Is Russia a Threat to Energy Supplies?

Jonathan Stern looks at the security of Russian gas supply in the aftermath of the Ukraine crisis

The crisis of 1–4 January 2006 which saw Russia cut gas supplies to Ukraine, with the consequence that Ukrainian consumers diverted significant quantities of gas in transit through their country to Europe, produced a huge negative reaction from governments and commentators on both sides of the Atlantic. These events have been received both in the media and in policy making circles as 'evidence' of Russia's willingness to use energy as an instrument of foreign policy and even as a political weapon. The ensuing six months have witnessed a downward spiral in energy relationships between Russia and Europe, each accusing the other of threatening energy security. Most of this discourse made little sense in analytical terms, and was symptomatic of a deterioration of political relationships between Russia and governments in both Europe and the USA. Meanwhile the most immediate threat to security of Russian gas supplies to Europe – the situation in Ukraine – continued to be ignored by OECD media and policymakers alike. Instead, there was an increasing focus on whether Gazprom would be able to maintain its exports to Europe because of anticipated future production decline arising from lack of investment in new fields.

Russia–Ukraine Crisis Aftermath

The Russia–Ukraine gas agreements of January and February 2006 did not provide an adequate commercial road-map for even the second half of 2006, let alone 2007 and beyond. The price of Central Asian gas purchased by Gazprom/Gazexport, principally from Turkmenistan, for onward sale to RosUkrEnergo and Ukraine is likely to rise from $65 per thousand cubic metres (mcm) at the Turkmen border, which Ukrainian buyers have been struggling to pay, to around $100/mcm in the fourth quarter of the year. Gazprom expressed concern that insufficient gas has been injected into Ukrainian storages which could create problems for the country's domestic customers during the winter months. Such problems are usually associated with shortfalls in the volumes available for Gazprom's European customers, most recently during February and March 2006, when buyers in Poland, Hungary, Italy and Austria reported that deliveries were between 10 and 35 percent below requested volumes on a substantial number of days.

> "It thus seems reasonable to suggest that Gazprom has strong incentives to maintain supplies to European customers"

The fact that the Ukraine was without a government for three months following the March 2006 elections and that, as this article was completed, opposition politicians were preventing the opening of the first session of parliament, is not confidence-inspiring for future political stability. The announcement from the Prime Minister-elect that all of the country's gas agreements needed to be reviewed suggested equally unfavourable omens for security of gas supplies.

Strengthened perceptions of the undesirability of increasing imports of Russian gas were partly addressed by the March 2006 EU Green Paper on energy strategy, which envisaged a deepening of the existing energy partnership with Russia and argued that the G8 should intensify efforts to secure Russian ratification of the Energy Charter Treaty and its Transit Protocol. But these suggestions were not new, and the failure of the European Commission to play any significant role during or after the events of 1–4 January 2006, using the institutions of the EU–Russia Energy Dialogue and the EU–Ukraine Summits, did not inspire confidence in its role in any future crisis management.

This was followed by strongly adverse public reaction to the following two sentences in a Gazprom press release of 18 April 2006:

> ...one cannot forget that we are actively developing new markets such as North America and China…
>
> It is necessary to note that attempts to limit Gazprom's activity in the European market and politicize gas supply issues, which are in fact solely economic, will not lead to good results.

These produced front page banner headlines in the Financial Times: 'Gazprom in threat to supplies: EU told not to thwart international ambitions; Group says it may divert sales to other markets.' This was despite the fact that Gazprom has no current capability to divert European supplies to North America or Asia and – in the most optimistic of all possible scenarios – will not have such capability for a decade. The commentary almost completely ignored other passages from the Gazprom CEO in the press release which read:

> Gazprom was and is the main supplier of natural gas to Europe. We understand our responsibility and henceforth will remain the guarantor of energy security for the European consumers. All the contracts signed to supply gas will be implemented. There are no doubts at all.

The reaction to the 18 April press release was followed, in early May, by US Vice President Cheney's speech to a conference of east European leaders in Lithuania when he noted in relation to Russia:

No legitimate interest is served when oil and gas become tools of intimidation or blackmail, either by supply manipulation or attempts to monopolize transportation.

Gazprom Investment in Production and Pipelines

More substantive than these (largely political) outbursts have been issues raised by, among others, the International Energy Agency, relating to the adequacy of Gazprom's investment in production and network infrastructure; and the lack of liberalisation and access for independent producers to Gazprom's network. The expected decline of roughly 200 Bcm/year at Gazprom's fields in production and under development over the next 15 years (Figure 1) would be extremely alarming were it not for the availability of gas from independent producers and Central Asia in the short term, and Yamal Peninsula gas in the longer term. Aside from the exact decline profile of the fields, the main issue which it raises is Gazprom's ability to develop supplies from elsewhere, and the cost and reliability of those supplies.

Many have jumped to the conclusion that declining production will jeopardise Gazprom's ability to fulfil its contractual commitments to Europe. However, Gazprom's domestic market is twice the size of its European export market. Mid-2006 prices in Gazprom's European long-term (15–20 year) export contracts are around \$240/mcm as a result of which the company will earn around \$37 billion dollars this year, which may equate to as much as 20 percent of Russia's foreign currency earnings. These contracts are enforceable under international arbitration with liquidated damages for non-performance. Contrast this with Gazprom's (mostly one-year) contracts with its non-residential customers at regulated 2006 prices of up to \$43/mcm (residential prices are lower), with some uncertainty as to whether all of its customers will pay in cash and on time. It thus seems reasonable to suggest that Gazprom has strong incentives to maintain supplies to European customers.

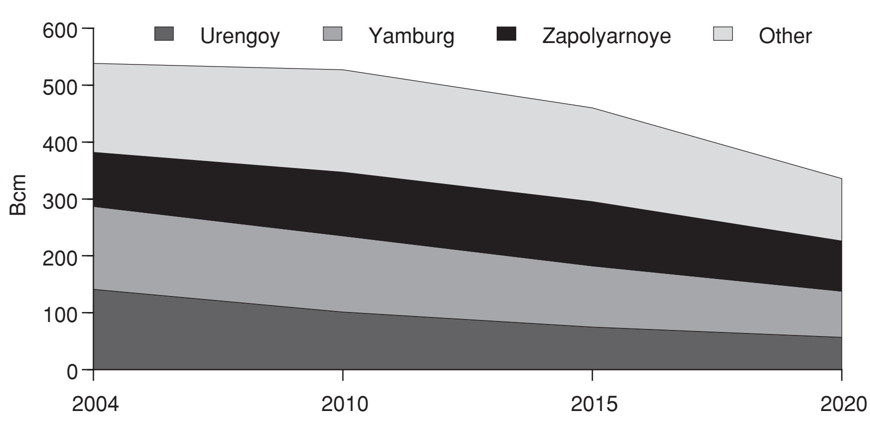
What might happen in the event that Gazprom should be unable to meet all the demands from domestic and international markets can only be guessed, but rationing gas to the domestic market would be both the logical and the historically expected response. Rationing would not mean leaving the population to freeze in the winter; it would involve restricting the amount of gas that industrial customers are allowed to purchase at regulated prices based on a number of criteria related to cost of service and ability to pay. This would provide a much-needed wake-up call to the Russian government that domestic prices are still nowhere near what will be required for viable investments in the next generation of fields on the Yamal Peninsula. But the main point is that Gazprom's major problem is not how to meet its contractual requirements in Europe, it is how to control growth of the domestic market where gas continues to be massively under-priced for political reasons.

Partly for these reasons, Gazprom's current investment programme is heavily weighted towards transportation infrastructure and there was much western speculation that the condition of the pipeline network was so bad that supply security would be compromised. During the two months immediately following the January 2006 Ukraine crisis, Russia and many parts of Europe experienced exceptionally cold temperatures well below minus 30 degrees Celsius for some ten days. Anecdotally, the winter is believed to have been the coldest since 1941 – some believe it was even colder. This raised gas demand in Russia and much of central/eastern Europe to extremely high levels, placing a huge strain on Russian gas and power networks which proved equal to the task. Much gas infrastructure and storage in Europe proved to be less robust and less well-prepared. In fact it would be hard to think of a European country where the utility industries would have coped as well as Gazprom and the Unified Energy System (UES) with the coldest winter in 65 years.

Supplies from Independent Producers and Central Asia

The need for Gazprom to more actively engage and encourage independent producers has been a constant refrain of OECD commentary. While there are those in Gazprom who are not opposed to this course of action, internal disagreements and clashes of personality have slowed things down. But 2006 may be a defining year for this process, albeit not in quite the way that was envisaged. In the past few months, Gazprom has acquired

Figure 1: Anticipated Decline in Gazprom's Production 2004–2020 (Bcm)



Source: Jonathan P. Stern, *The Future of Russian Gas and Gazprom*, OUP: 2005, Table 1.10, p. 32.

majority ownership of Northgas, a near-20 percent stake in Novatek and a controlling interest in Itera's Beregovoy field. These actions – all of which have different histories and rationales – have a common thread: Gazprom involvement in independent production. Since Lukoil's strategic partnership with Gazprom will apparently sell all of the company's gas (including that produced from Caspian joint ventures) to Gazprom, this leaves only three significant independent players: TNK-BP, Surgutneftegaz and Rosneft. The first is fixated on exports to Asian markets from the Kovykta field in Eastern Siberia, but could also have significant production in western Siberia from its Rospan subsidiary. The second appears to have little gas interest beyond that associated with its oil production. Rosneft, despite having rejected a merger with Gazprom, is discussing a long-term sales agreement with the latter for its west Siberian gas. Independents produced 93 Bcm of gas in 2005 and have reserves and investment availability which could see their production more than double by 2015. It will be increasingly in Gazprom's interest to ensure that the commercial environment is conducive to these developments.

"There are commercial and political problems between Russia and the transit countries through which its gas flows to Europe"

Central Asian gas supplies have also become very significant. In the past, deliveries of Turkmen gas to CIS countries (especially Ukraine) were a matter of logistical convenience; they are now essential to Gazprom's overall balance. In 2005, more than 54 Bcm of Central Asian gas was delivered to Ukraine and other CIS countries. Much higher volumes have been agreed by Gazprom – up to 90 Bcm/year from Turkmenistan alone – but the post-2003 period has seen significant demands for price increases from these countries, most recently reports that Gazprom has agreed to pay Kazakhstan $140/mcm for gas delivered in the second half of 2006. In terms of resource availability, exports from Turkmenistan, Kazakhstan and Uzbekistan could be as much as 150 Bcm/year by 2015 but for two outstanding problems: affordability and security. Comparing the prices that Central Asian countries want to charge for their gas with what CIS countries can afford, its attractiveness remains limited. Meanwhile President Niyazov of Turkmenistan has again threatened to cut off gas exports in October 2006 if he does not get the price he wants – just as he did at the end of 2004 (to both Ukraine and Russia) in the middle of winter at two weeks notice. Despite these problems, the option remains for Gazprom to use Central Asian countries as 'swing producers', regulating any shortfalls in its overall gas balance.

Conclusions

Despite a great deal of huffing and puffing in the media and political speeches about security of Russian gas supplies to Europe, the Russia–Ukraine crisis and its aftermath has told us two things that we should already have known:

- There are commercial and political problems between Russia and the transit countries through which its gas flows to Europe. These problems are part of the long-delayed break-up of Soviet political and commercial relationships.
- Gazprom has some difficult decisions to make about future supplies as between: investing in new fields, encouraging independent production and purchasing Central Asian supplies.

The first is an arena where European politicians can and should participate, but not simply by blaming the Russian government and Gazprom for everything that goes wrong and ignoring the actions of the transit countries. The second issue is not an immediate problem and will not become one unless relations with independent producers and Central Asian suppliers break down. Even in that event, the ensuing problems are much more likely to impact on Russian domestic users of gas than on Gazprom's European customers.

Giacomo Luciani asks whether Russia will remain a preferred gas supplier to Europe

The G8 Summit in St. Petersburg will be the first to take place under the chairmanship of the Russian Federation – and also the first one for which the host country has chosen energy security as a key item on the agenda. This is quite paradoxical: only in January 2006, Russia cut off gas supplies to the Ukraine, and extended shortfalls of supplies to countries in Central and Western Europe downstream of Ukraine did occur for a while. For the first time in thirty years, an acute feeling of insecurity has been created among Gazprom's European customers.

The US Vice President, Dick Cheney, has accused Moscow of making political use of 'the gas weapon', and encouraged the Central Asian republics to develop new pipelines bypassing Russia. Condoleeza Rice has echoed along the same lines. Claude Mandil, the executive director of the International Energy Agency, has stated that unless Gazprom revises its priorities and invests more in the upstream part of the business, it will be unable to honour its export commitments.

When the Soviet Union collapsed, an expectation was created that the New Independent States (NIS) in the Caucasus, Central Asia and of course the Russian Federation would embrace the precepts of the advanced market economies, behaving in line with OECD principles. They were urged to liberalise their oil and gas sectors, open up to international investment, increase production and exports. It was expected that the opening up of the hydrocarbon wealth of the former Soviet Union would allow for substantially downsizing the OECD's dependence on oil and gas imports from OPEC or the Gulf countries, which are perceived as unstable and a potential security threat.

On the basis of these expectations, the EU and, separately, the USA launched 'energy partnerships' and dialogues with the Russian Federation and the rest of the NIS: the latter would, it was believed, behave more like Norway than like Saudi Arabia or Mexico.

"resource nationalism always remained the prevailing political sentiment in the country"

The expectation that Russia would be different was initially supported by the process of privatisation of the oil industry. Several 'private' Russian oil companies saw the light, but the Duma always maintained a resource-nationalist attitude, creating obstacles to foreign investment, and refusing to approve legislation generalising the use of Production Sharing Contracts – a point on which US diplomacy insisted for a long time. In fact, resource nationalism always remained the prevailing political sentiment in the country.

In the gas arena, there was never any doubt. The former Ministry of Gas was transformed into a vertically integrated gas company – Gazprom – which quickly became the key source of power in the new Russia. Initially, as political power was weak in the hands of Boris Yeltsin, Gazprom took over, and its founder and head, Chernomyrdin, became Prime Minister. Later, the company attempted to set itself up as a parallel and independent power, subtracted from the control of its largest shareholder, the Russian government.

As soon as he entered the Kremlin, Putin moved to regain control, appointing a man of his confidence, Alexei Miller, as the CEO of Gazprom. In this respect, any notion that the gas sector could be 'opened up' to foreign participation was always a non starter. Suggestions that Gazprom could be unbundled – separating control of the pipeline network from control of gas production and gas sales – or that Gazprom could be divided into two or three separate and competing companies were flatly rejected.

Recently, the Russian government has moved more and more clearly to adopt the principles of resource nationalism in the oil arena as well. However, for reasons of political expediency, it does not wish to do so openly – as would be the case, for example, if it declared that all oil-producing companies should surrender at least 50 percent of their ownership to a national oil company, which is what a traditional OPEC country would do.

The new policy took shape with the undoing of Yukos, and the shady transfer of Yuganskneftegaz to Rosneft. There was talk that Rosneft would be merged with Gazprom, but in the end it remained independent, and Gazprom instead acquired Sibneft, leaving the Russian government with two corporate tools to control the sector. What is left of Yukos may soon be declared insolvent, opening the door to a further increase of government control of oil reserves.

In parallel, legislation was passed to declare larger oil and gas fields 'strategic' and to reserve them to majority-owned Russian investors. This excludes TNK-BP from competing for access to these assets, seriously undermining its upside potential. The last that was heard on this front is that new legislation may soon lower the threshold of what is considered 'strategic', bringing it from 150 to 70 million tons for oil, and from 1000 to 50 billion cubic metres for gas. In announcing the new legislation, Yuri Trutnev, natural resource minister, said that his proposal was designed to protect Russia's national interests, and would particularly affect TNK-BP.

What does all of this mean? It means very simply that Russia is an oil and gas exporter, and behaves as such. Resource nationalism is a logical and understandable strategy for natural resource producers wishing to progressively transform their economies into advanced industrial economies. The expectation that Russia would identify itself as an industrial country, rather than as a hydrocarbon exporter, was entirely ill-founded. Russia, albeit not a member of OPEC, has every interest in behaving just as if it were one.

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The expectation that resource nationalism would quickly become obsolete, and IOCs would gain access to much larger resources than they have had since the mid 1970s, was also unwarranted. Resource nationalism is in full swing, and higher oil and gas prices have eliminated one of the key reasons for calling back on the IOCs, i.e. scarcity of finance. Resource nationalism is not necessarily a threat to energy security: in fact Saudi Arabia and the other Gulf countries have contributed the most to increased global oil supplies, at a time of political tensions in other parts of the world.

Russia will, in all likelihood, also contribute to increased oil supplies, albeit probably at a slower pace than was achieved by Yukos under Khodorkovsky. But then, some people are of the opinion that Yukos was pumping too much oil out of their reserve base, and jeopardising the maximisation of recovery rates in the longer run. The rate at which reserves are drawn down is the major difference in expected behaviour between national and international oil companies, and it is not by chance that Surgutneftegaz or Lukoil has been more prudent than the old Yukos.

When it comes to gas, one cannot understand the conflict between Russia and the EU unless one also considers the latter's drive to create a single European gas market. Russia is still attached to the old order of things, based on bilateral monopolies, long-term take-or-pay agreements, destination clauses and indexed prices. In contrast, the European Union, following the British example, has decided to embrace liberalisation and the creation of a competitive, integrated European gas market.

The key driver of the European liberalisation policy is not so much security of supply or price stability – it is indeed dubious that either of these two would be better served by a competitive and integrated European market – but the creation of a single European energy market. The latter is essential because one simply cannot have a successful monetary union, or claim to have achieved the goal of establishing a Single Market, if national energy markets continue to be separated, and characterised by sharply divergent structures. For this reason, and notwithstanding the clear lack of enthusiasm with which some of the member countries have enforced liberalisation and competition, I believe that there will not be a turnaround in European energy policy. Rather, the Commission will propose, and the Council will in the end accept, progressively more stringent rules to guarantee the convergence of national markets into a single European energy market.

Through a string of initiatives (the European Energy Charter, the INOGATE umbrella agreement, the Barcelona process, the European Neighbourhood Policy, and the latest in the series, the Energy Community Treaty, which came into force on 1 July 2006) the EU has tended to expand the legal reach of the single European energy market beyond the member countries, to incorporate also countries in the so-called neighbourhood of Europe. With the Energy Charter Treaty, an attempt has been made to formulate rules that, while falling short of being fully in line with internal EU rules, are nevertheless at least compatible.

> "the EU has tended to expand the legal reach of the single European energy market beyond the member countries"

Russia's refusal to ratify the Energy Charter Treaty is a manifestation of the country's lack of interest in the European rules. Russia does not believe in a liberalised, unbundled, competitive European market. The Russian concept of things has been very clearly expressed by Igor Shuvalov, one of Putin's aides in the preparation of the G8 Summit. 'In our logic, Gazprom should emerge as a global energy company, forming partnerships with major oil and gas companies throughout the world,' Shuvalov was reported as saying in a speech in Paris. 'Our objective is not an association of gas producers, but a closely interconnected and mixed asset-management system whereby both consumers and producers are part of an integrated business structure,' and unless that happens 'there will be no energy security.' The same idea, of an exchange of assets between upstream and downstream, in order to cement a commonality of interests between buyers and sellers, has been articulated by Putin himself.

However, this approach is the negation of competition. It is a vision whereby Gazprom is at the centre of a constellation of bilateral deals with major national importers, each controlling its own national market, and not competing with each other.

In the end, and even if they continue to reject ratification of the Energy Charter Treaty, Russia will have to come to terms with European competition policy. In a recent move, the Competition and Energy Commissioners launched a joint inquiry into monopolistic practices in the energy market, whose results will be of crucial importance in shaping the future of the European energy market and of EU–Russia energy relations. The preliminary report of the inquiry, published in February 2006, asserts that, 'The five main barriers to a fully functioning internal energy market are:

1. Market concentration
2. Vertical foreclosure
3. Lack of market integration
4. Lack of transparency
5. Price formation'

While the preliminary report mentions no individual company by name, it is very clear that Gazprom, in association with its allies, controls a very large share of the European market, is a champion of vertical foreclosure, and does not want competitive price formation.

It is therefore fully to be expected that the Commission will conclude that Gazprom enjoys a dominant position in several of the member countries' gas markets, and is abusing it. Remedies will be proposed, and the doctrine of extraterritorial reach of the European competition jurisdiction will be upheld. One can guess that this will take the form of invalidating existing long-term contracts, forcing Gazprom to sell transmission and distribution assets that they might own within the EU, and eventually capping the share of total EU imports, unless the Russian government enforces a competitive environment at home, notably opening up access to pipelines.

Gazprom does not seem to understand the nature of the issue, or perhaps is trying to pre-empt the course of European policy by imposing a different regime before things evolve too far. So far, European directives have not enforced complete unbundling of ownership. The currently prevailing, mild degree of societal separation between stages has not been sufficient to promote effective gas competition. We should expect more rigorous unbundling to become mandatory.

In the end, Gazprom will have to come to terms with the idea that Europe wants a competitive gas market. If it insists on resisting European rules, it will inevitably find itself restricted in its freedom to penetrate the market. This has nothing to do with the presumed political use of the 'gas weapon' – Russia was justified in asking for a closing of the gap between prices paid by former Soviet republics and international prices, although it went about doing so in the most undiplomatic way possible. Indeed, the incorporation of the former soviet republics into the single European energy market, as proposed by the European Neighbourhood Policy, *requires* the abandonment of any form of administered or segmented prices. It has, nevertheless, a lot to do with enforcing competition.

Talk about Russia diverting gas exports to Asia or the United States is not relevant in this context. Russia will obviously diversify its export markets, but Europe will always be the one market that offers the best netbacks. In the same vein, although it may try to develop alternative export routes, Russia will always be dependent on the Ukraine to an important extent. The attempt to approach the issue with a geopolitical toolbox (by-passing, encircling, pre-empting competitors, pitting customers against each other) will in the end prove to be of not much use.

It would be an exaggeration to view Russia as a threat to energy security, but neither should it be viewed as a preferred supplier. Europe must create a level playing field, and focus on establishing the necessary transmission capacity (new pipelines, new regasification terminals) to allow an ever growing number of outside suppliers to compete on the European market. A *competitive* market, that is.

Shamil Midkhatovich Yenikeyeff explains Russia's energy strategy

In the current times of high energy prices, instability in the Middle East, growing Asia–Pacific energy demand and reserve depletion in the OECD region, energy-consuming nations are highly sensitive to any real and probable disruptions in the supply chain. It is, therefore, not surprising that the Russo-Ukrainian gas dispute of January 2006 resulted in the recent highly politicised debate on Russia's reliability as an energy producer. Apart from transit complications with the Ukraine, Moscow has also been increasingly criticised for hindering Central Asian and Caspian oil and gas deliveries to global markets, the Yukos affair and the growing state presence in the energy sector, resource nationalism, non-transparent rules and emerging constraints on foreign investment and third party access, and underinvestment in new oil and gas fields and the relevant energy infrastructure. Some commentators find it ironic that this year Russia as a G8 chair promotes energy security while using energy resources as a 'foreign policy weapon' against its neighbours.

Does this really mean that the world's largest energy producer is a threat to global energy security as some Western observers have recently suggested? To answer this question effectively one needs to examine Russia's energy strategy and its ability to use energy resources as a political tool.

Russia's energy strategy is driven by its determination to occupy a prominent role in global energy markets. To achieve this, it is actively seeking to transform Gazprom and Rosneft into global energy champions, mainly through upstream and downstream acquisitions, liberalisation of shares and gradual withdrawal from subsidised gas prices for domestic consumers and the neighbouring states – the former constituent parts of the Soviet Union. Russia is also attempting to diversify its oil and gas exports which are almost entirely dependent on European energy markets without compromising the existing contracts. In addition, Moscow aims to take an active part in the establishment of guidelines and a new regulatory framework for international oil and gas markets. In all the three described areas Russia has faced considerable resistance.

Transit and price issues involving Gazprom and Russia's neighbours have been the key problem. Russian officials insist that the Russo-Ukrainian gas dispute was of a purely commercial nature, and they have strong grounds for saying so. According to President Vladimir Putin, Gazprom, through low energy prices, subsidises the Ukrainian economy in the region of $3–5 billion per annum. As soon as the Russian energy giant demanded a higher price for the gas supplied to the Ukraine it immediately became a political issue. The essence of the Russo-Ukrainian gas dispute is not only about gas prices it is also about transit pipeline infrastructure and distribution networks. From a commercial point of view and for the sake of stable transits, it is simply a good idea for Gazprom to take control over this infrastructure.

"Russia's energy strategy is driven by its determination to occupy a prominent role in global energy markets"

Gazprom's recent relations with Belarus, Moldova and Georgia have also been developing along similar lines. Russia's oil companies and Gazprom used similar strategies towards Russian regions in the 1990s. If regional administrations were heavily in debt to oil and gas companies for energy supplies they would often be compelled to concede assets under their control, sometimes on a temporary basis. For example, the government of the Russian semi-autonomous region of Bashkortostan leased a local oil and gas refining plant, Salavatnefteorgsintez, to Gazprom to settle an outstanding debt. Like their Ukrainian and Belorussian counterparts, Russian regional leaders also resisted corporate penetration into their provinces and often attempted to use political rhetoric to protect local assets.

Gazprom's plans to acquire downstream assets in transit countries and Europe are often viewed as a threat to the energy security of the European Union. Some commentators argue that such moves would reinforce Gazprom's monopolistic position in European markets and undermine EU plans to boost security of energy supplies through their diversification. Russia, on the contrary, views Gazprom's downstream acquisitions as an essential component of security of demand. Access to European distribution, retail and generation capacities would provide Gazprom with a guarantee of demand for its new energy production and transportation projects, such as Yamal or the NEGP. In this situation, the suggestions of some European politicians, heightened by members of the journalistic community, to establish legal obstacles to Russian downstream acquisitions in Europe have created new uncertainties for Russian energy companies.

Some of the EU initiatives to change its energy relations with Moscow have resulted in serious incompatibilities between Russian and European energy strategies. The European Commission has recently come up with an idea of a sole EU–Russia gas framework which, in Russian eyes, seeks to undermine Gazprom's system of long-term bilateral agreements with European companies. Under the existing framework, EU partner companies of Gazprom's export arm, Gazexport, are restricted to selling Russian gas within their own territorial domains. The European Commission seeks to change this practice by making Gazprom sell its gas at the EU border, while European gas companies will no longer have any territorial restrictions when it comes to selling Russian gas. As a result, Gazprom's existing export revenues, long-term investments and strategic bilateral relations with individual EU countries (such as Germany) will be harmed. It also raises serious concerns in Russia about security of demand in relation to Europe since around 80 percent of Gazprom's supplies to the EU are conducted on the basis of long-term contracts. Some European suggestions to diversify away from Russia as a supplier have only strengthened mutual tensions and a climate of distrust in EU–Russia energy relations.

> "Russian officials insist that the Russo-Ukrainian gas dispute was of a purely commercial nature"

Russia's resistance to ratifying the Energy Charter Treaty (ECT) has also been subjected to misunderstanding and misinterpretation. Today the ECT is probably the only international document which aims to establish meaningful rules for energy cooperation between producer and consumer nations. Nevertheless, the Energy Charter is unlikely to be ratified by Russia in its current form. Since 1994, when over fifty countries signed the treaty, many of its provisions have become dated. Russian minister of finance, Alexei Kudrin, recently complained that many of the Charter provisions on investor protection and transit issues are weak and/or lost their value with the EU enlargement. Government officials in Moscow often hint that Russia may sign the Charter but without its annexe, the Transit Protocol, as this undermines Gazprom's commercial interests. The protocol seeks to open Russian gas pipelines to exporters in the Caucausus and Central Asia at a Russian transit charge of $0.35 per 1000 cubic metres. This will establish a serious competitive advantage for the gas from Turkmenistan, Kazakhstan, Uzbekistan, and Azerbaijan as it will cost around half the price of the Russian gas at the German border.

Moreover, Article 20 of the Transit protocol establishes exemptions for member states of the European Union whose energy relations are covered by the EU's own rules and regulations. This means that new members of the European Union, many of which are transit countries, are no longer covered by the ECT. Such provisions make this important international document an external policy paper regulating transit issues outside the European Union. As a result, the ECT has been devalued in the eyes of key producer nations, including Russia.

Today Russian government and independent experts agree that EU initiatives on diversification and market liberalisation have been implemented without proper consultations with suppliers. Since these initiatives are clearly undermining the commercial interests of producer nations, they are now trying to find some common ground (such as the formation of the GECF – the Gas Exporting Countries Forum) to deal with pressures from some European policy makers, described by Nadine Hallouche in the previous issue of the *Oxford Energy Forum*. Europe's one-way street approaches and ultimatums in its energy relations with Russia will not work and are undermining the energy dialogue.

It is rather unfortunate that some commentators and policy makers in their discussion of energy security tend to view energy resources as a potential foreign policy weapon in the hands of producer nations. This rhetoric, reminiscent of Cold War times, may well be part of an ongoing bargaining process between producer and consumer nations on new rules of the energy game, but it further damages mutual trust in the energy area. Russia is dependent on its consumers as they are dependent on stable energy supplies from Russia. Mutual dependency undermines Russia's ability to use energy resources as a weapon. At present, Russian energy exports are almost entirely dependent on European buyers and any serious disruptions in the supply chain hurt Russia as well as Europe. Possible transit complications which result in gas supply disruptions in European markets (like the ones involving Belarus in 2004 and the Ukraine in 2006) can only be prevented if all parties involved in the energy trade and transit develop a new international legal framework beneficial to all participants.