russia***

The rise of the new millennium found energy business at a new crossroad. Putin’s ascent to power came to graft statism with pragmatism. Politics and business were onward to walk hand in hand. Alexei Miller, one of Putin’s close associates, was appointed at the helm of Gazprom management with the mandate to centralize control of revenues. Past concessions to ITERA were to be revoked in a bid of strengthening both the company (Gazprom) and the state. However, centralization of financial control did not signal the end of intermediaries as a means of dissociating supply from transit in the case of Ukraine. On the contrary, it denoted the alignment of the terms of their use with the interests and policy priorities of the company and the state. All these set the stage for the replacement of ITERA by Eural Trans Gas (ETG) in the transit of

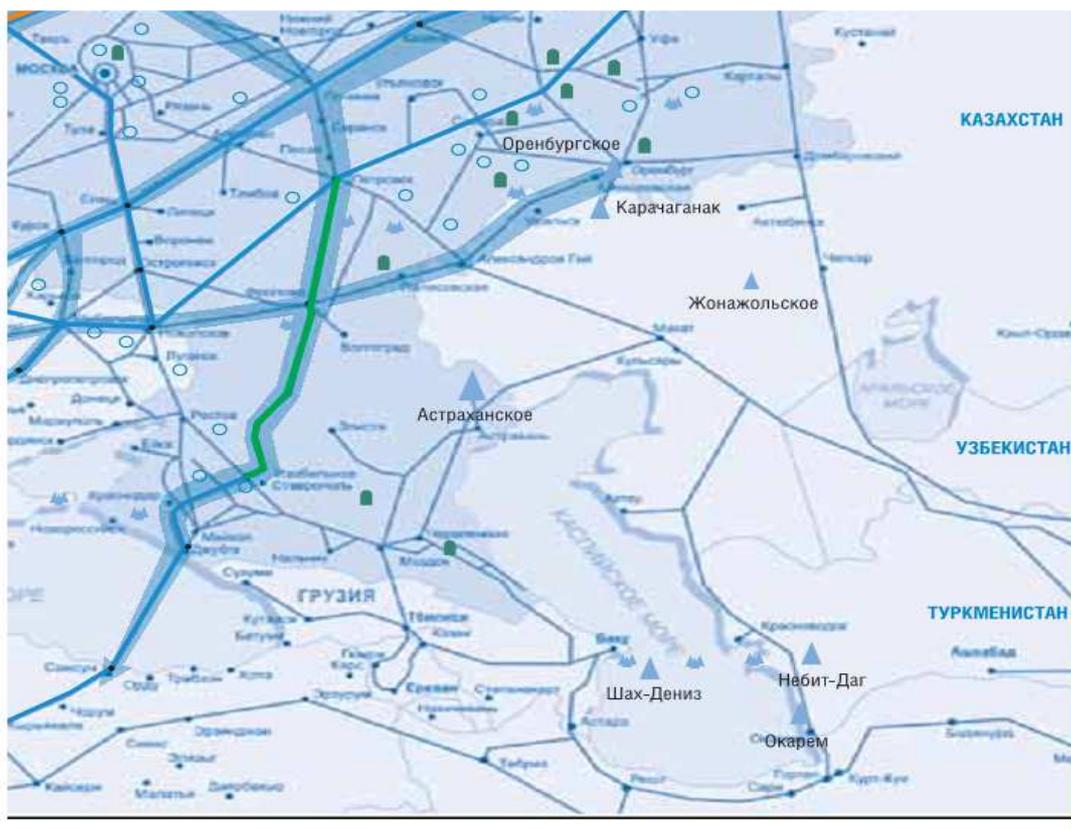
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<sup>124</sup> In April 1996, Leonid Kuchma’s presidency, backed by international financial institutions, initiated the Gas Trading Concession System in an effort to stop the accumulation of sovereign debt to Russia and reform the gas market. Theoretically, according to this system, selected gas traders would be awarded exclusive rights on gas import and sales over specific areas in Ukraine, with the concurrent unbundling of supply from transmission and distribution (Pirani, 2007, p.20). This ailing scheme, instead of liberalizing the gas market, as initially planned, swell corruption and ended up in a “cartel of wholesale traders” (Pirani, 2007, p. 20). These traders very soon took advantage of their position and exploiting pending payment arrears of various business groups, engaged in debt-for-equity swaps to strengthen their position in the Ukrainian industrial sector. Of course, major beneficiary of this Gas Trading Concession System was also ITERA, which in 1996, was not only shipper and importer of Turkmen gas to Ukraine, but also a wholesale trader (Pirani, 2007, p.21).

<sup>125</sup> During Leonid Kuchma’s presidency, energy market offered abundant rent-seeking opportunities. Noteworthy is the system of selective payments for the gas of private companies by the expenditures of the state budget. (Balmaceda, 2010). This system explains a series of events such as the crumbling of the Gas Trading Concession system into a “cartel of wholesale traders” as a result of fierce competition for the ‘paying’ gas contracts, Itera’s choice to do business only with lucrative contract-holding private gas companies etc. Of course, no need to mention how all these functioned at the expense of the Ukrainian citizens.

Turkmen gas to Ukraine. What is even more striking to note is the close relationship of ETG’s head, Ukrainian businessman Dmytro Firtash, with ITERA’s head, Igor Makarov (Pirani, 2007, p. 39).

Briefly noted, the switch in intermediaries came as a result of changes at the Russian domestic level. The centralized Gazprom was onward to claim its transit fees from a person (Dmytro Firtash) that had previously proved his ‘knack’ towards ensuring payments. The breaking point, however, with the ITERA period is that no other valuable assets had been conceded to ETG aside from transit. Thus, Turkmen gas was onward bought by Ukraine’s newly-fangled national gas monopoly “Naftogaz Ukrainy” at the Turkmen border, then sold to ETG for shipping and then re-bought by Naftogaz Ukrainy at the Russo-Ukrainian border, after transit fees had been paid to Gazprom. Evidently, this trade scheme, while fulfilling Gazprom aim of dissociating central Asian from European transit –since no formal Gazprom involvement could be traced-, it mostly came to the detriment of Ukrainian people, if considered the mark up to the gas prices due to the profit addendum to the fix-cost of the transit fees.



Map 4.2: Russia's central role in transporting Central Asian natural gas westwards<sup>126</sup>

<sup>126</sup> Source: (Gazprom, 2005, p.45).

As apparent, Putin's politico-economic pragmatism would not alter any of the energy policy priorities *vis-à-vis* Ukraine. What it would change, however, was the policy mix, with rising economic strangling to open up the way for politico-strategic concessions.

Ownership of Ukraine's GTS never fled the political foreground. In June 2002, an anew effort by the presidents of the two states brought consent to an "international consortium" for refurbishing and operating the transit network (Stern, 2006). This consortium would also provide for third party involvement, i.e. German participation. Gazprom, from the outset, in a bid of candidness, pressed for assuming control of the transit system on a concession basis (Pirani, 2009, p.115). President Kuchma initially endorsed such a concession, only to later recline in the face of fierce domestic opposition. Finally, the whole issue reached an impasse, with Putin's 2006 proposal for a swap of upstream Russian assets for control of Ukrainian downstream bumping into a new prohibitive legislative act, unequivocally stipulating the Ukrainian ownership of the GTS<sup>127</sup> (Pirani, 2009, p. 115).

All along the period of his 2000s ruling, however, as President first and subsequently as Prime Minister, Putin did not see the energy relations through rose colored spectacles. He knew very well that ownership of the GTS would not come that directly. Thus, he continued the strategy of 'oxidizing' Ukraine's transit leverage, but this time in a more methodical and target-oriented manner. Explicitly, having kept the gas intermediaries at play in order to maintain the dissociation of Ukrainian supplies from the EU transit, thus no justification for Ukraine to disrupt the latter once faced with payment arrears, he would push for the principle of economic rationality in the gas trade. Soon, Ukraine would accumulate debts and then the intermediaries, acting as "Trojan horses" at Russia's behest, would spearhead the effort at quashing Ukraine's sovereignty. So, reading between the lines, economic rationality and economic stifling were two sides of the same coin in Putin's strategy *vis-à-vis* Ukraine.

Following now the flux of events, the 'economization' of the bilateral energy trade traces its roots in 2000. Then, Gazprom net revenues increased 63% compared with 1999, due to both higher gas prices for the EU sales resulting from higher world oil prices and increase of the volume of gas supplied to the EU states aligned with the

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<sup>127</sup> Putin, in his 2006 suggestion, counted on the then newly-formed government by the pro-Russia Party of Regions, headed by Victor Yanukovich.

long-term contracts (Gazprom, 2000, p. 21). These facts led to a rapidly-widening gap between the European and FSU region gas prices, which, in turn, portrayed more vivid the losses yielded from the FSU region trade.

**Table 4.1: Gazprom average natural gas export price/bcm (2003-2004)<sup>128</sup>**

	2003	2004
<i>Europe: Volume of export, mcm</i>	132,9	140,5
<i>Average price/bcm, US \$</i>		
<i>Western Europe</i>	134,09	139,59
<i>Eastern Europe</i>	126,18	133,43
<i>FSU: Volume of export, mcm</i>	47,12	47,12
<i>Average price/bcm, US \$</i>		
<i>Ukraine</i>	50,87	50,87
<i>Belarus</i>	50,87	50,87
<i>Moldova</i>	50,87	50,87
<i>Kazakhstan</i>	50,87	50,87

The realization of such a damaging for Gazprom interests situation laid the groundwork for market principles in the energy trade, away from intergovernmental agreements, politics and barter payments. The push for European netback prices (i.e. European border prices minus transport costs), started to gain momentum from 2000 onward, only to be crystallized in Gazprom 2005 Annual Report, when it was clearly stated that the company was in pursue of a policy that would balance the FSU region gas price levels with those of Western Europe (Gazprom, 2005, p. 55).

Meanwhile, in summer 2004, Gazprom and Naftogaz Ukrainy tried to reach a settlement on past gas debts (period 1997-2000) as well as on the issue of the transit of central Asian gas to Ukraine<sup>129</sup>. That settlement would, *inter alia*, include “a single advance payment [by Gazprom] of \$1,25bn to Naftogaz of the Ukraine as payment for the transit of 19,2Bcm of gas via the Ukraine over 2005-2009. Said advance payment will make it possible to fix \$1,09/mcm/100km as a gas transmission tariff between

<sup>128</sup> Source: (Gazprom, 2004, p. 44-47).

<sup>129</sup> In 1998, Gazprom charged the Ukrainian side with illegally diverting from the transit pipelines gas destined for the EU markets. The claimed debt for these actions was as high as \$1,6bn (Stern, 2006, p.35).

2005 and 2009” (Stern 2006, p. 37). Following Jonathan Stern’s analysis, this advance payment would allow Naftogaz Ukrainy to pay off past debts and also set up a new framework for deliveries of Turkmen gas to Ukraine and transit of Russian gas to the EU (Stern, 2006, p. 38). Obviously, a shift from the barter trade towards economic rationality seemed to have already been underway<sup>130</sup>. However, Putin’s administration would not content itself with that initial agreement. It would parallel engage in other, covert ways to further embolden and strengthen the Russian relative advantage *vis-à-vis* the Ukrainian one.

A new intermediary, RosUkrEnergo (RUE), was registered in Zug, Switzerland on July 22<sup>nd</sup>, 2004 (Global Witness, 2006). While being in the same trajectory with its predecessors, ITERA and ETG, it differed in a critical point, the ownership structure. Now the Russian side participated in the business with a 50% share. The other 50%, reflecting the “Ukrainian side”, was mostly held by Dmytro Firtash (45%), former owner of ETG and major accomplice to ITERA’s arrangements in the Ukrainian gas market. However, that ownership structure was not so clear-cut as presented here. Opaque offshore schemes were to continue to guarantee the nominal dissociation of central Asian transit (i.e. Ukrainian gas supplies) from European transit<sup>131</sup>.

Being the byproduct of a Yalta meeting between Putin and Kuchma, RUE stood to symbolize the assertiveness of the centrally revamped Russian state. This is how: while, at first, ITERA (1996-2002) had served as “Trojan horse” at the hands of the few, then, the ‘*putinized*’ Gazprom set priorities differently. It initially put out of business the detrimental for the Russian state ITERA and exploited itself the latter’s former accomplice, then ETG’s head (2003-2004), Dmytro Firtash, to get just its transit fees. Soon, this cooperation was upgraded to a new JV, RUE (2005-2009), which functioned as a new “Trojan horse”, this time, at the hands of the Russian state. This case is further illuminated later on, when, after the bilateral gas dispute of 2006, RUE was accrued profitable zones in the Ukrainian gas market. In a word, ‘*putinized*’

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<sup>130</sup> All along 1990s till mid 2000s, Russia paid for the transit fees of gas exported to Europe with gas instead of hard currency. Then, Ukraine supplemented the rest of its energy needs with Turkmen gas. That was the core of the barter energy trade between Russia and Ukraine.

<sup>131</sup> The Russian side was represented by ARosGas Holdings, which on behalf of Gazprombank owned 50% of RUE shares. The Ukrainian side was represented by the company Centragas registered in Vienna. This company was held by Raiffeisen Investments AG (RIAG), which, in turn, was fully owned by RZB. As later revealed, the hidden Ukrainian beneficiaries behind these opaque offshore schemes were the former owner of ETG Dmytro Firtash (45%) and Ivan Fursyn (5%), a banker from Odessa (Kupchinsky, 2009a, pp.7-9).

Russia played Ukrainian corruption to its benefit, making the dictum “Plus ca change, plus c’est la meme chose” a perfect fit to the Ukrainian state of affairs.

The road to economic rationality/ strangling of Ukraine would gear up after the December 2004 “Orange Revolution”. That event set the stage for the succession of the pro-Moscow President Leonid Kuchma by the west-leaning Viktor Yushchenko and the appointment, in February 2005, of the gas trader and former energy minister, Yulia Timoshenko, at the Prime Ministership. Atop the priorities of the new administration (Timoshenko’s in particular) was to eliminate murky trade schemes (gas intermediaries) devised by Gazprom and Kuchma’s energy officials (Pirani, 2009). A benign assessment of Timoshenko’s priority could trace a genuine shift in the Ukrainian *modus operandi* away from blackmailing for free energy supplies using transit as leverage. Certainly, a step toward market principles. However, two plausible questions arise here: first, did Ukraine have the economic robustness to adjust to European netback gas prices and stop using the transit blackmail? Second, would Russia drop this sophisticated and lucrative trade scheme, once she held sway over it? As the first gas crisis of January 2006 showed, neither question could be answered affirmatively.

Expediting the collision course up to January 2006, the Russian Duma, at first, voted unanimously, in July 2005, the alignment of the FSU area gas prices with the ‘world’ (i.e. European) ones, starting from January 2006<sup>132</sup> (Stern, 2006, p. 41). The economic strangling was to become even more choking when in December 2005, Gazprom announced that it had contracted for all available quantity of Turkmen gas for 2006, i.e. 30bcm at a price of \$65/mcm, thus, leaving Ukraine as well as its gas contract with Turkmenistan for the period 2002-2006 hanging high and dry (Zhukov, 2009).

No doubt, ‘*putinized*’ Gazprom was now at the commanding heights. Controlling directly Turkmen gas supplies (and not only via the pipeline monopoly) and having intermediaries at play so as to dissociate central Asian (destined for Ukraine) supplies from European transit, it was in a perfect ‘shooting’ position. Thus, in the last days of 2005, President Putin, acting in tandem with the business sector, shored up Gazprom demand for European gas prices (\$230/mcm) from 2006 in the bilateral trade, unless an equity stake to the Ukrainian GTS was to be conceded (Stern 2006, p. 42).

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<sup>132</sup> Aligning also with Gazprom instigation for equalizing FSU region and Western Europe gas prices. See p. 106, second paragraph.

Subsequent intransigent and fruitless bargaining led Gazprom to cut off supplies to Ukraine on January 1, 2006, at 10.00 am Moscow time.

#### ***4.2.2 Quashing interdependence I: the Agreement of January 4, 2006***

The January 4, 2006 agreement was the first to be brokered strictly on market principles, away from any broader intergovernmental arrangement. The incumbent asymmetry of power, always measured at this research in energy terms, served the utmost to the Russian relative advantage<sup>133</sup>.

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<sup>133</sup> The onerous for Ukraine nature of the January 2006 agreement traces its roots, above all, to the powerful position of the newly centralized Gazprom vis-à-vis Ukraine. As a token of this asymmetry of power, when in the fall of 2005, Ukrainians threatened to use the transit leverage to intercept Russian assertiveness, Gazprom responded saying that it could rollover the problem of unsanctioned removal of gas to the EU customers, by transferring the spot of gas sales to the Russian border instead of the Ukrainian. Additionally, if instead of removing gas, Ukraine chose the path of raising transit fees of Russian gas exports to Europe, Gazprom still had the final say by equally increasing the transit fees of Turkmen deliveries to Ukraine, given the ownership of the pipelines (Stern, 2006). Explaining the rationale behind the first argument mainly, before 2006, when barter trade was rife, gas supplies to Ukraine and the rest of the FSU countries were defined by intergovernmental agreements upon which annual contracts were signed to regulate gas prices, transit volumes and transport tariffs. Pursuant to these contracts, 84,9% of gas supplied to Ukraine, in 2004, was treated as payment for transit fees (Gazprom, 2004, p.48). Therefore, given Ukraine's domestic consumption (see footnote 108), the only amount remained to be paid for was the 15,1% of the supplied gas. No doubt, this scheme heavily benefited Ukraine and therefore it would go at any lengths, as the January 2006 agreement portrayed, to keep it afloat, away from market principles.

All things considered, both these arguments summarize the Russian relative advantage and the Ukrainian submissiveness in the 2006 arrangement. Also, viewing things from another angle, the fact that Russia did not resort to any of the aforementioned alternatives to end interdependence meant that logistical as well as politico-strategic considerations had been at play as well. The latter is substantiated later on, with the April 2010 Black Sea Naval base agreement.

*The Agreement of January 4, 2006*

1. Gazprom will pay \$1,60/mcm/100km as transit fees to Naftogaz Ukrainy for the shipping of its gas to the European market. This price will last until 01.01.2011
2. In the sector of supplies, RosUkrEnergo will assume gas deliveries to Ukraine from 01.01.2006. Gazprom will not deliver any Russian gas to Ukraine while Naftogaz Ukrainy will not export via its territory any Russian gas received
3. For the marketing of gas in Ukraine, RosUkrEnergo and Naftogaz Ukrainy will form a JV, no later than 01.02.2006, which will assume this and other activities
4. The sides concluded agreements with the purpose of determining the annual gas balance for RosUkrEnergo, which as of 01.01.2006, will consist of:

Purchases:

- a) 41bcm of Turkmen gas, purchased from Gazexport (Gazprom Export) and Naftogaz Ukrainy,
- b) Up to 7bcm of Uzbek gas, purchased from Gazexport (Gazprom Export) with the purpose of being exchanged with Russian gas delivered to the Caucasus states
- c) Up to 8bcm of Kazakh gas, purchased from Gazexport (Gazprom Export) with the purpose of being exchanged with Russian gas delivered to the Caucasus states
- d) Up to 17bcm of Russian gas to be purchased from Gazprom at a price calculated on the base price for gas (Po=\$230/mcm)

Sales:

- e) In the first half of 2006, 34 bcm of gas will be sold at the price of \$95/mcm at the Ukrainian domestic market by the JV to be formed according to the Section 3 of the current agreement, without any re-export right.
  - f) In 2007, up to 58 bcm of gas will be sold by the JV to be formed according to the Section 3 of the current agreement, without any re-export right.
  - g) 15bcm of gas will be exported according to Gazexport (Gazprom Export) program.
5. The stipulated transit fees as well as the price of natural gas are subject to change only after mutual agreement by the parties. (Ukrainskaya Pravda, 2006)

The two sides of Putin's gas 'coin', i.e. economic rationality = economic stifling, had been well addressed by the aforementioned agreement. As its provisions reveal, the Russian side not only succeeded in ending the post-Soviet gas-for-transit barter system but also increased its revenue prospects by penetrating a neighboring market and principally its most lucrative sector, i.e. the industrial.

Tracing now the relative advantage provision by provision, the first in order stipulates that Gazprom would pay, from 2006 onward, *in cash* the transit fees for the shipment of its gas to European customers. No Russian gas would be offered in exchange for transit services, thus putting an end to the barter system. Pursuant to that, the next provision, aligned with the hitherto logic of intermediaries, assigned to RosUkrEnergo gas deliveries to Ukraine, thus guaranteeing the nominal dissociation of central Asian transit from the European one.

However, the *prima facie* economic rationality of the agreement was only half the intention pursued. Economic suffocation of Ukraine, as byproduct of the widening asymmetry of power, was the other half.

As earlier shown, Gazprom, having barred Ukraine from direct Turkmen supplies for the first half of 2006, had notably eased the Russian bargaining position toward the following goals<sup>134</sup>. First, permanent suspension of direct access to Turkmen gas. As stipulated in provision 4a, Turkmen gas exports were onward to be assigned to Gazprom Export for resale to the transit company RosUkrEnergo. This would entail further mark-ups to the price for the Ukrainian end-consumer, given the existence of two intermediaries (Gazprom Export and RosUkrEnergo) and their profit margins, in the otherwise direct Turkmen-Ukrainian trade with the sole involvement of Gazprom for receiving its transit fees. Second, according to the provision 2, the state-monopoly Naftogaz Ukrainy would be deprived of re-exporting any Russian gas received, thus terminating another source of revenues and further deteriorating its already waning bargaining weight<sup>135</sup>. Finally, provision 3 came to crystallize the Russian upper hand in the agreement, by stipulating the creation of a JV by RosUkrEnergo and Naftogaz Ukrainy, 'Ukrغاز-Energo', so as to assume the domestic gas marketing<sup>136</sup>.

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<sup>134</sup> The cessation of the Turkmen-Ukrainian direct relationship was a strong bargaining chip for the following reason. Until 2005, all gas contracts signed by the government of Turkmenistan stipulated payments in hard currency and in barter (usually on 50%-50% basis). This allowed Naftogaz Ukrainy to stay afloat for a long time despite deficits in its trade balance. Particularly, the barter system opened a window of opportunity for misuse. As stated in a report by Global Witness "many aspects of barter can be exploited, which, when combined, produced an opaque and chaotic system of payments for gas and other natural resources. For example, instead of tangible products, construction contracts and services such as technical assistance are often rendered as part of barter deals. The value of such work is hard to quantify, and construction contracts are open to inflated pricing" (Global Witness, 2006, p.26). Ukraine stood to benefit a lot from such schemes since it used to pay for Turkmen gas with overpriced goods and services. Therefore, more gas than what it was paid for could cover not only for the needs of the mostly non-paying domestic market but also be re-exported in Central-East Europe, at world prices, generating sizeable profits. As Turkmen President Niyazov argued, these Ukrainian barter schemes were a "mechanism for swindling" (Global Witness, 2006, p.27). This note partly explains how Russia by cutting direct Turkmen supplies to Ukraine could stifle the latter's economy and dictate its terms in the January 2006 agreement.

<sup>135</sup> The re-export of Russian gas as well as the subsequent large revenues for Naftogaz-Ukrainy follow the same logic as the Turkmen-Ukrainian barter system in reverse (see footnote 134). Explicitly Naftogaz was being supplied Russian gas as of 2004 at \$50,87/mcm and re-exported it to Europe at world prices, i.e. \$136,51/mcm on average (see Table 4.1). Consequently, there was a revenue inflow of approximately \$85,64/mcm.

<sup>136</sup> Ukrغاز-Energo would be primarily managed by the Firtash group. Moreover, its dominant position would be further emboldened after September 2006, when in the wake of the election success of the pro-Russian Party of Regions and the new government by Viktor Yanukovich, Yuri Boiko, a former Naftogaz CEO and Firtash's intimate friend would assume the energy ministry (Pirani, 2009, p. 103). RosUkrEnergo as well as Ukrغاز-Energo would add much to the debt-laden Naftogaz Ukrainy and concurrently to Ukraine's public debt, if considered the pre-2006 Naftogaz Ukrainy's business model "of subsidizing cheap gas for residential and public sector customers with sales of imported gas to industry and central Europe" (Pirani, 2009, p.104). So, here becomes even more apparent what had

Particularly, in 2006, Ukgaz-Energo would become the wholesale supplier of the one and only well paying sector of the Ukrainian economy, i.e. industry, with 34bcm at \$95/mcm (provision 4e), while from 2007 and 2008 it would monopolize the market, pumping 58bcm at \$130/mcm and \$179,50/mcm respectively (Pirani, 2009).

All things considered, ‘putinized’ Russia’s concerted efforts at destabilizing and debt-loading Naftogaz-Ukrainy seemed to bare fruits. Ukraine, brought down now to its knees, had little bargaining maneuverability, if any. Russia’s newly devised “Trojan horse” was ready to capitalize on the most lucrative part of the Ukrainian economy. Playing the card of the Ukrainian domestic corruption to its own benefit, Gazprom relished a shareholding in both RosUkrEnergo (50%) and Ukgaz-Energo (25%, logically extrapolated). Of course, the gas price demanded before the January 2006 crisis, i.e. \$230/mcm, might not have been reached instantly, however, the large concessions made in the Ukrainian gas market could make up for the slow pace of alignment with the European level prices<sup>137 138</sup>. The bottom line is that Gazprom had managed to transform itself from just an interdependent, blackmailed and at most times, non-paid shipper of central Asian gas to Ukraine, to a downstream ‘hidden’ wholesale trader, able to spearhead and maximize the Russian politico-economic interest at any convenient occasion.

#### ***4.2.3 Quashing interdependence II: the February 2009 agreement***

Since January 2006, political dynamics in Ukraine changed to forge new realities. Yulia Timoshenko returned to the prime Ministership in December 2007, after a year interval by the pro-Russian Viktor Yanukovych. As earlier said, Timoshenko was averse to both the existence of economy-damaging gas intermediaries as well as their siphoning profits off the national coffers. Therefore, after having conceded to the pro-European import gas price of 2008 at \$179,50/mcm, she fervidly fought the transit

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been earlier claimed that ‘putinized’ Russia had bet on the card of the Ukrainian domestic corruption to corrosion, in the mid-long term, the Ukrainian sovereignty.

<sup>137</sup> Here, someone should also consider the prospect of gross profiteering from other type of swaps that might have taken place between the supplier (Ukgaz-Energo) and the customer (industries), once the latter could not afford paying in cash. A repetition of what had happened in the second half of the 1990s with the Gas Trading Concession System, see footnote 124, p. 103.

<sup>138</sup> For the sake of inclusiveness it is reported that from 2005 that Gazprom had monopolized the purchase of central Asian gas, Turkmen prices followed an upward spiral from \$60/mcm in 2006 to \$100/mcm in 2007 and \$130/mcm in the first half of 2008, reaching a plateau at \$150/mcm in the second half of 2008 (Mitrova et al, 2009, p. 402).

schemes of central Asian gas to Ukraine. RosUkrEnergo along with Ukgaz-Energo were leading to economic asphyxiation (mark-ups), let alone asymmetric economic gigantism of Dmytro Firtash and his Russian counterparts. So, Timoshenko, a gas queen herself in the 1990s, opposing herself to the ‘nonsensical’ of the situation, nullified sales contracts and prohibited Ukrainian state-owned enterprises doing business with Ukgaz-Energo<sup>139</sup>. Meanwhile, payment arrears to RUE and subsequently to Gazprom kept rising, hence, legitimizing the latter on a possible cut-off due to pending debt<sup>140</sup>.

On January 1, 2009 things took the downturn. Gazprom cut all supplies for Ukrainian consumption, fact that shortly after, resulted in Ukraine siphoning off Gazprom stored and transited gas for the EU customers, claiming the absence of a supply and transit contract and its right on ‘technical’ gas<sup>141</sup>. Finally, the whole issue was settled on January 19, with the signing of two contracts, supply and transit.

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<sup>139</sup> Yulia Timoshenko was the head of the United Energy Systems of Ukraine (UESU), which during the introduction of the Gas Trading Concession system in April 1996, succeeded in winning the mandate for wholesale gas supplies in Donetsk, Ukraine’s most profitable industrial region (Pirani, 2007, p. 20). See also footnote 124, p.103.

<sup>140</sup> Naftogaz Ukrainy owed to RUE \$1,52 billion for outstanding gas deliveries, amount which was paid on December 30, 2008. However, Gazprom claimed that another \$614 million in fines and penalties was still pending, thus, it was legitimized in halting supplies on Ukraine’s fault. So, Gazprom was at perfect ‘firing’ position with Ukraine to take the blame. Even more incriminating for the latter was the letter on December 31, 2008, by Naftogaz Ukrainy’s head, Oleg Dubyna, stating that, “in case of supply interruption to Ukraine, any gas delivered by Gazprom for transit to Europe would be considered as belonging to an ‘unidentified owner’ and it could be confiscated under Ukrainian customs law”(Pirani et al, 2009, p. 17). So, according to this statement, Ukraine was to assume full responsibility for the plummeting European gas supplies in the first half of January 2009, when Gazprom paused supplies to Ukraine on debt claims.

In this manner, Russia managed to “pass the buck” to Ukraine, limiting the repercussions on its reputation as an EU supplier and heading for a new agreement that would further strengthen its position in Ukraine’s gas market. Ukraine, on the other hand, was not only economically drained off but also presented as the scapegoat for every Russian decision to disrupt gas trade.

<sup>141</sup> ‘Technical’ gas is the one required to run a compressor station or pipeline.

### The agreement of January 19, 2009: Core principles

#### Supply contract:

Article 2.2: The supplier (Gazprom) is obliged to provide the customer (Naftogaz Ukrainy) from January 1, 2009 till December 31, 2019 with natural gas, which for 2009 will amount to 40bcm while from 2010 onward will amount to 52bcm for each year, payable according to the provisions of the current contract.

Article 4.1: The contracted price is defined on a quarter basis, January 1, April 1, July 1 and October 1 of every year and extends to the agreed periods. The contracted price for the first quarter of 2009 amounts to \$360/mcm. The base price for this calculation is the European price of \$450/mcm, which means that Ukraine gets a 20% discount, with the complete alignment to be brought about by January 2010.

Article 5.1.2: The customer is obliged to pay in full the deliveries of the previous month by the 7<sup>th</sup> day of the month following that of the deliveries. In case this payment scheme fails, then, according to Article 5.8.2. the customer, no later than the last date of the month preceding that of the deliveries will be obliged to pay in full for the deliveries of the following month (advance payment).

Article 9.7: The customer is obliged to forge with OOO "Gazprom Sbyt Ukraine" (onward 'GSU') a long term contract, according which Gazprom's wholly-owned subsidiary will supply on an annual basis, from 01.01.2009 till 31.12.2019, 25% of the imported gas to the industrial sector of Ukraine.

#### Transit contract:

Article 8.1: The amount to be paid for the transit of Russian gas via Ukrainian territory is \$1,70/mcm/100km for 2009, while for 2010 \$2,04/mcm/100km.

#### Arbitration:

Stockholm's International Arbitration court is to rule ultimately possible disputes (Transit contract Article 12, Supply contract Article 8.2) (Ukrainskaya Pravda, 2009)

The strategy of economic rationality/stifling that had been mainly pillared on gas intermediaries, begun to greatly and evidently serve to the Russian relative advantage. Particularly, the provisions of the 2009 agreement put Gazprom and Russia at the helm of the bilateral gas trade.

Starting with the Article 2.2, Gazprom would keep its export monopoly over Turkmen gas, first time established with the 2006 agreement, for the next 10 years. Moreover, contracted gas prices (Article 4.1) would be set on a quarter basis according to the world prices. As for the first quarter of 2009, the price was set at \$360/mcm, 20% lower than the world level, whereas complete alignment would take place by January 2010. Attuned with that, a strict payment framework (Article 5.1.2) would further serve as a counter-motive for breaking away from market principles. So, Russia hitherto witnessed its methodically pursued desire to economic rationality on course to completion.

Of great interest, nevertheless, is the Article 9.7, which signifies the ‘dark’ side of economic rationality, that of economic stifling. Ukraine agreed to grant the marketing of 25% of imported gas to Gazprom wholly-owned subsidiary “Gazprom Sbyt Ukraine”. Specifically, this gas would be supplied to the sole well-paying sector of the economy, i.e. the industry. This provision should be perceived as the result of the economic pressure exerted in the previous years by the gas intermediaries. As claimed above, after the 2006 agreement, three intermediaries, let alone the breaking down of the Ukraine-Turkmen direct gas sales by Gazexport, came to add noteworthy mark-ups to the end-consumer. The competitiveness of main export and revenue-generating industries such as metallurgy and chemicals, was on a free fall, leaving Timoshenko with no other alternative but Gazprom. Therefore, if Article 9.7 and Article 2.2. are conjointly interpreted, it could be argued that Timoshenko conceded to Gazprom that market share (25%) in exchange for the latter to remove the then incumbent gas trading scheme (RosUkrEnergo and Ukgaz-Energo).

Under Timoshenko’s new concession, Gazprom would buy any central Asia gas, transport itself with its own pipelines (without the mark-up of RosUkrEnergo) and then sell it either to Naftogaz Ukrainy for domestic supplies or directly to the industrial sector (without the mark-up by Ukgaz-Energo). So, mark-ups may have ended to the relief of the Ukrainian economy, but with the high strategic cost of direct Russian presence. The hitherto covered “Trojan Horse” tactic, had revealed its true colors with Russia taking over the most lucrative part of the Ukrainian economy.

With the 2009 agreement, while economic rationality got on track to completion, economic stifling had just begun to gain momentum. The agreed gas prices were too high for Ukraine’s economic capacity and timely payment remained more uncertain at this point than it had ever been before. Even worse, Gazprom, by establishing its presence in Ukraine’s industrial sector, had limited Naftogaz Ukrainy’s capacity at investing in the refurbishment of its transit network, since sales in that sector were the only source of sizeable revenues. Definitely, the economic asphyxiation which had been aggravated by the 2009 agreement would assure more strategic profits for Russia in the years to come. The phrase by the scholar Andrei Tsygankov “if not by tanks then by banks” had just started to unfold in a full politico-strategic scale.

#### ***4.2.4 Quashing interdependence III: cheap gas for a Naval base and the April 2010 agreement***

In February 2010, the political tide brought Viktor Yanukovych to the Ukrainian presidency. The time was perfect for Russia to act again. A pro-Russian leader had been elected to the highest political position while the economy was having a rough ride. The January 2009 agreement had expedited the course toward the impasse. According to International Monetary Fund (IMF) which had been invited to assist with the situation, Ukraine should, in 2010, double its domestic gas prices the very same moment that revenue-shrinking households had been in the whirl of a 15% GDP reduction for 2009 (Korduban, 2010). Ukraine's main export industries had been in a plight, poised to suffer greater losses, even if operated at the relative lower agreed gas price for 2010, i.e. \$330/mcm<sup>142</sup> (Interfax, 2010a). So, such a high gas price along with its impact on GDP would not allow Ukraine to aspire at the resumption of IMF assistance, which in 2008-2009 amounted to \$11 billion (Korduban, 2010). As put by a scholar:

“The new Ukrainian government, experiencing a tight fiscal crisis and the situation of an industrial downturn, decided to reduce at any cost the price of Russian gas supplies to Ukrainian industrial enterprises in order to start the engine of economic growth. And this ‘any price’ appeared to be too high from the strategic and geopolitical points of view. At least, doubtful enough” (Karasirov, 2010)

On these grounds, on April 21, 2010, Gazprom and Naftogaz Ukrainy signed addenda to the supply and transit contracts of January 2009.

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<sup>142</sup> As Ukraine's PM Mykola Azarov stated “At a price of \$330 per 1,000 cubic meters the chemical industry will come to a standstill, and the mining industry will be operating at a loss. And, consequently, budget revenue will decline” (Interfax, 2010a). See also the January 2009 agreement.

## The addenda of April 21, 2010 to the January 2009 agreement

### *Supply Contract*

- 1) Naftogaz Ukrainy will pay for gas with the discount equal to the abatement in the export duty set for gas supplies to Ukraine by the Russian government
- 2) The abatement will amount to 30% of the gas price but no more than USD 100 per 1000 cubic meters, applicable to the volumes of 30bcm in 2010 and 40bcm in the following years

### *Transit Contract*

- 1) The reduction of gas price to Ukraine by 30% will automatically reduce the charge for transit
- 2) 80% of the gas transit fee will be paid by Gazprom before the 6<sup>th</sup> day and 20% before the 20<sup>th</sup> day of the month pursuant that of the deliveries.

Following the results of the meeting of the Economic Cooperation Committee, convening within the framework of the bilateral Russo-Ukrainian Inter-governmental Commission, in Sochi on April 30, 2010, the Prime Minister of the Russian Federation Vladimir Putin suggested the merge of Gazprom and Naftogaz Ukrainy.

### *Naval Base at Crimea*

- 1) In exchange, Russia secured a discounted deal on rent (30%) for another 25 years for its Black Sea Fleet, stationed at the Naval Base at Crimea, due to expire in 2017<sup>143</sup> (Gazprom, 2010; Interfax-Ukraine, 2010b).

In the aftermath of the agreement, a spate of public statements shed light on the agreed provisions. To begin with the Russian side and Vladimir Putin, he stated that “The Russian budget will absorb the losses from the discount via the export duty...neither Gazprom nor its shareholders will suffer from the reduction...the discount will be achieved by zeroing out the 30% export duty for Ukraine, that is, the discount will be made at the expense of the Russian budget” (Interfax, 2010). In the same line of reasoning, the head of Gazprom Alexei Miller noted that “the price cut will be compensated by a reduced export duty for Gazprom, and does not affect the company’s economic performance..the agreements will allow Ukraine to substantially increase its gas purchases in 2010...to 36.5 billion cubic meters. This is almost 3 bcm more than planned” (Interfax-Ukraine, 2010b). Assessing these statements, it once

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<sup>143</sup> The Black Sea fleet became a rather disputed issue between the two states on April 5, 1992, when Ukraine’s President Leonid Kravchuk issued a decree on rebuilding the Ukrainian armed forces. Part of decree placed the former Soviet Black Sea Fleet under Kiev’s control and subsequently all the naval forces deployed in the Ukrainian territory were to be painted in Ukrainian colors. That decree ignited a dispute between Russia and Ukraine, since most of the Soviet Black Sea Fleet has been Russian under the newly emerged status-quo after the dissolution of the USSR. The issue was finally settled on June 9, 1995 in Sochi, where the two countries agreed on Russia receiving 81,7% of all ships and vessels and Ukraine 18,3%. All warehouses divided fifty-fifty while Sevastopol was designated as the Russian Fleet’s stationing base (RIA Novosti, 2010).

more becomes clear the Russian relative advantage. Specifically, the *prima facie* 30% loss to the Russian budget could be indirectly offset by the increased amount of sales, now at lower prices. In other words, substituting smaller quantities at higher prices with larger quantities at lower prices. Therefore, the total in the national coffers, in the worst case scenario remains the same while in the best case scenario grows much bigger.

What's more to the Russian advantage, is that the 30% reduction is by no means to exceed \$100/mcm. This means that Russia provided a discount calculated on the, at the time, current price of \$330/mcm. So, if the price remained below \$330/mcm the discount of 30% would steadily apply. But in case of exceeding \$330/mcm, the 30% would be downwards adjusted so as the discount not to exceed \$100/mcm. Definitely, it was a short-term arrangement, bound to benefit Russia and soften a possibly anew concessionary Ukrainian stance in the medium term<sup>144</sup>.

Moreover, Gazprom would further benefit from the automatic adjustment of the export duty abatement to the payable transit fees. This would grant it the opportunity to increase either its profit margin or become more competitive in the European market. At this point it has to be noted that since the 30% discount was to be reflected in an equal reduction in the transit fees, the bargaining had already been a 'win-win' one and there was no need for Ukraine to approve the strategic concession of extending the Russian lease of the Naval base at Sevastopol, let alone subtracting 30% from the rent.

Ukraine was only interested in the direct/urgent gains of the agreement. The painstakingly built economic asphyxiation of the previous years, had stripped Ukraine off any diplomatic option for a 'win-win' bargain. Thus, being in dire need for immediate relief, it focused solely on the mathematics of the agreement. According to the Ukrainian President Viktor Yanukovich "Naftogaz Ukrainy will lose roughly \$0.35 billion a year due to the reduction in the transit tariff, based on the scheduled transit volume of 116 bcm..but it will save about \$4 billion...(there will be) a real investment resource worth \$40 billion in the next 10 years thanks to the signed agreements" (Interfax-Ukraine, 2010b; Felgenhauer, 2010).

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<sup>144</sup> The point-made here is that Moscow had linked the price of gas with the price of oil-products, and thus, when in 2011 there would be a surge in world oil prices, Ukraine would found itself anew at the corner, considering new strategic concessions to Russia, just to keep its economy afloat. This is case is visited later on.

Notwithstanding the positive assessment by the Ukrainian political leadership, critics dismissed the deal as anti-market and charged Yanukovich with only being interested in “acquiring easy money to sustain his hyper-centralized rule.. (rather) than making Ukraine modern and productive”<sup>145</sup> (Motyl, 2010). Therefore, if this course was to continue unabated, Ukraine was closer than had ever been before since independence to becoming a vassal state of Russia.

#### ***4.2.5 The endgame of interdependence***

Once Putin had corroborated the Ukrainian concessionary elasticity, he rushed to lock Russia’s long-craved target, i.e. the ownership of the Ukrainian gas transmission system and the conversion of interdependence to unilateral dependence. In the fall of April 2010, Putin, after a meeting with his Ukrainian counterpart Mykola Azarov, suggested that Gazprom and Naftogaz Ukrainy merge. In the startup, a JV would be created on a parity basis with production and transport assets from Naftogaz Ukrainy and natural gas deposits of equal value from Gazprom<sup>146</sup> (Kyivpost, 2010).

Russia, counting on the economic asphyxiation of the previous years, could now sound not only oppressive but also reasonable in its demands. As Gazprom deputy CEO Alexander Medvedev put it “Ukrainian gas pipelines are in bad shape. Naftogaz doesn’t have the money to invest, and we at our company are putting up half the costs for building and modernizing the network” (Kyivpost, 2010a). Therefore, the merger proposal echoed now less as a “hostile takeover” and more as an economic urgency. Modernization was *sine qua non* prerequisite for Ukraine to maintain its paramount place in the Eurasian energy transit, especially in light of alternative gas routes such as the South and the Nord stream. As its own President, Viktor Yanukovich, stated, “it is necessary to modernize gas pipelines for increasing the transportation of gas. We offer this [modernization] as an alternative to South Stream, because it is impossible

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<sup>145</sup> For the sake of accuracy, someone should ask here whether there was any time for Yanukovich to make any reforms, since changes in an inherited already debt-laden and inefficient politico-economic status quo were more than a herculean task to accomplish.

<sup>146</sup> For the sake of inclusiveness it is reminded here that in the early 2000s, Kiev and Moscow had discussed the possibility of a gas consortium (European partners included) to assume responsibility over modernizing the soviet-era Ukrainian transit network. The project finally faltered when the “orange revolution” of December 2004 brought to power the west-leaning Viktor Yushchenko. Since then, the Russian president, Vladimir Putin, expedited its “Janus face” strategy of economic rationality/ economic asphyxiation, toward ultimately curbing the Ukrainian resistance over its GTS.

to stop the Nord Stream project. That pipeline is already being built”<sup>147</sup> (Interfax-Ukraine, 2010a).

However, critics did not keep silent on the issue. According to the head of the Ukrainian opposition “Russia's proposal concerning the modernization of the Ukrainian GTS may result in the sale of part of the GTS..We are very worried and alarmed by the reports coming from Prime Minister Mykola Azarov and ministers in charge that we could follow the example of Belarus, and an agreement to sell a package [of stocks] will actually be prepared. Let me remind you that the Belarusian scenario involved the sale of a 50% share of Beltransgaz to Russia” (Interfax, 2010a).

Parallel to that, it was also the 2007 law, drafted by Yulia Tymoshenko and prohibited the expropriation of the national energy infrastructure assets. That law relished much of political consensus, given its enactment when Tymoshenko was in opposition and the Party of Regions (Yanukovych party) in office. Thus, this meant an extra impediment, institutional this time, to the economic urgency for modernization.

Putin, being aware of these dynamics plus the procrastination toward a reply to his merger proposal, became more threatening so as to talk the Ukrainian authorities into his plan. Specifically, on May 3, 2010, via his spokesman, Dmitry Peskov, clarified that the “implementation of the South Stream project is about to begin. This would result in severe losses to Ukraine’s gas transport system and to its valuation. Ukraine [should be] interested in having Gazprom as co-owner of Naftogaz, so as to ensure that Ukraine’s gas transport system continues to operate in working conditions, is steadily modernized and is supplied with gas” (Socor, 2010). Finally, regardless of the escalating pressure, the merger proposal met with little resonance in the Ukrainian political scene.

Nevertheless, the furrow of the Russian domination had already been ploughed. The April 2010 “naval base for cheap gas” tradeoff had paved the way for more concessions every time the economic occasion turned stifling for Ukraine. That moment would not take long to come. Despite the gas discount of the April 2010 agreement, Ukraine, found itself paying, in the third quarter of 2011, \$350/mcm, price which was expected to rise to \$400-500/mcm by the yearend according to Gazprom

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<sup>147</sup> Also, according to the Ukrainian PM’s estimates “the pipeline system can transport about 150 billion cubic meters of gas annually and may be able to carry up to 200 billion cubic meters per year if modernized” (Interfax, 2010a).

estimates<sup>148</sup> (Socor, 2011). Definitely, the Moscow-imposed link between the gas price and an oil-products basket was to put the screws on Ukraine every time oil-prices surged<sup>149</sup>.

Therefore, as late as of July 2011, the Ukrainian president and his government had to cope with many domestic “hot potatoes”. Energy-intensive factories, poverty-stricken households and export oriented steel and chemical industries, all unable to put up with such high gas prices, narrowed down the margin for any other ‘direct-effect’ option but selling off Naftogaz Ukrainy assets in return for a second deep gas price discount (Socor, 2011). So it planned. The governing Party of Regions drafted a bill to amend Timoshenko’s law (2007) so as to allow for the privatization of national energy infrastructure assets<sup>150</sup>.

That amendment, while still pending, proves, *inter alia*, Putin’s correctness in his consistent pursuit of the economic rationality/economic asphyxiation strategy. Despite a roughly solid perception of national interest in Ukrainian politics, Putin managed to detect any fissures and maneuver across them so as to reestablish gas relations on market principles and, concurrently, lay a hand not only in the GTS but also in major strategic targets. In this manner, Putin almost succeeded in turning the initial interdependence to ultimate unilateral dependence of Ukraine on Russia, guaranteeing the latter’s relative gains in its energy affairs with the former.

Overall, viewing the hitherto analysis through the lenses of the theoretical debate between Neorealism-Neoliberal institutionalism, the former qualifies as the most suitable explanatory account, given that the current energy relationship is a far cry from a ‘win-win’ situation where both sides stand to maximize their absolute gains. Currently, Russia’s gains are Ukraine’s losses. There is a *zero-sum* game going on, where economics open the door to political-strategic concessions at Ukraine’s expense.

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<sup>148</sup> For the price adjustment of the April 2010 agreement see p. 118.

<sup>149</sup> As a matter of fact, world oil-prices sky-rocketed in 2011 as a result of international rearrangements.

<sup>150</sup> The Ukrainian government, in July 2011, was considering breaking Naftogaz Ukrainy to smaller parts and selling some of them while setting up JVs with Gazprom on pipeline upgrading and gas extraction in Ukraine. Also, among the things discussed was the possibility of an Initial Public Offering (IPO) of a 10% shareholding in Naftogaz so as to raise the necessary funds for the modernization of the gas transit system (Socor, 2011).

### 4.3 Russo-Belarusian relations<sup>151</sup>

“Belarus has Russian ideology, even everyday patriotism is essentially that of the Greater Russia. Private interests of Belarusians are in no way being transported into the interests of Belarus as a nation or a state” (Karbalevich cited after Nesvetailova 2003, p. 153).

The case of Belarus is polar opposite to that of Ukraine. During the last years of the USSR, Belarus was among the few republics, if not the only, that had no revolutionary sentiments against Russia. On the contrary, since the late 1990s, the creeping sovietism of the mass psychosynthesis had been crystallized in the 40% of Belarusians favoring some kind of resuscitation of the USSR (Nesvetailova, 2003).

Apart from the pro-Russian public sentiment, Belarusian economy too was tied to the soviet mindset. With the exception of a short period in the early 1990s (1991-1994), the principles of collectivism and egalitarianism retained their primacy in the domestic political thinking. Particularly, with Aleksandr Lukashenka’s ascent to the presidency in spring 1994, collectivism became the dominant *modus vivendi* with all the means of production belonging to the state rather than to individuals, as occurs in western democracies (Leshchenko, 2008). Therefore, egalitarian nationalism emerged as a policy that *prima facie* favored the common good but in reality served as political opium to the civil society’s quest for true democracy. Without market economy it is difficult to imagine a strong and autonomous democracy. In total, under Lukashenka’s pro-soviet model of governance, part of the personal rights had been alienated so as to assure a manipulated democracy dancing to the president’s tune.

Such a model, however, would not at all be viable, unless a far greater power (Russia) was eager to guarantee cheap energy supplies as well as a vast market<sup>152</sup> (McMahon, 1997). So it happened. Belarusian strategic imports from Russia had been

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<sup>151</sup> Contrary to Ukraine which since 1993 had adopted a policy of “Neutrality, Non-Nuclear and Non-Block Status” as a means of disheartening any Moscow efforts to include it in post-soviet geopolitical frameworks such as the Commonwealth of Independent States (CIS) and the Russian-Belarusian Union, Belarus stuck to the Soviet politico-economic thinking, thus tying its fate to the Russian one (Martinsen, 2002).

<sup>152</sup> When in 1994 the Belarusian President Lukashenka abandoned the erstwhile efforts towards a pro-market transformation, international financial institutions as well as Western states stayed at arm’s length, condemning Belarus to international isolation while paving its way to the Russian embrace (Deyermund, 2004).

scoring as high as 90%, while the amount of Belarusian enterprises solely dependent on Russian natural resources had been near 80%. In particular, as far as natural resources are concerned, Russian exports had been covering in full the Belarusian needs for oil and gas (100%) and almost in full the need for coal and crude metals (80% and 86% respectively) (Nesvetailova, 2003, pp.157-158).

Thus, viewing things from this angle, it is understandable Belarus' "gearbox pattern" when dealing with Russia. Specifically, it is "going ahead with the (Union) project in its planning stages, when it can acquire maximum concessions from the Russian side, only to later create obstacles to the actual carrying out of the agreement" (Balmaceda, 2006, p. 193). The same pattern also interprets Lukashenka's persistent rhetoric for a union with Russia, policy that contributed the utmost to his first election in office in 1994 and had been bolstering his political standing in the electorate ever since.

#### ***4.3.1 The Union project: fears and insecurities in a puzzling era***

The project was commenced on April 2, 1996, when the Presidents of the two states, Boris Yeltsin (Russia) and Aleksandr Lukashenka, signed a Contract on the establishment of a Belarus-Russia community in Moscow (Soyuz, 1999). A year later, on April 2, 1997, that bilateral rapprochement was upgraded with the addendum of another contract, this time on the creation of a *Belarus-Russia Union* (Soyuz, 1999). The latter opened up the way for the signing of further agreements (i.e. on equal rights of citizens, on equal conditions for enterprises, etc.), all aiming at the deepening of the bilateral political and economic ties (Global Security, 2011). Finally, the integration fever culminated on January 26, 2000, with the contract on the establishment of a *Union State* and provisions for supra-state institutions such as the Supreme State Council, the Parliament, the Council of Ministers, the Court and the Chamber of the Union State (Article 6) (Soyuz, 1999).

*Agreement on the establishment of a Union-State: A brief commentary*

1. The rationale behind this project was to institutionalize a politico-economic union which, on the grounds of democratic governance, would make use of all market mechanisms to guarantee the socio-economic development of both member-states (Article 2.1b,e).
2. The Supreme State Council, the Parliament, the Council of Ministers, the Court and the Chamber of the Union State would facilitate the way, initially, toward the drawing up of a Common External Tariff and, later, toward the formation of a monetary union with a single issuing center (Article 13.1 and 22).
3. The Supreme State Council, being the ultimate supra-state institution of the Union would be administered by either the Russian or the Belarusian president on a rotating basis, unless the governments of the two member-states consented on a single person (Article 36).
4. The management of the energy transit infrastructure would fall into the Supreme State Council's jurisdiction (Article 17d),
5. Finally, *en route* from an economic to a possible political integration, developments would occur within a Confederal political framework, where the two member states would retain their sovereignty, independence, territorial integrity and administrative system (Article 6.1) (Soyuz, 1999).

Placing the aforementioned project in its historical context, certain dynamics have to be addressed. Principally, in the political sphere, major psychological imbalances shaped a reality where an enfeebled Russian president, fraught with the “Belavezha complex”, had to tackle his overly ambitious Belarusian counterpart in the quest of restoring a tittering Russia and Belarus to their rightful place<sup>153</sup>. In the words of an analyst:

“With 70% of Russians supporting the idea of the Russian-Belarusian Union, it is understandable why in the era of an impaired Yeltsin, Lukashenka –“the man of stability and order” appealed to many Russians and Belarusians as a potential leader for the new interstate formation” (Nesvetailova, 2003, p.161).

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<sup>153</sup> Many critics hinted at ulterior political motives behind the project of the Union State. Particularly, they discerned Lukashenka's desire for becoming president of a large Union State and Yeltsin's unique opportunity to restore himself as the leader who started the reunification of the former Soviet Republics after he had presided over the dissolution of the Soviet Union at the Belavezha summit in December 1991 (RIA Novosti, 2009c).

However, for Lukashenka's political ambitions to stand on solid ground, his pro-soviet economic model had, first and foremost, to stay afloat. Therefore, even before the commencement of the Union project in 1996, a number of other agreements, such as the Customs Union on January 6, 1995, had been signed so as to keep Russia in orbit<sup>154</sup> (Leshchenko, 2008). Cheap energy resources (at Russian domestic prices) as well as a vast Russian market for Belarusian exports had been *sine qua non* remedies in an otherwise inefficient economy, crippled by inflation and disguised unemployment. No doubt, Lukashenka's political ambitions were tied upon the Russian vehicle<sup>155</sup>. Once separated, promises for social expenditures would remain an empty letter<sup>156</sup>.

Parallel to Belarus, Russia had equally a lot to gain from that rapprochement, especially in the economic (energy) sphere. Oil and gas exports to the EU have been Russia's primary source of hard currency while Belarus has been a transit state necessary to cross *en route* to the EU market. Thus, securing an uninterrupted transport route was a major guarantee for Russia's foreign trade balance. Moreover, despite the overall deficiencies of the Belarusian economic model, a well educated and disciplined labor force stood out as a factor that Russian policy makers could hardly neglect when deciding over an initial Custom Union and possibly later a

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<sup>154</sup> According to estimates, from 1995 up to 1998 Russia had been subsidizing Belarus with an annual amount of \$1,5-2bln (Leshchenko, 2008, p. 1427).

<sup>155</sup> The Belarusian economy stood to benefit heavily from its energy dependence on Russian imports. In particular, 1) the indirect subsidization of the economy through lower than international gas and oil prices, 2) the possibilities opened by barter arrangements, 3) the extra income created by transit fees, and 4) the direct and indirect re-export of energy resources, all constituted ways of keeping the Belarusian politico-economic system afloat (Balmaceda, 2006, p. 151). What deserves special attention are the barter arrangements. That is because aside from the high prices the Belarusian authorities were assigning to their products for Russian oil and gas, they also contributed to the "relatively high GDP growth rates" by providing a market outlet for the otherwise outdated and uncompetitive goods of the state-owned enterprises (Balmaceda, 2006, p. 153).

<sup>156</sup> Such was the case in the monetary crisis of May 2011. When Russia stopped to subsidize the bilateral trade in 2006, Belarus started to form deficits and accumulate debts. So, as Lukashenka increased the nominal wages close to 35% in a highly political gesture for the December 2010 elections, inflation, according to the twin deficits hypothesis, crowded out the private-export capacity, further alienating Belarus from the international market. Printing more money was not an option anymore. So as devaluation. The former would only boost the inflation further while the latter although it would initially increase exports, in the end it would deliver no different result as the overall economy lacks in productivity. Thus inflation would remain. So, as Russians suggested, the sole remedy was a policy mix of privatization and devaluation (since the Belarusian state owns more than 70% of the enterprises). Privatization would boost productivity and absorb the inflation while devaluation would make up for the initial lack of domestic demand. In the long run, a more viable future awaited Belarusians. However, in the short-run, the Russians stood to benefit heavily (partly on energy assets) since they were the ones to provide the necessary transitional loans (Vedomosti, 2011a). A thorough look at Belarus' economic policy is also provided by: (Lisovskaia and Korosteleva, 2003).

Monetary Union<sup>157</sup> (IMF, 2009, p.16). Finally, Russia, by keeping warm economic relations with a brotherly nation such as Belarus, was also forging a reliable alliance in the anarchic realm of international politics (Nesvetailova, 2003, p.163).

Definitely, up to this point a mix of politics and economics weighed a lot to the two states' decision over entering a course of final unification. For Belarus and particularly for Aleksandr Lukashenka, teaming up with Russia was a 60-40 mix of economics and politics. Domestic political survival as well as the doable for the time presidential post of an onward unified political entity (the Union State), kept the fire burning. As earlier mentioned, the presence of a remorse-laden Russian leader (Boris Yeltsin) inflated Lukashenka's political ambition and made things seem rather achievable. Russia, on the other hand, focused chiefly on the economics of the rapprochement. Oil and gas exports stood atop with the promising Belarusian labor force and the prospects of international security scoring lower in the hierarchy.

Sooner or later though, the true dynamics beyond the unification project would be revealed. As long as Lukashenka and Yeltsin were at the presidency, the union agreements were more or less a cost-free exercise, where only by the promise of integration, short-term, minor politico-economic interests tended to be fulfilled. Not surprisingly, no concrete moves toward actual unification had been undertaken. Therefore, "if the emergence of the union project can be understood as a populist move by an unpopular leader then a decline in the relative importance of the union project under a leader with much greater domestic support would be expected" (Deyermond, 2004, p.1200). Exactly that is the case that started to unfold with Putin's ascent to the presidency in March 2000.

The new-oath administration pushed primarily for the clarification of the political status of the Union. The stagnant situation that had been nurtured since the mid-1990s was no longer sustainable. As Putin was quoted saying in a meeting with Aleksandr Lukashenka in St. Petersburg on June 11<sup>th</sup>, 2002, "Our partners should make up their minds and decide what they want. We often hear that something along the lines of the Soviet Union would be desirable. But if it is to be along the lines of the Soviet Union, then why write in the draft constitutional act that the states will be sovereign, have territorial integrity, and the right to veto on all decisions?..Then it is not something

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<sup>157</sup> As mentioned in the IMF report, the "share of education outlays relative to GDP hovers around 6<sup>1/2</sup>, significantly more than in OECD countries. This helped form a well trained labor force'. (IMF, 2009, p.17).

along the lines of the Soviet Union but something quite different” (RFE/RL, 2002). As commentary started to build upon this statement, the Belarusian Social Democratic Party leader, Mikalay Statkevich, stressed that the new Russian president was not at all fond of creating supranational power structures in a union where the Belarusian leader could enhance its political standing in the post-Soviet world. Similarly, the Russian State Duma deputy speaker, Vladimir Zhirinovskii, emphasized that Putin saw nothing in a ‘Yeltsin-type’ integration with Belarus, “which allegedly implied the restoration of a ‘pink-version’ of the Soviet Union” (RFE/RL, 2002).

If anything, Putin’s Russia would not succumb to any type of political structure that tried to “resurrect the USSR at the expense of the Russia’s economic interests, since this will [would] strengthen centrifugal forces within the country and weaken Russia economically” (RFE/RL, 2002). Therefore, when negotiations began on the enactment of Article 22 on the formation of a monetary union with a single issuing center<sup>158</sup>, brinkmanship diplomacy made its way to the forefront. In particular, this article soon constituted a major “*point de friction*”, since the formation of such a union without the necessary economic reforms (the case of Belarus), would eventually lead the weaker state to economic strangulation and jeopardize its independence and sovereignty<sup>159</sup>. Aleksandr Lukashenka finding himself stuck between the Scylla of Russian pressure and the Charybdis of the economic impasse that a monetary union would cause, tried to maneuver by suggesting the creation of two different issuing centers, one in each country<sup>160</sup>. Such a diplomatic trick would assist his effort to maintain the hitherto cost-free Union trajectory in orbit while preserving the critical for his politico-economic ambitions principle of equality (Article 6.1)<sup>161</sup>. Putin declined Lukashenka’s suggestion, stating that he would only accept one issuing

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<sup>158</sup> See p. 124.

<sup>159</sup> For a paradigm on monetary unions see: (Mousis, 2001, p.119-145).

<sup>160</sup> This suggestion no matter how strange it may sound, it made sense to Lukashenka given that if a usual monetary union was formed, his crippled and uncompetitive economy would sink into debt and sooner or later he would be forced to follow non-populist economic reforms, if it was for his whole state not to be bought out by Russia. This, in turn, would lead him to lose the power, given that the latter had been solely based on populist policies. In light of these, a second issuing center would buy him time, since printing inflationary money could be exercised as a short-term political practice not letting debt grow rapidly.

<sup>161</sup> Lukashenka up to 2000 aspired at the Article 36 of the agreement (see p. 124), which stipulated that “President of the Supreme State Council, the ultimate supra-state institution of the Union, could either be Russian or Belarusian on a rotating basis unless the governments of the two-member states consented on a single person”. Lukashenka nurtured the hope to capitalize on Yeltsin’s weak political standing and become president of the two states via the Union-State. However, for this two happen, Belarus had, first and foremost, to avoid being absorbed by the stronger Russia. Thus, the principle of equality was equally critical.

center, i.e. the Russian Central Bank, while any Union based on equality was not possible given that the Belarusian economy was equivalent to only 3% of the Russian one (RFE/RL, 2002; Deyermond, 2004).

What Putin clarified was that any Union, if actually any, would only occur on Moscow's terms, or at least on terms that do not sacrifice its economic interests. Pragmatism should govern bilateral relations. There is no more a remorse-laden leader to be exploited while seeking atonement for past realities. In the words of the Belarusian political leader Mikalay Statkevich, "Lukashenka has exploited Russia's help according to the pattern: [Russian] oil for [Belarusian] kisses. But now comes the end to [Lukashenka's] economic bluff" (RFE/RL, 2002). Onward, primary economic interests would no longer be sacrificed in the altar of, at times, elusive political intimacies.

#### ***4.3.2 Setting a new course: Russia on the offensive***

As earlier claimed (see p.125), Russia had also a stake in the rapprochement with Belarus. The latter constitutes a transit state (parallel to Ukraine) for Russian gas (and oil) exports earmarked for the EU market.

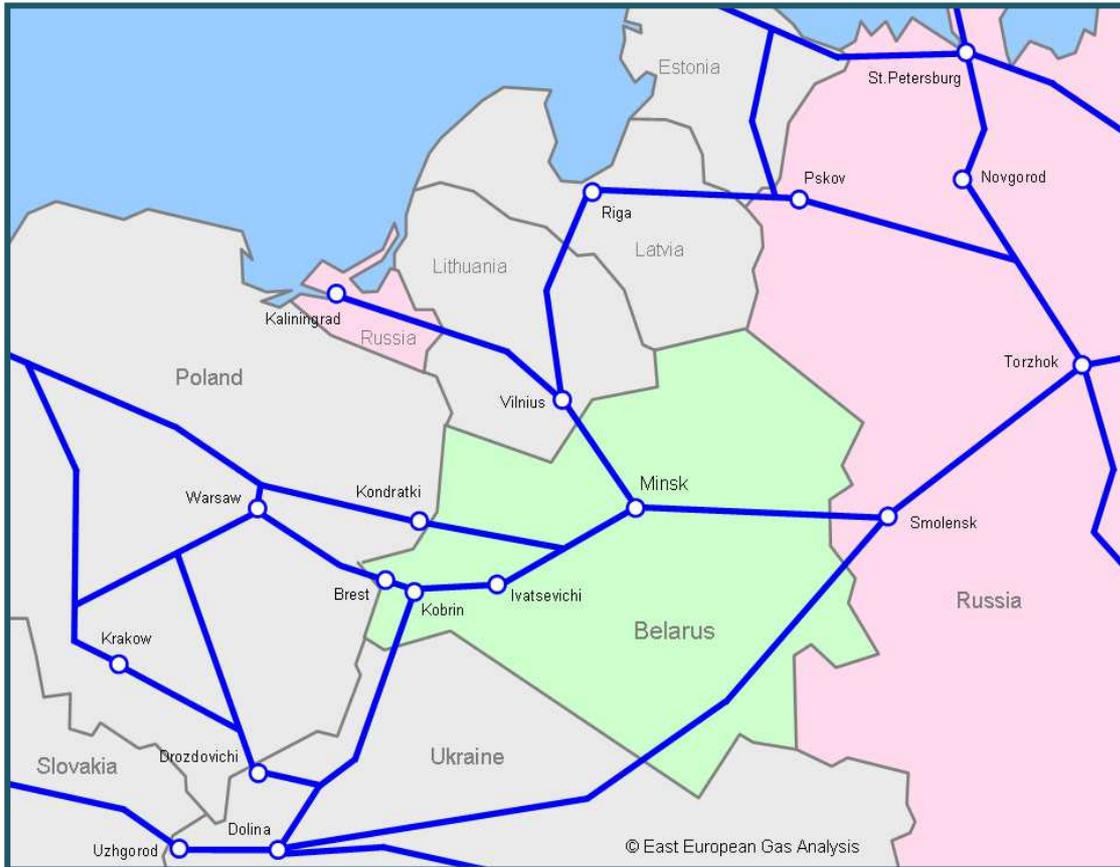


Map 4.3: Major Natural gas network(s) crossing Belarus

In particular, the Belarusian gas transit network consists of two pipeline systems, the Northern lights and Yamal Europe, both starting from the Russian gas fields<sup>162</sup>. Providing a brief overview, the Northern lights system is the older one, having been built during the Soviet times and becoming Belarusian property at independence. Its total capacity mounts to 51bcm/year, thus being the bigger of the two (EEGA, 2009). As far as the Yamal-Europe system (Yamal-1) (33bcm/year) is concerned, it is owned by Gazprom, given the principally Russian funding for its construction, and it is

<sup>162</sup> The map is retrievable at: [http://upload.wikimedia.org/wikipedia/commons/thumb/d/d7/Major\\_russian\\_gas\\_pipelines\\_to\\_europe.png/220px-Major\\_russian\\_gas\\_pipelines\\_to\\_europe.png](http://upload.wikimedia.org/wikipedia/commons/thumb/d/d7/Major_russian_gas_pipelines_to_europe.png/220px-Major_russian_gas_pipelines_to_europe.png) , See also: <http://secure.cges.co.uk/products/map-13-western-gas-export-pipelines>

exclusively used for transiting gas to Poland, Germany, Holland and Belgium (EEGA, 2009)<sup>163 164 165</sup>. The Russian ownership of the system places Gazprom in a



**Map 4.4: Major Natural gas network(s) of Belarus**

position of a fee-receiver from its Belarusian counterpart (Beltransgaz) every time the latter operates the system, while itself, it is paying rents for land occupation by both the compressor stations and the pipeline *per se* (Yafimava, 2009).

In total, both systems have an aggregate nameplate capacity of 84bcm/year out of which, only the 2/3 approximately is in use. Explicitly, in 2005, 21.7bcm of gas via Yamal-Europe and 18.7 bcm via Northern Lights were destined for the EU market, while 20.15bcm were earmarked for Belarusian domestic consumption (Gazprom,

<sup>163</sup> Elaborating on the gas systems crossing Belarus, the following networks are of prime importance:

- Torzhok-Kondratki-Frankfurt/Oder (Yamal pipeline/ Major transit pipeline), 1420 mm (56-in)
  - Torzhok-Minsk-Ivatsevichi, 3 x 1220 mm (48-in)
  - Ivatsevichi-Kobrin-Dolina, 2 x 1220 mm (48-in)
  - Kobrin-Brest-Warsaw, 1020 mm (40-in)
  - Minsk-Vilnius, 1220 mm (48-in)
  - Torzhok-Dolina, 1420 mm (56-in)
- } Northern Lights system: Trunk pipelines

<sup>164</sup> Particularly, it transits more than 50% of the exported Russian gas via Belarus (Gazprom, 2005a).

<sup>165</sup> The map is accessible at: <http://eegas.com/belarus1.htm> , Source: (East European Gas Analysis).

2005a). These make no secret of the fact that the Northern Lights system has been as vital for the Russian gas interests as the Yamal-Europe one (already owned by Russia).

However, aside from the fact that Belarus transits around 20-25% of Gazprom's EU exports, it is also entirely dependent on Russia to cover its own domestic energy demand. This is because natural gas holds a dominant position in its energy mix<sup>166</sup>. In particular, Belarus' natural gas consumption amounts to 20-21bcm/year, all of which is supplied by Russia (Yafimava, 2009, p. 133). Domestic production is as low as 0.23bcm/year, totally inadequate for substituting Russian imports.

All these shape an interdependence with a rather fragile profile. Energy politics, currently, are much less inextricable than in the previously examined case of Ukraine. Reasoning that, the pro-soviet political, economic and social set up of Belarus would make it easier for Putin's Russia to assert its own energy interests.

#### ***4.3.2.1 The road to market rationality and Belarus' unilateral dependence on Russia***

As earlier mentioned, when Putin came to the presidency set out a new course toward rationalizing bilateral gas trade and promoting Russian interests. Up to then, the idea of an ultimate Russo-Belarusian political Union had rendered gas issues secondary.

By 2000, Gazprom, witnessing Putin's bleak attitude toward political integration with Belarus, started to worry over the latter's ballooning gas debt undermining its trustworthiness as transit state<sup>167</sup>. That worry soon became official policy and on April 2002, the governments of Russia and Belarus signed two separate agreements on Establishing Equal Pricing Conditions and on Developing Cooperation in the Gas Industry. According to the former, Gazprom assumed the responsibility of supplying natural gas to Belarus at the wholesale prices of Russia's 5<sup>th</sup> price zone. In exchange, according to the latter agreement, Belarus would lay the foundation for the creation of a joint gas transportation enterprise based on its national gas company 'Beltransgaz',

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<sup>166</sup> It is reported that in 2004, "gas made up over 60% of the country's energy balance and 95.4% of electricity production was from gas" (Balmaceda, 2006, p. 148).

<sup>167</sup> It is noted that Belarus' national gas company 'Beltransgaz' indebtedness to Gazprom reached up to \$79 million for natural gas supplies during 1999-2002. The issue, however, was addressed on December 5<sup>th</sup>, 2003, when both sides agreed that total indebtedness as of November 1<sup>st</sup>, 2003 amounted to RR 134 million and was to be redeemed within 3 years (Gazprom, 2003).

no later than July 1<sup>st</sup>, 2003<sup>168</sup> (Gazprom, 2003). Reading between the lines, it is discernible the intention of the Russian government to use the carrot of low-priced gas supplies to Belarus so as to gain ownership of the latter's pipeline network (GTS), thus transforming interdependence to unilateral dependence and being free to push for subsequent economic as well as political concessions.

However, Belarus soon realized that selling its pipeline network without the intended political union in place, would mean becoming mute and short of influence *vis-à-vis* its powerful neighbor. No leverage would be in its disposal once needed. Therefore, in 2003, the Belarusian side backpedaled on the agreements, questioning the calculation of its indebtedness to Gazprom and procrastinating the negotiations over the establishment of the joint gas transportation enterprise between Gazprom and Beltransgaz<sup>169</sup> (Narodnaia Volia, 2010). Particularly, as far as the latter is concerned, the Belarusian side opposed to Gazprom's evaluation of Beltransgaz to \$500-600 million, insisting on the much greater estimate of \$5 billion while it also modified the shareholding in the company to 49%, instead of the initially agreed 50% (Narodnaia Volia, 2010). Under these conditions, things escalated to the worse, with Gazprom stating that it was no more under the obligation to sell gas to Belarus in domestic prices (Russia's 5<sup>th</sup> price zone) and instead it would increase prices in the contract of 2004 from \$30/mcm to \$50/mcm (Narodnaia Volia, 2010).

In the beginning of 2004, bilateral negotiations reached a gridlock with Belarus refusing to pay the gas price asked by Gazprom. Subsequently, the latter cut-off gas supplies via the Northern Lights pipeline system except for the gas destined for the EU market and flowing via the Yamal-Europe transit network. Initially, independent producers appeared in the gas equation to make-up for the Russian abstention on the basis of short-term supply contracts<sup>170</sup> (Gazprom, 2004a). However, when these short-term contracts ended, Belarus having nowhere else to turn to, started non-sanctioned off-taking of Russian gas transited via its territory (Yamal-Europe line) to the EU. In response, Gazprom, on February 18<sup>th</sup> at 18:00 Moscow time, cut flows from that line as well, putting the blame on Belarus for any supply disruptions might have occurred in the EU market. Auspiciously, this cut-off lasted only for a day, since on February

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<sup>168</sup> In simpler words, Belarus would sell 50% of its pipeline network to Gazprom.

<sup>169</sup> For Belarus' gas debt to Russia as well as the agreement on that see footnote 167.

<sup>170</sup> When on January 1<sup>st</sup> Gazprom stopped supplying gas to the Belarusian market via the Northern Lights pipeline system, Beltransgaz signed two short-term gas supply contracts with the independent producers 'Trans Nafta' and 'Itera', both of which ended on February 12, 2004 (Gazprom, 2004a).

19<sup>th</sup>, Beltransgaz signed a new short-term supply contract with the independent gas producer ‘Trans Nafta’ at \$46.68/mcm, expiring on March 3<sup>rd</sup> (Yafimava, 2009). Finally, that course continued unabated until June 2004, when the two sides, Gazprom and Beltransgaz, agreed on the amount of 10.2bcm at \$46.68/mcm for the remainder of 2004, while the transit fees also rose for the Northern Lights to \$0.75/mcm/100km from \$0.53 and for the Yamal-Europe to \$0.46/mcm/100km (Gazprom, 2004b; Yafimava, 2009).

The bottom line of the 2004 gas dispute was the immense asymmetry of energy power between Russia and Belarus. The latter, having an unreformed extremely energy-intensive industry and no other source of gas imports to turn to but Russia, was sooner or later expected to succumb to the former’s pressures for concession of its transit network and for alignment with the much higher European gas prices. No doubt, Gazprom was in a far more powerful position than its counterpart, Beltransgaz. That started to become apparent as early as June 2004, when Belarus, unable to ensure anymore short-term contracts by independent gas producers, finally succumbed to a price agreement with Gazprom at \$46.68/mcm. As previously said (p.132), in the fall of 2003 Gazprom threatened to increase gas prices from \$30/mcm to \$50/mcm. Belarus declined, considering the increase a severe breach of what had been agreed under the April 2002 agreement. However, as the short-term contracts with independent gas producers proved, Belarus had failed to substitute this agreement, thus succumbing to the price of \$46.68/mcm. Indisputably, this price was a victory for Gazprom considering the offer made (\$50/mcm) a couple of months prior. Especially, the fact that this price remained the same in the June agreement (2004), made no secret of the Russian intention to steadily grow more assertive in its energy diplomacy once Belarus had proven unable to find worth-relying substitutes<sup>171</sup>.

Indeed, from the June 2004 agreement onward, Russia would progressively have Belarus on a string. On December 30<sup>th</sup>, 2004, both parties agreed that for 2005, Belarus would receive 20.15bcm of gas for domestic consumption at the price of \$46.68/mcm while the transit fees charged to Gazprom would also remain unchanged (Gazprom, 2005a). The same trajectory was also followed on December 27<sup>th</sup>, 2005 when it was agreed that both gas price and transit fees would remain unchanged

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<sup>171</sup> It is reminded that the Russian energy policy priorities vis-à-vis Belarus had, first of all, been the joint gas transportation enterprise and subsequently the alignment with the European gas prices.

throughout 2006. However, in the last agreement, Gazprom was quick to clarify that market principles were at play and thus the price divergence from European prices should be accredited to specific reasons in full compliance with economic rationality<sup>172</sup>.

No sooner had the ink dried on the agreed contract for 2006, did Gazprom decide to employ at full scale the bargaining chip of “market principles” to get the maximum out of Belarus’ gas sector. Specifically, in April 2006, Gazprom announced to the Belarusian government that for the next year (2007), the price of gas would be as high as \$200/mcm unless the much-debated joint gas transportation enterprise (Gazprom/Beltransgaz) was coming to fruition (Narodnaia Volia, 2010). Belarus and particularly Aleksandr Lukashenka replied to Gazprom’s suggestion, arguing that if the price was to be near \$200/mcm, then the cost for the 50% shareholding in Beltransgaz would rise proportionally, i.e. \$17 billion (Narodnaia Volia, 2010). Negotiations continued with Gazprom initially re-adjusting its demand at \$170/mcm before it finally plunges to \$105/mcm. However, even in this much lower price, the Belarusian authorities did not quit complaining, claiming the violation of the 1995 Customs Union agreement<sup>173</sup> (Yafimava, 2009, p. 157). The bickering went on, with Belarus threatening to raise transit fees and asking for the signing of a separate transit contract before any other supply contract (Yafimava, 2009, p. 157). Notwithstanding the transit leverage, the margin was too tight for Belarus to maneuver<sup>174</sup>. The much stronger Gazprom would, sooner or later, find its way to dictate its own terms. So it happened.

Having avoided a new disruption to the natural gas trade, on December 31<sup>st</sup>, 2006, Russia and Belarus agreed at Gazprom’s Headquarters over a new five-year

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<sup>172</sup> Specifically, Gazprom in order to justify this price divergence resorted to the following reasons:

- a. Russia and Belarus had been in the process of establishing a common Union State.
- b. In 2005 Gazprom had registered all the necessary documents claiming full ownership of the Belarusian section of the Yamal-Europe gas pipeline and the land underneath had been leased by Gazprom on a long-term basis.
- c. In 2005, Russia and Belarus re-opened the case of establishing a JV within Beltransgaz for operating Belarus’ gas transmission network.

Concluding, Gazprom, at its official site, once more clarified that “all the prices fixed are economically underpinned...and beneficial for all of the company shareholders including representatives of the state and foreign investors” (Gazprom, 2005a).

<sup>173</sup> See also page 125.

<sup>174</sup> Aside from reasons earlier mentioned, i.e. an unreformed energy-intensive industry and the lack of other sources of gas imports but Russia, later on the current research, an extra parameter, crucial to Russia’s bargaining power, is analyzed, that of bypassing natural gas networks such as the Nord Stream. It is preliminary stated that the existence of such networks further weakened the transit leverage of both Belarus and Ukraine, leaving them totally exposed to the forces of the market and their own domestic problems of energy inefficiency.

supply and transit contract (2007-2011). What is important to discern here, is the power profusion on behalf of Russia. Long-craved and painstakingly masterminded energy strategies had been ultimately accomplished.

In particular, it was agreed that gas price for 2007 would be at \$100/mcm while from January 1<sup>st</sup>, 2008, there would be a progressive alignment with the European levels. That policy directive took the form of a strict schedule where in 2008, Belarus would pay 67% of the European price, in 2009 80% and in 2009 90%. The complete alignment would be achieved in 2011 (Gazprom, 2007). Moreover, there was also agreement on the transit fees' rate (\$1.45/mcm/100km) for the gas supplied by the Beltransgaz owned network as well as on the service charge for the Yamal-Europe gas pipeline operation (Gazprom, 2007). Atop stood the provision stipulating that Gazprom shareholding in Beltransgaz would rise to 50% at the price of \$2.5 billion, payable in four equal installments from 2007 to 2010. Overall, Gazprom summarized the contract announcing that the bilateral gas trade had been transformed according to the market principles and upgraded to reach the same level and terms as with all other customers. The price formula would onward depend solely on the market situation and the real price of an oil products' basket (implying here the link between oil and gas prices)<sup>175</sup> (Gazprom, 2007).

What is more to the previous contract is the supplementary protocol of May 18<sup>th</sup>, 2007 that stipulated the specifics of the shareholding reshuffle. According to that, after each installment had been paid, Gazprom would be entitled to a 12.5% stake in Beltransgaz. Parallel to that, it was also stipulated that: a) from 2008 up to 2010 there would be a gradual increase in the wholesale margin (оптовой наценки) in the price of gas supplied by Beltransgaz for domestic consumption<sup>176</sup> and b) the Belarusian

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<sup>175</sup> See p. 118, footnote 144. It's important to make reference here to this 'link' between the oil and gas prices since as Ukraine had previously been put on the line because of its inability to keep up with the rising gas prices, the same would happen, as it is shown later on, to Belarus. Definitely, this 'link' that Russia initiated and still maintains in its gas trade has been calling for consumers with energy efficient structures able to maneuver in periods of oil-price spikes. Laggard economies such as Belarus and Ukraine would every now and then face the (grave) consequences of their own reform-inertia.

<sup>176</sup> The wholesale mark-up refers to the difference between the import price and the sales price, 'at which Beltransgaz sells gas to the state-owned company, Beltopgaz, for distribution and sales to end users' (Yafimava, 2010, p.5).

A rather important parameter within the provision of the wholesale mark-up is that Gazprom had maneuvered and succeeded in linking this mark-up with the transit fees' increase. Specifically, as officially mentioned by Gazprom, "The protocol on setting up the joint Russian-Belarusian gas transmission company, Beltransgaz, provides that the rate for Russian gas transit via the company's pipeline system in 2009-2011 can be increased in case the Belarusian party introduces the wholesale markups for the gas resold to the purchasers in the Republic of Belarus" (Gazprom, 2010a). Indisputably, that protocol further strengthened Russia's relative advantage considering the 50% co-

government would abstain from implementing its special right to introduce a “golden share” (“золотая акция”) in Beltransgaz<sup>177</sup> (Gazprom, 2007a).

So, summarizing the contract and the protocol, it is evident the Russian power profusion, as prior mentioned. Gazprom not only succeeded in setting a strict schedule for Belarus’ alignment with “European Netback” gas prices but also paved its way to the capital structure of Beltransgaz. Furthermore, penetrating deeper the Belarusian gas market, it was guaranteed the latter’s profitability by the upward re-adjustment of the wholesale gas price, while most importantly, it managed to keep an open door for full ownership of Beltransgaz since no “golden share” had been introduced on behalf of the Belarusian state.

The bilateral gas developments of the ensuing years would not follow a separate furrow from that it had already been ploughed with the December 2006 agreement. In 2008, the oil-linked gas price for Belarus scored higher since market principles were governing the estimation procedure (рыночное ценообразование). Specifically, for the first quarter of 2008 Belarus paid \$119.53/mcm whereas for the remainder \$127.90/mcm<sup>178</sup> (Yafimava, 2009). Likewise, in the negotiations for the 2009 gas prices, the Russian side insisted on \$190/mcm while Belarus pushed for a more manageable (given its economic resources) settlement, i.e. at the price of \$140/mcm (Narodnaia Volia, 2010). Finally, both sides agreed that the Belarusian gas imports for 2009 would be 16.4% lower compared with those of 2008, thus reaching 17.6 bcm of gas, at the average price of \$148/mcm (Narodnaia Volia, 2010). The same trajectory was also followed in the price-setting for the first quarter of 2010, when the agreed price climbed higher at \$168/mcm. However, the average price for 2010 hovered around \$150/mcm since, as Gazprom mentioned, there were no tariffs charged for gas exports to Belarus while there was also an agreement for a transitional period

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ownership of Beltransgaz. In simpler terms, Gazprom, in the best case scenario, would take, more or less, back from the Belarusian market what it would at first have to pay as transit fees to Beltransgaz, whereas, in the worst case scenario, could profit from a combination of rising European (world) prices with stagnant transit fees, once the agreed mark-ups had not been imposed. Certainly, in the latter case it would have to fill possible holes in the financial balance of Beltransgaz, but even in this case, this extra burden would be minor compared to the expected major profits from a *stable and uninterrupted* gas trade with the lucrative EU market. So, reassessing the former scenarios, someone could argue that Gazprom, at best, could ‘stifle’ the Belarusian market with the mark-ups, while, at worst, be guaranteed a lucrative natural gas trade with the EU. In both cases, Gazprom and Russia were the privileged with the Belarusian transit leverage losing even more prominence/power as a bargaining chip.

<sup>177</sup> A “golden share” refers to the government right to run a company regardless of its shareholding.

<sup>178</sup> It had also been agreed that the gas price would onward be set per quarters (i.e. ежеквартально).

(переходный период) necessary for the latter's economy to adjust to the new higher prices<sup>179</sup> (Gazprom, 2009).

Beyond any doubt, that transitional period was indeed necessary since gas debt had started to accumulate again. Notwithstanding the divergent estimation, (the Russian side claimed \$192 billion whereas the Belarusian \$133billion), the fact is that the rapidly growing digits were seriously putting in question the projected gas price-alignment for 2011 (Narodnaia Volia, 2010; Interfax 2010c). In view of such a gloomy picture, the Belarusian President, Aleksandr Lukashenka, suggested, in the end of May 2010, the concession of a controlling stake in Beltransgaz to Gazprom in exchange for gas supplies in Russian domestic prices<sup>180</sup> (Narodnaia Volia, 2010). Gazprom, although it did not reject the offer, it made clear that any deepening of the cooperation should not come in contradiction with the terms of the signed contracts and the service of the pending debt.

Gazprom was now in a much stronger position to impose its own terms in the bilateral gas trade. The December 2006 agreement had already guaranteed what the Russian side was after and thus there was no need for backtracking. Of course, new concessions or negotiations were discussable but not at the expense of prior claims. Reasoning that, the Russian side, having initiated a strict timeframe for alignment with the "European netback" gas prices up to 2011, knew very well, especially if co-considered Belarus' reform inertia, that new bargains would, sooner or later, come on the table. That is exactly what happened with Lukashenka's offer for greater control in Beltransgaz in exchange for supplies at Russian domestic prices. However, this would not be the last of its series. In 2011, when the projected alignment was due, new pressures would be created. The gas price for Belarus in 2011 was estimated

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<sup>179</sup> At this point it is important to mention that for this price discount at \$150/mcm there are also other explanations of equal validity, that hold that the reduced price was a unilateral Belarusian act, not at all supported by Russia's Gazprom. Particularly, the reliable news agency Interfax has sited Gazprom spokesman, Sergei Kuprianov, saying: "Beltransgaz has decided to pay not at the contract price, but at a price they determine unilaterally"(Interfax, 2010c). Even in a press-release at Gazprom site it is reported that "In accordance with the contract (December 2006), the formula based price for the Russian gas delivered to Belarus was equal to USD 169 per 1,000 cubic meters in the first quarter of 2010, USD 185 per 1,000 cubic meters in the second quarter and it is assumed to be equal to USD 193-194 in the third quarter"(Gazprom, 2010a). Notwithstanding the *prima facie* convergence, we currently deviate, following another official press-release that holds that Gazprom was aware of the price reduction. The reason is that Gazprom, viewing the hardships of the Belarusian economy to keep up with the rising/stifling gas prices, might indeed have signed a 'last-minute' addendum (2009) to the December 2006 contract, since getting something is always better than nothing.

<sup>180</sup> It is important here to mention that Russian domestic gas prices were much lower and thus could temporarily be of a solution to the Belarusian economic dead-end.

around \$250/mcm and any reluctance of paying would skyrocket the pending gas debt to the red zone (Narodnaia Volia, 2010).

Meanwhile, brinkmanship diplomacy heated up for the remainder of 2010 with the Russian, Putin-aligned, President, Dmitry Medvedev, stating on June 15<sup>th</sup>, 2010 that unless Belarus serviced its gas debt within 5 days Gazprom would minimize the deliveries and the Belarusian President, Aleksandr Lukashenka, replying on June 18<sup>th</sup>, 2010 that Gazprom owed Belarus \$260 billion for transit (Narodnaia Volia, 2010; RIA Novosti 2010d).

With each side seeking to collect the debt from the other, both parties entered an anew tense period in their gas relations<sup>181</sup>. As the crisis started to escalate, on June 21<sup>st</sup>, 2010, Dmitry Medvedev, rejected Belarus' prior offer of repaying its debt with barter, saying that Gazprom will not take "pies or pancakes" for gas (RIA Novosti, 2010e). Parallel to that, he also had a meeting with the head of Gazprom, Alexei Miller, in which both agreed on a possible reduction of gas supplies to Belarus, equaling the amount of the outstanding debt. No sooner had the meeting finished, did Gazprom proceed with a 15% reduction in the gas supplies, announcing at the same time that further reductions could even reach up to 85% (Interfax, 2010e). Belarusian procrastination, however, over its gas debt continued, giving rise to a new round of reductions. Specifically, as stated by Alexei Miller "over the past twenty-four hours,

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<sup>181</sup> Belarus insisted on \$260 billion payable by Gazprom for transit services whereas Russia stressed that continued payment arrears on behalf of Belarus had reached the gas debt to \$200 billion, moving upwards to ultimately reach \$500-600 billion by the yearend (Narodnaia Volia, 2010).

A fair account of the facts would hold that Gazprom had indeed paid Belarus \$228 million for transit services from November to December 2009 and for the first five months of 2010 on the basis of a \$1.45/mcm/100km transit fee, while Belarus was vociferously claiming a \$1.74/mcm/100km for 2009 and \$1.88/mcm/100km for 2010 transit fee, thus increasing Gazprom's debt to \$260 million (RIA Novosti, 2010a). So, as the Belarusian First Deputy PM, Vladimir Semashko, claimed, Gazprom pending gas transit debt to Minsk after the aforementioned payments was \$32 million (RIA Novosti, 2010a). However, as Gazprom spokesman, Sergey Kyprianov, admitted, indeed there was a protocol that pinned a possible increase of the transit fee to \$1.74 and \$1.88/mcm/100km for 2009 and 2010 respectively, on the condition of a wholesale mark-up for Belarusian consumers (\$10.45 and \$11.07 for the same years). Since this mark-up had never been introduced, Gazprom, according to Kyprianov, was legitimized to abstain from any contractual obligation stipulating further increase of the transit fees (Yafimava, 2010, p. 11; the protocol to which Kyprianov referred to, was probably that of May 18<sup>th</sup>, 2007, according which the link between wholesale mark-up - transit fees had to take place within the 2008-2010 period. However there was no reference to specific rates to be adopted by both sides; See also footnote 178).

Following this argumentation, it is discernible that Russia' relative advantage had been solidified from the previous contracts, especial that of December 2006 and the supplementary protocol of May 2007. The laggard economy of Belarus would, onward, find it extremely difficult to keep up with the Russian economic rationality/stifling and thus it would try to fence it off by false argumentation which, at times, would pose into its eyes as a "legal base" for illegal actions such as the siphoning off of gas from transit pipelines.

Belarus has not taken any steps to repay the debts for the delivery of Russian natural gas and from 10 hours in the morning of June 22, a 30% cut in planned gas supplies to Belarus was introduced” (RIA Novosti, 2010b). In view of Gazprom’s determination to go further down the road, Belarus paid part of its debt and also sent a letter stating its intention to “start taking gas from the transit pipe for the needs of the national economy, if there are further cuts in gas supplies” (RIA Novosti, 2010b). Gazprom, aiming at showing the meaningless of the threat, stressed that while indeed sensitive in a transit cut-off, it was not also vulnerable since it could send higher volumes to the EU customers via Ukraine’s pipeline network<sup>182</sup> (Yafimava, 2010, p. 9). Belarusian authorities, nevertheless, defying Gazprom’s alternative, on June 22<sup>nd</sup>, reduced the transit of natural gas from Russia to Europe proportionally to the amount of gas they were not receiving from Russia<sup>183</sup> (Interfax-Ukraine, 2010).

Heading towards the scaling down of the dispute, on June 23<sup>rd</sup>, Belarus paid the remainder of its debt and on June 24<sup>th</sup> Gazprom started pumping gas supplies again (Yafimava, 2010). However, shortly before the final resolution, Belarus tried to get to the offensive, pushing ahead its own ‘fabricated’ argument about Gazprom transit gas debt. Belarusian authorities even tried to set a strict deadline for its repayment, only to later receive Gazprom official justification as to why the Belarusian claims were untenable<sup>184</sup>. Finally, the whole issue was settled on July 2<sup>nd</sup> with the signing of a new protocol that, more or less, restated, this time in detail, what had already been agreed in that of May 18<sup>th</sup>, 2007<sup>185</sup>. Specifically, it stated that “due to the fact that the Belarusian party raised the 2010 wholesale mark-up for the gas sold by Beltransgaz to USD 11.09...the rate for Russian gas transit via Beltransgaz owned networks will be equal to USD 1.88/mcm/100km in (the remainder of) 2010” (Gazprom, 2010a).

What makes this protocol rather essential, is its key role in first, elucidating the dispute and second, exonerating Gazprom. Belarus, by co-signing it, indirectly conceded that the charging of Gazprom with increased transit fees was in violation of the May 2007 protocol, given that there was not also a mark-up in the wholesale domestic gas market on its behalf prior to increasing transit fees. Consequently,

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<sup>182</sup> At this point is reminded that since January 2010, when the pro-Russian Ukrainian President Viktor Yanukovich had taken office, bilateral relations and especially those of natural gas had ameliorated.

<sup>183</sup> As a Belarusian government source told Interfax “Gas is flowing towards Europe, but its transit has been reduced proportionally to the amount Belarus is under-receiving from Russia now” (Interfax-Ukraine, 2010).

<sup>184</sup> See footnote 181 for an inclusive account of the facts.

<sup>185</sup> See pages 135(bottom) as well as footnote 176.

Gazprom was absolutely justified in paying a \$1.45/mcm/100km transit fee in line with the agreement of December 2006, instead of a \$1.75 and \$1.88/mcm/100km for 2009 and 2010 respectively, as the subsequent May 27<sup>th</sup>, 2007 protocol stipulated.

What the dispute of June 2010 once more revealed, is that Russia had succeeded in solidifying its relative gas advantage *vis-à-vis* Belarus. Predominantly, it had not only managed to gain ownership of the Belarusian transit network via the formation of a joint gas transportation enterprise based on Beltransgaz, thus seriously curbing the transit leverage, but it also assured compliance of the bilateral gas trade with the market principles. The latter is of prime importance considering that the unreformed, laggard economy of Belarus would, sooner or later, accumulate debts which occasionally would lead to disputes like the one of June 2010, based on ‘fabricated’ argumentation on behalf of the weaker state (Belarus) in anticipation of unexpected, undefined gains at the expense of the powerful state (Russia). Overall, Putin’s Russia succeeded in turning the initial interdependence to ultimate unilateral dependence of Belarus on Russia, thus having the latter’s relative gains easily attainable for as long as the energy power asymmetry allowed it<sup>186</sup>.

#### ***4.3.2.2 The undercurrent factor in Belarus’ submersion to Russia***

While earlier argued that oil and oil transit are hardly used as a means of today’s energy politics due to the commodity’s fungibility (see p. 72-73), Belarus seems to be the exception that proves the rule. The previously analyzed submersion of Belarus to the Russian gas demands had also to do with the bilateral oil trade. As a preliminary comment it is stated that re-exports of refined oil products by Belarus were among the primary sources of revenues for the pro-Soviet economy<sup>187</sup>.

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<sup>186</sup> For the sake of inclusiveness, it is mentioned that on November 25, 2011, Russia and Belarus signed a new gas supply and transit agreement according which Gazprom would purchase the remaining 50% share in Beltransgaz for \$2,5 billion, thus acquiring full ownership and totally breaking interdependence, while Belarus would receive its supplies at \$165,60/mcm for 2012, calculated under a Russian pro-market formula (Gazprom 2011f).

<sup>187</sup> Drawing back in history, Belarus had some of the largest and technologically advanced oil refining facilities in the USSR. After the dissolution of the Soviet Union, the single energy infrastructure as it had been developed during the Soviet period, created inescapable synergies, one of which was between Belarus and Russia, if not the prime (Balmaceda, 2006). All along the 1990s and especially in the second half, both parties tightened their relationship as a result of the project of political Union that had been launched from 1996 onward. That rapprochement had benefited both parties, with, first of all, the Russian companies being able to: a) participate in entrepreneurial schemes, partly involving oil refining, thus avoiding taxes and export duties imposed by the Russian authorities, b) invest in Belarus’ refinery sector and thus c) get higher prices in Western markets due to the modernization and

On January 1<sup>st</sup>, 2010, Russia levied export duties on crude oil deliveries to Belarus. No sooner had this policy taken effect, a further expansion followed covering refined oil products as well as “petrochemical raw material” supplies (Socor, 2010a). These duties, however, were applicable only to the 15 out of the 21 million tonnes of Russian crude oil annually delivered to Belarus (Socor, 2010a). As the then Russian First Deputy PM, Igor Sechin, put it in December 2009, “Belarus could import the domestic volumes (5-6 million tons) duty free, citing the ‘brotherly relations’ between the two countries, leaving the remaining 15 million tons subject to a full \$267/ton duty” (RIA Novosti, 2010a; Faulconbridge and Tomashevskaya, 2010).

The implications of such a policy for the Belarusian economy are not hard to tell. A price-increase spiral would ultimately deprive Belarusian refineries of the necessary

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upgrading of the facilities according to the Western European standards (Balmaceda, 2006, p. 187-188). Elaborating on the aforementioned, having a stake in Belarus’ oil refineries meant that Russian oil companies could not only export to the European market in a much more profitable way (due first of all to the proximity and second to the higher added-value of the refined oil products instead of just selling crude oil), but also supply with increased profitability the neighboring Russian oblasts, a scenario which could not happen if refined oil products were to come from Siberia and the Volga region (Balmaceda, 2006, p.189).

Of course, as said above, the Russian oil companies were not the only ones to benefit from that rapprochement. Belarus had also its share, especially if considered that steady supplies were the necessary base for all subsequent revenues. Giving an example, Belarusian refineries used to buy oil from Russia at domestic market prices and sell refined petroleum products in Europe at world prices (RIA Novosti, 2010a). That situation allowed for a huge profit margin, given the Belarusian shipping capacity of 400.000 barrels of oil per day heading westwards via Russia’s ‘Druzhba’ pipeline (Guardian, 2010). However, that bilateral relationship did not develop as smooth and balanced as someone would expect. Controversies and rivalries soon made their way up to the surface. The Russian side, aware of the economic-strategic potential of the refineries sought ownership as early as of the mid- 1990s. ‘Mozyr’ and ‘Naftan’, the two most profitable refineries in the FSU region able to produce EU standard diesel and gasoline soon constituted the bone of contention (Balmaceda, 2006).

Starting with the ‘Mozyr’ refinery, the Russian state managed to lay a hand in the shareholding via the Belarusian-Russian JV ‘Slavneft’ which since 1994 had been in control of half of Mozyr’s shares (Balmaceda, 2006). Moreover, when in 2002 the JV was fully privatized, there were two Russian companies (‘Sibneft’ and ‘TNK’) that acquired full control (98.5%) (Balmaceda, 2006, p. 190). However, the Russian penetration did not go any further. When again in 2004 the wholly Russian-owned Slavneft approached the Belarusian state-owned ‘Belneftkhim’ with the aim to acquire its share and finally be able to affect the decision-making in the company, the latter procrastinated the negotiations by piling demands and requirements only to keep in the end the control of the company to Belarusian hands (for the negotiations and the demands see Balmaceda, 2006, p.190).

While in the previous case the Russian state got very close to a commanding stake in the company, in the case of the ‘Naftan’ refinery developments had been polar opposite. Since the very beginning, almost all of its shareholding (99.8%) had been owned by the Belarusian state (Balmaceda, 2006, p. 191). Therefore, it had been much harder for a Russian company, either state or private, to enter into the ownership structure. In particular, periodic efforts (since 1995) toward the creation of a JV by LUKoil, one of the largest private Russian oil companies, had come to no avail.

Indisputably, the Belarusian government and especially Lukashenka had been very careful in all forms of cooperation that could entail granting a commanding stake in sources absolutely necessary for the nation’s economic sustainability. Summarizing the Belarusian strategy in the privatization negotiations with Russia, someone could easily identify the match with the general ‘gearbox’ pattern: “going ahead with the project in its planning stages, when it can acquire maximum concessions from the Russian side, only to later create obstacles to the actual carrying out of the agreement” (Balmaceda, 2006, p. 193).

capital for their technological upgrading and modernization, thus putting at stake their overall competitiveness in the European market. How? The Russian export duties markedly increased the purchase price of crude oil in Belarus, hence leading in the price-increase of refined products exported by the latter to the EU states<sup>188</sup>. Such a situation, however, would, in the mid-long term, risk the competitiveness of the Belarusian refineries, given the fungibility of the commodity. Therefore, in eschewing such an ominous scenario, the Belarusian authorities should abolish their own export duties on oil products earmarked for the EU market (Socor, 2010a).

But this would only be a short-term solution to the economy's most profitable sector<sup>189</sup>. The refineries would soon encounter shortages of the capital needed for their modernization unless readjustments to the processed capacity were made<sup>190</sup>. So it happened. In the first half of 2010, the output of Belarus' oil industry was cut-down by 30% while the downturn in the exports of petroleum products reached 40% (RIA Novosti, 2010b). Analysts estimated the loss at \$2.5 billion or 5% of Belarus' \$50 billion economy, fact that indisputably revealed the excessive level of dependence on the export of subsidized oil products (Falconbridge and Tomashevskaya, 2010).

Russia, by imposing such an aching hike in the customs duties, brought the cash-strap Belarus *face à face* with its own existential problems. On these grounds, it did not only succeed in securing the completion of the 50% acquisition of Beltransgaz by Gazprom on March 30<sup>th</sup>, 2010 (i.e. relative gains in the gas sphere), but also in expediting the negotiations with the Belarusian government over the Russian oil

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<sup>188</sup> Germany has been covering 15% of its oil needs by the Druzhba's spur crossing Belarus, while Poland has been relying on the same pipeline spur for more than 75% of its consumption (RFE/RL, 2010).

<sup>189</sup> As Yaroslav Romanchuk, the director of the Mizes think tank in Minsk, admitted, "Oil products are one of the main sources of export income for Belarus...Last year (i.e. 2009), oil products made up 37 percent of exports" (Falconbridge and Tomashevskaya, 2010).

<sup>190</sup> Reasoning the viability question, here we draw on political economy to remind that after a certain point (where the Marginal Cost (MC) curve intersects with the Marginal Revenue (MR) curve, signaling maximization of profit), the MC for an enterprise raises faster than the Marginal Revenue (MR). Thus, past that point production is not to the profit of the company.

In the case of Belarus, the scenario is much more gloomy, given that having, more or less, no other source of sizeable revenues in its economy, the re-export of initially cheap-bought Russian crude oil at far-higher European prices, provided it with the margin not only to function its refineries beyond the point of "maximization of profit", since the supra-profits from the purchase/sale price divergence could make up for the excessive costs, but also to stash possibly some extra revenues to be redistributed in other lagging, subsidy-driven sectors of the pro-Soviet economy. Therefore, once Russia levied the export duties, Belarus was presented with an existential problem. Not only it was forced to operate its refineries according to the "profit maximization" point, processing lower quantities, but also it was left with no cushion for other ailing economic sectors.

All in all, as stated by an oil trader, "if they (Belarusian plants) want to stay profitable they would need to slash imports by three quarters" (Zhdannikov, 2010).

companies Rosneft and LUKoil purchasing a stake in the Naftan refinery, given the narrowing margins for the latter to receive strategic investment<sup>191192</sup> (Interfax, 2010d).

All things considered, Russia, from 2000 onward, managed to nullify the ‘gear box’ pattern within which Belarus used to place its affairs and particularly its energy affairs with Russia. In 2010, Belarus’ maneuverability *vis-à-vis* Russia had been seriously limited and it remains to be seen up to what point the current energy power asymmetry may allow for the Russian relative advantage to advance. In particular, while the aforementioned oil dispute was ongoing, Russia, Belarus and Kazakhstan had agreed on the formation of a Customs Union, nominally enacted from January 1<sup>st</sup>, 2010<sup>193</sup>. Belarus, although it maneuvered within this institutional framework so as to ‘economize’ the dispute, claiming that in a Customs Union imports of Russian oil should be completely duty-free, the fact remains that “entering into a customs union with a big and powerful former empire like Russia often results in a much more politicized market than that typical for a Western free trade zone” (Belarus digest, 2010).

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<sup>191</sup> For the sake of inclusiveness here it is stated that Rosneft is a state controlled Russian oil company whose board was chaired at the time by the then Deputy PM, Igor Sechin.

<sup>192</sup> In facilitating the Russian ‘take-over’ tactic, Belarus’ vulnerability had definitely its own merit. Specifically, how vulnerable had Belarus been to the Russian oil export duties? Seeking an answer to this question, the Odessa-Brody oil pipeline makes a critical case. That pipeline, that crosses the Ukrainian territory reaching the border-line Belarusian refineries, could be of a solution to the Russian oil export duties as long as it was used as initially planned, i.e. south-north, thus, enabling both Ukraine and Belarus to import oil from other sources, such as Venezuela and become less dependent on Russian supplies. However, this never happened. From 2002, Russian oil companies had blocked Kazakhstani and Azeri oil supplies reaching the port of Odessa, using the pipeline in reverse, i.e. north-south (Socor, 2010b). Consequently, it was only possible the outflow/export of (Russian) oil. Even worse to that is the fact that the pipeline had been under-utilized for the best part since its construction, hence, limiting any fees that Ukraine, as a transit state, could gain and raising suspicions to Belarus over the future of its lucrative refineries. So, putting things in a laconic form, “no supply diversification, no transit fees, escalating dependence on Russia”. Under these circumstances, it is easy to understand how did Russia manage to set its tone in the energy negotiations with Belarus. Blocking the latter from its main source of hard currency, then, there were a few alternatives left, if actually any, but to succumb to whatever demands.

Overall, the 2010 export duties were the tip of the iceberg, given that previously, from 2002 onward, Russia had been painstakingly sculpturing the Belarusian vulnerability, only to exploit it whenever it saw fit.

<sup>193</sup> That Custom Union came actually into effect from July 1<sup>st</sup>, when the three ex-Soviet states agreed on a detailed Customs Code, ironing out all areas of disagreement (“the import of foreign cars and aircraft into the Union’s customs territory and export duties on Russian oil and petroleum products to Belarus”) (RIA Novosti, 2010b).

#### 4.4 The 3 'Bs': *Bypassing transit states, Breaking interdependence, Bordering the EU*

The quintessence of Russia's strategy towards breaking interdependence with the FSU region revolves around (recent) natural gas networks, designed to bypass Ukraine and Belarus and link directly Russia with the EU market.

Atop stands the "Nord Stream" ("Северный поток") pipeline project which runs across the Baltic sea from Russia to Western EU member-states<sup>194</sup>. Having no transit states on its way, this new export route is characterized by low country risk and transit costs while it adds a lot to the credibility and reliability of Gazprom as a natural gas supplier (Gazprom, 2011c). As mentioned by the official site on the intent of the project, this pipeline

"provides Russia with a third gas supply route to the EU, in addition to the existing transit routes through Ukraine and Belarus. It will minimize the technical, commercial or political risks of disruption of supply, as well as providing Gazprom and its European partners



Map 4.5: The Nord Stream pipeline project

with greater technical flexibility to meet changing EU demand" (Nord Stream, 2011). Such a prospect, which has actually become reality with the completion of the project in October 2011, expands the Russian bargaining power and relative advantage vis-à-vis the aforementioned transit states.

Putting the argument in numbers, this project has been slated to supply about 25% of the EU natural gas. Given that, Ukraine, which just before the commencement of the Nord Stream transited via Soviet-era pipelines almost 80% of Russian gas to the EU, seems to lose much of its bargaining standing vis-à-vis Gazprom. Elaborating on the argument, Ukraine's annual transit capacity has been reaching 142bcm, out of

<sup>194</sup> The map is retrievable at:

<http://www.businessinsider.com/germany-and-russia-2010-7?op=1>

which 100bcm have been destined for the EU market (Shiryayevskaya and Choursina, 2011). If now this amount was curtailed by 25%, then Ukraine would forfeit about \$550-\$700 million annually<sup>195</sup> (Shiryayevskaya and Choursina, 2011; RFE/RL, 2011). Undoubtedly, while a major blow to recent Ukrainian efforts towards renegotiating the stifling gas pricing formula with Gazprom, it has been a major plus for the latter, given that its CEO, Alexei Miller, tied any renegotiation with merging NAK Naftogaz Ukrainy with Gazprom, i.e. acquiring a stake in the Ukrainian GTS (RIA Novosti, 2010c).

Of course, it is implied that “Nord Stream” has been exerting the same leverage on Belarus, which has also been responsible for transiting the remainder (20%) of Russian gas to the EU market<sup>196</sup>. Overall, as put by Russia’s PM, Vladimir Putin, in September 2011 “we are slowly and surely turning away from the dictate of transit states” (Shiryayevskaya and Choursina,2011).

To that direction has also been pointing the “Blue stream” gas transit network, which since February 2003, when commercial usage started, has been directly supplying Russian gas to Turkey bypassing transit states of the FSU region (Gazprom, 2011d). This 1,213km long pipeline, that stretches from Izobilnoye area (Stavropol Krai) to Ankara (Turkey) via a submerged section of 393km long at the bottom of the Black Sea, has been responsible for large quantities of Russian gas reaching South Europe<sup>197</sup>. In 2010, 8,1 bcm of gas had been transported via this line (Gazprom, 2011e).



Map 4.6: The Blue Stream pipeline project

Given the project’s designed capacity at 16 bcm/year, it is easy to understand the leverage that could be exerted on transit states once larger quantities, initially

<sup>195</sup> Estimates have been made with the transit fees’ rates as of 2011.

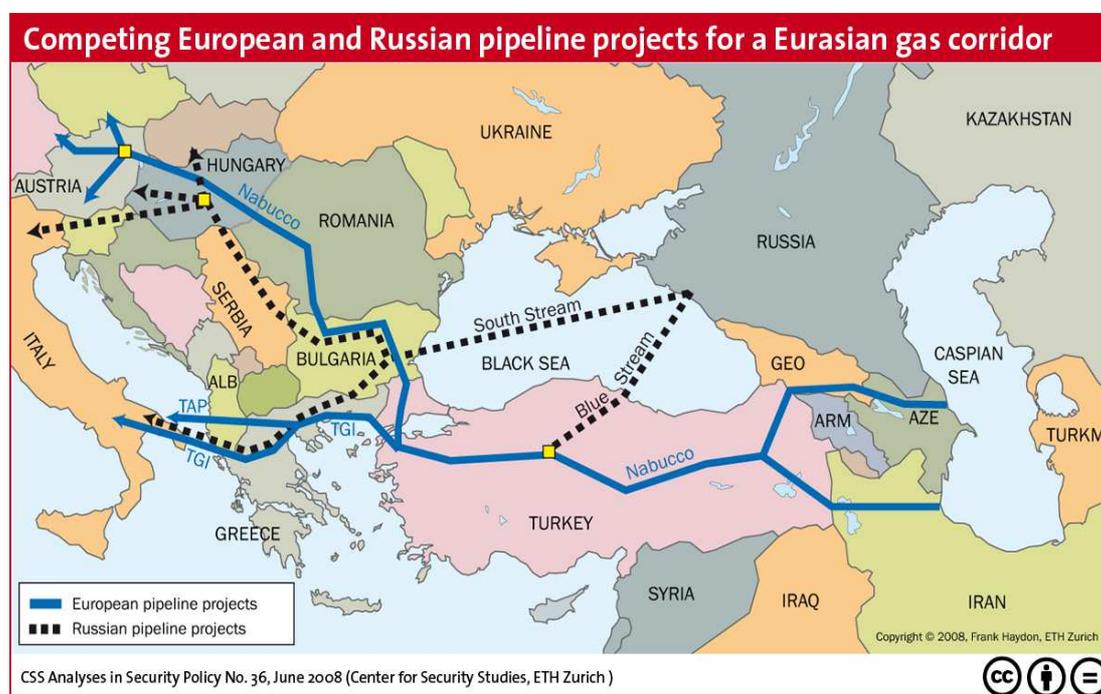
<sup>196</sup> It is illuminating, at this point, to cite how a Belarusian energy analyst has assessed the implications of this pipeline on the transit states. According to him “Russia needs Nord Stream to make both Belarus and Ukraine into colonies of the 18<sup>th</sup> century...it is necessary to realize that all this is being pursued within the framework of a single policy-the policy of colonizing this region” (RFE/RL, 2011).

<sup>197</sup> The map is retrievable at:

[http://www.declarepeace.org.uk/captain/murder\\_inc/site/pics/bluestream.jpg](http://www.declarepeace.org.uk/captain/murder_inc/site/pics/bluestream.jpg)

earmarked for them, were diverted via this line. Notwithstanding a less likely option, Gazprom still stands to benefit (bargaining power) to the detriment of both Ukraine and Belarus.

Another network, dubbed “South Stream”, albeit in the planning stages, is also intended to bypass transit states, thus adding to both Russia’s bargaining power and its firmer natural gas ties with the EU. Offshoot of the 2006 Russo-Ukrainian gas dispute and the subsequent cut-off, this transit network will be jointly constructed by Gazprom and the Italian ENI in the “Blue Stream” footing, running across the Black Sea to supply central Asian and Russian gas to South and Central European states<sup>198</sup> (Gazprom, 2011e).



**Map 4.7: The Nabucco and the South Stream pipeline projects<sup>199</sup>**

With an annual capacity of 63bcm/year, prospects become rather promising for Russia, with its level of transit dependence hitting new lows and its rapprochement with the EU gazing at new peaks<sup>200</sup>.

<sup>198</sup> From Bulgaria-Serbia-Hungary and Bulgaria-Greece-Italy.

<sup>199</sup> Source: (Socor, 2011a).

<sup>200</sup> This last scenario of Russia-EU “coming even closer” via the “South Stream” project, although it has many positive aspects such as bypassing problematic FSU transit states and thus enhancing the EU energy security, it did not alleviate the EU authorities’ suspicions over excessive dependence on Russia. Thus, the EU proposed instead of “South Stream” the construction of the ‘Nabucco’ network, bypassing both FSU states and Russia and directly bringing Central Asian gas (principally Azeri) via Turkey. However, a final decision is yet to be made.

Summarizing the mid-long term loss of bargaining power of the transit states (especially Ukraine's) vis-à-vis Russia, the following Figure by the International Energy Agency (IEA) draws a rather clear picture:

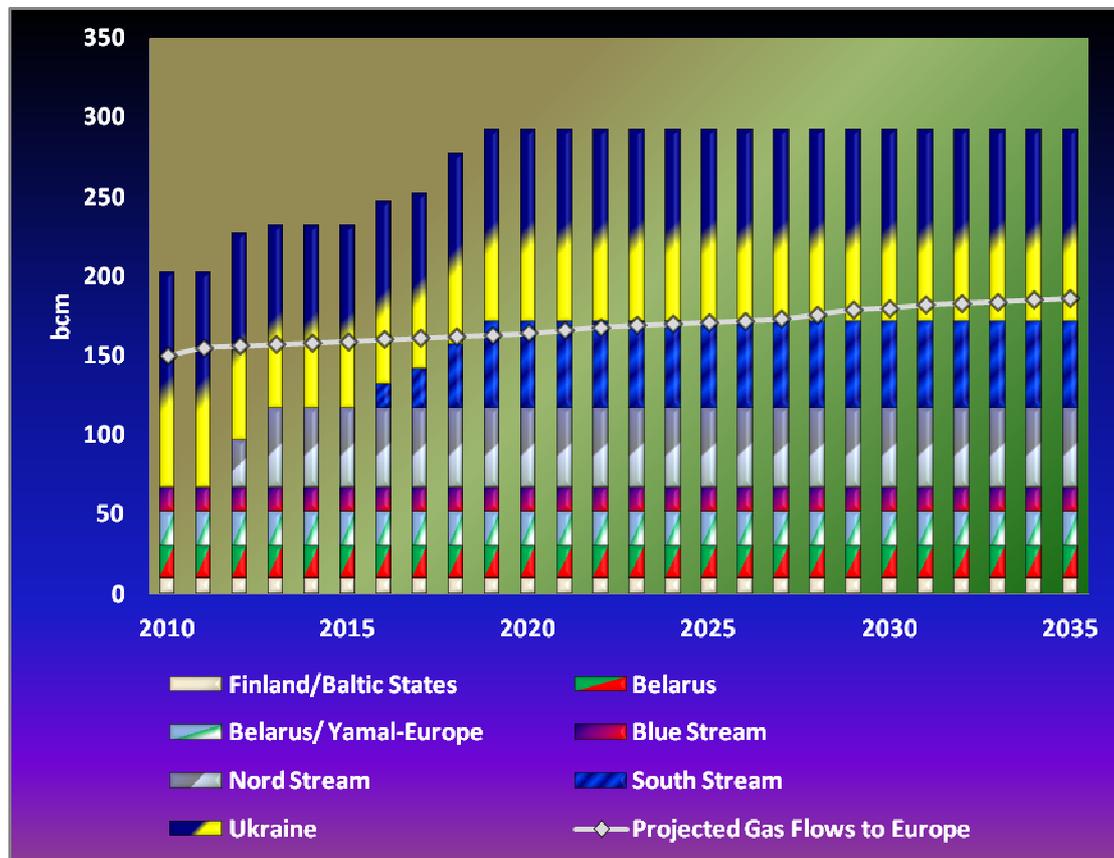


Figure 4.1: Mid-long term Russian gas flows to the EU, arranged by transmission network<sup>201</sup>

#### 4.5 Conclusion

To recap, Russia's 2000s pipeline diplomacy, on the one hand, played a key role in undermining the bargaining power of the FSU region (Ukraine's and Belarus' in particular) to the benefit of the former. While at first 'nominally' interdependent, Russia built on the overall energy power asymmetry to turn interdependence to unilateral dependence of Ukraine and Belarus on the former. As we have earlier seen, Russia maneuvered so as not only to guarantee market principles in the bilateral gas trade, but also to raise sovereignty issues by laying a hand in their transit networks, thus eradicating their transit leverage once and for all. Moreover, 'putinized' Russia

<sup>201</sup> This Figure has been remodeled strictly abiding by IEA's paradigm, (IEA, 2011, p. 338).

went further down that road, succeeding in ‘dictating’ various of the otherwise sovereign policies of these states. In Ukraine, military concessions were made in exchange for ‘reasonable’ gas prices whereas in the more pro-Kremlin Belarus, concessions, surpassed the military sphere, reaching the economy, with Russia pushing for the most lucrative sector, i.e. the oil refineries. If anything, the Russian natural gas relations with these two FSU states revealed the extent that Neorealism’s “relative gains” may reach when operating within a “unilateral dependence” framework. The powerful side may put on an assertive face, claiming interests in many societal spheres, i.e. military, economy, etc.

On the other hand, the 2000s constantly developing Russian gas transit networks set an orbit for Russia coming much closer to the EU market. Specifically, the level of proximity grew so high, that while the former was seeing a positive step towards energy security for the EU, the latter had been more skeptical, expressing concerns over excessive dependence on the former. Phrasing the argument in energy terms, the EU feared of the incumbent ‘true’ interdependent relationship, that allowed for an energy power symmetry, turning to one of unilateral dependence on Russia, where the latter would qualify to play the “political card” whenever it saw fit<sup>202</sup>. This delicate diplomatic maneuvering is analyzed right after.

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<sup>202</sup> The reason for the terms ‘nominal’ and ‘true’ interdependence is to show that in the case with the FSU transit states, Russia managed to manipulate and easily break its dependence on transit, given the immense demand for Russian gas on behalf of the *unreformed* and *undiversified* economies of Ukraine and Belarus and the pressing factor of the alternative natural gas networks. Russia had the comparative advantage vis-à-vis those states, thus a ‘pure’ form of Realism was employed to justify its energy behavior.

In contrast, in the case with the EU, the interdependence is characterized ‘true’ since Russia, at the time of writing, has not succeeded in substituting its energy export revenues with any other source, while the EU, for the same period, has been a far cry from an adequate diversification of its gas imports away from Russia. Both sides have been equally dependent. with equal means at their disposal (energy power symmetry).

# *Chapter 5: The strategic Russia-EU energy relations: until when?*

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## *5.1 Understanding interdependence*

### *5.1.1 The rise of the natural gas era in Europe*

Before entering the core of modern gas business between Russia and the EU, it would greatly benefit our understanding to take a brief look at the recent history of natural gas in a rapidly changing Europe.

The debut of natural gas in Western Europe occurred in 1959 with the coming into light of the Dutch gas field ‘Groningen’ (Stern, 2003; IEA, 2009, p. 420). Following that, major discoveries were made in UK’s sector of the North Sea and off the Norwegian coast, with the latter having so abundant resources, that they could cover not only the Norwegian needs but also be exported via newly built pipelines to the Continental Europe and the UK<sup>203</sup> (Stern, 2003). However, the need for external supply sources was not to be underestimated. Small quantities of Soviet gas had been steadily exported to Poland since the late 1940s, while the upgrading to large-scale gas exports was accomplished no sooner than the huge gas deposit ‘Shebelinka’ had reached culmination in 1975 and the Soviet production shifted to the Siberian fields ‘Medvezhe’, ‘Urengoy’ and ‘Yamburg’, thereafter<sup>204</sup> <sup>205</sup>(Stern, 2003). These developments were accompanied also by the construction of a multiple-string natural gas network aimed at connecting the aforementioned gas fields with Western Europe via Ukraine<sup>206</sup> (Stern, 2003). In parallel, new ties were forged with other regions as well.

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<sup>203</sup> Even in 2010, Norway remained a major supplier of Europe, given that from the continent’s annual overall natural gas production (247,9 bcm), 95,7 bcm or 38,6% came from Norway (BP, 2011). By the word ‘continent’, we refer here to the states of Central and Western Europe.

<sup>204</sup> See page 92 for a detailed account. In today’s geography, the ‘Shebelinka’ gas field was located in Ukraine.

<sup>205</sup> The gas fields ‘Medvezhe’, ‘Urengoy’ and ‘Yamburg’ are exactly located within the Nadym-Pur-Taz region. However, for the sake of inclusion someone should also consider the major gas field ‘Zapolyarnoe’, which has been commissioned in 2001 and ever since it has contributed a lot to the overall Russian production (IEA, 2011, p. 305). A detailed map of the aforementioned gas fields may be accessed at the site of Gazprom at: <http://www.gazprom.com/about/production/projects/deposits/>

<sup>206</sup> In the following decades, i.e. the 1990s and the 2000s, new natural gas networks were constructed, forging stronger and deeper ‘supplier-consumer’ ties between Russia and the EU (for a detailed account see the previous chapter and specifically pp. 94, 125-126, 140-142).

The Trans-Mediterranean gas network (from Algeria to Sicily via Tunisia) was laid down in 1983, connecting Northern Africa with the South EU, while with more than a decade delay, another gas network, the GME, focusing on the same geography but on the opposite direction, connected Algeria with Spain and Portugal via Morocco (Stern, 2003).



Map 5.1: The Trans-Mediterranean and GME natural gas networks<sup>207</sup>

So, in the broader picture of first the Western Europe and later the EU natural gas supplies, traditionally, there have been three large exporters: Norway, Russia and Algeria. Two of them, Norway and Algeria, have been partly supplying different regions of the EU. Norwegian gas supplies have been earmarked for the UK and Northwest Continental Europe while Algerian supplies have been earmarked for the Iberian Peninsula and Italy. The third, Russia, has been the main supplier, filling the needs across the EU in the continental northern, central and southern gas markets (Clingendael, 2008).

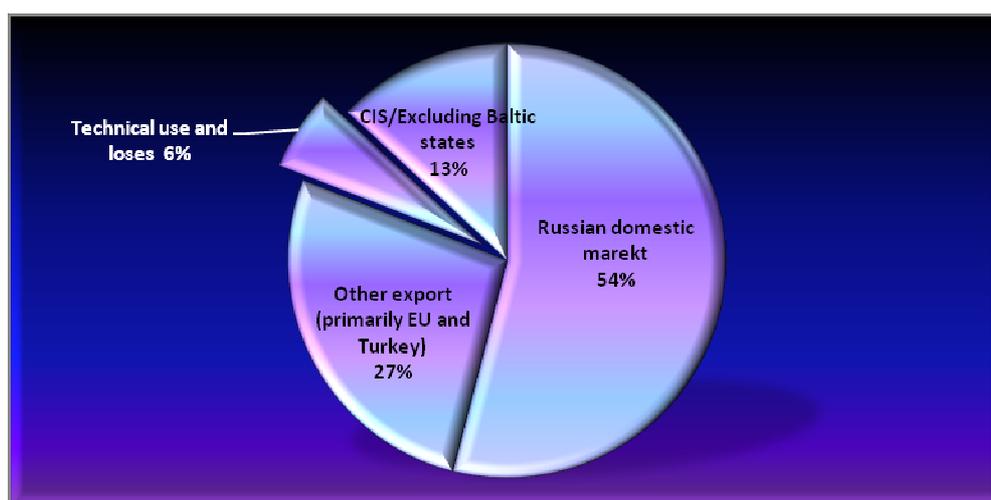
The primacy of Russia, however, in the EU gas balance during the 2000s as well as the strategic implications sprouting out of this situation, trace their roots back in the 1980s, when a handful of the then EC ‘pillar’ states, namely France, Germany and Italy, decided to deepen its cooperation with the Soviet Union by consenting to long-term take-or-pay contracts for more gas and to the extension of the Unified Gas

<sup>207</sup> Source: (Stern, 2003, p. 3 (Annex)).

System into Europe<sup>208</sup>(Clingendael, 2008, p. 20). This “cold war” geo-economic intimacy was growing so rapidly that added much to the fears of the then American administration that the Soviets had found a way to maneuver geopolitically at the expense of the West<sup>209</sup>.

After the collapse of the Soviet Union, Russia dominated even more the EU gas balance, so as after the first Russo-Ukrainian gas dispute of 2006 and the subsequent EU frustration, the issue of interdependence seemed more as a cause of suspicion and uncertainty than a solid foundation for further deepening the bilateral ties<sup>210</sup>.

For Russia, the EU has been its primary and most well-paying export market, absolutely necessary for the viability of its economy. Many of the formerly analyzed fierce policies *vis-à-vis* the FSU transit states of Ukraine and Belarus, find no better justification than the Russian necessity to defend its profile as a reliable supplier in the eyes of its one and only, at the time of writing, cash-generating export market.



**Figure 5.1: Russian natural gas exports in 2008<sup>211</sup>**

As illustrated in the Figure 5.1, Russian gas exports to the EU market, including those to Turkey, amounted to 27% in 2008, with the rest heading either to the

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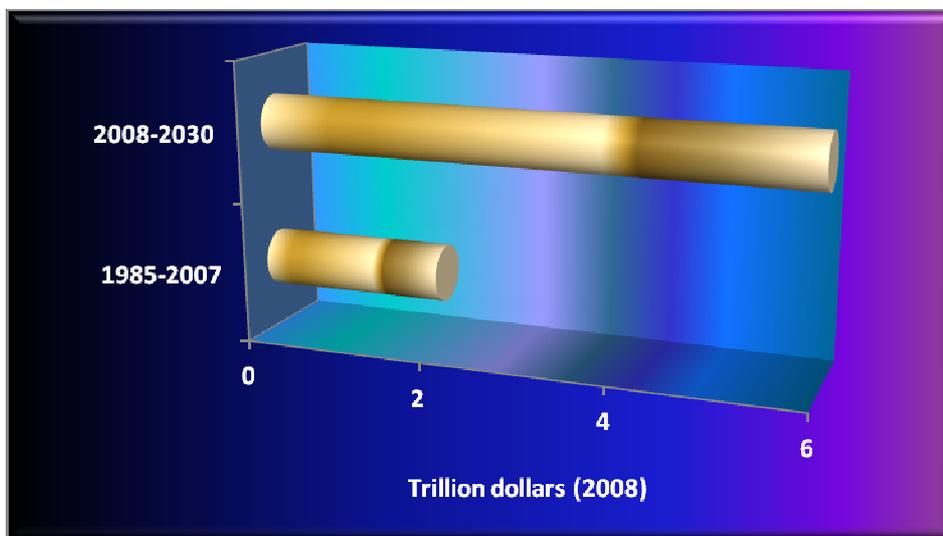
<sup>208</sup> The Unified Gas System (UGS) was used by the Soviet gas ministry in order to manage exploration, production and transportation and it traversed almost all the Soviet space, connecting the producing regions of Western Siberia and Central Asia with Belarus, Ukraine and the Comecon countries in Eastern Europe (Clingendael, 2008, p.24).

<sup>209</sup> Specifically, following Clingendael’s analysis, the agreement on the extension of the UGS into Europe had provided the USSR with a strategic advantage, since the latter could reorient oil deliveries away from Eastern Europe to more profitable and money-making world markets, once it had exploited the chance to “gasify the economies of the Comecon, thereby shoring up that alliance” (Clingendael, 2008, p. 20).

<sup>210</sup> Beyond the world interdependence it is implied the term “energy security”, defined as security of supply for the consumer side and security of demand for the supplier side.

<sup>211</sup> This Figure has been remodeled strictly abiding by IEA’s paradigm, (IEA, 2009, p. 465).

regulated and marginally profitable domestic market (54%) or to the cash-strapped FSU region (13%)<sup>212</sup>. The numerical aspect of the energy flows makes a far more concrete case, allowing us to assess precisely the aforementioned phrase “viability of its economy”. Specifically, the Russian economy experienced a dollar inflow equaling \$2 trillion for the period 1985-2007, whereas this amount is set to triple up to 2030, reaching approximately \$6 trillion (period 2008-2030). Considering now the Figures 5.1 and 5.2 together, it is made abundantly clear the dependence of Russia on the EU energy (gas) market<sup>213</sup>.



**Figure 5.2: Cumulative oil and natural gas export revenues<sup>214</sup>**

The EU, on the other hand, has no other bigger natural gas supplier in its import portfolio than Russia, fact that certainly adds to the latter’s special weight in the bilateral relationship. As illustrated in Figure 5.3, Russia dominated, albeit at a fluctuating rate, the EU gas imports throughout the 2000s, confining the other major exporters Algeria and Norway to lower levels of the supply ladder.

<sup>212</sup> On the most recent developments and projections concerning the Russian domestic market, see: IEA, 2011, pp. 245-281. Also for the payment problems in the FSU region, see the analysis in the previous chapter.

<sup>213</sup> Supplementary to these Figures, consider also Figure 3.3 in p.89 that depicts the overall structure of the Russian exports.

<sup>214</sup> This Figure has been remodeled strictly abiding by IEA’s prototype, (IEA, 2009, p. 126).

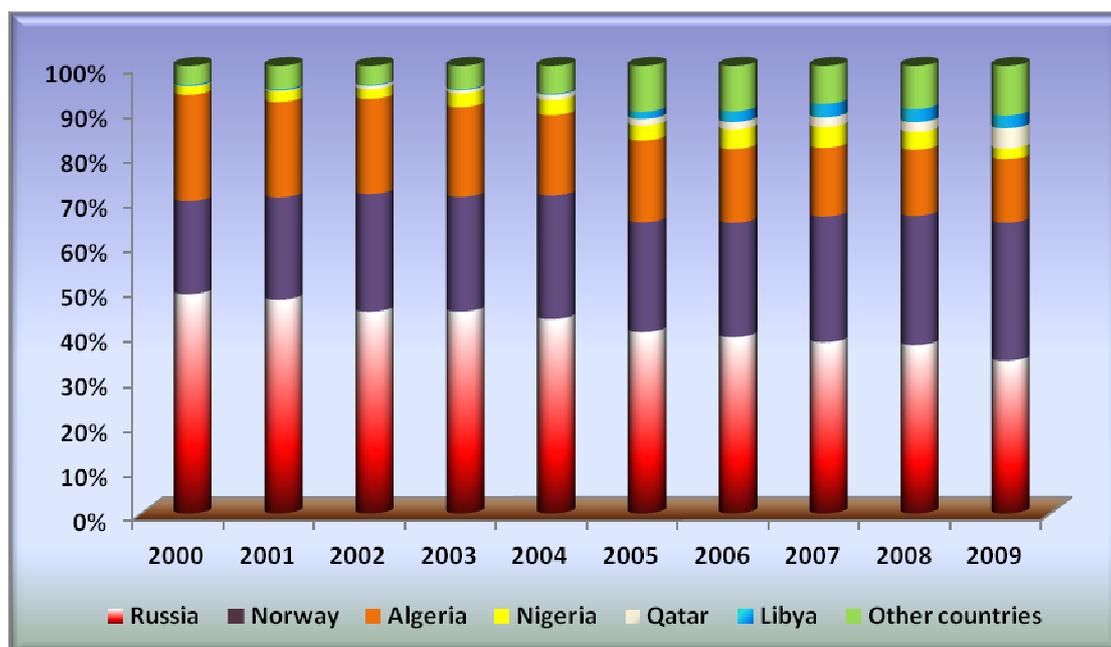


Figure 5.3: EU imports of natural gas by country of origin<sup>215</sup>

The analysis, hitherto, has portrayed the Russo-EU interdependence with the most vivid colors. Russia has had no other larger and more lucrative market than the EU to turn to, whereas the latter has had quite an exposure to the former's supplies. However, an insight to the dynamics of the incumbent interdependence calls for the brief examination of other factors, geopolitical and not, within a plausible time-frame. Hence, the forecasted European gas production levels and demand (mainly referring to Norway and the Netherlands as key players in the continental gas developments), the prospective role of both the LNG (since Qatar and Algeria have heavily invested in this form of gas) and the Asian markets, namely China, as well as the bilateral relationship *per se* (a buyers' market versus a sellers' one), constitute equally important analytic foundations of the Russo-EU energy bargaining throughout the 2000s. This is because in energy business, when policy makers negotiate, are aware not only of the alternatives at the time of the negotiation, but also of the forecasted alterations that may tilt the balance in favor of one or another side. Therefore, if all these factors are currently co-considered, interdependence acquires a rather dynamic form, allowing for a thorough assessment of the bilateral partnership upon the theoretical premises of the 'neo-neo' debate while opening the door for the full

<sup>215</sup>This Figure has been remodeled strictly abiding by the Eurostat archetype, (Eurostat, 2011, p.39).

examination of the new, pro-realism, theoretical dimension, that of Institutional Balancing.

### *5.1.2 The 2030/5 projections to explain the interdependence dynamics of the 2000s*

As it is established in the natural gas business, transporting gas either by pipeline or in the form of LNG is a rather costly procedure and adds considerably to the overall cost as assumed by the final consumers (IEA, 2009). So, it is plausible to think that states with a rich natural resources endowment “located closest to the main centers of demand often enjoy a considerable cost advantage and...are typically best-placed to profit from continuing demand in those markets” (IEA, 2009, p. 426). In the present analysis, all supply-regions, namely North Africa, Russia, Norway, Middle East, with geographic proximity to the EU stand to experience incremental (pipeline) gas demand in the foreseeable future. LNG, especially from the Middle East, North and West Africa and the Caribbean, will also follow an upward trajectory (IEA, 2009). However, accelerant to these forecasts is the fact that domestic (European/EU) production is set to dwindle notably.

Specifically, major suppliers such as Norway and the Netherlands are projected to fall back on their natural gas production. Norway, as the second largest exporter of natural gas to the EU after Russia, is expected to follow a downward trajectory after a 2007 peak, stabilizing at 126 bcm/year in 2030<sup>216</sup> (IEA, 2009, p. 479).

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<sup>216</sup> Norway exports primarily pipeline gas to the markets of UK, Germany and France.

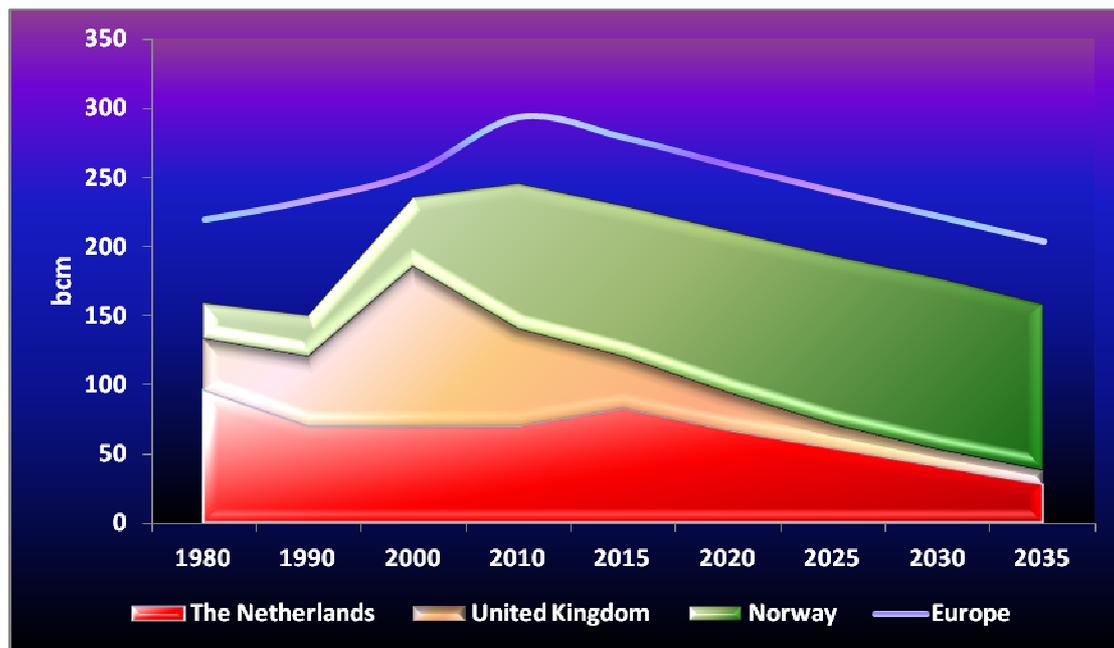


Figure 5.4: OECD Europe natural gas production by source<sup>217</sup>

The Netherlands is another principal supplier of natural gas to the EU, whose production is also set to decline from 85 bcm/year in 2008 to 45 bcm/year by 2030 (IEA, 2009, p. 479). The ‘Groningen’ field, once frontrunner of gas production in the European continent, is now facing depletion, therefore, other minor gas fields have been qualified to make-up for the stuttering giant<sup>218</sup> (IEA, 2009, p. 480). The same ‘grey’ picture holds also for the UK natural gas resources. Following IEA’s estimates, the production is expected to fall from 73 bcm/year in 2008 to 20 bcm/year by 2030 (IEA, 2009, p. 480).

<sup>217</sup> Source: IEA, 2009, p. 479; IEA, 2011, p. 165. The Figure’s remodeling is based on IEA’s World Energy Outlook 2009 and 2011 reports. The reasons for the present data compilation primarily draw on the fact that in 2009, the world had just crossed the threshold of the financial crisis, thus the figures reflect a rather conservative assessment, both in terms of supply and demand. Under normal circumstances, the increasing demand would expedite the downward-moving European domestic production, increasing concurrently the share of natural gas imports in the EU gas balance. Conversely, in the supply side, suppliers, and currently Russia, would be propelled to new gas upstream investments, once the traditional Western Siberia gas fields of Yamburg and Urengoy -that have been the backbone of the Russian production for quite a period of time- had started to follow a downward trajectory in terms of output (IEA, 2011, p. 305). Secondly, the IEA 2009 report grounds its forecasts principally in the Reference Scenario, which “describes what would happen if among other things, governments were to take no new initiatives bearing on the energy sector, beyond those already adopted by mid-2009” (IEA, 2009, p. 55). On the contrary, the IEA 2011 report uses as cornerstone of its forecasts the New Policies Scenario, that “takes into account recently announced commitments and plans, even if they are yet to be formally adopted and implemented” (IEA, 2011, p. 49). In light of these, the present analysis gravitates between the two, using the data and forecasts of the 2009 report after having first corroborated them in terms of consistency with the latest and most recent forecasts of the 2011 report.

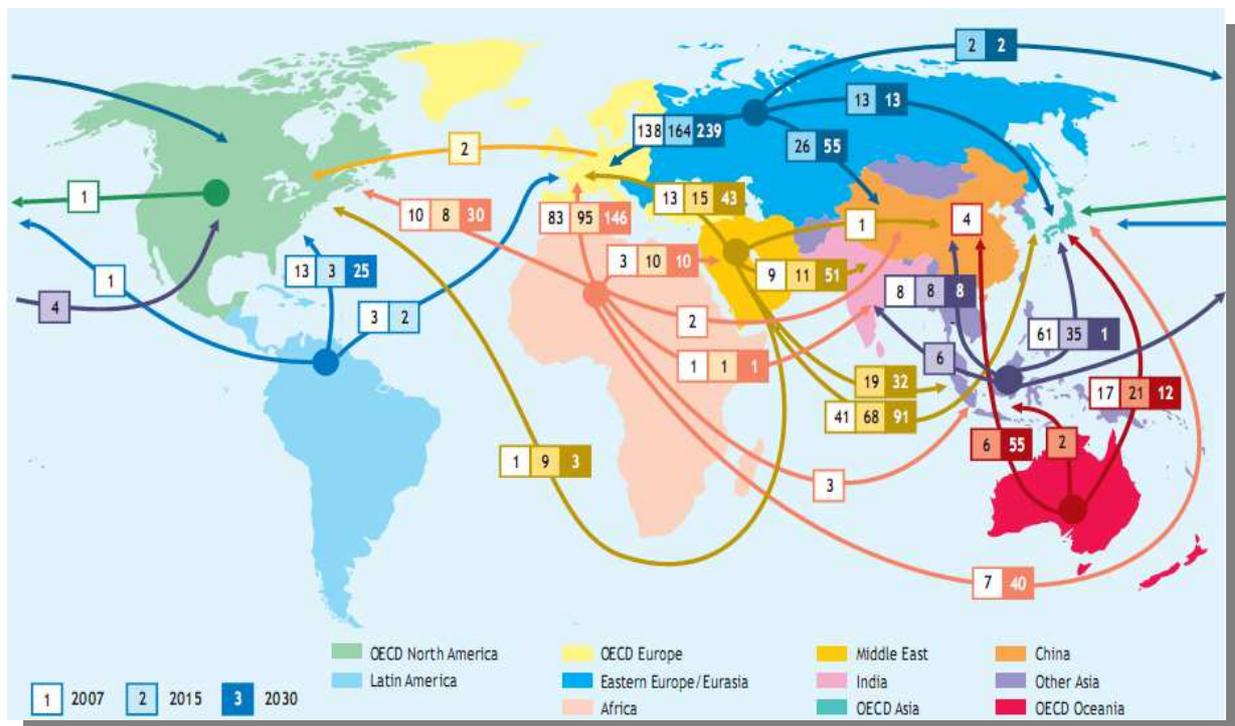
<sup>218</sup> The ‘Groningen’ natural gas field contained 1.24 trillion cubic meters reserves.

Overall, the EU gas balance will be challenged by constantly growing shortages up to 2030.

**Table 5.1: The European Union natural gas balance (in bcm)<sup>219</sup>**

European Union	2007	2015	2020	2025	2030
<b>Demand</b>	526	532	564	589	619
<b>Supply</b>	214	167	139	116	103
<b>Net Imports</b>	312	365	425	473	516

As depicted in the table right above, the EU is expected to expose all the more its average annual gas balance to imports up to the year 2030. Specifically, net imports stand to grow from 312 bcm/year in 2007 to 516 bcm/year in 2030, with the gap of the declining European domestic production being offset by both pipeline and LNG gas originating from adjacent regions. On the whole, the emerging inter-regional gas dynamics of the mid-long term are illustrated in the following map:



**Map 5.2: Net interregional natural gas trade flows between major regions in 2007, 2015, 2030<sup>220</sup>**

<sup>219</sup> Source: IEA, 2009, p. 478; IEA, 2011, pp. 159,165. The 2011 report's projections are very close to those of 2009. Indicatively, it is mentioned that in terms of Net Imports, the EU is meant to receive 398, 448, 486, 523 and 540 bcm of natural gas for the years 2015, 2020, 2025, 2030 and 2035 respectively. The joint analysis of the data in the reports' separate Tables (4.2 and 4.4) has been made by the author.

The FSU region, and Russia in particular, will strengthen its position in the Eurasian energyland, since it is anticipated an export growth of 18,8% by 2015, i.e. from 138 bcm/year to 164 bcm/year and of 45,7% from 2015 to 2030, i.e. from 164 bcm/year to 239 bcm/year. The overall increase from 2007 to 2030 is estimated at 73,1%. Similar developments, without however the same magnitude, will occur in the neighboring to the EU regions of Middle East and North Africa. In the former, gas exports (mainly in the form of LNG) will grow by 15,3 % up to 2015, i.e. from 13 bcm/year to 15 bcm/year and by 186% from 2015 to 2030, i.e. from 15 bcm/year to 43 bcm/year. In the latter, gas exports will grow by 14,4% up to 2015, i.e. from 83 bcm/year to 95 bcm/year and by 53,6% from 2015 to 2030, i.e. from 95 bcm/year to 146 bcm/year<sup>221</sup> (IEA, 2009, p. 435).

With regard now to the EU gas balance, the Russian supplies will be holding a share of 30,8% in 2015 and 38,6% in 2030. Striking is the reverse analogy between the decreasing European production and the increasing Russian supplies. The more the former dwindles the more the latter escalates. North Africa and the Middle East

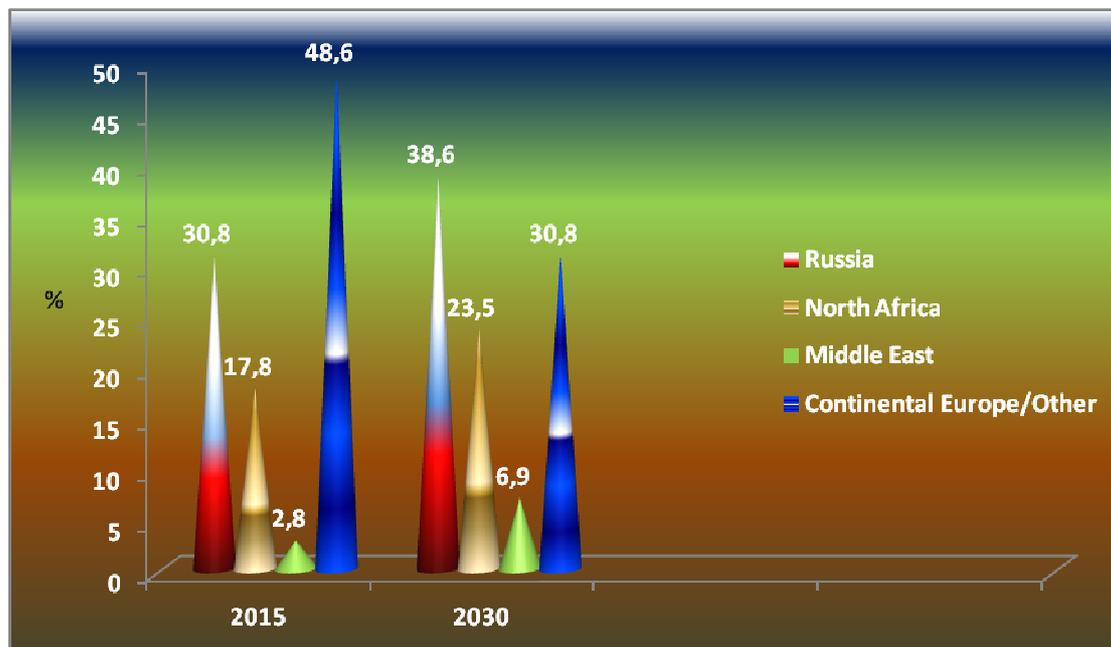


Figure 5.5: The EU natural gas balance in 2015 and 2030<sup>222</sup>

<sup>220</sup> Source: IEA, 2009, p. 435

<sup>221</sup> In these two regions, however, it should be noted that the overall expected increases, measured in percentages, i.e. 230,7% and 75,9% respectively for the period 2007-2030, are far less important than the Russian one, if converted and measured in absolute gas volumes destined for the EU demand. A joint analysis of the data in Table 4 and Map 12 draws a rather clear picture on this issue.

<sup>222</sup> The IEA 2011 report, following the *New Policies Scenario*, estimates that Russia's share in the EU gas balance will remain at 35% in 2020, before contracting to 32% in 2035 (IEA, 2011, p. 343). Although the estimates are very close to those in the Figure, it is reiterated that the 2011 report follows

are confined to a much lower contribution with 17,8% and 2,8% respectively for 2015 and 23,5% and 6,9% for 2030. Consequently, Russia stands atop the ladder of neighboring suppliers, surpassing both North Africa and the Middle East and relishing the prospect of becoming all the more indispensable for the EU.

Directly linked with the former is also the analysis pertaining to the scenario of LNG helping the EU member states diversify their gas imports away from Russia<sup>223</sup>. Any LNG coming to the EU originates either from the Middle East or North Africa. Qatar, which is the centerpiece of the Middle Eastern gas supplies, exports all of its supplies in the form of LNG (IEA, 2009, p. 438). The same holds also for North Africa whose natural gas has traditionally targeted the EU market (IEA, 2009, p.438). Drawing now the parallel with Figure 5.5, we may infer that LNG has not been and will not be a “game changer” in the EU gas balance neither up to 2015 nor up to 2030<sup>224</sup>. Both the Middle East and North Africa, albeit among the principal gas suppliers, fall short of substituting for the Russian supplies.

The analysis so far has examined the projected decline in the European natural gas production, the rise of the FSU region and particularly Russia and the restricted role of LNG in the EU market for the period up to 2030. However, the most critical parameter for understanding the Russia-EU energy bargaining during the 2000s is whether a trading partner of equal to the EU importance has been present for Russia or not. Why? Because no matter the Russian inroads to the EU market (e.g. supplies, gas networks, corporate politics), the interdependence would remain intact unless another promising partner, i.e. China, was to make up for the losses if, for example, Russia was to terminate its gas affairs with the EU, or threatened to do so (credible threat). As long as Russia needs the EU, there is no interdependence turning to either

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a slightly different methodological approach, i.e. *The New Policies Scenario*, which assumes changes in the national economy of Russia, mostly in terms of energy efficiency, thus allowing more gas for exports. It simultaneously underlines the rise of the natural gas demand in the Asian markets, and particularly China. Therefore, from this perspective they are justified both the rise to 35% in 2020 as well as the comparatively minor decline to 32% in 2035 (mainly due to the rise of the Chinese market). For more on the *New Policies Scenario* see footnote 223.

<sup>223</sup> As a preliminary note, it is stated that the analysis on LNG is brief and solely aims at buttressing the argumentation of the present chapter.

<sup>224</sup> Following IEA's analysis on the issue, Gazprom has indeed plans to export LNG from fields in the Barents Sea, i.e. Yamal and Shtokman, but for the projection period there will be no other LNG exports aside from Sakhalin due to reasons of supply cost (IEA, 2009, p. 437). Therefore, most of the incremental exports will come in the form of pipeline gas, fact that solidifies the projections in Figure 5.5 about Russian supplies.

interconnectedness or unilateral dependence of the latter on the former, as we have earlier seen in the gas trade between Russia and the FSU region<sup>225</sup>.

The role of China as well as its impact on the EU gas market is well epitomized in Map 5.2. As illustrated, Russian supplies will be following an upward trend for the projected period, reaching 26 bcm in 2015 and 55 bcm in 2030. Moreover, a comparative analysis of the supply dynamics places Russia along with the OECD Oceania, namely Australia and New Zealand, at the first place. As estimated by IEA, China's gas imports, especially those from Turkmenistan and Russia, will be covering almost half of the country's gas needs by 2030 (IEA, 2009, p. 437).

The adopted 12<sup>th</sup> Five Year Plan (2011-2015) by the Chinese government, albeit focused on the domestic energy developments, is entailed perceptible readjustments in the global energy dynamics (IEA, 2011, p.78). By setting among its priorities the energy efficiency, the use of cleaner energy resources, the reduction of carbon intensity and emissions of major pollutants as well as the diversification in the state's energy mix, it signals a "turning point" to the hitherto Chinese *modus operandi* (IEA, 2011, p.78). Up to now, China has been overly dependent on imported oil and coal to sustain its rapid growth<sup>226</sup>. The adaptation, however, to more environmental-friendly developmental patterns, albeit hotly debated, had never taken such a serious priority before. Consequently, abiding by this plan's projections, natural gas, nuclear and

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<sup>225</sup> In this case, Russia exploited the heavy energy dependence of the region as well as its non-payment record, to put on a really assertive face whenever the occasion was convenient. But, may the same strategy be employed against the EU? Facts are different. Most of the EU member states' energy dependence on Russia is not as high as in the FSU region, fact which means that, although highly unlikely, other sources may come in support of their gas balance for a limited period of time. Additionally and more importantly, the EU is essential for the Russian economy in total. Up to now, it is the only well-paying market, with the Chinese parameter, albeit existent, slowly brewing. Thus, no matter how deep in the EU market the Russian penetration may have and it is projected to proceed, the former retains its special weight in the latter's business plans. The interdependence is not as easy to tamper with. In the FSU region, Russia painstakingly removed the 'transit' impediment, building on the 'Trojan Horse' strategy and the parallel construction of bypassing gas networks<sup>225</sup>. But in the EU case, something more is needed; a trading partner of equal-to-EU profitability for Russia that would serve as an ace up its sleeve, qualifying it to pursue, at least, satisfactorily its relative gains in the bilateral energy trade. On these grounds, it is important to assess China's role in affecting the status of the EU gas market as a seller's or a buyer's one.

<sup>226</sup> Emphatically, it had been estimated that if China continued its prior course unabated, it would be importing 70% of its oil needs from the Middle East by 2015, with the rest being supplied by pipeline, rail or tanker from Russia, Central Asia and Africa (Kreft, 2006, p.110). On these grounds, it was built also the ESPO pipeline project, linking Skovorodino (Russia), via a spur, with Moha and Daqing (China).

renewables are currently presented with a golden chance of expanding their presence in China's energy mix<sup>227 228</sup>.

Foreseeing these tendencies, Gazprom had launched as early as in 2009 the Eastern Gas program, which stipulated the commencement of gas production centers mainly in the region of East Siberia (the Krasnoyarsk Krai, the Irkutsk Oblast, the Republic of Sakha (Yakutia), the Sakhalin Oblast and the Kamchatka Krai), as well as the construction of gas networks such as the Sakhalin-Khabarovsk-Vladivostok (SKV)<sup>229</sup> (Gazprom, 2009a). As IEA estimates, the overall share of Western Siberia in the total Russian output is anticipated to decline from around 90% in 2010 to 78% in 2035, principally, due to incremental gas output from the fields in Eastern Siberia and the Barents Sea (IEA, 2011, p. 305). Moreover, total gas exports for the same period are expected to rise by 64,4%, showing only a slight increase in the amount destined for Europe compared with the much bigger increase in the amount earmarked for Asia, and China in particular (IEA, 2011, p. 312). So, the Chinese gas needs, as described by the 12<sup>th</sup> Five Year Plan, dovetail the timely employed Russian supply strategy for the region.

Focusing now on the dynamics of the Eurasian energy triangle and assessing the impact of China in the Russo-EU energy bargaining of the 2000s, it is estimated that by 2035, Russia will be covering with its exports the same, more or less, amount of imports (30%) both in the EU (170bcm) and China (75bcm) (IEA, 2011, p. 329).

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<sup>227</sup> Previous estimates held the demand for natural gas increasing from 2% in 1996 to 11% by 2020 (Downs, 2000, p.5).

<sup>228</sup> Although China will significantly rely on natural gas imports to meet its domestic demand, its own gas production is expected, according to IEA estimates, to rise from 85bcm in 2009 to 290bcm in 2035 (IEA, 2011, p. 166).

<sup>229</sup> These developments in Eastern Siberia as well as their implications for the Russo-Chinese energy rapprochement are extensively visited in the following chapter.

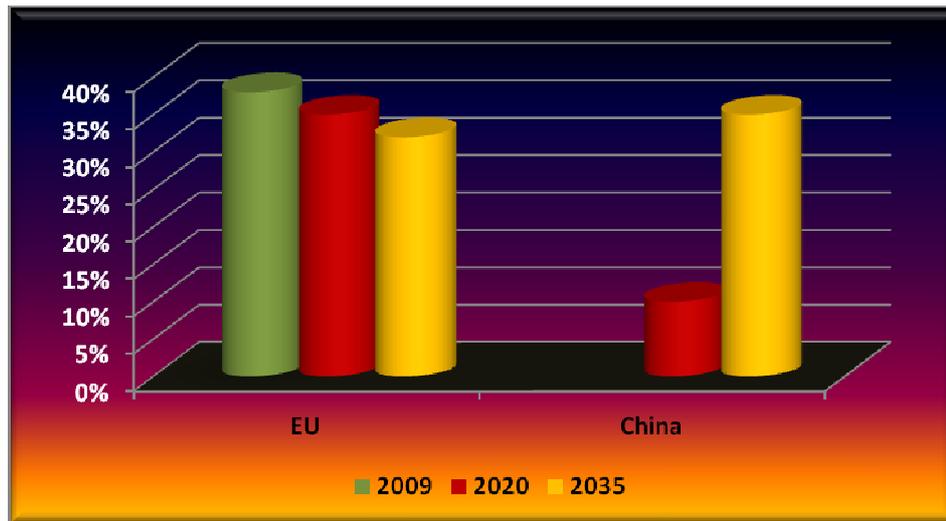


Figure 5.6: Russian share of natural gas imports in the EU and China<sup>230</sup>

This alludes to the constantly strengthened, ‘commanding’, role that Russia is set to assume in the Eurasian energyland. By setting foot in both markets, the EU and the Chinese, Russia provides itself with the prerogative of playing these two against its other in pursuit of its relative advantage in the bilateral energy trade. Europe and Asia become competitors in their quest for a place under the sun of the Russian energy supplies.

To put the argument in numbers, China is set to grow all the more important for the Russian treasury the very same moment that the EU will constantly lose ground. Explicitly, while in 2010 China accounted for only a minor share (2%) of the Russian total energy export revenues, this picture is expected to reverse radically by 2035, reaching 20% (IEA, 2011, p.335). On the contrary, estimates are not as promising for the EU with its important share of 61% in 2010 gradually dwindling to 48% in 2035 (Figure 5.7) (IEA, 2011, p.335).

No matter the prospective character of these developments, the fact remains that by engaging China in the energy chessboard, Russia, not only amplified its bargaining position all along the 2000s *vis-à-vis* the EU, but it also succeeded in keeping two doors open, maintaining “its position on the European market while decreasing its proportional dependence on European customers by increasing the share of its exports going to Asia” (IEA, 2011, p. 342; Energititseskaia Strategia Rossii, 2003).

<sup>230</sup> This Figure has been remodeled strictly abiding by IEA’s archetype, (IEA, 2011, p.343).

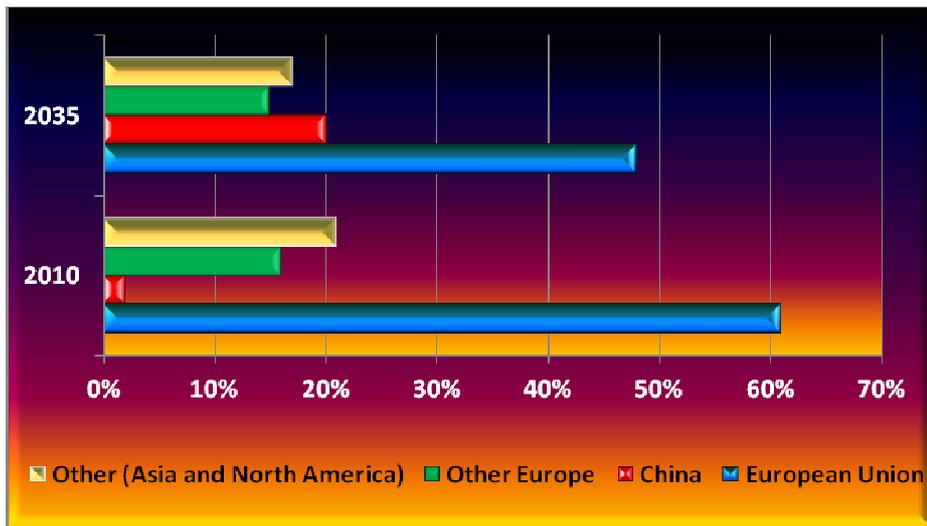


Figure 5.7: Sources of revenue from fossil fuels export sales, 2010 and 2035<sup>231</sup>

Reaching the end of this section, there are still some issues that plausibly arise. Specifically, what is the current state of affairs in the Eurasian energyland? Which have been the pragmatic implications of the aforesaid geo-economic developments on the 2000s Russo-EU energy bargaining? Has the balancing strategy been so powerfully established as described above?

In fact, the geo-economic correlations have been more of a brewing magma than a clear-cut Eurasian energy triangle, whereas, for the time being:

“Russia will continue to supply the majority of its gas via pipeline, anchored by long-term supply contracts; under these circumstances, the contractual scope for Gazprom to vary supplies by destination is small. Moreover in relation to switching supplies between Europe and China, the physical scope for abrupt change is even narrower...while geography and the structure of the gas trade make it unlikely that China and Europe will compete for incremental Russian supply on a short term basis, this is not to say that there will be no competition over the long term” (IEA, 2011, p. 344).

On these grounds, the role of China, albeit supportive to Russia’s bargaining with the EU during the 2000s, it should not be overstated. As previously shown, the Chinese parameter is to gain momentum from 2010 onward. Then, an energy bridge will be gradually constructed, granting Russia a ‘commanding’ role in a constantly equalizing Eurasian geopolitical triangle. But, in the short term, the prospects of directly challenging the EU as a sizeable and lucrative market for Russia, is a far more

<sup>231</sup> This Figure has been remodeled strictly abiding by IEA’s archetype, (IEA, 2011, p.336).

complex issue, pertaining also to China's gas demand and energy mix. Indeed, the 12<sup>th</sup> Five Year Plan, sets a new developmental path, away from coal and oil to more environmentally-friendly fossil fuels, but even in this case, the scenario of China becoming an export destination of equal-to-EU profitability is really one of long-term perspective<sup>232</sup>.

Having incorporated past, present and future developments and projections into the present analysis, we may now infer that all along the 2000s, the Russo-EU energy bargaining had taken place mainly upon a 50-50 buyers'-sellers' market pattern. The EU was the principal source of gas export revenues for Russia, while the latter was critical for covering the increasing demand on behalf of the former's member-states. An interdependent relationship was persisted, where the perfect power symmetry never allowed any of the involved parties to backpedal on its efforts towards energy security<sup>233 234</sup>. As put by the 2008 Clingendael institute's report, "security of supply concerns are now matched by security of demand concerns on the part of the producing countries. These latter concerns are focused on the return of investment for the national companies and the governments, control over export routes and access to markets" (Clingendael, 2008, p.19).

All things considered, the analysis has succeeded in one critical aspect; it established an energy interdependence of dynamic form, where the 2000s Russo-EU energy diplomacy is viewed and analyzed within an extended time-frame without, however, disregarding the actual developments at the time of the negotiation. So, the analysis is based on solid ground, allows for a thorough understanding of the bilateral diplomacy and most importantly, opens the door for informing and enriching the currently examined 'neo-neo' debate by adding the new, pro-realism, theoretical dimension, that of Institutional Balancing. How?

The 2000s energy interdependence, no matter how perfectly balanced it, *prima facie*, seemed, it had fissures as proved through its examination within a longer perspective (2035). Russia is poised to assume a hegemonic role in the Eurasian

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<sup>232</sup> It is once more reminded that in energy business, when policy makers negotiate, are aware not only of the alternatives at the time of the negotiation, but also of the forecasted alterations that may tilt the balance in favor of one or another side. Therefore, at present, the focus on the prospective role of China as well as on the energy dynamics in the Eurasian energyland constitute an indispensable analytical foundation.

<sup>233</sup> See footnote 210.

<sup>234</sup> It is once more reminded that the term 'power symmetry' should all along the current research effort be interpreted and assessed in energy terms. There is no reference to other means of power, i.e. military, etc.

energyland, but since this is to occur within a justified period of time, certain concessions should be made *vis-à-vis* its only, at that time, lucrative market, the EU. Such a concession had been the institutionalized cooperation. While realism does not give much credit to the function of international institutions in facilitating inter-state cooperation, at present, we refurbish this position, showing that when states share interdependence and institutional cooperation is unavoidable, then, Institutional Balancing emerges as a ‘compulsory’ strategy<sup>235</sup>. In this situation, states temporarily and superficially, consent to international institutions without, however, giving to them official and legally binding status. But, when they become aware of a much better position in the future, then the Institutional Balancing strategy turns from once ‘compulsory’ to ‘powerful’, thus fulfilling its realist roots. To put it in simpler words, international institutions are used as “empty shells”, or as a “necessary evil”, in the absence, or better said, in the anticipation of a much stronger international position that will allow states to assume an assertive profile, suitable when pursuing their relative advantage in an anarchic international sphere pretty much alike the Hobbesian “state of nature”<sup>236</sup>.

## ***5.2 The 2000s Russia-EU member-states natural gas diplomacy***

It is reminded that due to the special nature of the EU as far as its common energy is concerned, we pursue a *two-level* analysis: Russia- EU member-states (national level) and Russia-EU (supranational institutions level). Below, however, we first present a table of macro-strategies at the supranational institutions level, Russia-EU, since those formed the dynamics of their energy affairs during the 2000s and then proceed with the examination of the developments at the national level, Russia- EU member-states. So, it becomes easier for the reader to understand what aims did Russia pursue at the national level to short-circuit the supranational institutions level.

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<sup>235</sup> For a more detailed account on this pro-realism theoretical dimension see pp. 56-59.

<sup>236</sup> See also pp. 44-50.

**Table 5.2: Polar opposite strategies in the EU-Russia energy bargaining<sup>237</sup>**

<i>European Union</i>	<i>Russian Federation</i>
1. Break Russia's transit monopoly- Access the Russian/Central Asian energy resources.	1. Establish an outpost in the EU gas market via cooperation with major European energy companies.
2. Substitute the Russia-imposed long- term 'take-or-pay' gas contracts with more flexible forms of trade.	2. Maintain the long-term 'take-or-pay' gas contracts as a 'win-win' <i>modus operandi</i> .
3. Liberalization/ Unbundling of the EU member-states' national monopolies	3. Diversification of export markets to Asia and the United States.
4. <b>Strategic horizon: Best-case scenario:</b> Interconnectedness/ <b>Worst-case Scenario:</b> Unilateral Dependence on Russia.	4. <b>Strategic horizon: Best-case scenario:</b> Unilateral dependence of the EU/ <b>Worst-case scenario:</b> Interconnectedness.

Throughout the 2000s, the currently examined EU-member states had natural gas among the top resources to fill their energy mixes. Germany, at first, experienced an excessive reliance on natural gas, with Industry covering 35.5% of its needs with gas, Households 42% and Services 34.3% (Eurostat, 2009, p. 37). In, more or less, the same trajectory, Italian industries were covering 39.4% of their needs with gas, with Households and Services experiencing a much wider exposure, reaching 40% and 50% respectively (Eurostat, 2009, p. 54). French sectors also saw this side of the coin, with Industry being dependent up to 28.5% on gas, Households 31.8% and Services 26% (Eurostat, 2009, p. 51). Poland, finally, completed this picture, having its industries dependent up to 23.5% on gas, Households up to 21% and Services up to 16.6% (Eurostat, 2009, pp. 75-80).

This exposure gave Russia an ever increasing role in the gas balances of these EU member-states. As shown in Figure 5.8, Russia accounted for a large part of their gas needs, with Germany and Poland experiencing the greatest dependency.

<sup>237</sup> Further elaboration on these strategies can be found at: (Boussena and Locatelli, 2011).

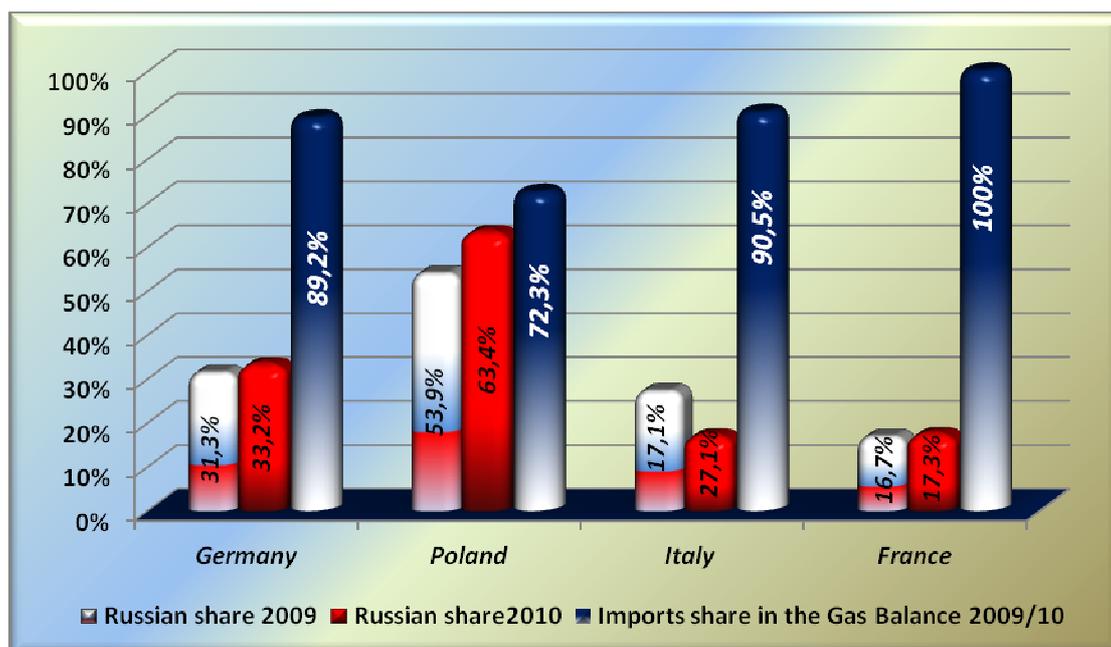


Figure 5.8: Percentage of Russian gas supplies to the EU member-states' gas balance (2010)<sup>238</sup>

Focusing on the turning of the examined decade (2009, 2010), Russia filled 33% of Germany's and 81% of Poland's gas needs<sup>239</sup>. Even in the remainder of the EU member-states (France and Italy) where the Russian supplies seem at first sight to have had a secondary role, with an average of 17% and 24% respectively, it is noted that both states had a broad gas-suppliers' base, fact which in turn brought Russia among the first (BP, 2010, pp. 29-30).

Consequently, what becomes clear hitherto, is that Russia, being the prime natural-gas supplier, had a critical say in the respective economies. However, this 'supply-dominance' was only one side of the former's presence in these markets. Russia had also amplified its position with the signing of Long-term take-or-pay gas contacts and the formation of various business schemes with the local energy (gas) companies, either national or private. Thus, it managed to 'penetrate', if not dominate, the respective gas markets, argument which is also strengthened by the previously

<sup>238</sup> Source: (BP, 2010;2011). Estimates have been made by the author.

<sup>239</sup> The selection of these two years, 2009-2010, is justified by the fact that the world, the EU included, had just entered the threshold of the financial crisis, so consumption across the board, gas included, had been seriously constricted. Consequently, the analysis and the data are based on a recession scenario, allowing the reader to think about the extent of the exposure prior and after the financial crisis, assuming, of course, that all the other parameters remain constant.

examined pipeline dominance, as it unfolded all along the 2000s and it is expected to expand further up to 2020<sup>240</sup>.

To begin with the ‘horizontal’ issue of the Long-term Contracts (LTCs), it is important to remember that this business *modus operandi* has been dominant since the early days of the then USSR-EC cooperation back in the 1980s, when a handful of the then European Community ‘pillar’ states, namely France, Germany and Italy, decided to deepen their cooperation with the Soviet Union by consenting to long-term take-or-pay contracts for more gas<sup>241</sup>. Ever since, this gas business practice remained intact with both sides consenting to it. Why?

These contracts, while often presented as substitutes for vertical integration in situations where merger is forbidden or assessed as not cost-efficient, they have delivered positive outcomes for both the supplier and the consumer. For companies, this type of contracts offers them the opportunity to “hedge price and quantity risks and therefore facilitate investment or operation” (De Hauteclocque and Glachant, 2009, p. 5400). Moreover, to this aim is also the inclusion of clauses such as the *take-or-pay*, which guarantee the purchase of the contracted amount regardless of the fluctuation in demand. Thus, costly investments can be assumed as long as returns are guaranteed. But investments and subsequent increased production, benefiting both the supplier (security of demand) and the consumer (security of supply) are not the only gains to emerge from such a situation. Other economic returns are to be assured as well. The limitation of double marginalization as well as the prevention of certain firms exploiting their dominant position in spot markets in order to widen their profit margins are two cases both serving more to the benefit of the consumer than the supplier<sup>242</sup> (De Hauteclocque and Glachant, 2009, p. 5401). Special emphasis merits the point-made regarding the spot markets. According to the Hauteclocque and Glachant analysis, “spot markets deliver better results than bilateral contracting only if sufficiently liquid” (De Hauteclocque and Glachant, 2009, p. 5402). This means that in the currently examined case where LNG has been a far cry from becoming a competitive alternative to pipeline gas and, thus, spot markets have had a rather

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<sup>240</sup> See pp. 144-147.

<sup>241</sup> See pp. 150-151.

<sup>242</sup> Double marginalization refers to situations where “several firms at different levels of the supply chain concurrently exercise their market power” in order to widen their profits margins. In these situations, an LTC, serving as a form of vertical integration, could allow “the total single margin to be lower than the sum of the margin in the de-integrate case”, adding, in this manner, to the welfare of the society (De Hauteclocque and Glachant, 2009, p. 5401).

secondary role in the EU gas supplies, the European Commission should deal with Gazprom's natural gas LTCs with the EU energy companies in a really careful manner, if the aim of promoting competition/anti-foreclosure measures in the EU gas market is not to be achieved at the expense of the member states' energy security, i.e. security of supply.

In general, the European Commission, enforcing the EU legislation on the anticompetitive effects of the LTCs, focuses primarily on two parameters, namely the market share thresholds and the inclusion of specific clauses (De Hauteclocque and Glachant, 2009, p. 5403). In particular, as far as the second parameter is concerned, specific clauses such as those of destination, reduction and tacit renewal, they all may hamper competition (De Hauteclocque and Glachant, 2009, p. 5402). Therefore, when the European Commission examines the usual clauses of duration and exclusivity, it also inspects the existence of one of the aforementioned clauses that serve as anti-competition accelerants and impediments to a single EU energy market. Nevertheless, even in the cases of duration and exclusivity, the EU legislation has provisioned certain criteria, the infringement of which may result in the European Commission acting against the involved parties<sup>243</sup>.

Notwithstanding the strict EU legislation, the Hauteclocque and Glachant analysis underlined, *inter alia*, that when the European Commission had to decide on the anti-competitive and the foreclosure effects of Gazprom's LTCs with major EU energy companies, it adopted a rather flexible profile, having been "more influenced by political considerations involving security of supply than by sound economic principles"<sup>244</sup> (De Hauteclocque and Glachant, 2009, pp. 5405-5406).

All in all, the natural gas LTCs, operating in the absence of a satisfactory spot market, served, all along from the 1980s onward, as a 'win-win' platform upon which Russia and the EU member-states founded their gas cooperation. However, this 'win-win' situation does not mean that it was also even, i.e. that both parties stood to gain

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<sup>243</sup> For the sake of inclusiveness, it is reported that for an LTC not to fall within the jurisdiction of the European Community, the market shares of each of the contracting parties should not exceed 15%. If, however, this is not the case, the LTC can still be held legal, as long as the ultimate reference point of 30% is not violated and the duration of the contract is neither indefinite nor over 5 years. With this spirit, the European Commission examines all the LTCs, including those between Gazprom and major EU energy companies (De Hauteclocque and Glachant, 2009, p. 5403).

<sup>244</sup> As the authors further note, the European Commission backtracked on the strict implementation of the EC competition law, limiting the scope of its inspection only to problematic clauses in terms of competition. Foreclosure effects have been widely disregarded while durations even up to 25 years, especially in the gas contracts, have become acceptable (De Hauteclocque and Glachant, 2009, p. 5405).

equally. Russia was gaining more by approaching a market situation pretty much close to *monopoly* and becoming even more critical for the economic sustainability of the currently-examined EU member-states. In any case, this intimacy, as nurtured and facilitated by the natural gas LTCs, progressed further, taking the form of specific business schemes between Gazprom and major EU energy companies and thus giving the chance to the former to use the latter as Trojan Horses in pursuit of the Russian relative advantage at the supranational institutions level, Russia-EU.

Before we proceed with the examination of each case separately, below, a map of the main EU energy (gas) companies per member-state serves to orient the reader in the following analysis.



Map 5.3: Major energy/natural gas companies per EU member-state<sup>245</sup>

These are the main EU energy (gas) companies with most of which Gazprom not only cemented its cooperation at the national level, but also built such a complex and inextricable web that would “short-circuit” every EU collective effort tried to stand against the Russian interests. Striking is the fact that when the European Commission had to decide on issues pertaining competition in the gas market or propose new legislation to the Council to the same end, it would ‘reconsider’ its efforts in light of the importance of the Russian supplies for the EU economy (see below the recent cases of Italy as well as the reactions against the implementation of the Third Legislative Package –Germany, France, Lithuania-). Let us now proceed with the ‘vertical’ aspect of the currently examined national level, Russia-EU member-states.

<sup>245</sup> Source: (Eurogas cited after E.ON Ruhrgas AG., 2010, p. 64).

### **5.2.1 Point of entry: Germany**

Germany has been the entry point of Russian natural gas to Europe. Traditionally, the Russian gas exports *en route* to western Europe had to cross a network traversing all Eastern Europe (Ukraine, Slovakia, and Czech Republic) and finally reach the town of Waidhaus near the German-Czech border. From there it was a link with the west European network, via which the Russian gas first crossed Germany and then it was further transported to France and Switzerland (E.ON Ruhrgas AG, 2012). Germany has been the principal European customer of Russian gas, having started doing business with the latter since the late 1970s, early 1980s. Always by-products of government-to-government prior agreements, the gas business relations had been initially conducted between the Soviet Ministry and the biggest German company Ruhrgas AG (Clingendael, 2008, p. 7; E.ON Ruhrgas AG, 2012).

This cooperation covered a broad-spectrum of technical and scientific areas, aiming at becoming something much more substantial and stable than just a cyclical supplier-consumer relationship. Over the years, the core of this relationship has remained unchanged, with only the companies' structures to have been re-adjusted, following both market and geo-political developments. Ruhrgas AG was purchased in 2004 by the E.ON AG company, the world's largest privately-held power and gas Concern (Gazprom, 2006). Ever since, the E.ON Ruhrgas AG owned a 11.273-km-long gas transmission network including 12 underground storage facilities, fact that brought the company not only at the helm of the German gas market but also rendered it among the top three firms in Europe (Gazprom 2006). Nowadays, the Russo-German natural gas relationship has been realized by the Gazprom-E.ON Ruhrgas AG partnership, founded upon a LTC, running up to 2036 (E.ON Ruhrgas AG, 2012).

So, Russia, by setting long-term ties with this major German gas company established a foothold in the EU gas market. However, this intimacy was to tighten further. The aforementioned, mutually acclaimed, broad target of deepening the bilateral cooperation to areas other than those of supplier-consumer, was once more reiterated on July 8, 2004, with the signing of a Memorandum of Understanding (MoU) that laid the groundwork for both sides to engage in asset-swaps of strategic importance, following the needs and the goals of each side (Gazprom, 2006).

To begin with, in 1999, OOO Gazprom Export and what later became to be recognized as E.ON Ruhrgas AG, formed the Joint Venture (JV) ZAO Gerosgaz, in which they relished a shareholding of 51% and 49% respectively. This JV owned 2.93% of OAO Gazprom (Gazprom, 2008). The years passed and in 2008, E.ON Ruhrgas AG, including its participation in the JV Gerosgaz, was the largest foreign shareholder in Gazprom, owning 6.5% of its shares and also an agreed shareholder in the Nord Stream pipeline project with a 15.5% stake (Gazprom, 2008;2011g; Nord Stream, 2011a). In parallel, Gazprom had formed the fully-owned subsidiary OAO Severneftegazprom, which, according to the license of the early 2000s, would develop the Yuzhno-Russkoye gas and oil field, the necessary resource base for the gas shipments via the Nord Stream pipeline to Germany<sup>246</sup> (Gazprom, 2006;2008). Consequently, when in October 2008 the CEOs of Gazprom and E.ON Ruhrgas AG met in the presence of the then Russian President Dmitry Medvedev and the German Chancellor Angela Merkel, they signed an agreement consenting to a sweeping asset-swap, obeying, as earlier said, to the needs and goals of each side.

Particularly, as stipulated by the agreement, E.ON Ruhrgas AG would be awarded 25% minus one ordinary share in the capital share of OAO Severneftegazprom, thus, getting the chance to contribute with its technical expertise to the development of the Yuzhno-Russkoye field, while Gazprom would receive 49% stake in the shareholding of ZAO Gerosgaz, thus, taking back part of the alien shareholding in its capital structure. Consequently, E.ON Ruhrgas, once the largest foreign shareholder in Gazprom with 6.5%, would be constricted to 3.5% the very next day of the agreement (Gazprom, 2008).

Reading between the lines, someone could describe this asset-swap as one of “granting access to upstream business for vertical integration”. An explanation for this could be found in the fact that at the outset of the millennium, Russia, had just started to get a grip on the up to then politically exploited and economically drained energy sector, under the directives of the then newly-elect President, Vladimir Putin. In the beginning, foreign capital in any form, especially from a wealthy and strategic partner such as Germany, was more than welcome. Later on, however, when Russia would start to bounce back, it would seek to restore order in the capital share of its powerful

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<sup>246</sup> Initially, the participation in OAO Severneftegazprom had been allocated as follows: OAO Gazprom 75% plus one ordinary share, BASF AG 25% minus one ordinary share (Gazprom, 2008). The Yuzhno-Russkoye oil and gas field is located at the Krasnoselkupsky region of the Yamal-Nenets Autonomous District (Gazprom, 2007b).

monopoly (Gazprom), by exchanging the foreign shareholding with a non-controlling stake in a gas field directly related to the Nord Stream. So it happened. Germany improved its position in terms of energy security (security of supply), while Russia gained almost full control of its national champion. Both sides profited from the swap, with Russia, however, gaining relatively more, if co-considered the LTC up to 2036, the almost buying out of E.ON Ruhrgas AG from Gazprom's capital share and the conceded non-controlling stake in the Yuzhno-Russkoye. Someone could argue that Russia benefited even in the case of the Yuzhno-Russkoye field and the associated with that Nord Stream pipeline project, since the influx of technological expertise would further corroborate its status as a reliable supplier, this time assessed in terms of available supplies, let alone further cement its affairs with Germany. However, this strategic partnership with the E.ON Ruhrgas AG would only be the beginning in a series of much more 'penetrative' gas relations with other major German/EU companies.

Such a case was Gazprom's cooperation with the BASF Group as forged for the first time in the beginning of the 1990s. That time, this bilateral cooperation was not as clear-cut as it seems today. The turmoil of the early post-soviet years and the needed time until the creation of what today is acknowledged as 'Gazprom', resulted in the foundation of Zarubezhgaz-Erdgashandel-Gesellschaft mbh (ZGG GmbH) in Berlin in 1990, a wholly-owned subsidiary of the V/O Zarubezhgaz, predecessor of today's Gazprom Export LLC, Moscow (Gazprom-germania, 2012). In 2006, ZGG GmbH was renamed Gazprom Germania GmbH (Gazprom-germania, 2012). This scheme was the parent company's (Gazprom OJSC) Trojan Horse, via which a complex network of partnerships across the EU was established to strengthen and promote the Russian presence in the European gas markets. Via this scheme many markets have been approached, e.g. France, England, Italy, Austria, U.S. etc<sup>247</sup>. However, as a preliminary note, it is stated that Gazprom Germania GmbH was the main, but not the only, 'bridge-landing' for Moscow in the EU gas markets<sup>248</sup>. The following figure presents a rather clear illustration of this case:

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<sup>247</sup> Most of these cases are examined later on, after the German section is completed.

<sup>248</sup> For reasons of clarity and historic accuracy, we mention that the term "bridge-landing" finds connotations in the period of the American revolution, when General George Washington and the American garrison of the Fort Lee crossed the Hackensack River in anticipation of the British invasion on November 20, 1776. The bridge, used to cross the narrows of the Hackensack River, was immortalized in history as the *Bridge That Saved a Nation* (Wright, n.d.).

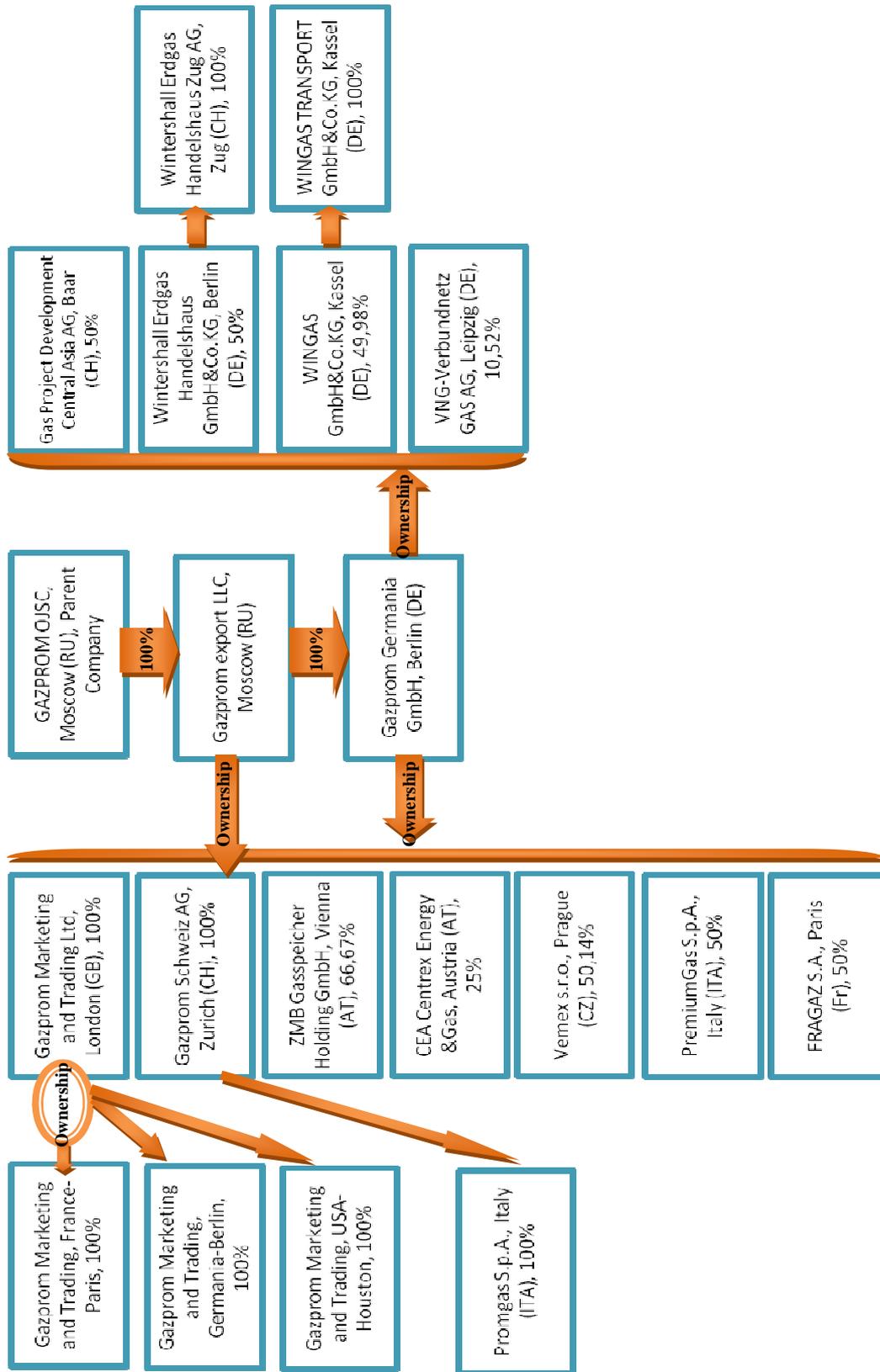


Figure 5.9: Gazprom Germania GmbH, Company structure

<sup>249</sup> The Figure is accessible at: <http://www.gazprom-germania.de/ru/kompanija/struktura-kompanii.html>, modified according to the company's further development.

As shown in the aforementioned Figure, Gazprom Germania GmbH built via partnerships with powerful national companies a complex network on behalf of Gazprom OJSC, Moscow. As prior said, the first partner that Gazprom Germania GmbH found in its expansive expedition was the BASF Group and particularly its Kassel-based oil and gas subsidiary, Wintershall Holding GmbH, onward BASF/Wintershall Holding GmbH. In 1990, Gazprom Germania GmbH and BASF-Wintershall Holding GmbH founded in cooperation the Wintershall Erdgas Handelshaus GmbH&Co.KG in Berlin in which the Russian side held 50%. A few years later in 1993, the same parties also founded the company WINGAS GmbH&Co.KG and its subsidiary WINGAS TRANSPORT GmbH&Co.KG in Kassel, in which the Russian side *initially* held 35%. These companies had been at the forefront of the Russo-German gas relationship all along up to 2010 and had been mainly employed to sell Russian gas in the German market under LTCs (WINGAS, 2010a). The contracted volumes had been procured by Gazprom Export LLC via the northern Yamal-Europe pipeline, whereas the network operated by WINGAS TRANSPORT linked the main gas reserves in Siberia with the burgeoning markets, either spot or not, in Western Europe<sup>250</sup> (WINGAS, 2010a).

What is even more critical for the analysis, however, is the position of WINGAS in the German market. As reported in the company's official site, the customer basis has been traditionally comprised of public utilities, regional gas suppliers, industrial companies and power plants in Germany as well as in other European states, while the gas network which has been managed by WINGAS TRANSPORT reached a total length of over 2.100 km<sup>251</sup> (WINGAS, 2010a; Gazprom 2007b). All these added not only to WINGAS' magnitude for the German/EU economy but also to Gazprom's constantly growing presence and influence in the region. As a token of WINGAS' special weight in the German market, it is reported that in 2000, 10 years since the

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<sup>250</sup> After the commencement of the Nord Stream in November 2011, Gazprom Export and WINGAS agreed on an amount of 9bcm/y to be procured via the new route over a 25-year period.

<sup>251</sup> Parallel to that, the company's weight is further increased if co-considered its presence in the largest Underground Gas Storage (UGS) facilities in Western Europe, i.e. Rehden (Germany) and Heidach (Austria). As mentioned by the analyst Elena Zhuk, the town of Rehden hosts the largest UGS in Western Europe "with a 250 million year old Zechstein reservoir located at a depth of nearly 2000 meters...while the second largest is being built in Heidach, Austria...with these two facilities in operation, the total storage capacity of Gazprom-Wingas' joint projects will amount to 8bcm of natural gas" (Zhuk, 2008).

The UGS are mainly used to provide steady and continued supply-flux in the costumers when either extreme weather conditions or supply-cuts take place. In other words, it is a guarantee, serving primarily to the customer's satisfaction and to the supplier's reputation.

Gazprom Export/Gazprom Germania GmbH and BASF/Wintershall Holding GmbH partnership had been inaugurated, more than 13% of the German gas market was under LTCs, running beyond the year 2036, with WINGAS (Gazprom-germania, 2012; WINGAS 2010a).

Whereas in the 1990s some sporadic steps had been made towards building ‘bridge-landings’ and establishing Trojan Horses (Gazprom Germania GmbH), in the EU gas market, what changed after 2000 was the *systemization* of this effort. As prior said, Russia, at the outset of the millennium, was not only in pursuit of foreign capital necessary for the resuscitation of its energy sector but also sought to achieve this while strengthening its ties with the EU energy majors and, hence, promoting its position in the EU market. Thus, “upstream for downstream” agreements constituted part of the overall cooperation framework.

In 2003, Gazprom and Wintershall AG agreed to set up the JV Achimgaz, located at Novy Urengoy and involved in the development of a pilot block of the Achimov deposits of the Urengoy gas and oil field<sup>252</sup> (Gazprom, 2003a). With both parties’ participation to the project equal (50%-50%), interesting is the fact that the first phase of the deposits’ development (the detailed engineered work and the trial commercial operation of the first block), would be solely funded by Wintershall AG, a BASF/Wintershall Holding GmbH 100% subsidiary (Gazprom, 2003a). Gazprom’ s financial contribution would be made out of the profits generated by the project and not by the company’s own means (Gazprom, 2003a). Finally, the agreement also stipulated that the JV would be selling all the gas produced to Gazprom as to guarantee a single export route. Profits would be distributed among partners according to the shareholding in the JV (Gazprom, 2003a).

The aforementioned points make clear what has been earlier said; the lack of foreign capital and the need for advanced technology, mainly possessed by western companies, in order to develop and operate complex gas and oil fields such as that of Urengoy. Nevertheless, Russia/Gazprom would not consent to any agreement that would not allow it to have the final say. That is the case with the provision that

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<sup>252</sup> Important for the analysis is to mention that the Achimov horizon runs at a depth of 3150-3800m and it is characterized by difficult geological structure if compared with other gas pools of the Nadym-Pur-Taz region. Therefore, technological expertise and foreign capital have been necessary for the development of its deposits.

According to Gazprom estimates, throughout the period of its development (43 years) more than 200bcm of natural gas will be produced, with the annual amounts reaching at 8.3 bcm (Gazprom, 2007c).

stipulated Gazprom as the final owner and distributor of the produced gas. So, the German company was allowed, or was ‘forced’ to allow Gazprom keep the “high ownership” of the product. As stated by Alexei Miller, chairman of the management committee, “we consider the project as a modal of cooperation with foreign partners in projects like this...Gazprom and Wintershall reached understanding in all key issues, a single export channel, price formula, financing forms and methods” (Gazprom, 2003a). Thus, this agreement served as the prototype of how ‘putinized’ Russia would view upstream cooperation with Western companies, even in cases like this, where Russia was in dire need for foreign investments and advanced technology; its relative advantage would not be relegated to the margins.

As expected, however, when Russia would start to gain a better economic standing, it would put on a more assertive face, linking any future upstream cooperation with downstream expansion (pushing its Trojan Horse, Gazprom Germania GmbH) deeper in the EU gas market. In particular, in 2007, Gazprom and Wintershall AG clinched a share swap deal according which the former would increase its shareholding in WINGAS GmbH from 35% to 50% minus one share while in turn, Wintershall AG would receive a 25% stake in OAO Severneftegazprom, the Yuzhno-Russkoye oil and gas field’s operator<sup>253</sup> (Gazprom, 2007b). This asset-exchange, increased, on the one hand, Gazprom’s presence in the German/EU downstream sector since it would acquire via its subsidiary, Gazprom Germania GmbH, a strong presence in both WINGAS and its wholly-owned subsidiary, WINGAS TRANSPORT.

On the other hand, Russia, just like in the E.ON Ruhrgas case, cleverly ‘traded’ the German need for energy security (security of supply) for further tightening the bilateral cooperation. According to estimates, the Yuzhno-Russkoye reserves surpass those of Urengoy almost three times, therefore, they could “satisfy Germany’s need for natural gas for the next 15 years and..substantially increase BASF production capacity” (Zhuk, 2008). Moreover, the BASF/Wintershall Holding GmbH was involved in the capital share of the Nord Stream project with a percentage equal to that of E.ON Ruhrgas, i.e. 15.5% (Nord Stream, 2011a). Assessing the magnitude of these developments, the Deputy Chairman of the BASF Board of Directors, Eggert Forsheau, stated: “Together (with Gazprom) we achieved a lot. We built a gas

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<sup>253</sup> See footnote 246. See also Figure 5.9 for the involved companies.

transportation system to ensure a reliable supply of this important energy source (Yuzhno-Russkoye) to Germany and other European countries”<sup>254</sup> (Forsheau cited after Zhuk, 2008). Despite the *prima facie* equally balanced intimacy that had been cultivated between the two sides, if we look beyond the surface, we will see that what discussed during the E.ON Ruhrgas AG case, retains its validity here. Russia was to equally benefit from both projects (the Yuzhno-Russkoye and the Nord Stream), if not more, since the influx of technological expertise was *sine-qua non* prerequisite for establishing and strengthening its status as a reliable supplier. Also, it should be kept in mind that no controlling stake was granted to the German company, just like in the E.ON Ruhrgas AG case.

What is more to the Russian advantage is the fact that this “upstream for downstream” share swap deal opened the door to Gazprom for a wider and more ‘penetrating’ presence in the EU gas downstream sector. Via the WINGAS group, Gazprom succeeded in setting a foot in a handful of other EU markets as well<sup>255 256</sup>.

This “upstream for downstream” share swap deal was the first of its series. The Gazprom group would further boost its downstream ‘penetration’ via Germany’s third

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<sup>254</sup> In addition to that comment, the current partnership has had wider connotations, surpassing the business sphere. Specifically, during the ceremony to mark the 20-year partnership between BASF/Wintershall and Gazprom, the former German Chancellor Gerhard Schroeder stated that: “No great international challenge-be it energy security, climate change or the conflicts in the Near and the Middle East-can be surmounted without Russia...BASF/Wintershall and Gazprom have essentially promoted and shaped this partnership over the last 20 years- and produced a blueprint for further cooperation” (WINGAS, 2010).

<sup>255</sup> Here, first consider the assets of WINGAS as previously mentioned along with the exposure of the German economy to natural gas and particularly Russian one. Also, it should be noted that WINGAS appeared considerable expansion in other important EU gas markets, such as Belgium and the UK. In Belgium, the company’s market share in the end of 2010 was estimated at approximately 10%, with the main customers being the industry and the processing sector (WINGAS, 2010a). In the UK, the company, as represented by WINGAS UK, supplied more than 60 critical for the economy industrial customers, i.e. chemical, pharmaceutical, paper, glass, etc. (WINGAS, 2010a).

<sup>256</sup> For the sake of inclusiveness, it should be mentioned that in 1993 the Gazprom Export/Gazprom Germania GmbH and BASF/Wintershall Holding GmbH partnership founded another JV, Wintershall Erdgas Handelshaus Zug AG (WIEE), which aimed at marketing natural gas to the Eastern Europe (later EU) states, Romania and Bulgaria. According to the company’s estimates, the JV, from 1993 to 2010 had procured more than 52bcm to Romania and 8bcm to Bulgaria, quantities that represented a sizeable share of the region’s natural gas imports (WIEE, 2010).

Moreover, WIEE has been a proactive company always seeking the expansion of the gas infrastructure in its markets. As reported by the company, a new JV, WIROM GAS S.A., has been recently (late 2000s) awarded gas distribution rights in the Romanian cities Turnu Magurele, Alexandria, Oltenia and Giurgiu (WIEE, 2010). Also, the same source mentions that WIEE has been examining its involvement in international cross-border pipeline projects along with major national energy companies, like the Romanian Transgaz S.A., the Bulgarian Bulgargaz and the Ukrainian Naftogaz (WIEE, 2010). All these underline the systematic and constantly growing, especially after 2000, Russian presence in these EU gas markets via Gazprom’s main Trojan Horse, Gazprom Germania GmbH.

largest natural gas importer and among EU top ten energy groups, the Verbundnetz Gas AG (VNG AG).

This company has also been critical for the supply security of Germany as well as of other EU states. Possessing an extensive gas infrastructure comprising 7000 km of pipelines and Underground Gas Storage facilities with a working capacity, as of 2010, of 2.6 bcm, the company covered a wide spectrum of business activities, i.e. gas imports, gas wholesale, gas transport, operation and marketing of storage capacity (VNG AG, 2012). More specific, VNG AG has had an international procurement portfolio which allowed it to establish a strong position in Germany's gas market as the third-largest natural gas importer (VNG AG, 2010, p.4). Aligned with the pro-Russian business *modus operandi* of LTCs, the company based its activities on such contracts, as a means of 'securing' deliveries to its customers (VNG AG, 2010, p.14). Its diversified clientele comprised regional distributors and utilities, industry, power stations and heating plants as well as other states<sup>257</sup> (VNG AG, 2010, p.16). In 2010, Poland and Italy were the main customers outside Germany, with the first holding also a 'strategic' role for further sales to other states and the second becoming all the more important customer, experiencing a year-on-year rise of 12% (VNG AG, 2010, p. 17). France also constituted a market that VNG AG successfully accessed in 2010 after applying for a license to distribute natural gas to non-residential customers, hence further diversifying its sales portfolio<sup>258</sup> (VNG AG, 2010, p.17).

Analyzing the gas procurement portfolio of the company, Russia has been atop the list. All the years from 2000 up to 2010, Russia supplied on average half of the company's supply mix. In 2000, Gazprom filled half of the company's needs (48%), leaving far behind traditional European suppliers like Norway (26%). The same pattern continued almost unabated until 2005, where Gazprom still covered most of the company's needs (45%), with Norway falling far behind (27%). However, the supply dynamics in the years up to 2010 presented a slight change, with Russia's Gazprom being again at the top (32%), European spot and future markets coming right after (31%) and Norway accounting for an even smaller share (18%).

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<sup>257</sup> Indicatively, it is mentioned that in 2009-2010, the average customer mix was comprised of Regional distributors and utilities (51.5%), Industry (13.5%), Power stations and heating plants (8.7%), Other countries (12%) and European spot and future markets (9%) (VNG AG, 2010, p.16).

<sup>258</sup> Aside from these major EU markets, VNG AG also expanded to other markets, such as Czech Republic, Slovakia, Switzerland and Luxemburg, fact that added to its importance as a major (but 'second-tier') 'bridge-landing' for other European/EU markets (VNG AG, 2010, p. 17).

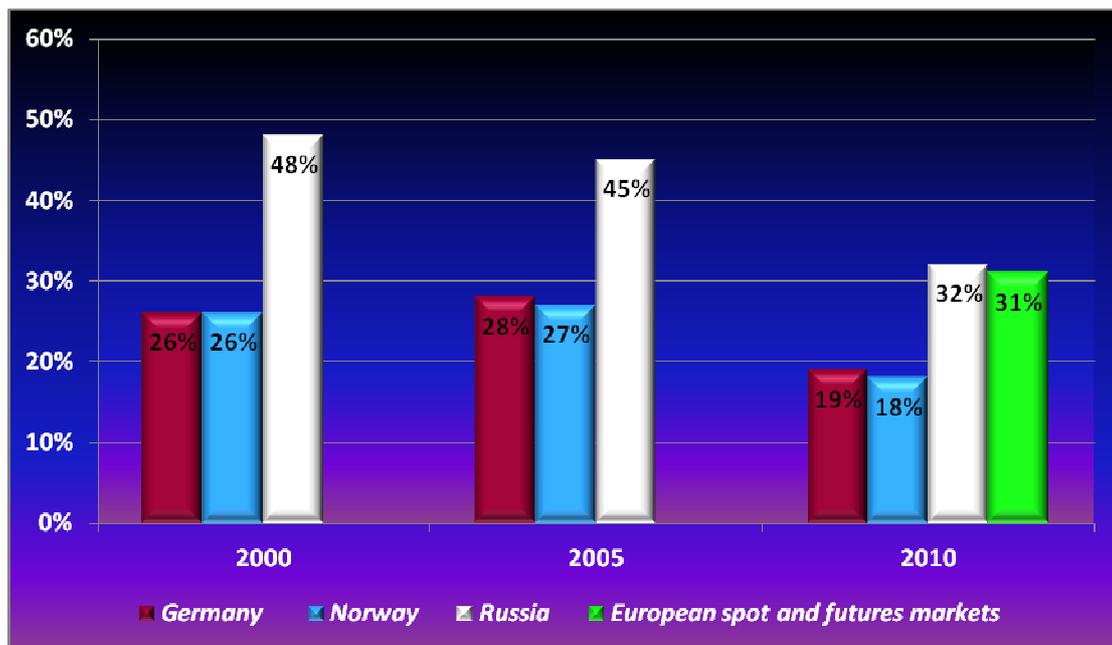


Figure 5.10: VNG AG natural gas procurement portfolio<sup>259</sup>

As prior said, these supplies had been contracted upon long-term gas purchase contracts, fact that further tightened the relationship between the two companies. Nevertheless, as the data of 2010 show, when the company realized that the global surplus of natural gas posed a threat to the competitiveness of the gas purchase LTCs, it did not hesitate to substitute the volumes from traditional suppliers (Russia and Norway) with the short-term but economically more profitable alternative of the spot markets. This is a critical point since it shows that the company, albeit its exposure to agreed LTCs for Russian supplies all along the 2000s, it did not stay complacent, searching for the most economically sound option. Someone could argue here, that for Gazprom it was not that easy to ‘use’ the need for supply security, as it did in the previously examined cases of E.ON Ruhrgas AG and the BASF Group, to ensure a stable position in VNG AG *modus operandi*.

Therefore, Gazprom, via its main Trojan Horse (Gazprom Export/Gazprom Germania GmbH), sought to solidify its presence in the company’s structures. Aiming at the downstream sector, it first established on May 19<sup>th</sup>, 2009, on a parity base with VNG AG, the JV Erdgasspeicher Peissen GmbH, in order to construct and operate the 585 mcm ‘Katharina’ UGS facility at Saxony-Anhalt (Gazprom-germania, 2012). In the same line of reasoning, on March 31<sup>st</sup>, 2010, it was decided that Gazprom Germania GmbH share in the capital share of VNG AG would rise from 5.26% to

<sup>259</sup> Source: (VNG AG, 2010, p. 63).

10.52% (Gazprom-germania, 2012; see also Figure 5.9). So, the shareholding of VNG AG took the following final form:



Figure 5.11: The shareholding of VNG AG<sup>260</sup>

Having already examined the intimate cooperation between the BASF and the Gazprom Group, it is plausible to conjecture that the Russian influence in the shareholders' structure of VNG AG was something much more than the 'nominal' 10,52%. Emphatically, albeit a slight exaggeration, someone could even place in the same side of the shareholders' equilibrium the Gazprom Germania GmbH and Wintershall Holding GmbH shares.

All these portray the Russian strategy to set a foot, as deep as possible, in the company's downstream presence. Exploiting its strong ties with one of the leading German companies in the world, i.e. the BASF Group, Gazprom set out to first solidify and then expand its presence in the assets of VNG AG, which although it had been a steady customer, contracted under LTCs all along the 2000s, it always kept an eye out for the most lucrative, albeit short-term, option (the spot and the futures market). Moreover, there was no cooperation in either Russian upstream or downstream project carrying supplies to the German market (e.g. Nord Stream) and, thus, necessary for the German energy security, a fact which made the relationship with VNG AG a rather 'loose' one. Thus, Gazprom increased its shareholding in the

<sup>260</sup> This Figure has been remodeled strictly abiding by VNG AG paradigm, (VNG AG, 2010, p. 9).

company via Gazprom Germania GmbH and set up a JV for the construction and operation of UGS facilities as a means of further strengthening its grip not only in the German but also in other EU markets<sup>261</sup>.

However, the German companies as well as their extensions to the rest of the EU markets were not the only targets to be pursued by the Russian bilateralism. Germany, as it is 'revealed' by the title of this section, has only been the entry point. The main Trojan Horse, Gazprom Germania GmbH, would progress further establishing partnerships with other major national companies as well. As illustrated in Figure 5.9, Gazprom Germania GmbH had expanded the Russian presence and influence, especially at the dusk of the 2000s to many major EU gas markets, such as Poland, France and Italy<sup>262</sup>.

### **5.2.2 Poland**

The adjacent to Germany Poland constitutes a much more evident case of Russian clout. Poland, as shown in Figure 5.8, has been covering most of its natural gas needs with imported volumes (72.3%). Out of these imports, Russia accounted, on average, for the 81%, fact that implied *de facto* intimate relations between the two states. This relationship, however, was accompanied by other developments that aimed at further tightening what was initially perceived as "close enough".

The Russo-Polish gas relationship has been founded upon the cooperation of the two state-owned gas monopolies, Gazprom and PGNiG, operating within the framework of LTCs. PGNiG is the largest petroleum company of Poland, active in many areas of the energy business, such as oil and gas field development, storage and transportation, construction and expansion of energy networks as well as natural gas exports and imports (Gazprom 2010b). As becomes apparent, PGNiG has a rather dominant role in the downstream business in Poland. Not only is in charge of the UGS and transport facilities but also controls the construction/expansion of (new) parts via which extra gas volumes will be distributed either to the domestic or other EU markets. In a word, PGNiG controls all the gas supply chain.

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<sup>261</sup> See page 179 and footnote 258.

<sup>262</sup> Of course, here, someone should not forget the expansion of the Russian influence to other EU markets as well (Netherlands, Denmark, Czech Republic, Slovakia, etc.) via Gazprom's cooperation with its German major partners.

Back in 1993, as a part of an intergovernmental agreement, Gazprom and PGNiG created the Joint-Stock Company EuRoPol Gaz Transit Gas Pipeline System (EuRoPol Gaz) with the aim of constructing and operating the Polish section of the Yamal-Europe gas pipeline<sup>263</sup> (Gazprom, 2010b). This company has been in charge of the 684-km Polish section with transporting capacity of 30bcm/y (Gazprom, 2010c). This network has also been essential for Russia transporting via Belarus gas supplies to the Polish and other EU markets<sup>264</sup>. The ownership of EuRoPol Gaz (pipeline included) was primarily divided between Gazprom (48.6%) and PGNiG (49.7), with the remaining 4% held by the JV Gas Trading S.A.<sup>265</sup> (Neftegaz, 2010).

The stable bilateral relationship throughout the 1990s up to 2010 had been based on two intergovernmental agreements, that of 1993 and 2003. Things, however, started to become more complex, when after the Russo-Ukrainian gas crisis in 2006 Gazprom stopped gas flows to Ukraine claiming the latter's ballooning debt as the prime-cause of the cut-off. Ever since, Poland has been a fervent supporter of the EU energy diversification policies, with emphasis placed on the adopted Third Energy Package<sup>266</sup>.

In 2009, Russia was presented with a chance of further penetrating the Polish market and gaining almost equal control with the PGNiG of the Polish downstream business. Specifically, in the years after the 2006 Russo-Ukrainian gas crisis, Poland's annual natural gas consumption had approximately been 13.7 bcm/y out of which only 30% was produced domestically (Gazprom 2010b). Thus, an amount of 10bcm had to be imported. Gazprom supplied the 9bcm, leaving the rest to the previously examined Russo-Ukrainian JV RosUkrEnergo<sup>267</sup> (Gazprom 2010b; Kureth 2010). In early 2009, RosUkrEnergo brought to a halt its agreed gas deliveries to Poland, leaving the latter hanging high and dry for the contracted amount of 1bcm. This shortage would start to become gradually more stifling, leading PGNiG to warn in late 2009, that any further

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<sup>263</sup> See Map 4.3. Additionally, the intergovernmental agreement of August 1993 stipulated, besides the construction of the gas pipeline network, Russian gas deliveries to Poland (Gazprom, 2010b).

<sup>264</sup> In order to understand further the importance of this network for the transit of Russian gas to the EU markets, it is noted that the annual Polish gas demand which has been covered via supplies of this network has been on average 13bcm/y. Hence, considering the network's total capacity of 30bcm/y, 17bcm have been destined for the rest of the EU markets.

<sup>265</sup> The ownership structure of the JV Gas Trading S.A. has been: PGNiG (43.1%), PHZ Bartimpex (36.17%), Gazprom Export (15.88%) and Wegelokoks and Wintershall Erdgas Handelshaus (2.27% each) (Neftegaz, 2010). Recalling the previous analysis, a link here could be made between Gazprom Export and Wintershall Erdgas Handelshaus in which Gazprom held via its main Trojan Horse, Gazprom Germania GmbH, 50% (the other 50% was held by BASF/Wintershall AG) (see Figure 5.9).

<sup>266</sup> See footnote 268.

<sup>267</sup> See pp. 107-116.

delay over an extra agreement with Gazprom in order to bridge this supply gap, would pose a threat to the supplies earmarked for the industrial sector (Dempsey, 2010). In parallel, Gazprom and PGNiG had been at loggerheads over the transit fees charged on the Polish section of the Yamal-Europe pipeline, with the latter pushing for an increase and the former opposing that (Eurodialogue, 2010). Consequently, the moment was perfect for Russia to act, attaching more ‘penetrating’ strings to the ‘hatching’ supply agreement.

Following Putin’s instructions over the implementation of a plan bringing the shareholding in EuRoPol Gaz to 50% for each side by April 1, 2010, the Gazprom management sailed for the signing of the new supply agreement (Putin, 2010; Rusmergers, 2010). This demand divided the Polish political elite, with the PGNiG and Waldemar Pawlak, the then economic minister and deputy Prime Minister, on the one hand, siding with Gazprom’s demands and Radek Sikorski, the then Foreign Minister, on the other hand, summoning the European Commission to decide whether the proposed agreement was aligned with the EU recently adopted Third Energy Package or not<sup>268</sup> (Dempsey, 2010). The officials in Brussels ruled against the agreement, with the spokeswoman for the EU energy commissioner at the time of writing, Gunther Oettinger, stating: “What we want is a level playing ground” (Dempsey, 2010). If the provisions of the EU energy legislation were breached this could not be achieved.

Notwithstanding the European Commission opposition, Gazprom, PGNiG as well as the members of the EuRoPol Gaz Management board agreed on some key points, all serving the Russian relative advantage. In particular:

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<sup>268</sup> In brief, the main provision of this policy package stipulated the Ownership Unbundling (OU) according which the supplier and the operator of the transit system cannot be the same person/entity (Council Directive 2009/73/EC; Dempsey, 2010). This policy package is analyzed later on, when the supranational institutions level (Russo-EU gas relations) comes to the forefront.

### **Russia-Poland Natural Gas agreement of 2010**

- ❖ Natural gas supplies from the Russian Federation to Poland were extended up to 2037.
  - ❖ An increase in the gas supplies to Poland up to 11bcm, starting from 2010 and progressing according to the Polish market demand.
  - ❖ Extension of the contract for natural gas transmission to Western Europe via the Polish section of the Yamal-Europe pipeline until 2045.
  - ❖ Resolution of the issues related to EuRoPol Gaz management and its tariff policy for Russian gas transmission via Poland during 2006-2009.
- (Gazprom, 2010b)

By this agreement, Russia tied Poland for the long-term, violating, at the same time, the EU legislation. It was not only the LTC up to 2037 and the extension of the contract for the use of the Polish gas network up to 2045, but also the gradual increase in supplies to 11bcm/y and the achieved ‘blocking’ shareholding (50%) in the EuRoPol Gaz that solidified the Russian presence in the Polish gas sector. Certainly, the latter point cemented the Russian presence in the Polish downstream sector, putting, at the same time, at stake any plans aiming at diversification of energy supplies. According to analysts, the projected for 2014 construction of an LNG terminal on the Baltic coast as well as the prospect of extracting natural gas from shale formation were both put on ice, since under the provisions of the prior agreement “investors would shy away from investing in shale or the LNG terminal” (Smolar cited after Dempsey, 2010). What’s worse to that and even more critical to the current analysis is that Russia used “Poland as a test case to see if it can get around EU legislation”, thus posing another question mark in the existence of an EU common energy policy (Smolar cited after Dempsey, 2010; Dempsey, 2010). This point, however, is better substantiated right after where the analysis turns to the supranational institutions level, i.e. Russia-EU.

### 5.2.3 France

France has been among the largest export markets for Gazprom. The Russo-French gas relationship traces its roots back in September 1975. Since then, the USSR (and after its collapse Russia's Gazprom) has delivered more than 225bcm to Gaz de France (GdF), the main importer of Soviet (Russian) gas to the French market and not only, upon supply LTCs (Gazprom, 2003b). Traditionally, Russian supplies has been playing a critical role in the company's supply mix. As shown in Figure 5.8, Gazprom, albeit it accounted for a *prima facie* small share of the total (16.7% and 17.3% in 2009 and 2010 respectively), it ranked second in the supply portfolio of GdF, right after Norway (21%) and above Algeria (13%) and the Netherlands (11%) (GdF SUEZ, 2010, p.27). This is due to the fact the GdF has had a diversified supply portfolio including many regions like Trinidad and Tobago (5%), United Kingdom (2%), Libya (3%), Egypt (3%), etc. (GdF SUEZ, 2010, p.27). In 2008, GdF and SUEZ were merged, forming one of the largest European energy companies, GdF SUEZ, operating in many areas of the gas value chain such as power generation and natural gas exploration, production, distribution and marketing (Gazprom, 2008a).

GdF SUEZ has been placing great importance on diversifying its suppliers -each party should hover around 20% in the supply mix- as well as its supply routes (GdF SUEZ, 2010a, p.3). As briefly mentioned above, the company has been conducting business upon LTCs of an average 15.5-year term, that allowed it to “ensure its development and safeguard its supplies- a key advantage in the European natural gas market” (GdF SUEZ, 2010a, p.3). In addition to that, GdF SUEZ has been operating the largest gas transportation network (37.144km out of which 32.044 in France) and the longest distribution network in Europe (290.000km)<sup>269</sup> (GdF SUEZ, 2010a, p.18). What differentiates, however, this company from the previously examined cases is its role in the LNG business. In particular, GdF SUEZ has been the largest importer of LNG in Europe and the United States and the second largest LNG terminal operator in

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<sup>269</sup> After the enactment of the Third Energy Package by the European Commission, the company aligning with its provisions, granted the operation of its main distribution network in France to its 100% owned subsidiary, GrDF, and the operation of the natural gas transportation network in France to its 100% subsidiary, GRT gaz, with the latter serving as an Independent System Operator (GdF SUEZ, 2010a, p.18). More detailed analysis on this policy Package is provided later on.

Europe (GdF SUEZ, 2010a, p.3). This is an area that as we shall see later on, Gazprom took part in, aiming at further increasing its influence in the gas business.

No matter the ongoing of the Russo-French gas relationship since 1975, it was not until the beginning of the new millennium that Russia started to move strategically in order to solidify its position in the French market. On June 28<sup>th</sup>, 2003, Gazprom and, at the time, GdF signed a memorandum of further cooperation at Saint Petersburg (Gazprom, 2003b). As stated by the then newly-appointed head of Gazprom, Alexei Miller, “Strong partnership relations have been established between Gazprom and Gaz de France. However, our joint core business has been gas deliveries to France. The document signed will ensure an expansion of the field of our partnership” (Gazprom, 2003a). This proclaimed ‘expansion’ would not take long until it started to get specific form.

The first sign came with the agreement on the swap of pipeline gas for LNG between Gazprom and GdF in November 2005. According to this LNG swap deal, Gazprom would supply GdF “with extra amount of pipeline gas in exchange for a shipment of LNG from MED LNG & GAS, a JV of GdF and the Algerian Sonatrach” (Gazprom, 2005b). The first LNG tanker was expected in early December 2005 at the Cove Point re-gasification terminal in Maryland, USA<sup>270</sup> (Gazprom, 2005b). This was a landmark deal, fact which was also corroborated by the words of the then deputy

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<sup>270</sup> It is important to note that this agreement was not the first of its kind. Gazprom had already set foot in the LNG business as early as in August 2005, when, via one of the fully-owned entities (Gazprom Marketing and Trading Ltd London), of its main Trojan Horse Gazprom Germania GmbH, LNG supplies were sent at the Cove Point re-gasification terminal in Maryland, USA (Gazprom, 2005b; see also Figure 5.9 for the abovementioned companies).

Overall, both these “LNG developments” were critical for Gazprom, since it was not only the expansion in an area (LNG) that could otherwise threaten its business position, albeit highly unlikely in the immediate future (see pp. 160-163), but also the access to a huge market that could be a significant and steady source of revenues for the Russian economy. Estimates of the time forecasted the steadily rising demand for LNG by the US market all along the 2000s, as a result of the declining domestic production (Gazprom, 2005b). Thus, a substantial increase in gas imports was anticipated. What is more to that, is the agreement that for 2006-2009, Gazprom’s LNG supplies would be realized upon mid-term contracts with US companies, fact which would change from 2010 onward, when direct long-term deliveries would take over as the principal *modus operandi*.

Aside from the opening to the US market, it should also be mentioned that in August 2010, GdF SUEZ delivered its first LNG cargo to the Shanghai terminal, signaling in this way the access to the vast Chinese market (GdF SUEZ, 2010, p.27). Although at the time of writing there is no agreement between Gazprom and GdF SUEZ over expansion to the Chinese market, it should not be excluded in the immediate future, since China is of strategic importance for the Russian energy business. However, this strategic role of China for Russia makes most probable that the latter would move toward setting direct energy ties with the former rather than approaching it through a European company. As claimed in the beginning of the current chapter, it is to the Russian advantage to expand to the Chinese market as a means of counterbalancing its overexposure, in economic terms, to the EU market. Then, Russia, would be in an even better position to play one against the other in pursuit of its relative advantage in the energy business (see pp. 160-164).

Chairman of Gazprom's Management Committee, Alexander Medvedev, who stated that "in an effort to solidify Gazprom's standing in the conventional European natural gas market, we are striving to enter a global gas market by swapping pipeline gas for LNG...this strategy of converting..into a world-class energy firm...will give us additional opportunities for promoting our business in the LNG supply sector" (Gazprom, 2005b).

Even more to the Russian advantage were the next agreements signed between Gazprom and GdF in 2006. Following their provisions, the supply LTC was extended up to 2030, while both sides agreed to the procurement of extra volumes (2.5bcm/y) to GdF by the end of 2010, once the Nord Stream gas pipeline became operational<sup>271</sup> (Gazprom, 2006a). More critical was the fact that Gazprom was awarded the right to deliver *directly* gas supplies to the final consumers up to the amount of 1.5bcm/y<sup>272</sup> (Gazprom, 2006a). Consequently, Gazprom, a) ensured the viability of the, at the time only planned, Nord Stream pipeline project, b) increased the exposure of the largest French company and sole importer of Russian gas to Russian supplies and finally, c) acquired direct access to the French downstream sector. As stated by the company's CEO, Alexei Miller, "the agreements are...a vivid example of Gazprom's successful implementation of its strategy aimed at entering the final consumer market in European countries and improving the Russian gas export efficiency" (Gazprom, 2006a). It is important to note, nevertheless, that no matter how grossly all these points seem to have benefited the Russian side, they had not been agreed in GdF's ignorance. Quite the opposite. The latter saw their interests being well taken of as well. Specifically, as stated by its CEO, Jean-Francois Cirelli, right after the agreements, "deeper business cooperation with Gazprom stimulates strengthening the gas supply security for our customers in France and Europe in a long-term perspective" (Gazprom 2006a). This is a token of the widely diffused Russian "soft

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<sup>271</sup> It is critical for the analysis to mention that Gazprom had already secured GdF's support for the Russia-backed Nord Stream Pipeline Project, by granting it a 9% stake, fact which, *inter alia*, served in further 'tightening' the bilateral cooperation (Nord Stream, 2011a).

<sup>272</sup> Gazprom had created in 1993 a JV with GdF under the name Fragaz S.A. This company served as an intermediary for the Russian supplies to GdF up to the amount of 1.5bcm/y. When in 2006 the aforementioned agreements were signed granting Gazprom the right to direct sales to the final consumers, its share in the venture (50%) was sold to Gazprom Germania GmbH along with the apparent directive to shift to other activities (Nefit Rossii, 2008). Reading between the lines, the parent company, OAO Gazprom, once it had established the tight and direct relationship it aimed at with GdF, it did not anymore need the JV. However, the latter was not abolished but on the contrary the share of OAO Gazprom was transferred to its main Trojan Horse so as the venture to engage in new activities, undisclosed at the time of writing (see also Figure 5.9).

power” that has been steadily exerted since the mid 1970s and contributed to the establishment of Russian supplies as an indispensable constituent of the European/EU energy companies’ *modus operandi*.

In fact, this establishment has been so firm that the subsequent to the first Russo-Ukrainian gas dispute (2006) public debate as well as the EU policy papers over diversification of energy resources and routes were met with little resonance. Even in the case of the Third Energy Package where the European Commission, viewing energy as a part of the Competition policy and hence within its exclusive competences, tried to impose a ‘top-down’ policy to the member states, it faced fierce opposition by almost all the currently examined EU energy companies<sup>273</sup>. However, this case is better substantiated later on the analysis.

Slightly different but equally ‘tightening’ was Gazprom’s relationship with the remaining two largest French companies, Total S.A. and Electricité de France (EDF).

In 2006, Gazprom decided that the Shtokman gas condensate field would become



the resource base of Russian gas deliveries to the markets of the Atlantic basin and Europe (Gazprom, 2008a). This field is situated in the central region of the Russian sector of the Barents sea and it is of

**Map 5.4: The Shtokman field**<sup>274</sup>

strategic importance to Gazprom, given that Putin’s strategy of Russia exporting 10% of its gas as LNG by 2020 has been primarily based on this field<sup>275</sup> (Gazprom, 2011h;

<sup>273</sup> Even though some companies aligned with the EU legislation, we have reasons to believe that the prior establishment of the Russian interests to the EU market has been so deep that any change by the EU companies was only *nominal*. See also the case of Poland, pp.178-191.

<sup>274</sup> The map is accessible at:

<http://d3n6f555sx1wcx.cloudfront.net/wp-content/uploads/2011/11/Russia-Gazprom-Statoil-Discuss-Cooperation-Deepening-in-Shtokman-Project.jpg>

<sup>275</sup> The Russian LNG strategy stipulated that a large share of the produced LNG (90%) from this field would be exported to the US market (Shiryaevskaya, 2011). Here, it should also be kept in mind the 2005 LNG swap deal signed between Gazprom and GdF which stipulated deliveries to the US market. As previously said, LNG has been a new business area for Gazprom that it should take into serious consideration if it was to maintain and, if possible, expand its market position.

Shiryaevskaya, 2011). The field is dark six months of the year and exposed to severe climate conditions. It is hard to develop unless high/western technological expertise and platforms impervious to icebergs are guaranteed (Kramer, 2007).

On these grounds, OAO Gazprom and Total S.A. signed in 2007 an agreement on the main conditions of cooperation at the Phase 1 of the field's development<sup>276 277</sup>. Specifically, it was agreed that a special-purpose company would be established to handle all the necessary installations, while this company would be the owner of the infrastructure for 25 years once commercial exploitation begun. Gazprom would hold 75% of this company while Total the remaining 25%, transferrable to Gazprom upon expiration of the 25 years (Gazprom, 2007d). New shareholders to this company might be invited without however Gazprom's share falling below 51% (controlling share). The license plus all the rights for marketing the commodities of this field would be held by Gazprom's fully-owned subsidiary, Sevmorneftegaz, later renamed Gazprom neft shelf (Gazprom, 2007d; Gazprom, 2011h). Finally, Gazprom neft shelf and the special-purpose company would sign a contract in which they would stipulate that "all financial, geologic and technical risks involved in extraction of natural gas and condensate, as well as in LNG production" would be assumed by the latter (Gazprom, 2007d). On February 21<sup>st</sup>, 2008, the special-purpose company, Shtokman Development AG, was finally established, when a shareholder agreement awarded to Gazprom the controlling stake (51%) and to the 'indispensable' western partners Total S.A. and StatoilHydro (Norway) from 25% and 24% respectively (Gazprom, 2008a).

As stated by Alexei Miller right after the agreement, "this strategic partnership of our companies brings together long experience, vast resources and advanced technologies...which will guarantee reliable and long-term gas supplies for European customers" (Gazprom, 2008a). No doubt, this upstream cooperation, just like all the previously examined, was portrayed, and in fact was, 'win-win'. Western companies would surely benefit, being guaranteed security of supplies. But the very same moment, Russia/Gazprom was also gaining, and in fact, relatively more. Not only participation in its upstream sector was ensured under its "high ownership", but also the development of new, hard to access, fields, like that of Shtokman, was indirectly

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<sup>276</sup> Total is a major, world-class energy company with its activities of storage and natural gas transportation and marketing extending to more than 130 countries (Gazprom, 2007d).

<sup>277</sup> Phase 1 projected for a yield of 23.7bcm/year with pipeline deliveries starting in 2013 and LNG in 2014 (Gazprom, 2008a). However, at the time of writing, these dates have been procrastinated to 2016, with LNG a year later.

championing Russia-backed networks to the EU market, like that of Nord Stream. In the case with Total S.A., Gazprom, aside from keeping for itself, via its fully-owned subsidiary, all the rights to marketing the production, it also stipulated a specific 25-year ‘deadline’ for the French presence in the field’s development. This brings to mind the, more or less, similar agreement between Gazprom and Wintershall AG in 2003 over the development of the Achimov deposits of the Urengoy gas and oil field<sup>278</sup>. In this light, if we test these cases against the assumption “who will gain more” from the bilateral cooperation, then, the data have shown that the equilibrium tilted to the Russian side.

In the same footing is the case with the last major French company, EDF, and its participation to the special purpose company, South Stream AG, responsible for the construction of the South Stream pipeline project. The latter constitutes part of the Russian downstream sector and has been widely disputed among the EU supranational bodies<sup>279</sup>.

In June 2007, Gazprom and Italy’s ENI signed a Memorandum of Understanding (MoU), stipulating the recommended course with regard to the development of the South Stream project. In November of the same year, the two signed a supplement to the MoU, specifying the establishment of a special-purpose company for the execution of the project (Gazprom, 2008b). Few months later, in January 2008, the special-purpose company, South Stream AG, was registered in Switzerland, with Gazprom and ENI holding a 50% stake (Gazprom, 2008b). This was only the beginning of subsequent rounds of negotiations with major EU energy companies, aiming at making South Stream as recognized and supported as the Nord Stream Project (Gazprom, 2009b). Indeed, the first expansion occurred in November 2009, when Alexei Miller and his counterpart in EDF, Henri Proglio, signed both a MoU stipulating the conditions under which EDF would participate in the South Stream AG and new supply LTCs (Gazprom, 2009b). Special emphasis should be placed on the latter, since they would “secure Gazprom’s marketing of the resources with one of the reliable European customers and enable EDF...to obtain guaranteed volumes of hydrocarbons from Russia in the long term” (Gazprom, 2009b).

Not until a year had passed, on June 6<sup>th</sup>, 2010, Gazprom, ENI and EDF signed in the presence of the then Russian President Dmitry Medvedev and his French

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<sup>278</sup> See p. 176-177.

<sup>279</sup> See also p. 146.

counterpart Nicolas Sarkozy a trilateral Memorandum, stipulating mainly that EDF's entry to the special-purpose company South Stream AG would "be accomplished before the end of 2010 through a reduction in ENI's stake in the joint venture" (Gazprom, 2010c). Thus, Gazprom would maintain its 'controlling' stake intact, leaving the other two, at the time, participants to share the remainder of the shareholding<sup>280</sup>. As stated by Henri Proglio, "the agreement...enables EDF, the world's biggest nuclear power producer, to reinforce its position on the gas market...and secure its supplies..for supplying its own electricity production facilities and...its customers" (Gazprom, 2010c).

No matter the expressed satisfaction from the French side, the fact remains that the Russian side gained relatively more. Exploiting successfully, once more, the EU energy companies' appetite for energy (supply) security, Russia ensured for itself increased, long-term demand for its supplies, transportable, via Russian pipelines. Especially, in the case of the South Stream, it has to be mentioned that the EU supranational bodies had expressed the official opposition to the project, since it would disproportionately tie the EU gas demand to Russian supplies. Nevertheless, Russia not only succeeded in 'enticing' many major EU energy companies to the project's special-purpose company, but it also achieved that, having the approval of the respective political elites, fact corroborated by the presence of the heads of states during the signing of the agreements.

As briefly mentioned, the South Stream project based on the initial 2007 Russo-Italian MoU. Scratching beneath the surface, we see that Italy has also been a long and steady European partner of today's Russian Federation.

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<sup>280</sup> For reasons of inclusiveness it is noted that on March 21, 2011, Gazprom and BASF AG signed a MoU, laying the groundwork for the Wintershall Holding GmbH participation to the South Stream project (Gazprom, 2011i). According to the Memorandum, Wintershall Holding GmbH's participation was estimated at 15%, with Gazprom maintaining the 'controlling' stake (50%). Thus, the final capital structure of the South Stream AG has been, at the time of writing, as follows: Gazprom 50%, EDF 15%, ENI 20% and BASF/Wintershall Holding GmbH 15% (Gazprom, 2011i; Gazprom, 2011j). Moreover, Gazprom advanced further, exchanging in the same Memorandum, the BASF/Wintershall Holding GmbH participation to the project with the conclusion of new supply LTCs with the JV Wintershall Erdgas Handelshaus Zug AG (WIEE), which, as we have earlier seen (see footnote 256), has been operating as a 'second-tier' Trojan Horse in the region of Eastern EU on behalf of Gazprom's main Trojan Horse, Gazprom Germania GmbH (Gazprom, 2011j). Acting in this way, Gazprom, not only got its downstream project widely recognized/approved, but it also 'exchanged' some companies' participation (EDF and BASF/Wintershall Holding GmbH), with the signing of new supply LTCs, hence further 'tightening' the Russo-EU bond.

## 5.2.4 Italy

Today's Russo-Italian gas relations trace their roots back in the late 1950s to early 1960s. While at first oil was at the core of the bilateral energy business, soon gas made its way to the top, triggering a series of events that would tighten the relationship all the more each time. During the 1960s the Soviet gas industry was developing apace, with an emerging gas network of trunk lines being laid down (Gazprom, 2012). However, the October 1961 decision to build an infrastructure of higher technological level would not be attainable if it was not for the Italian expertise to take part in (Gazprom, 2012). At the same period, it was also becoming obvious in Italy that the rising gas demand could not be met only with domestic production and a pipeline from the USSR could be of a solution. The USSR and Italy were *de facto* brought together. In 1965, both sides agreed on the obvious: technological expertise for abundant gas supplies. The Italian, state-owned, ENI would supply all the necessary expertise for the construction of the gas networks, inside and outside the USSR, while the latter would pay with gas supplies<sup>281</sup> (Gazprom, 2012). The gas pipeline deal was finally clinched in the late 1969, stipulating that for a 20-year period, the USSR would procure 6bcm/year to Italy's ENI in exchange for a loan of \$200 million along with the necessary technological equipment and expertise for the infrastructure construction (Gazprom, 2012). However, no sooner than 1974 had this deal been put in place.

This "start up" deal was the "first agreement of the kind in the whole world and the first one with the USSR in terms of value" (Gazprom, 2012). Right after, a series of new agreements would be signed upon the same pattern, further expanding and deepening the bilateral cooperation. In brief, in 1975, the two sides signed their second contract, stipulating for an increase to the procured gas supplies by 1bcm/y, while in 1986, the third contract, provided for another increase up to 8bcm/y as well as for technological equipment to the USSR (Gazprom, 2012). Following the geopolitical developments of the early 1990s, the then newly-created Gazprom and ENI signed in 1996 a fourth contract, again stipulating for a similar increase up to 8.8bcm/year until 2008 (Gazprom, 2012). All these contracts had been 'win-win'

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<sup>281</sup> The discussed gas network necessary for the then USSR supplies to reach the Italian market has been the Trans Austrian Gasleitung (TAG) with overall length of 1.140 km and annual capacity of 37bcm. With three compressor stations, this pipeline enters Austria at Baumgarten, on the Austrian-Slovak border, and reaches Italy at Tarvisio (ENI, 2012).

helping the Italian ENI to meet its rapidly rising domestic natural gas demand and the USSR/Russia to upgrade its gas export network to Western Europe.

With the turning of the new millennium and Vladimir Putin's ascent to power, the deepening of the cooperation would progress apace. New supply LTCs along with the extensive teamwork in the upstream and downstream sectors of both states would forge very intimate relations, if not 'penetrative' on behalf of Russia/Gazprom.

Setting briefly the background, in 1993, Gazprom Export and ENI had founded on a parity basis the JV Promgas S.p.A (Promgas), based in Milan, Italy, as a small-sized gas middleman with the aim of supplying Italy's second-biggest power group, Edison S.p.A (Edison)<sup>282</sup> (Interfax, 2011; Reuters, 2011). This JV has been purchasing gas from one parent (Gazprom) at the Austrian gas hub in Baumgarten and selling it to the other (ENI), thus Gazprom was not *directly* active in the Italian market<sup>283</sup> (EC, Case No COMP/M.5740-Gazprom/A2A/JV; Interfax, 2011). In 2000, Gazprom and Promgas agreed in a supply LTC of 2bcm/y until 2025 to Edison, solidifying, in this way, the position of the Russian supplies in a critical and lucrative at the same time, sector of the Italian economy (Gazprom, 2012).

A landmark to this 'tightening' course was the November 2006 agreement on Strategic Partnership between Gazprom and ENI. According to the main provisions of the agreement, Gazprom, would receive the opportunity to "launch from 2007 direct Russian gas deliveries to the Italian market" of a constantly increasing amount that would reach the 3bcm/y by 2010 (Gazprom, 2006b). Moreover, the supply LTC with ENI, would be extended up to 2035, while the companies assumed responsibility to work together "when laying new and developing existing transmission routes, including within the Blue Stream project, as well as in the LNG and new gas transportation technology areas"<sup>284</sup> (Gazprom, 2006b). Finally, the companies also agreed on joint investments mainly in the Russian upstream sector (Gazprom, 2006b).

Undoubtedly, this was a framework agreement, corroborating the commitment of both sides to "jointly develop projects in the entire gas chain" (ENI, 2011). However, no matter close to the 'traditional' business pattern of Russian supplies for Italian technology it may have been, it deviated in two critical aspects: a) the supply LTC up

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<sup>282</sup> Edison usually purchased no more than 2bcm/y, in a price which in 2011 exceeded \$400/mcm.

<sup>283</sup> This *modus operandi* has been extrapolated by a European Commission Regulation on a very similar case, that of the JV Premium Gas S.p.A (Premium Gas) between Gazprom Export and the Italian A2A Alfa S.p.A (Alfa). This case is visited later on.

<sup>284</sup> For the Russo-Italian cooperation on the Blue Stream project, see p.145.

to 2035 and b) the awarded right to Gazprom to sell *directly* gas to the Italian market. While the second aspect is a clear-cut case, as far as the first is concerned, it should be noted that this duration was far more extended compared with all the prior gas contracts<sup>285</sup>. Taken together, these two aspects make no secret of ‘*putinized*’ Russia’s strategy of not only ‘tightening’ the relationship but also gradually having a ‘direct’ say in the Italian market. As we shall see anon, on the grounds of this framework agreement, the bilateral relationship would grow all the more intimate, without, however, the Russian relative advantage being overruled.

In this light, in April 2007, ENI, via the SeverEnergia consortium (ENI held 60% stake while another major Italian company, Enel, held 40% stake) acquired gas production assets in the Russian upstream (the western Siberian fields) (Gazprom, 2012; ENI, 2011). This move was one of high political symbolism, given that the consortium purchased the second lot of assets that had been auctioned as a part of the liquidation of Yukos<sup>286</sup> (ENI, 2012). Nevertheless, SeverEnergia provided Gazprom with an option of a 51% stake in the consortium, exercisable whenever decided by the latter (Gazprom, 2012).

In the same vein, in July 2008, ENI’s fully owned subsidiary OOO ENI Energhia signed a contract with the Russian TKG-9 for the sale of natural gas in the latter’s electricity power stations in the Perm region (Russia). Specifically, the contract stipulated for the supply of 350 mcm/y by 2010 (ENI, 2011). This contract was of major importance, especially for ENI, since it would become “the most important European operator in the Russian downstream gas sector” (ENI, 2011). No doubt, this agreement, similar to which we did not come across in any of the previously examined cases, once more corroborated the ‘traditional’ importance of Italy for Russia. However, the need for ENI’s expertise did not mean that ‘*putinized*’ Russia would sacrifice its consistent strategy of relative gains. Quite the opposite.

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<sup>285</sup> This is also apparent in the case with Promgas, where the signed supply LTC stipulated deliveries up to 2025.

<sup>286</sup> It is reminded that Yukos, the biggest Russian oil company of its time, was forced out of business in 2003 as a result of its ‘complex’ relationship with the state authorities. Given that, the establishment of an Italian/foreign consortium at the place where once was operating the biggest Russian oil company of its time, could be perceived as a token of the Russo-Italian intimacy. Moreover, ENI, acquired at the same auction a 20% stake in Gazprom Neft, an oil production company belonging to the Gazprom Group, fact which also added to the aforementioned Russo-Italian intimacy, especially if considered the central role of the state-owned monopoly ‘Gazprom’ in the Russian energy business, domestic and international. For more on SeverEnergia’s acquisitions see:

[http://www.eni.com/en\\_IT/eni-world/russian-federation/eni-business/eni-business.shtml](http://www.eni.com/en_IT/eni-world/russian-federation/eni-business/eni-business.shtml) and <http://www.gazprom.ru/about/history/events/italy40/>

In September 2009, Gazprom decided to exercise its option for the controlling stake (51%) at the SeverEnergiya consortium, paying the amount of \$1.6 billion. As a result, ENI's shareholding was reduced from 60% to 29.4% and Enel's from 40% to 19.6%, with Gazprom, finally acquiring the controlling stake in "the biggest Italian-Russian company operating in the Exploration and Production sector" of the Yamal Nenets field (western Siberia) which have been producing the biggest quantity of gas in the world (ENI, 2011). After this reshuffling, ENI held in the end of 2009, 5 mining concessions in Russia equaling to 2.323 square km out of the total 6.636, fact which, albeit corroborated ENI as one of the biggest foreign players in the Russian upstream, if not the biggest, it did not qualify it with any 'commanding' power (ENI, 2011). Thus, Russia retained control of its upstream business and secured its relative advantage.

Placing now all the bilateral progress examined up to here in an inclusive explanatory framework, someone should start by recalling that Gazprom had ensured, in June 2007, ENI's participation to the South Stream project via the formation of the special purpose company "South Stream AG" on a parity basis (see p. 191). This was a strategic accomplishment as well as the reference point of all the aforementioned developments. Specifically, it could be argued that Russia/Gazprom 'rushed' for the November 2006 Strategic Partnership and was so 'benevolent' in its initial upstream concession to SeverEnergiya in April 2007, in an effort to lure ENI closer to it and particularly into the Russia-backed South Stream project the very same moment that the whole EU, being agitated by the January 2006 Russo-Ukrainian gas dispute and skeptical over the former's credibility, sought to diversify its supplies/supply routes away from it. Such an option was provided by the Nabucco project, major rival of South Stream, and US supported<sup>287</sup>. Thus, Gazprom, by 'tying' ENI to the South Stream project -an aim which was also pursued with the remainder of the key EU companies such as EDF and BASF/Wintershall-, it was undermining the feasibility of its geo-strategic adversary. Later, when the 'danger' would pass or at least subside, Gazprom, would take back the controlling stake in SeverEnergiya, ensuring the Russian relative advantage. The same argumentation holds also for the contract between ENI's fully-owned subsidiary OOO Energhia and the Russian TGK-9; this

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<sup>287</sup> See page 146, footnote 200.

agreement, however, was not of that strategic importance as the controlling stake in SeverEnergia, thus, it was not repealed or altered in any obvious way.

Nevertheless, ‘putinized’ Russia’s efforts to tie tighter the Russo-Italian bond would advance further, targeting more *systematically* also the Italian downstream sector.

Exploiting the experience acquired during doing business via the JV Promgas as well as the nurtured intimacy throughout the 2000s, Russia/Gazprom sought to convert the “non functional” JVs PremiumGas and Promgas into *active* downstream companies<sup>288</sup>.

PremiumGas had been established in September 2008 with its shareholding belonging to Gazprom Germania GmbH (50%) and A2A Alfa S.p.A (Alfa). The latter exercised along with EDF joint control over Edison<sup>289</sup> (EC, Case No COMP/M.5740-Gazprom/A2A/JV, par.4). In December 2008, the parties consulted the European Commission about the functionality of their JV, with the latter expressing its inhibitions<sup>290</sup>. Therefore, on May 7<sup>th</sup>, 2010, the parties again notified the European Commission over a new “General Business Plan” that would present the JV with its own infrastructure and personnel, just like an independent from its parents company, aiming at becoming “a mid-sized supply company on the Italian market” (EC, Case No COMP/M.5740-Gazprom/A2A/JV, par. 7). This plan referred to a proposed concentration and thus it had to be examined by the European Commission according to the competition rules. The Commission having examined the vertical relationships between the wholesale and retail gas supply “decided not to oppose the notified operation and to declare it compatible with the internal market and with the EEA Agreement. This decision...adopted in application of Article 6(1)(b) of the Merger Regulation”<sup>291</sup> (EC, Case No COMP/M.5740-Gazprom/A2A/JV, par.29).

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<sup>288</sup> As assessed by the European Commission, these JV had been characterized “non-functional” since they had been purchasing gas from one parent (Gazprom) at the Austrian gas hub in Baumgarten and selling it to the other (ENI), thus Gazprom was not *directly* active in the Italian market (EC, Case No COMP/M.5740-Gazprom/A2A/JV, par. 6).

<sup>289</sup> If considered the prior experience with Promgas in supplying Edison, then it is explained how Gazprom managed to establish also this JV (PremiumGas). See also p. 194.

<sup>290</sup> See footnote 288.

<sup>291</sup> Specifically, the Commission assessed that in the Italian wholesale market the main players had the following shares: ENI 30-40%, Enel 10-20%, GdF 0-5%, Hera 0-5%, A2A/Edison 5-10%. In the downstream retail supply, the JV PremiumGas had a 0-5% share while A2A had a 5-10% share. Furthermore, if these shares were tallied with specific groups of customers, then PremiumGas and A2A would hold in (a) electricity producers for their gas fired plants (CCGTs) 10-20%, (b) local distribution companies (LDCs) 5-10%, and (c) small customers (SCs) 5-10%. The parties also claimed that “because of (a) the limited combined market shares of the Parties on the downstream markets and (b)

Consequently, the European Commission approved the direct Russian presence in the Italian energy market. Gazprom, via its main Trojan Horse, Gazprom Germania GmbH, advanced to the Italian downstream sector, controlling a noteworthy market share.

No sooner had the ink dried in the previous approval, a new notification on a proposed concentration arrived at the Commission, in November 2011, concerning the acquisition by Gazprom Schweiz AG of ENI's share in the JV Promgas<sup>292</sup> (EC, Case No COMP/M.6409-Gazprom Schweiz/Promgas, par.1). This operation, just like the previous one, fell within the scope of the Competition policy of the EU, hence the same procedure had to followed. The European Commission, acting by the provisions of the Merger Regulation, "decided not to oppose the notified operation and to declare it compatible with the internal market and with the EEA agreement. This decision..adopted in application of Article 6 (1)(b) of the Merger Regulation (EC, Case No COMP/M.6409-Gazprom Schweiz/Promgas, par.1). As a result, Gazprom, as soon as this merger was completed assumed full responsibility over supplying Edison plus the profits from this operation, while, in parallel, it established its second direct presence in the Italian downstream.

Assessing the two mergers, someone could observe that in the PremiumGas case, Gazprom proceeded via Gazprom Germania GmbH while in the case with Promgas it moved via Gazprom Schweiz AG, a subsidiary *directly* owned by Gazprom Export, thus closer to the parent company Gazprom OJSC. Judging by the date of the mergers, it could be argued that PremiumGas may have been seen as a test case by Gazprom in order to assess the Commission's 'elasticity' over the proposed 'penetration'. Once the green light was given, Gazprom tried to centralize control of the downstream business by bringing ownership as close as possible to the parent company.

All things considered, the 2000s Russo-Italian relations had been characterized by the excellence of the former's relative advantage. While the 'traditional' pattern of "Russian supplies for Italian/Western technological expertise" kept, more or less, unabated throughout the 2000s, what changed was the systematic promotion of the

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the presence of the incumbent ENI and of a wide number of competitors belonging to multinational or Italian groups on this market, no customer foreclosure effects on the upstream gas market would materialize". The same also holds for risks over "input foreclosure on the downstream Italian gas and electricity market" (EC, Case No COMP/M.5740-Gazprom/A2A/JV, par.26).

<sup>292</sup> Gazprom Schweiz is controlled by Gazprom Export LLC, itself controlled by OJSC Gazprom. See Figure 5.9.

Russian relative advantage by Putin's administration. LTCs of much bigger duration were signed, bilateral cooperation over new supply routes requiring high technological expertise (e.g. Blue Stream) was agreed, while after the 2006 Russo-Ukrainian gas dispute, Russia and Italy decided to upgrade their bilateral relationship to Strategic Partnership. Both sides agreed to deepen their cooperation along the entire gas value chain, i.e. upstream, midstream and downstream. Italy, on the one hand, by participating to the Russian upstream (SeverEnergia), midstream (Blue Stream and South Stream) and downstream (agreement with TKG-9) sector, enhanced its energy security, since incremental gas supplies could be directly accessed and transported to it. Russia, on the other hand, aside from the necessary technological expertise for the development of its own resources, it 'stole' a valuable component of a possible EU diversification strategy and 'penetrated', with the European Commission permission, Italy's downstream sector, in a move of forging 'ironclad' ties with the latter. Consequently, in the question of "who gained more", Russia is to step forward.

The fact remains, however, that while the EU energy companies had been 'short-sighted' during cooperating with Russia, the latter appeared to be more of 'strategic' thinking, aiming at the long-term, beneficial to it, perspective. Thus, this relatively stronger position at the bilateral (national) level was crystallized at the supranational institutions level, as the ensuing analysis on the Russia-EU energy diplomacy reveals.

### ***5.3 The 2000s Russia-EU energy diplomacy***

Departing from the national level, we now enter at the supranational institutions level, i.e. Russo-EU relations, in order to assess how the aforementioned inextricable bilateral web between Gazprom and the EU companies 'short-circuited' any EU collective effort tried to stand against the Russian interests.

While beyond the scope of the current research, the Russo-EU energy relations started to gain institutional momentum from the early 1990s. Thus, we briefly refer to that period so as not only to see the genealogy of the bilateral demands during the 2000s negotiations, but also keep track of the balancing strategy that Russia employed in order to guard and promote its relative advantage. The substantiation of Russia's "Institutional Balancing" strategy is achieved by the examination of the following cases, The Energy Charter Treaty (ECT), The Energy Dialogue and the 3<sup>rd</sup> Internal Energy Market Package (Third Energy Package).

### ***5.3.1 The Energy Charter Treaty (ECT)***

At the meeting of the European Council in Dublin in June 1990, the Prime Minister of the Netherlands propounded that cooperation with non-EU energy suppliers, i.e. Russia, could achieve a dual purpose: a) stimulate economic recovery in both Eastern Europe and Russia by transferring Western technology and capital and b) increase security of supplies to the EU (The Energy Charter Treaty, 2004; Axelrod, 1996). The Commission, which had been invited to study the better implementation of this dual purpose, suggested the concept of a European Energy Charter. Subsequent negotiations culminated in December 1991 with 51 participants signing a Concluding Document at The Hague (The Energy Charter Treaty, 2004). This Document included all the necessary principles for promoting the east-west energy industry cooperation upon a legal platform that would guarantee investments, transit and trade. Finally, in December 1994, at Lisbon, the signatories of the first Concluding Document signed the establishment of the Energy Charter Treaty (ECT) plus the included Energy Charter Protocol on energy efficiency and related environmental aspects (The Energy Charter Treaty, 2004). The ECT soon gained world-wide significance with many non-European parties (Australia, Japan, African and Latin America states etc) co-signing it. (Andrews-Speed, 1999).

Among the main provisions of this Treaty have been:

### **ENERGY CHARTER TREATY-Selected provisions**

“Each Contracting Party shall accordingly endeavor to promote conditions for access to its capital market by companies and nationals of other Contracting Parties, for the purpose of financing trade in Energy Materials and Products and for the purpose of Investment in Economic Activity in the Energy Sector in the Areas of those other Contracting Parties, on a basis no less favorable than that which it accords in like circumstances to its own companies and nationals or companies and nationals of any other Contracting Party or any third state, whichever is the most favorable” (The Energy Charter Treaty, Article 9, par. 1).

“Transit: Each contracting party shall take the necessary measures to facilitate the Transit of Energy Materials and Products consistent with the principle of freedom of transit and without distinction as to the origin, destination and ownership of such Energy Materials and products or discrimination as to pricing on the basis of such distinctions, and without imposing any unreasonable delays, restrictions or charges” (The Energy Charter Treaty, Article 7, par.1).

“Each contracting party undertakes that its provisions relating to transport of Energy Materials and Products and the use of Energy Transport Facilities shall treat Energy Materials and Products in Transit in no less favorable a manner than its provisions treat such materials and products originating in or destined for its own Area, unless an existing international agreement provides otherwise” (The Energy Charter Treaty, Article 7, par 3).

“State and Privileged Enterprises: Each contracting party shall ensure that if it establishes or maintains an entity and entrusts the entity with regulatory, administrative or other governmental authority, such entity shall exercise the authority in a manner consistent with the contracting parties obligations under this Treaty” (The Energy Charter Treaty, Article 22, par.3).

“The contracting parties shall eliminate existing and create no new obstacles to the transfer of technology in the field of Energy Materials and Products and related equipment and services, subject to non-proliferation and other international obligations” (The Energy Charter Treaty, Article 8, par. 2).

Following Andrews-Speed’s argumentation, in the legal framework of the Treaty, it appears to be a nexus of interdependence between Russia and some of the FSU/Eastern Europe states on the one side, and Japan and Western Europe on the other (Andrews-Speed, 1999). Elaborating on this, the former are net exporters of energy and importers of capital and technology, while the latter are net exporters of capital and technology and importers of energy. Thus, provisions like those in Articles 8 and 9 would be of great assistance to the resuscitation of the Russian economy. On these grounds it is plausible to ask why Russia, while it has signed the Treaty since 1994, is yet to ratify it, hence granting it with legally binding status?

The answer to this question lays in the Article 7, pars. 1,3 and Article 22. These provisions constituted the bone of contention in the Russo-EU relationship, leading to the Russian non-ratification even as of the time of writing.

To begin with the Article 7, pars 1,3, it is stipulated that the natural gas state-monopoly Gazprom would have to grant free access –Third Party Access (TPA)- to its pipeline system to every energy company/material regardless of origin, destination and ownership. Up to the time of writing, Gazprom has been the sole exporter of Caspian gas to both EU and Western markets. No Turkmen, Uzbek or other foreign company involved in the Central Asian gas upstream sector can export to the Western markets without Gazprom’s transit services, since all gas networks traverse Russia and Gazprom holds the monopoly over their use. Therefore, the enactment of the Treaty and its TPA provision would gravely undermine Gazprom’s ‘controlling’ position over the Eurasian gas, let alone its necessary for the sustainability of the whole Russian economy profits<sup>293</sup>.

Similarly, another ‘endangered’ issue by the same Article has been the LTCs between Gazprom and its EU customers (Balmaceda, 2003). As we have earlier seen, Russia/Gazprom and major EU energy companies have founded their business upon this type of contracts. If, following the enactment of the ECT and the TPA, every party could access resources otherwise unapproachable without Gazprom’s mediation, then the repercussions for the latter would be as grey as previously<sup>294</sup>.

Finally, as far as the Article 22 of the Treaty is concerned, it has to be reminded that Gazprom had not been state-owned from 1993 to 2005<sup>295</sup>. Nevertheless, this meant only a ‘temporary’ dissociation between Gazprom and the Russian interest, for the reason that the former was still at the service and the profit of the few who were in charge at that time. Thus, it was not to their benefit to downgrade their “chariot of power” by signing the ECT<sup>296</sup>. This situation changed with Putin’s ascent to power and Gazprom’s renationalization in 2005.

All these points left the ECT signed but non-ratified by the Russian side. As then assessed and still stands valid, too many ‘vital’ interests have been at stake. The ECT was inaugurated and negotiated as a multilateral international institutional effort in a

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<sup>293</sup> For Gazprom and its role in the Russian economy see pp.81-82.

<sup>294</sup> As earlier shown, supply LTCs have been among the means that Gazprom employed in order to ‘tighten’ the Russo-EU member-states bond and thus exert control so as to ensure the promotion of the Russian relative advantage.

<sup>295</sup> That period the state owned only 38% of the company.

<sup>296</sup> See p. 102, footnote 122.

period where Russia had just exited its Soviet reality and laboriously tried to orient itself in the capitalist *modus vivendi*. Notwithstanding the wide de-organization and corruption that plagued the domestic business and politics, Russia acknowledged the importance of cooperating with the West, thus it signed the Treaty. But it could not go as far as to ratify it, since it knew that the *prima facie* ‘win-win’ provisions would turn to its mid-long term disadvantage. Thus, it abstained from any ratification. This pendulum, “signing but not ratification”, constituted the first case of Institutional Balancing, which albeit aiming at the promotion of the interest of the few in the Russian political and business elite, it concurrently promoted and the national one. This is exactly the only point that changed with Putin’s ascent to power in the 2000s. Russia became solid, with Gazprom being renationalized and thus officially identified with the Russian public interest. The tactic of Institutional Balancing, nevertheless, would not change.

### **5.3.2 The Energy Dialogue**

The rise of the Putin period witnessed the beginning of a more pro-active stance towards the Russian relative advantage without however disregarding the need for the EU/Western expertise. While the ratification process of the ECT had stalled, Russia and the EU did not stop sharing the same concerns over energy security, i.e. security of demand (Russia) and security of supplies (EU). Thus, a new effort for institutional cooperation had to be inaugurated.

In October 2000, the two parties convened at the Paris Summit aiming at the establishment of a strategic energy partnership, dubbed “Energy Dialogue”. This partnership would have more flexible and direct form than the ECT so as to promote more satisfactorily the bilateral energy goals. In the end, all achieved developments would constitute part of the PCA, already signed in 1997, with legally binding implications for both sides (EU-Russia Energy Dialogue, 2001, p.2).

The main goals, not at all different from those of the non-ratified ECT, in the agenda of the Energy Dialogue have been:

- (1) LTCs, Quantitative restrictions and Destination clauses
  - (2) Restoration of the energy (transport) system inside/outside Russia (TACIS)
  - (3) Non-discriminatory access to the transit pipelines (TPA)
  - (4) New Strategic Transport Infrastructure of Common Interest
  - (5) A Legal Framework for Production Sharing Agreements (PSA)
  - (6) Promotion of Joint Ventures (JV)
  - (7) Establishment of an EU-Russia Energy Technology Center (ETC)
- (EU-Russia Energy Dialogue, 2001)

Examining now the course of the Dialogue throughout the 2000s, it is important to see which goals were advanced further and which remained loose. In September 2001, the two parties met for the second time, negotiating possible developments in the aforementioned areas. Specifically, it was agreed a co-sponsored investment scheme for Russia in association with the EBRD and the EIB (EU-Russia Energy Dialogue, 2001, p.5). Later, it was further agreed that all technical assistance for the safety and efficiency of the hydrocarbon export network, inside and outside Russia, would be provided within the framework of the TACIS program (EU-Russia Energy Dialogue, 2002, p.1). Moreover, LTCs were bilaterally acknowledged as an “essential element for energy security that should continue to supply the European market” (EU-Russia Energy Dialogue, 2001, p.2). In parallel, it was specified that the new Strategic Projects of Common Interest would be decided on economic and commercial grounds, having first been approved and corroborated as such by a high-level team of independent experts. As projects of “common interest” were recognized the Nord Stream pipeline, the capacity expansion of the Yamal-Europe pipeline and the development of the Shtokman field (EU-Russia Energy Dialogue, 2001, p.3; 2002, p.3). Furthermore, it was agreed the exploration of various legal frameworks so as to facilitate the PSAs and the formation of JVs (EU-Russia Energy Dialogue, 2001, p.3). Finally, the ETC would be established in Moscow with the European Commission providing the funding as well as the necessary technical assistance (EU-Russia Energy Dialogue, 2001, p.6). Nevertheless, no agreement, even in principle, was reached with regard to the “non-discriminatory access to the pipelines”. Only a vague reference was

made in the section “New Strategic Transport Infrastructure of Common Interest”, where it was stated that “the growing EU demand for energy calls for..new energy production and transportation in Russia, and the non-discriminatory access for the transit of energy” (EU-Russia Energy Dialogue, 2001, p.2). It is reminded that this has been a major EU demand and the “*point de friction*” between the two sides over the ratification of the ECT.

All subsequent rounds of negotiations followed the same, more or less, pattern, serving to the Russian relative advantage and reflecting the tight ties that Gazprom had been forging at the national level with its EU counterparts.

In May 2002, the two sides met for the third time. The issue with the LTCs, once more gained the European Commission approval, being characterized this time as ‘indispensable’, while special attention was placed on the associated “destination clauses”<sup>297</sup>. Specifically, it was mentioned that progress was made on how to amend or delete them in the future contracts, without, though, referring to the exact content of this progress, i.e. if any final decision was reached, a fact definitely to the Russian advantage (EU-Russia Energy Dialogue, 2002, p.2). Moreover, it was specified that all technical assistance for the transport system restoration (TACIS program) would start from 2003 onward, with the EU mostly funding the needed investments so as to further guarantee its own security of supply. Finally, the ETC, which was established in Moscow on November 5<sup>th</sup>, 2005, would also relish the European Commission funding, initially provided for three years, while it would “act as a catalyst and a focus for increasing” the bilateral cooperation (EU-Russia Energy Dialogue, 2002, pp.4-5; EU-Russia Energy Dialogue, 2002a, p.3). Besides these, no other development was made to any of the other issues identified in the 2001 ‘start-up’ meeting.

The same ‘pro-Russian’ trajectory was also followed in the fourth meeting with both sides welcoming the progress achieved in the Russian Tax Code for the PSAs, while the Russian concern over a legal requirement for an EU member-state to “limit natural gas imports from a single non-EU supplier to 30% of consumption” was relieved when the EC along with experts from the EU member states assured that “no

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<sup>297</sup> “Destination clauses” are clauses in the supply LTCs that stipulate that the wholesalers are not allowed to re-sell the commodity outside the state they are established, thus granting the supplier the margin to maintain price differentials across different national markets as well as its market position. That is a point certainly to the Russian advantage in the bilateral business, giving the latter the chance to ‘control’ indirectly downstream business in each member state separately.

such requirement on quantitative limits for importing different kinds of fossil fuels from Russia” was in place (EU-Russia Energy Dialogue, 2002a, p.2).

In the fifth bilateral meeting, no course deviation emerged, while from the sixth meeting both sides agreed to further systemize and deepen their cooperation with the establishment of Thematic Groups on Investments, Infrastructures, Trade and Energy Efficiency, under the supervision of a Permanent Partnership Council (PPC) (EU-Russia Energy Dialogue, 2005). In their seventh meeting, an interesting point that was raised was the encouragement of “reciprocal participation of European and Russian companies in the whole energy chain, including through their asset swaps” (EU-Russia Energy Dialogue, 2006, p.3). However, as we have already seen, these asset swaps were most of the times under the Russian terms when revolving around the Russian upstream or midstream sector, and at least to the Russian benefit when pertaining to the EU member states’ downstream sector (the “Trojan Horse” strategy).

In their eighth meeting, while all the prior issues continued unabated, it was established the Early Warning Mechanism (EWM) on supply and demand of gas and oil (EU-Russia Energy Dialogue, 2007). This was an important step, given the prior Russo-Ukrainian dispute (2006) and the possibility of this mechanism ‘restoring’ the former’s reputation as an EU supplier, even though the ‘cracks’ had already appeared, i.e. supply routes diversification debates<sup>298</sup>. In any case, the EWM was another more ‘pro-Russian’ than ‘pro-EU’ development.

Finally, in the remaining two meetings that are currently examined, the ninth and the tenth, special attention deserves the Russian Federal Law “On procedures regulating foreign investment in sectors of the economy having strategic importance for state defense and security” and the contribution of the EWM to ‘restoring’ again Russia’s supplier profile to the EU eyes after the anew Russo-Ukrainian gas dispute in 2009<sup>299</sup> (EU-Russia Energy Dialogue, 2008, p.5; 2009, p.10). A critical point, however, that should not be omitted is the fact that during both these meetings, Russia started to express its inhibitions over the adoption of the Third Energy Package by the EU. Specifically:

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<sup>298</sup> See Map 4.7, footnote 200; also p. 196 the discussion on the Nabucco project.

<sup>299</sup> Specifically, after the dispute the involved parties, Russia, Ukraine and the EU, consented to the signing of the “Technical Terms for Monitoring the Supply of Natural Gas through Ukraine” on January 10, 2009 (EU-Russia Energy Dialogue, 2009, p.10).

“The EU side believes that (via this Package) is consolidating its efforts towards achieving a fully effective market opening and a single European electricity and gas market...The Russian side (assesses that the Package) is characterized by unfavorable investment climate for developments in the energy sector of the EU (and) significantly limits activities of Russian fuel and energy companies in the EU market, directly affecting their interests” (EU-Russia Energy Dialogue, 2009, p.6).

As prior said, the ‘cracks’ had already appeared in the Russo-EU relationship, a fact corroborated by the adoption of this package by the EU. This case is illuminated in the last section of the present chapter.

As far as the overall course of the Energy Dialogue is concerned, we witness that both sides and particularly Russia consented to all the provisions that would promote its relative gains. While the EU would also gain, in the question “who will gain more”, Russia is the answer to qualify. Likewise in the prior case with the ECT, Russia decided to cooperate institutionally, or at least presented itself as eager to do so, as long as none of its vital interests was sacrificed. Such an interest was the TPA provision that thwarted Russia from ratifying the ECT, thus granting it legally binding status, and also made it relegate it to the margins when cooperating within the framework of the Energy Dialogue. Russia was “Institutionally Balancing” its interests as to maximize its relative gains. As shown in the previous section (national level), Russia had imposed its terms on any form of cooperation, regardless of its place in the value chain; PSAs, JVs, Strategic Projects of Common Interest were all obeying and promoting the ‘pro-Russian’ logic. It would not be much of an exaggeration to claim that the EU collectively was ‘paying’ the national choice of excessively depending on Russia in terms of energy (supply) security<sup>300</sup>.

Overall, the Russian “Institutional Balancing” strategy was proved successful due to the fact that the EU reality attested to the Liberal Intergovernmentalist logic<sup>301</sup>. The Dialogue purely represented the incohesiveness that had been nurtured inside the EU as a result of the progressive bilateral ‘tightening’ at the national level which in turn qualified Russia as an effective “Institutional Balancer” at the supranational institutions level. This argument is even better substantiated in the following case.

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<sup>300</sup> For a brief but thorough presentation of the polar opposite strategies during the Russia-EU energy bargaining see Table 5.2, p.161.

<sup>301</sup> See pp.18-23.

### 5.3.3 The 3<sup>rd</sup> Internal Energy Market Package (“Third Energy Package”)

As prior said, after the Russo-Ukrainian gas dispute in 2006, the ‘cracks’ started to become all the more apparent, tampering with the dynamics that had been nurtured up to that time.

Throughout the 2000s, the EU dependence on Russia had been steadily growing, approaching the stage of unilateral dependence in terms of supplies. Both the currently examined levels (the national and the supranational institutions) indicate the ‘surrounding’ of the EU energy business by Russia; it was not only the upstream and downstream ‘tightening’ but also the midstream Russian dominance that connected and solidified this ‘tightening’<sup>302</sup>. So, if this midstream reality was intercepted, the ‘bridge’ between the supplier and the consumer would crumble along with all the achieved ‘tightening’. That was the logic beyond the Third Energy Package.

In light of these and the up to then unsuccessful efforts towards a legally binding institutional cooperation with Russia (the ECT and the Energy Dialogue), the EU supranational bodies decided to exploit the hybrid nature of Energy, viewing it as part of the *Competition Policy* in which they held exclusive competence, and thus the “Community method” would apply during the decision-making<sup>303</sup>.

On these grounds, following the European Council invitation in March 2007, the Commission developed a legislative proposal aiming at the “sale of gas on equal terms and without discrimination or disadvantages in the Community” (Directive 2009/73/EC, par.4). This proposal had at its core the separation of “networks from activities of production and supply (effective unbundling)” (Directive 2009/73/EC, par.6). In particular:

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<sup>302</sup> For an insight to these energy (natural gas included) business concepts, see footnote 85, p.72.

<sup>303</sup> See footnote 21 as well as pp.66-67.

### The 3<sup>rd</sup> Internal Energy Market Package- Key Points

- Ownership Unbundling, which implies the appointment of the network owner as the system operator and its independence from any supply and production interests, is...the most effective tool...to promote investments in infrastructure in a non-discriminatory way, fair access to the network for new entrants and transparency in the market...thus (solving) the inherent conflict of interests and ensuring security of supply (Directive 2009/73/EC, par.8).
- The setting up of a system operator or a transmission operator that is independent from supply and production interests should enable a vertically integrated undertaking to maintain its ownership of network assets whilst ensuring an effective separation of interests, provided that such independent system operator or such independent transmission operator performs all the functions of a system operator and detailed regulation and extensive regulation control mechanisms are put in place (Directive 2009/73/EC, par.13).
- (Thus), where...an undertaking owning a transmission system is part of a vertically integrated undertaking, Member States...should be given a choice between ownership unbundling and setting up a system operator or transmission operator which is independent from supply and production interests (Directive 2009/73/EC, par.14).
- Fully effective separation of network activities from supply and production activities should apply throughout the Community to both Community and non-Community undertakings (Directive 2009/73/EC, par.21).
- The provisions of this Directive shall not prevent the conclusion of LTCs in so far as they comply with Community competition rules (Directive 2009/73/EC, Article 32, par.3).
- The development of a true internal market in natural gas, through a network connected across the Community should be one of the main goals of this Directive (Directive 2009/73/EC, pars 57-58).
- Where certification is requested by a transmission system owner or a transmission system operator which is controlled by a person or persons from a third country or third countries, the regulatory authority shall notify the Commission (Directive 2009/73/EC, Article 11, par.1).
- If a natural gas undertaking encounters, or considers it would encounter, serious economic and financial difficulties because of its take-or-pay commitments accepted in one or more gas purchase contracts, it may...*refuse access* to the system<sup>304</sup> (Directive 2009/73/EC, Article 48, par.1).
- Member States...shall apply those measures from 3<sup>rd</sup> March 2011 with the exception of Article 11, which they shall apply from 3<sup>rd</sup> March 2013 (Directive 2009/73/EC, Article 54, par.1).

As made apparent by the brief presentation of the Third Energy Package, the EU supranational bodies acted *unilaterally* in an effort to forge a common EU energy policy via a “reverse bottom-up” procedure. Specifically, viewing Energy policy as part of the Competition Policy, the EU supranational bodies addressed, or at least tried to, all the ‘pro-Russian’ issues in the bilateral relationship that nurtured the excessive reliance of the EU on Russia and paved the way to the unilateral dependence of the former on the latter. LTCs, Gazprom pipeline dominance inside the EU territory, part of which is attributed to the ‘tight’ relationship between Gazprom and major EU energy companies, as well the unbundling of the EU energy security from Russian supplies, could be achieved via breaking the ‘bridge’ between the supplier and the

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<sup>304</sup> The italics have been added by the author to show that the text at this point has been slightly modified to fit the current analysis.

consumer. Emphasis should also be placed on what became widely known as the ‘Gazprom’ or ‘Reciprocity’ Clause, that stipulated the ultimate regulatory role of the Commission over any third country undertaking operating as transmission system owner or operator (see Article 11; Cohen, 2008, p.34; Zwitterloot, 2008, p.36). If all provisions were adopted, TPA would be guarantee in the EU system, competition would function more effectively and the consumer would eventually be free to choose among different suppliers.

The Ownership Unbundling (OU) could take place via two ways: the ‘direct’ and the ‘indirect’. The first is described in par.8 and stipulates for a complete separation of ownership with the supplier/producer and the network owner being two totally different entities. The second provides for an Independent System Operator (ISO) or a Transmission System Operator (TSO) which would operate independently from the supplier/producer, with the latter, however, maintaining the ownership of its network assets<sup>305</sup>. Therefore, an effective separation of interests would be accomplished.

These provisions caused wide-spread concern, both from the EU and the Russian side. The fiercest opposition came from Germany, “the land of the ‘big four’, as the country’s dominant energy companies are called”, and France, since the EU legislative package would require energy giants like E.ON and EDF “to sell off their transmission infrastructure or hand over control to an independent system operator” (Nicola, 2008, pp.27-28). Special attention deserves the comment made by Bruno Wallnofer, the head of an Austrian hydropower company, who tagged the OU as the “greatest expropriation in Europe since the Bolshevik revolution” (Wallnofer cited after Nicola, 2008, p.28). This is a key-comment to understand how deep the bilateral ‘tightening’, as described above, had advanced<sup>306</sup>. Thus, both governments lobbied for another alternative parallel to the options of OU and ISO/TSO (Nicola, 2008, pp.31).

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<sup>305</sup> Specifically, here, is made reference to a status of “high ownership” since as stipulated by the Directive, “Where an independent system operator has been designated, the transmission owner shall finance the investments decided by the independent system operator and approved by the regulatory authority, or give its agreement to financing by any interested party including the independent system operator” (Directive 2009/73/EC, Article 14, par.5b). Furthermore, “In close cooperation with the regulatory authority, the relevant national competition authority shall be granted all relevant powers to effectively monitor compliance of its transmission system owner with its obligations under paragraph 5” (Directive 2009/73/EC, Article 14, par.6). This last provision called for the constant supervision of the functioning of this type of unbundling, hence, limiting or forestalling possible deviations.

<sup>306</sup> Of course, this is not to tell that the EU energy companies did not have their own reasons to oppose the OU, i.e. market dominance etc. Their exposure, however, to Gazprom and the Russian supplies should not be underestimated, given that if it were not for the capabilities the Russian supplier were offering, their position would not be as strong in neither the national market nor the rest of the EU.

The Russian side also came in support of the within EU opposition, emphasizing the issues that were at stake. First it was the issue of the economic losses. Gazprom, “as a shareholder of Wingas (had) invested more than a billion euros in infrastructure in Germany”, and it had also constructed in the 1990s the Yamal-Europe network via Poland to Germany (Zwitsersloot, 2008, p.36; Danichev, 2010). Under the new legislation, it would not only forfeit these property rights, but it would also have to “turn into a financial donor obliged to execute investment decisions taken by an independent system operator”<sup>307</sup> (Medvedev cited after Danichev, 2010). Second, there were mid/long-term strategic implications. As stated by the then Deputy Speaker of the Russian Duma, Valeri Jazev, the new legislation aimed at increasing competition between ‘virtual’ gas suppliers (Abdulaev, 2011a). Certainly, such a situation would lead, in the short-term, to lower gas prices since Gazprom would have to leave the traditional practice of tying the gas price to a basket of oil products, adopted within the framework of the LTCs, and start competing with the prices offered by the LNG suppliers at the spot market (Abdulaev, 2011a). However, in the long-term, when the demand would increase or the spot market prove insufficient to satisfy this demand, the supply by the main supplier (Gazprom) may fall as a result of the short-term/low priced contracts prohibiting the latter of investing and bringing on stream new resources from the Shtokman and Yamal fields (Abdulaev, 2011a). Meanwhile, in view of such a gloomy perspective, it should not be ruled out a Moscow-initiated dual tactic of tightening control over the central Asian resources and colluding with producers from the Middle East and Northwest Africa in order to maintain the prices high in the short-term (Abdulaev, 2011a). In fact, Jazev stressed the possibility of a gas cartel that would serve to the detriment of the EU consumer both in the short and the long term perspective, since neither supply security nor lower prices would be achieved in the end. Along these lines were also the statements by Alexei Miller, who stressed the fact that the package would dwindle investments in the EU gas networks, thus creating a major risk for the adequate supplies the EU needed in order to guarantee its energy (supply) security (Gazprom, 2012a).

These reactions coupled with pressures that had been exerted on the Commission from the very beginning of the discussions (March 2007), led to the final presentation

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Therefore, from this perspective, the EU national energy companies and Gazprom have been on the same side of the dispute against the EU supranational bodies.

<sup>307</sup> See footnote 305.

of the Directive in July 2009 with certain ‘loopholes’ to Gazprom’s advantage. First, the provision for an ISO/TSO instead of a full OU should be perceived as a concession, since it allowed the companies to maintain the “high ownership” of their assets along with the possibility of an “under the table” influence to the ISOs/TSOs<sup>308</sup>. Second, the Article 48, par.1, allowed for natural gas undertakings to deviate from the provisions of the Directive when “economic and financial difficulties” due to the ‘take-or-pay’ clauses of the LTCs did not leave them much of maneuverability. This is certainly a ‘pro-Russian’ provision, since the dominant practice of LTCs included clauses such as this one<sup>309</sup>. Consequently, Gazprom, albeit it was ‘forced’ by the Directive to forfeit its pipeline ownership in the EU territory, the same time it was given an indirect control of this network, once the ‘prohibitive’ ‘take-or-pay’ clauses raised the costs for a natural gas company and its designated ISOs/TSOs to breach them so as to guarantee the provisioned TPA<sup>310</sup>. Finally, it should also be noted that some states (e.g. the heavily exposed to Russian supplies Latvia), were exempted from the provisions of this Directive, fact that certainly subtracted from the latter’s normative power and contributed to “keeping them in the grip of Gazprom” (Dreyer, 2010).

All these points bring us back to our main assumption that if Russia had managed to establish a strong presence inside these EU member-states’ gas-markets, if not dominant, then its relative gains would be mirrored in the supranational structures of the EU, obeying to the Liberal Intergovernmentalist logic. Consequently, Russia would have affected the official EU position to its benefit. This is exactly what happened with the Third Energy Package. While the Commission tried to forge a common EU energy policy via a “reverse bottom-up” procedure, exploiting the hybrid nature of Energy Policy and placing it within the area of its exclusive competences as part of the Competition Policy, Russia had already established a stronghold in the EU territory, spearheaded by its Trojan Horses (primary and second-tier ones), leading to the corroboration of the Intergovernmental Logic in the within EU developments.

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<sup>308</sup> Major EU energy companies such as VNG AG and GdF SUEZ resorted to this option. For more see: GdF SUEZ, 2010a, p.22; VNG AG, 2010, p.11.

<sup>309</sup> See pp.167-168.

<sup>310</sup> In the previous section we saw that Gazprom signed LTCs with almost every major EU energy company up to 2030s. So, if these LTCs were accompanied by ‘take-or-pay’ clauses, then it becomes sufficiently clear how the Russian gas would and will dominate the EU gas networks for all the projected period.

## 5.4 Conclusion

Epitomizing the developments discussed in this chapter, special reference should be made to the Table 5.2 where the bilateral strategies during the energy negotiations throughout the 2000s are summarized. The worst-case scenario for one side has been the best-case scenario for the other. Both sides had polar opposite starting points. The EU, especially after the 2006 Russo-Ukrainian gas dispute, was further mobilized at intercepting the constantly growing dependence on Russia. While up to then the EU had made (institutional, legally binding) efforts towards making the bilateral cooperation more even, no change occurred, thus strengthening the scenario of unilateral dependence on Russia. In light of these, it moved forward alone, trying to *impose unilaterally* a shift of the relationship towards a more reciprocal pattern. By liberalizing the domestic energy (gas) market, the EU sought to adopt an equidistant stance from all suppliers. A level playing field would onward be the case. However, as we have argued in the beginning of this section, gas supplies, regardless of form, had not been and will not be as abundant so as to enable the EU keep Russia at arm's length. During the financial crisis of 2008-2009, a temporary reduction might have led to this conclusion, but such a scenario is not one of long-term perspective.

In parallel, Russia tried to solidify its position in the EU energy market. A multitude of tactics aimed at 'tightening' the bilateral bond, making it impervious to a possible EU supranational effort that would target Gazprom's position in the former's market and thus the Russian relative advantage. Where possible, Gazprom 'penetrated' the EU downstream business, acquiring a direct say in the local developments (the "Trojan Horse" strategy), while where this was not possible, other less direct but 'pro-Russian' means (upstream and midstream cooperation) surfaced. Also, the strategy of diversifying export markets (China) was gradually gaining momentum. The dynamics, as argued at the outset of the chapter, have been positive but not yet as established as to substitute the EU as Russia's most lucrative export market.

Consequently, the relationship remained interdependent. Energy power symmetry kept the two sides marching together. Both could be heard and push forward their demands<sup>311</sup>. The EU on the one hand, aspired to establish the bilateral cooperation

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<sup>311</sup> Probably that was the reason behind the EU rationale on the adoption of the Third Energy Package.

upon an institutional, legally binding framework that would guarantee everything agreed as a conductible demand. Russia, on the other hand, did not want to lose its most lucrative market. This energy power symmetry, however, does not mean that realism and the relative gains argument lose their explanatory rigidity. Quite the opposite. They appear in another pro-realism form, that of Institutional Balancing.

Russia, having anchored its presence in the national level and being poised to assume, in the mid-term, a hegemonic role in the Eurasian energyland, it managed to ‘manipulate’ the EU-backed institutions to its relative advantage. As previously stated, when states share interdependence and institutional cooperation is unavoidable, then, Institutional Balancing emerges as a ‘compulsory’ strategy. In this situation, states temporarily and superficially, consent to international institutions without, however, giving to the them official and legally binding status. But, when they become aware of a much better position in the future, then the Institutional Balancing strategy turns from once ‘compulsory’ to ‘powerful’, thus fulfilling its realist roots. International institutions are used as “empty shells”, or as a “necessary evil”, in the absence, or better said, in anticipation of a much stronger international position that would allow states to assume an assertive profile, suitable when pursuing their relative advantage in an anarchic international field, pretty much alike the Hobbesian ‘state of nature’<sup>312</sup>.

While the starting point in the Russo-EU relations was ‘interdependence’, the Russo-Chinese relations could be characterized as ‘interconnected’ throughout the 2000s; carefully balanced, on the premises of uncertainty but strategic necessity, if it is for Russia to assume a hegemonic profile in the Eurasian energyland<sup>313</sup>.

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<sup>312</sup> See also pp. 44-50.

<sup>313</sup> See also pp.160-164.

## *Chapter 6: The enigmatic Russo-Chinese energy relations*

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### *6.1 Lessons from the past*

While the contours of the recent Russo-Chinese relations have been described above<sup>314</sup>, the fact remains that historic developments of the 19<sup>th</sup> and 20<sup>th</sup> century formed, as of today, two major powers with ambivalent public sentiment towards each other (Shlapentokh, 2007). Therefore, a glimpse of them would be conducive to our better understanding of the dynamics in the Eurasian energy triangle, as currently examined.

The 19<sup>th</sup> century found Czarist Russia in a powerful position *vis-à-vis* the declining, at the time, Chinese empire. This imbalance resulted into the signing of treaties that provisioned the expansion of the former into far eastern territories, formerly belonging to the latter (Sutter, 2008). This situation kept unabated also in the first half of the 20<sup>th</sup> century, a fact that qualified the new leaders of the USSR, Lenin and Stalin, to support only favorable to the ideological platform of the Soviet regime neighboring revolutionary movements (Sutter, 2008; Shlapentokh, 2007). Such a case was the alliance formation between Mao Zedong's People's Republic of China (PRC) and Stalin's USSR, officially signed on February 14<sup>th</sup>, 1950 (Sutter, 2008, p. 327). While at first promising, this alliance soon took the downturn.

After Stalin's death in 1953 and Khrushchev's ascent to power, deepening differences over the international affairs (especially with regard to the US) as well as the role of the USSR and China as developmental and ideological flagships for the world communist movement, laid the groundwork for the subsequent escalation and, ultimately, clashes over territorial disputes (Sutter, 2007, p. 327; Shlapentokh, 2007, p. 4). In March 1969, the Chinese troops released an attack against their former allies, aiming at the control of a border, minuscule and desolate island of the Ussuri River, called Damanskii (for Russians) or Zhenbao (for the Chinese) (Shlapentokh, 2007, p. 4). This conflict was of importance given the death of 32 soldiers and its wider

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<sup>314</sup> See Chapter 1.

implications for both nations (Shlapentokh, 2007, p. 4). Moreover, in the same year, another armed conflict broke out at Lake Zhalanashkol. Both these incidents took place within the context of bilateral antagonism over leadership in the world communist movement (Shlapentokh, 2007, p. 4).

This antagonism eased for a while with the death of Mao Zedong in 1976 and its succession by Deng Xiaoping, only to culminate again in 1979, when the USSR backed Vietnam's invasion to the neighboring Cambodia and China replied with a low-scale attack to Vietnam. This, in turn, led the USSR to threaten with military deployment along China's northern border (Sutter, 2008, p. 328). That time was also raging the Soviet invasion of Afghanistan, another front in which China opposed the Soviets, siding with the US and supporting anticommunist guerillas<sup>315</sup> (Sutter, 2008, p. 328).

Not until Gorbachev came to power did the Sino-Soviet relations follow a de-escalating course. With most of the talks focused on the settlement of the military issues of the 1970s, both sides tried to construct mutual trust by, first, reducing the number of military forces that had been deployed along their common border. This initial step was followed by the exchange of visits at the highest political level, with Gorbachev visiting Beijing in May 1989 and Li Peng, China's PM, reciprocating the visit in April 1990 (Sutter, 2008, p. 328). Summarizing, in brief, what has been discussed up to now, Shlapentokh's account draws a rather clear picture:

“In general, in the 50 years after the victory of the Chinese revolution in 1949, Russians saw China as an ally for seven years (1949-56) and for 30 years they looked at China as a dangerous enemy (1957-87)” (Shlapentokh, 2007, p. 5).

After the dissolution of the USSR, the Russo-Chinese relations advanced from their 1980s 'de-escalated' pattern to a more 'intimate' rapprochement in the 1990s, let alone the 2000s<sup>316</sup>. However, the public sentiment in both nations, and particularly in

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<sup>315</sup> At this point, someone should also consider the wider geopolitical shifts happening in Asia, with the smoothening of the China-US relationship (consider the US President's, Richard Nixon, travel to Mao's China in 1972) and the 1978 China-Japan friendship (Sutter, 2008, p.328). These developments weighed much to the Soviet calculations and strategies in the region, especially in the light of the added burden that defense/military preparations and equipment purchases were entailing for the Soviet economy.

<sup>316</sup> For the developments in the Russo-Chinese relationship in the 1990s, see pp.31-34.

Russia, could not be purged from the historical bequest of the Soviet times. Notwithstanding today's Chinese economic miracle and the positive impact it might have on the neighboring Russia, especially in the poverty stricken east Siberia and the far east, many Russian business circles, with the majority of them originating from these regions, have held a rather negative perception of China<sup>317</sup> (Shlapentokh, 2007, p.15).

“ ‘Russia (is) in the process of becoming a raw materials attachment to China’, mostly as a supplier of fuel. In the near future, China, with its vast technological progress, will flood the Russian market, not with its cheap clothing, but with cars and other durable goods” (Timofeeva cited after Shlapentokh, 2007, p. 16).

The above lines vividly portray the fears and inhibitions that govern the Russian public sentiment *vis-à-vis* China. However, when it comes to the political elites, and particularly to the ruling one (which is classified into the ‘Statist’ school of foreign policy), it is discernible the admiration for the “Chinese model” of development<sup>318</sup>. To them, China’s accomplishment to transform the command economy into a thriving market one is attributable to “Beijing’s refusal to destroy ‘the ideology, and the structures of economic power’ and...to the preservation of ‘the collective type society’” (Nikitin cited after Shlapentokh, 2007, p. 17). Reading between the lines, it has been the primary role of the state in conjunction with the maintenance of the political legacy of communism and the “collective type society” that led to this successful transformation.

All things considered, it has been made abundantly clear why contemporary Russo-Chinese relations have been characterized as ‘ambivalent’. This ‘ambivalence’, which has been taken into serious consideration by the political elite, has also tallied with the dominant pattern of cooperation in Asia. Hence, elucidating first this pattern, we, then, proceed with the examination of the Russo-Chinese energy relationship, on the one hand, and the extent at which China and its regional role have been an efficient ‘tool’ in Russia’s effort to balance (institutionally) the EU in its pursuit for energy (gas) hegemonism in the Eurasian energyland, on the other.

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<sup>317</sup> They perceive the Chinese cheap goods as a threat to the local enterprises.

<sup>318</sup> For the Russian schools of foreign policy, see Chapter 1.

## 6.2 Binding factors

Inheriting the 1990s momentum, the new millennium witnessed the bilateral as well as the central Asian cooperation mainly realizing within the structures of the Shanghai Cooperation Organization (SCO)<sup>319</sup>. Having taken its official form since 2001, this institution hosted, at first, central Asian concerns with regard to regional security. Ethnic nationalism and its outcome of various minorities seeking to establish separate states, had been the principal reasons for China initiating, as early as of April 1996, the idea of the “Shanghai Five”<sup>320</sup>. China shares land borders with 14 states, with many of the non-Han Chinese inhabitants of the border regions spreading across the borders, forming in this manner trans-border nationalities (Zhao, 2011, p. 55). Special reference should be made to Tibet, Mongolia and XUAR in the northwestern part of China that have all been kept under the Chinese rule, regardless of periodical clashes for further autonomy<sup>321</sup> (Zhao, 2011, p. 55; Karagiannis, 2010a).

Alike the Chinese XUAR region that has been inhabited by Turkic-speaking Muslim Uyghurs, the other members of the Shanghai Five and later the SCO have also had their own “areas of tension”. Widely known is the Russian rivalry with the Muslims in Chechnya, while Kyrgyzstan, Uzbekistan and Tajikistan have too had major issues with the rise of the belligerent form of Islam in their respective territories (Zhao, 2011, p. 56). All these formed the necessary groundwork for the establishment of the aforementioned institution upon the common commitment to fighting against

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<sup>319</sup> For this organization see also Chapter 1, p.36.

<sup>320</sup> The initial signatories of this institution were China, Russian, Tajikistan, Kazakhstan and Turkmenistan. Later, in 2001, when this institution renamed Shanghai Cooperation Organization, Uzbekistan was added to its members.

<sup>321</sup> Of strategic importance is the XUAR, given the region’s energy resources (the Tarim Basin) as well as its transit status for oil and gas pipelines coming from Kazakhstan and Turkmenistan (Lelyveld, 2009). With regard to the former, an 1000-km long oil pipeline from Kazakhstan traverses the region, while the Turkmenistan-China gas pipeline also crosses the same territory. Apart from these, Xinjiang contains gas reserves of 1.4trillion cubic meters, more than any other Chinese region or province, while in terms of oil production, it is accountable for more than 14% of China’s output (Lelyveld, 2009). Since 2000, the region has met with increased interest by the government, with, first, the former President Jiang Zemin launching energy projects such as the “Develop the West” or the “West-East” gas pipeline that traverses China from the Tarim basin to Shanghai and brought lots of Han workers to the region during its construction (Lelyveld, 2009). These developments, however, worsened the situation in the region, with the non-Han permanent Chinese inhabitants ardently complaining for being outnumbered by the incoming waves of Chinese, not having satisfactory participation to the government and being sidelined in the allocation of the wealth deriving from the region’s natural resources (Lelyveld, 2009; Karagiannis, 2010a). For a detailed account on the issue also see:

[http://www.rfa.org/english/energy\\_watch/energy-risk-07132009103219.html](http://www.rfa.org/english/energy_watch/energy-risk-07132009103219.html) .

the “three evils” of terrorism, separatism and extremism and, thus, ensure the regional security (Boland, 2011,p. 5).

The participation of China to the SCO has been a landmark, since as noted among pundits, China switched “in its strategic thinking from emphasizing ‘self constraint’ (zhiwo yueshu) to ‘accepting constraint’ (jieshou yueshu)”<sup>322</sup> (Zhao, 2011, p. 55). Yet, this switch did not signal the abatement of highly-esteemed principles such as that of “state sovereignty”. China, Russia and all the other nations that have been participating to institutional structures of regional cooperation did not consent to any sort of alienation of their state sovereignty in exchange for an EU-type integration. They agreed to cooperate as long as a problem, such as that of regional security, could be better disentangled at the regional than the state-level. Consequently, what it has been qualified was a ‘flexible’ approach toward regional/international institutions that enabled participants to steer clear of any legally binding resolutions which, in turn, would entail breaching of sovereignty and involvement in their internal affairs. In the words of the professor Suisheng Zao,

“many East Asian countries share China’s preference and are reflected in the famous ‘ASEAN way’ that emphasizes consultations, dialogue and consensus and...resists building enforcement or punitive mechanisms that could interfere in the internal affairs of member states” (Zhao, 2011, p. 64).

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<sup>322</sup> Along with the SCO, they should also be considered other institutions of regional cooperation such as the Association of South East Asian Nations (ASEAN)+3, the ASEAN Regional Forum (ARF), the Asian Pacific Economic Cooperation (APEC), the East Asian Summit (EAS), etc. (Zhao, 2011, p. 53). However, China perceives among the most important the SCO and the ASEAN+3, probably assessing them in terms of institutional structure, thematic coverage and official set-up. The institutional structure of the SCO consists of the Secretariat, based in Beijing and overseen by the three year serving Secretary General, and the Regional Anti-Terror Structure (RATS), based in Tashkent (Boland, 2011, p. 8). Because of these attributes as well as the existence of a signed treaty, the annual meetings and the establishment of issue specific centers in the members’ capitals, it has often been presented as a “military counterweight to NATO” (Boland, 2011, p. 13). Nevertheless, this “exclusionary or exclusive” picture is not accurate, since the SCO has been very careful into building balanced relations not only among its members but also with external major power such as the US. A recent example of that is the October 2010 successful raid by Russian, US and Afghan forces against drug labs in Afghanistan (Boland, 2011, p. 12). While not “exclusionary or exclusive” in character, there have been occasions that the SCO members acted as such, when after the sixth summit on July 5<sup>th</sup>, they adopted an anti-Western rhetoric, suggesting a withdrawal timetable for the US-led military coalition in Afghanistan and opposing to any foreign interference into the internal affairs of any sovereign state (Blagov, 2005)

Elaborating on the “ASEAN way”, Wu Jianmin, former president of China’s Foreign Affairs College, summarized this concept in “the five ‘Cs’: consultation, consensus, cooperation, comfort level, and closeness” (Jianmin cited after Zhao, 2011, p. 65). In light of these, the “ASEAN way” stands for a unique mode of regional cooperation that has held atop the principle of state sovereignty<sup>323</sup>.

The analysis hitherto has highlighted a pattern of regional cooperation in which states consent or interact within a pro-realism framework in order to promote common issues and preemptively deal with areas of friction. The widely-shared principles of “state sovereignty” and “non-interference” to the domestic affairs of other states have been the founding stones of this pattern, which, albeit loose and flexible, has been the common denominator in the Asian affairs. Thus, these two principles have been the key binding factors, with the consensual form of cooperation (integration), as illustrated in the “ASEAN way”, being the ‘remedy’ to what could otherwise be called an opportunistic and fluid assemblage of indifferent states. This process may be slow, but it aims at becoming as all-inclusive as possible.

In this light, Russia and China have qualified the SCO, primarily, and the APEC, secondarily, as the main forums to address issues of regional security and economic cooperation (integration). Putin underscored their importance, when, in 2006, decided to host the 2012 APEC meeting in the Far Eastern Vladivostok as an act of showing the catalytic role this institution may hold in the economic development and indirectly delimiting the region, particularly *vis-à-vis* China<sup>324</sup>. Moreover, he highlighted the rising prominence of the Asia-Pacific region by stating that “although the global crisis has affected this region, it continues to build up its economic power and has kept up its growth rate for the most part. I believe that our participation in the integration process underway in this region will boost socioeconomic growth in Siberia and Far East” (Putin cited after Haoning and Lianglei, 2012). In the same vein, Tavrovsky, a prominent political expert from Moscow Friendship University, stated that the APEC summit has been and it is to orient further the remote Siberian and Far East regions to “Look East” and “Turn South”, much more after the EU enlargement and the US military presence in Europe with the defense shields (Tavrovsky cited after Haoning

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<sup>323</sup> The reason for the supremacy of state sovereignty in the Asian-type of regional integration has, to a large extent, to do with the diverse cultural and political backgrounds among the Asian states (Zhao, 2011, p. 65). This issue, however, draws far beyond the scope of the present research, so any further consideration would be supererogatory.

<sup>324</sup> Here, recall the previous analysis as well as Chapter 2 on the Russian Far East and its role in the Sino-Soviet, at first, and then Russo-Chinese strained relations.

and Lianglei, 2012). Similarly, the intermittent, but not ideologically divergent administration of Dmitry Medvedev had also called for “the government to strengthen Russia’s positions in Asia and the Pacific” since “Russia’s specialization in the high-technology sector (involving energy, aircraft construction and space services) has been defined already on the Asia-Pacific market” (Interfax, 2010f).

During the 2000s, many developments occurred within the structures of the SCO and APEC, with the former expanding its scope beyond the affairs of regional security to those of economy and particularly energy. Moreover, it has also constituted the framework or better the starting point for new ideas and plans towards expanding and deepening the regional energy cooperation.

In 2006, Putin espoused the idea of an Energy Club that would comprise the SCO members and observers and would be subdivided into four main dimensions: a) the global, b) the regional/Eurasian, c) the sub-regional/ Central Asia and d) the national (Rosner, 2010). This Club would be a framework for inclusive cooperation on energy issues, such as the construction of transnational networks, investments in the energy fields of the rich natural resources states of the region such as the Central Asian ones, etc. Consequently, the SCO would also acquire an energy aspect, a fact which would facilitate the consensus-building among regional players, necessary founding stone according to the Asian pattern of international institutional cooperation. Some political and economic analysts in Moscow saw beyond this idea a diplomatic way to avoid any possible clash with China over Central Asian resources (Blagov, 2007). In particular, the political analyst, Igor Cherkashenko, noted that “an unhurried struggle for spheres of interest is starting between the region’s largest centers of influence, Russia and China, within the framework [of the SCO]” (Cherkashenko cited after Blagov, 2007).

These last points as well as the, up to the time of writing, unaddressed idea of an Energy Club reveal hidden regional energy dynamics that have been forging highly-sensitive balances in the Russo-Chinese relations with regard to Central Asia and not only. Delicate diplomacy should be employed if it was for strained bilateral relations to be avoided.

In this point it is reminded that in the previous chapter we saw how the EU-initiated energy institutions (aiming at re-establishing the Russo-EU energy relations within a new, legally binding framework) have been stalled by the Russian side via the Institutional Balancing tactic. We argued that this tactic has been possible because

of the incumbent economic interdependence and an opening to the Asian market (with emphasis placed on China) would transform it from once ‘necessary’ to ‘powerful’, revealing in this manner its neorealist roots. More specific we claimed that by setting foot in both the EU and the Chinese market, Russia provides itself with the prerogative of playing these two off against each other in pursuit of its relative advantage in the bilateral energy affairs. Hence, keeping this in mind, we proceed first with the examination of the Russo-Chinese energy relationship and, second, with the assessment of how has “the turning to Asia” helped Russia with its Institutional Balancing strategy *vis-à-vis* the EU

### 6.3 The Russo-Chinese energy interconnectedness

Russia and China dovetail in energy terms. China, as the world’s second largest oil consumer and third oil importer with a constantly growing demand for imported natural gas, has been in search of diversifying its energy imports’ portfolio away from the Persian Gulf and the vulnerable to a number of external threats, Malacca straits, being guaranteed, in this sense, security of supply (Downs, 2010a, p. 146). On the other hand, Russia as the world’s second largest oil producer and exporter and top natural gas producer and exporter, has been examining strategies which would allow it to balance its interdependent gas relationship with Europe, thus opening up space for ‘hegemonic’ maneuvers in the Eurasian energyland.

In 2005, Russia accounted for 11% of China’s crude oil imports while China held a rather limited share in the Russian crude oil exports’ portfolio, equal to 4-5% (Downs, 2010a, p. 147).

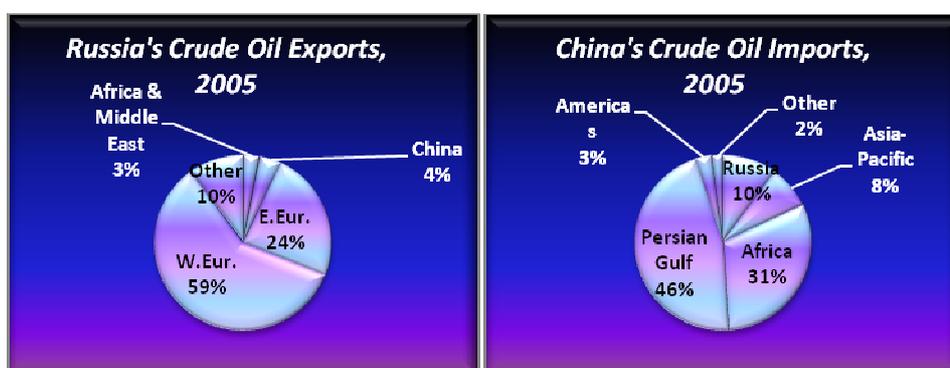


Figure 6.1: The bilateral crude oil trade dynamics<sup>325</sup>

<sup>325</sup> This Figure has been remodeled strictly abiding by Down’s paradigm, (Downs, 2010a, p. 149).

As depicted in the figure, Russia has been primarily oriented to the EU market for its exports, while China has been heavily relying on the Persian Gulf and Africa for filling its constantly widening oil supplies gap. Consequently, both states have been interconnected as far as the crude oil trade is concerned, with each relishing a very low level of exposure to the other.

The same picture of interconnectedness holds also for the natural gas trade. China's XUAR has been critical for the domestic natural gas production. Specifically, this region (Tarim Basin) contains gas reserves of 1.4trillion cubic meters, more than any other Chinese region or province, while the 4,000km-long 'West-East' gas network, endorsed by the Jiang Zemin administration, has been running since 2004 from Lunnan in Xinjiang to Shanghai, aiming at producing electricity in the Yangtze River Delta area and replacing coal with gas in Shanghai<sup>326 327</sup> (People's Daily Online, 2006). Ever since, the Chinese domestic gas network and production have been expanding, aligning with the projections of raising the ratio of natural gas in the Chinese energy consumption from 3% in the mid-2000s to 5,3% in 2010<sup>328</sup> (IEA, 2011, p. 78; People's Daily Online, 2006; Xinhua News Agency, 2008).

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<sup>326</sup> In the draft of Guidelines for the 11<sup>th</sup> Five-Year Plan for National Economic and Social Development (2006-2010) it had been discussed the construction of another west to east natural gas network to support the rapid growth of East and Central China (People Daily, 2006). Finally, in 2008, the construction work begun with the aim of carrying natural gas from Turkmenistan and Xinjiang to the Yangtze and Pearl River deltas in the South-East Chinese regions (Xinhua News Agency, 2008). It is important to mention that by this line, China would for the first time pipe natural gas from a foreign country ( via the Central-Asia-China gas pipeline), thus tampering with the regional energy dynamics (Xinhua News Agency, 2008). In conclusion, this second West-East gas pipeline would be constructed by CNPC, the biggest oil and natural gas Chinese company, whose general manager, Jiang Zemin, former President of the PRC and initiator of the first West-East pipeline, had assumed the position in a revolving door process (Xinhua News Agency, 2008).

<sup>327</sup> The map is accessible at:

[http://www.rfa.org/english/energy\\_watch/energy-risk-07132009103219.html](http://www.rfa.org/english/energy_watch/energy-risk-07132009103219.html) .

<sup>328</sup> Following EIA's analysis, natural gas comprised, in 2009, 4% of the country's total primary energy consumption, see: <http://www.eia.gov/countries/cab.cfm?fips=CH>

There has been a number of factors in China that contributed to the rising role of natural gas in the country's energy mix, ranging from environmental to energy security concerns.



Map 6.1: China's 'West-East' natural gas network

To begin with the former, suffice it to say that in the recently adopted 12<sup>th</sup> Five-Year plan, there is for the first time a CO<sub>2</sub> intensity target, aligned with China's Copenhagen pledge "to achieve 40% to 45% reductions below 2005 levels by 2020" (IEA, 2011, p. 78). Environmental concerns, however, have been present in the Chinese political scene since 2000, when the Development Research Centre of the State Council published a report on the main directions of a revised national energy policy, with environmental priorities being among the highest-ranking. Later they would also be included in the 11<sup>th</sup> Five-Year plan (2006-2010) (Meidan et al., 2009, p. 610). The excessive reliance of the Chinese economy on coal had been highlighted and hotly debated by the international community, with IEA reporting that "the coal consumption grew by 50% alone, between 2005 and 2010...an increase (which) was equivalent to more than total coal demand in the United States in 2010" (IEA, 2011, p. 382).

More pertinent to the current analysis, however, are the energy security reasons that have led to the rise of natural gas in China's energy mix. In 1993, China turned into a net oil importer and ever since its dependence on imported oil kept rising. Oil, along with the domestically produced coal, have been at the heart of the economic miracle, as experienced by the Chinese society throughout the 2000s with the double digit increases in the GDP. This, in turn, gave rise to debates over energy security, since, as prior said, all of the seaborne oil imports have been susceptible to a number of external factors, e.g. a naval blockade by the US fleet, which China could not

intercept (since it did not possess the necessary naval power capabilities)<sup>329</sup> (Downs, 2006, p. 14). In view of this, the Chinese policy makers have long abandoned the pre-1993 concept of ‘self-sufficiency’ as a means of energy security and turned to more pragmatic alternatives. Adequate supplies at reasonable prices and safe delivery of imports have now become strategic parameters of the term “energy security”<sup>330</sup> (Downs, 2006, pp. 13-14).

In a more thorough examination of the aforementioned strategic parameters it is easy to discern that energy security is associated with three choices of energy policy, a) on supplies, b) on efficiency and conservation and c) on environmental protection, which, in turn, are associated with another sub-set of policies according to the category and targets pursued (Meidan et al., 2009, p. 599). Consequently, when referring, for example, to supplies there are decisions to be made on security of transport as well as on the fuel mix adopted, so as the proper policy combination to lead to adequate supplies, safely delivered, at reasonable prices. Of course, policies in the other two fields (energy efficiency and environmental protection) may also lead to the same results, while a policy mix comprising all three fields should not be excluded.

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<sup>329</sup> As mentioned by Erica Downs in her analysis, on November 29<sup>th</sup>, 2003, during the Central Economic Work Conference, the then newly-elect Chinese President Hu Jintao referred to the “Malacca dilemma”, in an effort to express his concern over the security of the bulk of oil imports (80%) that cross the Malacca straits in order to reach China (Downs, 2006, p. 14). For a thorough understanding check also: Figure 6.1, China’s Crude Oil imports, p.222.

<sup>330</sup> Elaborating on the strategic importance of uninterrupted oil supplies to China, Downs identified the “continued economic growth, the prevention of Taiwanese independence, China’s continued emergence as a global power, and the survival of the Chinese Communist Party (CCP)” as the major issues at stake from a potential oil disruption (Downs, 2006, p. 13).

Assessing now how China has prioritized its energy policies throughout the 2000s, it could be argued that the political leadership chose an ‘across-field’ and “all time-frame” strategy, beginning with the short and expanding to the long-term. Specifically, without denying its constantly expanding need for imported oil, it approached Russia with the aim of constructing an oil pipeline carrying overland Siberian supplies to the Chinese refineries, thus alleviating the Chinese excessive reliance on the risky seaborne supplies. This option, however, albeit more secure, did not shield China against import dependence, while, along with the dominant coal, they formed an energy mix rather hostile to the environmental priorities,

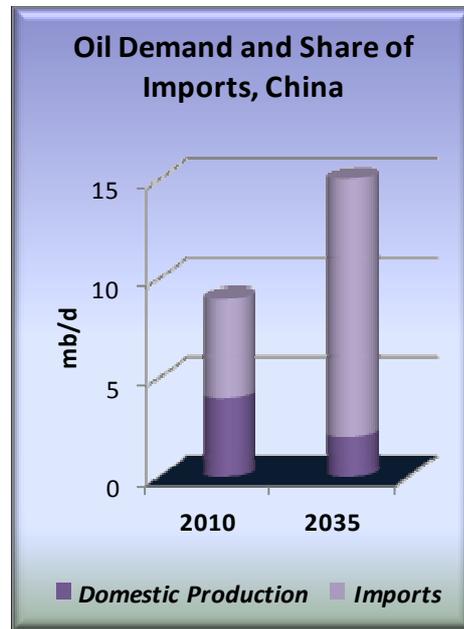


Figure 6.2

as officially adopted in the beginning of the 2000s. Thus, the addendum of natural gas along with other renewables to the country’s energy mix qualified as a potent, long-term step to the political leadership’s preferred energy policy.

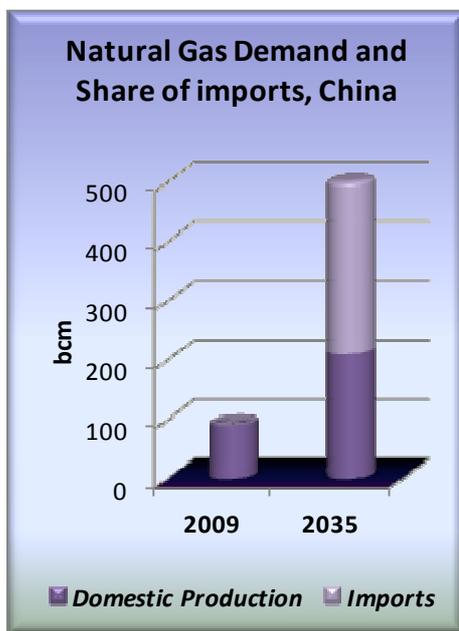


Figure 6.3

As depicted in the Figure 6.2, oil demand in 2010 has been quite high, with domestic production and imports accounting for 50% each for its fulfillment<sup>331</sup>. This short-term picture, however, is set to change in the long-term, with imports taking over in 2035, while the Chinese energy mix will try to adjust, as

<sup>331</sup> These Figures illustrate China’s oil and natural gas balance for specific periods (2010-2035 and 2009-2035). Also, the Figures have been remodeled strictly abiding by IEA’s paradigm, (IEA, 2011, pp. 92-93).

much as possible, to the use of natural gas. As depicted in the Figure 6.3, while in 2009 China did not import any gas, or better said minor quantities especially from Central Asia (case which is visited later on), in 2035, it is anticipated that natural gas will play an ever increasing role in its energy mix, with both domestic production and imports following an upward trend, thus aligning with the political leadership's long-term objectives. Certainly oil will continue to play a major role, *but not the only*, since the gradual turn to a more environmental friendly developmental pattern (using all the more natural gas), will present the policy makers with an internationally approved alternative, able to ameliorate energy security by reducing reliance on seaborne oil imports and bringing Russia and China much closer.

Consequently, reasons of energy security as well as environmental protection signaled a "turn around" course for the Chinese developmental pattern from 2000 onward, with all the more greater emphasis placed on the role of natural gas.

Following now the aforementioned "all time-frame" logic of the Chinese strategy towards energy security, below is examined the Russo-Chinese relationship as well as its repercussions on the Eurasian level. At first, it is studied upon the ESPO project, which, albeit it would alleviate the Chinese excessive reliance on seaborne supplies, constituted a front of hard diplomatic bargaining. Then, we proceed to the natural gas sphere, examining the bilateral relationship *vis-à-vis* China's efforts to forge oil and gas ties with the Central Asian states, Kazakhstan and Turkmenistan, especially in the mid 2000s, a fact which might added to the Russian suspicion, without, however, being the cause, as of the time or writing, for meddling with the fragile regional geopolitical and geo-economic balance. On the contrary, Russia maintained a watchful course, prioritizing projects (Gazprom's Eastern Gas program) and resorting to strategies that added to its Eurasian standing. In this way, it respected the dominant 'equidistant' pattern of cooperation in Asia, which, albeit unstable, it could provide it with a useful 'tool' for balancing the EU in their energy affairs<sup>332</sup>. Delicate but assertive diplomacy has been conducted with its results to be shown during the ensuing analysis.

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<sup>332</sup> It has to be clarified, at this point, that, although it may be argued that the inherent in Asia pro-realism principles of national interest and state sovereignty reveal part of the current 'Neo-Neo' testing, the truth is that they set a more challenging stage for our analysis. Knowing that both powers have been interdependent in terms of energy, it is rather intriguing to examine how did they maneuver to push forward the relative gains logic as well as the primacy of the state instead of the common or regional interest.

### 6.3.1 Ambivalence and Mistrust: the ESPO project

The feeling of mistrust and national egoism in the Russo-Chinese energy affairs became evident as early as in 1994. Then, the cash-strapped Russia was in dire need for finding buyers for its natural resources, while China figured as the most suitable solution. On these grounds, Russia proposed, for the first time, the construction of an oil pipeline to China along with other assets<sup>333</sup> (Downs, 2010a, p. 154). According to the plan, the project would be assigned to the Russian company ‘Yukos’, while the selected route would be that from the Russian city of Angarsk to the Chinese city of Daqing (the so-called “Daqing route”) (Karagiannis, 2010a, p. 57; Downs, 2010a, p. 155; Itoh, 2011, p. 22). Despite the promising prospects, the bilateral negotiations, which had been conducted on behalf of the two governments by Yukos and the Chinese state company CNPC, remained stagnant throughout the 1990s, with Russia seeking for money and China being a tough negotiator, knowing that the low oil prices (which in December 1998 hit the record low of below \$11 per barrel), would guarantee it security of supply<sup>334</sup> (Downs, 2010a, p. 154). Consequently, China, exploiting the fact that the oil and natural gas markets of the time had been buyer’s and not seller’s ones, protracted the negotiations aiming at “gaining price concessions from the Russians” (Downs, 2010a, p. 154).

It would not take long, however, until the politico-economic tide changed in favor of Russia. The ascent of Vladimir Putin to the presidency along with the increase in the average annual oil price (reaching the \$72 per barrel in 2007), altered completely the dynamics (Downs, 2010a, p. 154). In particular, Yukos got involved in a rivalry with the official power in Kremlin, a fact which resulted in its ultimate liquidation, while Putin, seriously empowered by both the international rise in the oil prices and a newly-appeared Japanese offer for an alternative pipeline route, re-considered the, up to that time, passive Russian stance towards China<sup>335</sup>.

Following the flux of events, as early as in July 2001, the Russian state-owned oil pipeline monopoly, Transneft, along with the other Russian state-owned company

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<sup>333</sup> It had also been proposed a natural gas network from the Kovykta gas field to China (Downs, 2010a, p.154).

<sup>334</sup> The same hard-line stance had also been kept with regard to the proposed gas network from the Kovykta field (Downs, 2010a, p. 154).

<sup>335</sup> The importance of the Japanese factor for the Russian strategy *vis-à-vis* China is better understood through the famous saying of the Chinese strategist Sun Tzu, the “enemy of my enemy is my friend” (Zu, 2003).

Rosneft would take over from Yukos, suggesting the construction of an alternative network from Angarsk to Nakhodka in the Primorsk Region (the “Nakhodka route” or the ESPO line) (Itoh, 2011, p. 23; Buszynski, 2010, p. 279). This route, according to the companies’ justification, would, first, eliminate the risk of emerging a buyer’s market (thus giving China the upper hand), second, deny China any chance of profiteering by reselling Russian crude oil to a third party at a premium and third, absolve the “geopolitical risk of building a direct pipeline to an adjacent historical rival” (Itoh, 2011, p. 23). All these, together with the Japanese PM’s, Junichiro Koizumi, visit to Moscow in January 2003, during which he declared Tokyo’s interest in the ESPO pipeline, were more than enough arrows in Putin’s quiver when dealing with the, at the time, intransigent China.

In May 2003, it was decided during a cabinet meeting the “Nakhodka route” to be the trunk network and the “Daqing route” a spur (Itoh, 2011, p. 24). Moscow was now in position to play the two off against each other, in pursuit of its national interest. In 2004 and 2005 intense domestic debate took place over the exact routing of the pipeline, with Viktor Khristenko, the then minister of Industry and Energy, finally signing a decree in April 2005 stipulating the construction of the ESPO line by Transneft’s own financial resources in two phases: a) from Tayshet in Eastern Siberia to Skovorodino (due for the second half of 2008) and b) from Skovorodino to Perevoznaia Bay (which would be later substituted for the Kozmino Bay, located within the Nakhodka Bay)<sup>336</sup> (Itoh, 2011, p. 25).

Striking and concurrently stifling for the Chinese side was the fact that during the public discourse in Russia over the project’s routing, no reference was made to the spur to Daqing. If in this is also considered the rising international oil prices and the emerging energy security concerns, then it is easy to understand the plight of the Chinese side<sup>337</sup>.

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<sup>336</sup> This change in the initial plan was officially approved by the Federal Government in February 2008 (Itoh, 2011, p.25).

<sup>337</sup> Recall here that the oil prices had skyrocketed from an average of \$14 per barrel in 1998 to \$72 per barrel in 2007 (see p.228). Therefore, oil from the international market was not only becoming all the more expensive but also more scarce, while the constant vulnerability of the sea lanes of transport had been an extra worry to China’s energy security concerns.



Map 6.2: The ESPO oil pipeline<sup>338</sup>

Although Japan seemed to backtrack in its interest in the ESPO pipeline in June 2005 as stated by the then Russian Foreign Minister S. Lavrov after his visit to Japan, the fact remains that the events had taken their own course. The initial Japanese interest was the much-needed trump card for Russia to balance the intransigent China, while the rise of the international oil prices was the critical factor to change utterly the Russo-Chinese dynamics.

The multi-consumer “Nakhodka route” remained the dominant choice, while China, not only restrained itself to a spur of the trunk network, a fact polar opposite to what the initial “Daqing route” stipulated, but also adopted a more conciliatory and responsive attitude *vis-à-vis* Russia. On February 17<sup>th</sup>, 2009, it was announced that, after 15 year of negotiation, the China Development Bank (CDB) would lend Rosneft and Transneft \$15 billion and \$10 billion respectively (Jiang and Sinton, 2011, p. 22). According to Chinese pundits, the Russian government together with Rosneft had reached out to the Chinese government and CNPC for funding, with the latter

<sup>338</sup> Source: Konończuk, Wojciech (2008), “The East Siberia/Pacific Ocean (ESPO) oil pipeline: a strategic project - an organizational failure?”, in *CESCOMMENTARY Centre for Eastern Studies*, No. 12, October 22, 2008, in: [http://images.google.gr/imgres?imgurl=http://osw.waw.pl/images/WSTO1\\_en.gif&imgrefurl=http://osw.waw.pl/en/epub/ecomment/2008/081022/Commentary12.htm&usq=\\_p0gJENC-1rttkdwiQn\\_mOL5cxo=&h=387&w=690&sz=47&hl=el&start=38&tbnid=HHL-OrDDrmX97M:&tbnh=78&tbnw=139&prev=/images%3Fq%3DESPO%2Bpipeline%2B2010%26gbv%3D2%26ndsp%3D20%26hl%3Del%26sa%3DN%26start%3D20](http://images.google.gr/imgres?imgurl=http://osw.waw.pl/images/WSTO1_en.gif&imgrefurl=http://osw.waw.pl/en/epub/ecomment/2008/081022/Commentary12.htm&usq=_p0gJENC-1rttkdwiQn_mOL5cxo=&h=387&w=690&sz=47&hl=el&start=38&tbnid=HHL-OrDDrmX97M:&tbnh=78&tbnw=139&prev=/images%3Fq%3DESPO%2Bpipeline%2B2010%26gbv%3D2%26ndsp%3D20%26hl%3Del%26sa%3DN%26start%3D20), (date of retrieval 29-09-09).

responded promptly<sup>339</sup> (Jiang and Sinton, 2011, p. 23). Indeed, the agreement this time did not take long to be clinched. The CDB would provide the aforementioned amounts at the favorable, for the time, rate of 5,69% (given that in view of the then ongoing global financial crisis no commercial bank was lending any money), while CNPC would be entitled to 300kb/d of crude oil at market price for 20 years (from 2011 to 2030)<sup>340</sup> (Jiang and Sinton, 2011, p. 23; Lelyveld, 2009a). Moreover, according to the agreement, the spur would originate in the Russian town of Skovorodino in the far-eastern Amur region, enter China at Mohe and terminate at the northeast city of Daqing in the Heilongjiang province as of late December 2010, covering 64km of Russian and 900km of Chinese territory<sup>341</sup> (Xinhua News Agency, 2010, 2010a; Interfax, 2010h).

The aforementioned, long-awaited, agreement was hailed by the political leadership of both states, with, first, the then Russian deputy PM, Igor Sechin, tagging the deal as a ‘breakthrough’ given that “\$25 billion is a unique deal in the history of global economy” (RIA Novosti, 2009d). In the same vein, the Chinese Vice Premier Wang Qishan stated during the seventh round of the Sino-Russian energy negotiators’ meeting that the “Sino-Russian energy cooperation is all around, long-term and strategic and is an important component of the Sino-Russian strategic partnership of coordination” (Xinhua News Agency, 2011). Atop, however, stands the comment by the then Russian President Dmitry Medvedev who stressed on the bilateral gains. In his own words, “the project strengthens our strategic partnership and engagement. It is aimed into the future, it is mutually advantageous and I am sure it will benefit our two countries” (Interfax, 2010g). Reading between the lines, it is easy to discern the complacency of the Russian leader for having secured the Russian national interest and gains *vis-à-vis* China on this specific project. However, when referring to the “mutually advantageous” character of the project, the question that plausibly comes to mind is who benefited the most?

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<sup>339</sup> It is important for the analysis to recall that according to Khristenko’s April 2005 decree, Transneft was to finance by its own resources the construction of the ESPO project (see p. 229). However, the break out of the financial crisis in 2008 found Rosneft to be behind with a debt of \$13 billion due for the summer 2009 and the government unable to help (Jiang and Sinton, 2011, p. 22). A way out of this plight could be the faster development of the East Siberian oil and gas fields and exports to the Asian market. So the Russian government and Rosneft reached out to their Chinese counterparts for one more time. This time, nevertheless, the former were in a much more strengthened position *vis-à-vis* the latter.

<sup>340</sup> For the scheme of the loan see: Jiang and Sinton, 2011, p. 22.

<sup>341</sup> The pipeline was completed on schedule and put into operation on January 1<sup>st</sup>, 2011 (Xinhua News Agency, 2011).

As previously shown, Russia has been the side to benefit the most both in financial and geopolitical terms. It is not only the favorable agreement of February 2009 which granted its companies with the necessary capital for making their opening to the Asian market, let alone cushion the, at the time, crisis-crippled Russian government, but also the fact that this agreement was made without changing the earlier endorsed “Nakhodka route” *in lieu* of the initially planned “Daqing route”. Therefore, Russia gained the Asia-Pacific geopolitical opening for its energy exports, whereas China, albeit it was signing what appeared to be as a ‘loan-for-oil deal’ that indeed was absolving its energy security fears, in reality, it had been missing the big picture of not succeeding to impose its own strategic terms on the former<sup>342</sup>.

Overall, the ESPO project corroborated the neorealist logic of relative gains and national interest on behalf of Russia in a region dominated by this logic. The latter, however, justifies also China’s *concurrent* strategy to circumvent Russia’s bargaining power by establishing ties with Central Asia and particularly Kazakhstan<sup>343</sup>.

### ***6.3.2 Counterbalancing Russia: the Sino-Kazakh rapprochement***

While the balance started to tilt, approximately from 2000 onward, all the more to the Russian side in the Russo-Chinese energy equilibrium, China did not stay passive. On the contrary, it sought to strengthen its diplomatic standing by infiltrating Central Asia.

As early as 1997, CNPC revealed its interest in participating to Kazakhstan’s upstream sector. Specifically, it was agreed the start-up investment of \$4,3 billion for the development of the oil fields in Aktyubinsk and Uzen over a 20-year period (Seaman, 2010, p. 23). Then, a series of acquisitions followed, with CNPC buying in 2005 the Canadian firm, PetroKazakhstan, for \$4 billion and thus acquiring upstream rights in the oilfields of the Turgai basin and Kezermunai (Seaman, 2010, p. 23). In 2009, there was also another major acquisition by CNPC and KazMunaiGaz (KMG), Kazakhstan’s state-owned company, of Mangistau-MunaiGaz (MMG), the largest independent producer in Kazakhstan with rights to a handful of oil and natural gas

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<sup>342</sup> For these terms check Transneft’s analysis against the “Daqing route” (p.229, second par.). If this is seen in reserve, i.e. from the Chinese perspective, then it becomes abundantly clear the geopolitical loss that China suffered.

<sup>343</sup> A similar case occurred in the natural gas trade, with China establishing ties with Turkmenistan, Uzbekistan and Kazakhstan. This case is visited later on.

fields (Seaman, 2010, p. 24). Attached to the previous acquisition agreement was also a loan of \$5 billion by CNPC to KMG<sup>344</sup> (Seaman, 2010, p. 24). The Chinese investment ‘fever’, however, to Kazakhstan would be concluded with the purchase by the China Investment Corporation (CIC) of approximately 11% stake in the KMG for \$939 million (RIA Novosti, 2009e).

Acting in this way, China managed to establish a noteworthy upstream presence in a resource-rich neighbor of Russia, thus providing itself with a weighing alternative in the previously examined developments (ESPO project) that had been seriously strengthening Russia in the bilateral negotiations throughout the 2000s. Nevertheless, the upstream expansion would only be the one side of the coin. The other would be the ‘tying’ of Kazakh resources upon the Chinese ‘chariot’.

To this direction pointed the 1997 midstream-sector agreement for the construction of a 1,384-mile oil network, running from Atyrau port in northwestern Kazakhstan to Alashankou in China’s northwest Xinjiang region (EIA, 2012). The Aktobe region’s and Kumkol fields were designated as its resource base, while the project was carried out in three stages (EIA, 2012a). The first stage (Kenkiyak-Atyrau line -Phase 1) was completed in 2003, with the second (Atasu-Alashankou line-Phase 2) agreed in 2004 and completed in 2005 (operational since 2006), and the third (Kenkiyak-Kumkol line-Phase 3) agreed in 2007 and completed in 2009 (EIA, 2012).

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<sup>344</sup> This fact is of major importance since it highlights the Chinese urgency for securing central Asian resources. In bibliography, these Chinese loans are referred to as “loan-for-oil” deals according which China, exploiting its abundant hard currency reserves, extended credit lines to capital-seeking natural resources states, either in central Asia or in other regions such as Africa or Latin America, in exchange for multi-year oil and gas contracts. Currently, a similar case has been briefly addressed in the previous analysis on the ESPO project (the February 2009 agreement) (see p.231). However, for more on the issue and how the ‘loan-for-oil’ scheme operated, see the recent analysis by Jiang and Sinton, 2011, pp. 23-24. KMG is the second largest oil producer in Kazakhstan after the Chevron-led Tengizchevroil consortium, in which KMG holds a 20% stake (EIA, 2012)



Map 6.3: The Kazakhstan-China oil pipeline<sup>345</sup>

The Kenkiyak-Atyrau pipeline was the first oil network to be constructed in Kazakhstan since independence and it was initially flowing westwards (EIA kazk, 2010a, p.4). Later, when China expanded its presence in the country and the following phases were agreed on in a piecemeal pattern, this line ended up being used in reserve, serving what finally, on October 6<sup>th</sup>, 2009, became known as the Kazakhstan-China oil pipeline<sup>346</sup>.

In a deeper level of analysis, it is plausible to theorize that the piecemeal pattern upon which the aforementioned oil pipeline was agreed and finally constructed might be linked with the gradual Russian bargaining empowerment, as prior analyzed in the ESPO section. China, in view of the rising international oil prices and the Japanese interest in the Siberian and Russia's Far East resources, realized that it would soon be in a predicament as far as its energy bargaining with Russia is concerned. Therefore, it strove towards 'tying' Central Asia, and currently Kazakhstan, to its voracious energy needs by entering both upstream and midstream sectors<sup>347</sup>. Nevertheless, as the previous section on the ESPO project showed, the Chinese expansion to Central Asia

<sup>345</sup> The map is accessible at:

[http://www.engdahl.oilgeopolitics.net/Geopolitics\\_Eurasia/China\\_Gauntlet/china\\_gauntlet.html](http://www.engdahl.oilgeopolitics.net/Geopolitics_Eurasia/China_Gauntlet/china_gauntlet.html)

<sup>346</sup> The pipeline has also been used for the transportation of oil from Western Siberia via the Omsk (Russia)-Pavlodar, Shymkent (Kazakhstan)-Turkmenabat (Turkmenistan) pipeline which connects to the Atasu oil terminal. Thus, Russia, upon completion of Phase 2 (2005), could have some access to the Chinese market. But completion of Phase 3, that in reality directly connects China with Kazakhstan's major fields in the Aktobe region and also provides access to the huge deposit in the Kashagan field, demonstrates China's urgency to control, as much as possible, Kazakhstani resources, making Russian supplies secondary to them.

<sup>347</sup> The phrase "voracious energy needs" as currently used is justified by the close to double digit growth of GDP throughout the 2000s.

was not enough to prevent Russia from meeting its national interest in the best possible way and gaining relatively more in comparison to China according to the neorealist logic.

Up to now, it has only been analyzed the ‘short-term’ feature of China’s policies towards energy security, as devised in the report by the Development Research Centre of the State Council and later included in the 11<sup>th</sup> and 12<sup>th</sup> Five-Year plans. However, there has been also the ‘long-term’ aspect the Chinese leadership highly prioritized in the 2000s<sup>348</sup>. On these grounds, natural gas has been a critical factor in play in the regional energy affairs, let alone the primary area of concern in the present research effort.

### ***6.3.3 The natural gas diplomacy***

Albeit China has been self-sufficient in terms of natural gas supplies up to 2010, regional cooperation on the issue emerged as early as the mid-1990s. Particularly, in 1994, CNPC and RUSIA Petroleum, the operator of the Kovykta gas field (the largest natural gas deposit in eastern Siberia), signed a memorandum of consensus on the construction of a natural gas network (Itoh, 2011, p.27). A few years later, in 1999, an intergovernmental agreement was also signed, stipulating the beginning of the necessary feasibility study, while the Korea Gas Corporation had been added to the initial partakers of the project<sup>349</sup> (Itoh, 2011, p.27). Upon completion of the feasibility study, the only abeyance was the governmental approval by Moscow, which, in turn, was not acquiescent with the idea of building a direct line to China<sup>350</sup> (Itoh, 2011, p. 27). In view of this, the results of the feasibility study were shelved and the regional

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<sup>348</sup> For a thorough analysis on this, see pp.224-227.

<sup>349</sup> The project would carry 20bcm/year of natural gas from the Kovykta field in Russia’s Irkutsk Province to China’s north-eastern provinces, i.e. Harbin in Heilongjiang province, Shenyang in Liaoning province, Beijing, Dalian in Liaoning Province (Alexander’s gas and oil connections, 2004; Itoh, p.28). From there, an undersea pipeline in the Bohai Rim would transport an additional quantity of 10bcm/year to South Korea (Alexander’s gas and oil connections, 2004).

<sup>350</sup> According to Itoh’s analysis, Moscow was examining from the beginning a route which would traverse Mongolia *en route* to China. The underlying reason was the restoration of Russian influence in Mongolia, which had seriously waned after the dissolution of the USSR and the subsequent conversion of the latter into a buffer state once the Russo-Chinese relation got the downturn (Itoh, 2011, p.28). Whether this assessment shares solid ground or does not, the fact remains that Moscow wanted to avoid tying exclusively the exports of its largest natural gas field in the region to China. Be it for geopolitical or geo-economic reasons, Russia preferred its autonomy, flexibility and balancing potential to any other option.

negotiations on the issue got into a fresh start with Putin's ascent to power and the centralization of power<sup>351</sup>.

As early as July 2002, the new Russian administration in the context of an overall centralization, stripped ROSNEFT off any initiative in East Russia, assigning to Gazprom the responsibility to draft the "federal Development Program for an integrated gas production, transportation and supply system in Eastern Siberia and the Far East, taking into account potential gas exports to China and other Asia-Pacific countries (Eastern Gas Program)" (Gazprom 2009c; Itoh, 2011, p. 28). Although it had a 5-year period to pass for the "Eastern Gas Program" to be officially approved by the Ministry of Industry and Energy and Gazprom be designated as the Program Execution coordinator (until September 2007), the fact remains that Gazprom assumed responsibility over the regional natural gas affairs from the very beginning of the 2000s.

On October 14<sup>th</sup>, 2004, Gazprom and CNPC signed the agreement of Strategic Cooperation which stipulated, *inter alia*, the examination of all the issues related to the delivery of natural gas from Russia to China. To this aim, a Joint Coordinating Committee and a Joint Working Group would also be created to ensure both the short and the long-term implementation of the Agreement (Gazprom, 2012b). However, this was more of a 'broad' than a 'concrete-policies' agreement, given that neither a price for supplies nor any route for their transport, incumbent or prospective, was agreed<sup>352</sup> (Gazprom, 2012b). Not even in the draft of the "Eastern Gas Program" that had been drawn a couple years earlier was any reference made to constructing a pipeline; neither from the Kovykta nor from any other East Siberian deposit to China (Itoh, 2011, p. 33).

Therefore, the 2004 Russo-Chinese agreement was more of a paper tiger, leaving many loose ends that China would try to circumvent by infiltrating the neighboring Central Asian states, as it did in the previously examined case with the oil trade.

Turkmenistan, which ranks fourth in the world in proven natural gas reserves, quickly made its way up to China's list. On April 3<sup>rd</sup>, 2006 the former Turkmen President Saparmurat Niyazov and his Chinese counterpart, President Hu Jintao, signed in Beijing a framework agreement on oil and gas cooperation, while in parallel,

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<sup>351</sup> See also Chapter 3.

<sup>352</sup> Gazprom was pushing for European prices while CNPC was insisting on lower levels (Blagov, 2011).

the Turkmen Ministry of the Oil and Gas Industry and Mineral resources and CNPC signed two framework loan agreements amounting to 200 million Chinese yuan (Blagov, 2006). According to the first agreement, China would purchase 30bcm/year at the Turkmen border over a 30-year period, beginning from the date the then agreed Turkmenistan-China gas network would be commissioned, i.e. in 2009. Moreover, both sides consented to set the terms for this network along with the gas prices by December 2006 and to strengthen their cooperation on the upstream business by exploring and developing new gas deposits in the region near the Amu Darya River, which would also be the resource-base of the gas network to China<sup>353</sup> (Blagov, 2006). Finally, in the Article 9 of the agreement it was stipulated that “The present agreement does not affect the rights and obligations of the parties arising from other international agreements” (Blagov, 2006).

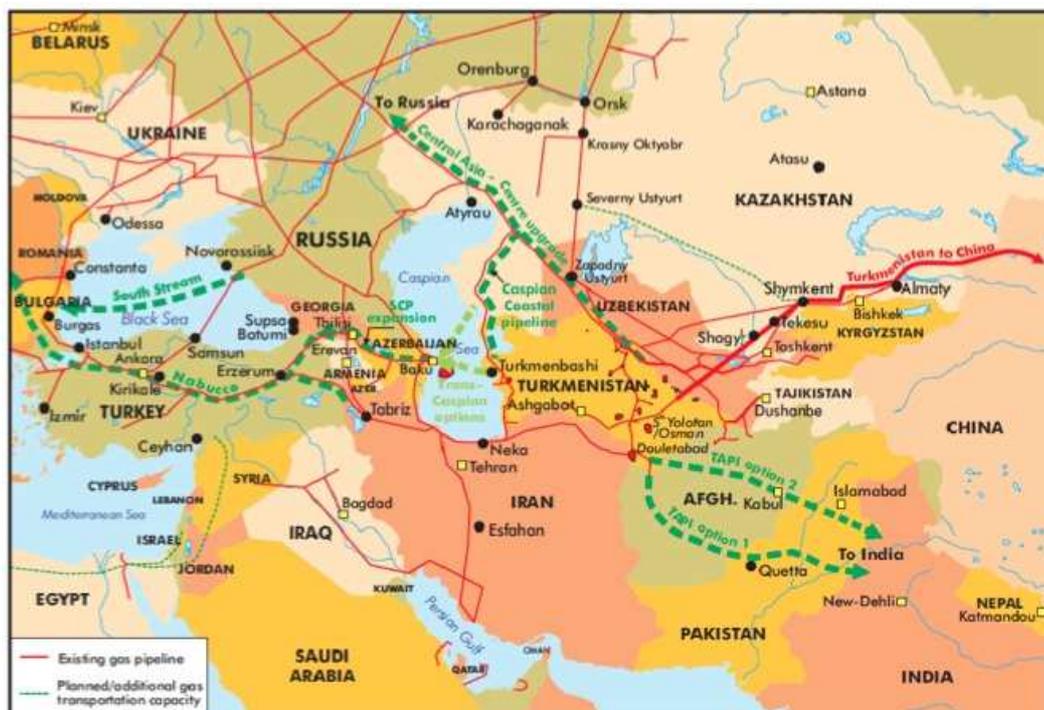
With the first step successfully having been made, the two sides met again on July 17<sup>th</sup>, 2007. Again in the presence of the two Presidents, CNPC signed with the State Agency for Management and Use of Hydrocarbon Resources and Turkmenengaz a PSA and a gas sales and purchase agreement on the Amu Darya River right shore’s Bagtiyarlik field (CNPC, 2007). This was a landmark agreement given that CNPC became the first foreign energy company to operate in such a way in Turkmenistan, given the latter’s preference to control the upstream business and allow foreign companies to service only contracts (Socor, 2009; Seaman, 2010, p. 24). Consequently, China, while stranded in negotiations with Gazprom, established a strong upstream presence in a state which was also in the traditional sphere of Russian influence.

Reading between the lines of these agreements, it is discernible China’s interest in overcoming all the impediments which had been presented when cooperating with the Russian side. Neither a gas network nor a price for the natural gas supplies had been agreed, albeit the protracted negotiations and the ultimately signed Strategic cooperation in 2004. The agreements with Turkmenistan came to address and resolve these issues, since both a gas network and a price for the natural gas supplies were agreed. Especially with regard to the latter, reference was made to a “fair basis”

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<sup>353</sup> In the article 4 it was stipulated that “The price for natural gas will be set at reasonable levels and on a fair basis, basing on the comparable international market price” (Blagov, 2006).

according to the “international market price”<sup>354</sup>. From this point it becomes clear that the mistreatment of Turkmenistan by Russia over the previous years, opened the door for China to exploit the need of Central Asia for hard currency. By employing its familiar tactic of ‘loan-for-oil/gas deals’, it signed two framework loan agreements with Turkmenistan with “strings attached” pertaining to the bilateral gas cooperation. Nevertheless, both sides appeared very careful in their rapprochement and the implications it might have on regional affairs in general, and on Russia in particular, a fact which becomes apparent from Article 9 and its provision on *pacta sunt servanda* irrespective of the contracted party<sup>355</sup>.



Map 6.4: The Turkmenistan-China natural gas pipeline or the CAGP<sup>356</sup>

The construction of the gas network would involve not only Turkmenistan but also the neighboring Central Asian states of Uzbekistan and Kazakhstan in what it

<sup>354</sup> The insistence on the “international market price” should be associated with the acrimonious Russo-Turkmen relationship as it had been evolved during the negotiations for the price of Turkmen gas in the second half of 2006. Specifically, Turkmenistan pushed for a raise in the price of gas deliveries to Gazprom to \$85/tcm, up from the \$65/tcm for the first half of that year (Blagov, 2006; see also p.108, second par.). Russia disagreed with the Turkmen demand, leading the latter to complaints over unfair treatment.

<sup>355</sup> This article might refer to the April 2003 framework agreement between Russia and Turkmenistan over a 25-year contract (from 2010 onward) on gas supplies (100bcm/year) to Russia (Blagov, 2006; supplementary see also pp.103-108).

<sup>356</sup> The map is accessible at: <http://bhuvanjan.files.wordpress.com/2011/04/pipelines.jpg>

would become to be known as the Central Asia Gas Pipeline<sup>357</sup> (CAGP). As early as December 2005, quadrilateral talks had already begun with the Turkmen delegation to Beijing discussing the gas price at \$80/tcm<sup>358</sup> (Blagov, 2006).

In the context of constructing the gas network, China also approached Uzbekistan following the same pattern as it did with Turkmenistan. In April 2007, the two governments agreed on the construction of the 490km-long Uzbek section of the CAGP, which at full capacity would carry 30bcm/year, equaling, in this way, half of Uzbekistan's annual production (Weitz, 2011). This was quite a development for Uzbekistan, since it would provide the latter with the long-awaited leverage *vis-à-vis* Gazprom, which was buying the Uzbek gas at very low prices, exploiting the fact that since independence, no energy infrastructure was directed elsewhere but northward to Russia (Weitz, 2011). Alike Turkmenistan, Uzbekistan was in anticipation of fair treatment. Gazprom's tactic had been creating a 'thirst' for hard currency, let alone the undercurrent acrimony<sup>359</sup>. In view of such a situation, China had extended credit-lines to Uzbekistan from the early 2000s, waiting for the right moment to come (when

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<sup>357</sup> The CAGP starts from CNPC's gas field at Bagtiyarlik in north-central Turkmenistan and runs for about 100km until the Uzbek border. From there, it transits Uzbekistan for 490km before meeting the Kazakh border, where the Kazakh section begins, covering some 1304,5 km until the border town of Khorgos in the XUAR, China. Then, China's domestic gas network of 4,500km ensures the transportation of gas as far as Shanghai (Energy Economist, 2010). The gas network consists, at the time of writing, of three parallel lines (A,B,C) which, when at full operating capacity (from 2016 onward), will transport as much as 65bcm/year of Caspian natural gas to China (Socor, 2012). While in the initial negotiations the network had been planned with two lines, i.e. two 42-inch pipes, aiming at transporting principally Turkmen supplies to China, later, in September 2011, a third line (Line C) was added, since Uzbek and Kazakh supplies would feed into the trunk network via connections with the domestic grid and spurs that had been agreed with the two states (CNPC, 2011a; Energy Economist, 2010; see also the analysis below).

An important element that should not be omitted here is the involvement of Russia's StroiTransGaz in constructing a "184,5km feeder line into the CAGP from the Turkmen-operated Malay field in central Turkmenistan" (Energy Economist, 2010). The Russian involvement in the project, albeit minor and indirect, might signal three things: either the Russian desire to covet a project set to sideline its energy primacy in the Chinese market or the Turkmen and Chinese desire to maintain the regional balance by inviting the Russian company to participate in the project or a mix of the two.

<sup>358</sup> A joint analysis of this price along with the developments in the Russo-Turkmen relations as described in footnote 354, reveals that there is a 'win-win' logic governing the Sino-Turkmen rapprochement; i.e. neither special nor unfair treatment. China carried the cash while Central Asia carried the natural resources in an effort to exploit to their advantage the gap by Russia over-indulging its need to secure its relative gains in its energy affairs in Eurasia.

<sup>359</sup> This acrimony had occasionally taken specific expressions, with Uzbekistan resigning from the Moscow-led Eurasian Economic Community in 2008 after two years of membership, declining to participate in a possible Custom Union between Russia, Kazakhstan and Belarus, resenting the Russian military presence in Central Asia, particularly in Kyrgyzstan, and the military might of the Collective Security Treaty Organization (CSTO) and, finally, reprimanding Moscow 2008 intervention in Georgia (Weitz, 2011).

negotiations with Russia would reach a plateau), to expand the cooperation in the energy sector, as occurred for the first time with the 2007 agreement<sup>360</sup>.

In the same logic, China approached the last but equally necessary part of the Central Asian gas chain, Kazakhstan. On October 31<sup>st</sup>, 2008, in the presence of the Chinese Premier Wen Jiabao and his Kazakh counterpart Karim Masimov during the 7<sup>th</sup> PM's SCO meeting, CNPC and KazMunaiGaz signed a framework agreement on expanding natural gas and gas network cooperation (CNPC, 2008). According to this agreement, the two companies consented to the construction of the Kazakhstan-China gas pipeline (Phase I), the last section of the CAGP which would solely transport Turkmen gas, while they also laid the groundwork for the construction of another gas network, the Beineu-Bozoy-Kyzylorda-Shymkent (Phase II) of the Kazakhstan-China gas network, which would export additional quantities (5-10bcm/year) of Kazakh and CNPC natural gas developed at the Aktobe and Urikhtau fields<sup>361</sup> (CNPC, 2008).

Finally, the Turkmenistan-China (CAGP) gas network (Line A) was opened on December 14<sup>th</sup>, 2009, carrying in the first year of its operation 6-7bcm of Turkmen gas, with most of it coming from CNPC's production at the Amu Darya River's right bank<sup>362</sup>. China, however, in spite of the aforementioned agreements, would not stop strengthening its position in Central Asia, much more as negotiations with Gazprom over natural gas prices remained frozen as late as March 2010 (Itoh, 2011, p. 36).

On June 23<sup>rd</sup>, 2009, the Chinese and the Turkmen delegations signed an additional sale and purchase agreement according which Turkmengaz shall deliver an extra amount of 10bcm/year to CNPC over the previously agreed 30-year period<sup>363</sup> (Socor, 2009). As a result, the total amount to be supplied by Turkmenistan to China rounded up to 40bcm/year, volume equal, more or less, to Russia's imports of Turkmen gas (Socor, 2009). Furthermore, in absolute alignment with the previous agreements and the logic of 'loan-for-oil/gas deals', the State Development Bank of China offered a \$4 billion loan on soft terms for exploration and development of the

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<sup>360</sup> Following Weitz's reporting, during the 2000-2005 period, China's investments in the country surpassed the \$2 billion. Moreover, when in the mid of the global financial crisis China extended short-term credits to all the members of the SCO to help them cushion the repercussions of the crisis, Uzbekistan received long-term soft loans by the EXIM (Export-Import) Bank of China which supported, according to the government, 20 infrastructure projects, the cost of which amounted to \$600 million (Weitz, 2011).

<sup>361</sup> For a better understanding see also Maps 6.3, 6.4.

<sup>362</sup> See p.237.

<sup>363</sup> See p.237.

gas fields South Yolotan and Osman<sup>364</sup> (Socor, 2009). There were also other (economic) incentives, pertinent to the energy sphere and not, aiming at further tightening the ties between the two economies which were perceived by China as “highly complementary”<sup>365</sup> (Socor, 2009). Alike the first time, China was very careful in maintaining the balance in the regional affairs, a fact that derives from its commitment to “strengthening Turkmenistan’s international positions and upholding its policy of *permanent neutrality*” (italics added by the author) (Socor, 2009).

On June 10<sup>th</sup>, 2010, it was Uzbekistan’s turn to agree, for the second time, with China over expanding cooperation in the natural gas sector (CNPC, 2010). Following the meeting between President Hu Jintao and his counterpart Islam Karimov, CNPC and Uzbekneftegaz signed a framework agreement according which Uzbekistan assumed responsibility over supplying 10bcm/year of natural gas to China (CNPC, 2010). Furthermore, both sides agreed on joint efforts to connect Uzbekistan’s gas network with the Uzbek section of the CAGP (the Uzbekistan-China line) (CNPC, 2010). Certainly, what becomes crystal clear is China’s desire to further solidify its position in Uzbekistan, targeting both upstream and midstream sectors.

It would not take long until Kazakhstan was added to the aforementioned chain of events. On June 12<sup>th</sup>, 2010, following the meeting between the President Hu Jintao and his counterpart Nursultan Nazarbayev, CNPC and KazMunaiGaz signed another agreement confirming the joint construction of the Phase II of the Kazakhstan-China section of the CAGP, (the Beineu-Bozoy-Kyzylorda-Shymkent network), which would be destined for meeting gas demand in south Kazakhstan and exporting Caspian (Kazakh) gas to China, if possible<sup>366</sup> (CNPC, 2010a).

In this way, China, after its initial infiltration of Central Asia in the early-mid 2000s when it successfully entered the ‘promising’ upstream and the ‘binding’ midstream sectors of the region, continued unabated in the late 2000s, signing new framework bilateral agreements, aiming at further deepening and expanding its

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<sup>364</sup> The full development of these two gigantic fields could possibly open the way for Chinese imports of Turkmen gas exceeding those by Russia, thus bringing Turkmenistan, if not most of the Central Asian states, closer to China and subsequently tilting the balance in the regional energy affairs in favor of China.

<sup>365</sup> For these “multifaceted package deals” see: (Socor, 2009).

<sup>366</sup> The Phase II will be sourced from Karachaganak, Tengiz and Kashagan oil fields (associated gas) at the Mangghystau region on Kazakhstan’s Caspian coast and connect with the CAGP at Shymkent in Kazakhstan’s south (Socor, 2012; CNPC, 2011). Construction begun as late as December 2010 and when both phases operate at full capacity, the project will be expected to carry 10-15bcm/year of Caspian (Kazakh) natural gas (CNPC, 2011).

presence in the region and providing not only itself but also the central Asian states with a powerful diplomatic leverage *vis-à-vis* Russia. This Sino-Central Asian rapprochement, however, loomed rather threatening for the Russian interests not only in Central Asia but also in its largest neighboring market in Asia, i.e. China. Thus, the question that plausibly arises here is, how did Russia position itself in the ongoing developments as described above?

After the 2004 agreement of Strategic Cooperation, Russia (Gazprom) and China (CNPC) met one more time, in March 2006, signing a memorandum on the delivery of gas supplies from 2011 onward (Blagov, 2011). However, the price issue remained unresolved.

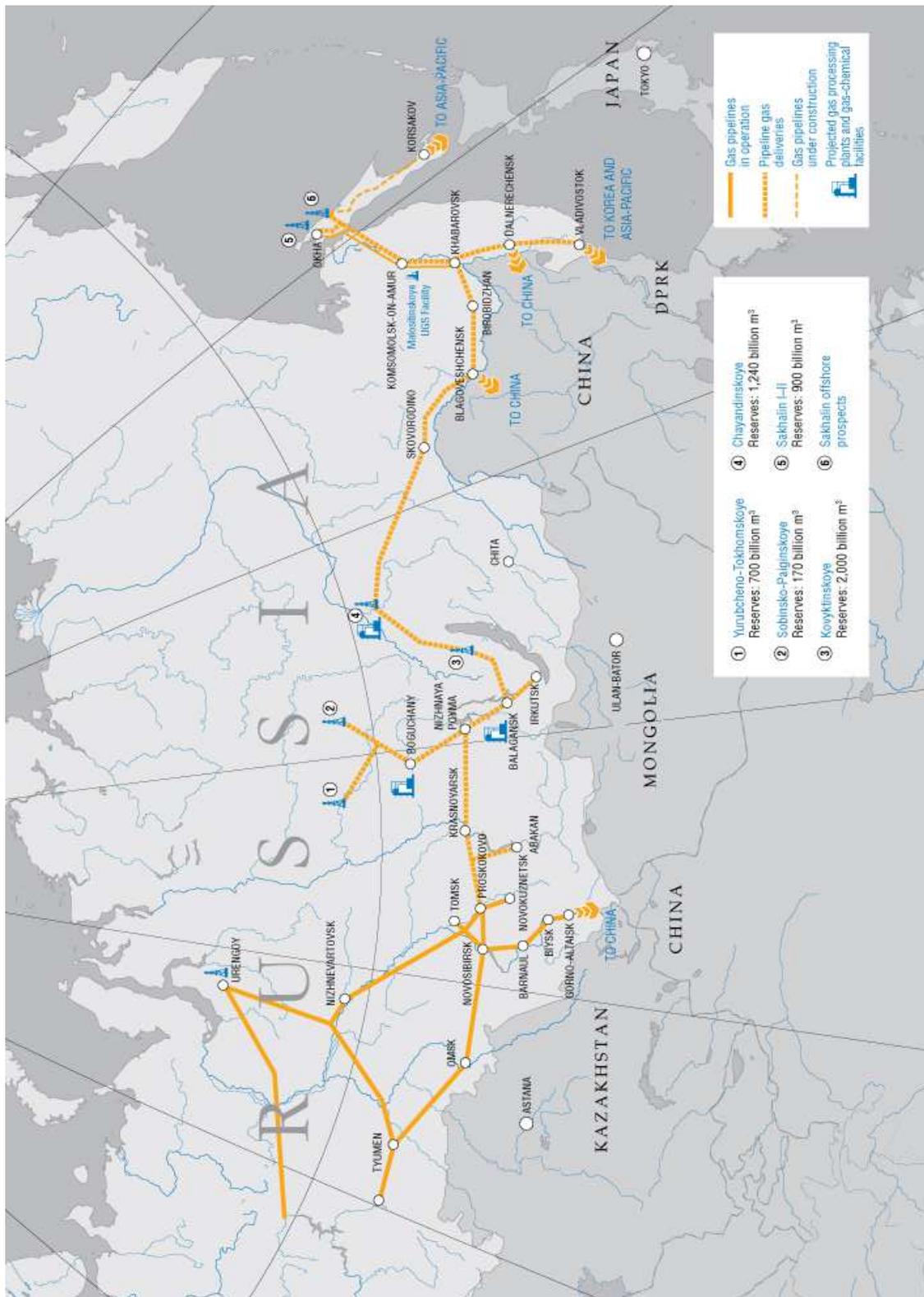
Meanwhile, Russia would continue to count on the “Eastern Gas Program” as a satisfactory means of developing Eastern Siberia and the Far East (two lagging areas largely susceptible to the Chinese population superiority in the region with wider repercussions on state sovereignty) and securing Russia’s relative advantage in its energy (gas) affairs with the EU, China and even Central Asia.

Eastern Siberia and the Far East account for 60 per cent of the Russian Federation in geographic terms, while their aggregate gas resources amount to 52,4 tcm onshore and 14,9 tcm offshore (Gazprom, 2012c). The total gas potential remains to be seen, since up to the time of writing a mere 7,3% of the onshore area and a 6% of the offshore have been explored (Gazprom, 2012c). These figures portray a rather auspicious profile of the region while justifying Russia’s international ranking as the largest producer and exporter of natural gas in the world.

The Eastern Gas Program stipulates the establishment of gas production centers in the Krasnoyarsk Krai, the Irkutsk Oblast, the Republic of Sakha (Yakutia), the Sakhalin Oblast and the Kamchatka Krai, along with the formation of a unified gas transmission system, LNG facilities and other gas processing and gas chemical industries<sup>367</sup> (Gazprom, 2012c).

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<sup>367</sup> The first Russian LNG plant was put in operation in early 2009, when the first cargo was shipped to foreign consumers (Gazprom, 2009d). It was developed primarily by Gazprom as a part of the Sakhalin II project, while it reached its projected capacity (9.6 mln tons/year) in 2010 (Gazprom, 2009d).



Map 6.5: The Eastern Gas Program<sup>368</sup>

<sup>368</sup> The map is accessible at: [http://gazprom.com/f/posts/69/808097/map\\_4\\_31\\_new\\_eng.jpg](http://gazprom.com/f/posts/69/808097/map_4_31_new_eng.jpg)



Critical not only for the present analysis but also for Gazprom and the Russian government has been the Sakhalin-Khabarovsk-Vladivostok (SKV) gas network. This project has been highly prioritized since its construction began in 2008 and it has been designated for supplying gas to most consumers in the Khabarovsk and Primorsky Krai, the Jewish autonomous Oblast and the Sakhalin Oblast (Gazprom, 2012d). In particular, following its routing, the SKV network would secure gas supplies to

**Map 6.6: The SKV natural gas network<sup>369</sup>**

Vladivostok and to the power generating capacities at the Primorsky Krai, with special emphasis on “those intended for the 2012 APEC summit”. The resource base of the project is the Sakhalin offshore fields<sup>370</sup> (Gazprom, 2012d).

The prioritization of the SKV network and the special emphasis on the APEC should not be perceived as two completely irrelevant facts. As shown in Map 6.6, the SKV ends up in the port of Vladivostok, a fact which gives Russia a plentitude of export options (in the form of LNG), either Asian or not. Otherwise, if the consumer-end was finishing in a specific state (China), the latter would gain notable negotiating power<sup>371</sup>. Therefore, there are only minor spurs to China but not a whole project committed to it (see Map 6.5). Also, the reference point of the APEC 2012 Summit was not random. At this summit, when Vladimir Putin would signal more emphatically that integration into Asia becomes “a guarantee for future success”, especially in light of the economic downturn in European countries and their

<sup>369</sup> The map is accessible at: [http://www.gazprom.com/f/posts/99/380804/sakhalin\\_mest\\_eng\\_1.jpg](http://www.gazprom.com/f/posts/99/380804/sakhalin_mest_eng_1.jpg)

<sup>370</sup> The SKV gas network was put into operation in 2011 and when it reaches full operating capacity with 14 compressor stations, it will be able to transport as much as 30bcm/year of Sakhalin gas (Gazprom, 2012d). If this amount is to come only from one gas network, it is easy to assume the huge quantities that will be available for the domestic as well as the export markets as soon as the Eastern Gas Program in total, as illustrated in the map below, is put into operation. No need to mention the overshadowing of the central Asian states’ export potential and the powerful position in which Russia will establish itself (large available quantities → wide price margins → price wars → Gazprom dominance). Nevertheless, it should not be omitted the fact that this is a mid-term perspective.

<sup>371</sup> It is exactly the same logic with what was analyzed in the ESPO case.

dwindling demand for oil and gas, the most critical appendage of the vast Eastern Gas Program (the export end) would be in place to give to the Russian President's statement vigor. (People's Daily Online, 2012; Kramer, 2012).

Taken together, the immense prospects of the Eastern Gas Program, as they have been gradually unraveling throughout the 2000s (see Map 6.5) as well as the prioritization of the SKV (along with its implied emphasis on the Asian and global markets instead of solely the Chinese), brought China once more to the negotiating table with Russia in an effort to sign a workable agreement.

In June 2009, the Russian and the Chinese governments signed a MoU for cooperation in the natural gas sector, which was soon concretized, when in October 2009 Gazprom and CNPC “inked the Framework Agreement on major terms and conditions for natural gas supply from Russia to China” (Gazprom, 2012b). According to its provisions,

- a gas pipeline would be constructed
- the gas prices would be connected with the “Asian oil basket”
- gas supplies would start flowing in 2014-2015 (Blagov, 2011).

These three points reveal that Russia, finally, succeeded in getting China to agree with its own terms<sup>372</sup>. Recalling what has been earlier analyzed, on October 14<sup>th</sup>, 2004, the two sides had failed to agree on a specific price for natural gas supplies as well as on a route for their transport, facts that led China to intermingle its energy priorities with those of the Central Asian states. But as proved here, this was a trump card of “limited range”, since no matter the noteworthy developments, it did not shield China against the Sino-Russian agreement's provisions. Russia got the higher (international) price and the pipeline-routing it preferred from the beginning, thus adding to its relative gains *vis-à-vis* China.

The analysis, hitherto, has shown how Russia's gradual empowerment, via the immense Eastern Gas Program, led China to succumb to its terms. But it does not explain why did Russia tolerate all the developments, upstream and midstream, occurring in its traditional sphere of influence, Central Asia?

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<sup>372</sup> Although we were not able to access more details in the agreed gas pipeline, we have reasons to believe that it will not be something different from the routes portrayed in the Map 6.6. All these routes are according to Russia's logic of avoiding any exclusive ‘tying’ to one consumer, in our case China, and qualifying, instead, spurs to the trunk network as a means of satisfying the neighboring states' needs.

A hasty answer would hold that there was no need to interfere and thus jeopardize the regional energy affairs balance for something of much lesser importance compared to the Eastern Gas Program. However, the 2009 Russia-engineered explosion at the km 487 of the Turkmen network due to the former's denial to assume responsibility of the oversupply of Turkmen gas to the recession-hit Europe, points to the opposite direction<sup>373</sup>. Even more, if considered that the two sides had signed, according to a senior Turkmen official, a take-or-pay agreement for the export of 50bcm during 2009 via the northern route (Russia) (Energy Economist, 2010). The explosion resulted in gravely limiting output and exports, with the latter falling to 25bcm in 2009 from 55bcm the year before (Energy Economist, 2010). Also in Kazakhstan, Russia had enough room to maneuver given that the Russian oil was indispensable for the Kazakhstan-China oil pipeline to operate satisfactorily<sup>374</sup> (Seaman, 2010, p. 28). Both cases reveal Russia's capability to interfere in the regional energy affairs anytime, with the first case displaying in a rather unambiguous way that Russia, when needed, did not hesitate to demonstrate its power superiority and inflict losses on its central Asian partners.

The explosion occurred in April 2009, few months before the Turkmenistan-China (or CAGP) gas network (Line A) was put in operation. This means that Russia did not oppose the construction of the network, since if this was the case, Russia would have taken action during the initial negotiations and not years after, when the course of the project would be irreversible. To this argumentation attests also the fact that in Kazakhstan, where an oil pipeline to China had been built, no impediment (explosion included) was posed. Consequently, Russia's tolerance of the energy developments in the region should not be perceived as synonymous with 'non-interference', or even worse 'indifference', as upheld by the supporters of the 'hasty' answer. Russia, indeed, heavily interfered when its national interest and relative gains were at stake. But this interference did not, at all, target the Chinese side or the rapprochement between the latter and Turkmenistan, Uzbekistan and Kazakhstan.

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<sup>373</sup> For the Russia-EU gas trade and the role of Central Asian supplies, see Chapter 4. On April 8<sup>th</sup>, 2009, Gazpromexport, the gas recipient, gave a 24h ultimatum to Turkmengaz, demanding from the latter to reduce pressure and the flow of gas in the Central Asia-Center network (see Map 6.4) (Energy Economist, 2010). Turkmengaz asked for more time with Gazpromexport declining the request and ordering its technicians to reduce the intake valves. Finally, the altercation resulted in the explosion at the km 487 of the Turkmen gas network (Energy Economist, 2010).

<sup>374</sup> Following Seaman's analysis, the Russian oil has been necessary for the Kazakhstan-China oil pipeline to "maintain sufficient supplies and a proper viscosity" (Seaman, 2010, p. 28).

A more profound analysis would identify behind Russia's tolerance of the regional developments, a strategic gain. As examined in the previous chapter, Russia has been at odds with the EU commission over the construction of a Southern gas corridor to the EU markets. Russia backed its own project (South Stream), while the EU commission favored the construction of the alternative Nabucco project, sourced from Azerbaijani and Turkmeni resources<sup>375</sup>. While the prospect of the Azerbaijani resources had been addressed by Russia, Turkmenistan remained an open case<sup>376</sup>. That is the point where China served to the strategic benefit of Russia. By engaging central Asia and particularly Turkmenistan, it was excluding the latter from the supply list of the Nabucco project. Specifically how? After the latest round of the Sino-Turkmen negotiations for deeper upstream and midstream cooperation, it was agreed that Turkmenistan would supply the former with 40bcm/year for 30 years. Considering now that its production in 2010 amounted to 42,5bcm, it plausible to doubt whether there will be any quantities available for Nabucco, not to mention the legal problems pertaining to the construction of a trans-Caspian network<sup>377 378</sup> (BP, 2011). Of course, the picture becomes more grey for Nabucco, if we also take into account the full spectrum of China's involvement in the region (the deepening of gas relations with Uzbekistan and Kazakhstan and the expansion of the Turkmenistan-China/CAGP network from the initial two to three lines)<sup>379</sup>. In light of these, no investor would be eager to invest in a project whose profitability is uncertain.

Thus, turning a blind but not indifferent eye to the Central Asian developments was a strategy employed by the Russian leadership in order to maximize its relative gains in both the EU and China fronts.

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<sup>375</sup> For the latter to be feasible a trans-Caspian network had been under consideration.

<sup>376</sup> As far as Azerbaijan is concerned, the Shah Deniz (Phase I) field, the principal resource-base of the Nabucco project, produced 7,6 bcm in 2010 with the Phase II expected to yield another 16 to 17bcm/year. However, the commencement of Phase II has been protracted for 2016 even 2017 for a number of reasons, thus posing a serious impediment to the realization prospects of the project. Toward further enfeebling these prospects, Russia also signed an agreement with Azerbaijan in September 2010 over the purchase of increasing gas volumes from 2010 onward (Mammadov, 2010).

<sup>377</sup> Involvement of all 5 littoral states, conflicting interests and the unresolved Caspian legal status. For more on the issue, see: (Janusz, 2005).

<sup>378</sup> Someone could raise here the issue with the Turkmen supplies that are being bought by Russia and re-exported to the European market (around 40bcm/year). Judging from the above numbers and Russia's ease with the issue of the China's involvement, it would not be far-fetched to assume that in light of the Eastern Gas Program and the prevalence of South Stream over Nabucco, losing Turkmen supplies would be a minor loss in pursuit of a higher gain in the Eurasian energy chessboard.

<sup>379</sup> See footnote 357.

#### **6.4 Conclusion**

Built against a historic background of mutual distrust and suspicion, the 2000s Russo-Chinese energy affairs walked a fine line. The ‘realist’ profile of international (institutional) cooperation in Asia laid the groundwork for the energy relations among Russia, China and Central Asia, with Russia gaining relatively more.

Russia, exploiting its oil and gas interconnectedness with China, it developed a perfectly balancing strategy not only in the bilateral trade but also in the Central Asian region. Elaborating on the latter, Russia, albeit it initially seemed as being sidelined from a ‘supplies-thirsty’ China, in reality, it stood to benefit the most. Allowing the Sino-Central Asian rapprochement to evolve, Russia was bolstering its institutional balancing position *vis-à-vis* the EU all the more the latter was being excluded from critical suppliers for EU-backed projects, such as Turkmenistan and the rest of the resource-rich central Asian states. However, this Sino-Central Asian rapprochement was not unconditional. Whenever the Russian national interest and relative gains were at stake, Gazprom was ready to go as far as triggering an explosion. Of course, such aggression would not be possible if it was not for a massive project to empower Russia as a major and indispensable supplier in China and the Asian region in general.

The Eastern Gas Program and its gradual development since the early 2000s, was the necessary foundation for Russia’s balancing strategy. The latter has had the resources and soon would have a complete network, capable of satisfying the most voracious energy needs. Thus, China could not steer clear of such a pragmatic perspective, especially in light of the major international and environmental implications its energy-intensive economy would have unless its energy mix was addressed upon considerations of energy security. The rapprochement with the central Asian states could only be a ‘temporary’ solution, unable to substitute for the vast Russian resources. The latter, foreseeing these developments, prioritized the Eastern Gas Program and succeeded in convincing the latter to concessions that in earlier round of negotiations were not possible.

Summarizing now the analysis upon the theoretical premises of the Neo-Neo debate, two points deserve special attention: a) Russia’s success in defending its national interest and multiplying its relative gains from its energy cooperation with China, thus corroborating the Neorealist argument and b) Russia’s maneuverability in

the Asian energy affairs, fact which empowered its institutional balancing strategy *vis-à-vis* the EU. If it was not for its successful balancing in Asia, it is doubtful whether Russia would be able to be that assertive in the EU front, let alone promote its relative gains.

Overall, the present chapter, aside from examining the Russo-Chinese relations *per se* via the lenses of the Neo-Neo debate, it also constituted the necessary explanatory appendage to the previous chapter for the pro-realism Institutional Balancing strategy to be presented in full extent and, thus, inform the Neo-Neo debate. Recalling what has been said in the previous chapter, when two states share interdependence and institutional cooperation is unavoidable, then, Institutional Balancing emerges as a ‘compulsory’ strategy; but it is when states are aware of a much better position in the future that the Institutional Balancing strategy turns from once ‘compulsory’ to ‘powerful’, thus fulfilling its realist roots. Exactly this point of a “much better position in the future” is the one which is being validated with the present chapter and leads to the full substantiation of the Institutional Balancing strategy.

# Chapter 7: Conclusions

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## 7.1 Introduction

From the very beginning it has been made reference to Eurasia and its critical role in today's energy politics. Specifically, identifying the natural resources rich Russia as the major habitant of the region, we paraphrased Mackinder's 'Heartland' to 'Energyland'. Then, in this Eurasian energyland we placed the current research, examining Russia's energy affairs with the two geopolitical ends, the EU and China. The FSU region has also been an indispensable part of this geopolitical space, since, aside from the deep historic-politic ties it does share with Russia, it is the necessary crossing for the latter's natural gas and oil supplies earmarked for the EU market. As a result, a Eurasian energy triangle emerged with fragile balances and delicate diplomatic practices in the sphere of energy politics. Even more interesting, however, have been the existing different types of bilateral cooperation; interdependent, unilaterally dependent and interconnected relationships formed a diversified triangle. In this context, we attempted a geopolitical and geoeconomic analysis, with emphasis placed on the latter. More specific, we aspired at re-inventing the term "power politics" in contemporary world affairs, by bringing to the fore its economic side.

Then, we substantiate our analysis by designating both the theoretical framework and the research hypotheses. Specifically, with regard to the former, we presented a revised 'Neo-Neo' debate with the addendum of the 'middle-ground' branch of "Institutional Balancing" so as to address cases of symmetric relationship/interdependence and unavoidable institutional cooperation. Next, the research hypotheses appeared in a threefold manner, according which the revised 'Neo-Neo' debate would be tested towards the disclosure of the Putin's Russia energy diplomacy rationale *vis-à-vis* the FSU, the EU and China. Specifically, a) in the 'Russia-FSU' case, it was expected that the testing of the debate would qualify Neorealism's argument of "relative gains" as the best explanation, b) in the 'Russia-EU' case, it was anticipated the limited explanatory capacity of the 'Neo-Neo' debate and its update by the 'middle-ground' branch of Institutional Balancing and c) in the 'Russia-China'

case, it was expected Neorealism's "relative gains" argument to qualify again as the best explanation.

Consequently, what has been achieved, in this manner, is to, first substantiate and, second, update the 'Neo-Neo' debate. By re-establishing it upon these premises, we may expect certain outcomes given specific type of bilateral relationship. The abovementioned typology covers the biggest part of the IR spectrum, while the incorporation of "Institutional Balancing" adds to its explanatory validity. Of course, someone could argue, at present, that such an update is case-limited, restricted only to the energy affairs and particularly in whatever revolves around pipeline trade without other substitutes, like the currently examined case with the natural gas trade<sup>380</sup>. Certainly, this might be a allegation, but just like in every other occasion, theories are open to testing and falsification. Departing now from the academic implications of the present research, below, we proceed with the overall findings.

## ***7.2 Overall findings***

The 2000s Russian energy policy in Eurasia was subdivided into three bilateral relationships: a) Russia-FSU region, b) Russia-EU and c) Russia-China. Each of them relished a different status, with the first revealing the unilateral dependence of the latter on the former, the second interdependence and the third interconnectedness<sup>381</sup>.

In the first case, we examined the natural gas relations between Russia and the FSU region, with particular focus on the transit states Belarus and Ukraine. Both states held a transit status for the Russian supplies earmarked for the EU market. Exploiting their status, they, initially, aspired at presenting their relationship with Russia as interdependent, a fact which would, in turn, allow them to have negotiating power and equal saying in the decisions made. However, this aspiration proved to be more of wishful thinking than a factual event. Russia, combining the construction of new, direct networks with the EU market with the excessive reliance of both transit states on it for supplies, soon proved that any interdependence was only nominal.

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<sup>380</sup> It is reminded that oil trade has been secondary and conditional in the present research effort, since seaborne supplies could make up for its pipeline trade. For more see Chapter 3.

<sup>381</sup> It is reminded that these terms have been preceded in the current research effort by those of 'symmetry', 'asymmetry' and 'balance', while, at times, they have been used interchangeably without however being conflated, see: Chapter 2, p.64, footnote 72.

A scene of unilateral dependence emerged to depict the power asymmetry. Building on that, Russia pushed hard for securing its relative gains. It was not only the market discipline that was imposed in its trade with both states, but also the sovereignty issues raised against them, with Russia laying a hand in their gas transit networks, thus eradicating any transit leverage once and for all. Of course, as shown in the respective chapter, the sovereignty issues, while beginning with the gas sphere, they soon ran much deeper. In Ukraine, military concessions were made in exchange for ‘reasonable’ gas prices whereas in the more pro-Kremlin Belarus, concessions surpassed the military sphere reaching the heart of the economy, the oil refineries. Consequently, the findings on Russia’s energy policy in the FSU region revealed the extent that Neorealism’s “relative gains” may reach when operating within a “unilateral dependence” framework. The powerful side may put on an assertive face, claiming interests in many societal spheres (military, economy, etc).

In the second case, the gas relationship between Russia and the EU proved the need for revising the ‘Neo-Neo’ debate. As the data revealed, no matter the efforts of each side towards altering the status of the relationship, this remained interdependent, giving to both sides an equal saying during negotiations. The EU, on the one hand, has been pushing for the establishment of institutional, legally binding cooperation upon the premises of conductible demands. Russia, on the other hand, could not afford losing its most lucrative, economy-buttressing, export market. Regardless of the various strategies it employed, it did not succeed in rendering itself in a position of bargaining immunity *vis-à-vis* the EU. The latter should be heard and a middle ground had to be found if the two sides were to continue their energy relationship.

That is the point where the ‘Neo-Neo’ called for revision (with the addendum of the Institutional Balancing branch), if it is to address circumstances of increased economic interdependence and unavoidable international institutional cooperation. The EU managed to coerce Russia to some form of institutional cooperation (the ECT, the Energy Dialogue) which, however, has not, at the time of writing, ended up in any form of legally binding framework. Thus, international institutions remained “empty shells”. How?

First, it has been Gazprom’s penetration of the EU market (the “Trojan Horse” strategy, Russian upstream for EU downstream cooperation, etc.). Second, it has been the smoldering prospect of the Asian and particularly the Chinese market throughout the 2000s. Both these parameters (they could also be classified as direct and indirect-

effect parameters) qualified Russia with a successful institutional balancing strategy *vis-à-vis* the EU efforts, either unilateral and emerging from the EU commission (Third Energy Package) or consensual and aspiring at the commitment of all the involved sides (ECT, Energy Dialogue).

The points raised in this case called for further research in the other end of the currently examined Eurasian triangle. The Russia-China case would serve a dual purpose, since it would be, first, examined via the lenses of the classic ‘Neo-Neo’ debate so as to ascertain the motives of the Russian energy policy *vis-à-vis* China, whereas, second, it would have to provide our research with the necessary evidence for showing how the once ‘compulsory’ Institutional Balancing strategy in the stagnant Russo-EU energy relations may be transformed into a ‘powerful’ one, fulfilling in this way its realist roots. In fact, this prospect emerges when states are aware of a much better position in the future. In this light the Russo-Chinese relations have been examined.

The Russo-Chinese energy relations cover, first of all, the last type of bilateral relationship, that of interconnectedness. This status led to fragile balances in the Asian energy affairs, while it allowed for increased flexibility and autonomy. Especially, if it is also added the dominant pattern of regional cooperation, then it should come as no surprise the prevalence of the Neorealist logic. Russia exploited its vast natural resources and its geographic location to push forward its relative gains. Either by engaging a third party (Japan) in what otherwise would be a bilateral negotiation (the ESPO case) or allowing for the intervention of a third party (China) in what otherwise would be its traditional sphere of influence (Central Asia), Russia forged delicate balances always to its benefit and to the maximization of its relative gains.

Special reference deserves the ‘flammable’ balance between Russia and China over the Central Asian resources as well as the Eastern Gas program. In the former, Russia delicately guarded its national interest, albeit the extreme case of the April 2009 explosion, knowing that the commitment of a large part of the central Asian resources to China would undermine the status of the region as supplier for the EU-backed gas network projects and would amplify the institutional balancing strategy it (Russia) was concurrently employing in the EU front. In the latter case, the Eastern Gas program has been the *sine qua non* prerequisite not only for China to succumb to the Russian demands in the bilateral gas negotiations, but also for the Institutional

Balancing strategy to acquire ‘powerful’ standing. In this light, it becomes abundantly clear the dual purpose this case (Russia-China) served to the whole analysis.

As a concluding remark, we would like to summarize that during the Putin administration in the 2000s, the Russian natural gas policy in the Eurasian energyland was better explained by the Neorealist argument of the relative gains, be it either in its traditional form (cases 1 and 3) or in its revised form of Institutional Balancing (case 2). Consequently, the research hypotheses are answered by the evidence presented in the respective chapters.

### ***7.3 Policy implications***

An issue that certainly has to be addressed in this concluding chapter pertains to the policy implications. Having scrutinized Russia’s rationale beyond its natural gas affairs in Eurasia, one of the principal findings is that Russia has been primarily concerned with the maximization of its relative gains. This means that the liberal thinking of a ‘win-win’ situation succumbs to the realist philosophy of proportional power (who gains more is what matters the most). Consequently, keeping this in mind, what are the lessons to be drawn for all the involved parties and particularly for the EU?

The EU should certainly worry about the trustworthiness of Russia as an energy supplier. The latter has set bridges to Asia, strengthening, in this way, its balancing prospects in Eurasia. But ‘balancing’ from ‘dropping’ the EU market for another of equal profitability are far apart. As argued during the analysis and particularly in the beginning, Eurasia is a geopolitical place which Russia may exploit by astutely maneuvering so as to strengthen its international standing and great power status. Dominating the region in energy terms will have serious implications for its international affairs. It is anticipated that it will toughen its balancing position *vis-à-vis* the EU, pursuing its relative gains in a much more assertive way. But in any case, the bottom line is that Russia and the EU are on the same boat.

Another lesson to be drawn is that Gazprom has established a very strong position in most of the principal EU markets. The commercial ties are very strong and poised to expand further. Some states (e.g. Germany), after the Fukushima disaster in 2011,

have decided to phase out their nuclear power plants<sup>382</sup>. This is a manna for Russia since demand for natural gas will rise. An energy expert stated that “what was really beneficial for Russia is not what Germany decided, but the Fukushima event itself. Gas markets will tighten more”, while the European energy commissioner, Gunther Oettinger, stated that “after Berlin’s decision, gas will be a driver of growth” (Cala, 2011). All these come in support of the current research, while they pave the way for even tighter bilateral cooperation in the years to come.

However, it is interesting at this point to see that the EU has tried to reduce unilaterally the dependence on Russia. It has not only been the Third Energy Package but also the recently launched (fall of 2012) investigation by the EU Commission on charges of Gazprom violating the anti-monopoly legislation and abusing its monopoly position in Central and Eastern Europe (Ponomareva, 2012). Vladimir Putin quickly responded by issuing a decree, preventing the “strategically important companies that do business overseas- a category that includes Gazprom- from providing information to foreign regulators without approval from the Kremlin”<sup>383</sup> (Kramer, 2012a). If in this escalation is also considered the Russian neorealist *modus operandi*, the gradual opening to the Chinese and Asian markets in general and the strategic role of Eurasia, it is plausible to predict that, Russia, the more hegemonic it becomes in the Eurasia the harder balancer it will be against the EU<sup>384</sup>.

In this light, the EU, instead of viewing market liberalization as panacea -a fact which certainly adds fuel to the fire-, it could employ other, smarter strategies that would forge deeper ties with Russia, also resulting to the amelioration of the natural gas relations. For example, in chapter 3 has been analyzed the “Dutch disease” and the measures (mainly diversification) via which an economy may be ‘healed’. The erstwhile Russian President Dmitry Medvedev focused on reforms that could transform the Russian economy from a “natural resources” one to another of overall increased competitiveness<sup>385</sup>. For this to occur, however, it would be, *inter alia*, required foreign direct investments, technological expertise, etc. The EU is leading the way in these areas. Thus, why not the EU prioritize this type of cooperation, the deepening of which would also drift the natural gas relations?

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<sup>382</sup> The German government’s roadmap stipulated for the phase out of nuclear power plants by 2022 (Cala, 2011)

<sup>383</sup> For more on the issue see also: (Kommersant, 2012; Liutova et al., 2012)

<sup>384</sup> The same case also holds for China.

<sup>385</sup> For a detailed account see Chapter 3.

#### ***7.4 Further research***

From the lines above also derive the limits of the current research as well as some guidelines for further research. In the first chapter, we made reference to Mackinder's theory of 'Heartland'. Although today this theory is widely considered obsolete, still there are some points that have lost neither their explanatory validity nor their relevance to contemporary world affairs. In particular, it is stated that "The actual balance of political power at any given time is the product, on the one hand, of geographical conditions, both economic and strategic, and, on the other hand, of the relative number, virility, equipment and organization of the competing peoples" (Mackinder, 1904, p. 437). In the present research effort, we focused primarily on energy affairs as the 'vehicle' for Russia's resuscitation in the world affairs. We also acknowledged that our analysis principally adopts a geoeconomic perspective which is also interlinked with geopolitics. This is not to say, however, that the latter are of lesser importance to the former. Quite the opposite. But respecting Putin's emphasis in his doctoral thesis on natural resources for Russia's restoration in the international affairs, we stayed in the same path with only parallels drawing to geopolitics<sup>386</sup>.

But as noted in Chapter 1 and corroborated by Mackinder's aforementioned excerpt, there are much more for a political power to become a rather strong entity. Pointing to this direction, the erstwhile President Medvedev called for reforms in the areas of education, sci-tech (telecommunications, digital models), research and development (R&D), pharmaceuticals, etc. The EU has the capacity to provide Russia with the technological 'know-how' and the necessary foreign direct investments in order to improve the "equipment and organization" of its people (Mackinder, 1904, p. 437). Certainly, a rapprochement of this type could also have positive 'side-effects' in their strained natural gas relations as late as the fall 2012, especially in light of a 'post-Fukushima' era where natural gas is anticipated to hold a larger role in the EU energy mix, as this signaled by the 2011 decision of "turning away" from nuclear power.

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<sup>386</sup> Vladimir Putin obtained his Ph.D on "The Strategic Planning of Regional Resources under the formation of Market Relations" from the St. Petersburg Mining Institute (Mehdi, 2012). In his thesis, Putin argued in favor of creating national energy champions as a vehicle of economic success (Mehdi, 2012).

All these issues exceed the present research scope and could easily be addressed by other research efforts. The dynamics in Eurasia become rather motivating. Will Russia manage to dominate this region in economic, strategic and human resources terms? What will be the repercussions on its international standing and great power ambitions? What is the position that the other two powerful and important players of the triangle are expected to hold? To what extent economics (as presently analyzed in the form of energy politics) may sideline politics in the IR field?

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