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# Energy Security

Is Russia a secure source of energy for the EU?

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# Abstract

There has been considerable scepticism in Europe over the reliability of Russia as a secure source of energy for the EU. Despite Russia and EU being economically interdependent with regard to energy and other trade, there is still concern over potential supply disruptions. What can be gathered from media and scholarly sources is that Russia is potentially an unreliable supplier yet it is currently the only alternative for the EU, for especially natural gas. Russia may not be a secure source of energy, however it is important to keep in mind that most concerns have arisen from Russian behaviour in what it deems the 'near abroad'. European relations with Russia are not comparable to those between Moscow and the CIS. The true danger in relying on Russia for energy security stems from the impending investment crisis in the energy industry. This is to a large extent related to the excessive state control of the energy sector. At the risk of engendering ill will in Russian-European affairs, it is important for the EU to try and diversify away from Russian energy supplies. That said, energy fuelled Russian power games aimed at the Union seem to be fairly unlikely for the time being.

*Key words:* energy security, interdependence, energy resources, Russia, European Union

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# 1 Introduction

Energy security has been a contentious issue for decades as a result of a tumultuous relationship between producers and consumers of energy. Energy is a commodity that the modern world is unable to do without, therefore an increasing number of countries are becoming ever more dependent upon energy producers. However, one must keep in mind there are two sides to a coin, and producers are as dependent on the security of demand as consumers are on the security of supply. For many producer countries, energy sales represent the lion's share of export income.

A general definition of energy security is the availability of sufficient supplies at affordable prices, yet for different countries it means different things. For energy-exporting countries it is a focus on maintaining security of demand, for Russia it is the aim to reassert state control over strategic resources and gain primacy over main pipelines and market channels, yet for Europe the debate centres on how to manage dependence upon imported natural gas<sup>1</sup>. To address the issue of energy security between EU and Russia, it is important to balance and analyse the two contrasting viewpoints.

This paper aims to shed some light upon the issue of energy security between Russia and the EU. Russia is the biggest energy producer on the European continent. Russia should be the natural and primary source of energy for the EU, and as it stands, it is playing an increasing role in supplying the union with much needed energy supplies. In future the amount of energy consumed, and thereby also volumes of purchased energy is predicted to rise significantly. Moreover, Russia looks poised to enhance its share of the EU's total energy imports. However, there are certain question marks that have to be addressed within this relationship to try and determine whether Russia is a secure source.

Firstly, this paper will be taking into consideration certain theoretical aspects of interdependence to underline the true economic nature of the energy relationship. The EU and Russia are dependent upon each other for respectively a secure source of supply and demand. However this mutual dependence is not sufficient to determine the energy relationship secure, as interdependence is possible in a milieu of political volatility. There are certain extant political conditions that are present in Russia, and in other producer countries that threaten energy security, such

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<sup>1</sup> Yergin, Daniel, 2006. "Ensuring Energy Security" *Foreign Affairs* vol. 85 issue 2 p.70

as lack of transparency and democracy. However, despite the presence of such problems, the EU and Russia are highly dependent upon each other for trade, especially in the field of energy. This is particularly true for Eastern Europe, which brings to forefront the concluding discussion for this section where some of the possibilities for lowering dependence will be highlighted. Some of the main questions addressed in this section are as follows; to what extent is trade mutually dependent? How sensitive and vulnerable is interdependence? And how can the EU lower dependence upon Russia?

In the second section there will be a discussion underlining some of the problems with which the Russia-EU energy trade relationship is faced. This is an important conduit through which to analyse the state of affairs, as these problems contribute to insecurity in the energy relationship. The main issues that will be considered in the area are problems that Russia may face with future energy supply and questions of trust between the EU and Russia. This is especially important with regard to the fact that member states do not act unanimously toward Russia, but have rather built bilateral ties which are more secure between some members than others. This is highly problematic for inter-EU relations, as it leads to a fractured consensus regarding potential responses to Russian pressures backed by energy power.

The third section aims to outline the risks that Russia would be taking if it decided to 'misbehave' toward the EU with the energy supply, such as intentional energy supply disruptions as was seen in Ukraine January 2006. This analysis will be taking into account both the political as well as the economic considerations. In some respect the economic, in this instance largely technical arguments, will bear potentially greater weight as there is and has been an understanding that no matter the politics, in most cases regarding energy, "as long as there is money, it will continue to change hands, and energy will continue to move across borders"<sup>2</sup>. It is important to establish why it is unviable for Russia to turn toward emerging Asian energy markets, at the same time as asking what opportunities might Russia take to undermine European energy security?

The final section is designed to briefly analyse the role of the Kremlin in the question of energy security, with special emphasis on who sets the agenda. What role has the change in leadership from Yeltsin to Putin played? This appears to play a rather large role when judging the shape of the energy industry under the two leaders. Here the dominant issues are the contemporary investment climate as well as the domestic situation with regard to social well being.

From a methodological perspective, research for this topic has been conducted largely on journal and article basis, as well as original interview and energy information sources. The author has aimed to have

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<sup>2</sup> Interview with Aigar Ojaots

put forward an objective analysis of the energy security issues between EU and Russia, while creating plausible scenarios to determine how secure of a source of energy Russia is.

## 2 An Interdependent Relationship?

Interdependence is an incredibly important aspect of modern day politics as a result of the fundamental changes that have taken place in the world over the past century. The first half was characterised by a strong emphasis on ‘national security’ politics, however as the century began drawing to its close, innate changes had transpired. The 1980s and 1990s saw transformations and developments that were to change world politics for good, such as the colossal growth of the banking sector, the development of communication technology such as internet, and the end of the Cold War, to mention a few.

As a result of the above-mentioned developments, states became increasingly dependent upon one another. Another important factor that further increased this effect was the growing energy dependence in industrialised countries that occurred alongside technological applications becoming an ever more important part of general public consumption. The subsequent effect has been the gradual evolution of less developed countries which have now become increasingly large energy consumers, such as China and India. In general terms these processes have led to exponential growth in worldwide energy demand in the world, where even the most advanced and powerful states become dependent upon producer countries, as the most developed countries happen to have supplies incapable of meeting their voracious demands.

In order to conduct a deeper discussion on the topic of interdependence, it must initially be defined. Interdependence is mutual dependence resulting from international transactions; flows of money, goods, people and messages across international boundaries<sup>3</sup>. Interdependence applies to situations where countries are engaged in trade of essential goods rather than luxury goods. For instance, fur importing countries are not as dependent on a continual supply of fur as are oil importing countries on the constant flow of oil. When there are reciprocal costly effects of transactions, there is interdependence. However, in cases where interactions do not have significant costly effects, there is simply interconnectedness. We have to also keep in mind that interdependence does not only apply to mutual benefit, but also situations such as the strategic interdependence between the former Soviet Union and the USA.

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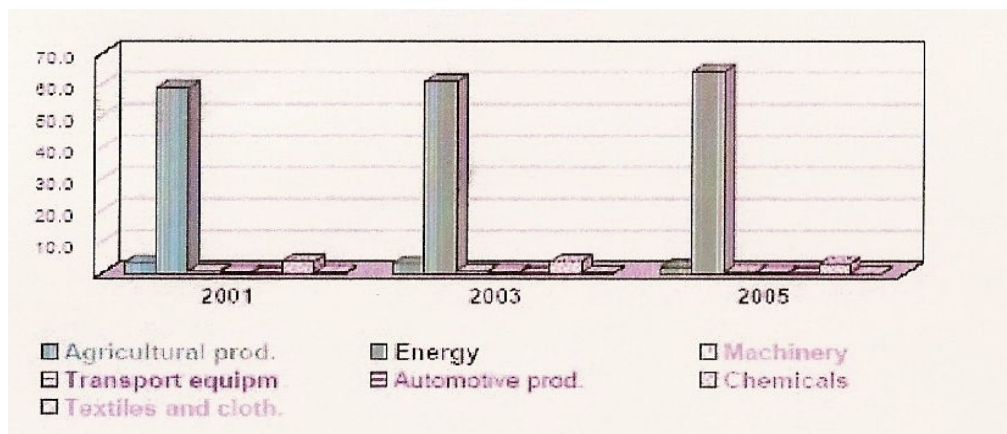
<sup>3</sup> Keohane, Robert O.; Nye, Joseph S., 2001. *Power and Interdependence*. 3rd Edition. New York: Longman.p. 7

Two more aspects need to be taken into account when analysing the theoretical base for interdependence. These are sensitivity of interdependence and vulnerability. The former applies to the degree of responsiveness within a policy framework, meaning; ‘how quickly do changes in one country bring costly changes in another, and how great are the costly effects?’<sup>4</sup> Vulnerability rests upon the relative availability and costliness of alternatives that various actors face. “In terms of cost of dependence, sensitivity means liability to costly effects imposed from outside before policies are altered to try to change the situation. Vulnerability can be defined as an actor’s liability to suffer costs imposed by external events after policies are altered”.<sup>5</sup>

## 2.1 EU-Russia vulnerability and sensitivity

Having defined the basic assumptions behind interdependence, it is important to establish how sensitive and vulnerable the EU and Russia are in their trade relationship. When looking at trade figures, from Russia’s point of view the EU is its biggest trade partner, bringing in highest revenues. Statistics elucidate that EU import patterns from Russia are dominated by energy imports. Statistically speaking, between 2001 and 2005 energy imports covered by far the largest share of imports from Russia to the EU. This can be seen in figure 1<sup>6</sup> below.

**Figure 1 : Russian export pattern to EU**



<sup>4</sup> Keohane, Robert O.; Nye, Joseph S., 2001. *Power and Interdependence*. 3rd Edition. New York: Longman.p.10

<sup>5</sup> *ibid* p.11

<sup>6</sup> Larsson, Robert L., 2006. “Energisäkerhet: Sveriges och Europas beroende av importerade energibärare” *FOI Swedish Defense Research Agency*, FOI-R-2092—SE, Underlagsrapport, November 2006, p.56



When looking at total imports of gas to the EU, then Russia provides 50 percent, which can be seen below in figure 2<sup>7</sup>.

Figure 2 EU gas suppliers	
Country	% of total imports
Russia	50
Algeria	23
Norway	22
Other	5

Source : EU figures in Energimyndigheten (2006), *Europas naturgasberoende: åtgärder för tryggad naturgasförsörjning* (Eskilstuna: Energimyndigheten), p. 21.

Finally, trade with Russia is growing significantly from all aspects, and most importantly the EU is Russia's main trading partner, accounting for 52% of Russia's overall trade<sup>8</sup>.

What can be gathered from this information is the fact that firstly, energy trade is the main export from Russia to the EU, which in terms of only gas adds up to 50% of the bloc's total imports. Secondly, Russia is dependent upon the EU for 52% of its overall trade, which would indicate concentrated dependence upon one market. What can be concluded from this in terms of sensitivity and vulnerability of interdependence is the fact that both the EU, in terms of energy imports, and Russia are quite sensitive when judging the import patterns. This implies that if there were sudden disruptions in energy supply, there would be considerable costly effects on the European market. For Russia, disruption in trade from the EU would likewise result in considerable costly effects, which would not be in Russia's interests. This is an indication that there is considerable sensitivity in interdependence between the two. When judging vulnerability, then one can assume that the EU would encounter considerable costs when attempting to handle the supply disruptions, as there are few alternatives to be relied upon for such a substantial energy contribution.

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<sup>7</sup> Larsson, Robert L., 2006. "Energisäkerhet: Sveriges och Europas beroende av importerade energibärare" *FOI Swedish Defense Research Agency*, FOI-R-2092—SE, Underlagsrapport, November 2006 p.19

<sup>8</sup> [http://ec.europa.eu/trade/issues/bilateral/countries/russia/index\\_en.htm](http://ec.europa.eu/trade/issues/bilateral/countries/russia/index_en.htm)

From a theoretical perspective there are several factors that can be seen as symptoms of vulnerability; a scarcity of domestic resources, lack of known substitutes, few producers, a sole supplier, few foreign suppliers, foreign resources situated far away, hostile ideologies at foreign supplier countries, low potential for recycling, and foreign trade limitations<sup>9</sup>. When looking at the abovementioned factors, many characterise the EU's energy situation. There are indeed few large producers, exacerbated by the fact that nearly all of them happen to be ruled by unstable governments. Russia is situated closer than other suppliers, there is a lack of domestic resources and there is indeed a lack of possibility of recycling energy as well as a lack of alternative sources of energy. However, the possibility of increasing nuclear power's share in energy supplies has been mooted, as Russia is seen as unreliable in face of growing European demand.

The EU would suffer mostly in terms of gas imports as gas is currently sourced through pipelines, which implies that gas needs to be transported from a somewhat nearby country. However, this problem could be solved in future with the development of and wider use of Liquid Natural Gas (LNG) which can be transported by sea. This technology will however take time and significant funds to develop.

The problem of energy dependence is particularly relevant to Eastern Europe, which imports most of its energy from Russia. The Baltic states are highly dependent as is Poland, and this dependence has also proven to be rather problematic, as Russia has been known to pressure the countries using the threat of supply disruptions. For example, in 2005 Russia announced to Kazakhstan that it would not be permitted to supply oil through Russian pipelines to Lithuania's Mazeikai Refinery as a result of Russian attempts to stop the sale of the refinery to foreign companies<sup>10</sup>. These exercises of power are a cause for concern for the future as the rest of Europe becomes increasingly dependent. One will begin to question whether Russia will be equally ruthless toward old members as they are to new, or whether this situation is a result of lingering post-Soviet tensions with Eastern Europe?

From a Russian point of view, it is hard to tell based upon these figures how vulnerable it is. As the EU exports such a wide variety of goods; machinery, manufactured goods, chemicals, transport equipment and food and live animals<sup>11</sup>, it is difficult to say to where and in what time span Russia would be able to shift its imports. However, one can assume that it would take considerable time, as EU imports make up such a

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<sup>9</sup> Larsson, Robert L., 2006. "Energisäkerhet: Sveriges och Europas beroende av importerade energibärare" *FOI Swedish Defense Research Agency*, FOI-R-2092—SE, Underlagsrapport, November 2006 p. 14

<sup>10</sup> Smith, Kerr C., 2006. "Security Implications of Russian Energy Policies" *CEPS Policy Brief* no.90 January 2006 p. 2

<sup>11</sup> [http://ec.europa.eu/trade/issues/bilateral/countries/russia/index\\_en.htm](http://ec.europa.eu/trade/issues/bilateral/countries/russia/index_en.htm)

substantial percentage of total imports as to imply that Russia is also vulnerable. It is possible to continue to discuss which of the partners has a comparative advantage, however this author has not deemed it necessary to further develop this point.

To draw this subsection to a close, it is important to mention one final point. Imports of Russian energy are predicted to grow significantly in the future due to a number of factors. Firstly, consumption of energy within the EU is predicted to rise, despite the fact that industry is continually being made more energy efficient, and there is continual research conducted to develop alternative energy sources. Secondly, imports of natural gas are predicted to grow in future in Europe, especially with the start-up of the anticipated NordStream pipeline which is to be built between Russia and Germany. This pipeline would push Germany's gas dependence on Russia to over 50%<sup>12</sup>.

The EU has been very closely monitoring the situation around the Caspian Sea, and the disputes over who owns what parts of it, in order to guarantee its own energy security. Statistically speaking, EU's energy import dependence on Russia is projected to grow to 68% by 2030. This is a cause for concern for the EU due to Russian instability, especially with regard to recent riots in Estonia where Russia is rumoured to have rerouted 85%<sup>13</sup> of transit through other countries due to the move of the Bronze soldier. This most certainly raises questions of energy security to the EU if disputes were to arise, and could provide impetus for the EU to attempt to diversify suppliers and to keep a close eye on the Caspian Sea, under which lies a considerable energy source.

## 2.2 Energy security threats and the need to lower dependence

In the above section the criteria for vulnerability were mentioned, and they are synonymous with threats to energy security. To quickly remention them; a scarcity of domestic resources, lack of known substitutes, few producers, a sole supplier, few foreign suppliers, foreign resources situated far away, hostile ideologies at foreign supplier countries, low potential for recycling, and foreign trade limitations<sup>14</sup>.

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<sup>12</sup> Anonymous, 2006. "EU eyes Caspian for security" *Petroleum Economist* May 2006 p.1

<sup>13</sup> Interview with Aigar Ojaots

<sup>14</sup> Larsson, Robert L., 2006. "Energisäkerhet: Sveriges och Europas beroende av importerade energibärare" *FOI Swedish Defense Research Agency*, FOI-R-2092—SE, Underlagsrapport, November 2006 p. 14

These are the theoretical criteria, and incidentally Russia happens to fulfil a large number of them. There is a limited availability for alternative reliable suppliers. The current situation in the world is that most large energy suppliers are ruled by unstable governments, and Russia happens to be one of the large suppliers deemed to be one of the less dangerous ones. Russia is also not a member of OPEC which makes it an attractive alternative to many other suppliers.

However despite the fact that Russia is considered one of the less dangerous suppliers, it is still a problem for the EU to continue to depend upon Russia to such a large extent, and in future to do so significantly more. Ideally, the EU should lower its dependence upon Russia in order to try and guarantee its energy security. The more diversified the supply is, the safer in energy terms. From a theoretical point of view, there are a number of methods which would help lower dependence; substitution, use of alternative sources, developing their own resources, new projects for exploration of resources, recycling, storage, newly designed products, changes in environmental restrictions, investment and tax incentives, special trade agreements and military means<sup>15</sup>. When looking at the criteria, there are several that are relevant to the EU. Firstly, it is not feasible for the EU to find alternative suppliers, especially for gas, as they are either too far away or highly unstable. With regard to the different tax incentives, there is not a lack of investment within the EU, the main problem is the fact that there is an inherent lack subsoil energy resources on EU territory. There are some resources in the Netherlands, Italy, the UK (the Atlantic), but the problem is that none of these are substantial enough to fill the energy demand in the EU. The EU is forced to import a total of 80% of oil supplies, due to a domestic lack of resources<sup>16</sup>.

Recycling and storage are not useful options either as fossil fuels do not present any significant recycling possibilities, and storage is not a viable option due to the quantities that have to be stored in order to make it feasible. Finally, when looking at alternative energy sources, it is not currently possible to substitute fossil fuels for alternatives. Nuclear power is currently the only option, however it is not popular due to the toxic by-product. However, there have been suggestions that nuclear power may become an increasingly popular option to the extensive and increasing dependence on Russia.

What would be a viable policy for the EU to pursue in order to secure energy supply is to promote an increased interest in the 'neighbourhood', or as Russia calls it, the 'near abroad'. It would be strongly in European interests to encourage stability and increased involvement with these countries in order to potentially access alternative

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<sup>15</sup> *ibid* p. 59

<sup>16</sup> Johnson, Debra, 2005. "EU-Russian Energy Links: A Marriage of Convenience?" *Government and Opposition* vol.40 issue 2 p.264.

sources of energy to Russia. However the problem is that countries such as Kazakhstan are landlocked, with virtually all oil exports travelling through Russia. If the EU was able to develop closer political and economic ties with the 'neighbourhood', then possibly it could also develop transport logistics of energy to the EU. As a response to such policies "Russia could react neurotically to EU meddling in what it sees as its backyard"<sup>17</sup>. In the face of an ever stronger Russia, with political ties between itself and EU on thin ice, especially with the 2006 October EU-Russia summit ending under less than desirable conditions, there is a need to try and diversify away from so much dependence from such an unstable country.

When drawing this section to a close, it is important to mention a couple of concluding points. What can be established at this point is the fact that Russia and the EU are most certainly highly dependent upon each other and that there would undoubtedly be costly effects in the domestic market in the short term if trade was stopped. There would most likely be costly effects upon policy change as well, which implies high levels of vulnerability and not just sensitivity of interdependence. However, one must keep in mind the fact that Russia is a relatively unstable country and has been previously known to try and influence its neighbours with energy politics, which has been increasingly seen in Eastern Europe. This has brought forward the need for the EU to try and diversify away from this increasing dependence on Russia. As it stands, there are at this point few alternatives to trying to develop closer relations with the 'neighbourhood', as other sources are geographically too distant, and the territories belonging to the EU happen to have extraordinarily scant natural fossil fuel resources in order to try and meet its own demand.

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<sup>17</sup> Anonymous, 2006. "Europe, Russia and in-between; Charlemagne" *Petroleum Economist* p.58

### 3 Trouble in Paradise?

The Russia EU trade as well as political relationship has hardly been a smooth affiliation, especially concerning politics. Since the Second World War, there have been significant problems in terms of diplomacy as well as trade disputes. This troubled relationship has to a large extent included Eastern Europe, from the Cold War days of western criticism of human rights violations, to modern day EU and NATO enlargement. On the other hand, despite this Russia is an important trading partner, as was established in the previous chapter. Russia is also known to have close ties with certain member states such as Germany, especially in the aftermath of the Iraq war, and less so with countries like Estonia and Latvia. Many existing problems in the Russia-EU relationship will be touched upon in this chapter. They can be seen as factors contributing to diminished energy security in both the present and the future. A number of questions will be addressed in this section; How much can Russia produce in the future? How reliable is Russia? How does Russia conduct itself toward the EU? How do these problems affect EU energy security?

The first issue that needs to be considered is the security aspect; assessing Russia's ability to supply energy in the future. Russia is known to be extracting oil from its producing oil fields at an astonishing speed, which has resulted in reserves depletion and encountering such poor conditions due to over-exploration that it becomes impossible to continue extracting. Russia has approximately 6% of world oil resources, compared to Saudi Arabia's 22%, yet Russia was in 2005 the second largest oil producer in the world<sup>18</sup>. In 2003 Russia produced 11% of the world's crude oil<sup>19</sup>. This implies serious over-consumption of oil, and as a result Russian oil reserves are predicted to last 21.4 years if extraction continues at its current rate<sup>20</sup>. On the other hand, these predictions need to be taken lightly as it is in reality highly unlikely that Russia will run out of fossil fuel resources, as new fields are constantly explored. Most

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<sup>18</sup> Larsson, Robert L., 2006. "Energisäkerhet: Sveriges och Europas beroende av importerade energibärare" *FOI Swedish Defense Research Agency*, FOI-R-2092—SE, Underlagsrapport, November 2006 p.38

<sup>19</sup> Johnson, Debra, 2005. "EU-Russian Energy Links: A Marriage of Convenience?" *Government and Opposition* vol.40 issue 2 p. 267

<sup>20</sup> Juurikkala, Tuuli; Ollus, Simon-Erik, 2006. "Russian Energy Sector- prospects and implications for Russian growth, economic policy and energy supply" *Bank of Finland, BOFIT Online*, no.4 p.5

importantly, very large parts of northern Russia remain currently unexplored, and there are likely to be gargantuan oil and gas resources in this area. There have been time and again doomsday predictions of future oil supplies, this anxiety has been present since the 1880's. The fact is that "global output has actually increased by 60 percent since the 1970's, the last time the world was supposedly running out of oil"<sup>21</sup>. With regard to gas, Russia has 26.6% of world gas reserves at present, and this number is predicted to grow<sup>22</sup>.

The above argument has been widely discussed, and has been known to cause serious concern with regard to secure future supply from Russia. However, at this moment this concern does not seem highly valid. It is unlikely that energy producers, especially Russia, will end up running out of resources as there is so much unexplored ground. However, from a different aspect there is serious justified concern that Russia will be unable to fill demand of energy in future due to several reasons. The first of these is the fact that Russia has an incredibly energy intensive industry, and large sections of it are situated in the northern territories of Russia. The second issue that interrelates is that on top of this very energy intensive industry, the domestic oil prices are highly subsidised. They fail to reflect supply and demand relations, which has resulted in a considerable loss of potential revenue for the state, as well as hindering development<sup>23</sup>. As a result Russia consumes large percentages of its own energy, and to be able to meet external demand it buys energy from the 'near abroad' and sells it at prevailing market prices. However, despite the 'near abroad', problematically enough Russia will most probably be unable to fill demand if it does not make domestic industry more efficient and liberalise domestic prices. Figure 3<sup>24</sup> serves to highlight the potential shortages of supply that the Russian gas exports may face.

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<sup>21</sup> Yergin, Daniel, 2006. "Ensuring Energy Security" *Foreign Affairs* vol. 85 issue 2 p.71

<sup>22</sup> Juurikkala, Tuuli; Ollus, Simon-Erik, 2006. "Russian Energy Sector- prospects and implications for Russian growth, economic policy and energy supply" *Bank of Finland, BOFIT Online*, no.4 p.6

<sup>23</sup> Johnson, Debra, 2005. "EU-Russian Energy Links: A Marriage of Convenience?" *Government and Opposition* vol.40 issue 2 p.259

<sup>24</sup> Milov, Vladimir, 2005. "Russian energy sector and its international implication" *Institute of Energy Policy*, Discussion Paper p. 12

**Figure 3***Russia's projected gas balance as for 2010*

	2004	2010
<b>Gazprom gas production</b> (optimistic case, without introduction of Yamal gas fields)	545	550
Gas exports by Gazprom (Europe, Turkey, CIS, not including Asian exports)	191	312 (incl. 200 Europe and Turkey, 112 CIS)
Gas produced by Gazprom and available for domestic supplies	354	268
Domestic gas demand in Russia <sup>3</sup>	423	545
<b>Deficit</b>	<b>69</b>	<b>307</b>
Supplies of Turkmen gas (optimistic)		70
Supplies of Kazakh gas		15
Current volume of gas production by Russian independent gas producers		90
<b>Total deficit</b>		<b>132</b>

*Source: Gazprom, BP, Lukoil, Oxford Institute for Energy Studies, Institute of Energy Policy*

The graph displays a fall in domestic supplies from 2004 to 2010, and this is very unlikely to be caused by a true shortage of reserves, but rather by over-exploration of oil wells and most importantly by a lack of investment into the industry. There is a desperate need for investment into the Russian oil and gas industry in order to maximise efficiency. Between 2001 and 2030 the Russian gas industry will require a total investment of \$330 billion and the oil sector will require \$328 billion<sup>25</sup>. The state cannot afford this, the industry cannot re-inject money into investments and the state has significantly restricted foreign investment. This is a serious problem for the EU, as the future production possibility of the Russian energy industry is of crucial importance to energy security, as earlier established, there are few alternative producers. There are numerous foreign companies willing in to invest substantially in Russia, yet the state is reluctant to permit this. This problem will be discussed in further detail in Chapter 4.

### 3.1 Distrust

As mentioned at the start of this chapter, there are several problems in the EU-Russia relationship, one of which is a lack of trust. There have been a number of events which have been a cause for concern for the EU, when it has had to rely on Russia for energy security. Using energy as a weapon

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<sup>25</sup> Bahgat, Gawda G., 2005. "EU seeks energy security in stronger supplier ties" *Oil & Gas Journal* vol. 103 nr. 38 p.23



is one of the foremost reasons for the EU to be apprehensive. This is most certainly not a new concept; however it has become increasingly evident over the years that Russia is not reluctant to use energy as a means of influence, given the opportunity. This became painfully clear to the European Union on January 1<sup>st</sup> 2006 when Russia cut gas supplies to the Ukraine. However, as was mentioned in the previous section, Russia has been using energy as a weapon against the eastern member states for years, yet Brussels has been reluctant to comment upon the events. The events on January 1<sup>st</sup> 2006 left Brussels with no choice but to make their opinion heard.

The gas flow disruption to Ukraine opened up the long feared possibility that Moscow might do the same to the EU, however there are some very important points to take into account in this instance. It has been showcased in the press that this act by Russia was a random exercise of power, however in fact it is very hard to argue that this is a real danger to the EU currently as the circumstances are very different. In 2005 Ukraine paid \$50 per 1000 cubic meters of Russian gas compared to the \$240 the EU pays<sup>26</sup>. Belarus, to which Russia switched off the gas supply in 2004 February and January of this year, has been known for being notoriously late in paying for the significantly below market gas price. What can be gathered is the grim reality that Russia will continue to exercise its energy power if it afforded the opportunity. Moreover, the current situation is ideal, as these countries are highly dependent on inexpensive energy and at the same time owe a considerable amount in debt to Russia. What can be concluded is that in terms of this incident being a possible premonition of the EU-Russia energy relationship, there is a “need for planning and a certain amount of grim realism, but not for outright panic”<sup>27</sup>. The reality is that Russia has a great potential to be an unreliable partner, however, the kind of situation typified in CIS is very difficult to replicate as the EU pays market prices and does not owe Russia sky-high debts. It bears mention that Ukraine was also known to be siphoning off some significant amounts of gas to itself, therefore, in combination with the abovementioned factors, a serious reaction could be anticipated from Russia. Furthermore, Ukraine’s flirtation with NATO as well as EU, and their anti-Russian government failed to do any favours for the relationship.

Having now established that it is possible that the panic following the gas cuts in Ukraine was exaggerated, it is still important to keep it in mind as a valid risk. This becomes even more relevant as Germany continues to push forward the NordStream project - the anticipated gas pipeline traversing the Baltic sea from Russia to Germany. This ties

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<sup>26</sup> Anonymous, 2006. “Nervous energy – Energy Security” (Special Report) *The Economist* 7 January 2006 vol.378 issue 8459 p.2

<sup>27</sup> *ibid* p.2

Germany and Russia economically and politically, and as many fear, it may also lead to Russian gas export monopoly Gazprom finding its way into the board rooms of German oil companies. The trepidation stems from the fact that Gazprom could potentially acquire a large enough share in German oil companies to be able to for example veto shipments to Poland. However, it is not very fruitful at this point to predict the future, but rather to give an idea of the concerns that are taking shape within Europe.

This pipeline is also an area of concern for the Nordic countries in addition to the Baltics. Sweden and Finland fear environmental damage as well as loss of potential revenue, and the Baltic States fear a loss of revenue from energy transit. However, Estonia, Latvia and Lithuania's alarm seems unjustified at present. Just because a gas pipeline is being built to Germany does not necessarily imply that the current pipelines running through the Baltics will be switched off. As stated in the beginning of the paper, the general rule tends to be that if there is money then trade will continue to take place. With the new pipeline Russia could sell even more. However, what should concern the Baltics more at this point is that energy ties may very well be cut for other reasons, such as the redirection of most of Estonian transit oil as a result of the recent removal of the Bronze soldier in Tallinn.

The true problem that is brought forth within the discussion of NordStream and Russian use of energy as a weapon is that the EU does not act as a unified entity, but tends to rather have bilateral ties with member states. NordStream is in fact a very good example of member states, in this instance Germany, acting unilaterally. This situation has been seen time and again when Russia has bullied eastern member states with energy, and only a stony silence has echoed from Brussels. The end result of a non united energy policy toward Russia is not positive for the EU, as this only makes Russia stronger. The EU, being gravely concerned for future energy policy, would certainly gain by standing as a united actor against Russia.

The natural question that follows this line of argument is whether the EU needs a united energy policy in order to avoid the problem of battling Russian energy pressures. This situation has caused frictions within the EU as well, as certain eastern member states feel pressured and no response is obtained from Brussels. This has been a trend that has been noticed for some time, and needless to say, it is not beneficial for EU unity and further integration to be pushed apart by relations with the bigger neighbour.

When looking at the prospect of a common energy policy, it would most certainly be helpful for the EU to stand on a united front. However, there are several problems with this prospect. For one thing, the member states are still rather independent of the EU with regard to non economic questions. To have a common energy policy, there would have

to be some form of common foreign policy, which at this point seems very difficult to attain.

For another, having established EU's Achilles' heel as its non-united stance and Russia's affinity for using energy as a weapon towards Eastern Europe and the 'neighbourhood', there does not seem to be a reason for the EU to be too gravely concerned. It is highly unlikely that the EU will be affected in the manner that Ukraine or Belarus were. Russia is unlikely to switch of energy supplies to the EU, however, the EU will still be affected if the 'neighbourhood' is affected. If supplies are cut to Ukraine, the EU will be adversely affected as there will be a delivery shortage during the affected period. This is a reason for concern in energy security terms. If these sorts of power games by Russia continue, the EU should concern itself with securing supply, however, this kind of an action is not very likely at this point. On the other hand, it is difficult to predict, as recent events in Estonia showed that Russia was able to reroute 85% of transit within a day.

One final point needs to be highlighted in this context. Russia has not once during the last half century failed to deliver energy to Europe. Throughout the Cold War a reliable flow of supply came from the USSR, and later from Russia, to Europe. "Moscow has frequently pointed out, Russia has supplied Europe with gas without interruption for 40 years.. too little has been said about the part Ukraine played in the disagreement"<sup>28</sup>. Despite this fact, EU does still need to be concerned, as a third party, with the effects of supply cuts on transit states.

## 3.2 Russia as a neo-merchant

Over the last decades it has become increasingly clear that Russia is embracing a neo-mercantilism<sup>29</sup> of sorts. The world has changed significantly since the Soviet era, as has inevitably the situation of Russia. There is certainly a case to be made for a Russian super-power complex as a result of these rapid ground breaking changes that have occurred. Rather than being the second half of the bi-polar power struggle, Russia is currently a country with a reasonably poor economy and oodles of transition problems. This has led to a situation of xenophobia and sensitivity toward the rest of the world, especially the West. This can be

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<sup>28</sup> Anonymous, 2006. "A Perfect Match" *Petroleum Economist* July 2006 p. 2

<sup>29</sup> Larsson, Robert L., 2006. "Energisäkerhet: Sveriges och Europas beroende av importerade energibärare" *FOI Swedish Defense Research Agency*, FOI-R-2092—SE, Underlagsrapport, November 2006 p.57

very clearly seen in the Kremlin policies toward the energy sector, where foreign investors are being kept out of the loop of influence.

As a result of the abovementioned situation, the Russian view on energy security is very different to that of the West, where there has since the Coal and Steel Union existed a belief that security is an increasing interdependence upon each other. Russia on the other hand has adopted more of an attitude where it is happy to have other states increasingly dependent upon it, but would rather keep its own situation independent. This has been seen as the xenophobia of foreign investments, a fear of foreigners taking over natural resources in Russia, as involvements of this type would lead to diminished power for Russia. However, as has been discussed earlier, if no real investment is made into the energy industry, there is a real risk of an investment crisis.

This situation can turn out to be rather problematic in the long run for all parties concerned. Russia is being pressured politically and ideologically by the West, which is having an adverse effect on Russian-Western relations. This situation could be potentially very dangerous from an energy security perspective as this might lead to a situation where Russia will seek alternative buyers of energy. However, the two buyers of EU's calibre, China and India, are at this point not viable options for Russia. The second problem with pressuring Russia excessively is if the energy resources do start depleting to an alarming rate, with little hope for exploration of new fields. If this situation was to occur, there would be considerable competition for Russian resources, which may put the EU in an uncertain situation.

Before proceeding with a discussion of Russian risks, there is a need to mention some concluding points for this chapter. There are several problematic areas in the Russia-EU relationship which are a threat to energy security in the short and long term. Firstly, a discussion has been conducted on the sustainability of Russian energy resources in future. Pessimists claim there is only a finite amount of resources left, yet optimists claim that there is a large amount of unexplored resources. However, the immediate threat is still the impending investment crisis.

Secondly, there are considerable trust issues, which have been further advanced by situations such as the Ukraine gas cut in 2006. This problem has tended to spill over into intra-EU relations as well. And finally, what can be pinpointed as one of the main problems in the relationship is the view Russia has taken regarding energy security. Russia is acting like a neo-merchant, hoping to have states dependent upon its resources, yet it aims not to be dependent upon others. This is naturally neither realistic nor sustainable, and most of all has been a cause of concern for the EU.

## 4 What Does Russia Risk?

As has been shown in the above section, Russia has tendencies to make the EU occasionally uneasy about energy security in relation to reliance on Russia. There are several different aspects that have been a cause for concern for the EU, which have been discussed above, and some of which will be looked at further detail below. It is important in this discussion of whether Russia is a secure source of energy, to address the question; what would Russia risk if it was to ‘misbehave’ toward the EU? There are several factors, which will be discussed below, which speak for a situation where it would be highly unlikely that Russia would be prepared to stop energy supplies to the EU.

Firstly, one of the most important things to keep in mind yet again is the fact that the EU is Russia’s biggest trading partner. The concept of “old friends are the best”<sup>30</sup> seems to be upheld in this instance. The risk of meddling with a trade partner worth 52% of imports should be a risk too great to bear, along with the political implication of having broken ties with the EU.

Despite the occasional problematic relations the EU and Russia face, for Russia it is still important to keep close relations with certain EU member states. A prime example of this was the close relationship that was shaped in the build-up to the Iraq war with France and Germany. Germany is also an invaluable business partner for Russia with regard to the NordStream pipeline which is in planning stages currently, but will enable gas to flow directly to Germany, and will be a great source of income for Russia, without a middleman. This is a very important factor as Ukraine and other ‘near abroad’ countries are known to be siphoning off gas from the pipelines, and the Baltics and Central Eastern Europe take a substantial transit fee for handling the energy.

Secondly, good political relations with Europe, which result in good economic relations, is a beneficial situation for Moscow with regard to the United States as well. Relations between Washington and Moscow have been in a dire state for some time now. By having closer ties to the EU, Russia is able to firstly, better avoid unnecessary contact with Washington and its political pressures, as well as find solace behind EU when Washington is active. This situation has become increasingly true in

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<sup>30</sup> Milov, Vladimir, 2006. “Europe-China-India energy triangle: whither Russian energy future?” *Institute of Energy Policy* p.1

the past half decade as EU-US relations have deteriorated simultaneously with US-Russian relations. The Iraq war played a substantial role in this phenomenon, at the same time as splitting the EU states internally for and against the war.

From the economic cost point of view there is yet another argument to take into account. As earlier mentioned in this paper, energy is by far the biggest export commodity from Russia to the EU. If this was suddenly disrupted for some reason, the direct costs from the energy industry would be too large to bear for Russia. If energy supply was stopped, the oil industry would suffer unbelievable costs, as refineries would have to be shut down. Shutting down refineries for a short disruption would be incredibly expensive, and not only from the point of view of revenue loss from halted sales, but purely from cost of physically shutting down refineries. Nor would storing be a suitable option again due to cost. There is firstly, a lack of space to store the amounts of oil that are produced in a day. Secondly, it would be too expensive and impractical to try and build storage space in the event of a desired disruption. As far as oil is concerned, it would not be a worthy risk for Russia to disrupt supply for a short period of time. The only viable option would be to reroute supply, a problem which will be discussed in the following section.

With regard to gas, it is much easier to cut supply, by several methods, including exonerating a part of a pipeline. This would naturally also be rather costly, however less so than the abovementioned problems with dropping oil supply. Furthermore, with regard to cost of Russia cutting supply, there is one final point to take into account. Europe is an incredibly important market for Russia as it is the most profitable one, which pays strictly the highest prices per cubic metre of gas and per barrel of oil.

## 4.1 Alternative buyers?

Russia has been looking at the ‘Asian Tigers’<sup>31</sup> in order to diversify its energy sales. This would be highly beneficial for Russia as it would make it a global rather than a regional supplier, however it would imply the redirection of energy supplies from Europe.

The two largest and most realistic options would be to supply India and China, which are both emerging markets of a substantial scale. Secondly, they are within a reasonable distance as opposed to USA or the

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<sup>31</sup> Milov, Vladimir, 2006. “Europe-China-India energy triangle: whither Russian energy future?” *Institute of Energy Policy* p.1

like. When looking at these markets in more detail, a certain number of issues arise. Firstly, China is a gargantuan market, and developing at an incredible rate, which will imply a marked rise in energy demand. It is a market with unlimited potential as energy importer. This could be an ideal alternative for Russia, were it not for certain issues. Firstly, China prefers to develop its own energy production, however it lacks oil. This is a reason why to a large extent it has decided to focus on gas production, in order to be self-sufficient to the largest extent possible<sup>32</sup>. Secondly, the estimates of China's oil demand are currently misleading due to a highly uneven development among the regions within the country. It is very hard to at this point estimate what the real energy demand will be when comparing the development of Shanghai or Beijing to most of the country side. Finally, if Russia were to build a pipeline to its eastern border, in order to supply both China and Japan, the cost would be too large. There would be many thousands of miles of landmass to cover, and the climate is harsh in the eastern border, hence the sea mass would be frozen for parts of the year when the pipeline should be built. Simply put, at this point it is not economically viable for Russia to try to turn toward the East.

The Indian market, is also growing at an astonishing pace. It imports most of its oil from the Middle East, but has very little gas production in the domestic market, which would make it an appealing market with growth predicted to rise rapidly. The problem with this market on the other hand is in fact logistical. It is one of the hardest markets for Russia to access. Most importantly, India would most likely be willing to import gas, yet this would have to be transported by pipeline, due to lack of LNG facilities. The main problem is that Russia and India are separated by huge mountain ranges as well as unstable areas, such as Pakistan and Afghanistan. It would be unsafe for the pipeline to be built there as well as the technical problems of building a pipeline across the Himalayas among others. What can be concluded is that in fact India and China would hold very little appeal for Russia as it stands, and one cannot stress enough the fact that the European market is the most profitable to sell to.

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<sup>32</sup> Milov, Vladimir, 2006. "Europe-China-India energy triangle: whither Russian energy future?" *Institute of Energy Policy* p.1

## 4.2 Safeguards against supply disruptions

As has been established throughout the paper, there are certain reservations as to how reliable Russia is as an energy supplier. The EU has been conscious to try and identify certain safeguards to energy disruptions, however, these are not very successful, especially in the short term. When looking at the safeguards against short term supply disruptions, incentives such as desire to be reliable, political hindrance such as democracy, risk of losing revenue, need of constant revenue, need for outlet for energy, risk for badwill, dependence on the West, desire to take negative consequences and EU/NATO membership as protection<sup>33</sup>. When looking at these criteria, for short term supply disruptions, Russia will not be discouraged to stop supply in fear of the above consequences. In the short term, the need for an outlet, revenue loss, democratic pressures or dependence of the West are not effective. Russia will not be subjected to serious harm in this regard for short supply disruption. “The barriers (Russia’s need for export revenues, transit dependence and risks of destroyed reputation etc) against short and partial supply disruptions are weak”<sup>34</sup>. However, one has to keep in mind with regard to having an oil outlet, the supply disruption needs to be incredibly short, as was earlier established, oil is very expensive to store, even in the short term.

The democratic incentive is not relevant in the case of long or short disruptions as politically there are few democratic pressures and values to uphold in the face of society and the country. The only incentive for Russia in the long and short term to continue supply is the aspect of reliability. Russia has for years been trying to clarify its image and reputation, and a long or short term supply disruption would have catastrophic future consequences if Russia wants to keep its reputation of reliability. Nevertheless, this does not appear to be a very significant barrier for Russia at this point.

Following the above discussion, it is still impossible to determine how large the risk for future disruptions is at this point. It can be assumed that there could be a risk for future disruptions in the event of a serious break of relations. In any other event a disruption is highly unlikely. Secondly, in the event of a break of relations, a supply disruption is much more likely toward the Former Soviet Union (FSU) states rather than west European states. “Russia appears to see certain European states affordable

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<sup>33</sup> Larsson, Robert L., 2006. “Energisäkerhet: Sveriges och Europas beroende av importerade energibärare” *FOI Swedish Defense Research Agency*, FOI-R-2092—SE, Underlagsrapport, November 2006 p. 55

<sup>34</sup> Larsson, Robert L., 2006. ”Russia’s Energy Policy: Security Dimensions and Russia’s Reliability as an Energy Supplier” *FOI Swedish Defense Research Agency*, FOI-R-1939—SE, Scientific Report p.297



collateral damage”<sup>35</sup>. A clear example of this is the energy pressure put on Eastern Europe, and especially the recent events in Estonia. Furthermore, a disruption of supply to a group of states such as the EU is also improbable. This would involve too grave consequences both economically as well as politically. Nevertheless, it is clearly possible, following the events in Estonia, that energy supply may be rerouted.

What can be gathered as one of the fundamental problems with regard to Russia and its energy power, and European dependence upon it, is the fact that it will not play by the same rules as other states do. Russia has been known to ignore criticism and is unwilling to change its behaviour. “The core problem is the combination of Russia’s perception, intentions, capabilities and track record along with lack of real stability, a high degree of unpredictability and a development away from democracy, rule of law and market norms”<sup>36</sup>.

Before proceeding to the next section it is important to mention some concluding points. Russia has a considerable amount to lose if it chooses to cut supplies to the European Union, yet what has been established in this chapter is the fact that Russia has determined it can afford certain losses and might determine that some economic losses may be worth the political statement. With regard to risks, if Russia was to cut supply to the EU, it would upset its biggest trade partner, to which it exports most, and imports from most. Secondly, as it stands it is not economically viable for Russia to try and turn to alternative markets such as China or India due to logistical problems as well as profit maximisation. Finally, what has also been established is that the safeguards against short term supply disruptions from Russia are very low. What can be concluded from this information is the fact that the EU is a crucial trading partner for Russia, yet its dependence upon Russia makes Russia a powerful partner in the short term. There are naturally low incentives for Russia to enhance scepticism about its reliability as a trading partner, yet what is also evident is that there is little the EU could really do if a short disruption took place. However, as it stands it is highly unlikely that Russia would choose to cause a supply disruption to a group of countries such as the EU, but rather a possible disruption to one single state, which would most likely be an FSU state. This has been witnessed in Estonia recently, and has previously been witnessed among the East European states.

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<sup>35</sup> *ibid* p.296

<sup>36</sup> Larsson, Robert L., 2006. “Russia’s Energy Policy: Security Dimensions and Russia’s Reliability as an Energy Supplier” *FOI Swedish Defense Research Agency*, FOI-R-1939—SE, Scientific Report p.297

## 5 Who Sits in the Kremlin?

This final section is dedicated to addressing the question the role of the Kremlin, and who is the leader? What implications does this have on energy policy? This is particularly important in Russia, as during the past years the involvement of the state in the energy sector has caused significant uproar within and outside of Russia. The Russian president is a very powerful position which would insinuate that the leader might play a role in energy policies. A significant shift can be seen in energy policies when comparing the leadership periods of Putin and Yeltsin. Yeltsin was known for liberalism, and at times too much of it, where as Putin has taken hold of the energy sector, and processed many of the oligarchs who arose in the Yeltsin era. This section will be taking into account the adjustments that have taken place under Putin, such as xenophobia of foreign investment, hard line against oligarchs and increased roles of state owned Gazprom and Transneft. This section will question how the abovementioned adjustments will affect the EU and its energy supply.

### 5.1 Taming the Oligarchs

At the time Putin rose to power, Russia was in considerable disarray, with marked differences between rich and poor as well as wide spread lawlessness. This has been handled by Putin over his seven years in power by different means and it is questionable how successful his policies have been. The energy sector saw some large transformations at this time, especially with an increasing role of state owned Gazprom and Transneft, and bold tax claims being presented to the oligarchs. The most famous of these examples has naturally been the Yukos affair. The Russian state has tried to tame the oligarchs with arrests due to back taxes, however, most of the threatened ones left, with the exception of Khodarkovsky, who involved himself in politics, and remained in the country as a political statement. The Yukos affair has been a milestone not only because Khodarkovsky was imprisoned for a minimum of eight

years, with rumours of continuous harassment under detention, and Yukos bankrupted, but also because it changed the Russian energy industry<sup>37</sup>.

The Yukos assets were auctioned off, and Rosneft, the state-owned oil company, was the one to quickly buy it below market price. The result has been that the state sector has been gaining increasing energy resources, including Yukos' Yuganskazneft, one of the biggest oil fields. The result has been increasing state domination of the energy sector. "The Kremlin, not the private sector, has become the key decision maker in licensing oil fields, determining the location of pipelines, and approving consortia for production and transportation."<sup>38</sup> For the ones who were expecting Russia to continue to liberalise and develop, this may have been an unwelcome turn as it seemed to take a step backward rather than forward.

The EU is also affected by this type of environment in the Russian Federation. It is dangerous from a dependency perspective to rely on a market that is increasingly state controlled by non transparent forces. Secondly, an open market environment can on most occasions guarantee trade as long as there are finances. However, a sector that is this strongly controlled by the state is directly dangerous to the EU if there is a serious break in relations, which could result in supply disruptions.

Increased state control has also a negative impact on the investment climate. Events such as Khodorkovsky's arrest and numerous other oligarchs that were forced to leave the country to avoid arrest have an adverse effect on the investment climate. This is a less than wise move on behalf of the state, as has earlier been established; there is an increasing need for investment in the energy sector. However, the investment climate is plagued by other predicaments as well, but these will be discussed in more detail in the following section.

Finally, as the state has imbedded itself deeper into the energy industry there is also less transparency. The Russian state is not known for being democratic and transparent, and this transforms the energy industry into a closed sector. This is again very harmful for the investment climate.

## 5.2 Xenophobia of foreign investment

With the increased control of the energy sector there is a distinct xenophobia of foreign investment. This poses a conundrum of how the

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<sup>37</sup> Watkins, Eric, 2007. "Putin's oil grab" *Oil & Gas Journal* vol.105 nr. 1 p.30

<sup>38</sup> Cohen, Ariel, 2005. "Russian oil after Yukos: Implications for the United States" *The Heritage Foundation Executive Memorandum* nr. 961 p.1

energy sector upgrades and maintenance will be financed if investment is limited from abroad, and it has become painfully clear that within Russia there is a deficiency of funds for this purpose.

In February 2005, the Minister of Natural Resources stated foreign firms should not be allowed to bid for natural resource projects of any type, however this was retracted in April and more of the market was opened<sup>39</sup>. At the end of 2005, Gazprom shares were liberalised, however, the state maintained 51% ownership. Yet the Kremlin decided to exclude all foreign investors in October 2006 from the Shtokman natural gas project<sup>40</sup>. Despite the partial liberalisation of the market, there are still significant constraints on opportunities for foreign investors. As it stands, foreign companies are unable to own more than 50% minus one share in Russian energy companies<sup>41</sup>. There is also a preference of natural resource exploration licences being granted to state owned Gazprom and Rosneft rather than private or foreign companies. In the gas sector, Gazprom, which has a 90% gas sector monopoly, “limits upstream gas investments and third party access to its gas lines by independent gas producers and oil companies”<sup>42</sup>.

To date there has only been one successful Russian-Foreign merger in the energy sector which is the TNK-BP merger. This is not a desirable situation for the Russian state as it gives exclusive information on energy reserves to foreigners, which in fact means foreign access to state secrets. Successful mergers are rare for this exact reason, it is not desirable for the state to have foreign companies privy to such information. Foreign companies are also subject to very high taxation if they are able to enter into the Russian energy market.

There are numerous foreign companies that have lower shares in certain energy companies, and feel they have been cheated as they cannot gain control of the company despite significant investments. However, despite all of the obstacles and discontent, foreign investors are still keen, if given the opportunity, to break into the energy market in Russia as the possibility of profits are too high to leave unexplored.

The obvious problem that can be identified is the desperate need for investment in the energy sector, yet there are obstructions for foreign investors. As has been continuously highlighted in this paper, Russia needs substantial investments. This is a dangerous situation for the EU in terms of energy security, as declining infrastructure will result in

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<sup>39</sup> Larsson, Robert L., 2006. "Russia's Energy Policy: Security Dimensions and Russia's Reliability as an Energy Supplier" *FOI Swedish Defense Research Agency*, FOI-R-1939—SE, Scientific Report p.82

<sup>40</sup> Wallander, Celeste A., 2007. "Russian Transimperialism and its Implications" *The Washington Quarterly* vol 30 issue 2 p. 111

<sup>41</sup> [http://www.europarl.europa.eu/hearings/20070228/afet/milov\\_en.pdf](http://www.europarl.europa.eu/hearings/20070228/afet/milov_en.pdf)

<sup>42</sup> Leblond, Doris, 2006. "IEA presses for Russian natural gas sector reform" *Oil & Gas Journal* vol. 104 nr. 29 p. 32

declining output, which is a danger for future energy supply. This impending investment crisis is a serious concern for the EU as it continues to depend on Russian energy at an increasing rate.

Russian protectionism of its energy sector as well as increased state control of it will have wider implications for the Russian economy. This sort of control will affect growth of the Russian economy negatively as well as create inefficiency. It has been proven through history, particularly in the USSR, that a state controlled energy industry is highly inefficient. It is extremely harmful for Russia, as the only recorded successful development in the energy industry took place between 1999 and 2004<sup>43</sup>. This successful development took place in companies that had been privatized and restructured. This should be an incentive for the Kremlin to liberalise the market.

The lack of democratic development plays into this factor as well. The EU should be gravely concerned about this aspect as an open market is their prime interest. Secondly, a lack of democratic development makes Russia less stable which is yet again a threat in terms of energy security.

The reason for the xenophobia of foreign investment can be analysed from a theoretical perspective. Celeste A. Wallander has described Russia as a Transimperialist<sup>44</sup> country, meaning it is transnationalist as well as imperialist. This analysis has taken into account Russian foreign policy in a globalized strategic context and the nature of the authoritarian political-economic system under Putin, which very often uses energy for leverage. Russia is known to use energy as a weapon, as has been seen in the 'near abroad', and currently is powered by very high energy prices. However, being powered by high energy prices is not necessarily a negative situation as, this can "fuel growth in new supplies by significantly increasing investment and by turning marginal opportunities into commercial prospects"<sup>45</sup>. This could be an even more profitable situation if the energy sector would be subject to less state control.

Russian society is a patrimonial society, where the primary relationship in society is between patron and client. This is the explanation for the xenophobia of foreign investors and NGO's, as they would undermine the patron-client relationship. An introduction of foreign companies and NGO's would imply democratisation pressures which would serve to undermine the patron-client relationship. The "patron-client relationships are dependent on control and distribution of "rents," wealth created not by productive economic activity but by the

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<sup>43</sup> Milov, Vladimir, 2005. "Russian energy sector and it's international implication" *Institute of Energy Policy*, Discussion Paper p. 8

<sup>44</sup> Wallander, Celeste A., 2007. "Russian Transimperialism and its Implications" *The Washington Quarterly* vol 30 issue 2 p. 107

<sup>45</sup> Yergin, Daniel, 2006. "Ensuring Energy Security" *Foreign Affairs* vol. 85 issue 2 p. 71.

political manipulation of economic exchange”<sup>46</sup>. According to this analysis the actions of the Russian state are logical, and any form of reform would undermine the powerbase in society. By this logic, the only way for the EU to try and secure its energy supply would be to promote democratisation in Russia. However, attempts to date have been unsuccessful.

The Kremlin is a very important factor in Russian energy policy. As has been witnessed over the past sixteen years, there is also a grave importance placed upon who sits in the Kremlin and makes energy policy. This is important as the position of the President of the Russian Federation is a very powerful one with significant influence over most policy sectors. It has been seen that during Putin’s second term, energy policy has become increasingly stringent and xenophobic. The state has resumed control of the energy sector, which has been proven through history to be an inefficient policy approach.

This increased control has also reflected negatively upon Russia’s reputation internationally, and has caused concern for the European Union. Firstly, the increased state control of the energy sector is a cause for concern as it makes energy trade increasingly dependent upon sound political relations. Secondly, due to stringent policies upon foreign investment and ownership of Russian energy companies, there is an increased concern for the impending investment crisis. If substantial investment is not made into energy infrastructure, there will be a predicted drop in possible future exports. The problem is that “the Kremlin wants to encourage foreign companies to invest capital, knowledge and technologies in exchange for minor ownership, however, it still would want to retain direct ownership control”<sup>47</sup>. Finally, this sort of energy policy will affect growth of the Russian economy adversely resulting further concerns for energy security. The EU can only respond to this with democratisation pressures at this point. However, it is difficult to predict the future, as there are scheduled presidential elections in Russia next year, which might result in a more favourable leader? This, however, is a very unpredictable path as well.

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<sup>46</sup> Wallander, Celeste A., 2007. “Russian Transimperialism and its Implications” *The Washington Quarterly* vol 30 issue 2 p. 116

<sup>47</sup> Milov, Vladimir, 2005. “Russian energy sector and it’s international implication” Institute of Energy Policy, Discussion Paper p. 14

## 6 Conclusion

Energy security was a term coined by Reagan in 1973 following the second oil crisis. There are various definitions for it depending on perspective, either from the supply or the demand side. What can be established when looking at the energy relationship between the EU and Russia is the fact that the understanding of the term varies significantly between the two. For the EU energy security is interdependence, and for Russia it is neo-mercantilism. This definition discrepancy is a cause for concern in the energy relationship, as Russia is reluctant to play by the same rules as other states do<sup>48</sup>. Using energy as a weapon is a principal concern in this instance.

However a point of primary importance is that the EU and Russia are interdependent, with considerable sensitivity and vulnerability, which leaves limited leeway for unreliability. Trade between EU and Russia is of a considerable percentage for both. For the EU, Russia is a main energy supplier, especially with regard to gas, which is a key import with a large potential to grow. From a Russian perspective the EU is the source of 52% of all Russian imports. An interdependent relationship of such a nature could presume a pragmatic and reliable trade liaison.

There are however numerous concerns despite the clear economic dependence. Firstly, despite the fact that Russia is deemed politically more reliable than some OPEC countries, it still a relatively unstable state. This is a concern for the EU as this implies an increased importance being placed upon political relations rather than economic benefits. Secondly, there are issues surrounding future Russian production ability due to a dire need for investment in the energy sector. This is a genuine concern that may result in decreased future supplies for the EU if energy infrastructure in Russia is not improved. The viable option for the EU to guarantee future energy security would be to improve relations with the 'neighbourhood', in order to potentially acquire direct deliveries from the area, by investing in infrastructure that bypasses Russian territory. Gas suppliers located further away are not a realistic option without development of LNG facilities.

The second option for the EU would be to increase pressure upon the Kremlin to open the energy market more for private and foreign

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<sup>48</sup> Larsson, Robert L., 2006. "Russia's Energy Policy: Security Dimensions and Russia's Reliability as an Energy Supplier" *FOI Swedish Defense Research Agency*, FOI-R-1939—SE, Scientific Report p.297

ownership rather than increased state control, in order to let market forces guide development. This approach has historically been much more efficient economically rather than state controlled energy sectors.

Finally, Russian use of energy as a weapon is yet another cause of apprehension on behalf of the EU. From a European energy security perspective it is not safe to have a large neighbour with such influence over surrounding states. The risk of intentional supply disruptions to the EU is very low, however, a gas disruption in one of the western CIS transit states (Commonwealth of Independent States) could affect the EU as a third party. Secondly, the risk of a supply disruption to a group of states, such as the EU, is also highly unlikely. More plausible is the scenario that there can be a disruption to a single state, as a result of powerful political turmoil.

This thesis has concluded that Russia is not the most reliable supplier for several reasons, yet there are limited options for the EU. There are no alternative preferable suppliers nearby, especially with regard to gas. It is highly unlikely that supply disruptions to the EU would take place, however it is important to be aware of the dangers as Russia is not a very stable country. It is important for the EU to try to diversify suppliers and find alternative sources of energy to lower dependence on Russia and make supply more secure. There is however no need for outright panic as it seems highly unlikely that Russia can either run out of resources or cut supplies to the EU at this point. Security of supply in the long term is a different topic which is not possible to predict now, especially with regard to the looming presidential election in Russia.



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