Dear Post-comm colleagues,

Sorry for the delay in sending in my paper for the November 19 meeting.

The discussion paper I am submitting is actually a chapter of a book soon to be published. The book, *The Politics of Energy Dependency: Ukraine, Belarus and Lithuania Between Domestic Oligarchs and Russian Pressure, 1992-2012* (University of Toronto Press, forthcoming), compares these three states’ reactions to the serious external shock of their sudden transformation, virtually overnight, from constituents of a single energy-rich state to being separate energy-poor entities heavily dependent on Russia, as well as politically independent transit states. The book analyzes how these states’ unique location, not only between a major energy producer (Russia) and its main market (the EU), but also between powerful domestic economic actors often making a profit of their situation of energy dependency (“oligarchs”), and Russian power, has affected the Russia’s ability to use energy as a foreign policy tool in the region.

The chapter I am presenting is chapter 3 (the last chapter in the “background” section of the book; see Table of Contents), “Domestic Contradictions, Foreign Energy Policy Levers, and Trans-borderrent-seeking: the Domestic Russian Background to the Role of Energy in Relations with energy-poor FSU States.” This piece represents the intersection between the work I’ve been doing in the last years (work mainly focused on the energy imports-dependent states of the FSU) and the Russian side of the energy question, an area which I hope to develop in the next stage of my research. After years of working in great depth and detail about the energy-dependent-country side of the question, I am looking for ways to expand my research agenda to Russia as well.

For the Post-Comm meeting, I would be especially grateful for comments on

1) How to turn this chapter (or parts of it) into a self-standing article. The chapter as written now is meant mainly as background for the Ukraine, Belarus and Lithuania case studies in the book, so for an article I would need a bit of a different focus and more detail in the needed areas.

2) More generally, ideas about how to expand my research agenda into Russian energy and political issues, without forgetting about the larger issues and question that have driven my research (Looking at post-Soviet international relationships *from the inside out*, i.e. from below and from a non-Moscow-centric perspective, questions such as “How have the rent-seeking opportunities opened by the post-Soviet transition affected the course of political development and international relationships in the post-Soviet area?” and “What factors are the real drivers of international relationships between FSU states?”)

Many thanks in advance!
The Politics of Energy Dependency: Ukraine, Belarus and Lithuania
Between Domestic Oligarchs and Russian Pressure, 1992-2012

Acknowledgments

Part I: Larger Influencing Factors
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2. The Legacy of the Common Soviet Energy Past:
Path Dependencies and Energy Networks

3. Domestic Contradictions, Foreign Energy Policy Levers, and Trans-border rent-seeking: the Domestic Russian Background to the Role of Energy in Relations with Ukraine, Belarus and Lithuania

Part II: Case Studies

4. Ukraine: Energy Dependency and the Rise of the Ukrainian Oligarchs

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Chapter 3: DOMESTIC CONTRADICTIONS, FOREIGN ENERGY POLICY LEVERS, AND TRANS-BORDER RENT-SEEKING: THE DOMESTIC RUSSIAN BACKGROUND TO THE ROLE OF ENERGY IN RELATIONS WITH UKRAINE, BELARUS AND LITHUANIA

Russia remains the main energy supplier, transit gatekeeper and energy rule-setter in the post-Soviet region, and understanding the Russian side of the energy supply question is essential for making sense of energy policy actions and reactions in its energy-poor neighbors.¹ This chapter focuses on the impact of Russia’s domestic political economy of oil and gas on the energy-dependency management landscape faced by these energy-poor states. This impact takes place mainly through three dimensions analyzed in this chapter: (1) through Russia’s own resource base and changing ability to supply foreign markets, which affect Russian export priorities and transit preferences; (2) through changing patterns of interaction between the Russian state and the country’s main energy players; and, (3) through the way domestic energy issues affect value-added chains and Russian actors’ participation in trans-border rent-seeking arrangements with actors in the energy-poor states, also affecting these actors’ preferred types of interactions with Russian actors.

Actors in Russia involved in energy production (Gazprom, other gas and oil producers) or with other means of control over their transportation and distribution

Transneft and other state policy-making players, including the top political leadership ("Kremlin")) are constantly making choices about where to “use” or “direct” these energy resources and associated profits. These choices occur along two dimensions. In a geographic dimension, main choices revolve around whether these resources will be used domestically or externally. In a “modalities of use” dimension, energy can be “used” or “traded” in a spectrum ranging from sale in open markets to trade under various “special deals,” to political use in domestic and foreign directions. (As a scarce commodity with great potential for arbitrage gains,\(^2\) of course, energy resources can also be used as a means of personal economic gain.) While in practice the dividing lines between these choices are more blurred than they appear on paper, each of these ways of using energy implies different incentive structures for the players involved. These decisions, in turn, are not made in a vacuum, but are the result of the interplay of factors such as the desire for profit maximization (at a state, company or personal level), maintenance of markets or political influence in an area, and relationships with the Russian state and actors within it. Given this context, this chapter explores how Russia’s domestic political economy affected the choices faced by Russian actors in “using” energy, and the implications of these choices for Russia’s energy-poor neighbors, also in terms of how actors in these states will interact with Russian energy actors.

As discussed in chapter 1, oil and gas differ in terms of their production and transportation processes and associated value-added chains. In the Russian case, they also differ markedly in terms of the domestic organization of the sector with -- in simplified

\(^2\) Arbitrage refers to the possibility of making a profit out of manipulating price differentials for the same good between various markets of within sectors of the same market. Among other reasons, such arbitrage possibilities existed due to Russia’s desire to maintain a special relationship with the post-Soviet states, including through the provision of gas and oil at preferential prices.
form -- the state retaining control over a monopolized gas sector, and the oil sector more independent of the state and divided into a number of large competing players. These differences also affect the structure of incentives facing players in these two sectors, and the way they assess the choices discussed above. In addition, gas plays a more prominent role both in the structure of Russias’s energy consumption (53.2% of TPES in 2008, as opposed to 20.5% for oil) and in its exports to Ukraine, Belarus and Lithuania, a reality also reflected in this chapter.3 Because of these differences, this chapter addresses both sectors separately, with somewhat more attention paid to gas than to oil issues. Section I analyzes Russia’s domestic political economy of gas and its impact on Russia’s energy poor neighbors, while Section II addresses the issue in the case of oil.

Section I: The Political Economy of Russian gas and its impact on the energy-poor states

Post-Soviet Russia’s gas relationships are closely related both to the way the sector developed during the Soviet period, and to its post-Soviet transformation. In 1993, the remnants of the Soviet Ministry of Gas Industry were transformed into a state-controlled vertically-integrated company, Gazprom. In contrast with the break-up of the oil industry, Gazprom retained control of the near-totality of gas production and transmission, as well as other perks such as sole ownership over gas storage facilities and export pipelines, and a de-facto monopoly on gas processing and exports. Similarly, the
top leadership of the sector remained virtually unchanged from the Soviet period until the early 2000s.

Reform of the gas sector progressed during this period, but at a deliberately moderate pace. While in the early 2000s relatively radical changes such as the “unbundling” of Gazprom into separate companies dealing with production, transmission and distribution were widely discussed, this was de-facto replaced by a much weaker option: financial unbundling and “functional specialization” of 100%-Gazprom-owned subsidiaries.\(^4\) Rather than dismantling, Gazprom began expanding beyond gas: its 2005 purchase of a majority stake in Sibneft broke the administrative division between oil and gas, and, together with new ventures in the coal and electricity generation sectors, discussed below, seemed to open the door for the eventual establishment of a powerful global conglomerate encompassing multiple energy sectors.

**Russia’s changing gas resource base**

Decline in gas production and ability to exploit and transport these resources

Russia is a paradoxical energy power, as seen clearly in the gas sector. On the one hand, its large gas resources (in 2009 it possessed 23.7% of the world’s proven gas reserves and was, until 2009, the world’s largest producer and in 2010 continued to be, by far, the largest exporter\(^5\)) make it a crucial player, giving the country a strong basis for international leverage. While Russia’s gas production has been stagnant or in decline

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\(^4\) See Mitrova, “Natural Gas in Transition,” 23.

\(^5\) In 2009, the boom in shale gas production in the US made the US the largest gas producer in the world, overcoming Russia. Data on gas reserves from Statistical Review of World Energy, June 2010, 22.
since the late 1980’s, and fell significantly in the 1990s, compared to the much steeper decline in oil production during the 1990s, the gas sector remained a relative island of stability in the energy landscape (see Table 3.1 and 3.2).

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6 As discussed in chapter 2, there are several reasons for this decline, having to do with the legacies of predatory production methods, taxation, pricing and investment policies. Heinrich, however, cautions against using actual gas production data as evidence of production problems or future production capacity, as given storage difficulties, “gas is produced only after supply contracts have been signed.” Andreas Heinrich, “Under the Kremlin’s Thumb: Does Increased State Control of the Russian Gas Sector Endanger European Energy Security?” Europe-Asia Studies 60 no. 9 (2008): 1539–1574, here 1556.
Table 3.1: Gazprom’s and total Russian Gas Production, 1991-2009 (in bcm/yr)

<table>
<thead>
<tr>
<th>Year</th>
<th>Gazprom Production in Bcm</th>
<th>Total Production in Bcm</th>
<th>Gazprom’s production as % of total production</th>
<th>Exports to Europe</th>
<th>Exports to CIS</th>
<th>Total exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>595</td>
<td>643</td>
<td>92.53</td>
<td>91</td>
<td>156</td>
<td>247</td>
</tr>
<tr>
<td>1992</td>
<td>599</td>
<td>640</td>
<td>93.59</td>
<td>89</td>
<td>106</td>
<td>195</td>
</tr>
<tr>
<td>1993</td>
<td>578</td>
<td>617</td>
<td>93.67</td>
<td>101</td>
<td>79</td>
<td>180</td>
</tr>
<tr>
<td>1994</td>
<td>571</td>
<td>607</td>
<td>94.06</td>
<td>105</td>
<td>76</td>
<td>181</td>
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<td>1995</td>
<td>560</td>
<td>595</td>
<td>94.11</td>
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<td>1996</td>
<td>561</td>
<td>601</td>
<td>93.34</td>
<td>128</td>
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<td>1997</td>
<td>534</td>
<td>571</td>
<td>93.52</td>
<td>120</td>
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<td>592</td>
<td>92.22</td>
<td>131</td>
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<td>2000</td>
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<td>584</td>
<td>89.55</td>
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<td>60</td>
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<td>2001</td>
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<td>581</td>
<td>88.12</td>
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<td>49</td>
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<td>2002</td>
<td>526</td>
<td>595</td>
<td>88.40</td>
<td>134</td>
<td>51</td>
<td>185</td>
</tr>
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<td>2003</td>
<td>548</td>
<td>620</td>
<td>88.38</td>
<td>142</td>
<td>47</td>
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<tr>
<td>2004</td>
<td>552</td>
<td>633</td>
<td>87.20</td>
<td>145</td>
<td>55</td>
<td>200</td>
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<tr>
<td>2005</td>
<td>555</td>
<td>641</td>
<td>86.58</td>
<td>159</td>
<td>47</td>
<td>206</td>
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<tr>
<td>2006</td>
<td>556</td>
<td>656</td>
<td>86.28</td>
<td>161</td>
<td>41</td>
<td>202</td>
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<tr>
<td>2007</td>
<td>549</td>
<td>653</td>
<td>84.07</td>
<td>154</td>
<td>37</td>
<td>191</td>
</tr>
<tr>
<td>2008</td>
<td>550</td>
<td>664</td>
<td>82.83</td>
<td>158</td>
<td>36</td>
<td>194</td>
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<tr>
<td>2009</td>
<td>462</td>
<td>584</td>
<td>79.10</td>
<td>120</td>
<td>47</td>
<td>167</td>
</tr>
</tbody>
</table>


*Including gas from Central Asia.

Note: data for 1991 is for the USSR as a whole.
Location, accessibility, and cost of exploitation are also important issues affecting which reserves will actually be exploited and brought to market. As discussed in chapter 2, by the late 1980s Gazprom had come to rely increasingly on Western Siberian fields. As these fields started to decline, Gazprom came under pressure to move production to more remote areas – by the early 2000s, c. 37% of its reserves were located in hard-to-reach areas in the Yamal Peninsula and the Barents Sea; accessing and bringing this gas to market required especially large investments.\(^7\) Given this situation, one reason these new resources have been slow to come online had to do with Gazprom’s investment strategy since 1991, a strategy which largely neglected reserve replacement (the rate at which exploitation of reserves is compensated by the addition of new reserves) and investments geared to increasing production.\(^8\)

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\(^7\) Sakhalin oil and gas, produced in close proximity to key Asian markets, is a partial exception. See Michael Bradshaw, "A New Energy Age in Pacific Russia: Lessons from the Sakhalin Oil and Gas Projects," *Eurasian Geography and Economics* 51, no. 3 (2010): 330-359, here 332-335.

\(^8\) Gazprom’s reserve replacement ratio went from c. 450% in 1991 to less than 50% between 1994-2001, with a return to c. 100% between 2002 and 2005. IEA, *Optimizing Russian Natural Gas* (Paris: OECD/IEA, 2006), 28 (Figure 1).

\(^9\) Fears have been repeatedly voiced about a possible shortfall in Gazprom’s supplies to WE. Various estimates exist as to the size of this shortfall and when it would kick in. See Table 5 in Heinrich, "Under the Kremlin's Thumb," 1559, and Jonathan P. Stern, “The Russian Gas Balance to 2015: Difficult Years Ahead,” in *Russian and CIS Gas Markets and their Impact on Europe*, ed. S. Pirani (Oxford and New

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The end of cheap gas, Gazprom’s options, and the energy-poor transit states

In the early 2000s, these production difficulties coincided with rising domestic consumption, severely straining Gazprom’s ability to fulfill its contractual obligations.\(^9\)

At issue is, as noted by the IEA, the end of the era of “relatively ‘cheap’ gas” based on
inherited Soviet production infrastructure, and the beginning, not only of higher-cost gas, but also of difficult dilemmas for Gazprom. Some of the options about how to “replace” this increasingly hard-to-produce gas involved increasing gas imports from Central Asia, and, domestically, increasing efficiency and changing the domestic energy mix to reduce reliance on gas (both of which would require a relative increase in gas prices), encouraging production by independent gas producers, and increasing investments in new, higher-cost fields. While not necessarily mutually exclusive, each of these options had important implications in terms of the relationship between Gazprom and the state, Gazprom and other energy players in Russia, and energy relations with Ukraine, Belarus and Lithuania.

Externally, these dilemmas involved how to balance various export markets and what kinds of relationships to build with other producers, first and foremost in Central Asia. (Relations with Central Asia are discussed later in this chapter.) As oil and gas demand in WE continued to stagnate (most starkly, but not only, as a result of the 2008-2009 economic crisis), growing emphasis was put on oil and gas export projects aimed at developing China and Asia-Pacific region markets as a means to balance this stagnation.10

In addition to production issues, the new situation also involved the issue of how to bring these resources to market, and important choices concerning what kind of transportation options to pursue (upkeep and repair of existing pipelines, building of new

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10 See Bradshaw, "A New Energy Age," 333.
pipeline routes, and liquefaction into LNG for shipment via tankers).\textsuperscript{11} Russia’s limited gas storage (as noted in chapter 2, after the USSR collapsed significant Soviet gas storage facilities remained in the other former republics) and LNG liquefaction facilities (the first one, which opened on February 2009, is located in remote Sakhalin, limiting its impact on the marketing of gas produced in other areas\textsuperscript{12}) meant limited options for what to do with its gas output. This affects Russia’s ability to manage export pricing (“parking” gas in the summer and selling in winter when demand is higher), and even its overall ability to monetize the gas it produces, as, if it does not ship the gas, it has to burn (flare) it.\textsuperscript{13}

Echoing the discussion of asymmetrical interdependence in chapter 1, and of how possession of crucial infrastructure such as underground storage facilities can provide a counter-weight to energy supply dependence, this situation strengthened the role of transit countries and those having significant underground storage facilities, such as Ukraine, in Gazprom’s value-added and revenue chains.

\textit{Domestic gas issues and their effect on sector actors’ participation in trans-border rent-seeking arrangements}

During the period covered by this book, domestic energy issues affected Russian gas-related actors’ relationships with actors in the energy-poor states and affected these

\textsuperscript{11} Each of these options, in turn, implied different value chains and patterns both in Russia and in the transit and importing countries.

\textsuperscript{12} Despite high expectations about LNG processing and shipment by tanker as means of helping solve energy transit security challenges, the technology still faces important limitations having to do with its high cost, limited use for landlocked countries or for those without appropriate port facilities, and the fact that under current technology up to 20% of gas is lost in the process of liquidification, making LNG as problematic as coal from a sustainability point of view. I thank Michael Bradshaw for this insight. Further development of LNG plants in Russia is in doubt following the discovery of unconventional (shale) gas in the US, which reduced the prospects of the US as a market for LNG gas from Russia’s Shtokman field. Bradshaw, “A New Energy Age in Pacific Russia,” 333.
actors’ preferred types of trans-border interactions with Russian actors. Among these domestic issues, the most prominent were Gazprom’s relationship with the state, its monopolization of the gas market, the importance of personal-within-the-corporation-interests within the company, the role of intermediary companies, and Gazprom’s investment policies. Like pieces of a single puzzle, these five elements strongly reinforced each other during the period under study.

Gazprom’s relationship with the state

The question of Russian state influence over Gazprom or Gazprom’s influence over state policy is a complex and longstanding one, and the relationship is by no means a uni-directional one. Continuing tension between Gazprom’s dual roles -- fulfilling both important domestic and external, economic and political roles -- has been an important driving force in this relationship. While on the one hand the Russian state has relied on Gazprom the economic player as an important source of foreign revenue and other budget contributions (between 1995 and 1999, taxes paid the oil and gas industry amounted to c. 12-24% of Russia’s consolidated budget14), it has also relied on the company to fulfill a number of broader political and social tasks. These include both domestic (helping maintain social stability through low energy prices, providing social services) and foreign-oriented tasks (helping manage the relationship with Russia’s energy-poor neighbors, among others), and these two goals have often been at odds.

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13 Gas flaring refers to the practice of burning-off at the well and into the open air surplus gas otherwise not considered economically feasible to use or transport; it is also used for safety purposes.
14 See Table 7 in S. Tabata, "Russian Revenues from Oil and Gas Exports: Flow and Taxation," Eurasian Geography and Economics 43, no. 8 (2002): 610-627, here 616.) For most of the late 1990s and early 2000s period, gas amounted to c. 15-20% of all exports to non-CIS states; the figure rises to 38-58% when oil exports are included. Table 3.5 in Jonathan Stern, The Future of Russian Gas (Oxford: Oxford University Press, 2005), 129.
Gazprom and domestic energy supply issues

A small excursus on policy dilemmas around the role of gas in Russia’s domestic energy supply provides a good illustration of Gazprom’s complex relationship with the state. Crucial to Gazprom’s domestic role has been its large-scale supply of gas for residential users at subsidized prices, as well as to electricity-generating plants, contributing to keeping electricity prices low, helping fulfill deeply-held popular expectations born of the Soviet energy-social contract discussed in chapter 2.15 Thus, some of the contradictions between Gazprom’s roles came to the fore through the issue of how much gas should Gazprom supply domestically at subsidized prices (and, thus, how much would it have available for exports), a question closely related to the question of what would be the preferable domestic energy mix. This was so because for most of the period up to 2010 -- and especially during the period of economic upheaval in the early and mid-1990s -- pricing policies kept domestic gas prices not only significantly below international ones, but also artificially low compared to other fuels, prompting consumers to move to lower-price gas whenever possible, and leading to an increase in the already high share of gas in the country’s energy mix, to c. 52% in 2000.16

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15 In the same way as cheap and plentiful energy supplies served as a bonding agent that kept the Soviet economy -- however inefficiently -- together, expectations of cheap and reliable electricity and piped-in residential heating supplies became part of the Soviet population’s cultural definition of welfare, and part of a minimal “energy-social contract” between the regime and its citizens, making household consumers carriers of Soviet energy culture. Such expectations of energy-related welfare, part of general expectations of rising living standards, became part of the very legitimacy of Soviet power, in a context in which ideology was becoming less and less central to this legitimation. Even after the demise of the Soviet system, being able to provide such services has been a central element of the new states’ legitimacy vis-à-vis their own citizens.

16 Migration from coal to gas was especially notable. Russia’s coal market was liberalized through the use of an exchange in the early 2000s, with the result that by 2005 its (per calorie) price was nearly 1.5 times higher than that of gas, leading to increased demand for gas. Valerii F. Dashkevich, Energeticheskaya Zavisimost Belarusi: posledsvia dlia ekonomiki i obshestva (Minsk: Izdatel I. P. Lovginov, 2005), 37.
Energy mix issues and the structure of relative prices for various energy sources (gas, oil, and heating oil, among others) are not trivial, as they affect not only the domestic consumption of these and what will be available for export, but also how the producers of various fuels will benefit from the price differentials between domestic and export markets and prioritize supplies to each. In the late 1990s, for example, as price trends made exports increasingly profitable, Gazprom sought to reduce its domestic supply commitments as a way to maximize exports and related profits. In the early 2000s, after the increase in gas use that accompanied the spur of import-substituting growth following the 1998 crisis, this led to growing tensions between Gazprom and domestic electricity producer RAO UES, another major domestic political and economic player. Gazprom’s preferred means of reducing its domestic supply commitments was RAO UES’ conversion of its electricity generating facilities to heating oil or coal as a way to free more gas for export. This, however, was not desirable from RAO UES’s perspective, as using these fuels implied significantly increased costs as compared to gas. Subsequently, Gazprom dealt with the issue by aggressively buying actives in the electricity generating sector, and seeking to develop new coal-fired generation facilities where coal from its new partner the Siberian Coal Energy Company (SUEK) could be burned, allowing Gazprom to maximize gas exports.

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18 Many independent observers saw the debate on Gazprom supplies to RAO UES not only as one of domestic supplies vs. exports, but also as a political issue related to a possible desire to curtail the power of Anatolii Chubais’ (head of RAO UES). See Lyudmila Romanova, "Budet' li Gazprom renatsionalizirovan?" Nezavisimaya Gazeta, November 6, 1999.
19 State monopoly RAO UES was dissolved in 2008; our discussion here refers first and foremost to the pre-2008 period. As part of RAO UES’ reorganization, its generation, transmission and sales units were separated to create separate companies, which would be subsequently privatized. RAO UES’ electricity generation network was also broken up into a number of smaller producers, which have been sold individually to foreign and domestic investors, most notably Gazprom.
This example provides a good illustration of the contradictions discussed above: despite its benefitting from Gazprom’s exports and thus theoretically also from a domestic reorientation away from gas as a way to increase these, the state was lukewarm about allowing significant domestic gas price increases as a way to reduce demand, as low domestic energy prices provided an important tool for mitigating the social costs of economic transformation, and because of the role of low energy prices in the competitive pricing of Russian exports.

Another way in which the diversity of interests concerning Gazprom’s role interfaced with domestic supply issues concerned the issue of domestic gas price increases. The gap between the energy prices charged to consumers inside Russia and those that could be fetched in international markets had a variety of implications for the interrelationship between various players within Russia, for Russia’s relationship with international markets and international organizations, and for the relationship with its energy-poor neighbors. In the previous paragraphs, we discussed how Gazprom’s bid for higher domestic prices as a way to moderate demand and secure higher profits through exports affected its relationship with other players within Russia. Gazprom’s actions also affected relationships with international organizations, as bringing up Russian domestic energy prices to international ones had long been a demand of the IMF, the WTO, and the EU, which had argued that below-cost domestic prices represented a hidden trade subsidy. As can be seen from Table 3.2, differences between domestic vs.

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20 It must be noted, however, that Russia’s domestic gas demand has been relatively inelastic, and we simply do not know how demand would react to sharply increased prices. (See Stern, “The Russian Gas Balance to 2015,” 75-76.)

21 IEA, Optimising, 43.
export prices also affected the relationship with Russia’s energy-poor neighbors by helping shape the incentives for selling domestically or exporting.
Table 3.2: Average gas sale prices by Gazprom to CIS/Baltics and European markets (excluding export taxes and customs duties), 2003-2006, in US$ per tcm

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average (industrial and household) Russian domestic gas prices</td>
<td>22</td>
<td>28</td>
<td>33</td>
<td>40</td>
</tr>
<tr>
<td>-(as percentage of sale price to WE)</td>
<td>22.98</td>
<td>27.55</td>
<td>23.55</td>
<td>20.76</td>
</tr>
<tr>
<td>Average sale price for CIS/Baltics</td>
<td>34.40</td>
<td>36.33</td>
<td>50.02</td>
<td>76.37</td>
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<tr>
<td>-(as percentage of sale price to WE)</td>
<td>35.93</td>
<td>35.75</td>
<td>35.70</td>
<td>39.65</td>
</tr>
<tr>
<td>Average sale price for WE</td>
<td>95.72</td>
<td>101.61</td>
<td>140.09</td>
<td>192.59</td>
</tr>
</tbody>
</table>

Source: Data on sale prices to CIS/Baltic and WE from Stern, “The Russian Gas Balance to 2015,” Table 12.1, 396; data for domestic gas prices derived from IEA, Optimizing Russian Natural Gas (Paris, IEA, 2006), 42. The apparent discrepancy between the “Average Sale Prices for CIS/Baltics” in this figure, and prices in Table 1.9 in chapter 1 of this book is due to the fact that prices in Table 1.9 include taxes and customs duties, while the prices quoted here do not.
In November 2006, the Russian government announced that domestic gas prices would gradually increase so as to reach “European netback” levels by 2011. The plan stipulated that, between 2007-2011, gas prices for industrial and household users would increase 40%, and that by 2011 domestic gas prices for industry would be such that would guarantee the equal profitability (ravnaia dokhodnost) of foreign and domestic sales. Yet it soon became clear that, in order for the principle to be fully implemented, actual increases would need to be much more significant than the originally-envisioned 40%, and many voices within Russia -- including in the Kremlin (e.g. Minister of Economic Development Elvira Nabiullina) -- started to argue that, given the economic and social consequences of larger-than-originally planned increases in domestic prices, the principle of raising domestic prices to European levels should not be implemented fully by 2011. In March 2010, it was announced that the target price parity date had been moved back to 2014.

Effects on relations with the energy-poor states: the case of Belarus

The first and most general connection with the energy-poor states, especially Belarus (which for much of the 1994-2010 period, as discussed in chapter 6 below, claimed a right to domestic Russian gas prices stemming from its special relationship with Russia), goes back to the very existence of price differentials between domestic

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22 This goal was enshrined in the May 2004 agreements between Russia and the WTO. See Heinrich, "Under the Kremlin's Thumb," 1567. “European netback” prices refer to the replacement value of gas at an European delivery point (usually the German border), minus transportation costs, in practice understood to mean the equal profitability of European and domestic sales.

23 It must be noted, however that this initiative was not so much about a deregulation of gas prices, but about a “regulated transition to higher prices.” Mitrova, “Natural Gas in Transition,” 36.


Russian prices and those charged them. If there was no difference between domestic and export prices, then there would simply be no reason for Belarus to insist on paying “domestic Russian prices.”

Russia’s announced move to domestic netback prices also affected relations with Belarus in a more direct way. In the December 31, 2006 gas agreements between Belarus and Russia (which put an end to the “gas war” of late 2006 between both countries) it was agreed that by 2011 Belarus should pay 100% of the Polish price (minus the difference in transportation costs). This was interpreted by the Belarusian side as valid as long as Belarus and Russia would be moving simultaneously to netback prices by 2011. But when Russia announced that the timeline would be further drawn out, Belarus considered this sufficient reason for new negotiations on the issue and demanding a suspension of planned increases applicable to it.

Multiple interests, Gazprom-state relations and “convertible points:”

Implications for Gazprom-state relations

Clearly, Gazprom’s interests as a corporation –albeit one with significant state ownership-- and those of the state were not always compatible. Why, then, would Gazprom choose to forego the large, nearly-assured profits implied in exports to Western markets as compared to domestic sales, especially when that revenue was crucial to Gazprom as means to compensate for low domestic gas prices and preferential-price deliveries to former Soviet republics? One possible explanation would be that the company was simply forced to do so by the state. A better way to look at this, however, is through the prism of the tension between Gazprom’s various interests and goals, as the
company, while losing revenue from the opportunity cost of not exporting to higher-paying Western European markets, also benefitted politically from its subsidization of domestic consumers. From a Gazprom corporate perspective, the goal of profit maximization through exports to WE coexisted -- and at times collided with -- the goal of fostering good relations with the state through the provision of various services; it is exactly the provision of such services that largely explains the state’s support for Gazprom’s monopoly role. 

The concept of “convertible points,” focused on the informal side of the relationship between the state and major energy companies, provides us with a useful tool for understanding this relationship. Although the Russian state may not be able to dictate to Gazprom as a corporation what policies to pursue, the company may find it useful to follow state and/or Kremlin preferences anyway. Gazprom can accrue “points” with the Russian state through services provided domestically or internationally. Domestically, such services have included the provision of social services to Gazprom’s c. 400,000 employees, the provision of gas to the population at lower-than-international prices, and, especially during the liquidity crisis of the 1990s, maintaining supplies to

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28 The relationship between Gazprom and the Russian state plays itself out at several levels simultaneously: a direct relationship, and a more complex, indirect relationship. The first relationship plays itself out through the dynamics of corporate governance and membership in Gazprom’s board of directors, and other overseeing bodies, and the relative influence of the state in these organs. The second “game” refers to a more complex, informal set of relationships.

29 Data is for the mid-2000s.
hospitals and other social objects and residential users despite lack of payments, helping prevent the social unrest that would likely have come from the large-scale disconnection of non-paying consumers. Internationally, these services have included helping to manage the relationship with Russia’s neighboring states by supplying gas to energy-poor neighbors at preferential prices, or tolerating repeated non-payment on their part.

The concept of “convertible points” helps us gain a fuller view of the interrelationship between Gazprom and the state in Russia’s neighboring states. When companies such as Gazprom lost potential profits by selling gas to Belarus or Ukraine at preferential prices, they accrued informal “points” with the Russian state. These “points” could be later “converted” into advantages in other areas. How these virtual points were transferred from the foreign policy realm to a domestic arena and eventually converted into monetary benefits varied from sector to sector and case to case. In the gas sector, the conversion often took place informally through access to credits, the setting of gas prices, and the granting of privileges in privatization contracts and other investment opportunities, such as preferential access to especially strategic gas fields.30

Clearly, not all the benefits received by the parties in this relationship could be measured in direct monetary terms: the benefits received by the state were primarily political in nature, such as a continued presence in neighboring states, or influence on their leadership for strategic gains. Similarly, the benefits received by Gazprom also included non-monetary ones, such as protection against international pressure for breaking up the monopoly and significant “administrative resources” it could, in turn, use

30 Bruce, citing Russia’s Kommersant, discusses the possibility of Gazprom being compensated (by Russia’s Ministry of Finance) for some of the debt forgiven Belarus by means of a complicated tax credit system. See Chloë Bruce, “Friction or fiction? The gas factor in Russian-Belarusian relations,” Chatham
for its own benefit in other areas. These administrative resources were related to the official or unofficial regulatory powers granted by the state to Gazprom over a number of areas (such as access to Russia’s domestic and export pipeline grid, and the coordination of the development of eastern Siberian gas resources, among others), and to the company’s ability to exert pressure on other players with significant resources of their own, for example the judicial system. These administrative resources have been translated by Gazprom into a number of more tangible economic advantages, including gaining a foothold “into many independent gas projects without making significant investments or paying an adequate market price.”

The discussion above highlights the two-sidedness of the relationship between Gazprom and the state. Repeated instances of the company’s successful fending-off of attempts by the Ministry of Finance to make it face its full tax liability also speak of its power vis-à-vis parts of the state apparatus. 2001’s easing out of Rem Viakhirev as Chairman of Gazprom’s board and his replacement by Aleksei Miller, strengthened the state’s formal role in the company. Such gains were consolidated after October 2004, when a complex operation involving oil company Rosneft allowed the state to come to control over 50% of Gazprom’s shares, as well as a majority of seats in its Board of Directors, assuring it a direct say in the company’s most important decisions. (The further impact of post-2001 changes in Gazprom is discussed below.)

31 Heinrich, "Under the Kremlin's Thumb," 1549.
32 Ibid.
33 After the failure of a merger with Rosneft planned for October 2004, the state increased its stake in Gazprom to more than 50% by creating a special-purpose holding, Rosneftegaz, which held state shares in Rosneft to be used as collateral for the state’s purchase of an additional 10.74% of Gazprom’s shares. See William Tompson, “Back to the Future: Thoughts on the Political Economy of Expanded State Ownership in Russia,” Le Cahiers Russie, no. 6 (2008): 1-18.
Gazprom’s monopoly role

Gazprom’s continued monopoly role is the central defining feature of Russia’s political economy of gas, a role, in turn, related to the company’s political weight and relationship with the state. As of the late 2000s Gazprom controlled more than two-thirds of Russia’s gas reserves, accounted for over 80% of all of Russia’s gas production, and owned the Unified System of Gas Supplies (USGS), which permitted it to dictate terms to independent gas producers and control all gas exports. Gazprom’s monopoly refers not only to its export monopoly role inherited from the Soviet Ministry of Gas Industry (and enshrined into the Law on Gas Exports in 2006), but also to the company’s conscious blocking of new producers from entering the domestic gas market. Two issues were at stake here: gas exports by producers other than Gazprom, and the issue of whether associated gas produced by other companies would be allowed into USGS, Gazprom’s domestic gas distribution system. Until the mid-2000s, Gazprom officials emphasized that allowing producers other than Gazprom into the exports market would only bring down the price of Russian gas in WE, reducing Russia’s associated budget revenues. Later, the company’s argument changed: that the issue is a purely technical one, having to do with the pipeline’s (lack of) physical capacity to transport gas volume additional to those produced by Gazprom.

34 Calculated from Table 3.1 in this chapter.
35 While Gazprom has enjoyed a de-facto monopoly on exports since the Soviet period, its monopoly was given a legal status in 2006 when a law was passed giving Gazprom’s arm Gazprom Export a legal monopoly on exports. Article 3 of the law confers this monopoly on the owner of the UGSS transit network, i.e. as of 2008 Gazprom and Gazprom Export. Stern, “The Russian Gas Balance to 2015,” 91, footnote 80. However, 2010 reports that “independent” gas producer Novatek thanks to his well-connected co-owner Gennadiy Timchenko, may have received permission to independently export some LNG from future production points to the fact that the rules may be changing, at least concerning LNG and those with the right connections. See Irina Reznik, “Chelovek nedeli: Gennadiy Timchenko,” Vedomosti, June 28, 2010.
A brief examination of these new producers and Gazprom’s relationship to them provides important insights into the connection between Gazprom’s monopoly and Russia’s role as gas exporter. A first group of new gas producers are non-Gazprom, “independent” producers such as Novatek and Itera. However, the fact that many of these companies have relied largely on fields left over from Gazprom, and are fully dependent on access to Gazprom’s gas processing and transportation facilities, has facilitated Gazprom’s attempts to increase its ownership control over them, making many of these companies independent only on paper. A second set of new gas market players are oil companies producing small amounts of natural gas, either as “associated gas” (see below) or from their own natural gas deposits; LUKoil and Rosneft have been the major players. “Associated gas” generated in the course of oil production has been a particularly problematic issue, with producers facing significant hurdles to transport or market this gas. With the gas transit system controlled directly by Gazprom (in contrast with the oil sector, where there is a pipeline authority, Transneft, separate from the producers) and Gazprom having the prerogative of not transporting other producers’ gas, oil companies have had little choice but to sell this gas at the wellhead to Gazprom (or associated companies) at extremely low, regulated prices, seriously limiting the

36 See Heinrich, "Under the Kremlin's Thumb," 1547.
38 In 2006, gas production by oil companies amounted to 55.5 bcm, c. 15.7% of Russian production. From Table 2 in Heinrich, “Under the Kremlin's Thumb,” 1546.
39 While on paper the level of access by non-Gazprom producers to Gazprom’s pipelines grew steadily from the late 1990s (37 bcm in 1997) to the mid-2000s (c. 114.3 bcm in 2008), a closer look reveals these numbers as showing not so much a real demonopolization of the market, but access by either intermediary companies (such as Eural Trans Gas and RosUkrEnergo, suspected of having had special ties with the Gazprom leadership at some point or another) importing gas from Turkmenistan to Ukraine, or non-Gazprom producers with whom the company had reached long-term agreements (LUKoil and Novatek).
32.
profitability of such production. This situation, in turn, has led up to c. 25% of the gas produced by oil companies being flared in the open air, a loss of c. 2.4 to 9.6% of Russia’s total gas production.\textsuperscript{41} Thus, despite the fact that, as shown in Table 3.1, non-Gazprom producers’ share in total gas production has been increasing rapidly since 2000, Gazprom’s gatekeeper role already at the wellhead level prevented these new players from contributing fully to Russia’s gas production.\textsuperscript{42}

\textit{Impact of Gazprom’s monopoly on the energy-poor states}

With Gazprom a gas export monopolist, the energy-dependent states found themselves at a great disadvantage, not being able to “play” different producers against each other. In addition, Gazprom’s active role in hindering the role of other gas producers prevented them from becoming not only alternative suppliers, but also alternative voices to be reckoned with in the Russian energy policy-making process.

Gazprom’s gas exports monopoly also increased the Russian state’s potential ability to use these exports for political goals. However, as will be discussed below,

\textsuperscript{41} Calculated from gas production figures in Table 1 in Heinrich, "Under the Kremlin's Thumb," 1545. According to official Russian statistics, 2004 loses due to gas flaring amounted to 15 bcm of gas; IEA and a number of Russian and Western experts estimate the number to be much higher, up to 60 bcm/year. IEA, Optimizing, 17, 21. As of 2010, there was no federal legislation limiting the flaring of associated gas, with regulations on the issue only set at the regional level or in the production licenses issued jointly by the Ministry of Natural Resources and regional authorities; and fines for above-limit flaring have been low. See Ibid, 147, 154 and J. DeLay, “Moscow Considers a Move on Gas Flaring,” NewsBase, FSU Oil & Gas Monitor, no. 21, May 30, 2007, cited in Heinrich, "Under the Kremlin's Thumb," 1565.

\textsuperscript{42} In the early 2000s, Gazprom started paying lip service to the idea of allowing new players into the market, but it is widely suspected that this was related to individual attempts at “asset stripping” involving Itera. Interested in supporting the move to unregulated prices for domestic industrial gas consumers as a means to increase domestic gas prices and in reducing its domestic sales to be able to concentrate on more profitable exports, in 2006 Gazprom supported the creation of a gas exchange (the Mezhregiongas (MRG) exchange), whose aim was to help move towards unregulated prices for domestic industrial gas consumers. However, as of 2007, the exchange accounted for only c. 2% of gas sold in Russia, and was dominated by Gazprom “in terms of volumes, access to information and trading rules.” Stern, “The Russian Gas Balance to 2015,” 72.
Gazprom’s monopoly also had more complex effects, especially on energy trade schemes and trans-border rent-seeking alliances.

**Personal-within-the-corporation interests in Gazprom**

When discussing the relationship between Gazprom and the state in the previous section, the picture presented was one based on a simplified view of the company as pursuing corporate interests, vs. the state pursuing state interests. Looking at the company as an amalgam of three different sets of interests: state, corporate, and personal-within-the corporation interests, provides a more realistic picture.

In particular, at issue have been personal-within-the corporation interests, which have often been pursued separately from the company’s “corporate” interests. At the same time, this issue cannot be wholly separated from the relationship with the state or close-to-the Kremlin political elites, which often benefitted from the murkiness inherent in Gazprom’s amalgamation of interests. Thus the maintenance of Gazprom’s monopoly privileges is best understood as related, not only to its provision of important domestic services, but also to the way lack of transparency in the company made possible the transformation of Gazprom’s economic resources into a little-regulated source of revenue (some would say a kind of parallel state budget) which could later be used by the Russian leadership with little if any independent control.

Some of the ways in which these “personal interests within the corporation” manifested themselves during the period analyzed in this book were through the misuse of corporate property for the pursuit of private profit by individuals holding official
positions in the company, and through the company’s alleged role in helping set up murky intermediary companies, which we discuss in the next section.

The complex relationship between state, corporate and personal interests within Gazprom had important effects on the energy-poor states. First, the coexistence of these multiple interests added a variety of not officially acknowledged but de facto real actors to negotiations between Russia and each of these states. Second, Gazprom’s own lack of transparency, lack of clear corporate governance, and mingling of personal, corporate, and state interests in its management limited the company’s ability to act coherently vis-à-vis the energy-poor states.

Role of intermediary companies

The growing role of intermediary companies such as Itera from the mid-1990s on was one manifestation of the increased significance of personal interests-within the corporation in Gazprom during this period. Originally developed as a means to facilitate the barter of Turkmenistan gas for Russian products at a time of severe liquidity constraints in the mid 1990s, intermediary companies quickly expanded and, by the late 1990s, had become a central feature of the post-Soviet political economy of gas. Their growth was facilitated by the intermingling of state, corporate, and personal interests in

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43 The term “intermediary companies” can be used to denote a variety of types of companies, especially in the gas area -- including domestic gas distribution companies with intermediary functions (for example Ukraine’s United Energy Systems (UES) in the mid-1990s), gas trade companies with access to their “own” gas resources in Russia (Itera until 2001), as well as transit intermediaries (Eural Trans Gas) and companies dealing with a single (Dujotekana in Lithuania) or multiple suppliers (RosUkrEnergo in Ukraine since 2006). Our discussion here focuses mostly on Itera, the most clear and best-known example.

44 The first intermediary company was Itera, established in 1994.
Gazprom, as well as by the companies’ dominant role in Central Asian gas markets. Good relations with Gazprom allowed Itera to produce or buy gas at especially low prices; in particular, Gazprom sold gas to Itera at below-market “internal transfer” prices (thus minimizing taxes), gas which Itera subsequently exported at a higher price. Itera was able to do this because, in contrast with Gazprom, it operated outside of formal state-to-state agreements, was not subject to price ceilings, and could sell gas to countries such as Ukraine for prices higher than those charged by Gazprom. Indeed, if Itera’s role in CIS markets has often been analyzed mainly in terms of Gazprom’s maximization of profits (the main arguments being that the original transfer of CIS markets to Itera was a way to reduce Gazprom’s losses resulting from politically-motivated prices\(^45\)), a closer look reveals the importance of other factors playing a role, in particular the role of personal-within-the corporation factors in Itera’s establishment.

Intermediary companies partially supplied gas from their “own” fields (as in the case of Itera), and partially as intermediaries for the transit and/or sale of Central Asian gas to these countries. Of the cases analyzed in this book, intermediary companies were especially active in Ukraine, where from 1999 to 2002 supplies by Itera exceeded supplies by Gazprom; between 2000 and 2002, Itera exported more gas to CIS countries than Gazprom.\(^46\) With the acquiescence of important players in each of the countries involved, Itera and related companies were able to divert significant profits from both Gazprom and the importing countries by charging high prices for services such as

\(^{45}\) Similarly, it has been argued that the easing out of Itera from Gazprom’s markets a few years later was a way for Gazprom to regain profits, especially after these CIS markets started to recover. Katja Yafimava, *Post-Soviet Russian-Belarussian Relationships: The Role of Gas Transit Pipelines* (Stuttgart: Ibidem-Verlag, 2007) makes the last argument was in the case of Belarus.

\(^{46}\) Stern, *The Future of Russian Gas*, 69 (Table 2.2).
“arranging transit” for the benefit, not only of Itera, but of members of Gazprom’s top management itself.47

If perhaps the best-known incidents of asset-stripping in detriment of Gazprom but in benefit of intermediary companies concern Itera, the case is hardly unique. As we will see throughout the following chapters of this book, our case studies present numerous examples of situations where formally state-owned companies have been used by some of their top managers for the pursuit of personal interests.

**Impact on the energy-poor states**

The important role played by intermediary companies had significant effects on Russia’s gas relationships with CIS states, especially Ukraine. Looked-at from the perspective of the energy-poor states, intermediary companies especially active in the trade of Central Asian gas offered the promise of easing the way to geographical and contractual diversification.

In a purely short-term perspective, the deals put in place by intermediary companies could also help moderate price increases, as the official state companies (for example, Gazprom and NAK Naftohaz Ukraini) could be paid less, leaving a margin that could be used to charge lower prices than those charged by non-insider deals, while still retaining a margin for whatever “accommodation money” could be needed.48 In a longer-

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48 For a more positive assessment of intermediary companies’ role in securing a gradual, “soft-landing” transition from heavily subsidized to “market” gas prices, see Andrei Konoplyanik, “Russia-Ukraine Gas...
term perspective, however, intermediary companies had much more detrimental effects. For example, it was not in the interest of Itera (and, arguably, in that of the high Gazprom management presumably linked to it) that the question of the non-sanctioned extraction (e.g., “stealing of gas”) from the transit pipelines crossing Ukraine be solved. Indeed, totally closing the Ukrainian “hole” would not have been in Itera’s interest, as the company was suspected of illegally exporting 3 to 4 bcm of gas yearly to the West, but covering this up by ascribing it to “stealing by Ukraine.” 49 As shown especially clearly by the Ukrainian case discussed in chapter 4, intermediary companies were often used for the shared appropriation of rents by Ukrainian and Russian elites, serving as an important mechanism for the short-term harmonization of their interests. Even when intermediary companies such as Itera and RosUkrEnergo officially presented themselves as devoted to coordinating interests in the energy area, it could hardly be expected that, given these interests, such companies could play a long-term positive role in helping reduce long-standing tensions between Ukraine and Russia around the gas stealing issue.

Last but not least, the misuse of corporate property for the pursuit of private profit through companies such as Itera affected the pressures and rent-seeking opportunities experienced by actors in the energy-poor states. Thus, for example, actors in the energy-poor states acquired new incentives to engage in corruption. 50 As will be discussed in

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50 It has been argued that intermediary companies and the associated corruption opportunities were part of a Russian strategy to weaken Ukrainian resolve to deal with its energy dependency on Russia. See Margarita M. Balmaceda, “Energy Business and Foreign Policies in Belarus and Ukraine,” presentation at the conference on "Economic Interests and Foreign Policy Choices: the Case of Slavic Triangle," University of
more detail in chapters 4 and 6, intermediary companies provided actors in both Russia and the energy-poor states with important rent-seeking opportunities, and cannot be seen as one-sidedly benefitting the “Russian side” alone. Their important role in trade with the energy-poor states, however, is directly related to Gazprom’s internal organization and domestic role. Paradoxical as this may seem at first, it was Gazprom’s de facto monopolization of post-Soviet gas trade which set the stage for the important role played by intermediary companies. This is so because it was exactly this monopoly role which gave Gazprom (or, more likely, influential players within it) the ability to sway actors into accepting such intermediary companies.

It could be argued that this very monopolization made it easier for those pursuing personal interests within the corporation to push under-the-table, non-transparent arrangements on their energy-poor partners than if there was no monopolization. This is so because in the absence of a real competitive gas market, it was easier for actors within Gazprom to peddle alternative, poorly-regulated deals as the only possible means for “diversifying” contracts. With privileged access to proprietary information on gas flows, as the sole regulator of the export pipeline, and with a “relatively costless and effortless way of hiding its profits,” Gazprom managers were able to effectively present their preferred schemes as alternatives to the company’s monopoly. In other words, the

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52 As most likely happened in during the January 2006 negotiations involving Ukraine’s Naftohaz, Gazprom, and the intermediary company RosUkrEnergo. See Oleksander Chalii (former Ukrainian Minister of European Integration) in Radio Free Europe program for Ukraine, Vichirna Svoboda, January 8, 2009, heard on www.radiosvaboda.org.
monopoly and gate-keeping powers held by Gazprom as a corporation gave individual actors within it the perfect conditions to create artificial scarcities that could then be turned into rent-seeking opportunities.\textsuperscript{53}

The rise of intermediary companies, many of which dealt with Central Asian gas, took place in the context of Gazprom’s growing involvement in Central Asian markets. Thus, a small excursus on the issue is in order, before we return to issue of changes in Gazprom after 2001.

\textit{Gazprom, Central Asia, and the energy-poor states: a brief excursus}

One of the options available to Gazprom to compensate for its own decreasing production was to tap Central Asian gas production. By the early 2000s, Central Asian gas had become essential for Gazprom to make up the difference between its domestic production and its total commitments (domestic demand and export contracts to CIS and WE markets).\textsuperscript{54}

Yet these increased imports from Central Asia were also the result of a business decision: that it would more advantageous to import gas from Central Asia for re-export to WE markets than to engage in the large-scale development of expensive new fields.\textsuperscript{55}

While this model worked more or less efficiently as long as Central Asian leaders could


\textsuperscript{54} The use of Central Asian gas to fulfill Gazprom export commitments increased significantly after 2000, to 59.7 bcm in 2007. By 2008, Gazprom had in place contracts with Turkmenistan, Kazakhstan, and Uzbekistan amounting to c. 70-100 bcm/year by the early 2010’s. Stern, “The Russian Gas Balance to 2015,” 70.

\textsuperscript{55} Exports to the Asia-Pacific Region and LNG exports involved a different logic and a different type of calculations. See Bradshaw, "A New Energy Age in Pacific Russia".
be coaxed into selling gas to Gazprom at prices significantly lower than WE prices, this changed cardinally in 2008 as Gazprom and Turkmenistan signed an agreement providing for, effective 2009, the sale of that gas to Gazprom at European prices, while WE gas prices declined.  

What were the implications of Russia’s growing reliance on, and growing role in, Central Asian gas markets, for Russia’s energy-poor neighbors?

First, Central Asian gas was used by Gazprom for something more than simply filling in for domestic production – it was also used to delay the demonopolization of the domestic gas market, as it allowed Gazprom to continue to fulfill its export commitments without opening access to exports to other Russian producers. This affected Ukraine, Belarus and Lithuania by preventing the emergence of alternatives to Russian supplies from Gazprom.

Second, Gazprom’s buying up of a significant (in some cases the whole) gas production of Central Asian states such as Turkmenistan created obvious problems for the energy-poor states’ ability to diversify, as -- at least in theory -- Central Asian gas was many energy-poor states’ only realistic alternative to sole dependency on Russian gas. Third, Gazprom’s near-monopolization of Central Asian gas exports and gatekeeper role in their marketing facilitated the involvement of Russian-based intermediaries in energy trade between Central Asia and the energy-poor states.  

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56 While the 2008 Gazprom agreement with Turkmenistan was done largely in an attempt to prevent the latter from selling those volumes to the EU-supported Nabucco gas pipeline project and the Chinese market, it also implied significant economic costs, in particular a significant reduction in Gazprom’s arbitrage gains in reselling Central Asian gas in Europe at higher prices than originally paid. Stern, “The Russian Gas Balance to 2015,” 75. See also Andrew Kramer, “Gazprom caught in a trap of its own,” *International Herald Tribune*, May 15, 2009.

57 Here it is interesting to note comments by the Gazprom management, especially in the early 2000s, to the effect that states such as Ukraine should rely less on Gazprom gas and import more from Turkmenistan,
made it possible for new forms of corruption to emerge, best exemplified by companies such as Eural Trans Gas and RosUkrEnergo which, as discussed in chapter 4 below, were able to, with the acquiesce of important players in each of the countries involved, divert significant profits from Gazprom and the importing countries by charging high prices for services, such as “arranging transit,” that could be offered directly by Gazprom at a much lower price.\(^58\)

Last but not least, the actual modalities under which Central Asian gas trade was conducted -- under whose control and under what “rules of the game”-- had important effects in terms of the energy poor states’ broader energy trade with Russia. How manipulations around CA gas would be part of corrupt rent-seeking arrangements also involving Russian players would also come to affect the possibility of this gas becoming a factor of real diversification (as opposed to pseudo-diversification) for these states.

**Pre- and post-2001 changes in Gazprom and their impact on personal interests within the corporation**

Impatience with the “asset-striping” and other personal-interest-within-the corporation deals to the benefit of Itera and other intermediary companies going on at Gazprom -- as well as with the company’s alliance with Kremlin foe Moscow mayor Yuri

\(^58\) For examples of this situation in the case of Ukraine, see chapter 4 below and Balmaceda, *Energy Dependency*, 92 ff. and 112.
Luzhkov—partially explains the government’s 2001 initiative not to reappoint Gazprom CEO Rem Viakhirev. Most often, the change has been interpreted as a reassertion of Gazprom’s corporate interests, as opposed to “personal interests within the corporation.” Together with growing state control of the oil sector after 2003 (discussed later in this chapter), Viakhirev’s dismissal is most often interpreted as an example of growing state control of the energy sector. An alternative explanation of this change, however, focuses on Putin’s need to establish full control over Russia’s biggest company after he became president in 2000; thus Viakhirev’s replacement by Aleksei Miller, and that of gas-sector professionals with many years of experience by younger professionals from the close-to-Putin “St. Petersburg group” with little gas experience but proven loyalty to the new president.

While these personnel changes signaled a strengthening of Putin’s allies within the company, they did not, however, mean an end of divisions within the company, nor an end of personal-interests within the corporation. Indeed, rent-seeking through intermediary companies did not end with Viakhirev’s removal. As will be discussed in detail in chapters 4, 5, and 6, if around 2002-2003 a trend towards replacing Itera or other suppliers for the benefit of either Gazprom itself (in the case of Belarus) or other Gazprom-related intermediary companies (Ukraine, Lithuania) could be observed, this change seemed to have been more about the names of the companies involved than about a cessation of their often corrupt rent-seeking. In terms of divisions within the company,

59 On Viakhirev and Luzhkov, see V. Paniushin, and M. Zygar, Gazprom: Novoe russkoe oruzhie (Moscow: Zakharov, 2008).

60 As of 2010, only four members of Gazprom’s 17-member management board had a gas-industry background. See http://www.gazprom.ru/management/board/ (accessed May 10, 2010).

it is worth noting the emergence of a strong “pipeline lobby” within the company during this period -- a phenomenon with both policy (building of new pipelines sidestepping Ukraine and Belarus) and potential rent-seeking implications.\textsuperscript{62} Another example of divisions within Gazprom concerns the tension between \textit{siloviki} (representatives of the security apparatus) and “civilians” within the company, best exemplified by the conflict between head of the Presidential Administration Igor Sechin and Dimitry Medvedev during the latter’s tenure as chairman or vice-Chairman of Gazprom’s board (2000-2003).

Despite these caveats, it is clear that after 2001 Gazprom becomes a “more consolidated entity,” as seem, for example, by the way subsidiaries associated with private-interests-within the corporation were bought back by the company after 2001. After 2001, Gazprom is also is more protected by the executive, as seen by its success at reducing its tax liabilities and at fending attempts by reformers (such as the Minister of Economic Development German Gref) to restructure the company.\textsuperscript{63}

\textbf{Gazprom’s investment policies}

Gazprom’s investment strategies have been blamed by many for the company’s declining production after 1991. Even if figuring into the equation the company’s difficult economic situation in the early- and mid-1990s, at issue have been fundamental questions of investment preferences given these limited resources. Much of Gazprom’s investment policy since 1992 was directed, not so much towards upstream operations

\textsuperscript{62} It has been argued that this lobby’s interest specifically in building pipelines is related to rent-seeking considerations, as non-transparent financial flows are easier to maintain in that area. On the “pipeline lobby,” see also \textit{Neftegazovaya Vertikal}, no. 12 (2005): 80.

(e.g., replacing reserves and increasing production), or core downstream activities (assuring reliability of deliveries and the efficient use of existing pipeline infrastructure), but towards the acquisition of non-core businesses (*neprofilnie aktivy*). Plans to develop high-cost and less immediately crucial midstream infrastructure such as new pipelines largely duplicating already existing ones through Ukraine and Belarus, would also be examples of this tendency. Although serious discussion of building pipeline infrastructure specifically to bypass Ukraine and Belarus --the NEGP and White Stream projects-- did not start until later, c. 2006, already in the earlier period Gazprom was devoting significant investment resources to major alternative export infrastructure projects, such as the Yamal-Europe pipeline through Belarus and Blue Stream through Turkey. Gazprom’s purchase of newspapers and TV stations critical of the Russian government, arguably at the request of the Kremlin and with the aim to limit their critical voice, was an additional area of questionable investments.

**Impact on the relationship with the energy-poor states**

The neglect of investments in production and core transit infrastructure had important consequences for the relationship with the energy-poor states.

First, whereas the state of disrepair of export pipelines crossing Ukraine has received most attention, lack of investments in the upkeep of Russia’s own aging pipeline system led to the inefficient operation of the turbines moving gas through the pipeline, and to reduced pressure ratings that in turn limited the amount of gas the system could transport, in addition to increased losses through gas leaks. These are not trivial issues, as gas used in the operation of the gas pipeline system itself accounted for almost one third
of Russia’s total final gas consumption (c. 2005), leading to less gas available for export. Reduced pipeline throughput capacities led, in turn, to smaller spare transmission capacities, repeatedly cited by Gazprom as the crucial reason for limiting third party access and the development of domestic competition in the upstream sector. The causality, however, could be looked at differently: in fact, Gazprom has used lack of spare capacity in the system as an excuse for limiting third party access to its pipeline system. Limited investments in the core downstream sector also affected Gazprom’s ability to bring to market the gas it produces, strengthening dependency on transit states and neighboring countries having significant storage facilities.

Section II: The Political Economy of Russian oil

The specificities of the Russian oil industry are closely related to its development in the post-Soviet period. Following a 1992 presidential decree calling for the break-up of the state monopoly on oil, a number of companies were set up either on a geographical (the Eastern Oil Company), “republican” (Tatarstan’s Tatneft, Bashkorkistan’s Bashneft) or a vertically-integrated basis combining production units, refineries, and distribution facilities irrespective of the geographical location of their units (LUKoil, Surgutneftegaz). While a significant portion of shares was sold to company insiders, the state would retain a majority of shares in most of these companies until the 1994-1995 “loans for shares” program where, cash-strapped, the state put oil and other strategic industries up as collateral for large loans. With the non-repayment of these loans, some of the country’s

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64 IEA, Optimizing., 36.
most strategic assets (including oil companies Sidanko, Yukos, and Sibneft) became the property of emerging private banks. This process was also widely seen as president Yeltsin’s capitulation to budding domestic oligarchs, whose economic power grew immensely as a result of the deals. By 1996 Russia’s oil sector had emerged from the privatization process with the former oil monopolist divided among eleven vertically-integrated, partially privatized companies.  

**Russia’s changing oil resource base**

Similar to the case of gas, the early 2000s signified for Russia the end of “cheap oil.” As can be seen in Table 3.3, the disarray immediately following the Soviet demise led to sharp declines in oil production, which went from 461 Mt in 1991 to 301 in 1996. Production stabilized between 1996 and 2000, and started to grow again in 1999—strongly until 2004, and at a much more moderate pace until and 2007, after which it started to decline slightly again. By the late 1990s, growing export prices relative to production costs led the oil companies to seek to maximize exports as a means to increase liquidity, but their strategy during this period was a short-term one, as they sought to increase production for export largely through the acquisition of smaller companies, and

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65 Ibid, 19. In 2002, “Gazprom had to reduce the throughput of the system to 60 bcm less than its rated operational capacity.” Ibid.

66 For 1996 data on the percentage of state ownership in each of Russia’s eleven vertically-integrated companies, see International Energy Agency, *Russian Energy Survey 2002* (Paris, IEA, 2002), 69 (Table 4.3).

67 Most analysts see these declines as an undesired outcome resulting from structural issues and tax disincentives; Gaddy and Ickes, on the other hand, see them as the intended result of a conscious “depletion rates management” policy by the Russian state aimed at preventing over-production and over-reliance on oil rents. Clifford C. Gaddy and Barry W. Ickes, “Russia’s Declining Oil Production: Managing Price Risk and Rent Addiction,” *Eurasian Geography and Economics* 50, no. 1 (2009): 1-13. See also Gaddy and Ickes, “Resource Rents” and (for a perspective focusing on “hidden” rents) E. Guvrich, “Neftegazovaia Renta v Rossiiskoi Ekonomike,” *Voprosy Ekonomiki* 11 (2010): 4-24.
not by investing in substantial exploration that would ensure the long-term sustainability of such level of exports.

Strong increases in production the early 2000s coincided with the consolidation of private control over oil companies. Undoubtedly, the increase in world oil prices during the 2000s, which made production from previously marginal fields profitable, was an important contributing cause, but there is debate about other causes at play. Some have argued that it was the new companies’ Western-style management style that was first and foremost responsible for these improvements and that, similarly, post-2005 declines in production are to blame on inefficient management after the increase in state control. Others have argued that it was actually the 1998 economic crisis that helped boost oil production, as the devaluation of the ruble reduced production costs in comparison to export prices, which increased sharply in 1999-2000.\(^68\) Still others argue that these increases in production were mainly the result of easy-to-lift oil “left on the ground” during the period of decreased production in mid-1990’s.\(^69\) The trend towards increased production continued until 2007.

As in the case of gas, in addition to production volumes, reserve replacement ratios are an important indicator of future production trends. Whereas in the Soviet period yearly additions to reserves typically far exceeded production, exploration of new reserves fell drastically after 1991, reducing reserve replacement, which fell below production for most of the period 1994-2004.\(^70\)

\(^{68}\) See David Lane (ed.), The Political Economy of Russian Oil (Oxford: Rowman and Littlefield, 1999). World prices nearly tripled during this period. The previous period, 1995 to 1998, had been a difficult one for Russian oil companies due to weak domestic demand and the over-valuation of the Russian currency, which led to reduced export profits once these were converted back into rubles.

\(^{69}\) Gaddy and Ickes, “Russia’s Declining Oil Production,” 2.

\(^{70}\) See Figure 2 in Valeriy Kryukov and Arild Moe, “Russia’s Oil Industry: Risk Aversion in a Risk-Prone Environment,” Eurasian Geography and Economics 47, no. 3 (2007): 341-357, here 344.
Table 3.3 Russian oil production and exports, 1991-2009 (in Million Tons)

<table>
<thead>
<tr>
<th>Year</th>
<th>Oil Production</th>
<th>Exports to CIS (for 2003-2009 FSU)</th>
<th>Exports to rest of the world</th>
<th>Total Exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>461</td>
<td>117</td>
<td>57</td>
<td>174</td>
</tr>
<tr>
<td>1992</td>
<td>396</td>
<td>76</td>
<td>66</td>
<td>142</td>
</tr>
<tr>
<td>1993</td>
<td>344</td>
<td>48</td>
<td>80</td>
<td>128</td>
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<tr>
<td>1994</td>
<td>316</td>
<td>38</td>
<td>89</td>
<td>127</td>
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<tr>
<td>1995</td>
<td>307</td>
<td>31</td>
<td>91</td>
<td>122</td>
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<tr>
<td>1996</td>
<td>301</td>
<td>23</td>
<td>103</td>
<td>126</td>
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<td>1997</td>
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<tr>
<td>2000</td>
<td>323</td>
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<td>126</td>
<td>143</td>
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<td>23</td>
<td>135</td>
<td>158</td>
</tr>
<tr>
<td>2002</td>
<td>361</td>
<td>N/A</td>
<td>N/A</td>
<td>185</td>
</tr>
<tr>
<td>2003</td>
<td>421</td>
<td>44</td>
<td>181</td>
<td>225</td>
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<td>2004</td>
<td>459</td>
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<td>2008</td>
<td>489</td>
<td>35</td>
<td>203</td>
<td>238</td>
</tr>
<tr>
<td>2009</td>
<td>494</td>
<td>34</td>
<td>211</td>
<td>246</td>
</tr>
</tbody>
</table>

Domestic oil issues and their effect on sector actors’ participation in trans-border value-added chains and rent-seeking arrangements

Some of the same types of domestic issues that we saw in the case of gas also affected relations with the energy-poor states in the case of oil. However, the specificities of oil production, transportation and value-added chain also played a role, meriting a separate discussion. Some of the most important issues at stake were issues related to the state of oil-related infrastructure, the state’s relationship with major Russian and international oil companies, the role of Transneft as exports gatekeeper, and the impact of taxation modalities in the area. Each of these elements, which we discuss below, had important implications for Russia’s energy-poor neighbors.

Existing infrastructure

Two aspects of Russia’s oil infrastructure were to have an important effect on relations with energy-poor neighbors: limited export pipeline capacity and limited oil refining capacity. A shortage of oil export pipeline capacity, largely due to poor maintenance, limited oil producers’ ability to bring oil to market, and allowed the state to use access to oil export capacity as means to influence private oil companies. Another important infrastructure issue concerned Russia’s limited oil refining capacity. During the Soviet period, decisions on the building of refineries were made on the basis of the USSR as a single energy market, with specific oil refineries throughout the USSR linked with specific production areas in Russia. As a result, some of the largest and most advanced refineries were located outside Russia -- especially in Belarus and Ukraine -- a factor that would increase the attractiveness of refining in these countries as an often more profitable
means of supplying WE markets (and, in some cases, close-to-the border Russian markets as well). With refining capacities far exceeding local production, these refineries came to rely on ties with Russian producers for their survival; Russian producers, in turn, had strong incentives to use these idle refining capacities as a way to maximize their own value-added chain. As noted in chapter 1, at issue was not so much Russia’s lack of refining capacity per se, but the lack of modern facilities offering the necessary deepness of refining to maximize the added value of exports to WE.

Oil companies’ relationship with the state

In the case of oil, relations between state and private actors developed somewhat differently than in the case of gas due to the different historical trajectories of both sectors since 1991, as well as structural factors, such as Gazprom’s ownership of its export pipelines, while oil producers had to rely almost exclusively on export pipelines owned by Transneft.71

Earlier in this chapter, we discussed how the use and transfer of “convertible points” from the foreign policy realm to a domestic arena, and eventually converted to monetary benefits, varied from sector to sector and case to case. In contrast with the case of gas, the means available to the Russian state -- at least until 2003 with the onset of the confrontation with Yukos -- to affect the behavior of oil companies seem to have been more formal than in the case of gas. The main instruments used for this were export taxes,

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71 Some export shipments took place outside the Transneft pipeline system, for example by rail. Although starting in the early 2000s oil companies started to develop plans to build their own pipelines (most prominent among which were Yukos’ proposal to build a pipeline to China in the early 2000s, and the plan by LUKoil, Yukos, Surgutneftegasa, TNK-BP and Sibneft to build a pipeline from West Siberia to Murmansk that would have facilitated exports to the US), these did not progress far, as the state did not want to lose an important lever (Transneft’s monopoly on oil pipelines) of control over oil companies.
regulating the size of exports vis-à-vis domestic supplies, export quotas and, more generally, control of access to the export pipeline by transit pipeline operator Transneft.\textsuperscript{72}

The regulation of exports through the Transneft state-owned system of oil export pipelines has been crucial given Russia’s oil export pipeline volume deficit relative to production.\textsuperscript{73} Although all companies were in theory allowed to export c. 30\% of their production, de facto “those with greater lobbying power” were able to export a higher percentage of their production.\textsuperscript{74} Additional export quotas (“\textit{dopqvoty}”) were granted for a variety of reasons, for example, as compensation for otherwise unpaid (or paid only subsequently) services to the state.\textsuperscript{75} Yet there seemed to be no fully institutionalized system as to the adjudication of additional quotas, leaving the system prone to manipulation on the basis of political or other interests. This added significance to the question of who controls Transneft; given its power, it is not surprising that the company found itself at the center of repeated battles for its control throughout the 1990s and early 2000’s.

\textsuperscript{72} Other means of state control and state pressure over individual oil companies included the amount of oil that the government receives as part of Production-Sharing Agreement (PSA) arrangements involving Russian oil companies (“\textit{gosdol}”), the granting (or not) of licenses and other privileges in privatization and other investment opportunities, as well as other, ad hoc measures, such as the intentional overzealous tax review of specific companies, as in the case of Yukos, 2003-2004.

\textsuperscript{73} While Russia’s oil production grew significantly in the early 2000s, Transneft’s pipeline capacity did not, and actually was reduced with the termination of pipeline shipments to Latvia’s Ventspils in 2004. Subsequent initiatives, such as the development of the Baltic Pipeline System in Russia’s Baltic coast, have sought to address export capacity issues as well as perceived over-dependence on transit states.

\textsuperscript{74} IEA, \textit{Russian Energy Survey 2002}, 93, Footnote 50.

\textsuperscript{75} On whether “political” or “just economic” interests played the central role in these decisions, see Yakov Pappe, \textit{Oligarkhi} (Moscow: Vyschaya Shkola Ekonomiki, 2000). Oil companies received additional export quotas for a variety of reasons: in one case, an oil company received an additional quota to be able to afford reconstruction after damage sustained in an earthquake, another because it supplied oil to hardship-stricken Kamchatka, another because it operated in Dagestan, in the border with war-ridden Chechnia. These examples show that the system of additional export quotas was often used not so much to regulate exports, but as a way to deal with a variety of domestic concerns.
The Yukos case and its effects on the energy-poor states

The period between 2003 and 2008 marks a change in the main means of influence used by the state in its interaction with oil companies. If until c. 2003 the main means for such influence was control over export infrastructure (through pipeline operator Transneft for oil and Transneftprodukt for oil products), after 2003 we start to see the beginnings of stronger and more direct control. Many ascribe the change in government tactics to the breakdown of the compromise achieved between president Putin and Russian oligarchs upon his coming to power, in the sense of the state respecting their ownership rights -- however murkily acquired -- over strategic assets such as oil companies, in exchange for some changes in their behavior (a less speculative approach), and, most crucially, a retreat from politics.

Nothing served as a clearer sign of these changes as the arrest of Yukos’ -- until then Russia’s largest oil company76 -- CEO Mikhail Khodorkovskii in October 2003. By December of 2004 Yukos had been largely dismantled, with much of its property passing to state hands.77 In particular, Yukos’ filing for bankruptcy to cover the government’s tax claims facilitated the sale of its assets to largely state-owned Rosneft, which became Russia’s largest oil producer as a result.

Changes in the relationship between major oil players and the state affected relations with the energy-poor states through the effects of ownership changes on who would control the use – including the use for political purposes – of these companies’ assets in the energy-poor states. This was most clear in the case of Lithuania, where

76 Yukos overtook LUKoil, the 1990s Russian oil industry leader, in oil production just before Khodorkovskii’s arrest.
77 Technically, this took place through a series of sales to totally — or partially— state-owned companies to cover Yukos’ unpaid taxes.
Yukos had purchased a controlling package of shares in the Mazeikiu Nafta refinery in 2002 (see chapter 6). In that case, the poor relationship between Yukos and the Russian government made it impossible for the refinery to access necessary crude oil supplies from Russia, dooming the enterprise from its very start. Second, as Mazeiku Nafta came under threat as a result of the Russian state’s decision to liquidate the assets of its mother company, Yukos, the company, feeling threatened by the Kremlin and in urgent need for cash to pay its growing tax bill, responded by agreeing to sell the totality of its share package in the refinery. As the battle for control of Yukos’ assets continued, Rosneft, which had assumed Yukos’ debt, sued to block the sale of Mazeiku Nafta to the new bidder, Poland’s Orlen, but was not successful.78

“State” control or crony control?

Yukos’ liquidation was followed by other significant changes increasing the state’s role in the oil sector. The growing state presence in the energy sector was seen not only through the state reaching ownership of 51% of Gazprom’s shares in 2005, but through the reversal of policies concerning foreign investment in important gas projects such as the Sakhalin II project -- where, in disregard to previous agreements, foreign investors (the Royal Dutch Shell-led consortium) were pressured to retreat from the multi-billion dollar oil and gas development project and a controlling stake in the project was transferred to Gazprom.

78 In 2005 Rosneft had signed a confidential agreement with Western creditor banks to assume Yukos’ debt in the event the company was forced into liquidation, which made Rosneft a creditor in Yukos’ bankruptcy filing. See Andrew E. Kramer, “Lithuanians Are Given a Taste of How Russia Plays the Oil Game,” The New York Times, October 28, 2006.
In September 2005, Roman Abramovich --one of the few Russian oligarchs remaining after the forced easing out of Khodorkovskii in 2003-- under pressure from the Kremlin, sold a majority stake in Sibneft’, Russia’s fifth-largest oil producer, to Gazprom. Gazprom’s acquisition of Sibneft’s assets was especially significant as it made Gazprom a significant oil producer, broke the administrative division between oil and gas, and seemed to pave the road for the eventual establishment of a powerful state-controlled kontsern encompassing both oil and gas assets, which could become a mighty instrument for the pursuit of foreign policy goals. By 2008, the Russian government had significantly increased its ownership role in the oil sector, holding 75 percent of shares in Rosneft, Russia’s largest oil producer, and significant minority stakes in several smaller oil companies.

How should we interpret these events? Is the story of the Russian gas and oil industry after 2003 simply one of increased state control? The conventional narrative would argue that the changes in the Russian oil (and gas) sector after 2001, including but not limited to Yukos’ takeover, represented an increased level of state control over the sector. Although there was, indeed, increased state ownership in both sectors, two caveats are in order. First, state ownership in and of itself does not tell the whole story, as the means for control of an enterprise may take a variety of forms -- from setting the rules of the game to controlling the transportation of energy -- above and beyond ownership. Secondly, despite widespread coverage of “Putin bringing the state back in,” the actual meaning of this often-used phrase is unclear. First, because of the lack of a consistent policy due to competition between different factions with different agendas. 79 Second, because of

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79 Heinrich, “Under the Kremlin’s Thumb,” 1542. See also the discussion of post-2001 divisions within Gazprom above.
continued lack of clarity as to whether what is being presented as “state interests” in the battle against anti-Putin oligarchs actually concerns the private interests of Putin’s close associates.\(^{80}\) Moreover, given the lack of democratic control over policy-making, Putin’s proclaimed drive to free the state from the power of interest groups was, de facto, prone to be accompanied by an increase in opportunities for “business capture” by new close-to-the Kremlin elites.\(^{81}\)

**Particularities of Russia’s oil taxation**

Russia’s oil taxation system, known for giving companies few incentives to increase production from existing fields or to invest in expanding future production capacity, had important effects on relations with the energy-poor states. This has to do not only to the nature of Russian oil taxation (which, despite fine-tuning the early 2000s, remained generally highly onerous for producers), but also to uncertainty about its application, including the existence of significant and particularly non-transparent “informal taxes.”\(^{82}\) More generally, the weakness of both property rights and user rights

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(such as exploration licenses) for mineral resources, often used as a means for “compelling the oil companies to share resource rent with the state,” created strong disincentives for oil companies to invest, fostering short-term strategies focused on maximizing output instead.  

One specificity of post-Soviet Russia’s oil regulation system has been the continued use (with a small interruption in 1996-1999) of oil export duties (eksportnye poshlini, often translated as “export taxes”), an instrument rarely used by other countries.  

Officially justified by the state as a way to create institutional incentives or disincentives for oil exports, such duties and taxes were also used to regulate access to scarce export pipeline capacity and, possibly, for more direct political purposes.

Russian companies’ interests in the energy-poor neighbors were impacted by such export regulations, which affected incentives to engage in various refining-and-re-exporting schemes in order to maximize sales to high-profit markets and, thus, profits. This is so because shipments to certain CIS or Customs Union countries, most notably Belarus (as well as, during some periods, Ukraine) did not count as “exports” during much of the 1991-2010 period. (Indeed, the issue of which countries should be

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83 Kryukov and Moe, “Russia’s Oil Industry,” 353.
84 See Alexeev and Conrad, “The Russian Oil Tax Regime,” 109. Oil export taxes were abolished in 1996 at the urging of the IMF, but were reinstated in 1999 as a means to appropriate some of the profits made by exporters in the wake of the 1998 economic crises, when the devaluation of the ruble reduced dollar production costs and increased the profitability of oil and gas exports. In 2002, oil export taxes started to be calculated according to a formula that increased them as world oil prices increased. See IEA, Russian Energy Survey 2002, 78, and Shinichiro Tabata, “Russian Revenues from Oil and Gas Exports: Flow and Taxation,” Eurasian Geography and Economics 43, no. 8 (2002): 610-627, here 617.
85 The hope of no export duties was an original source of support for the CIS Customs Union; similarly, whether oil and gas deliveries will be duty-free has been one of the major issues of debate concerning the Russia-Belarus-Kazakhstan Customs Union that entered into force on July 1, 2010.
exempted from these export duties was a constant issue of debate, and also used by the Russian side for political purposes.\textsuperscript{86)}

The impact was especially seen in the case of Belarus, which, for most of the period examined in this book, was not considered a foreign “export” destination and deliveries to which were not subject to export duties.\textsuperscript{87} Exporting crude oil to Belarus for refining and subsequent sale to third markets was an attractive means of circumventing Russian export limitations, and also allowed the Belarusian government to reap very large profits which, as will be discussed in chapter 6, became crucial for its economic and political survival. As export limitations on the part of the Russian government increased, this often led to more oil being shipped to Belarus (and Ukraine) for refining and subsequent ‘indirect export’ in the form of oil products. Similarly, 2002 changes in the tax code making the size of oil export duties dependent on world prices increased the incentives for Russian companies to avoid these during periods of rising world oil prices by engaging in such refining and re-exporting schemes.\textsuperscript{88}

\textsuperscript{86} The taxation of Russian oil (and gas) exports to former Soviet states has been subject to a variety of complex and changing regulations involving country-of-origin or country-of destination application of VAT, export and excise taxes. For a background on the issue and its impact on Ukraine, see Clinton R. Shiells, “Optimal Taxation of Energy Trade: the Case of Russia and Ukraine,” 2-6 (available at \texttt{<http://www.etsg.org/ETSG2005/papers/shiells.pdf>}) (accessed June 28, 2006), and Clinton R. Shiells, “VAT Design and Energy Trade: The Case of Russia and Ukraine,” \textit{IMF Staff Papers} 52, no. 1 (2005): 103-119. While it is impossible to fully trace the changing regulations here, it is worth noting that the very complexity of these regulations facilitated their manipulation for both tax-evasion and political purposes. See also Tabata, “Russian Revenues,” 625-626.

\textsuperscript{87} On January 1, 2010, in the midst of worsening relations, Russia introduced export duties on crude oil deliveries to Belarus.

\textsuperscript{88} Similarly, the dramatic decrease in world oil prices since 2008 and reduction in the gap between domestic and world prices reduced the possible profits that could be accrued by Russian companies through refining-and-re-exporting operations. As will be discussed in chapter 5, in the case of Belarus, changes in the distribution of tax and duties between Russia and Belarus after 2007 further reduced Russian companies’ incentives in this area.
Conclusion

Russian energy actors had to balance a number of different interests vis-à-vis the state and other local and international actors. This helps us explain, among others, their willingness to supply oil and gas to CIS markets despite their very limited profitability until 2008. Lower price levels in most post-Soviet markets were largely compensated by the possibility for large and easily-accessible rent-seeking through arbitrage gains from price differentials between different energy markets (in turn related to the way exports to various post-Soviet markets were designated and taxed\(^8^9\)), by the importance of transit countries as elements in Russian companies’ value-added chain, and by the system of virtual “convertible points,” which allowed domestic energy producers to convert their losses in an area into advantages in other aspects of their relationship with the state.

These three elements manifested themselves differently in the oil and gas cases. In the case of oil, through a more institutionalized relationship between the state and oil companies, and, in the case of gas, subsumed, in a much more politicized way, into the general relationship between Gazprom and the state, a relationship complicated by the multiple roles often played by the Gazprom leadership, at times as Gazprom managers and at times as private rent-seekers.

Russia: an energy giant with feet of clay?

During the period covered by this book, Russia remained a paradoxical energy power. On the one hand, its large gas and oil resources made it a crucial player, giving the country a strong basis for international leverage. On the other hand, significant
domestic problems (declining gas production, creeping Dutch disease, an outdated and poorly-managed energy infrastructure, and over-dependency on volatile energy revenues) made Russia an energy giant with feet of clay. In particular, the broader disbalances in the Russian economy often referred to in shorthand as “rentier state disease” also affected Russia’s ability to project its energy power in the neighboring states.

While there is little doubt that Russia has sought to use energy as a means to exert political power over its energy-poor neighbors, Russia’s use of energy for foreign policy goals was itself limited by a number of domestic factors. Some of these factors, as we have discussed in this chapter, had to do with the physical limits on the “resource” itself and the cost involved in bringing supplies to market. Russia’s growing commitments to use energy in other geographical directions (including domestically for various policy and political reasons) further limited the energy resources available for political pressure on the neighboring states. Last but not least, domestic Russian rent-seeking around oil and gas (and the Kremlin’s either participating in it or tolerating it for domestic political reasons) also affected Russia’s ability to use energy as a means of foreign policy pressure. The coexistence of state, corporate, and personal-within-the corporation interests in companies such as Gazprom also tells us that a multitude of pressures and influences affect foreign energy-policy-relevant behavior by Russian energy actors. Thus, there is one important limitation in the “energy as a weapon” approach in terms of explaining Russia’s behavior in the FSU -- if, indeed, energy can be used as a political “weapon,” it can also be used for other purposes, with these various ways of “using” energy often in competition with each other. Within this framework, the use of energy for direct external

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89 There were repeated changes in this area due to changing Russian regulations and membership in various customs agreements, but, for most of the period under consideration, supplies to Belarus were considered
economic pressure on their post-Soviet neighbors is only one among several options. As will be seen in the following case studies, however, the role of Russian energy actors in the energy-poor states went well beyond Russia’s ability to use energy as a foreign policy tool. Rather, energy actors on both sides of the border found themselves tied to each other in a multitude of ways, deeply enmeshed into local value-added and rent-seeking chains and, ultimately, in the domestic cycle of energy rents.

equivalent to domestic supplies, while supplies to other post-Soviet republics were not.