Return of the Bear? The Extent of Russian Revisionism as Applied to Oil and Gas Machinations

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Abstract
The 2009 Russo-Ukrainian gas skirmish was the most recent example of Gazprom's oil and natural gas disputes with its neighbors. Over the past several years, Russia has been accused of using Gazprom to further its "neo-imperialist" and "expansionist" foreign policy goals by cutting off energy supply to nations that seem to be orienting toward the West. Careful examination of Gazprom's actions toward Lithuania, Azerbaijan and Belarus, however, indicate the elimination of foreign subsidies and the normalization of gas prices for all. This trajectory reflects Gazprom's approach toward deliberations: profits, not politics, dictate how disputes are resolved. This paper argues that ultimately, Russia acts out of economic necessity, not political retribution.

Keywords
natural gas, oil, Russia, revisionism, Gazprom, energy security, Social Sciences, Political Science, Rudra Sil, Sil, Rudra

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Return of the Bear?

The Extent of Russian Revisionism as Applied to Oil and Gas Machinations

A Thesis

Submitted to

the Faculty of the Political Science Department

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of the Requirements for the Degree

Bachelor of Arts

by

Julie Steinberg

Dr. Rudra Sil, Thesis Supervisor

March 2009
Acknowledgments

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I am also grateful for the support and love from my family, whom I neglected over spring break to work on this project. My father is the best editor I know – he taught me to declare war on extraneous adverbs, among other things, and I am thankful for his suggestions on how to write more clearly. My mother listened to me puzzle out theories over numerous meals and offered her own observations while providing much-needed comic relief. My sister and eternal best friend listened to me whenever I needed a springboard – which was often – and is one of the most brilliant and incredible individuals I know. Lastly, this thesis is dedicated to all of my grandparents, whose unconditional love is matched only by the premium they place on education.
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“We know that many people are apprehensive about our largeness and often associate us with
dangerous and clumsy bears. This association, by the way, is quite to the point here. Since a bear
is a caring father and attached to its family it has no enemies in the natural environment. Usually,
it doesn’t attack if not disturbed …Yes, we are bears! But what’s wrong with that?”
-- Alexei Miller, CEO of Gazprom, December 12, 2008

I. Introduction

The image of Russia as a menacing bear, ready to spring on friend and foe alike if it senses a
threat, is as salient a depiction today as it was in the 19th century. Over the past few years,
articles in The New York Times and The Wall Street Journal have stressed the resurgence of a
dominant grizzly Russia, intent on dislodging the United States from its position as the
international superpower. Arctic races have replaced space races, missile defense receptors in
Poland have supplanted Reagan’s Strategic Defense Initiative, and scholars and newspapers alike
have announced a “new Cold War” with trepidation¹. Accounts of power centralization under
Prime Minister Vladimir Putin, combined with the creeping eradication of local authority, have
only further contributed to fears about an emergent Kremlin bid for global hegemony.

This ascension is not contained within the military realm. In fact, it is the energy sector that
has commanded more attention since Putin became president in 2000 and subsequently chose
Dmitri Medvedev, former Chairman of Gazprom, the national energy company, as his successor
in March 2008. Russia’s emergence as the world’s largest producer of natural gas, combined
with its geographical proximity and control of regional pipelines, have prompted fears regarding
likely energy dependence among European and Commonwealth of Independent States (CIS)
countries. Critics allege that the vertically-integrated nature of Gazprom and the state’s 50.002
percent share indicate Russia’s desire to exert its influence over global affairs using energy as a
foreign policy instrument. The Russo-Ukrainian gas dispute in January 2009, for example,

¹ See, for example, “Is This a New Cold War?” RFE/RL, August 27, 2008; Cathy Young, “From Russia with
attracted international attention when a regional pricing disagreement resulted in gas disruptions for European citizens.

Since 2002, under the leadership of former president and current Prime Minister Vladimir Putin, natural gas and oil prices have been steadily rising both domestically and abroad. Gazprom’s 2007 decision to raise gas prices for Russian industrial consumers to market levels in 2011, while controversial, was foretold in the 2003 Energy Strategy for Russia. It called for a “well grounded increase in domestic prices for energy carriers at such rates which are economically-warrantable and acceptable for consumers,” a direct precursor to the steps the Russian government has allowed Gazprom to take toward eliminating domestic subsidies. The government has taken similar actions abroad by creating new long-term contracts with Baltic and CIS states that increase energy prices annually. When one of the transit states refuses to or cannot pay the specified amount, Gazprom shuts off the pipeline to those states or only pumps enough gas to meet its contractual obligations to its European customers (Germany, Poland, Slovakia, Czech Republic, etc). Gazprom currently has contracts in place (three worth $250 billion) that extend to 2020. As the domestic demand for gas rises due to increasing incomes, the “conflict between demand priorities” will eventually become inevitable. As such, Gazprom must not only invest in new projects and field exploration, it must raise prices in order to gain revenues for those projects to take place.

It is against this backdrop that the debate over “revisionism” has been resurrected among scholars studying international relations. Those who believe Russia wants to reshape the

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international order tend to view Russia as a “revisionist” state rather than a “status quo state.”

The extent to which a state is status-quo or revisionist has traditionally been examined by placing it within a geopolitical or military context, and much like the semantic arguments offense-defense theory has engendered, scholars have offered succeeding definitions of the relevant terms. Perhaps the most basic distinction has been proposed by Hans Morgenthau, who contends that “a nation whose foreign policy aims at acquiring more power than it actually has, through a reversal of existing power relations, pursues a policy of imperialism,” while “a nation whose foreign policy tends toward keeping power and not toward changing the distribution of power in its favor pursues a policy of the status quo.”

Jason Lyall writes that though the definition of revisionism depends on the context and the shared rules of the game must be understood by both parties, revisionist states “provide the shock that disrupts the international equilibrium.” He also argues that revisionist states are willing to violate norms by using force and seek to recast the “existing material balance of power,” which is “defined by relative military capabilities.”

Alastair Ian Johnston agrees that revisionist states may consider military might a critical tool, because it will prove helpful if “the actor has internalized a clear preference for a radical redistribution of material power in the international system and the actor’s behavior is aimed […] at realizing such a redistribution.” Rebuilding an international order, then, comprises the ultimate goal of revisionist states. They seek not only to maximize security in an anarchic world, but also to increase their sphere of influence or power relative to other states.

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8 Ibid., 18.
The approach of policymakers and policy wonks to Russian energy security is consistent with the revisionist model. Senate hearings perpetuate confirmation bias by soliciting nearly-identical testimonies, such as the June 12, 2008 Senate Foreign Relations Committee hearing that portrayed Russia as the sole aggressor in Eurasian energy security disputes. All four panelists offered the same insight: the need for Europe to diversify away from Russia owing to the volatile nature of its gas transport. None of them blamed the recipient or transit countries for the disruptions. At the hearing, Senator Richard Lugar opened the proceedings with a statement that read: “Gazprom’s monopoly-seeking activities cannot be explained by economic motives alone […] the Kremlin and Gazprom have shut off energy supplies to six different countries during the last several years.”

Lugar’s non-sequitur, that is, Gazprom’s shutting off energy supplies must be unrelated to its economic motives, indicates the extent to which politics has been infused into this discussion. Keith C. Smith of CSIS jumps to the same conclusion when he writes that “Moscow’s success in using its energy resources as political leverage” will “undermine the new democracies that most recently emerged from decade of Kremlin control.”

The policy linkage to which he alludes is both logically unsound and bereft of evidence. Another example conflating politics and economics reads: “its energy market power has allowed Russia to consolidate political power internally… Putin … has orchestrated a change in rules for parties to get into the lower house of parliament.”

The logic here seems to predicate on the linking of energy market power and political power. Carlos Pascual of the Brookings Institution assumes that Gazprom’s profit and market capitalization have enabled Putin to control the

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appointments of governors and the upper house (known as the Federation Council) of the Duma. It might be true that ensuring high approval ratings is contingent upon keeping the Russian coffers full of oil money. Claiming that those coffers allowed Putin to change the percentage threshold a party must obtain to gain entrance into the Duma, however, is tenuous. Ultimately, Lugar’s and Pascual’s specious arguments obscure the real issue at hand and allow the Western perception of Russian energy negotiations to be tainted by irrelevant observations about domestic political manipulations.

Unsurprisingly, the Baltic media has attacked Russia for the periodic gas cuts, suggesting that Russia’s inability to fix the broken Druzhba pipeline that connected Russia to Lithuania in August 2006 was reflective of the Kremlin’s antagonism toward Lithuania. While this attitude is to be expected from post-Communist states eager to be rid of Russia’s influence, the Western media has also been quick to demonize Gazprom, claiming that negotiations are politically motivated and ultimately painting Belarus, Ukraine, or other recipient countries as the victim. An article chronicling the Russo-Ukrainian gas skirmish of January 2009 described the dispute as one “ostensibly over prices and transit fees, but that is also deeply entwined in post-Soviet politics.” Another article in February described Russia’s resort to a familiar position as “empire-builder and scourge of the West.” These revisionist images seem not to be based on a systematic analysis of Russian energy policies yet they seem to influence public discourse.

While the status-quo/revisionist dichotomy is useful in generating questions pertaining to the rise of a state on the international stage, neither term adequately explains Russia’s intentions with regards to its energy machinations. Russian foreign policy is perplexing because it hasn’t

14 In 2007, Putin raised the percentage threshold of votes a party needed to gain entrance to the Duma from 5 percent to 7 percent. See Richard Sakwa, *Putin: Russia’s Choice*, (Oxon: Routledge, 2008), 120.
15 “Pipeline to Mazeikiu may remain dry for up to one year,” *Baltic Times*, August 10, 2006.
fulfilled some scholars’ predictions of a neo-imperialist state, but its character has undoubtedly become more assertive under Putin.\textsuperscript{18} Moreover, Russia can fall into both realist and neo-liberal camps; it issues threats to Georgia, warning it not to interfere with its pipelines, but simultaneously accedes to regional economic cooperatives, such as the Black Sea Economic Cooperation Organization. Assigning Russia a status-quo or revisionist label, then, might prove an arbitrary exercise. In addition, some power transition theorists argue that revisionist states act as realist states do, by attempting to maximize security while benefiting from the rules of the game. In their view, all states operate with the same cost-benefit analysis, so revisionist states act rationally and are simply looking after their national interests.\textsuperscript{19} Then again, this view leads to the over-prediction of revisionist states, and Lyall counters that as revisionist states are less common than the theory stipulates, scholars cannot simply call revisionist states realist and be done with it.\textsuperscript{20} These conflicting views on Russian intentions have prompted several important questions to be explored. First, to what extent is Russia a revisionist power? A corollary of this question is, to what extent are “revisionist” and “status-quo” appropriate labels for Russian behavior?

Even if neither the status-quo nor the revisionist labels fit perfectly, this paper suggests that the labels can be treated as ideal-types to be used for interpreting Russian interaction with CIS and Baltic states within the energy sphere. The breakup of the Soviet Union led to the formation of bilateral trade agreements between individual countries and Russia. Because Estonia, Latvia and Lithuania were the first to leave the ruble zone in 1992 and orient themselves toward Europe (both politically and economically), they incurred Western European prices for their natural gas.

\textsuperscript{18} Lyall, “Paths of Ruin,” 239.  
\textsuperscript{20} Lyall, “Paths of Ruin,” 45.
and oil imports from Russia. The countries that remained, Belarus, Ukraine, Azerbaijan and Moldova, for example, negotiated agreements with Moscow that assured them of subsidized energy supplies (sometimes in exchange for free defense assistance or commercial goods). In the 1990s, Boris Yeltsin did not hesitate to use energy supplies as a measure of the Kremlin’s (dis)satisfaction with various state policies. Cutting off gas supplies to the Baltics in 1990 for declaring independence and then again in 1999 to pressure Lithuania into giving a Russian firm a stake in its oil refinery are but two examples. For the most part, however, the former Soviet republics were eager to trade their billion-dollar debts owed to Russia for cheap energy supplies that were discounted as much as 60-70 percent of world market prices. At the same time, the Russian leadership could count on firm support from the general public by keeping natural gas prices artificially low, much to the chagrin of Gazprom, which struggled to make a domestic profit. In 2007, Russia expended the second highest amount of energy subsidies in non-Organisation for Economic Cooperation and Development (OECD) countries, $50 billion worth in oil, gas, electricity and coal.

This paper will address the status-quo/revisionist debate by placing it within the context of Russia’s oil and gas policies, a treatment that has been undertaken by few scholars. Thus, several more questions need to be answered: is Russian domination of its natural resources unique among states? How are Russian oil and natural gas prices decided? Are Russian actions uniform, or do price discrepancies emerge based on identity politics? This paper seeks to determine whether Russian elimination of domestic and foreign subsidies constitutes a political decision meant to punish pro-democratic countries, or whether it is redolent of a desire to normalize energy machinations between states. I argue that first, it is natural for Russia to seek regional

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hegemony and fulfill its role as a realist state. Indeed, “Russia is a logical contender to play the role of economic hegemon in the region, given the historical legacy, the size of its market, its rich endowment with natural resources, and its diversified commercial ties.”

Second, Russia’s elimination of energy subsidies is neither revisionist nor unique. Its pipeline negotiations with its neighbors, previously derided for their blatant political motivations, have acceded to neo-liberal institutionalist principles as gas prices have normalized over the past nine years. Moreover, Russia can be compared with other emerging powers whose national oil companies are used to profit the state. Most importantly, in spite of different historical relations with Russia and different degrees of dependence on Russian energy resources, the three "most different" cases examined in this paper reflect similar patterns of bargaining over oil and gas prices and similar shifts that bring each country’s prices closer to "normal" world market levels. Therefore, this paper is intended partly as a corrective to the sensationalistic treatments of Russian actions in this arena.

II. Hypothesis-Generating Study

As the global consumption of natural gas increased from 1 percent in 2000 to 2.5 percent in 2007, it became evident that Russia would continue to play a large role in the export of natural gas and oil to its CIS, Baltic and European neighbors. Russia possesses 1/3 of the world’s natural gas reserves, 1/10 of its oil reserves and supplies Europe with 25 percent of its natural gas needs. Diversifying away from Russian energy imports is a possibility some European countries are exploring, but such an activity is at once both expensive and difficult. Shifting

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dependence onto Iran is a repugnant option in light of its nuclear capabilities, and importing more natural gas and oil from Central Asia will be complicated, as most of its pipelines traverse Russian territory. It is clear that discussions of energy security within the Eurasian and Caspian regions could not take place without the inclusion of Russia as a prominent factor. Russia’s humiliation after the Cold War and the chaotic nature of the Yeltsin years have no doubt eased the way for restorationist sentiment: the re-emergence of Russia as an important power player in geopolitics. But the national self-image of Russia attaining its former heights is less frightening than has been predicted. The current debate regarding this phoenix-from-the-ashes centers on Russian neo-imperialist and expansionist tendencies, without giving much credence to the actual economic theory and practices underlying Russian decisions. Transferring the focus from geopolitics to geoeconomics can shape how Russia is likely to be perceived by its Western counterparts. Through no fault of its own, Russia’s interactions thus far have cemented its reputation as a risky business partner that “would not hesitate to cut off energy to the Baltic states.”

But as the 2008 Russo-Georgian war displayed, Russia ignored a perfect opportunity to destroy the Baku-Tbilisi-Ceyhan pipeline that delivers gas from Central Asia to Western Europe. Sabotaging the pipeline would have increased Europe’s dependence on Russian gas imports, and Russia’s restraint signaled the extent to which economics supersedes politics. The message was clear: “the energy business is too serious to expose it to the risks of local wars.”

This paper seeks to champion that viewpoint by offering an alternative explanation for the Russian elimination of subsidies and its periodic gas-flow interruptions, an explanation that makes Russian behavior in the energy sphere less revisionist than often assumed.

To demonstrate that Russia is raising prices for all of its trade partners regardless of political orientation, I will examine three countries with which it conducts regular energy negotiations: Lithuania, Azerbaijan and Belarus. While there are plenty of countries from which to choose, these three represent the best sample across the region for several reasons. First, in order to advance the claim that Russia’s implementation of market policies is without political motivation, I will show that each country is experiencing the same trend. I therefore have chosen three countries that have had historically different relationships with Moscow and continue to experience different levels of cooperation with the former center today (See Figure 1).

Figure 1. Historical variations with Moscow:

<table>
<thead>
<tr>
<th>Worst Relations</th>
<th>Best Relations</th>
</tr>
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<tbody>
<tr>
<td>Lithuania</td>
<td>Belarus</td>
</tr>
<tr>
<td>Azerbaijan</td>
<td></td>
</tr>
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</table>

The “most different” systems analysis centers on countries that diverge widely on two main variables: the history of relations with Moscow and the level of dependence on Russian energy supplies. All three countries have varying levels of closeness and varying levels of dependence, but all have experienced a similar pattern of negotiation and pricing. The traditional model that has been continually espoused in the media and within academia suggests that Moscow seeks to impose its control on states that have tried to escape its clutches; in this case, Lithuania. Conversely, extending the logic would indicate that Belarus, due to the younger-brother-esque relationship seen between current president Alexander Lukashenko and Putin, would expect to receive ideal pricing conditions that do not fluctuate. Yet these two hypotheticals do not hold true when they are measured against the pattern Moscow has sought to install in the region.
Because all three countries have had their natural gas and/or oil prices raised since 2002, they provide an excellent springboard from which to assess Moscow’s policies toward its former compatriots. In addition, the pricing disputes that have arisen between Moscow and each of the countries stem from several sources: the refusal of the recipient or transit country to pay the terms previously-negotiated, the piling up of energy debt as a result of inability to pay market level prices, or failure to exchange energy debts for Gazprom’s stake in downstream oil refinery and distribution companies. This paper will suggest that the disputes were unaffected by the political developments simultaneously taking place. While energy security undoubtedly retains a position every politician’s agenda, at least within the region under discussion, I argue that the pricing wars that occurred between Gazprom and each of the three governments took place on commercial grounds, not political ones.

Another reason these countries may be usefully compared has to do with their degrees of dependence on Moscow. Because Azerbaijan does not display what Joseph Nye calls “vulnerability interdependence,” and thus was able to refuse to buy gas from Moscow after prices rose in 2007, it is different from both Lithuania and Belarus, which are much more dependent upon Moscow for its natural gas exports and do not have the same luxury to diversify their energy portfolio. Though Lithuania obtains 83 percent of its electricity from its nuclear power plant, it is still reliant on Moscow for 90 percent of its oil needs. Both Belarus and Lithuania are connected to Russia via pipelines and both retain weak bargaining positions. Yet, contrary to what the media reports, Belarus has been able to extract concessions from Russia because the pipeline that runs through it transports gas to Poland and Germany. Thus Russia is dependent upon Belarus for transit and also suffers when pricing disputes are unable to get resolved. Examining Russian actions toward these countries in light of their varying levels of

dependence would be one way to assess whether Russia’s energy policies maximize profits, not politics.

The three countries’ histories collectively provide rich examples of oil and natural gas negotiations with Russia that have been misrepresented in academic writing and in the press. This paper endeavors to scrutinize them more closely to ascertain Gazprom’s economic motives in shutting off the gas. Because gas disruptions cause Gazprom billions of dollars in both profit and contract violation fees with its European customers, it is less eager to stop supply than has been portrayed. Indeed, Gazprom must earn back the fixed costs of building the pipelines, as it is “not economically or commercially possible to generate the investment for such costly infrastructure without robust arrangements for recouping it.”

This paper will investigate the period from 2000-2008 under the leadership of Putin and his successor, Dmitri Medvedev, who came to power in March 2008. The inclusion of the Yeltsin era would not be useful given the fluidity of both ownership structures and systems of production and pricing during the 1992-99 period. While the discussion of each country’s relations with Moscow will reference the energy machinations in the 1990s under Yeltsin, it is more useful to keep the sample period limited to the 2000-08 era as this is when a national energy strategy went into effect.

In compiling these case studies, I will employ several methods of inquiry to ensure qualitative completeness. Process tracing, or the analysis of historical method, will entail the study of annual reports and shareholders’ meetings minutes from Gazprom, original national

30 For the purposes of this thesis, I am assuming a diarchic system in which Medvedev and Putin share power. As the 2008 Foreign Policy Concept was introduced as a supplement to the 2000 Foreign Policy Concept, I am assuming continuities between Putin’s and Medvedev’s leadership. In addition, the 2003 Energy Strategy document applies until late 2009, at which point a new policy will be introduced. Analysts predict it will barely deviate from its predecessor. Unless Medvedev attempts to separate his own policy path, this thesis makes no distinction between the two leaders’ regional oil and gas policies.
energy strategies from Russia and Lithuania, and other records from policy makers. Macro-historical analysis will inform the discussion of how original subsidies came into existence and how their eradication has become politicized. Congruence procedures, “which evaluate the consistency between evolution of independent and dependent variables within each case,” will contribute to a framework that examines countries with difficult relations with Moscow and their resultant energy prices.\textsuperscript{31} Statistics obtained from government websites as well as from the International Energy Agency will allow us to locate the debate within the wider context of international political economy. Ultimately, the lens of energy security policies will hone and sharpen the point of inquiry to ensure general ideas about statist revision are applied to areas other than military capacity.

\textbf{III. Background of Russian energy policy and its adaptations}

In August 1989, the Soviet Ministry of the Gas Industry was converted into a state-owned corporation called Gazprom that extracted and exported natural gas. It became a private joint stock company in 1992 under Yeltsin and allowed members of the public to purchase shares. While the state allowed Gazprom to remain intact, the Soviet Ministry of Fuel and Energy became a joint stock company called Rosneftegaz, which was then split up into several smaller companies such as LUKoil and Yukos.\textsuperscript{32} Throughout the 1990s, none of the ventures made much profit, as world market oil and natural gas prices were low and revenues barely covered the cost of transportation, exploration and distribution. The devaluation of the Russian ruble and subsequent bankruptcy of the Russian government in 1998 further exacerbated the situation.

By 2000, however, due to rising demand from countries like China and India, gas and oil prices began to rise. With the election of Putin to the presidency, oil strategy experienced a


significant shift toward “aggressive opportunism.” Putin “actively wooed business deals for Russian firms while fueling commercial and political uncertainty to discourage foreign rivals.”

While foreigners had previously been able to own shares in Gazprom, a ring fence around the company was set up to encourage domestic investment and maintain the state’s control. By 2005, the state’s shares had reached 50.002 percent, making it the majority shareholder and necessarily redefining Gazprom strategy to fulfill its fiduciary duty to the state. With regards to oil production, in 2000 the state’s share of total crude oil production was 16 percent and by late 2007 it had increased to about 50 percent. Coupled with the state’s increasing power over the natural gas and oil industries was the realization that the days of cheap gas had to come to an end. In 2005, for example, Gazprom lost eight billion rubles from subsidized deliveries to the domestic market. Recognizing the need to make a profit and reallocate those funds to areas such as field exploration, the government issued its 2003 Energy Strategy, which emphasized the need to transition to market prices for both domestic and foreign markets. Gazprom, apparently relieved that its 2004 and 2005 Annual Reports were having an effect upon government policy, reiterated its position in its 2008 report. “Maintaining the predominant position of Russian natural gas in the energy sector” was key, and the way to accomplish this task was to “adjust the existing agreements in order to move to contractual terms and conditions as well as pricing mechanisms similar to those affective in European countries.”

Because the government stopped regulating the price of coal and other fuels in the 1990s, but has kept natural gas prices artificially low since then, domestic industrial and household consumers now comprise the most natural-gas-consuming-economy in the world. The share of

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35 Gazprom Annual Report, Shareholder’s Meeting, June 30, 2006
natural gas in Russia’s energy demand pattern grew dramatically from 42.1 percent in 1990 to 48.1 percent in 2007, forcing Gazprom to re-examine its market strategy.\textsuperscript{37} Energy-saving techniques have become noncompetitive because gas is so plentiful, and in order for Gazprom to meet demand, it must produce 14 billion cubic meters (bcm) per year.\textsuperscript{38} Economic Development trade minister German Gref reportedly expressed worry that Gazprom would be unable to keep up with growing demand if it failed to invest in new projects.\textsuperscript{39} Consequently, the company must look to other areas of exploration, as its four main fields have declined in production in recent years. As part of its new strategy, Gazprom received permission to enact gas floors and ceilings in 2007 for industrial consumers, who may choose the price at which to supply provided it falls within the two bands.\textsuperscript{40} By 2011, Gazprom will be able to charge market prices to industrial consumers.\textsuperscript{41}

Actions toward leveling the playfield in foreign markets have mirrored the steps taken to eliminate subsidies in the domestic realm. As early as 2001, former Minister of Defence Sergei Ivanov heralded Russia’s new approach to the problems posed by its interactions with CIS states. In 2000, debts incurred by the Commonwealth of Independent States (a group formed of countries formed after the breakup of the Soviet Union) amounted to $5.5 billion, which led Ivanov to call for economic pragmatism predicated upon the market, not privileges.\textsuperscript{42} Because Putin wished to discontinue subsidizing energy exports, even to nations with which Russia had a cooperative relationship, in December 2005 the government announced price increases for

\textsuperscript{37} Ibid, 56.
\textsuperscript{39} Anatoly Medetsky, “Cabinet Disagrees on Gas Production,” \textit{Moscow Times}, March 5, 2007.
\textsuperscript{40} Gazprom Annual Report 2007, (Moscow: Gazprom 2008).
\textsuperscript{41} It is important to note that though household consumers will not encounter market prices (yet), gas prices will increase for them as well. For instance, households in price band II paid 447 rubles per thousands of cubic meters (mcm) in 2003 and 835 rubles for the same amount in 2007.
\textsuperscript{42} Alex Danilovich, \textit{Russian-Belarusian Integration: Playing Games Behind the Kremlin Walls}, (Hampshire: Ashgate Publishing Limited, 2006), 118.
Ukraine, Moldova, Azerbaijan, Armenia and Georgia, as “all relations with CIS were to be built on a sound economic reason.”

In early 2007, Dmitri Medvedev continued this trend when he told the World Economic Forum in Davos that “being a part of the world economy … means there will be no more natural free gas for anyone.” In April 2008, Foreign Minister Sergei Lavrov announced that within two to three years, Russia expected to export natural gas and oil to every country at market prices. He also stated that the share of Russian gas on the market would increase from the current 26 percent to 33-35 percent by 2020. Wishing to capitalize on this larger role within the European market, Gazprom announced in July 2008 that it would raise prices for CIS, Baltic and Western European countries across the board. This trajectory demonstrates the Kremlin’s economic planning and its centrality within Russian foreign policy. The continued attempts to phase out subsidies for domestic and foreign markets over the past nine years display the unshaken resolve of the Russian government to adhere to a free-market, capitalist system.

The Foreign Policy Concepts of 2000 and 2008 propose the international role the government envisions for the country: how it will conduct itself with its neighbors and how it expects to be perceived by other states. In the Foreign Policy Concept of June 28, 2000, Section 2 reads: “The Russian Federation is pursuing an independent and constructive foreign policy. It is based on […] mutually advantageous pragmatism. This policy … takes into consideration the legitimate interests of other states and is aimed at seeking joint decisions.” Shortly after, Section 3 puts forth its “main priority in international economic relations,” which “promote[s] development of

46 “Gazprom is raising prices…for everybody!” *RIA Novosti*, July 10, 2008.
the national economy, unthinkable without broad integration of Russia in the system of world economic ties.  

This document was signed into law by Putin himself, who had been in office just over six months when the concept was introduced. Positioning itself as an arbiter of disputes within its immediate neighborhood, Russia stood to benefit from the quiet patriotism latent within the text. More specifically, the government could advance its national interests while remaining respectful of the international organizations from which it could benefit.

The Foreign Policy Concept of 2008 advances these basic premises but intensifies the language to better express Russia’s presence within the new world order as well as its dominion in the Eurasian energy sector. Section II describes Russia “as a country possessing major potential and significant resources in all spheres of human activities” and as a country that “exerts a substantial influence upon the development of a new architecture of international relations.”

Cognizant of the ramifications of its actions toward its neighbors, the government could elevate the country’s status as a major world power, at least on paper. Moreover, Section III, part 4 mentions energy supplies specifically, stressing the need to guarantee reliability, stability of demand and secure transit. This is followed by a description of Russia’s trade with the CIS, which “takes into consideration market principles […] an important condition for promoting truly equal relationship.”

The relationship with the CIS had been mentioned in the 2000 document, but the extent to which it is outlined here indicates its increasing importance in a world in which Russia functions as a reliable energy supplier. Ultimately, it is this nexus of Russia’s self-image, adherence to free market principles and interactions with the Near Abroad that informs the issue at hand. Russia can pose as a major world power because its energy

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49 Ibid.
machinations provide the confidence to do so. But it is important to consider that though Russia wants to re-emerge as a great power on the world stage, it is not willing to topple the entrenched system to do so. Rather, the Foreign Policy documents identify the influence Russia retains and will continue to retain within its backyard. When understood in the context of Russian energy policy, the documents illuminate how Russia interacts with the three countries that will be examined in the next section.

IV. Case Studies

A. Lithuania

Of the three cases to be examined in this paper, Lithuania has had the most difficult relationship with Russia. The tension between the two countries can be traced to nationalism and identity politics that emerged in the 20th century and led Lithuania to declare its independence. Collectively, the three Baltic states have been aggressive and confident in their energy negotiations with Moscow. But Lithuania’s failure to distance itself from post-Communist asymmetrical trading manifests itself in its extreme dependence upon Russia for natural gas and oil. Due to its early experiences with statehood and the construction of a national memory alluding to an idealized myth of a homeland, Lithuania wanted to guarantee its political and economic independence from Moscow. This sentiment, coupled with the merging of Communist party elites and dedicated Sajudis reformers, encouraged the formation of national identity that still fears Russian dominance and interference.

i. Lithuanian – Russian Relations in Historical Perspective

Lithuania once formed part of the Polish-Lithuanian Commonwealth that dated back to 1386 before being absorbed into the Russian empire in 1795. This absorption prompted the first stirrings of distrust toward Russia and her progeny and supplied the historical roots for
contemporary Lithuanian apprehension toward the state. In the 1880s, the intellectual elite created publications that reflected the first mobilized feelings of nationalism. Because the journals were confined to the intelligentsia, however, grassroots efforts to generate enthusiasm for a state were practically nonexistent. In 1905, in light of the October Revolution occurring across the border in Russia, the elites demanded an autonomous zone that would function independently on a local level but still remain part of the tsarist empire. Their request was largely ignored, but the geospatial events of World War I would give rise to the notion of independent statehood, albeit for a limited existence. In 1915, the Germans occupied Vilnius. Two years later, the local government announced an alliance with Germany. By 1919, however, the Soviet Union had established the Lithuanian-Belorussian Soviet Republic in Vilnius. A Polish victory against Russia in the Polish-Bolshevik war led to a power vacuum in 1920, and, largely as an accident, Lithuania had its first brief flirtation with the establishment of an independent state, which resulted from “German eastern diplomacy, weakness of Russian state and British policies in the Baltic region.”

During the interwar period, cultural awareness flourished and Lithuanian nationalism spread. After the Soviet Union recognized Lithuania and signed a peace treaty, the standardization of culture, language and education meant new generations of children would grow up speaking a the Lithuanian dialect. The interwar state “provided the political space within which Lithuanian national identity, promoted by an independent government, first became widely shared among the population.” In the 1990s, the glorification of a homeland was predicated upon this first experience of independence.

51 Abdelal, “National Purpose,” 89.
52 Abdelal, “National Purpose,” 87.
In the late 1930s, the cultural flowering taking place came to an abrupt end. The Ribbentrop-Molotov Pact, signed between the Soviet Union and Nazi Germany, annexed the three Baltic states to the Soviet sphere of influence in 1940. Though still an issue of great debate today, as the Russian government refuses to admit the states were forced to join, it set the precedent for the intense anti-Russian sentiment that flowed through several generations of Lithuanians. The Soviet Union occupied Lithuania in June 1940 and incorporated it into its empire as a constituent republic two months later. Following the 1940 annexation, the process of Sovietization effectively demolished most Lithuanian cultural hubs. Soviet laws replaced Lithuanian ones and mass deportations fulfilled the Soviets’ goal of ridding the country of political dissenters and bourgeois nationalists. Indeed, the Sovietization process attempted to force the integration of the Lithuanian Soviet Republic into the Soviet Union by denationalizing Lithuanian identity, introducing a command economy and eliminating civil society entirely.53

The introduction of a command economy strengthened the connection between the peripheral republics and the center in Moscow. With Lithuanian territory fully ensconced within the Soviet sphere, the Soviet government began efforts to supply the constituency with cheap natural gas, thereby instituting the cycle of energy debt that chained Lithuania to the empire for so long. The first natural gas shipment arrived in 1961 from Western Ukraine and the Soviets completed the Druzhba (‘Friendship’) oil pipeline by 1968. The pipeline began at Polotsk in Belorussia and ended at the port of Ventspils, Latvia. A refinery was built at Mazeikiai in Lithuania to process the crude oil shipments. While this process invariably increased dependence upon the Soviet Union54, it also stimulated domestic industry, particularly the growth of the chemical industry

54 In 1938, trade with Europe constituted 79 percent of Lithuania’s exports. By 1990, 90 percent of its exports went to the Soviet Union.
that produced fertilizers. The rapid economic growth in the 1960s gave way to stagnation in the 1970s and 80s, when product shortages became more common and Lithuanians had money burning in their pockets. The economic situation thus increased frustration at the “exploitation by the center,” a feeling that would eventually crystallize into outright resentment. Fearful of losing its grip upon the republic, the Kremlin embarked upon a path of Russification, replacing Lithuanian with Russian as the new language of government and business in 1978. In 1979, emboldened by the world’s reaction to the Soviet invasion of Afghanistan, Lithuanian dissidents issued the usual calls for human rights and religious freedoms, but went further than before in demanding outright independence, the publication of the actual text of the Ribbentrop-Molotov pact, and the withdrawal of all Soviet soldiers from Baltic states. Their pleas went unanswered at the time, but the movement slowly gained momentum in the 1980s, as the center decided the Baltic states were ideal candidates to experiment with a system of local self-governance while remaining under the auspices of the Soviet Union. It is due to the economic success of the 70s that the Soviets decided their experiment in the Baltics, a reason that gave Lithuanians hope that their eventual state could maintain fiscal responsibility in the wake of a Soviet departure. Borrowing an idea that Estonia had proposed in 1987, the Soviets agreed to an introduction of local self-rule commencing in 1990. Gorbachev, realizing the political and economic implications such a plan would have for the strength of the Union, recast the proposal and removed the republics’ right to secede under Article 72 of the Soviet constitution. Reforms were well and good, he believed, but only when carried out by the central administration.

56 Lane, “Lithuania stepping Westward,” 70.
57 Lane, “Lithuania Stepping Westward,” 104.
Shortly after perestroika and glasnost were introduced in 1987, Lithuanian intellectuals established the Lithuanian Movement for Restructuring, known as Sajudis. They proposed greater Lithuanian autonomy and eventually merged with the Communist Party of Lithuania (CPL). In March 1989, the Soviets held elections to the All Union Soviet Congress of People’s Deputies and Sajudis won 36 out of 42 electoral districts. By December 1989, Sajudis called for a break with the Communist Party of the Soviet Union (CPSU) and the CPL renamed itself the Lithuanian Democratic Labor Party (LDDP). When the Supreme Soviet voted 124-0 to declare independence in April 1990, Gorbachev cut off the oil and gas for the first time, successfully using energy as a blunted foreign policy tool. The disruption didn’t last, however, and in August 1991, Gorbachev resigned and the Soviet Union recognized Lithuania’s independence.\textsuperscript{58}

Once Lithuania received its independence, it moved very quickly to extricate itself from the shadow cast by the Iron Curtain. Identifying its economic dependence on Russia as the primary security threat, it sought to paint itself as an extension of Europe and thus a natural choice to acquiesce to Europe’s supranational institutions. Diversifying its trade links, then, was imperative for attaining Lithuania’s ultimate foreign goal: joining the European Union. In June 1992, the Lithuanian parliament ratified the Constitutional Act on Nonalignment of the Republic of Lithuania to Post Soviet Eastern Alliance, which proclaimed that the state would “never and in no way join any new political, military, economic or any other state alliances or commonwealths formed on the basis of the former USSR.” Still sensitive from the economic blockade of 1990, Lithuania reluctantly agreed to a system of barter agreements with Russia in 1992. By April 1993, Russia agreed to trade energy materials such as diesel, natural gas and fuel in exchange for meat and milk products from Lithuania.\textsuperscript{59} It was understood, however, that these agreements

\textsuperscript{58} Abdelal, “National Purpose,” 92.
\textsuperscript{59} Bradshaw, Hanson and Shaw, “Economic Restructuring,” 176.
were meant to be temporary in nature, as Lithuania further incurred Russian displeasure when it opted to issue its own currency in May 1992 and exit the ruble zone in October of the same year. As a result, Russia decided to raise gas prices for the three Baltic states in May 1993. The increase to market prices was set to occur gradually over the decade, but the ensuing deals made between the Russian government and individual states detracted from such a goal.

Meanwhile, Lithuania turned its attention toward ingratiating itself with the West. It signed a free trade agreement with the EU in 1994, became an associate member in 1998 and issued an action program based on “merging into the European market of goods and capital” in 1997. It refused to award Russia Most Favored Nation trade status, a typical attribute of bilateral treaties, until 1995. From 1998 to 1999, Transneft, a state oil company, cut off the oil supply to Lithuania nine times in an attempt to force Lithuania to cede control of its oil refinery and port terminal to LUKoil. This is a clear example of the Kremlin using energy as a political tool, and serves as a comparison for how Russian government has conducted relations with Lithuania since then. While it continued to receive discounts on energy supplies, though not at CIS prices, Lithuania’s decision to forgo Russian patronage and cheap gas prices was reflective of its desire to separate itself once and for all.

ii. Current oil and gas machinations with Russia

Lithuanian actions in the post-Soviet space depict a clear preference for association with Europe, especially in light of its ascension to the EU in 2004. Since that year, it has become embroiled in a series of commercial disputes with Russia as gas prices have risen to almost Western European levels. While the Russo-Lithuanian relationship is fraught with distrust and exasperation on behalf of both sides, the Lithuanians are too quick to interpret Russian actions as political retribution. Indeed, “it has become extremely difficult for many not to ascribe

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60 Abdelal, “National Purpose,” 98.
underlying imperialist designs in virtually any and all Russian moves.”

61 Such simplistic perceptions engender further misunderstanding and exculpate states, in this case, Lithuania, from carrying out fiscal responsibility.

By claiming that Russian elimination of subsidies is punishment for Lithuanian integration into the West, Lithuania presents a compelling narrative that is, for the most part, largely accepted without question by the international community. That Lithuania’s credibility in the international arena seems to increase each time it accuses Russia of politicizing a gas dispute is suspect. A central reason for the world’s apparent willingness to take Lithuania’s side, regardless of how exaggerated its claims may be, stems from the inherent biases of Western nations toward democratic states. Keith Smith writes that “a more democratic Russia would likely have more respect for the sovereignty and aspirations of its neighbors.”

62 This observation is flawed in three ways. First, he assumes that Russian actions are centered on threatening the sovereignty of neighboring nations. But cutting off the gas supply as a result of intractable price discussions has little to do with undermining a nation’s self-determination. He then erroneously infers that democracies handle business decisions differently (more ethically?) than do authoritarian nations. Vietnam functions as an appropriate counterexample, as its increasingly authoritarian regime has maintained financial growth and stability free from scrutiny over the past several years. Smith also disregards Russian aspirations in his resolve to defend the Baltic states. Why should Russia not have the same opportunity to maximize profit and increase revenues? For that matter, why does he exonerate Lithuania, though it too participated in a seemingly irresolvable standoff over prices? He later contends that “Europe could be less concerned if Russia were

62 Smith, “Russia Energy Politics (a),” 63.
rapidly moving in the direction of Western-style diplomacy.”⁶³ That Russia is moving in the
direction of free-market economies, a staple of Western-style democracies, seems to have evaded
his attention.

Natural gas is exported to the Baltic states based on long-term contracts that extend until
2015. Since the early 2000s, when Gazprom redefined its strategy to equalize domestic and
foreign revenues, it has sought to “[bring] the prices charged for the gas sold in CIS and Baltic
states up to a balanced level (adjusted to the transportation distance) with gas prices charged
from its European customers.”⁶⁴ Lithuania comprised 3.4 percent of Gazprom’s sales to CIS and
Baltic countries in 2007.⁶⁵ While it provides significantly less revenue than Ukraine and Belarus,
Lithuania still remains an important customer, as it is entirely dependent on Gazprom for its
natural gas needs. Its energy strategy, which was updated in 2003 in preparation for the country’s
ascension to the EU, states bluntly that “energy supply is vulnerable.” As such, the document
places a premium on finding alternative methods to import and/or suppliers of natural gas.⁶⁶ As
Figure 2 demonstrates, however, Lithuania has increased its annual imports:

Figure 2. Lithuanian gas imports from Russia, 2000 – 2004⁶⁷:

<table>
<thead>
<tr>
<th>Year</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total bcm</td>
<td>2.57</td>
<td>2.8</td>
<td>2.7</td>
<td>2.9</td>
<td>2.93</td>
</tr>
</tbody>
</table>

Lithuania is unlikely to diversify away from Russian natural gas and oil imports any time soon,
and accordingly, the increasing gas prices over time have caused yearly spats between the

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⁶³ Smith, “Russian Energy Politics (b),” 1.
⁶⁷ Adapted from Stern, The Future of Russian Gas, 69.
country and Russia. Gazprom ownership in national gas or oil ventures has also prompted some controversy. In 2002, for example, Lithuania wanted to prevent Gazprom from buying more shares in the national natural gas company, Lietuvos Dujos. To combat this, Gazprom established Dujotekana, a local subsidiary, and acquired 30 percent of the gas marketing company Stella Vitae. By the following year, Dujotekana had taken 60 percent of the gas market from Lietuvos Dujos. Lithuania then decided to sell more equity in Lietuvos Dujos to Gazprom, which increased its shares to 37 percent. While this business venture is clearly one of ruthless coercion on behalf of Gazprom, it was not informed by political motives. Gazprom does not care who is in office or to whom it sells gas; as long as it makes a profit, the company is willing to do business with any country.

Lithuanian consumers were impacted 2004 when Gazprom ceased deliveries to Belarus as a result of pricing disagreements. While some immediately decried Russia for directly affecting European consumers, the stoppage is more to Gazprom’s detriment than to any other party’s. The EU depends on Russia for a quarter of its natural gas consumption, but Gazprom depends on the EU for 70 percent of its export earnings. Gazprom’s designation of Europe as a focal point of its business expansion strategy speaks to the seriousness with which it approaches long-term gas and oil contracts: “in the mid term, we continue to regard Europe as the most important market despite the European Commission’s plans to develop alternative energy,” Gazprom CEO Alexei Miller stated in 2008. Arbitrarily shutting off the gas would be a foolish decision for a company trying to maximize its relationship with Europe and build new pipelines. Simply put, there is no room for Russian energy blackmail within this economic context. During the gas stoppage in February 2004, the Russians made certain to deliver 5 million bcm to Lithuania from

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68 Ibid., 127.
69 Medvedev, “Is Gazprom political,” 64.
70 RIA Novosti, April 18, 2008.
the Latvian Inchukalinskoye UGS facility, even though there were no gas metering stations at the site to prevent gas from being siphoned off illegally.\textsuperscript{71} Realizing Lithuania had become inextricably caught up in another country’s pricing dispute, Russia attempted to ameliorate the situation by providing whatever supplies it could from another route. Instead of punishing Lithuania for joining the EU that year by withholding gas, Gazprom instead found other means to follow through on its contractual obligation to the country. In 2004, the Baltic states paid an average $83.52 per mcm of natural gas.\textsuperscript{72} That same year, Gazprom announced it would raise prices in 2005, a move that international audiences interpreted to be punitive as Lithuania had just joined the EU. But the news was not greeted with a large amount of surprise or criticism in the Baltic press as the increase had been expected.

In May 2006, Lithuania and Russia clashed once again. The Russian oil company LUKoil, Russian-British hybrid TNK-BP and Polish energy company PKN Orlen submitted bids at an auction to purchase the Lithuanian government’s 30.66 percent stake of Mazeikiu Nafta, an oil refinery company. PKN Orlen submitted the highest bid, the other two companies were unwilling to match the price, and so the Polish company was set to buy the stake in Mazeikiu Nafta in December 2006. The Russian government was annoyed at this outcome and tried to prevent the transfer of power to the Polish, but failed to secure ownership of the stake. On July 29, 2006, Transneft halted supplies to the Druzhba pipeline, citing environmental and safety concerns due to a leak the pipeline had sprung in the Russian region of Bryansk.\textsuperscript{73} The Lithuanians were outraged, immediately linking the decision to halt supplies with Russia’s desire to gain ownership of the stake in Mazeikiu Nafta and prevent the Polish deal from occurring. But

\textsuperscript{72} Gazprom Annual Report 2004, (Gazprom: Moscow, 2005), 2. Specific figures for Lithuanian gas consumption were not available for that year.
“though Lithuanian politicians and analysts were quick to decry the development as a ploy by Russia, which [was] still angered at being shut out of the refinery's recent sale,” 74 it is important to note that the pipeline had been constructed nearly forty years before and had sprung leaks in other parts. After a study was conducted in the fall and 8,000 defects were found by the Russian Federal Environmental, Technological and Nuclear Oversight Service, Russia decided to cease deliveries all together for up to a year, until the pipeline could be fixed. It was then decided that the pipeline was beyond repair. 75 Russia promised, however, to deliver crude oil from the sea port of Sochi to compensate for the absence of the pipeline, which increased the cost of oil by $8 per ton. Though the Lithuanian Economy Minister himself, Vytas Navickas, cited the technical nature of the problem, several newspapers and analysts denounced Russia for “us[ing] economic leverage to force an outcome of its liking.” 76 In response to the Russian refusal to fix the pipeline, the Lithuanian government vetoed cooperation talks between Russia and the European Commission for two years, only lifting its ban in May 2008. 77

As the dispute over the Polish stake in Mazeikiu Nafta unfolded, Gazprom made good on its promise to raise Baltic prices to world market levels. In November 2006, the company announced a gas hike from the 2006 price of $110/mcm to a 2007 average price of $260/mcm. 78 In January 2007, Lithuania paid $202/mcm (in contrast to the Europeans, who paid $260/mcm), but the price rose several months after to $260/mcm. 79 By June 2008, Lithuania was paying $400/mcm, figures higher than had been predicted in December 2007, which projected imports costing $363/mcm. Figure 3 charts the increase in prices from 2004 through 2008.

74 “Pipeline to Mazeikiu May Remain Dry for Up to One Year,” Baltic Times, August 10, 2006.
75 “Russia Won’t Fix Oil Pipeline to Lithuania,” Kommersant, June 1, 2007.
76 Pourchot, “Eurasia Rising,” 56.
Figure 3. Lithuanian prices for natural gas imports from Russia, 2004 – 2008

<table>
<thead>
<tr>
<th>Year</th>
<th>2004</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price in USD/mcm</td>
<td>83.52</td>
<td>110</td>
<td>260</td>
<td>400</td>
</tr>
</tbody>
</table>

The rise in Lithuanian’s gas price is consistent with the philosophy underpinning Gazprom’s strategy in the Baltic states: the gradual transition to market prices in order to compensate for the profits lost on the domestic market. The nationalist sentiment that characterized Lithuania’s secession from the Soviet Union and the subsequent distrust of Russia’s pipeline monopoly in the region may have contributed to how Lithuanians view their former overseer. But Lithuania’s orientation toward the West had little bearing upon commercial transactions that were rooted in making profits for a company bent on besting veritable American giants such as Chevron and Mobil. Furthermore, Gazprom’s decision to raise prices annually were neither out-of-the-blue nor deviously-arranged. Lithuanian trade ministers held multiple talks with Gazprom once the company announced its intentions; withholding gas and oil was thus a response to technical issues as opposed to deep-seated political divergences.

B. Azerbaijan

i. Azeri – Russian Relations in Historical Perspective

Russia’s oil and natural gas meddling in Azerbaijan began in the early 1990s, with the discovery of extensive oil fields in the Soviet Union’s backyard. But its empire over Central Asia and the Caucasus, formally known as Turkestan and Transcaspia, dates back to the 19th century. Azerbaijan’s history is littered with conquests. First conquered by the Romans, Persians, Arabs, Turks, Mongols, and Persians again, the territory was finally divided between

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Persia and Russia in the early to mid-nineteenth century. The Treaty of Turkmenchay established new borders and removed from power the last dynasties of local Azerbaijani khanates. While it did oscillate between dependency and colonial rule, Azerbaijan grew adept at concentrating power within the local administration, as government and judicial powers were left in the hands of the natives. From the mid-nineteenth century onward, cultural assimilation into the Russian mainstream was relatively rare, as the mid-level bureaucracy was selected from the Azeri constituency. After WWI and following the 1917 October Revolution, the country enjoyed a brief two years of self-determination. The Red Army then invaded in 1920 and Azerbaijan was joined with the USSR in the Transcaucasus Republic in 1922. In the 1920s, under the Soviet policies of nationalist localization, “alphabet reform and secularism broadened the Azeri development into a nation,” but in 1936, it became a Soviet Republic, useful to the Russians for its oil and gas resources in several offshore fields.

Under Stalin’s 1936 constitution, Azerbaijan became a Soviet Republic but, in accordance with Russian nationalism policies, developed local culture and built up its elite. By the 1930s, Azerbaijan had experienced anti-Islamism, collectivization, and industrialization in the cities. In 1936, it was upgraded to a constituent republic in order for the center to exert the greatest influence upon its activities. A vertical chain of command, instead of a horizontal identification of culture with other republics, set the historical precedent for future Azeri-Russian relations. The 1937 purges that spread across the Soviet Union reached the Azeri borders, but the arrests, mass deportations and executions were based on charges such as “Pan-Turkism” and “Pan Islamism.” Much like the manifestation of its anti-Semitic policies, the state under Stalin (and

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beyond his rule) prosecuted Muslims and took the side of Christians in its local skirmishes, most notably within the Azeri-Armenian conflict.

By the early 1990s, Azerbaijan’s relationship with Moscow was neither entirely hostile nor completely friendly. The conflict with Armenia had encouraged the formation of political groups, and in the beginning, Moscow refrained from supporting either side. In January 1990, however, the civil war led to the flight of the Armenians from Baku, the capital, and the intervention of Soviet soldiers, who stationed themselves around the city and wounded and killed hundreds of Azeri citizens. The Azerbaijani Supreme Soviet passed a resolution calling for the withdrawal of Soviet troops and the lifting of the Moscow-imposed state of emergency. At this point, however, few calls for independence were made. Rather, the Azeris sought to minimize Moscow’s influence while still remaining under its protection. The Communist party resurrected itself in 1990 and roundly defeated the opposition Democrats, who garnered only 26 of 350 mandates.\(^86\) The leader of the Communists, Ayaz Mutalibov, was put in power by Moscow as the new president in June 1990. Though the country announced its independence from the Soviet Union on August 30, 1991, it was not meant to “lead to collision with SU as Russia [had] played a positive role and offers huge markets.”\(^87\) Indeed, the speech announcing Azerbaijan’s independence stressed the closeness of the two states and the Soviet Union’s role in shaping Azeri national development.

In February 1992, Armenian and Russian forces took control of Khojali, a city in Azerbaijan, and massacred over 600 Azeri citizens. Under pressure from the opposition group, the Azerbaijan Popular Front (APF), Mutalibov stepped down as president for mismanagement of the Khojali massacre. The Supreme Council of Azerbaijan reinstated Mutalibov after

\(^86\) Ibid, 212.
\(^87\) Ibid., 216.
exonerating him from responsibility, but mass demonstrations led by APF forced him to flee to Moscow, where he has resided since. The pro-Western chairman of the APF, Abulfaz Elcibey, was elected president in June 1992 but was deposed after fleeing during another round of the Azeri-Armenian conflict in June 1993. Heidar Aliev, the head of the Communist party, came to power and ruled until October 2003, when his son, Ilham, succeeded him. Politically, the Alievs have managed to remain integrated into both Eastern and Western spheres. The Azeri executive branch has traditionally carried the most weight within government, much like the president’s position in Russia. The authoritarian nature of Azerbaijan’s government complemented Yeltsin’s political style, as he had originally carved out a super-presidentialist system to maintain stability. Azerbaijan’s overtures to the West, in the form of oil agreements with multinational companies, helped shield it from criticism pertaining to its less-than-stellar human rights record and active repression of political dissenters. While Yeltsin’s meddling in the Azeri-Armenian wars was meant to demonstrate to Azerbaijan the perils of looking toward the West, relations between the two countries were never openly hostile. Azerbaijan meticulously balanced its new position in the world order after 1991: it maintained a cordial relationship with Russia while reaching out to Western powers in the 1990s version of the “Great Game,” or the conquest of oil in the Caspian Region.

Though the political dimension of the countries’ relationship was largely pleasant, the economic interactions were more acrimonious. Upon his election, Elcibey immediately withdrew the country from the CIS and introduced proposals that would bind the country closer with Turkey and Europe. He introduced the Azeri currency, the manat, in August 1992 as a supplement to the ruble, which was supposed to cease circulation on June 15, 1993. He left office on June 13, however, and Aliev was less enthusiastic about abolishing the ruble, preferring
to postpone the plan until July.\textsuperscript{88} Though Aliev was more pro-Russian than Elcibey, the country was still ambiguous about its economic future and the extent to which it wanted to participate in an alliance with Russia. For example, after Azerbaijan withdrew from the CIS, Russia retaliated by raising import duties on industrial products to 65 percent.\textsuperscript{89} Aliev was especially aware of the Russian interest in the emerging Azeri oil market. By the end of 1994, Russia had extended 5.9 billion credits to CIS countries; 2.8 billion credits made up energy supplies that had been delivered at prices below world market level. After the dismantling of the ruble zone, Russia warned it would raise energy prices in September 1993 to alleviate the accumulation of debts it had encountered from virtually all of the CIS countries, which were billions of dollars in arrears.\textsuperscript{90} Partnering with Azerbaijan proved a tempting offer for Russia, which would attempt to protect its economic interests and maintain control over the lucrative oil industry.

Since 1992, Azerbaijan has focused on developing the country’s oil resources through the exploration of its offshore fields in order to ensure its energy security. In September 1992, the State Oil Company of Azerbaijan (SOCAR) was established with the merger of Azerineft and Azneftkimiya, the country’s national oil companies. Since its inception, SOCAR has regularly retained a 50 percent stake in its deals with foreign companies, as “oil has been the only viable, export-capable economic lever independent Azerbaijan has known.”\textsuperscript{91} In September 1994, the Azerbaijan International Operating Consortium (AIOC) signed “the Contract of the Century,” a product sharing agreement (PSA) with foreign companies to invest about $11 billion in developing Azeri and Chirag offshore fields over a 30-year span. Azerbaijan was the first post-

\textsuperscript{88} Abdelal, National Purpose, 54.
\textsuperscript{89} Swietochowski, Russia and Azerbaijan, 221.
Soviet state to sign PSA’s with foreign parties. Some of the companies that took part included BP, Amoco, LUKoil and of course, Azeri state companies.\textsuperscript{92}

In an effort to offset the influence foreigners would exert in the Caspian region, an area Moscow considered under its oversight, Russia set about “maximizing the role for Russian companies in the area, controlling oil transport out of the country, [and] using the uncertain legal status of the Caspian Sea to prevent unilateral offshore oil developments.”\textsuperscript{93}

After the demise of the Soviet Union, five littoral states bordered the Caspian Sea: Azerbaijan, Kazakhstan, Russia, Turkmenistan and Iran. Despite numerous meetings and joint talks, the countries could not agree as to how best to assign sovereignty over this body of water. Azerbaijan wanted to divide the sea bottom into national zones, so as to have access to the oil at the bottom, while Russia supported dividing only the seabed, leaving the bottom of sea free to explorers from any of the littoral states.\textsuperscript{94} Irked by the combination of Azerbaijan’s assertive stance and its dealings with foreigners, Russia issued a document entitled “Conceptual Provisions of the Strategy for Counteraction of Major Threats to the National Security of the Russian Federation,” a part of which read:

“The most important task is not allowing the realization of the Caspian oil contract in its present form. In this case it would be expedient to implement a set of measures…including, if necessary, the use of force in order to stop any activities of foreign companies in the former Soviet part of the Caspian until its legal status is defined; to apply pressure on the Baku regime, for example, by creating threats of fragmentation of Azerbaijan and Armenian military offence.”\textsuperscript{95}

Russia’s willingness to use force to protect its vital economic interests fulfills one definition of a revisionist state. The country strove to make Azerbaijan aware of the consequences of preventing Russia from attaining regional hegemony; it was willing to intervene more deeply in the Azeri-

\textsuperscript{92} Rutland, “Oil, Politics and Foreign Policy,” 171.
\textsuperscript{93} Emmanuel Karagiannis, \textit{Energy and Security in the Caucasus}, 117.
\textsuperscript{94} Bertil Nygren, “The Rebuilding of Greater Russia,” 168.
\textsuperscript{95} Emmanuel Karagiannis, \textit{Energy and Security in the Caucasus}, 41.
To ensure its position in the Great Game. Two years later, Russia and Azerbaijan signed a treaty of friendship, cooperation and security. The atmosphere was tense, however, as Russia continued to display its support for Armenia by undertaking joint military and naval exercises with Armenian forces near the Armenian-Turkish border. Compounding Russia’s insecurity was the introduction of the United States and other Western powers into the Caspian region. By the late 1990s, the Clinton administration had developed a policy to “contain Russia, reward old and new allies such as Georgia and Azerbaijan, develop alternative energy sources to reduce reliance on sources in the Middle East, and project U.S. influence into what by then seemed to be a regional power vacuum.” Russia believed the U.S. wanted to prevent Russian regional hegemony and concluded that Azerbaijan and the United States were colluding to ensure it wouldn’t occur. Despite its uneasiness with the American presence in the region, Russia was forced to moderate its aggressive position toward Azerbaijan by 2000, as it realized its economy depended on a stable economic and political relationship with CIS countries.

**ii. Current oil and gas machinations with Russia**

Since Putin came to power in 2000, the Russian-Azerbaijani relationship has improved considerably, though Azerbaijan still balances its interests against both those of Russia and the Western powers. Due to its large reserves of natural gas and oil (17 percent of the world’s proven oil reserves), the country has been better able to withstand pressure from the Kremlin regarding its energy negotiations. Russia’s interest in the Caspian region has also changed slightly. Instead of solely selling gas, Russia has contemplated buying gas from Azerbaijan at European prices. This evolution is testament to Russia’s willingness to adhere to international norms and continue the normalization of gas prices across CIS states. More specifically, “the play for Eurasian

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resources essentially boils down to commercial competition among energy companies and financial interests.”

Continuing the dialogue over the legal status of the Caspian Sea, in 2001 Putin traveled to the region and signed a bilateral agreement that promised to expand economic relations with Azerbaijan over the next decade. In 2002, the two countries signed an agreement demarcating and assigning segments of the Caspian Sea. By May 2003, Russia, Azerbaijan and Kazakhstan had focused on deciding precisely the point at which their segments met, but Iran and Turkmenistan disagreed with the measures to assign sovereignty over the body of water. Undeterred, Putin conducted nine meetings with Azerbaijan through 2005, hoping to resolve the issue. 2006 saw no breakthrough, but the level of engagement with the problem remains high on both sides. Trade relations over oil and gas also improved in 2001. Agreements signed in December of that year and renewed in 2002 and 2003 underlined Russian-Azerbaijani trade cooperation and proposed more volumes of oil to be moved through the Baku-Novorossiysk pipeline. While Azerbaijan did use the Baku-Novorossiysk pipeline for several years, in 2007 it rerouted its shipments through the Baku-Tbsili-Ceyhan (BTC) pipeline.

As Figure 4 indicates, from 2000-2003 Azerbaijan’s natural gas imports increased. And although Azerbaijan began exporting its own gas with the development of its Shah Deniz oil fields in 2006, its net consumption of 400 billion cubic feet (bcf) of natural gas in 2006 and its production of 350 bcf in 2007 still qualified the country as a net importer.98

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Figure 4. Azeri natural gas imports from Russia, 2000 – 2003

<table>
<thead>
<tr>
<th>Year</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bcm</td>
<td>.26</td>
<td>3.1</td>
<td>3.9</td>
<td>4.1</td>
</tr>
</tbody>
</table>

Unlike Lithuania and Belarus, Azerbaijan is set to become a major oil and natural gas exporter over the next several years. Growth from the Azer-Chirag-Guneshli field, which totaled 700,000 barrels of oil per day (bbl/d) in 2007, has facilitated Azerbaijan’s move toward energy independence. SOCAR plans to invest $224 million to expand natural gas production over the next ten years. Moreover, the first natural gas supplies via the BTC pipeline were shipped in 2007, while the first deliveries of natural gas to the EU market via the Turkey-Greece pipeline were shipped in 2007. The emerging export market enabled Azerbaijan to alter its commercial imports structure with Russia. Prior to 2007, Azerbaijan had been importing the aforementioned levels of natural gas at the following prices:

Figure 5. Azeri prices for natural gas imports from Russia, 2002 – 2007

<table>
<thead>
<tr>
<th>Year</th>
<th>2002</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price in USD/bcm</td>
<td>52</td>
<td>52</td>
<td>60</td>
<td>110</td>
<td>235</td>
</tr>
</tbody>
</table>

At the end of 2006, Gazprom announced it would raise natural gas prices from $110/bcm to $235/bcm for 2007. Azerbaijan’s foreign minister called the move “unacceptable” and claimed

100 Azerbaijan,” *Country analysis brief*, Energy Information Administration.
103 Proposed price by Russia, ultimately rejected.
the increase was “more than just a market message,” as Ukraine, Georgia and Belarus had experienced similar price hikes. While the foreign minister interpreted these increases to be a result of Russian aggression toward its neighbors, in actuality Gazprom was executing its business strategy for the region. Armenia, one of Russia’s most important allies in the region, experienced the same price hikes; its contract with Gazprom doubled natural gas prices from $56/bcm in 2005 to $110/bcm in 2006. That Armenia faced the same gas price increase that Azerbaijan had encountered debunks the Azeri claim of Russian favoritism; Russia’s actions are clearly market-based if its closest allies are treated the same way as its competitors.

In making its case against Russia and offering itself as a supplier to the Europeans, Azerbaijan asserted that “Caspian gas and oil would allow Europe to reduce its dependence on unreliable energy suppliers,” presumably referring to Russia. The relationship between Azerbaijan and the EU need not be zero-sum; while it is important for the Europeans to develop sources of natural gas and oil elsewhere, relying on Azerbaijan instead of Russia perpetuates dependence on a single supplier. It is in Europe’s best interest to maintain trade relations with both Russia and Azerbaijan. The proposed Nord Stream pipeline, which will link Russia to Germany by circumventing the Baltic states, has been labeled as a high priority project in the EU because it is understood that transit states such as Ukraine and Belarus are the problem, not Russia itself. Azerbaijan’s eagerness to portray Russia as unreliable is understandable, given its own economic interests in the region, but it also a hyperbolic claim.

In response to Gazprom’s proposed hike for 2007, Azerbaijan withdrew from its contract with Russia. Instead, “it redirected a portion of its crude oil production from exports to refining and

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used the more expensive fuel oil to make up for the gas it needed for domestic consumption.

Since the end of 2006, Azerbaijan has refused to import natural gas from Russia. Still, this latest development hasn’t prevented the two countries from cooperating on a host of new deals. On July 3, 2008, Medvedev met with Aliev to discuss the possible exportation of Azeri gas to Russia, for which Russia would pay European market prices. The reciprocity of the new bilateral agreement symbolizes the post-2000 approach Russia has taken to its energy machinations. Further, the decision of Turkmenistan to raise its natural gas prices to European levels has been met with understanding by Russia, which will continue to purchase it when prices increase over the summer of 2009. The preservation of good relations with these countries, even if only to facilitate a more favorable gas price, displays Russia’s integration within the international order. While Russia serves as competition for Azerbaijan in the Caspian Region, its policies reflect economic aspirations of maximizing profit, not political ones aimed at establishing domination over Azerbaijan in the international arena.

C. Belarus

i. Belarusian – Russian Relations in Historical Perspective

Of all of the union republics, Belarus has clung the most closely to Russia after the fall of the Soviet Union and has enjoyed special trade privileges as a result of that proximity. The past several years under Putin have thus come as a great surprise to Belarus, which had expected to maintain favorable trading arrangements, specifically with regards to its imports of Russian natural gas. Belarus is 100 percent reliant on Russia for its oil imports, 80 percent reliant on natural gas imports and has viewed rising prices with befuddled consternation. Despite the

106 Pourchot, Eurasia Rising, 82.
107 Interfax Russia & CIS Oil & Gas Weekly, July 9, 2008.
historically tight-knit relationship the countries have shared, the normalization of gas prices
extends to even the closest of allies.

Originally part of the Grand Duchy of Lithuania, Belarus came under Russian rule in 1795. Small
groups of nationalists were scattered throughout the country, but the Russification of the
area imposed a Slavic identity upon most inhabitants. However, the turn of the 19th century
fostered cultural development that eventually paved the way for a Belarusian state in 1918-1919.
The Germans occupied the country shortly thereafter, ending the possibility of autonomy. In
1939, the Soviets established the Belarusian Soviet Socialist Republic and conducted purges
under Stalin to eliminate dissent. They banned the use of Belorussian in the local press of
western Belarus and by the 1980s, most Belarusians spoke Russian as their primary language.108
From 1965 to 1980, Pitr Maherau functioned as the first party secretary of the Central Committee
of the Communist Party of Belarus. Seen as one of the less corrupt officials, Maherau deepened
the connection Belarusians felt toward the center. Because Belarusian goods were not
competitive in Western markets, Belarus relied primarily on trade with the Soviet Union. By the
late 1980s, Belarus’ research institutions had undergone modernist updates that entailed
sophisticated technology and expanded budgets. The political climate was stable, the older
generation could look forward to an easy retirement and save for the few nationalist groups, most
citizens were content to remain under the Soviet Union’s protection.109

The situation changed drastically with the introduction of perestroika and glasnost in 1987. In
1988, the Belarusian Popular Front (BPF) was established and called for complete economic
independence from Russia. The group also demanded integration with key Western institutions,

108 Abdelal, National Purpose, 132.
109 Anastasia Nesvetailova, “Russia and Belarus: The Quest for the Union; or Who Will Pay for Belarus’s Path to
Recovery?” in Contemporary Belarus, eds. Elena A. Korosteleva, Colin W. Lawson and Rosalind J. Marsh,
such as the European Economic Community and NATO. In the 1990 parliamentary elections, however, the BPF was entirely marginalized, winning less than eight percent of the total number of seats. Unlike the nationalists in Lithuania, who fused with the Communists and galvanized a large base of support, the BPF was disavowed by the Communists and forced to hold its congress outside of Belarus. The political elites were accustomed to life in the Soviet Union and change was seen as dangerous and inimical to their national goals; they opposed the nationalists at every phase. In July 1990, Belarus declared state sovereignty but also designated neutrality as its ultimate aim. It asserted its support for the USSR even as it was forced to repudiate its influence. In August 1991, it unenthusiastically declared independence and outlawed communism, but the members who controlled 85 percent of the legislature still considered themselves Communist, despite the structural changes. Because the ruling elite did not embrace nationalism and the reforms it entailed, there was strong resistance to both a free-market transition and political decoupling from Russia. In addition, the external support from Western countries given to the nationalists paled in comparison to the attention Russia lavished upon Belarusian elites. Though Belarus was granted funds from the IMF and European Bank for Reconstruction and Development to help “consolidate democratic trends,” it was not enough to supersede Russian influence. By 1991, the initial economic changes proved to be disastrous for much of the population, many of whom lost their entire life savings and saw the quality of life plummet. Comparisons with life under the Soviet Union were inevitable; by 1995, GDP was 33.9 percent lower than what it had been in 1991. In an annual poll conducted by the Belarusian Public Opinion Center, 48 percent of Belarusians approved of the breakup of the Soviet Union in 1992.

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Three years later, only six percent did. It slowly became clear that independent statehood could not justify such egregious economic sacrifice.

In July 1994, the Belarusians witnessed their first-ever election between two presidential candidates. The debates between the two centered on proving who was more pro-Russian and, by extension, less inclined to succumb to Western democratization. Alexander Lukaschenko won the election and has remained in power since his inauguration. In the 1995 parliamentary elections, the BPF didn’t win a single seat, which meant that the entire parliament was effectively anti-EU and pro-CIS. A 1995 referendum registered 80 percent of voters who wanted the Russian language to be given equal legal status with Belarusian. In addition, the majority of Belarusians approved of Lukaschenko’s plan of economic integration with Russia. By 1995, it was exceedingly obvious that Belarus wished to maintain the same type of relationship with Russia as it had experienced underneath Soviet rule. For example, that same year, the Ford car dealership opened a location in Minsk, but Belarus shut it down in 1997 because Russia owned a 77 percent stake in Slavneft, the oil company. It also controlled the Belarus-based Mozyr oil refinery and didn’t want competition from foreigners. Aside from Belarusian desire to remain close with Russia, the structural limitations of an authoritarian regime limited exposure to the Western markets, forcing a dependence on Russian imports.

After the fall of the Soviet Union, Belarus wished to remain in the ruble zone, but was ultimately forced out in 1993 when Russia disbanded it in favor of transitioning to market prices. In 1994, the two countries created a monetary union, with Belarus receiving energy supplies at the same price Russian households paid. They also negotiated political agreements, which contained vague promises of eventual integration, and at meetings between the heads of each country in 1996, 1997, 1998, and 1999, the monetary union was renewed. In 1993, Lukashenko

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113 Nesvetailova, “Russia and Belarus,” 157.
had waived rights to Soviet assets in return for the elimination of its energy debts, a zero-option deal it would repeat in 1996. By 1997, however, Belarus owed Russia $200 million in gas payments and fees.\textsuperscript{114} The debts compounded so that by late 1998, Belarus owed half a billion dollars. An inability to agree on prices prompted Russia to deliver supplies without a contract in the first few months of 1999. The fluid nature of these agreements was permissible only due to the patron-like attitude Russia took toward its protégé. Though there were claims that Russia needed Belarus to serve as a buffer between the states that had defected and turned to the West, Russia needed Belarus far less than Belarus needed Russia. Belarus relied on Russia not only as a market for its goods and a source of cheap energy supplies, but also as its overseer in the international arena. And though Russia could rely on Belarus for supporting its policies toward the Near Abroad, as Belarus was viewed as its “appendage,” realistically the unstructured energy agreements of the 90s hindered Russia’s ability to make a profit. With the departure of Yeltsin from the scene, Belarus would have to accept its place as just another customer.

\textbf{ii. Current oil and gas machinations with Russia}

It was becoming clear that Russia needed to abandon its paternal benevolence and adopt a tough set of agreements that would dictate universal, or near-universal, energy policies. Table 6 shows the increase in imports Belarus accumulated from 2000 to 2004. Gazprom could not continue to subsidize these hefty imports and expect to make a profit. Thus, economic calculations, not prior relationships, would serve as the basis from which to negotiate gas and oil prices.

\textsuperscript{114} Rutland, “Oil, Energy, Foreign Policy,” 168.
But Russia’s plans to nudge Belarus into paying market prices had to be implemented slowly. An immediate and significant gas hike would have quickly undermined negotiations and prevented a realistic solution from being found. Instead, Russia proposed a governmental agreement in 2002 whereby Belarus would pay for gas at the domestic 5th band price level in exchange for a joint venture between Gazprom and Beltransgaz, the Belarusian pipeline monopoly. Negotiations proceeded slowly and Belarus began accumulating debt once more. In July 2003, Belarus assigned a $5 billion value to the joint venture, of which Gazprom would have to pay $2.5 billion in order to receive a 50 percent share, in addition to an extra $1.73 billion for refurbishment. Negotiations trailed off and in September 2003 Putin remarked: “we have decided that Russia and Belarus should switch to market relations in this industry without ceasing negotiations to create a single transportation company.” When the 2003 agreement expired, Gazprom halted supplies and independent companies stepped in to make up for the lost gas. The situation only deteriorated from there: a 30-hour gas stoppage in February 2004 limited deliveries to European customers who received gas via Belarus. For the first half of 2004, Gazprom refused to pump any more gas to Belarus, as the country refused to sell part of Beltransgaz to Gazprom and also raised transit fees, despite previous agreements. Lukashenko referred to the joint venture as “a crime against the Ukrainian people” and went so far as to recall

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115 Adapted from Stern, The Future of Russian Gas, 69.
116 Abdelal, National Purpose, 98.
the Belarusian ambassador.\footnote{Danilovich, “Russian-Belarusian Integration,” 147.} Answering questions in a press conference in February 2004, Gazprom CEO Alexei Miller said:

> We maintained that from 1 January 2004 onwards the gas price would be commercial. When we were saying what would be a basis for the price, we were leaning upon the Russian and Belarusian Presidents’ agreement achieved in the city of Sochi in September of 2003. The Presidents agreed to apply in Belarus the gas supply terms identical to those Ukraine was abiding by.

> On 30 January, the Belarusian Economics Ministry, unilaterally adopted a decision (without coordinating it with the RF Federal Energy Commission and thus contradicting the Agreement adopted) to raise the gas transit cost through Belarus up to USD 1.02 for the transit of 1,000 bcm of gas per 100 km. I’d like to remind you that the cost was almost twice as less last year, accounting for US 53 cents. We accepted these terms to avoid putting in jeopardy gas deliveries to our consumers and said that the new cost suited us fine. But we still don’t have the contract. So, that’s why our position is like this: no contract for gas transit, no contract for gas deliveries. We’re reiterating our determination to deliver 10.2 bcm of gas at a USD 50 price.\footnote{Alexei Miller, Gazprom Press Conference, February 2004.}

> The Russian frustration with Belarus’ breach of contract resulted in a gas cutoff, despite 2004’s unseasonably cold winters and despite the international outrage at Russia’s alleged cruelty. Ignoring world sentiment and adhering to free-market principles, Gazprom refused to budge on the issue until July 2004, when a new agreement was drawn up. Gazprom would charge $46.68/bcm, similar to what the independent companies had been charging, and the company itself would pay a transmission tariff of 0.75/mcm for using Beltransgaz’s pipelines. Belarus accepted the terms and gas prices remained steady until 2007, when another price hike resulted in another dispute.

> In November 2006, Russia announced a four-fold price increase to $180-$200/bcm, as well as an export tariff of $180 per ton of petroleum sold to Belarus.\footnote{Goldman, Petrostate, 151.} As Belarus was the only post-Soviet country at the time that was paying below $50/bcm, and it hadn’t yet incurred an export
tariff, it made financial sense for Gazprom to increase the amount per bcm and levy the tariff. Lukashenko disagreed, protesting that Russian energy policy was inadequate and that Belarusian prices should remain at Russian domestic levels. In 2006, Belarus transported 30 bcm through the Yamal-Europe pipeline and 14.5 bcm through Beltransgaz. The Russians still coveted a 50 percent share in Beltransgaz, but Lukashenko refused to relinquish it. Instead, in retaliation for the expected hike, Belarus levied a $45 per ton transit fee on the petroleum the Russians sent to Western Europe. Russia agreed to lower its export duty from $180 to $53 and lower gas prices to $100/bcm in exchange for the abolition of the transit fee. A deal was also finally struck with respect to Russian ownership of Beltransgaz. Gazprom would pay $2.5 billion over four years for 50 percent of Beltransgaz shares. By 2011, the natural gas price for Belarus would reach the European level, and the transit tariff Russia would pay would increase from .75 to 1.45/tcm per hundred kilometers.

According to the agreement with the European Union regarding World Trade Organization membership, in order for Russia to join it must eliminate all domestic subsidies by 2011. Accordingly, the elimination of subsidies for Belarus seemed likely to occur. Alexander Medvedev claimed that the WTO insisted upon free-market trading with Russia’s CIS partners. However, because details of the agreement have not been made public, it is not known whether Russia is required to eliminate subsidies for its foreign market as well. According to David Tarr, the former lead economist at the World Bank, it is unlikely that Russia signed anything formally relating to the elimination of subsidies for its neighbors. Still, because Belarus pricing reflected pricing for Russian domestic consumers, it is logical that the

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120 “President Lukashenko Urges Russia to Sell Gas to Belarus at Domestic Rate,” Kommersant, November 23, 2006.
121 Ioffe, “Understanding Belarus,” 122.
122 Medvedev, “Is Gazprom political,” 64.
123 David Tarr, e-mail message to author, March 11, 2009.
country should pay whatever Russia’s households pay (or more, in line with Russia’s new approach).

Smith contends that Russian actions toward Belarus in 2006 were an “intensification of Russia’s petro-politics that began as early as 1990.” But the sharp divergence in policy between the Yeltin era and Putin’s reign underscores the different mechanisms Russia had in place to deal with energy negotiations. Tables 7 and 8 depict the prices Belarus has paid for crude oil (contrasted here with the European Union’s price) and natural gas, respectively.

Figure 7. Belarusian and European Union prices per ton of crude oil from Russia, 2001 – 2006

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belarus</td>
<td>116</td>
<td>---</td>
<td>133</td>
<td>182</td>
<td>218</td>
<td>268</td>
</tr>
<tr>
<td>European Union</td>
<td>156 (+40)</td>
<td>---</td>
<td>181 (+48)</td>
<td>233 (+51)</td>
<td>350 (+132)</td>
<td>470 (+202)</td>
</tr>
</tbody>
</table>

As Figure 7 indicates, the difference between Belarusian and European crude oil prices has still widened, in spite of Russian efforts to close the gap. Even as prices have doubled for the European countries, Belarus has still commanded a large subsidy, despite protests from the Belarusian government. As Figure 8 shows, however, Gazprom has been more successful at negotiating a deal that will eventually move Belarus to market prices.

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125 Ioffe, “Understanding Belarus,” 117.
Figure 8. Belarusian prices for natural gas imports from Russia, 2001 – 2011

<table>
<thead>
<tr>
<th>Year</th>
<th>Price in USD</th>
<th>Transit tariff</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>30</td>
<td>0.55</td>
</tr>
<tr>
<td>2002</td>
<td>24</td>
<td>0.55</td>
</tr>
<tr>
<td>2003</td>
<td>30</td>
<td>0.75</td>
</tr>
<tr>
<td>2004</td>
<td>47</td>
<td>0.75</td>
</tr>
<tr>
<td>2005</td>
<td>47</td>
<td>0.75</td>
</tr>
<tr>
<td>2006</td>
<td>47</td>
<td>0.75</td>
</tr>
<tr>
<td>2007</td>
<td>100</td>
<td>1.45</td>
</tr>
<tr>
<td>2008</td>
<td>67% mp</td>
<td>1.45</td>
</tr>
<tr>
<td>2009</td>
<td>80% mp</td>
<td>1.45</td>
</tr>
<tr>
<td>2010</td>
<td>90% mp</td>
<td>1.45</td>
</tr>
<tr>
<td>2011</td>
<td>100% mp</td>
<td>1.45</td>
</tr>
</tbody>
</table>

To demonstrate the efficacy of free market principles, it is worth noting that Russia is not the only country to increase its prices in the ongoing dispute with Belarus. On January 6, 2008, Belarus raised the oil transit rates: the rate for pumping oil via the Unecha (Vysokoye) - Adamova Zastava (toward Poland and Germany) pipeline was raised by 15.7 percent to 2.8 euro per ton and the rate for the Unecha (Vysokoye) - Brody route was raised by 16.7 percent to 1.2 euro per ton. Further oil transit fees were announced on January 8, 2009. The transit fee for using the Unecha (Vysokoye) to Adamova Zastava will be raised by 22.5 percent to 3.43 euro per ton.127

The market manipulations between Russia and Belarus have been blown out of proportion. While the paternal relationship between the countries influenced oil and natural gas prices in the 1990s, since Putin took power there has been a shift toward the normalization of policies. The route toward unregulated markets is not contingent upon political relationships or sympathies toward dependent countries. Gazprom’s need for revenues trumps sentimental friendship – and as Belarus’ transit fees indicate, the country seems to understand.

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VI. Comparisons and Implications

A. Lithuania, Azerbaijan and Belarus

These three cases are useful comparisons because they illustrate a) historical and current variations with Russia and b) differing levels of dependence on Russian energy. Using “most different” system analysis shows that three countries with diverse backgrounds nevertheless experience the same pattern of normalization of oil and natural gas prices since 2000 (see Figure 9).

Figure 9. Comparison of Lithuania, Azerbaijan and Belarus

<table>
<thead>
<tr>
<th>Variable</th>
<th>Lithuania</th>
<th>Azerbaijan</th>
<th>Belarus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year of independence from Moscow; attitude toward independence</td>
<td>August 1991; elated</td>
<td>August 1991; unenthusiastic</td>
<td>August 1991; grudging</td>
</tr>
<tr>
<td>Level of dependence on Russian natural gas/oil</td>
<td>High</td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td>Russian elimination of energy subsidies?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Disruption of gas supply due to price disagreements?</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Gas prices trend post-2000</td>
<td>Increasing</td>
<td>Increasing</td>
<td>Increasing</td>
</tr>
</tbody>
</table>
The variables contained within the table can be compared so as to underscore the differences between the countries and how Russia’s approach toward all three has been consistent with its business strategy. Historically, all three countries declared independence from Moscow in August 1991; Lithuania was the most enthusiastic about the prospect of autonomy, Belarus was hesitant, and Azerbaijan fell somewhere in between. The manner of secession from the Soviet Union dictated the paths the countries would take toward their former master. Lithuania was eager to cast away all political and economic ties binding it to Russia – even if it meant forsaking cheap energy supplies. Azerbaijan was generally ambivalent toward its relationship with Russia, but cultivated strong business ties with both Gazprom and Western oil and gas companies. Belarus, on the other end of the spectrum, remained committed to the notion of a monetary and an eventual political union between the two countries and was happy to remain under Russia’s protection.

As these three countries sought to define themselves in the post-Soviet space, energy negotiations with Russia were underlain with identity politics. The Kremlin used energy as a political weapon in the 1990s, meant to instill fear or evince policy changes in its former republics, and the wielding of such a powerful tool led both Lithuania and Azerbaijan to seek greater ingratiation with the West. Lithuanian relations with Moscow were hostile in the 1990s, and gradually thawed post-2000, but still remain strained. Azerbaijan has managed to carefully balance Russia and Western countries since the early 1990s, though it has shown greater proclivity toward the West since 2000. Belarus, on the other hand, is grateful for Russian patronage and has continued to resist Western attempts at democratization.
Economically, despite attempts to shed its dependence on Russia, Lithuania was forced to import nearly all of its natural gas and oil supplies via Gazprom’s pipelines. Belarus also remained a lucrative source of revenue for Gazprom, as it experienced a high level of dependence on Russian natural gas. Azerbaijan, by contrast, began developing its own oil and natural gas fields in the early 2000s and was able to minimize its dependence on Russian imports by 2006.

Despite the countries’ varying historical backgrounds, current economic and political relationships with Russia and levels of dependence on Russian energy, all three have been guided toward a similar trajectory characterized by Russian elimination of subsidies and normalization of oil and gas prices. The nature of the disputes between Russia and each of the three countries is strikingly similar when viewed holistically as part of a greater regional trend. All three countries have been subjected to the gradual elimination of subsidies, annual (or semi-annual) gas price hikes and gas supply stoppage. Lithuania’s experiences in 2004 and 2006, Azerbaijan’s disputes in 2006 and 2007, and Belarus’s yearly gas battles embody the convergence of Russian policy in the region. Since 2000, Putin has championed free-market principles to govern business interactions as an alternative to Yeltsin’s politically-soaked machinations. That Azerbaijan and Armenia, Russia’s competition and close ally, respectively, received the same gas price increase speaks volumes about Russian intentions to accede to both realist and neo-liberal institutionalist tenets. Moreover, Gazprom’s decision to supply gas at unregulated prices in 2011 to domestic industrial consumers is an important signifier of broad changes in national energy policy. The need for revenues, coupled with the need to reallocate funds toward investment and exploration, has prompted Gazprom to take the politically-risky move of increasing prices for domestic consumers. Allowing foreign subsidies to remain, while
phasing out domestic ones, makes little economic sense and would defeat the purpose of
deregulating domestic prices.  

The prices themselves have been converging for all three countries. Lithuania is expected to pay around $350-$400/bcm in 2009, while Belarus will pay 80 percent of market price in 2009. Azerbaijan, had it not turned down Russia’s offer, would also be expected to pay similar numbers for its gas. Inevitably, there will still be marginal differences in what each country pays for energy supplies; transit tariffs, transportation costs, the amount of equity Gazprom retains, etc., are all important factors to be taken into consideration. Still, Russia’s attempt to make Gazprom an indispensable global energy company necessarily entails a uniform strategy for all of its customers.

**B. Russia in Comparison to Emerging Powers**

When Russia increased its shares in Gazprom to become the majority stakeholder, critics immediately denounced the intrusion of the state into a private company. Indeed, the state’s 50.002 percent share has encouraged revisionist interpretations of the Russian government’s use of Gazprom to facilitate its grand strategy. Recently, however, national oil companies have become the norm and private companies the aberration. Belying revisionist accusations, Russian actions adhere to an international phenomenon: the rise of national oil companies. To illustrate that Russian state ownership is neither revisionist nor unique, we can compare it to other countries that have built up their national oil companies.

The International Energy Agency’s list of 50 leading oil and gas companies of 2007 underscores how many top oil and gas companies are state-owned. The presence of so many state-owned companies on this list is testament to a macroeconomic trend over the past several

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128 In some instances, Gazprom provides cheaper energy supplies in exchange for equity in local distributional companies or national oil and gas companies. This practice is likely to continue as long as Gazprom believes it is making good investments and garnering profits from retaining a monopoly over the region’s pipelines.
years: the emergence of national oil companies and the resultant decline of international oil companies such as Shell, BP and Chevron Total. Of the 50 leading oil and gas companies (ranked by total oil and gas production), 27 of them are partially or wholly state-owned. The China National Petroleum Corporation (CNPC) ranks seventh on the list, with state ownership totaling 100 percent, while Petrobras of Brazil (56 percent state ownership), Petronas of Malaysia (100 percent), StatoilHydro of Norway (63 percent), Sinopec of China (100 percent), also appear. Mexico’s Pemex and Turkey’s TPAO are also 100 percent state-owned, though they don’t appear on the list of top producing companies. The prominence of national oil companies signifies a change in the way states prefer to do business; democratic states such as India and Brazil have embraced national oil companies as fervently as Saudi Arabia and Ecuador have. Because these state-owned companies promote industrialization and economic and social development, they are key players in solidifying both national energy strategies and energy security. More tellingly, since they control most of the world’s oil and gas reserves, the companies’ share of oil production is expected to rise 57 percent in 2007 to 62 percent in 2030. Similarly, their share of natural gas output is expected to rise from 44 percent to 55 percent.

China and India provide two good examples of emerging powers, like Russia, that are faced with increased energy consumption and must ensure steady supply for their consumers. Chinese net energy consumption is expected to rise from 59.6 quadrillion BTUs (British thermal units) in 2004 to 145.5 quadrillion in 2030, an increase of 144 percent. Projecting China’s consumption of world energy to total 20.7 percent in 2030, the International Energy Agency speculates that

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130 Ibid., 340.  
131 Ibid., 348.
China must invest $3.7 trillion in natural gas and oil development to provide energy for the emergent middle class consumers who will buy cars, air conditioning, and other such devices.\footnote{Michael T. Klare,} While emerging powers are still holding discussions with multinational companies, the inclination toward strategic partnerships with national firms has become a welcome form of diplomacy. The previous Chinese approach to its energy security had been to focus on its domestic supply of coal. As the coal deposits are proving insufficient in light of rising demand, however, China has begun to diversify its energy portfolio by reaching out to the other countries and working with state-controlled firms. The Chinese government sets the major objectives for its energy companies: CNPC, Sinopec and the China National Offshore Oil Corporation (CNOOC). The government selects the chief operating officers, consults on major acquisitions and provides generous loans from state-owned banks. In addition, President Hu Jintao and Premier Wen Jiabao travel to other countries acting as the “advance men” for the oil companies. Much like Putin and Medelev, who are present at every meeting at which bilateral treaties are signed between Russia and other countries, so too do China’s leaders act as the front-men for the energy industry. Because there is a “distinct preference for forging alliances between state controlled forms and national oil companies of other countries,” the Chinese leadership wishes to laud those occasions as diplomatic events, complete with promises of further cooperation.\footnote{Michael T. Klare,} For instance, in 1999, Sinopec reached out to Saudi Arabia’s Aramco and formed a strategic oil partnership. Sinopec will work with Aramco to develop natural gas fields in Saudi Arabia, in exchange for Aramco’s construction of refineries in China. This relationship is only one of several China is currently advancing; it is working with Gazprom to deliver Russian natural gas and is also conducting talks with Kazakhstan regarding the importation of Kazakh natural gas.

\footnote{Klare,} \textit{Rising Planet}, 77.
India is also a useful example because its standards of business are thought to be more transparent due to its democratic underpinnings. Continuing the historical trend of central planning, however, the government retains control over 75 percent of the country’s energy companies, which include Oil and Natural Gas Corporation (ONGC), Indian Oil Corporation, and Hindustan Petroleum Corporation. Like the Russian government, the Indian government has not hesitated to impose price ceilings and force its companies to sell oil below cost.\textsuperscript{134} This has resulted in some oil companies’ failing to make a profit some quarters and has prompted their executives to call for the elimination of domestic subsidies.

In 2006, India’s energy consumption totaled 17.1 quadrillion BTUs, estimated to rise to 31.9 quadrillion in 2030.\textsuperscript{135} In an attempt to bolster its energy activities, India has actively been seeking properties around the globe. Thus far, it has acquired oil and gas fields in Algeria, Indonesia, Kazakhstan, Libya, Russia, Sudan, Syria and Vietnam. Following China’s lead in stressing strategic partnerships, ONGC has paired with Venezuela’s PdVSA in the development of the Orinoco oil sands in South America and with an Iranian oil company in the exploitation of Iran’s South Pars gas deposit.

Brazil is another emerging power that has utilized its national oil company to further the country’s aims – namely, energy integration – in the Southern Cone. Petrobras, the state oil company, was founded in 1953 as an exclusively state-controlled company, but allowed for some privatization in 1997. Today, the state owns 56 percent of shares and since the early 1990s has embarked upon ambitious plans to become the main energy supplier in the region. It has acquired regional distribution companies in Bolivia and Argentina, built a pipeline to Bolivia and set up

\textsuperscript{135} Klare, Rising Planet, 82.
operations in eight countries in South America. One of the consistently high-performing companies in South America, Petrobras expects to double its production of oil from 2.18 million barrels per day in 2008 to 3.31 million in 2013 and to 5.1 million by 2020. Answering to the state and to its 170,000 shareholders, Petrobras is intent on becoming one of the world’s top five energy companies. Like Gazprom, its goal is to become an internationally-recognized company that still strives to maximize profits to the state. Though Brazil’s plans for expansion are analogous to Russia’s desires to control local regional companies, the media has focused on Gazprom as an extension of Russian might while ignoring Petrobras’s similar activities.

National oil and gas companies face a pressing dilemma: they must be attuned to the needs of the titular constituencies while also maximizing profits. To that end, the state has spent political capital to make economic gains at the expense of a disgruntled citizenry. Because large domestic subsidies undercut the oil companies’ profitability and “limit funds for capital spending,” the companies have been forced to introduce reforms that will improve their market performance. One significant reform is the elimination of subsidies that allow for an increase in oil and gas revenues, the track Gazprom has taken. The Russian gas industry especially is at a crossroads as the country’s main fields decline and production shifts to regions that are difficult to access and even more difficult to exploit. To invest in more field exploration, Gazprom needs to reallocate funds it has expended on domestic and foreign subsidies in the past.

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VI. Conclusions

This paper has undertaken both internal and external comparisons to illustrate that Russia’s energy negotiations rest on economic principles meant to advance national interests. The comparison of Russian energy policies toward Lithuania, Azerbaijan and Belarus, three countries with varying relations and levels of dependence, indicate a standardized pricing mechanism Russia is putting in place. Since 2000, Belarus, a country that enjoys close relations with Russia, has experienced the same sort of natural gas and oil price hikes that less friendly countries like Lithuania and Azerbaijan have encountered. Because the three countries have immensely diverse backgrounds, the uniform pricing measures Russia has implemented indicates the extent to which economics underlies the negotiations. Russia’s national energy strategy since 2000 has been one of normalization and adherence to free-market principles because Gazprom can no longer afford to subsidize foreign and domestic subsidies. While the recipient countries have been undoubtedly distressed over the loss of cheap energy, Gazprom’s cutting off the gas supply had little to do with political retribution and everything to do with the necessity of enforcing previous agreements. In the post-Soviet space of the 2000s, Russia’s position is unequivocal: pay for the gas or it gets turned off.

It is not enough to point out the unfair treatment of Russia, however, without offering comments on how the revisionist interpretation might be discarded. The question invariably becomes one of approach. Keeping Russian intentions in mind, how should countries look upon the 2009 Russo-Ukrainian gas war, for instance, and more importantly, Russian energy policy in general? A few recommendations can fashion the explicit arguments within this paper into policy proposals to stabilize Western relations with Russia.
First, Western diplomats must reorient their attitudes toward Russian behavior. Though the reset button Hilary Clinton offered to Sergei Lavrov as an expression of bridge-mending made for a good photo opportunity, the State Department should stop viewing Russia with the suspicion that has colored policy as Russian-American relations have deteriorated. Both the State Department and the U.S. Congress, specifically the Senate Foreign Relations Committee, subscribe to the revisionist images perpetuated by well-meaning policy wonks. Instead of generating further understanding, they disseminate the image of Russia as an expansionist, neo-imperialist power. Toning down the rhetoric of Russia as an “energy blackmailer” will increase Russian trust and help combat misperceptions. Understanding Russia as a capitalist entity bent on maximizing profits, not politics, can guide diplomats in how they deal with problems that arise in the future. Instead of a knee-jerk recourse to Cold War-era mentalities of bipolarity, a measured response on behalf of the U.S.’s top officials will be greatly appreciated by their Russian counterparts. Divesting the relationship of the mistrust that has characterized it for so long, then, becomes a crucial step in bridging relations.

We can observe the effects of this new approach by placing it within the context of the Russo-Ukrainian gas dispute of December 2008 and January 2009. In November 2008, Gazprom officials met with Ukrainian representatives to discuss Ukraine’s outstanding debts to Gazprom for delivered but unpaid gas, which totaled $2.4 billion. Unable to agree on a contract for 2009 that would both address the missed payments and set a new price for natural gas deliveries, Gazprom shut off the gas supply on January 1, 2009 and halted deliveries for export to Europe on January 6 because it suspected Ukraine was siphoning off gas for domestic consumption. The two countries met frequently over the next several weeks, wrangling over the prices Russia

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suggested and the prices with which Ukraine countered. As the negotiations continued, millions of citizens in Eastern Europe suffered a bitterly cold winter without heat. It wasn’t until January 20 that a deal was cemented: Ukraine would pay $208-$240/bcm in 2009, a 20 percent discount on European prices that would be eliminated the following year.\textsuperscript{142} The initial media response to the dispute proclaimed Ukrainian innocence and Russian aggression. Critics deemed the crisis a repeat of the 2006 cutoff Gazprom had enacted. In 2006, critics accused Russia of punishing Ukraine for its political orientation toward the West; Gazprom, for its part, argued that the lack of a viable contract prevented the company from supplying regular shipments. In both the 2006 and 2009 disputes, it was evident that the wielding of political leverage did not interest Gazprom executives, who were more concerned about breaching their contracts to their European customers in the wake of alleged Ukrainian stealing of gas.

It has become easy and commonplace to dismiss Russo-Ukrainian gas altercations as just another political spat, but the alternative explanation offered in this paper suggests a different approach is necessary. Russia can make the case that Ukraine is executing energy blackmail by taking gas meant for export to the Europeans and disrupting transit. Moreover, Gazprom’s complaints regarding the lack of a contract that satisfied its concerns cannot be dismissed. Under the stipulations of this paper’s argument, one could claim that Gazprom was the victim in this instance, as Ukraine’s outstanding debts and inability to accept the elimination of cheap gas effectively penalized Europeans who are dependent upon the country as a transit state. Future discussions regarding natural gas between Russia and Ukraine are certain to occur; not for the political reasons \textit{The New York Times} espouses, but for the economic realities that force Gazprom to shut off supply if it is not guaranteed payment.

This analysis has sought to refute impressionistic and sensationalistic treatments of Russian energy policy in both media and academic circles. By highlighting a convergence of policy toward Lithuania, Azerbaijan and Belarus, this paper suggested an alternative explanation for Gazprom’s rigid adherence to its pricing structure. Ultimately, Russia is neither revisionist nor unique. Its actions toward its neighbors are reflective of a uniform energy policy put in place by Putin and continued by Medvedev. Russia has explicitly conveyed its stance of an emerging power seeking to champion its national interests by maximizing the profits of its oil and natural gas companies. It is important to realize that Russia’s posture as a revisionist state has been exaggerated by those who vilify its energy machinations. While Gazprom may function as a tool of the state, it seeks profits, not political retribution, a fact that Western scholars and pundits would do well to remember the next time a gas battle erupts.
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Appendix A

Gazprom natural gas deliveries to Former Soviet Union and Europe

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Appendix B

Current and planned Gazprom delivery routes\textsuperscript{144}

\textsuperscript{144} *Gazprom in Figures 2003 – 2007*, 38.
Appendix C

Regulated vs. unregulated gas prices for Russian industrial consumers, 2007

<table>
<thead>
<tr>
<th>Price band</th>
<th>Regulated gas prices for consumers in the Russian Federation except gas sold to household consumers from 01.01.2007, rubles/1000 m³</th>
<th>Indicative gas prices based on equal yield from gas sales in the external and domestic market published by FTS in 2007, rubles/1000 m³</th>
<th>Regulated vs. indicative wholesale gas prices</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3rd quarter</td>
<td>4th quarter</td>
<td>3rd quarter</td>
</tr>
<tr>
<td>I</td>
<td>779</td>
<td>2.295</td>
<td>2.335</td>
</tr>
<tr>
<td>II</td>
<td>937</td>
<td>2.762</td>
<td>2.690</td>
</tr>
<tr>
<td>III</td>
<td>1,104</td>
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<td>3.169</td>
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<tr>
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<td>1,242</td>
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<td>3.566</td>
</tr>
<tr>
<td>IVa</td>
<td>1,198</td>
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</tr>
<tr>
<td>V</td>
<td>1,270</td>
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<tr>
<td>VI</td>
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<tr>
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</table>

\[145\] Gazprom in Figures 2003 – 2007, 54. Anticipating the 2011 changes for industrial gas prices, Gazprom calculated “indicative gas prices” for the 3rd and 4th quarters of 2007 that would demonstrate how much more revenue could be taken in if the prices were unregulated and allowed to fluctuate freely. The indicative prices were almost three times higher than the regulated ones, fueling Gazprom’s desire to eliminate domestic subsidies for industrial consumers.