

# Russian policy towards former Soviet countries covered by the ENP

'Gazprom is a key element of the state's energy security system and its export potential and, no less important, it gives Russia strong commercial and political leverage in the world'<sup>10</sup>.

'Russia will maintain state control over the pipeline network in former Soviet republics'<sup>11</sup>.  
*President Vladimir Putin*

During Vladimir Putin's government, especially during his second term of office, Russia's policy towards CIS countries has undergone major change. In fact, Moscow gave up its rhetoric on reintegration, so dominant during Boris Yeltsin's term of office, and took a more pragmatic approach, a key element of which is control of the energy sectors of former Soviet countries. To achieve this aim, Russia has used price rises of resources, especially gas, for recipients in the CIS. By gaining a dominant position in this key sector of the economy, Russia intends to have far more political control than it currently has in CIS countries. From the point of view of Russia's political interests, Ukraine and Belarus and, to a lesser extent, Moldova, are the most important. Russia uses gas and oil as political leverage in relations with those

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<sup>10</sup> Speech during the celebration of the tenth anniversary of the establishment of Gazprom, Moscow, 14 February 2003, <http://www.kremlin.ru/text/appears/2003/02/29774.shtml>.

<sup>11</sup> Speech during a conference with Chancellor Gerhard Schröder, Yekaterinburg, 9 October 2003, <http://www.rferl.org/reports/securitywatch/2003/10/41-141003.asp>.

countries because they are totally dependent on Russian energy resources or, in Ukraine's case, on gas imported across Russia from Central Asia.

The approach of the current Russian authorities differs from the approach in the 1990s in that for more than ten years after the break-up of the USSR Russia kept prices for natural gas for Belarus, Ukraine and Moldova low – it was barely higher than the price charged in Russia itself and much lower than that paid by the countries of Central Europe. However, Belarus, Ukraine and Moldova were unable to pay even that low price for gas, thereby incurring debts of hundreds of millions of dollars. In exchange for low energy prices, Moscow demanded political loyalty. At the same time, Russia made its first attempts to take control of Belarusian and Ukrainian gas pipelines and transit oil pipelines. Gazprom in particular has been trying since the mid-1990s to take control of the gas system in Ukraine and Belarus, but this has been unsuccessful. The Ukrainian and Belarusian political elites were already aware that this was one of few tools they could use to counterbalance their dependency on Russian resources. Debts in respect of oil and gas supplies caused Russia to suspend supplies several times. Russia's greatest successes were in Moldova, where in 1998 Gazprom succeeded in taking over, in exchange for the debts, 50% + one share in Moldovagaz, the enterprise managing the country's gas system and controlling the transit of Russian gas through Moldova to the Balkan countries (approx 20 billion cubic meters annually).

The coloured revolutions in Ukraine and Georgia and problems with seemingly loyal partners such as Belarus made the Kremlin realise that the low gas and oil prices offered to former Soviet countries were no guarantee of Russia's political control over them. It seems that the realisation of this fact was a key factor that led to the above-mentioned fundamental change in Russia's policy.

For Russia, the significance of Ukraine and Belarus as transit countries remains important in the foreseeable future. Russia cannot entirely cease transporting oil, and especially gas, through them to European markets. Gazprom and other Russian energy companies are, however, striving to

limit their dependency on transit countries, which is why they are initiating new projects, such as the gas pipeline at the bottom of the Baltic Sea (Nord Stream), the gas pipeline through the Black Sea from Russia to Bulgaria (South Stream) and the Baltic Pipeline System, which is entirely in Russia, and the oil terminal in Primorsk near Saint Petersburg. After the 2002 launch of the Primorsk terminal, Russians succeeded in decreasing the importance of the Druzhba pipeline (in 2006 almost 70 million tonnes of Russian oil were exported from Primorsk), but it continues to be the most important pipeline exporting Russian oil (approx. 80 million tonnes annually).

To a large extent, Russian energy corporations are the instigators of this new Russian policy towards CIS countries, including Ukraine, Moldova and Belarus. Controlled by the state (i.e. the Kremlin), these corporations, primarily Gazprom, Rosneft' (which took over virtually all of Yukos' assets, till 2003 Russian number one oil company), Transneft' and RAO JES, are to be the principal instruments in restoring Russia's position in former Soviet countries and in other parts of the world and could even contribute to the success of a new Russian concept of an 'energy empire'.

### Price games

At the same time as the Kremlin's role in the Russian oil sector has been increasing, an example of which was the take-over of Yukos, Russian authorities have begun the process of introducing new gas and oil prices for recipients in the CIS, including Ukraine, Moldova and, with a certain delay, Belarus. It is worth stressing that the increases affect both the countries that the Kremlin considers 'defiant' and those it considers 'loyal'.

The harsh price increases affect countries that more or less openly declared themselves in favour of integration with the West. In June 2005, the Russian Duma unanimously voted in favour of a resolution stating that Ukraine, Moldova and Georgia should pay 'world prices' for gas. The idea of a new Russian energy policy towards former Soviet countries was well explained at the time by Andrei Kokoshin, chairman of the Duma committee

for CIS affairs and Compatriot Relations, who stated 'Russia has the right to demand that CIS countries pay new prices. We shouldn't be subsidising their economies, especially since some of them have announced their desire to integrate with European and North Atlantic structures'<sup>12</sup>. In Kokoshin's opinion, 'Demand for Russian energy resources in the world is continuously increasing, many countries are willing to pay any price for them and it is in our interest that that price is not low'. The Russian authorities have officially begun to argue that a price increase is driven by the necessity to bring gas prices in line with world prices so that its relations with its neighbours can be based on 'normal economic terms'.

At the end of 2005, Gazprom announced it was increasing the price of gas for Moldova from 80 to 110 dollars. This was opposed by Chisinau, which refused to pay the new price, causing the Russian corporation to suspend supplies at the beginning of 2006. The Moldovan-Russian gas crisis did not end until mid-January 2006, partly because the EU did not in fact take any notice of Russia's blackmail of Moldova, which is much less important than Ukraine in the transit of Russian gas to the EU market. The new price of the gas for Moldovan recipients was set at 110 USD in the first half of 2006, after which it rose to 160 USD. Such a significant increase can be explained as a 'punishment' for Chisinau's pro-Western policy. As a result, relations between Chisinau and Moscow visibly began warming in August 2006. Despite the change towards a pro-Russian policy in Moldova, at the beginning of 2007 the price of gas increased to 170 USD and it was agreed that over the next five years there would be gradual increases until it reached the average price for Europe. Gazprom's consent to a transition period was bought at a price: the Russian corporation significantly expanded its influences in the Moldovan energy sector and increased its stake in Moldovgaz to 63.4%.

Russia's decision to increase gas prices at the beginning of 2006 was rapidly accepted by three states in the Caucasus: Georgia, Azerbaijan and Armenia, but was opposed by Ukraine. Like Chisinau, Kyiv refused to pay

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<sup>12</sup> 'RIA Novosti', 07.12.2005.

the new price (it was initially supposed to be over 200 USD), which led to Gazprom's suspending supplies. The Russian-Ukrainian gas crisis was the most visible manifestation of Russia's new pricing policy<sup>13</sup>. The cut-off of gas supplies in January 2006 caused a significant drop in the supplies of gas not only to Ukrainian recipients, but also to certain European countries that were consumers of Russian gas (such as Austria, France, Hungary and Italy). For the EU and EU states, this clearly signalled the negative effects of dependency on Russian energy and also proved that Moscow would unscrupulously exploit that dependency politically. Pressure from the West was one of the arguments that determined the January 2006 signing of the Russian-Ukrainian compromise, under which the price of gas for Ukraine was increased from 50 to 95 USD, and the sole supplier of Russian gas to Ukraine became RosUkrEnergo, half of which belongs to Gazprom, and the other half to two little-known Ukrainian businessmen, Dmytro Firtash and Ivan Fursin<sup>14</sup>. Since 2007, RosUkrEnergo has been supplying only Central Asian gas to Ukraine.

In subsequent months Russia, in full control of Central Asian gas supplies to Ukraine, continued its price increase policy. At the end of 2006, the price of gas increased to a 'moderate' 130 USD, in exchange for which Kyiv agreed to make certain concessions for Gazprom. The concessions concerned the expansion of UkrHazEnergo's influence on the Ukrainian gas market. RosUkrEnergo and Naftohaz, a Ukrainian state enterprise, each own half of UkrHazEnergo. The price for Ukraine was increased, even though in Kyiv the government was led by Prime Minister Viktor Yanukovich, acknowledged as being more favourably inclined towards Russia than the Orange camp. If the Ukrainian government had been 'orange', the price of gas would probably have been higher.

In 2006, gas prices were raised not only for Georgia and Azerbaijan but also for Armenia (from 60 to 110 USD), which is considered Russia's

<sup>13</sup> For more details see: J. Stern, *The Russian-Ukrainian Gas Crisis of January 2006*, Oxford Institute of Energy Studies, January 2006, [http://www.oxfordenergy.org/pdfs/comment\\_0106.pdf](http://www.oxfordenergy.org/pdfs/comment_0106.pdf).

<sup>14</sup> J. Mostova, *Gazova firtashka*, 'Zerkalo Tyzhnia', 29.04–12.05.2006.

‘strategic ally’. At that time, only Belarus succeeded in keeping the price unchanged (47 USD).

The beginning of 2007 was the next stage in the change towards market prices for CIS countries and its most characteristic event was the Belarusian-Russian gas and oil crisis. Belarus, which had successfully avoided the price increase at the beginning of 2006 and that at the beginning of 2007 was paying the least of all the former Soviet countries, opposed a price increase from approx. 47 USD to – according to Gazprom’s initial declarations – 200 USD. After lengthy negotiations and the Russians’ threat to withhold gas supplies, on 31 December 2006 a new contract was signed, under which the price rose to 100 USD and a new schedule of further price increases was established up to 2011, when the price is to be equal to the “European price”<sup>15</sup>. In exchange for a transition period, Minsk allowed Gazprom to take control, by 2011, of 50% of the shares in Beltransgaz, the Belarusian enterprise that owns the transit pipeline transporting Russian gas to the West. For many years Lukashenka’s regime has fought against selling shares in this strategic enterprise to the Russians, convinced that Beltransgaz is a tool Belarus could use to counteract its total dependency on Russian energy resources.

The Belarusian-Russian gas crisis was continued by the oil crisis, caused by Russia’s imposing customs duty of 180 USD per tonne on the export of oil to Belarus in December 2006. In 2007, Minsk reacted by charging transit duty (45 USD per tonne) on Russian oil transported along Belarus’ stretch of the Druzhba pipeline and then began pilfering oil. As a result, Russia withheld the transport of oil through Belarus, thereby stopping supplies to Poland and Germany as well. The dispute between Minsk and Moscow was not settled until January 2007<sup>16</sup>. The duty on oil was reduced to 53 USD, but that change will still mean that the existing scheme of

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<sup>15</sup> For more details see: W. Konończuk, *Belarusian–Russian Energy Conflict: The Game is Not Over*, Stefan Batory Foundation, January 2007, <http://www.batory.org.pl/doc/belarusian-russian-energy-conflict.pdf>.

<sup>16</sup> *Ibidem*.

processing Russian oil in Belarusian refineries, which was a major source of income for Lukashenka's regime, will be much less profitable. As a result, the measures adopted by Russia undermined the existing model of the Belarusian economy, which over recent years has experienced growth largely thanks to the oil boom.

**Table 3. Gas prices paid by Ukraine, Moldova and Belarus in 2006–2007 (in USD).**

	<b>2005</b>	<b>2006</b>	<b>2007</b>
Ukraine	50	95	130
Moldova	80	110–160	170
Belarus	47	47	100

Observing the changes that have taken place in Russia's energy policy towards CIS countries, it can be concluded that countries that have experienced moderate increases in gas prices (Belarus, Ukraine, Armenia) and those that have been forced to pay much higher prices (Moldova, Georgia) continue to be treated differently. Ukraine belongs to the first group probably thanks to the formation of Viktor Yanukovich's government. However, Russia did not waive price increases for the first group of countries, it merely spread them out over a period of time. Under the Russian-Belarusian gas agreement, in 2011 Belarus will be forced to pay the European price (approx 230–260 USD). The situation with prices for Ukraine is still unclear. The current rate of 130 USD applies only until the end of 2007 and a further increase is just a matter of time. It remains to be seen what concessions Kyiv will have to make for Gazprom to allow a transition period of several years, as it did for Belarus.

Next to Georgia (which pays 235 USD), of the CIS countries Moldova pays the highest price for gas. In exchange for price rises spread out until 2011, Chisinau allowed Gazprom to take over further parts of the Moldovan gas market.

## Attempts to take over infrastructure

Irrespective of certain differences in Gazprom's pricing policy towards Belarus, Ukraine and Moldova, the aim in each case is the same: to take control of their energy sectors. Dominance in these strategic areas of the economy will result in those countries becoming economically dependent on Russia and therefore allow Russia to gain important political influence. Russia's energy expansion in former Soviet countries can be seen in the example of Moldova, where Russian energy companies have experienced the greatest success. Moldova could be a kind of case study of Russia's energy expansion because Russia's aims and methods of operation are clearly visible. In the 1990s, Gazprom was successful in taking over most of the shares in Moldovagaz, the most important energy company, with a monopoly on the Moldovan market. Hence, Gazprom took control both of the transit gas pipeline transporting Russian gas to the Balkan countries and over virtually all of Moldova's internal gas network. Following the Moldovan-Russian gas agreement at the end of 2006, Gazprom obtained consent to increase its stake in the enterprise to a 63.4% stake, to the take-over of two combined heat plants and to the take-over of control of power lines along which electric energy can be exported to the Balkan countries. As a result, the Russian corporation controls both the network for the distribution and transit of gas and the important assets in the electric energy sector. Added to RAO IES' purchase in the 1990s of the largest Moldovan power station in Transnistria, which is not under Chisinau's control, it can easily be concluded that Russian corporations have succeeded in taking over control of all of Moldova's energy system<sup>17</sup>.

However, Moldova is still the least significant of the countries mentioned. Far more important to Russia's plans are Belarus and, primarily, Ukraine, which control the transport of 80% Russian gas and (partly) oil

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<sup>17</sup> In the end of 2006 the first part of oil terminal in Giurgiulesti on Danube (2 million tons capacity) was put into operation in Moldova. In the near perspective, the terminal, owns by Azpetrol, the Azeri company, will allow Moldova oil supplies from other direction than Russia.



to the EU and whose domestic markets are much greater than Moldova's. In the 1990s, the most important success of the Russian corporations was the take-over of control of the Ukrainian oil sector. By 2002, Russian oil corporations (Lukoil, TNK, Tatneft', Alliance Group) had taken over control of four out of six Ukrainian refineries (in Lysychansk, Odessa, Kremenchuk and Kherson), which produce 90% of oil derivative products in Ukraine. The main influence exerted on Kyiv so that it would sell those refineries was the suspension of oil supplies, which put those enterprises at risk of bankruptcy. The view of the then Ukrainian authorities can be shown in the words of President Kuchma, who said that 'when Russian companies take control of Ukrainian refineries, there will be oil and oil derivative products, payments and everything else'. Although at the end of the 1990s there was the idea of creating a Ukrainian oil corporation, it did not happen and the largest refineries ended up in the hand of Russian companies<sup>18</sup>.

Yet, it should be remembered that in the 1990s the Kremlin's degree of control of oil corporations was much smaller than it is today. Hence, the presence of Russian capital did not necessarily mean direct political pressure at that time.

In Belarus, Russian corporations Gazprom Neft' and TNK-BP (through Slavneft', which they controlled) own 42.5% of the shares in one of two Belarusian refineries, in Mozyr. Gazprom controls the Belarusian stretch of the Yamal pipeline that was launched in 2004 (with a capacity of approx. 30 billion cubic meters).

Attempts in earlier years to take over Ukraine's and Belarus' gas transit networks, built during the Soviet era, failed, but under the Belarusian-Russian gas agreement signed in December 2006, in June 2007 Gazprom took over the first tranche of Beltransgaz shares, 12.5%, that it had been trying

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<sup>18</sup> The Ukrainian authorities returned to this idea in 2005. Oleksy Ivchenko, then chairman of Naftohaz, stated that Ukraine should regain control over the largest refineries in Lysychansk and Kremenchuk as quickly as possible because they 'had in fact been stolen from the State'. (Quoted in: 'Neft', gaz i fondoviy rynok', 8.06.2005. In July 2007, the Ukrainian authorities succeed in taking control of Ukratnafta, which is the owner of Ukraine's largest refinery, in Kremenchuk (30% market share).

to acquire for years. It is to take over another 37.5% of the shares by the middle of 2010. Russian energy companies are also keen to take over some other Belarusian strategic energy assets, including refineries in Mozyr and Novopolotsk as well as chemical enterprises.

Yet, Russia's most difficult aim is to take control of the Ukrainian gas system (which transports 80% of Russia's gas to the EU). For several years there have been discussions about the creation of a Russian-Ukrainian consortium that would manage the gas transit pipelines, so far without result. In February 2007, Vladimir Putin unexpectedly stated that both sides were working on a new project for the consortium, and in exchange for surrendering some of its shares to Gazprom, Naftohaz would be given access to Russian gas deposits. In response, also in February 2007, the Ukrainian parliament almost unanimously adopted a statute prohibiting the privatisation of the Ukrainian gas system, which could have led to its being taken over by Gazprom<sup>19</sup>.

However, Russia had major successes in taking over Ukraine's domestic gas market. Under the Russian-Ukrainian agreement of January 2006, Ros-UkrEnergo and state enterprise Naftohaz set up a joint venture, UkrHaz-Enerho, which took on the responsibility of distributing gas on the domestic market. Until the company was set up, the Ukrainian gas sector had been monopolised by Naftohaz, which controlled both the distribution and the transit of gas. UkrHaz-Enerho's position strengthened further following the Russian-Ukrainian gas agreement signed at the end of 2006, under which, in exchange for concessions granted to the joint venture company set up with Gazprom, the price of gas for Ukraine was only increased to 130 USD. Consequently, Naftohaz's importance is increasingly coming down to supplying the population with gas extracted domestically, which is a less profitable segment of the market because of the lower prices for industry and because of the problems with debt collection. In addition, over the next few years, UkrHaz-Enerho intends to expand its activity and take over

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<sup>19</sup> A. Yeromenko, *Zakon 'Pro trubu': yak zalataty dirky*, 'Zerkalo Tyzhnia', 10–16.02.2007.

30% of the Ukrainian oil products market and wants to invest in the electric energy sector<sup>20</sup>.

Russia's strategy can also be seen in the obstacles it creates in the implementation, or even the outright torpedoing, of projects that could provide alternatives to Russian supplies of oil and gas to the countries mentioned. One example is the action it took to prevent the use of the Odessa-Brody pipeline as a possible route for Caspian oil. In 2003, Russian gas companies, contrary to economic calculations, began using it in the other direction (i.e. in reverse) to export Russian oil. Another example is Gazprom's control of the emerging gas pipeline from Iran to Armenia, following which Gazprom obtained the opportunity to influence the possible future transit of Iranian gas through Armenia to Georgia.

### Forecast of Russia's future actions

Over the next few years Russia's current energy policy towards Belarus, Ukraine and Moldova can be expected to continue. On the one hand, Russia will strive to take over more of the Belarusian and Ukrainian energy sectors, especially the gas transport infrastructure (transit and domestic) and the processing of crude oil, and will also take care to strengthen its current position, especially in Moldova<sup>21</sup>. On the other hand, it will strive to implement a strategy to minimise its dependency on transit countries for the export of its gas and oil to the EU. The first step in this direction was its decision to build a gas pipeline at the bottom of the Baltic Sea (Nord Stream), but because of the forecast increase in gas consumption in EU countries this will be unlikely to materially limit the transit via Belarus and Ukraine.

However, a new element is the decision to build an oil pipeline avoiding Belarusian territory. Immediately after the signing of the oil agreement

<sup>20</sup> O. Gavrysh, *UkrGaz-Energo khorosho gazanulo so starta*, 'Kommersant – Ukraina', 14.03.2007.

<sup>21</sup> In April 2007 Gazprom announced it was increasing its investment in the development of the Moldovan gas network. 'BBC Monitoring Ukraine & Baltics', 24.04.2007.

with Minsk on 12 January 2007, Transneft' announced a plan to build an oil pipeline from Unecha to Primorsk with a capacity of 50–80 million tonnes per year, which – if implemented – will have a serious adverse effect on the Druzhba pipeline or quite simply cause it to close down. Whether this project goes ahead depends largely on the further development of Russia's relations with Belarus and on whether Russian energy corporations are successful in taking control of the refineries in Mozyr and Novopolotsk.