

EU–RUSSIA ENERGY DIALOGUE AND LITHUANIA’S ENERGY SECURITY

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Background

National security, energy security, and co-operation in the energy sector between Russia and the West start regaining their status of extra-popular subjects. After the unjustifiably long time Lithuania has eventually witnessed the opinion that its energy security is impaired by not only Russia’s, but also Western partners’ unfriendly policy. On the other hand, this “afflatus” has not produced the sufficient impetus to shaping Lithuania’s clear security policy and to starting its implementation. Action is limited to discontent that not all partners are friendly, that no account is taken of Lithuanian interests and that our problems are ignored. Frustration at the same time is accompanied with the hope that someone will help resolve those problems and offer an analogous NATO “umbrella” (by the way, such an initiative was brought up by the Polish Prime Minister). Unfortunately, from back in the times of the industrial revolution energy security has been a national matter, often much dearer (in all senses) than “friendship”.

At present, there have been signs of developing the measures, which could neutralise Lithuania’s vulnerabilities in the energy sector. However, many of them are beyond the means for a small state or even a group of states. What seems apparent is that Lithuania will not be able to stop the construction of the North European Gas Pipeline (recently renamed to “Nord Stream”) alongside our coast same as we would not have been able to lay the gas pipeline from Norway, which was planned ten years ago. At times decisions that can improve energy security are much simpler than that, requiring no billion-worth expenditure, which is never to pay off.

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This article demonstrates that not before the energy sector becomes a “normal” business submitting only to the laws of economy will it submit to other, geoenergetic, laws. The provided geoenergetics-based explanation of trade in energy resources describes the processes developing around Lithuania as natural and inevitable. Lithuania is stuck between Western Europe and Russia with all the resulting effects on our energy security, and none of the parties are interested in changing this situation.

This is how it would have been remained be it not Russia’s decision to block gas supplies to Ukraine on the first days of January 2006. This Kremlin’s decision was not the first and, likewise, not the last (as also shown by the dry oil supplies to Mažeikių nafta). It is nevertheless special for destroying the established routine of trade in energy resources between Western Europe and Russia, which will have to be created anew. The statement that the development of a new order enables Lithuania to substantially improve its security status is based on the theory of the formation of international regimes. This change lies in presenting Europe with two alternatives: either the European Commission becomes a common focal point for energy policy, including security, or Lithuania makes its best effort to support the expansion of Russia-controlled enterprises to Western Europe to give the latter the chance to experience all the twists and turns of the Russian energy business. Both solutions would be beneficial for Lithuania with *status quo* being the most harmful option.

Preconditions for EU–Russia co-operation in the energy sector

The world through the prism of geoenergetics

One of the greatest challenges for the states’ energy policy was, has been and will be the ensuring of energy security. It is like *perpetuum mobile*, which forces co-operation, competition, ignoring and constant looking back over the shoulder. Energy security is the securing of long-term stable supply of strategically important raw materials for acceptable price. Ensuring energy security implies full satisfaction of demand for energy resources for acceptable price through stable supply of diversified resources over diversified routes from stable suppliers, i.e. the maximum minimisation

of the risk of potential change in the supply conditions. This definition of energy security applies to countries which both import and export energy resources.

The following can be viewed as the major threats for Lithuanian energy security: *first*, dependence on the single supplier of energy resources; *second*, unavailability of offsets from the (economic, political and social) influence of the resource supplier; *third*, dependence of the national economy on the single energy resource (natural gas, nuclear fuel or oil); *fourth*, too high dependence of the national economy on energy resources – high energy intensity; *fifth*, monopolisation of the energy sector and vertical integration, particularly if the energy supplier is the subject of control; *sixth*, dependence on the vulnerable energy infrastructure; *seventh*, dependence on unstable and/or unpredictable supplier/-s of energy resources; *eighth*, the unavailability of threat-neutralising measures. In the broad sense, energy security encompasses the ensuring of the favourable and stable position of a state or another actor (a group of states or a region) in the global energy market, elimination of potential risks and the capacity to eliminate them.

As can be seen, energy security inevitably relates to external policy, primarily to relations with suppliers of energy resources. According to the researcher of the energy security policy Michael A. Toman, energy security is fundamentally an international problem that transcends any one country's supply picture or policy measures; effective measures to countervail energy disturbances may require significant international cooperation [1]. Another important aspect in the analysis of energy security policy is that it must be focused on the long term because short-term measures are normally good only for reactive action and cannot be viewed as an acceptable prevention tool. Energy security measures must project not only policy changes with respect to specific actors, but also the alterations and adjustments of the energy system. This is how energy policy finds itself somewhere in between economy, business, domestic and external policy, geopolitics and international relations. One of the most acceptable instruments to find out who acts where, how and why is *geoenergetics* or *energy geopolitics*.

1. Michael A. Toman, "What Do We Know About Energy Security?", <http://www.cato.org/pubs/regulation/reg14n1i.html>

Geoenergetics can be defined as the constituent of geoeconomics which explores: *first*, the dissemination of energy policy in the global space; *second*, the conformity of energy policy with geopolitical transformations; *third*, the influence of energy resource markets on state policies; *fourth*, in what way political actors use their energy systems to develop their power; *fifth*, state and regional vulnerabilities in the energy field; and *sixth*, the regions' interrelationships in the energy field. Geoenergetics is one of the aspects producing the strongest correlation between geography and economics, which shows how the unequal distribution of natural resources on the Globe brings geoeconomic advantage and power to specific areas. Geoenergetics may also be used to define energy policy as the use of energy systems to achieve desired goals. Actors which implement such a policy are geoenergetic actors [2].

Geoenergetic research serves as a basis for the formation of geoenergetic schemes – the instruments of analysis used to determine the principal actors, their business trends and their impact on the geopolitical situation as well as the impact of the energy aspects in the geographic area on geopolitical processes. The geoenergetic scheme consists of three types of geoenergetic zones, which are determined according to the prevailing nature of infrastructure: *first*, producing of energy resources, *second*, transportation and processing of energy resources, and *third*, distribution and consumption. Based on the dependence of political formations (states or regions), geoenergetic zones are broken down into the following types by geoenergetic actors: *first*, producers, *second*, transporters and processors, and *third*, consumers. Identification of the types of actors in the entire geoenergetic scheme allows for the determination of the trend, nature and strength of their interdependence.

2. Geoenergetic actor is an institutional or non-institutional economic-political actor which operates or is related to the specific part of the energy system. Geoenergetic actor is described by not only the management of physical energy elements, but also the actions aimed at changing existing systems, retaining them or using them to achieve political goals. Geoenergetic actor can be energy companies (private or state-owned, national or trans-national), states or international organisations.

Table 1. Geoenergetic and geoeconomic zones

Geoenergetic zone		Geoeconomic zone		Examples
Zone	Criteria	Zone	Criteria	
Production1*	<p>Production of energy resources.</p> <p>Predominant position of the energy sector in economy.</p> <p>Development of relations with consumer states and search for new markets.</p> <p>Investments from consumer states into the sector of natural resources.</p>	Periphery	<p>Technological backwardness.</p> <p>Cheap labour force.</p> <p>Consumption of products from core states.</p> <p>Supply of natural resources to core states.</p> <p>Economy specialisation in the sector of natural resources.</p>	<p>Russia, the Caspian Sea Basin, Western Africa, North Africa, East Africa, the Caribbean Sea Basin, the Persian Gulf.</p>
Transportation and processing2*	<p>Import of energy resources from production zones.</p> <p>Transit of energy resources of production zones to consumption zones and processing.</p> <p>Dependence on production or consumption zones.</p> <p>High energy intensity.</p> <p>Broad network of transportation links.</p>	Semi-periphery	<p>Average technologies.</p> <p>Qualified cheap labour force.</p> <p>Competitive economy.</p> <p>Import of raw materials from periphery.</p>	<p>Central and Eastern Europe, South Asia.</p>

Consumption^{3*} High consumption of energy. Import of energy resources from production zones. Investments into the energy sector of production zones.	Semi-peripheral consumption zone	Ref. criteria for consumption zone and for semi-periphery.	India and China
	Core	Advanced technologies. Highly-qualified labour force. Production of high-quality end products. Import of raw materials from periphery states.	Western Europe, North America, East Asia (Japan, South Korea).

1* *Geoenergetic production zones* are geoeconomic peripheries characterised by technological backwardness, cheap labour force and technological dependence on consumption zones. The economy of production zone states is normally non-diversified and depends on the energy sector. Russia and the Caspian Sea Basin are the most relevant zones for energy security of Lithuania and the entire Central and Eastern Europe.

2* *Geoenergetic transportation and processing zones* are geoeconomic semi-peripheries, whose distinguishing features are competitive economy, qualified and cheap labour force and average, yet rapidly developing, technologies. Their key geoenergetic criterion is the nature of the energy infrastructure – a broad network for transporting energy resources. Through these areas energy resources are transported from production zones to consumption zones. Transportation and processing zones are also dominated by the processing industry. The semi-peripheries are dependent on both consumption zones (technological dependence) and production zones (natural resources dependence). Lithuania, like the majority of other Central and East European states, is a typical transportation and processing zone country: *first*, it imports the total quantity of consumed gas and most of oil; *second*, the refinery Mažeikių nafta processes oil brought from Russia (at present also from other production regions), whereas oil products are supplied to not only neighbours, but also consumption zone countries; *third*, Russian oil is exported through the Būtingė Oil Terminal (before cut-off of oil supply); *fourth*, using the uranium produced in Russia, Ignalina Nuclear Power Plant produces electricity for not only Lithuania, but also the neighbouring states.

3* *Geoenergetic consumption zones* normally are geoeconomic core where production is based on high technologies and qualified labour force. Core zone states import raw materials from the periphery, i.e. production zones. Consumption zones, in exchange for energy resources, invest into production zones and transfer the technologies required for the maintenance of the raw material sector. Lithuanian energy security directly depends on the processes in the Western European consumption zone and on its relations with other actors.

This definition of the principal actors in the global market of energy resources facilitates the explanation of their behaviour. On the one hand, it seems natural that actors in different consumption zones compete with each other (China, USA, Western Europe), that so do actors in different production zones (Russia with the Persian Gulf countries, for instance, with Iran, over gas supplies to the EU), that the control of the transportation and processing zone is important for both producers and consumers and also that actors in production and consumption zones find it important and beneficial to co-operate (Europe and Russia).

On the other hand, it is apparent that behaviour in energy resource markets is not necessarily determined by the geoenergetic scheme. This was clearly shown in 2006 when many things were or started to be turned upside down – *the actors' interests started changing*.

Unsuccessful attempts to institutionalise relations

The most apparent attempt to institutionalise relations between actors of the production, consumption and transportation and processing zones was the Energy Charter Treaty (ECT), which was supposed to project energy supplies from former Soviet Union in exchange for investments and technologies, and stable transit. In 1994 the ECT was signed by 49 states and the European Union. Following ratification by 30 states on 14 April 1998, the ECT came into force. It envisages the goal to create “a legal framework in order to promote long-term cooperation in the energy field, based on complementarities and mutual benefits” (article 2). The ECT defined conditions for investing into the production of energy resources and the principle of freedom with respect to the transit of energy resources and its non-discriminatory nature. In the case of conflict between the ECT member states, the counterparts undertake not to discontinue supply of energy resources and products (in contrast to what was done in the Ukrainian case). The ECT, however, never started to fully operate because it was not ratified by one of the key states for the envisaged regime – Russia. In January 2001, the hearing of the ECT ratification was held in the Duma. The Government and some state-owned companies expressed support to ratification, but Gazprom was strictly against. The major argument was the

competitive fear of Central Asian states. This argument has still remained as the principal one.

Following review of the ECT provisions and the predicted preferences of actors in the international energy sector, it is seen that the new regime [3] was most favourable for actors of the consumption and transportation and the processing zone (stable supply, investing opportunities, consolidation of the transportation and processing zone). For actors of the production zone, namely the Russian Government, this implied merely the implementation of stable supply and of the development of the energy sector. Owing to the activity of actors in the consumption zone, the ECT would impair the chances of the Russian Government to control the energy sector and earned income and would reduce decision-making autonomy in developing alternative markets. The creation of transit opportunities for competing actors (Central Asian states) would impair the competitive advantage of Gazprom (and of other companies engaged in production), undermine the monopolist's annuity, reduce the opportunities to control consumption markets and cut the price of energy resources. For this reason the fact that Russia renounced the ECT and will never ratify it, the way it is now, is absolutely natural.

January 2006 – fall of the regime

On the other hand, the fact that the ECT did not work does not imply that there has been no regime in the international energy sector, at least in Europe. During the Cold War, trade between Western Europe and the Soviet Union was particularly stable. The socialist block used to receive strong currency and technologies for gas and oil. Trade was never discontinued for political or economic reasons to admit only a few technological faults (which is the favourite argument of Gazprom and the Russian Government in discussions on

3. The definition of international regime provided by Robert Keohane is perhaps the most appropriate for relations on the global market of energy resources: regime are institutions with clear rules agreed by governments and applied to specific fields of international relations. A regime changes only when norms and principles change – any other changes must be considered changes in the regime. Robert Keohane, “Neoliberal Institutionalism: A Perspective on World Politics.” Book by Robert Keohane (ed.), *International Institutions and State Power: Essays in International Relations Theory*. Boulder: Westview Press, 1989, 4 (1-20).

Russia's reliability). Similarly, co-operation has been successfully developing at present – it is simply not institutionalised.

Analysis of relations between Western European actors (states, the EU and companies), USA (government and companies) and Russia (government and companies) shows that co-operation in the past decade has been developing taking into account mutual goals and preferences. The Russian Government, on the political level, agreed to develop relations in the energy sector with both the EU (EU-Russia energy dialogue) and the US Administration (a similar energy dialogue); control of fields and production of energy resources was ensured; the investing opportunities of foreign companies are totally controlled by Kremlin; in exchange for limited investing opportunities and stable supply Russia imports (or rather seeks to import) technologies from consumption zone states (imports of natural gas liquefaction technologies from the USA, Canada and Norway); there have been attempts to diversify consumption markets; and control of income from energy resources has undergone centralisation. Russian state-owned companies do not face survival risks; control of the most promising fields has been taken over from private companies with help from the government; and co-operation with Western partners has been developed in the field of investments and technologies. In co-operation with Russia, states of Western consumption zones expanded energy imports and thus diversified import sources and increased autonomy as well as competed with each other over access to the Russian energy sector. Even the issue of the price of energy resources was addressed with help from the Russian Government (for instance, Russia's "benevolent" consent to increase production after the beginning of war in Iraq). The limited chances of Western companies did not cause too much harm because they all had equal conditions (at least before Russia started demonstrating exclusive acceptance of German companies).

Central and Eastern Europe was also indirectly involved into this co-operation (regime). Throughout this period, control over transportation and processing was continuously passing (or, to be more exact, returning) to Russian enterprises. This satisfied both the Russian Government and actors of Western consumption zones since stability was guaranteed. This kind of regime did not meet the preferences of Central and East European states: apart from the development of transportation through this area, alternative networks were also

developed with their decreased autonomy in the energy sector and diminished significance. CEE companies had no opportunity to compete with Russian actors with respect to both acquiring the existing infrastructure and developing it. Although CEE actors' preferences did not match the regime, they did not have sufficient power to change it.

The existence of an established regime has also been evidenced by the currently intensified discussion about changing it. Western European actors initiated the questioning of the regime because, for the first time, priority interests in the international energy sector, i.e. stability of supplies, were impaired. It is not the first time when Russia discontinues energy supplies: withdrawal of natural gas supply for Ukraine in 1991, oil exports through Latvia in 2003, natural gas supply to Belarus in 2004 and natural gas to Ukraine in 2006. However, for the first time it did affect the states of the Western European consumption zone. Apparently, this precedent was a good lesson for all actors and, firstly, the reputation of Russia as a reliable regime partner will be/has been reviewed.

Russia may seem to have changed its *energy policy* preferences and decided, using pressure measures, to take over the control of the transportation and processing zone actor (in the energy sector). However, if this explanation could be applied to the Belarus situation in 2004 (cut-off of natural gas could be treated even as specific sanctions on Belarus for disregarding the regime – the disagreement to allow Russian actors to directly control transit), it is not exactly applicable in the Ukrainian case. The Russian Government revised its list of energy policy preferences by including the interest to render energy policy an effective tool of foreign policy. This did not meet, if not the goals, then at least the expectations of other regime participants.

It is obvious that the relations between Western Europe and Russia in the energy sector are changing and will no longer be as before. This change process will be different from the previous one due to the challenge it now has to face – the Western European objective to institutionalise relations and the key rules. Intentions to do so are contained in the revised EU-Russia Partnership and Cooperation Agreement (PCA) that expires on 30 November 2007. In order to envisage what the new regime will be like and in what way it will challenge Lithuanian energy security, it is necessary to evaluate the outcomes of the EURussia energy dialogue and the current situation.

The geoenergetic status of Western Europe-Russia relations

Stranded EU-Russia energy dialogue

The primary scenarios of EU-Russia co-operation in the energy field [4] were based on not only economic, but also political and cultural projects – Russia’s europeanisation in the general sense – which were supposed to integrate Russia into the European area. Part of the truth lies in statements that this integration should be similar to the modernisation of CEE and obtrusion of conditions by big powers, therefore there is nothing strange in that Russia refused it [5]. In Western European discourse Russia was seen mostly as both a potential source of instability and a reliable supplier of energy resources. Securing of energy supplies and exporting EU rules was supposed to reduce threats to the EU. The EU was eager to liberalise the transit of energy resources across the Russian territory and thus to have the chance to import natural gas and oil from not only Russia, but also the Caspian Sea Basin. The Russian energy sector had to be de-monopolised and internationalised. State monopolies (Gazprom, United Energy System) had to be disintegrated, whereas Western companies to be provided conditions similar to those enjoyed by Russian to

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4. Reference was taken from the reports on EU-Russia energy dialogue. The Russian Vice Prime Minister Victor Khristenko and Director-General of the European Commission, “EU-Russia Energy Dialogue: Second Progress Report.” Brussels, Moscow, May 2002, http://europa.eu.int/comm/energy/russia/joint_progress/doc/progress2_en.pdf; The Russian Vice Prime Minister Victor Khristenko and Director-General of the European Commission Francois Lamoureux, “EU-Russia Energy Dialogue: Third Progress Report.” Brussels, Moscow, November 2002, http://europa.eu.int/comm/energy/russia/joint_progress/doc/progress3_en.pdf; The Russian Vice Prime Minister Victor Khristenko and Director-General of the European Commission Francois Lamoureux, “EU-Russia Energy Dialogue: Fourth Progress Report.” Brussels, Moscow, November 2003, http://europa.eu.int/comm/energy/russia/joint_progress/doc/progress4_en.pdf; The Russian Vice Prime Minister Victor Khristenko and Director-General of the European Commission Francois Lamoureux, “EU-Russia Energy Dialogue: Fifth Progress Report.” Brussels, Moscow, November 2004, http://europa.eu.int/comm/energy/russia/joint_progress/doc/progress5_en.pdf; The Russian Vice Prime Minister Victor Khristenko and Director-General of the European Commission Francois Lamoureux, “EU-Russia Energy Dialogue: Sixth Progress Report.” Brussels, Moscow, October 2005, http://europa.eu.int/comm/energy/russia/joint_progress/doc/progress6_en.pdf
5. For instance, the task force to explore the perspective of Russia-EU relations headed by head of the Russian Council for Foreign and Defence Policy S. A. Karaganov, for more ref. “Европейская стратегия России: новый старт.” Россия в глобальной политике, 2, 2005, <http://www.globalaffairs.ru/numbers/13/3947.html>

participate in all energy fields. The assumptions were that investments would promote Russia's modernisation, diminish the influence of politics on economy and ensure Russia's "more transparent" position in the international environment. This kind of scenario, in the medium-term, would have turned Russia into an area of action for Western companies, would worsen Kremlin's independence and would inevitably force Russia itself to restrict its political autonomy and to integrate more rapidly into Euro-Atlantic structures.

In the long-term this development of events would, indeed, provide prerequisites for the formation of the Pan-European [6] energy security area. Its geoenergetic expression would be a consolidated Western Eurasian geoenergetic region with the dominating Western European consumption zone in the medium-term. Apart from Western Europe and the western part of Russia (the eastern border would extend across the Central Siberia Plateau), this region would also include the Central and Eastern Europe transportation and processing zone. The Pan-European project would have established Russia's European focus, which would inevitably become one of the principal parts of the EU energy security policy. A similar geoenergetic alliance has formed in North America between the USA and Canada. These neighbouring states are united by not only supply of raw materials, but also by the broader economicpolitical union.

The relationships between the geoeconomic and geoenergetic core, Western Europe, and the semi-periphery, Russia, in the medium-term would inevitably become unequal. Russia's submission to the imposed rules of the "game" – democracy, development, securing of human rights, restructuring and diversification of economy, improvement of investment conditions, securing transparent business – in the long-term could provide Russia with all prerequisites to become a core state. Russia's changed status in global geoenergetics (and the entire geopolitics) would allow for the revision of relations with partners in Western Europe. This, seemingly, too utopian scenario could imply both negative and positive effects for Lithuania. First of all, it is

6. At the start of the energy dialogue the EU had hopes that Russia's measures for legal modernisation, technological assistance and consolidation of international legal environment had to shape an international regime of trade in energy resources – a safe pan-European energy area. Such a liberal approach to energy security gave many hopes to europeanise Russia, to bring it closer to Western Europe and to reduce the threats for energy security.

likely that in exchange for progress the EU would be forced to make concessions for Russia in its “Near Abroad”. In the medium and long-term, with the view to consolidating the single Eurasian area, unique opportunities would emerge (and will never be available again) to become a real economic-political-cultural link between East and West. Russia’s non-conflictive europeanisation could accelerate the engagement of Lithuania and the entire Central and Eastern Europe into the Western European consumption zone – the extinction of the Central and Eastern European transportation and processing zone and the eventual enlargement of Western Europe. The listed perspectives, and particularly their potential outcomes, would endanger not only the power balance in Eurasia, but also the entire global regime. A new security area from the quality point of view would emerge. On the other hand, conditions for this turned out to be inadequate.

Russian political elite, which started establishing its position in Kremlin after Putin became president, can be characterised by a high level of impatience and short-sightedness of strategic planning. The easiest way to consolidate one’s influence in the Russian political system was to adopt control over the energy resource sector and to consolidate Russia’s influence in international policy – strengthen governmental influence on energy companies by merging them into mega-monopolies. The outcome of this policy is restriction on foreign investment and centralisation of economy, which will hinder restructuring and diversification. The economic effects of a too high dependence of the country’s economy on a single branch is the so-called “Dutch disease”, the political effects are the strengthening of authoritarianism, whereas the geoenergetic effects are lingering in the semi-periphery, diminishing opportunities to modernise and degradation to the periphery. In Russia’s case this would imply the tiring out of the still-functioning branches of economy and capital outflow from the country. As A. L. Moshes states with a slight hyperbola, from the economic point of view Russia might become “Siberian Nigeria”[7].

Following its renouncement of the course of action offered by the EU energy dialogue, Russia inevitably froze itself in the existing situation for a time and maybe even convicted itself for the periphery. This is an important first conclusion in assessing the current situation: the relations between Western

7. А. Л. Мошес, “Еще раз о плюсах европейского выбора.” Россия в глобальной политике, 4, 2005, <http://www.globalaffairs.ru/numbers/15/4509.html>

Europe and Russia now have no chance to develop as equal relationships and will remain the relations of the core with the periphery – between producer and consumer. This means that Lithuania, likewise the entire Central and Eastern Europe, at least for some time, will remain a transportation and processing area.

*Intensifying inter-dependence of Western Europe and Russia
Foreseen growth of energy imports from Russia*

EU-Russia inter-dependence in the energy sector is of mutual nature. Twenty five per cent of total consumed natural gas in the EU is imported from Russia (half of total EU natural gas imports), which exactly corresponds to the Russian oil consumed in the EU – 25 per cent (30 per cent of EU total oil imports) [8]. The Russian federal budget receives as much as 40 per cent revenue and the major part of foreign currency from trade in natural resources with the EU. Taking into account the fact that trade in energy resources accounts for more than 60 per cent of Russia's total exports and EU is the key partner (for example, the EU accounts for 85 per cent of Russian oil exports), it can be concluded that Russia and the EU are linked by mutual dependence. Moreover that this dependence will only increase owing to the decreasing production of energy resources in the North Sea and to EU's growing demand for imported resources. According to different forecasts, in 2030 the EU will import 70 per cent of total consumed energy resources. This leads to the second conclusion that imports from Russia will all but increase.

Expansion of energy infrastructure

Recently, co-operation between Western Europe and Russia has particularly strengthened through the expansion of energy infrastructure. Trade in natural gas is the most susceptible for the inflexible continental energy infrastructure – pipelines. At present Russia is particularly active in trying to implement two new projects for the supply of natural gas over these pipelines: the North European Gas Pipeline (“Nord Stream”) and the South European Gas Pipeline.

8. “EU-Russia Energy Dialogue”, <http://www.euractiv.com/en/energy/eu-russia-energy-dialogue/article-150061>

In the year 2006, due to the active resistance of the Baltic countries and Poland, the gas pipeline which is bound to connect Russia and Germany, NEGP, has raised particularly numerous discussions [9]. Over NEGP, Gazprom seeks to supply gas to Western Europe, bypassing CEE states for political and economic reasons. It is possible to bypass those states over the gas pipelines only by laying pipelines across the sea. It is declared that the NEGP project will enable the Russian gas monopolist Gazprom to achieve its two major goals: *first*, to expand the capacities of gas transportation exports to Europe, and *second*, to diversify gas exports and to reduce the influence of transit countries (Ukraine, Belarus and Poland) on Russian gas exports. The new gas pipeline should connect the Western Siberian basin “Yuzhno Russkoye” with Germany and extend across the bottom of the Baltic Sea (from Vyborg in the Finnish Bay down to Greifswald in Germany). The possibility to prolong it all the way to the coasts of Holland and United Kingdom at a later time is not denied. Assumptions are that the new gas pipeline could also serve as alternative for the Lithuania-crossing pipeline to Kaliningrad. NEGP meets both Western European and Russian interests, yet by its nature of total disregard towards CEE countries’ interests, it not without reason resembles, for some people, the 1939 Molotov-Ribbentrop Pact, which divided CEE [10].

Intentions are to bypass Lithuania with not only the Russian and German project, but also the South European Gas Pipeline planned by Russia and Central Europe. SEGP should connect the Blue Stream gas pipeline extending from Russia to Turkey across the bottom of the Black Sea through Bulgaria, Romania and Hungary. From Hungary one branch of the gas pipeline will run to Austria and Western Europe, and the other to Slovenia and Croatia, and from there to Italy. In the meantime, this EUR 5 billion-worth project has gained more acceptance only in Hungary: MOL and Gazprom will jointly perform the technical and economic validation of the pipeline. It is important to emphasise that it also provides for the expansion of natural gas storages in

9. The idea of this pipeline emerged in late 1999 during the completion of the construction of the first line of the Yamal-Europe gas pipeline. The capacity of the gas pipeline, depending on the market demand, will be around 55 billion m³ of gas per year. The price for the NEGP may reach USD 5.7 billion because even 1,189 km of the 3,000 km of the pipeline would be under the water.

10. Daniel Dombey, “EU’s Energy Policy Brings Hitler Jibe from Poland”, *Financial Times*, 30 April 2006, <http://www.gatago.com/talk/politics/misc/14737033.html>

Hungary, which would provide prerequisites for Hungary's becoming an important CEE node. SEGP is a direct competitor to the Nabucco project. Even if SEGP is not implemented, one may draw the third conclusion that energy infrastructure which connects EU and Russia is expanding. In the medium term it will substantially impede diversification opportunities: for the EU to reduce the relative share of imports from Russia and for Russia to reduce the relative share of exports to the EU. For this reason relations between those two actors will inevitably have to intensify.

Russian ambitions to surround Europe

Gazprom not only plans new routes and pipelines, which will inter-bind Russia and Western Europe even more, but also threatens to take over at least part of supplies control from other production zones. North Africa is one of Europe's major traditional suppliers for natural gas. This region was not competitor to Russia before Gazprom's active expansion to Western Europe, particularly as far as access to its direct consumers is concerned. Its markets covered the countries on the northern coast of the Mediterranean Sea. After Russia (its state-owned companies) altered its policy and with its seeking to become an active player on the Western European market, eyes started turning also to traditional European partners.

Gazprom pipelines do not reach the Iberian Peninsula, but it does not mean that its consumers will not feel the influence of the Russian company. With all resulting advantages and disadvantages. The attempts of Russian companies to approach North African companies have existed for years. However, only this year did they gain a more concrete character. The ice-breaking event was the visit of Putin-lead delegation to Algeria in the March of 2006, which helped to gain the blessing on the supreme level for the co-operation of the two countries' state-owned companies. The process was promoted by not only the summit visit, but also the generous gesture from Kremlin: Moscow relieved the Northern African state from the debt in the amount of USD 4.7 billion and signed a USD 7.5 billion agreement on the services of armour supply and servicing. Back in August 2006, the Algerian state-owned company Sonatrach and Russian Gazprom and Lukoil signed agreements in Moscow regarding co-operation in Russia, Algeria and third

countries, which provided for the opportunity to exchange resource production projects [11]. This will have several significant effects for the EU. *First*, Russia will be able to participate in the supply of natural gas from North Africa to the EU and USA, thus increasing its share in those markets. Agreements on the exchange of products have not been concluded so far, but Gazprom intends to supply Algerian liquefied gas (LNG) to North America in exchange for Russia's gas supplies to Europe. *Second*, prerequisites are provided for the formation of an alliance between one of the major suppliers of natural gas for Europe. This, as could be expected, raised the concern of South European consumers. The Italian Minister of Industry Pierluigi Bersani wrote a letter to the EU Energy Commissioner Andris Piebalgs to draw attention to the potentially decreased number of natural gas suppliers for Europe and the resulting potential price increases for natural gas. Naturally, this also referred to the possible cartel agreements, which are of no use for Europe. Italy imports 80 per cent of required gas amount: Russian gas covers 32 per cent of Italian demand, while Algerian – 37 per cent [12]. *Third*, bypassing Western countries, Russia will be able to receive access to the sodesired technologies, and primarily liquefaction of natural gas. Russia's need for technologies might serve as a wild card in negotiations on access to Russian energy resources. Now that Russia will be able to receive it from another supplier country, the negotiation position of Western Europe may weaken. So may the position of foreign investors already operating in Russia, which is based on technological advantage. Therefore the fourth conclusion from the assessment of EU-Russia geoenergetic links is as follows: Russian state-owned companies can increase their influence on EU imports not only directly, within the framework of trading with Russia, but also through EU trade in energy resources with other production zones, primarily North Africa. The probability that Russia will engage also in the exports of South American countries to the EU should not be denied. This development may enable Russia to more freely review of its preferences in relations with the EU.

11. "Gazprom and Lukoil Seeking Closer Relations With Algeria", Moscow Times, 7 August 2006, <http://www.themoscowtimes.com/stories/2006/08/07/042.html>

12. Sarah Laitner and Ian Limbach, "Italians Fume Over Russia-Algeria Natural Gas Deal", *Financial Times*, 9 August 2006, <http://www.ft.com/cms/s/c51d9b94-2743-11db-80ba-0000779e2340.html>

EU attempts to attract alternative suppliers

EU attempts to restrict the expansion of Russian influence to other production zones are mostly based on developing supplies of energy resources from the Caspian Sea Basin to the EU which are independent from Russia. There are three potential routes: the Nabucco pipeline, the Georgia-Ukraine-EU gas pipeline and the Odesa-Brody-Plotsk oil pipeline.

In the January of 2006, Austrian, Bulgarian, Hungarian, Romanian and Turkish energy ministers, in co-operation with the EU Energy Commissioner Piebalgs, signed the Ministerial Statement of commitment to the Nabucco gas pipeline project. Over the Nabucco gas pipeline, which will start at the crossing of the Baku-Tbilisi-Erzurum and Iran-Turkey gas pipelines, from Azerbaijan, and later also from Iran, through Turkey, Bulgaria, Romania, Hungary and Austria (ending at the Baugarten node) gas should reach the EU. The major argument for laying this 3,400 km-long and USD 4.6-5.8 billion-worth route has a geoenergetic nature because, *first*, the Russia-bypassing route for transporting Caspian energy resources to Europe (near Azerbaijan intentions are to connect also the Kazakhstan and Turkmenistan basins by pipelines) would be created. *Second*, Europe would be provided conditions to import Iran's natural gas and to diversify supplies. *Third*, to decrease Gazprom's influence in the countries through which the new gas pipeline will run (half of the gas supplied over it should remain in transit countries). *Fourth*, new gas pipeline should consolidate Turkey's function of the geoenergetic node for pipelines and reinforce Austria's role in CEE, which, in the long-term, could compete from significance point of view with Ukraine currently holding the key position. It is worth mentioning that Gazprom also demonstrated intention to join this project by offering its gas, which reaches Turkey over the gas pipeline laid on the bottom of the Black Sea, the Blue Stream. The project participants, however, are sceptical about this opportunity.

Another project which can shape alternative paths of natural gas to Europe is the 1,000 km USD 2 billion-worth gas pipeline from the Georgian Supsa harbour to the Ukrainian Feodosia harbour across the bottom of the Black Sea (it should extend for 700 km across the sea), and from there to the EU (Georgia-Ukraine-EU). So far this project has been viewed very sceptically, but with the remaining high prices of energy resources, the increasing need to

diversify sources and with Russia disallowing third countries to freely transport energy resources through its pipelines, it may turn out quite attractive. The GUEU feasibility study is currently under development. It is envisaged that the Baku-Tbilisi-Erzurum branch (which is parallel to the Baku-Tbilisi-Ceyhan oil pipeline) of the gas pipeline running from Azerbaijan to Turkey would extend from Tbilisi to Ukraine. Intentions are to use this gas pipeline for exporting natural gas from Azerbaijan, and later, if a gas pipeline is laid across the bottom of the Caspian Sea, also from the Central Asian states.

Construction of the Odesa-Brody-Plock oil pipeline is also associated with the resources of the Caspian Sea Basin [13]. This pipeline should supply Caspian Sea oil to CEE and Poland. In 2006 Ukraine, Poland and the EU signed a declaration to accept the construction of the oil pipeline. In the July of 2006, Poland and Ukraine signed a memorandum to incorporate a joint venture, which will engage in the building of the oil pipeline. This project is one of the priorities for the new Polish administration, which, still before election, declared its aim to ensure country's energy security.

With all these pipeline projects, be they implemented, EU could improve its independence from Russia and strengthen inter-binding with the Caspian Sea Basin. This would partly reduce Russia's influence on co-operation with areas rich with energy resources eastwards from the EU, but would not substantially limit the Russian share in EU imports. As it was mentioned before, the relations between Western Europe and Russia currently have no chance to develop as equal relationships and will remain relations between core and periphery. Furthermore, in consideration of the strengthening physical connections of areas and Russia's intentions to surround the EU from the geoenergetic point of view, one may forecast that the relations between the Western European consumption zone and Russian production zone will intensify and will become increasingly based on geopolitical assumptions.

13. With its capacity of 9 million tons per year, the 647 km-long Odesa-Brody line has already been laid (finished in 2001), with the remaining 500 km section from Brody to Plock still to be constructed. The planned capacity of the Brody-Plock oil pipeline is 25 million tons per year and the price around EUR 450 million.

Closer relations between states and companies

Redistribution of power on the global market of energy resources

The future regime of the EU-Russia relations in the energy sector and Lithuanian energy security will be influenced by not only geoenergetic trends, but also the recently observed redistribution of power on the market of energy resources: states gain more and more significance compared to international private companies. From the analysed point of view, i.e. what kind of regime may develop in the energy sector between Russia and the EU and how, global trends are significant inasmuch as they have direct impact on the EU energy sector. Firstly, it is the formation of giant companies and the increasing importance of national states on the Western European markets. Growing power of national states is primarily understood as direct intervention into the market in order to ensure energy and national security – a variety of economic protectionism or “economic patriotism”. It differs from the policy of the President of Venezuela Hugo Chavez with respect to international investors, the nationalisation campaign of the new Bolivian leader Evo Morales in the natural resource industry or the order of the President of Chad Idriss Déby to foreign oil companies to move out. It first of all means that in the future the geopolitical aspects of the energy sector will become only stronger.

At present, eight out of the world’s ten largest companies are state-owned. State-owned companies control 90 per cent of global oil and natural gas [14]. Most new fields, if found, will also be subjected to the control of state-owned companies. According to the Economist estimates, 16 out of 20 largest by shares energy companies are state-owned [15]. Furthermore, apart from exporting resources, state-owned companies also actively operate in consuming countries, what signals the transformation of national companies into national transnational ones. Such are Saudi Arabian Aramco, Norwegian Statoil and Brazilian Petrobras. Russian Gazprom should shortly join this flock of companies.

14. “Oil’s Dark Secret”, *The Economist*, 10 August 2006, http://www.economist.com/business/displaystory.cfm?story_id=E1_SNSDPDT

15. “Really Big Oil”, *The Economist*, 10 August 2006, http://www.economist.com/research/articlesBySubject/displayStory.cfm?story_id=7276986&subjectid=381586

Effects of the establishment of Russian state-owned companies

State-owned companies, particularly in the energy field, are normally characterised by the following negative features in comparison with the private sector. The main one is higher expenditure as compared with the private sector, and also efficiency, for the mere reason that the state burdens them with expensive social and political programmes (Russia, the countries of the Persian Gulf). If they are not engaged in political projects, they may be forced to pay a tribute to the state selling products for prices lower than the market's (India, China, Russia); a poor level of corporate management; too large administrative structures; limited transparency of business, and higher corruption as compared to private companies.

The giant expenditure conditioned by state policy could be compensated by a preferred position in business when acquiring new fields or licences, obtaining political support for development abroad or receiving transportation quotas (the Russian case), which determine the scope and profit of exports. However, companies' profit is also redistributed by the state (depending on the state's transparent and not so much transparent goals), which reduces not only the motivation of corporate management, but also the opportunities to make efficient investments and seek even bigger profits.

In Russia, the differences of the activities of state-owned companies from those of private ones are far greater. They have extra-favourable opportunities to ensure their interests on both federal and local government levels, for instance, with regard to receiving tax advantages. The undoubted feature of Russian state-owned companies is the exclusive conditions to obtain licences and to operate new fields. The government can impose stronger control over the activities of state-owned companies as compared with private ones, which diminishes the government's suspicion regarding the relations with foreign partners and provides more favourable conditions for attracting foreign investment. The government can also assist companies in receiving loans (for example, not without Kremlin's help the German Government issued guarantees for the Gazprom loan to build NEGP).

What do such exclusive conditions, first of all for Gazprom and Rosneft, imply? *For Russian private companies* it implies a particularly intricate business environment, where, seeking similar conditions (acquiring fields, quotas for

transportation and the “moderate” attitude of the tax inspectors), they need to make concessions and do favours for the government. Owing to these favours – assistance in the implementation of the state’s domestic and external policy – the term “loyal to Kremlin companies” appeared. Currently it defines nearly all enterprises in the Russian energy sector, because the “disloyal” normally find no place in Russian business. *For foreign companies which intend to do business in Russia* it implies the only choice in search for partners. Private enterprises will not be able to ensure security for investors’ money as companies closely related to politicians could. The best example of such co-operation is perhaps the project for the assimilation of the Shtokman field. *For foreign companies already operating in Russia*, which started business in the country back in the last century, such establishment of state-owned companies poses a direct threat. Particularly in the event they implement a project attractive to Gazprom or Rosneft. What does this imply for the states where these companies control whole energy economies, for instance, Lithuania? Without any paranoia, which Russia often reproaches us with, it may be assumed that these are potentially among the most active influence agents in those countries.

Increasing significance of states in the European energy sector

State-controlled companies or growing energy giants enjoying state care are everyday life for not only those countries which produce energy resources. Similar trends also dominate in countries which consume energy resources. The most relevant situation for Lithuania is in the EU, which, especially this year, has witnessed growing tension regarding the future of energy companies.

According the EU Competition Commissioner Neelie Kroes, between 2000 and 2005 the number of merger bargains of cross-border companies in the energy sector grew by 75 per cent, whereas in 2006 alone there were 10 such mergers, which fell under the jurisdiction of the European Commission [16]. This denotes accelerating concentration of the energy sector in the hands of the big companies. The merger process, however, has been gradually changing and gaining a global character conditioned by the formation of large state-owned

16. Mark Mulligan and Andrew Bounds, “Spain Set to Soften Stance on Endesa”, *Financial Times*, 3 September 2006, www.ft.com/cms/s/eeb905a8-3b73-11db-96c9-0000779e2340,dwp_uuid=e19fdde0-a39a-11da-83cc-0000779e2340.html

or national private companies with the state's strong protectionist backing. This process was marked in 2006 by the attempts of the Spanish Government to block the intentions of German E.ON to purchase the country's largest electricity group Endesa for EUR 29.1 billion; the endeavours of the French governing coalition to block the attempts of the largest Italian electricity company to purchase the French former state-owned electricity enterprise Suez; the plans of Italian politicians to merge Enel with Italy's largest oil and gas company Eni. These processes are only part of the moves in Europe based on "national interests", covering only the energy sector and only year 2006 [17].

What is interesting is that, without exception, all government attempts to protect national energy sectors were based on the dramatic dilemma between the ambitions of the liberalisation of the EU energy market and the state's strategic position or even security protection, as was described by the Spanish Minister of Industry, Trade and Tourism Joan Clos [18]. A solution for this dilemma comes from the European Commission, which cannot boast a particularly positive opinion about the manifestations of "economic patriotism" in Europe [19].

17. The attempt of the Spanish Government to block the coming of the Germans served as expression of agreement to the commercially less attractive offer from another Spanish company Gas Natural regarding the purchase of Endesa. When E.ON increased the offered price by almost 40 per cent and knocked all cards from the Spanish Government's hands, it was not long before a response came. When threatened to lose the biggest company, the government can either interfere with the bargain or create a new biggest company. The Spanish Government decided to create an energy company larger than Endesa. The actions of the French Government are similar to those of its neighbours': politicians developed a plan on how state-owned Gaz de France could take over Suez. For France this step may imply the loss of the majority holding, but this is how EU's largest natural gas and electricity enterprises may emerge. And all this is not economic protectionism, but, according to French Prime Minister Dominique de Villepin, primarily protection of the French national interests. Martin Arnold and Peggy Hollinger, "De Villepin Rejects Protectionism Charges", *Financial Times*, 28 February 2006, <http://news.ft.com/cms/s/691d09ec-a89f-11da-aeeb-0000779e2340.html>

18. William Chislett, "Inside Spain 27", *Real Instituto Elcano*, <http://www.realinstitutoelcano.org/materiales/insidespain/Chislett090606Newsletter.pdf>

19. The company merger process may not be treated as the emergence of international European-type companies because they develop on a strong national background. According to the head of the European Employers' Association UNICE Ernest-Antoine Seillière, the opposition to liberalisation and to the coming of 'outsider' companies rises not from companies themselves, but rather from governments and trade unions. "The Nationalist Resurgence", *The Economist*, 2 March 2006, http://www.economist.com/research/articlesBySubject/displayStory.cfm?story_ID=5575147&subjectid=348978 This is now in the spring of 2006 the Italian Government still headed by Silvio Berlusconi granted itself the right of veto (the so-called "golden share") with respect to potential 'hostile' attempts to purchase Italy's largest gas distribution company Snam Rete Gas. The Italian Government now possesses the company's majority

Central and Eastern Europe has also witnessed similar trends. In the last few years three regional companies which can feel strong governmental backing have been the most influential: Polish PKN Orlen, Austrian OMV and Hungarian MOL. Recently, as many experts of the region's market observe, from unprofitable state dependents companies have turned into developing business structures. MOL acquired the Slovak oil refinery group Slovnaft and a stake in the Croatian oil company INA. PKN Orlen bought the majority holding in the Czech oil refinery and chemical group Inipetrol and is finishing documentation arrangements for the purchase of shares of the Lithuanian oil refinery Mažeikių nafta and the Būtingė oil terminal from Yukos and from Lithuanian Government. OMV acquired the majority holding in the Romanian refinery Petrom. All these acquisitions are blessed and supported by "home" governments. The shift of influence towards governments primarily implies future improvements in the significance of state preferences relative to company interests. This is also another signal of strengthening geopolitical aspects of energy.

Developments in investment regimes

The need for investments of Russia's energy sector

The World Energy Investment Outlook [20] prepared by the International Energy Agency in 2003 claims that the Russian need for investments will be USD 269 billion in 2001-2010, 391 billion in 2010-2020, 389 billion in 2020-2030 and in total USD 1.05 trillion until 2030. These include USD 328 billion for the oil sector, 332 billion for natural gas, 13 billion for coal and 337 billion for electricity generation. Compared with the Western European (EU-15) needs for investments – USD 1.6 trillion until 2030 – this figure does not seem that high. In Western Europe, however, this accounts for less than 0.5 per cent of GDP and only about 2 per cent of total future investment, whereas in Russia more than 5 per cent of GDP and 31 per cent of total required investment. The need for investment from Russia's point of view is somewhat more moderate.

holding, but in accordance with the EU legislation will have to reduce it down to 20 per cent before 2008. Although the EU "golden shares" are prohibited, national security is more important, especially when such trends exist all across Europe.

20. International Energy Agency, „World Energy Investment Outlook: 2003 Insights“, <http://www.iea.org/textbase/work/2003/washington/Cozzi.pdf>

In June 2006 the Russian Deputy Minister for Industry and Energy Andrej Dementyev claimed that Russia's energy sector would need USD 27.5 billion of investment until 2010, including 16.5 billion for oil and natural gas sector [21]. These figures evidence not only the tremendous impact of the energy sector on the entire economy, but also that Russia may face problems in attracting investments – neither the Russian companies, nor the Russian Government have and will have such money.

Challenges for foreign investors in Russia

Russia's offered model for foreign investors into the energy sector is that companies are provided access to fields and extraction projects in exchange for specific political and/or economic benefits. They will be able to operate in projects as small shareholders, ensuring financial flows and technologies and also providing conditions for Russian companies to access consumers in the countries where the extracted products will be traded.

Such co-operation had been already agreed upon by the German chemical company BASF, receiving 25 per cent of shares of the Yuzhno Russkoye field in Western Siberia in exchange for the opportunity to increase its stake in the German natural gas distribution company Wingas up to 50 per cent minus one share. In the summer of 2006 a similar exchange was performed by another German giant E.ON. In exchange for E.ON stake in Hungary (50 per cent minus one share in the natural gas storage E.ON Foldgaz Storage and the natural gas distribution company E.ON Foldgaz Trade and 25 per cent plus one share in the electricity and gas company E.ON Hungaria) Gazprom granted 25 per cent minus one share in the same Juzhno Russkoye field [22]. There have also been signs that Dutch Gasunie, Italian Eni and French Total will follow the same course of co-operation. Be there more examples, one could claim that such regime of investor behaviour in Russia is starting to settle down. Furthermore, the exchange such as E.ON and Gazprom increases Russia's influence as monopolist on CEE. Having regard to the fact that in this process Western

21. "EU, Russia: An Elusive Energy Partnership", http://www.stratfor.com/products/premium/read_article.php?id=263613

22. "Газпром" обменялся активами с немецкой компанией E.ON", <http://www.newsru.com/finance/13jul2006/eongaz.html>

partners assist the Russian company, CEE states may hardly expect support by decreasing the impact of Russian capital.

In Russia, foreign-controlled companies cannot have more than 51 per cent in the projects of development of fields which are categorised as “strategic”. The majority of fields in Russia fall under this type. This means that operators of at least three projects will have to revise their investments in Russia: Khariaga – French Total, Sakhalin-1 – ExxonMobil, and Sakhalin-2 – RoyalDutch-Shell. Khariaga project is encroached upon by Rosneft and the other two by Rosneft and Gazprom. The fate of these fields will also help to determine future rules for Russia-investor co-operation. According to the Russian Minister of Industry and Energy Victor Khristenko, such restriction on the activities of foreign investors will not be absolute prohibition, but rather the attempt to ensure Russia’s national interests [23]. The same was reiterated by the Minister of Natural Resources Yury Trutnev, who provided a draft of somewhat more stringent regulations with respect to investors. The draft stipulates that companies whose 50 per cent and more stock are owned by foreign companies will not be able to develop fields with over 70 million tons of oil and 50 billion m³ of gas. According to the minister, these amendments would mostly affect TNK-BP business [24].

The future guidelines for the investment regime should reflect in the three currently developing stories: the Shtokman field development project, the outcome of the Sakhalin-2 project and the development of the Kovykta natural gas field. Many companies expressed a wish to participate in the development project for the Shtokman field [25], but the simulations of several-year tenders have been endless. Gazprom promised to announce companies to participate in the project before the G8 summit in June 2006, afterwards following the G8 summit and has now postponed it to the beginning of 2007. The potential

23. “Энергетика способна стать более мощным “локомотивом” развития России”, <http://www.rian.ru/economy/resource/20060613/49422937.html>

24. Arkady Ostrovsky, “Russia Further Restricts Foreign Oil Groups”, *Financial Times*, 13 June 2006, http://www.ft.com/cms/s/90d25580-fb12-11da-b4d0-0000779e2340,_i_rssPage=7c2e2eb0-cbe5-11d7-81c6-0820abe49a01.html

25. The Shtokman field was discovered in 1988. It is located in the central part of the Barents Sea. The confirmed reserves comprise 3.2 trillion m³ of natural gas and 31 million tons of oil. V.V. Rusakova, “Shtokman Project – The First Gazprom’s LNG Project”, http://www.ebconline.org/files/EBC_041104_Gazprom.pdf#search=%22shtokman%22

participants should be Norwegian Norsk Hydro and Statoil (owing to their technologies and experience in extracting resources under severe conditions), French Total (owing to their financial sources and political benefits for the EU) and US Chevron and ConocoPhillips (owing to their financial resources, the future North American market and political benefits). However, the decision on the political-economic project is missing namely for political-economic reasons. Kremlin hoped to use the Shtokman field project and the potential participation of US companies as the tool to facilitate Russia's accession to the World Trade Organisation [26]. When this card turned out unsuccessful (the USA did not give consent regarding WTO during the G8 summit), Russia decided to reserve it for the next game-negotiation. In September 2006, during the meeting with the French President Jacques Chirac and the German Chancellor Angela Merkel, Putin, imposing pressure on the George W. Bush's administration, promised to direct 45 billion m³ of natural gas to the European market [27], i.e. to punish Washington. This developing story is not merely another example of how business is done in Russia. Rather, this is another particularly bad precedent for everyone willing to see a depoliticised energy sector, at least in Europe. Energy policy and energy security are confused with political issues, which at times have nothing in common with economy, and which, in turn, serves as direct threat for those who want to see energy only as another branch of economy.

Another "litmus paper" to identify the future investment regime is the RoyalDutchShell problems in developing the Sakhalin-2 project. The largest energy resource production project controlled by foreign companies is the Sakhalin-2 oil and natural gas production and natural gas liquefaction project under implementation by the RoyalDutchShell-run consortium Sakhalin Energy in the Far East of Russia, on Sakhalin Island. The implementation of the project started in 1999. Gazprom has never tried to conceal its annoyance with not participating in it. In 2005 Gazprom agreed with RoyalDutchShell on the exchange of shares: in exchange for the Sakhalin-2 blocking shareholding RoyalDutchShell was supposed to receive a stake in one of the Siberian deposits.

26. Andrew E. Kramer and Steven R. Weisman, "Russia, U.S. Push to Get Moscow into Trade Group", *New York Times*, 12 July 2006, http://www.signonsandiego.com/uniontrib/20060712/news_1b12wto.html

27. "Gazprom Ready to Send Shtokman Gas to Europe", <http://www.barentsobserver.com/index.php?id=364608&cat=16290&xforcedir=1&noredir=1>

However, when RoyalDutchShell adjusted the project's estimated expenditures by almost doubling it and thus reduced Gazprom's potential revenue, the Russian monopolist decided to alter the course of events. In September 2006 the Russian Ministry of Natural Resources announced that it detected environmental violations during the implementation of the project and that it suspended its further development. The environmental arguments perhaps, indeed, seem serious, but all experts without exception admit that Royal Dutch Shell's major environmental violation is the disregard of Gazprom interests [28]. Therefore if investors are not insightful, losses may be much more substantial than expected, for instance, the loss of the licence and its transfer to Russian companies: the field is "strategic" after all.

Similarly, a far from pleasing environment in Russia surrounds another big investor British Petroleum, which established joint venture TNK-BP with Russian companies. The greatest shortcoming of British investors which conditioned Kremlin's disfavour is that it owns 62 per cent of shares in one of the largest natural gas fields in East Siberia, Kovykta. This field is one of the major gateways to the promising Chinese market. It is known that Gazprom associates its big plans with China, therefore according to the logic of Russian stateowned business, the field is also supposed to belong to Gazprom. The Russian Government prevents TNK-BP from exporting the gas of the Kovykta field to the East, which hinders any extraction plans there. Owing to the conflict with Gazprom and cumbersome relations with Kremlin, TNK-BP is not able to take actions which could further increase tension. Such actions could include competing with Russian companies when acquiring companies in CEE, for instance, Lithuanian refinery Mažeikių nafta. Not many expected that before matters are resolved in East Siberia the company would start acquiring the enterprise which is claimed by Russians. By the way, this is what happened: TNKBP demonstrated willingness to acquire the Lithuanian refinery, but then, for some reason, changed its mind.

Consequences of the investment regime

The fact that state-owned companies control about 90 per cent of the world's deposits, yet produce only half of the total amount, evidences broad-

28. Neil Buckley, Arkady Ostrovsky, Ed Crooks, et al. "Moscow Faces Global Oil Backlash", *Financial Times*, 19 September 2006, <http://www.ft.com/cms/s/866e2cd6-481a-11db-a42e-0000779e2340.html>

scale problems of the investment policy [29]. The most efficient way to resolve these problems would be to privatise state-owned companies, however, as it was mentioned before, global trends are the opposite. In 2005, gas production in Russia accounted for 598 billion m³ of natural gas, which is only by 1.5 per cent more than in 2004 [30]. Gazprom increased production only by 0.5 per cent: from 545.1 billion m³ to 547.9 billion m³ of natural gas [31]. According to the plan approved by Gazprom in 2005, until 2008 production will experience only the minimum annual growth of 0.4 per cent [32]. Such a development shows the essential problems of a monopoly: ageing fields, the inability to efficiently develop the volume of production and shortage of investment into fields and into new technologies. Gazprom's production is levelling on the edge of maximum capacity, whereas in consideration of growing domestic and external demand and of the ambitious plans of the Russian President to expand shipment of natural gas for the Russian regions and increase exports to Europe, China, Japan and the USA, resources may be insufficient to cover for all needs, particularly in the cold winter period.

Minimum growth of production should raise the concern of Gazprom customers. In the last decade, Gazprom managed to start operation of only one new field "Zapolyarnoye", all the remaining newly-operated fields having been bought/taken away from other both private and state-owned companies. To add unreliable supply to the vague production perspectives, Gazprom's declining image of a reliable partner is no longer merely a matter of public relations, especially when assessors such as Standard&Poor's started having doubts about its reliability [33]. This company named limited investments into the development of fields as major challenge for Gazprom.

29. "Oil's Dark Secret", *The Economist*, 10 August 2006, http://www.economist.com/business/displaystory.cfm?story_id=E1_SNSDPDT

30. "Quantifying Energy. BP Statistical Review of World Energy", June 2006, http://www.bp.com/liveassets/bp_internet/globalbp/globalbp_uk_english/publications/energy_reviews_2006/STAGING/local_assets/downloads/pdf/statistical_review_of_world_energy_full_report_2006.pdf

31. Alexey Miller, "Gazprom – Strategy for the Energy Sector Leadership", <http://www.gazprom.ru/eng/articles/article20334.shtml>

32. Roman Kupchinsky "Russia: Gazprom – A Troubled Giant", *Radio Free Europe*, <http://www.rferl.org/featuresarticle/2006/01/aacaf75d-5629-436a-b453-7c8a470c4368.html>

33. "Russian Oil Shortfall Predicted", *Agence France Presse*, 11 June 2006, www.nautilus.org/aesnet/2006/APR1206/AFP_Russia_shortfall.pdf

A similar situation is observed in the Russia's oil sector. Although in 2005 oil production in Russia grew by 2.7 per cent³⁴, according to expert calculations, exports declined from 254 million tons in 2004 to 251 million. Russia has oil reserves for 27-29 years, but this is still insufficient ground for optimism because at present Russia produces only the most profitable fields, whereas money is not invested into the problematic ones³⁵. Owing to the already mentioned specific activities of state-owned companies, investments into expensive geological surveying are minimum, which determines the inevitable future decrease in production with the production peak having been already reached in many fields. Only Lukoil covered 102.3 per cent of production with new stocks in 2005³⁶. Of course, a straightforward conclusion that this is another example of how a private company manages better than a state-owned one would be too brave, but this still reflects the general trends in Russia. According to the executive director of the International Energy Agency Claude Mandil, oil supply from Russia should be discouraging in the next four years because expectations for growing exports from Russia were too optimistic³⁷. Therefore, he claims, IEA will be forced to revise Russian forecasts.

A similar situation has developed in the field of the transportation of energy resources: pipeline monopolists Gazprom and Transneft find it difficult to handle vital investments. Insufficient funds are allocated to the renewal of the old infrastructure. Lithuania also had a chance to experience what negative effects this may have in the summer of 2006 when the supply was discontinued due to a breakdown in the Druzhba oil pipeline. Even if this breakdown was more of a political rather than technical nature, few had doubts about its actual possibilities. Even if Russia could attract foreign investment, on extremely stringent terms, into the development of oil and natural gas fields, expecting that foreign enterprises would invest into pipeline networks, which nobody gets

34. "Quantifying energy. BP Statistical Review of World Energy", June 2006, http://www.bp.com/liveassets/bp_internet/globalbp/globalbp_uk_english/publications/energy_reviews_2006/STAGING/local_assets/downloads/pdf/statistical_review_of_world_energy_full_report_2006.pdf

35. Михаил Крутихин, "Тяжелые потери Сырьевая база нефтедобычи имеет мало шансов на рост в обозримом будущем", <http://www.rusenergy.com/articles/a20060404.pdf>

36. Alexander Anatolyev, "The Basis of Competitive Advantages", <http://www.oilru.com/or/28/500/>

37. Carola Hoyos and Kevin Morrison, "Russia to Supply Less Oil Than Expected", *Financial Times*, 11 April 2006, http://www.ft.com/cms/s/df552d4e-c981-11da-94ca-0000779e2340,_i_rssPage=9d5b9ebec8bc-11d7-81c6-0820abe49a01.html

access to, would be all but naive. At present, only 25 per cent of all pipelines are newer than 20 years, 32 per cent are 20-30 years old, and the remaining 43 per cent (almost half) more than 30 years [38].

Regime of Russian investment in Western Europe

One of the key objectives of ensuring Russian energy security is expanding access to end consumers, i.e. increasing influence in production zones. Nearly all discussions on energy security underline that Russian companies (primarily Gazprom) must have the same opportunities as Western companies to access EU's end consumers. Gazprom's new export strategy provides that if European countries refuse entering into long-term agreements on the supply of natural gas, the concern will be forced to demand concessions from partners in the transportation and distribution of energy resources [39]. This turn more than apparently denotes the altered power balance between Russia and the EU. At least Kremlin views it as changed.

It is with this aim – to gain firm position in the Western European production zone – Russia seeks to purchase natural gas distribution companies and petrol station chains in Western Europe. As it is known, Russia implemented its objectives of access to end consumers in CEE without greater challenges back in the last decade. However, in Western Europe, with the exception of Germany, it was far less successful. One of the most vivid examples of particular relevance for the assessment of today's situation is Gazprom's attempt to gain position in the United Kingdom.

In early 2006 Gazprom declared intention to consider the opportunity to acquire UK's largest gas distribution company Centrica (with 60 per cent market share in the public utilities sector and 15 per cent share of the market of commercial consumers). Stock markets welcomed this news enthusiastically, but not so much the politicians. This is understandable. The entrance of a Russian company to the market, direct access to consumers and plans to ensure 20 per cent of supply until 2015 can provide the opportunity to shape one's own

38. Михаил Крутихин, “Развитие по схеме: Вслед за “Газпромом” профицит мощностей наращивает и “Транснефть”, <http://www.rusenergy.com/articles/a20060705.pdf>

39 “Евросоюз ответил на ультиматум “Газпрома”,
[http://www.newsru.com/finance/21apr2006/
gazprom.html](http://www.newsru.com/finance/21apr2006/gazprom.html)

rules of the game. What almost all CEE countries have faced for the whole decade has become a threat also to Western Europe. The fear-raising logic is not so much economic (too large market concentration) or protectionist (foreign capital will gain a too strong position) as political: the capital controlled by the Russian state with doubtful transparency of business and the non-existent boundary between business-focused and political decisions. This kind of reaction from UK politicians perhaps was not expected in Russia probably on the grounds of the Western European experience of the non-interference into Gazprom's active expansion in CEE. The response from the Russian President Putin was: "When [European] companies come to us it's called investment and globalisation, but when we go there it's called expansion by Russian companies." [40]

In the spring of 2006, the UK Government decided to review the merger control regime in order to block the possible passage of Centrica to Gazprom's hands because this may jeopardize British energy security. It is proposed to include energy companies into lists of enterprises whose deals can be blocked by ministers to protect national security interests. What is interesting is that this decision emerged in the office of UK's Secretary of State for Industry and Trade Alan Johnson, who was one of the most proactive critics of protectionism in Europe and the USA and of French and Spanish actions to protect their own companies [41]. Possible involvement was based on the assumption that ministers must take action as soon as national security interests arise, which is always the case when any company intends to acquire one of the natural gas distribution companies [42]. This kind of observations were supposed to subdue the suspicion that concern was raised due to Gazprom, but the Russian monopolist came to reason and temporarily gave up on its intentions.

Political resistance has been the attribute of all acquisitions of Russian companies in the unfriendly "Near Abroad", and in all cases "alternative" tools

40. Hugh Williamson, Peter Ehrlich and Neil Buckley, "Putin Hits at European Investment "Double Standards", *Financial Times*, 27 April 2006, <http://www.ft.com/cms/s/484193e0-d61d-11da-8b3a-0000779e2340.html>

41. Jean Eaglesham, "Gazprom Prompted Rethink on UK Merger Rules", *Financial Times*, 16 April 2006, <http://www.ft.com/cms/s/ac558d4a-cd7c-11da-afcd-0000779e2340.html>

42. Jean Eaglesham, "Proposal to Block Gazprom Generates Unease", *Financial Times*, 18 April 2006, <http://www.ft.com/cms/s/a9e7539e-ce77-11da-a032-0000779e2340.html>

of imposing influence have been employed: threatening, blackmail, intimidation and ultimatums. Cut-off of natural gas supply to Belarus and Ukraine, termination of oil exports through Latvia, cut-off of oil supply to the Lithuanian refinery, restriction on the natural gas exports from Turkmenistan, and termination of natural gas and electricity supply for Georgia. All these actions have been accompanied by public and non-public demanding rhetoric: for Belarus to hand over the control over the gas transportation company Beltransgaz and for Latvia the oil export terminal, for Lithuania to interfere with the bargain with PKN Orlen, for Turkmenistan not to increase the gas sales price and for Ukraine to ruin the country's economy and punish unfriendly government, etc.

Kremlin was going to apply similar action to relations with the West. In the April of 2006, following the meeting of Gazprom leader Aleksey Miller with EU ambassadors, the company published a statement claiming that “attempts to limit Gazprom's activities in the European market and to politicise issues of gas supply, which in fact are of an entirely economic nature, will not lead to good results. It should not be forgotten that we are actively familiarising ourselves with new markets, such as North America and China” [43]. This was basically a threatening urge for Europe to accept Gazprom's rules of the game, i.e. first of all to provide access to the Russian company to the natural gas distribution business in Western European countries. The threatening nature of such statements is reinforced by the fact that they were made just right after Gazprom's unsuccessful attempts to acquire the already mentioned UK Company Centrica and after agreements between Russia and China regarding natural gas supplies to the growing Asian economy. The response of the European Commission was unexpected for Russia, likewise threats for Europe: Europe must look for new suppliers and improve diversification of supply, which means that Russia's participation in the supply of gas to Europe is no longer sufficient [44]. This is how the spiral of escalation was started: Gazprom representative Sergey Kurpiyanov relied to the statements of the European

43. Neil Buckley and Arkady Ostrovsky, “Gazprom Issues Threat to EU Gas Supply”, *Financial Times*, 19 April 2006, http://news.ft.com/cms/s/ac6fb4ca-cfc7-11da-80fb-0000779e2340,dwp_uuid=d4f2ab60-c98e-11d7-81c6-0820abe49a01.html

44. Евросоюз ответил на ультиматум “Газпрома”, <http://www.newsru.com/finance/21apr2006/gazprom.html>

Commission that “if the decision is made to drive Gazprom out of Europe, we will all go to those markets where we are welcome and this will be Gazprom’s return step” [45]. Afterwards, possibility to turn away from Europe was confirmed by Putin [46].

Prospects of the new regime

Having regard to the currently developing Russia-Western Europe relations in the energy sector, one may draw the following conclusions:

- The old regime of Western Europe-Russia relations is under review and inevitably changes because, *first*, Russia’s preferences in energy policy have altered – it was decided to use this policy also as a lever of foreign policy, *second*, trust in Russia as a reliable supplier of energy resources has been undermined in Western Europe.

- Western Europe-Russia relations are developing as those of consumption and production zones – core and periphery. The position of Central and Eastern Europe, and also that of Lithuania in the short-term when the new regime will be formed, will remain in the transportation and processing zone: there are no signs showing its movement towards the Western European consumption zone.

- Energy infrastructure between Russia and Western Europe is expanding. So are Russia’s exports to the EU and Russia’s share in EU imports. For this reason relations between these two actors will inevitably have to intensify. The intensifying dialogue has nothing to do with the assessment of political processes in Russia or, as representatives of democratic powers in Russia attempt to emphasise, with the “sale” of European democratic values for the favourable supply of energy resources [47].

- Owing to the policy of diversification of energy resources that is applied by Western Europe, the distinction between the different produc-

45. Ibid.

46. Hugh Williamson, Peter Ehrlich and Neil Buckley, “Putin Thanks Blair Over Support for Energy Plans”, *Financial Times*, 28 April 2006, <http://news.ft.com/cms/s/904379e4-d652-11da-8b3a-0000779e2340.html>

47. Garry Kasparov, “Investors Must Not Sell Out Russian Liberties”, *Financial Times*, 19 July 2006, <http://www.ft.com/cms/s/c6f72b04-ffb8-11da-93a0-0000779e2340.html>

tion zones in Eurasia – Russia and the Caspian Sea Basin – becomes more clear. This distinction will enable a more flexible inclusion of the Caspian Sea production zone into the new regime, reserving the opportunity to conclude separate agreements with it in the future. This development denotes a situation different from that which existed when adopting the ECT: exports from the Caspian Sea Basin, in the medium-term, will not be totally dependent on Russia.

- Influence of states on national and international markets of energy resources has been apparently improving. This process encompasses both Russia and the entire EU – Western Europe and CEE. This implies that states' preferences in the new regime will have more impact than those of companies.

- Russia's need for investment has been increasing, and its applied regime for foreign investments has likewise become more stringent. Restrictions on foreign investments have had painful consequences on the development of the country's energy sector and that is why Russia will inevitably have to make concessions to attract foreign capital.

- The ambition of Russian companies and government to expand access to end consumers has been strengthening, i.e. to ensure the same conditions as it already has in CEE. This issue will have to be necessarily included into discussions on the new regime and cannot be ignored.

The interests of Russian Government and companies in the new regime

Analysis of situation allows for the review and the more accurate definition of the potential interests of actors in geoenergetic zones. The interests of the Russian Government are to:

- Retain existing markets and to expand them – increase exports to Eastern, South Asian and North American markets (also recorded in the Russian energy strategy until 2020 [48]). In spite of all threats, this diversification should not take place at the expense of exports to Western Europe. Seeking to retain markets, one need to, *first*, limit the expansion of exports of other production

48. “Энергетическая стратегия России на период до 2020 года”, <http://www.minprom.gov.ru/docs/strateg/1>

zones to Western Europe, primarily from direct competitors – the Caspian Sea Basin and Persian Gulf (Iran). Control of transit through the territory of Russia is a direct expression of this limitation. *Second*, to secure long-term agreements for the supply of energy resources.

- Secure a stable transit through Central and Eastern Europe to Western Europe – the only transportation and processing zone that separates Russia from export markets (also included into the Russian energy strategy until 2020). The most efficient way for Russia to ensure stable transit would be through the control of transit routes.

- Reduce the transit supply risks by reducing the number of transit countries – improve the opportunities to bypass Central and Eastern Europe through the development of the infrastructure directly connecting Western Europe and Russia.

- Retain a full autonomy in the energy sector without providing prerequisites for the establishment of foreign actors. This autonomy provides conditions for the independent redistribution of earned income and, as appropriate, for a flexible use of the energy policy, as well as for internal and external policy goals. For this reason it is necessary to retain control over fields through the limiting of opportunities for foreign actors to take over production in “strategic” sectors and the further improvement of state-owned companies’ influence.

- Secure a stable development of the energy sector, seeking larger domestic and foreign investments into the energy sector and access to technologies, particularly in the field of natural gas liquefaction (the Russian energy strategy until 2020).

- Secure a maximum earned price from exports of energy resources.

The interests of Russian state-owned companies should meet those of government, with the exception of the ambition to manage financial flows independently from government authorities and to minimise participation in the government’s cost-inefficient domestic and external policy, for instance, the sales of resources for less than the market price to internal consumers or “friendly” states (Belarus). The interests of Russian private companies probably still greatly differ from those of the government compared with state

owned companies, but with regard to the fact that their primary interest is survival, opposition to Kremlin's energy policies, as the Yukos case showed, can be disastrous.

Interests of Western European actors

The most probable interests of governments in Western European consuming states when defining a regime of trade in energy resources with Russia are the following:

- Secure continuous imports of energy resources – economic and political stability in Russia; security of transportation infrastructure.

- Secure acceptable and stable prices for energy resources, i.e. not provide conditions for Russia to control the majority of all imports and to manipulate supply volumes and prices. For this reason retention of the balanced structure of imports diversified by supplier, transit route and energy resource is absolutely required.

- Secure a stable transit through Central and Eastern Europe to Western Europe – the only transportation and processing zone that separates Western Europe from export markets. There is not significant difference in how this stability will be ensured: this can be done also by Russian companies through the control of transit routes.

- Ensure a stable and free transit of the energy resources of the Caspian Sea Basin through Russia, to CEE and Western Europe.

- Reduce the transit supply risks by decreasing the number of transit countries – improve the opportunities to bypass Central and Eastern Europe through the development of the infrastructure directly connecting Western Europe and Russia.

- Retain autonomy in the energy policy field at least as long as the energy sector is considered a strategic sector directly associated with national security. This aim relates to both reluctance to transfer energy issues to the purview of the European Commission and the aim to limit access for Russian state-owned companies to end consumers.

- Provide conditions for Western European companies to directly participate in the production of energy resources in Russia.

- Western Europe can secure the development of its energy sector both from the investment and the technology point of view all by itself, therefore this issue should be excluded from the future regime.

The interests of Western European state-owned companies, same as in Russia's case, coincide with those of their governments: they speak in favour of close co-operation with Russia [49]. The major difference from Russia is that governments in Western Europe still do not subject the companies' business to domestic and external policy, which reduces the likelihood of cost-inefficient activity. The interest of private companies (primarily the shareholders' interest), in contrast to the state-owned ones, is profit. Therefore they find the intervention of governments into their business and the spreading EU "economic patriotism" useless. For this reason the ambition of private companies, which differs from those both of governments and state-owned companies, may be claimed to be total liberalisation of the market.

The position of the European Commission, which often contradicts governments and companies, should also be attributed to Western European actors. The interests of the European Commission are best reflected in its 2006 Green Paper "A European Strategy for Sustainable, Competitive and Secure Energy" [50]. It states the following key objectives:

- An open, competitive, non-protectionist and single European Union electricity and natural gas market. This means not only EU's full geoenergetic infrastructural integration (primarily by connecting the Baltic States and Ireland to Western Europe with networks), but also limited opportunities for governments to interfere with the market.

49. In the spring of 2006, following the start of the European debate on Russia as reliable supplier, the head of Germany's largest gas and electricity company E.ON Wulf Bernotat clearly spoke against any questioning of Gazprom reliability by calling all such talks nonsense. Richard Milne and Mark Mulligan, "Eon chief jumps to defend Gazprom", *Financial Times*, 1 May 2006, <http://news.ft.com/cms/s/c3021af2-d977-11da-8b06-0000779e2340.html>; European Round Table of Industrialists, appealing to the pink forecasts of Russia's development, in May 2006 distributed a statement saying that *the European Union could benefit substantially from increased economic integration with its largest neighbour and one of its best customers*. Stefan Wagstyl, "Top Bosses Step in to Soothe Relations With Moscow", *Financial Times*, 22 May 2006, <http://www.ft.com/cms/s/032b9dd6-e9bf-11da-a33b-0000779e2340.html>

50. Commission of the European Communities, Green Paper "A European Strategy for Sustainable, Competitive and Secure Energy", Brussels, 8 March 2006, http://ec.europa.eu/energy/green-paper-energy/doc/2006_03_08_gp_document_en.pdf

- Physically, economically and politically secure transportation of energy resources.
- Diversification of the energy mix through the increase of the consumption of renewable resources.
- The improving efficiency of the consumption of the energy resources – to stabilise growth in the EU demand and ensure environmental requirements.
- Technology development.
- A harmonised EU External Energy Policy, which includes a clear policy on securing and diversifying energy supplies); reacting effectively to external situations; integrating energy into other policies with an external dimension and energy partnerships with producers, transit countries and other international actors. The last module basically implies the aim to form clear international regimes, also with Russia. This regime, called “common regulatory space” in the Green Paper (it would be regulated by the planned Pan-European Energy Community Treaty) should become the basis for the Pan-European Energy Community already referred to in the review of the EU-Russia energy dialogues) – to create a predictable, open and harmonised market which prompts investment and growth. The Pan-European Energy Community would be a consolidated geoenergetic region encompassing production, transportation and processing and consumption zones. According to the proposals of the European Commission, this area should cover the EU, Turkey, Ukraine and the countries of the Caspian Sea Basin, Maghreb and Mashreq.

As it can be seen, not all EU preferences match those of governments and companies. Most of the controversy comes from two fields directly related to the future regime: the free market of energy resources in the EU and the creation of the Pan-European Energy Community. Free market contradicts the ambitions of governments to retain control over the energy sector (even in the countries which propagate liberal trade such as United Kingdom). The creation of the Pan-European Energy Community primarily rests on the assumption that single energy policy will be created in the EU. This ambition is opposed by the governments’ interest in retaining autonomy. *Second*, the Pan-European

Energy Community – the geoenergetic region – would be created around the Western European consumption zone (geoeconomic core). It would cover the key production zones supplying resources to Western Europe (Russia, the Caspian Sea Basin, suppliers of the Persian Gulf and North Africa), and also transportation and processing zones (non-EU CEE countries, primarily Ukraine, and Turkey, which are becoming one of the most important energy nodes). However, such a complicated and complex system contradicts not only the interests of actors in all other consumption zones (from the USA to China), but also the interests of Western European governments to apply different policies to different suppliers. It is this particular goal which is served, for example, by the “liberation” of exports from the Caspian Sea Basin through the infrastructure which is independent from Russia. Therefore the Pan-European Energy Community project could be implemented only in the long-term. In the short-term, individual regimes should be aligned with individual suppliers: the EU-Russia regime should be a separate issue.

Thus the common interests of Western European consumption zone actors in relations with Russia include:

- Stable and continuous energy supplies;
- Acceptable and stable prices;
- Stable transit through CEE;
- Opportunities to participate in the production of energy resources in Russia.

The clashing and mismatching interests are the single and free market (the European Commission and private companies) vs. the autonomy of governments (governments and state-owned companies) as well as decision-making regarding external energy relations – the European Commission vs. national governments.

Interests of Central and East European actors

The likely *common* interests of governments in the CEE transportation and processing zone (with the retained inter-competition for transportation volumes, routes and conditions):

- Reliable energy supplies – stable co-operation of actors in consumption zones through the transportation and processing zone.
- Acceptable and stable prices for energy resources.
- Diversified supplies, including transit through CEE and the energy resources of the Caspian Sea Basin and the Persian Gulf (for instance, Iranian natural gas), which leads to the ambition to ensure a stable and free transit through the Russian territory.
- Autonomy from other actors, primarily from Russian state-owned companies, which, apart from their core business, often also perform ancillary functions for Kremlin's policy.
- Retaining the importance of the transportation and processing zone by neutralising projects which intend to bypass this region (NEGP).

The interests of state-owned and private CEE companies fully match those of their governments. The pre-condition for companies' survival is governments' strive for autonomy. There are no international organisations covering energy issues in the entire CEE. Energy issues are included into some co-operation formats (GUAM) only episodically.

Matching and contradictive interests of geoenergetic zones

The interests of Western European, Russian and Central European governments match owing to, *first*, stable and continuous supplies from Russia through Central and Eastern Europe to Western Europe (on the Russian part, this ambition is valid to the extent that it does not contravene external policy arrangements); *second*, deepening of co-operation between Western Europe and Russia, but only to a certain extent – as long as it does not threaten to become totally dependent from a single supplier or a single consumer, and, *third*, securing of stable and acceptable prices for energy resources. These three conditions basically comply with the currently existing regime, apart from the limited guarantees that Russia will not discontinue natural gas supplies, for example, in the winter of 2007 in the event of a conflict with Belarus regarding natural gas prices. As long as there is no single regime – a package of rules – the best guarantee for stable and continuous supplies could be long-term supply agreements supported by both Russian and Western European governments. This

choice, however, is hardly probable because it contradicts the commitments to secure a free market in the EU's energy sector.

In all zones governments seek to retain autonomy in their energy sectors. However, in Russia and Western Europe, in contrast to the majority of CEE states, where Russian companies are quite active, governments enjoy those conditions. The autonomy retention interests are opposed by the interests of both Western European and Russian actors to have direct access either to fields and production (Western Europe) or end consumers (Russia). The European Commission and Western European private companies disagree with the retention of governments' autonomy in all geoenergetic zones. CEE interests to retain and increase the volumes of transit to Western Europe may be qualified as contradictory interests, failing to meet Western European and Russian ambitions to reduce the number of transit states. The third group of contradictory interests is the free transit of energy resources through the Russian territory sought by Western Europe, which is the main reason for Russia's disagreement to ratify the ECT.

One can distinguish one more group of preferences – specific interests. This is primarily the Russia's ambition to attract European investment and technologies.

Alternatives of EU-Russia energy regime

Having regard to the matching and contradictory interests, there exist several alternatives to align those interests, which could serve as basis for an institutionalised regime (for instance the EU-Russia agreement to replace PCA). The *first* alternative would be institutionalisation of the existing regime through the obtaining of Russian guarantees for stable supplies, Western European guarantees for stable settlement and the consent of CEE countries which are EU Member States not to restrict transit. None of the parties commits to open its energy sector for companies within another geoenergetic zone (of course, with the exception of CEE countries where both Western European and Russia companies are active anyway). This means that Russia would have no access to Western European consumers, whereas Western European companies to the production of energy resources and exports from Russia. Russia would not commit itself to allowing free transit of energy resources over its operated

pipelines. Neither would the investment regime be firmly established, which would limit Russia's opportunities to attract Western European investment and technologies.

Such retention of *status quo* would not alter Lithuania's position or its opportunities to improve the state of energy security: Lithuania would linger in the CEE transportation and processing zone, partly isolated from Western Europe; it would also be dependent on Russia's and its companies' ambitions to vertically integrate the Lithuanian energy sector; energy imports would be controlled by the same Russian state-owned companies; Lithuania would be dependent on the vulnerable and worn-out energy infrastructure – pipelines for whose renovation Russia has no funds.

The *second* alternative, apart from the three fields which are agreed upon (stable supplies, prices and transit through CEE), would be to establish Russia's obligation to provide independent from state-owned companies access to Western European companies to the production of energy resources and exports: this, without additional conditions, should secure the flow of Western European investments and technologies to Russia. Western Europe would commit to refrain from limiting the acquisitions of Russian companies, which enable direct sales of resources to end consumers [51]. Transit through the Russian territory could be subjected to a transitional period as long as the Caspian Sea Basin countries have transportation routes to the EU as alternative for Russia. Chances to have access to end consumers and to production and exports should not diminish Western European and Russian ambitions to bypass Central and East European countries as long as Ukraine and Belarus are not involved in the agreement. A maximally flexible liberalised market could ensure better competition (due to the mere participation of the Russian capital) in the

51. In March 2006, in Moscow during the meeting of Putin and the President of the European Commission José Manuel Barroso, the Russian President provided exactly the same proposal – European companies will be accepted to production and exports of Russia's oil and natural gas, but Russian companies must have the opportunity to not only supply, but also transport, process and distribute the energy resources in Western Europe. "EU-Russia Energy Talks Stalled in Moscow" <<http://www.euractiv.com/en/energy/eu-russia-energy-talks-stalled-moscow/article-153504>>. This position is basically similar also to the one presented by the EU Energy Commissioner Andris Piebalgs and the Austrian Minister for Economics Martin Bartenstein in the letter dated May 2006 to the Russian Minister of Industry and Energy Victor Khristenko – Gazprom will not be discriminated on the EU market if Russia opens its markets for Gazprom competitors. "EU: Competition Rules Apply to Gazprom", <http://www.eiropaskustiba.lv/en/russia>

EU, energy efficiency and development of alternative resources. In the medium-short term de-politicisation of the energy sector could be expected.

For Lithuania, this alternative would bring the best opportunities to improve energy security. *First*, the likely expansion of the activities of Russian companies in Western Europe would render the energy sectors of those countries more similar to those in CEE from the point of view of controlling actors. The challenges for Russian-controlled business should be addressed by not only CEE, but also Western Europe. This would naturally enforce creation of clear rules for transparent business in the entire EU and improved liberalisation of markets. Such a perspective would decrease companies' chances for manipulative action in Lithuania among others. *Second*, the expansion of European companies' business in Russia will increase their influence on the Russia's energy sector and eventually reduce the capacity of the Russian Government to employ energy policy for political purposes. *Third*, the creation of a single market should diminish the importance of the transportation and processing zone with Lithuania and entire CEE increasingly resembling a consumption zone – it is likely that a more active consolidation of the EU as the single consumption zone would take place. Alternative to Russia's oil and natural gas would reach Lithuania at approximately the same time as the entire EU, but, in contrast to Western Europe, they would be supplied through Russian territory. The major obstacle for this second compromising alternative will be the reluctance of the Russian Government to reduce influence on the energy sector. Therefore, as long as companies such as Gazprom do not care about European principles of liberalism, the liberalisation scenario does not seem secure. On the other hand, Lithuania and most other CEE states have nothing to lose.

The *third* alternative would be based on the hardly feasible condition: the EU Member States would agree to limit their influence on energy sectors, would speak in favour of the total completion of liberalisation of the energy sector and would not object to delegating external energy relations to the European Commission. This would be an internal consolidation of the EU as a single geoenergetic consumption zone. The relations of this consolidated zone with Russia would take place in a centralised manner through the European Commission. First of all, this would imply that agreements on energy supplies would be concluded with Russian companies through a single EU focal point.

The regime of investments in Russia would not be established in the new arrangement: Russia could do this unilaterally. This kind of regime would have the same effects for the development of the Russian energy sector as in the case of the first alternative. Liberalisation of transit through the Russian territory could be subjected to a transitional period, likewise in the case of the second alternative until Russia no longer has the need to restrict transit, i.e. suppliers of the Caspian Sea Basin have export routes alternative to Russia. The EU, as the single focal point for decision-making on energy policy could develop regimes with other production zones similar to those with Russia. The exclusive role of the European Commission in relations with production zones would enable a more efficient *global* competition with US, Chinese and Indian companies over access to energy resources and negotiations with state-owned energy producing companies and companies with strong political backing.

This prospect would enable Lithuania to limit the further expansion of Russian companies in the country with preferences on CEE and Western European companies. Lithuania's becoming part of the consumption zone should neutralise the majority of energy security challenges faced by the states of transportation and processing zone. Furthermore, Lithuania would have the opportunity to put a veto on decisions regarding the energy infrastructure projects, which it finds unfavourable. However, as it was mentioned before, the likelihood that states will agree to delegate more powers in the energy sector to the European Commission is very low.

As it can be seen, the principal choice for the EU and Russia lies between the *status quo* and the new regime. Should the decision be to change the regime rules, much will depend on the willingness of the EU Member States to delegate external energy relations to the European Commission and on the resolution of the Russian Government to reduce intervention into the energy sector. Be Russian state-owned companies gradually deprived of their privileged position in Russia, one could expect a decision about the second compromise, which is most beneficial to Lithuania. If Russia disagrees to free competition in its energy sector and EU Member States do not object to the delegation of rights to the European Commission, the decision regarding the third alternative is possible. For Lithuania, any change is useful, except for the *status quo* situation.

Conclusions – Lithuania’s opportunities and objectives

As paradoxical as it may seem, the fact that in the January of 2006 Russia cut natural gas supplies to Ukraine, which, in turn, to Western Europe, is beneficial for Lithuania. This blockade destroyed the regime of energy relations between the Western European consumption zone and the Russian production zone, which formed a unique situation requiring the development of a new regime that must meet the interests of Lithuania, among others. The needs of the CEE transportation and processing zone, including Lithuania, have so far been ignored – tolerating the unlimited expansion of Russian companies in national energy sectors and the development of the infrastructure which bypasses CEE. It would therefore be unforgivable if Lithuania did not actively engage in the formation of the new regime and did not use the gained opportunity to improve the status of energy security.

First of all Lithuania must engage in discussions within the EU on the development of EU’s energy sector. A *constructive* contribution to promoting a free market, delegating external energy relations to the EC and a quality-wise new agreement with Russia to replace PCA should be the three major directions in those discussions. It should be noted that the escalation of the extrapopular issues of ratifying the Energy Charter Treaty in Russia and of building NEGP are of no use. The building of NEGP is a totally natural outcome of today’s geoenergetic framework, as is the rejection of the ECT in Russia.

A constructive contribution to the discussion within the EU would facilitate involvement in EU-Russia negotiation on the new regime and its institutionalisation. Russia tries to eliminate the CEE transportation and processing zone countries, the majority of which are new EU Member States, from the future negotiation by discrediting them, defining them as non-constructive and incapable of negotiating. Such attempts are reflected, for instance, in statements made by the Russian Ambassador in the EU that the new Member States interfere with the EU-Russia relations and aggravate strategic partnership [52]. In consideration of the fact that these observations are well heard and receive a supporting response in Western Europe, CEE and Lithuania must make efforts to render this voice audible as well.

52. George Parker, “Russia Says New States Damaging EU Relationship”, Financial Times, 21 May 2006, <http://www.ft.com/cms/s/c0c691fe-e8e6-11da-b110-0000779e2340.html>

Following the assessment of the geoenergetic situation in Western Eurasia and of the maximally limited opportunities of Lithuania and CEE to alter their potentially endangered geoenergetic situation between Western Europe and Russia, we should avoid the formation of loud “defence alliances” from Russian energy policy. One of these proposals was the initiative of the Polish Prime Minister Kazimierz Marcinkiewicz to create a “NATO for Energy Security”. This initiative, without any realistic – geoenergetic – grounds, served merely for increasing tension and the separation of CEE from decision-making regarding the new regime. By the way, likewise the Polish resistance to “new Molotov-Ribbentrop” pacts.

Lithuania must support *any* solution to change the current situation because it is more useful compared to *status quo*. If large EU Member States from Western European consumption zone do not approve of making the EC the single and principal focal point for the formation of global energy policy within the EU (Lithuania can hardly have any influence on this process) and basically reject the third possible option for the new regime, it is necessary to seek the second one: the formation of a free market between the EU and Russia. Lithuania’s voice calling Russia for full-fledged acceptance of European companies into its energy sector, production and exports, would not be heard, and even if it would, then only as another example of destruction. For this reason an alternative move is possible: support to Russian investments in the EU.

This seemingly controversial proposal would prompt the “export” of Lithuania’s problems to Western Europe and, as mentioned before, stimulate the search for common solutions. Furthermore, Russia would be interested that the development of its companies’ business in Western Europe be supported by EU Member States, especially “Russophobic” new members, and would therefore provide adequate conditions for this voice to be heard and appreciated. The criticism of “economic patriotism” and protectionism in Western Europe would provide firm support to the EC’s liberalisation ambitions in the energy sector. Lithuania could initiate in the EU a group of common-minded states holding the clear position that conditions must be provided either for the expansion of Russian companies *all across* the EU or for EC’s becoming a single focal point for energy policy. This would not be blackmail for the mere reason that both alternatives would be useful for Lithuania.

The biggest guarantee of energy security for Lithuania as for any other state that imports energy resources would be the transformation of energy sector into “normal” and non-politicised business. The major threats for the country’s national security arise from the energy sector in every instance when political interests appear on the scene. On the other hand, expecting the energy sector to become depoliticised would be naive. At least as long as an extra-large amount of political projects in one state which supplies us energy resources are associated with this branch of economy.