

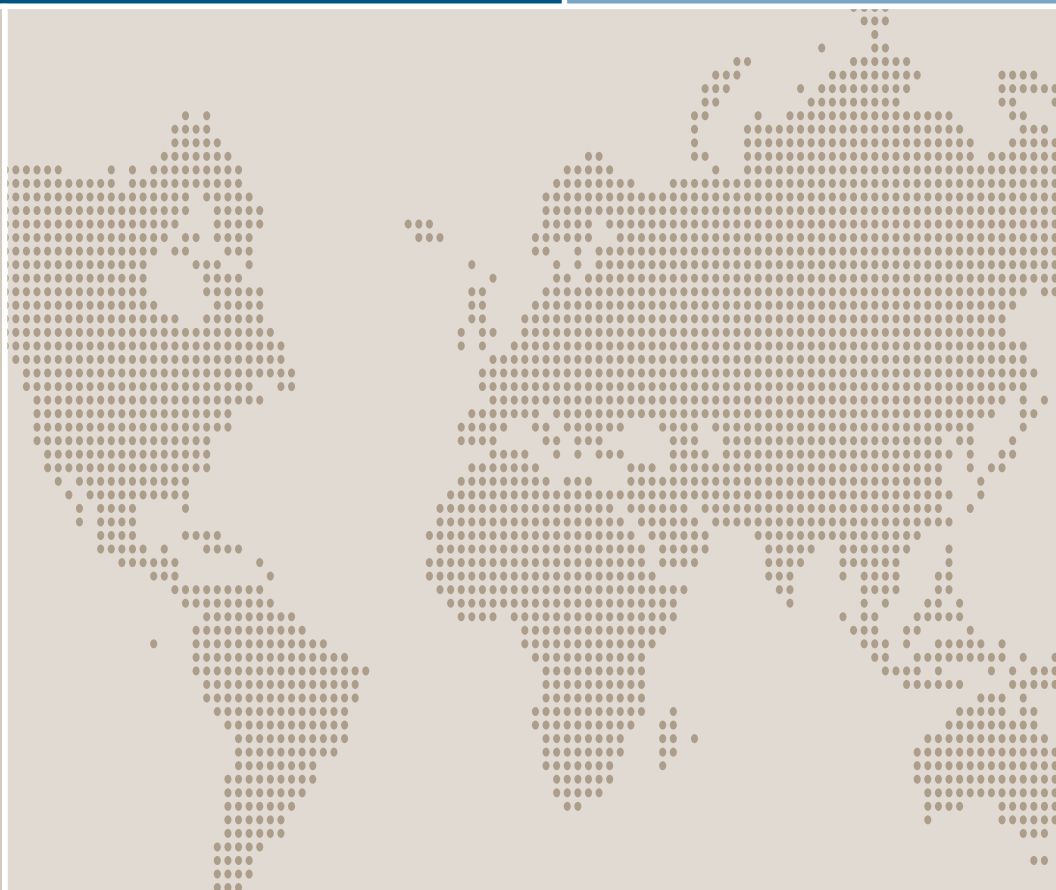
Russia and the West

The Energy Factor

AUTHOR
Vladimir Milov

PROJECT CODIRECTORS
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Thomas Gomart

JULY 2008



EUROPE, RUSSIA, AND THE UNITED STATES
FINDING A NEW BALANCE



CSIS | CENTER FOR STRATEGIC &
INTERNATIONAL STUDIES

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Contents

Preface	iv	
Russia and the West in the General Global Energy Environment		1
Russia's Domestic Situation and Energy Development Potential:		
Strategic Dilemmas and Choices	8	
Is There Room for a Positive Agenda in Energy Relations with the West?		13
Conclusions	18	

Preface

The joint CSIS/IFRI project “Europe, Russia, and the United States: Finding a New Balance” seeks to reframe this trilateral relationship for the relevant policymaking communities. We are motivated by the possibility that new opportunities may be emerging with leadership changes in Moscow and Washington. In particular, we hope that our analyses and recommendations will be useful as France takes over the chair of the European Union on July 1, 2008.

The title of the project reflects our sense that relations among Europe, Russia, and the United States have somehow lost their balance, their equilibrium. The situations of the key actors have changed a great deal for a variety of reasons, including but not limited to the wars in Afghanistan and Iraq, the expansion of NATO and the European Union, and the unexpectedly rapid economic recovery of Russia. At a deeper level, we find ourselves somewhat perplexed that nearly 20 years after the collapse of the Berlin Wall and the subsequent conclusion of the Cold War relations among Europe, Russia, and the United States seem strained on a multitude of issues. In Berlin in June 2008, President Dmitri Medvedev of Russia invoked the language articulated 15 years earlier by then-Presidents Bill Clinton and Boris Yeltsin about “unity between the whole Euro-Atlantic area from Vancouver to Vladivostok.” Despite many achievements over the past 15 years, it is hard not to conclude that collectively we have underachieved in building greater trust and cooperation. We are convinced that, for enhanced European as well as global security, we must increase the level of trust and cooperation among the transatlantic allies and Russia and that this cooperation must rest on a firm economic and political grounding.

We humbly acknowledge that we have no “magic bullet,” but we hope that the series of papers to be published in the summer and fall of 2008 as part of this project may contribute to thinking anew about some of the challenging issues that we in Europe, Russia, and the United States collectively face. We are very grateful to the excellent group of American, European, and Russian authors engaged in this task: Pierre Goldschmidt, Thomas Graham, Rainer Lindner, Vladimir Milov, Dmitri Trenin, and Julianne Smith. We also want to thank Keith Crane, Jonathan Elkind, Stephen Flanagan, James Goldgeier, Stephen Larrabee, Robert Nurick, Angela Stent, and Cory Welt, participants in the workshop held on May 16, 2008, in Washington, D.C., for their rich and thoughtful comments about the papers and the project. Finally, we want to thank Amy Beavin, research associate of the Russia and Eurasia Program at CSIS and Catherine Meniane and Dominic Fean of the Russia/NIS Center at IFRI for their indispensable support in making all aspects of the project a reality.

This project is the continuation of the IFRI/CSIS transatlantic cooperation started in 2006. We would like to thank warmly our financial supporters—France Telecom, the Ryan Charitable Trust, and particularly the Daimler **Fonds**.

By publishing some articles in Russian, *Russia in Global Affairs* will also take part in this project.

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RUSSIA AND THE WEST

The Energy Factor

Vladimir Milov¹

Russia and the West in the General Global Energy Environment

In a rapidly globalizing world, relations between Russia and the West in the energy area cannot be separated from the general global context. This context, in turn, is characterized by a growing global energy-resource imbalance: twelve of the world's countries (members of the Organization of the Petroleum Exporting Countries, or OPEC, and Russia), while producing only 6.5 percent of the global nominal gross domestic product (GDP),² control more than 80 percent of the total global proven oil and gas reserves; and countries that produce more than three-quarters of the global GDP (members of the Organization for Economic Cooperation and Development, or OECD, China, and India), control only about 10 percent of the total global proven oil and gas reserves.

Oil and gas reserves of the OECD countries are rapidly depleting, which underscores the remarkable growing energy-import dependence of OECD member states. By 2030, according to projections by the International Energy Agency (IEA),³ 65 percent of OECD oil consumption will be imported (from 49 percent in OECD North America to as much as 75 percent in OECD Europe and 93 percent in OECD Pacific). Gas consumption presents a similar picture: by 2030 the OECD will import about 40 percent of gas, ranging from 16 percent in OECD North America to 53 percent in OECD Pacific and 63 percent in OECD Europe.

The above figures are important because, by all reasonable forecasts, oil and gas will continue to dominate the global and OECD energy mix in the foreseeable future—even with accelerated development of alternative energy sources. Under the IEA's reference case projections, by 2030, the share of oil and gas in the global primary energy mix will be about 56 percent.⁴ The main

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² International Monetary Fund, World Economic Outlook Database, April 2008: Nominal GDP list of countries, data for 2007.

³ Organization for Economic Cooperation and Development (OECD), International Energy Agency (IEA), *World Energy Outlook 2007: China and India Insights* (Paris: OECD/IEA, 2007), chapters 16 and 17 (reference scenarios).

⁴ Ibid.

problem in the development of alternative energy sources is finding an alternative for oil consumption in transport, suitable for massive-scale use. Whereas the OECD countries dramatically reduced the share of oil in the power generation mix after the Arab oil embargo of the 1970s (the share of oil in the power generation mix of the OECD countries fell from more than 25 percent in 1973 to less than 5 percent at present, according to the IEA), transport still remains fundamentally dependent on oil, with no viable large-scale alternatives in sight.

Gas is also considered an attractive alternative to other traditional power generation sources, particularly from an environmental point of view. This is why gas consumption is expected to grow, and according to IEA projections, the share of gas in the global energy mix will grow from the present 20.5 percent to around 22.6 percent in 2020. However, unlike coal, the reserves of which are distributed around the globe more or less evenly, proven gas reserves are largely concentrated in Russia and the OPEC countries (which control more than 75 percent of total global proven gas reserves).

This situation underscores the increasing role of “global energy inequality” as a factor in international relations: the growing energy-resource imbalance strengthens the political weight of the dozen energy-rich countries (OPEC plus Russia), whereas the international positions of the Western countries are fundamentally weakened by their growing energy-import dependence.

What makes the situation an even bigger concern is the fact that energy-rich countries are either nondemocratic (Middle East countries) or becoming increasingly authoritarian (Venezuela and Russia). Political leaders of these countries seem to be interested in protecting their borders from the influence of Western-style democracy and, potentially, in using their energy resources as a “power currency” to increase their international influence and to challenge the current global leadership of the democratic Western nations.

The use of energy resources as power currency has become increasingly possible, as the recent period of sustainable high energy prices has contributed to the amazing economic growth of the energy-rich economies, enabling the leaders of these countries more opportunities for global influence backed by remarkably strong economic performance. Indeed, the nondemocratic energy-rich countries could become an important source of opposition to the international influence of the Western democratic model, and their energy resources could provide them with the tools to back it up.

The increasing potential of a global “values conflict” fueled by “energy inequality” is one of the important factors that could adversely affect international politics in the coming years. Also, competition for energy resources among energy-importing countries, which include not only the democratic West but also nondemocratic China, an increasingly important global energy consumer and importer, should not be discounted. China has been gaining a slight competitive advantage over the West in the competition for energy resources, through broader tolerance of authoritarianism and human rights abuses in some energy-producing countries like Sudan or Central Asia, but is also offering energy-rich countries an attractive alternative to the Western

markets—an ability to attract energy investments and sell energy resources without being questioned on democracy and human rights issues.⁵

This conflict may not necessarily take open forms, such as the Arab oil embargo of the 1970s. After that embargo, the Western countries managed to develop effective measures for self-protection from the risks of short-term energy-supply disruptions (in the form of strategic oil stocks, which may possibly be followed by development of strategic natural gas stocks). This system enables Western countries to largely survive disruptions of supplies for a period up to three months and possibly even longer. In such an environment, “short energy wars” simply do not work, and energy producers have to wage a well-coordinated and long-term “energy war” on energy importers to be able to achieve major political goals. Spontaneous energy embargos may create shocks, but they will not lead to catastrophic consequences.

Also, the ability of energy-rich countries to act in a coordinated manner to execute some form of energy embargo of the West is highly questionable, plagued as they are by the risks of free-ridership and the severe lack of political trust among some of the leading players. (This factor could prevent the possibility of the emergence of a full-scale future strategic partnership between Russia and Saudi-led OPEC, despite common interests and development trends.)

Therefore, the probability of a large-scale, open energy conflict between energy-rich and energy-importing countries remains insignificant; nevertheless, a general “values gap” between these countries admittedly continues—and most definitely will affect the spirit of relations among energy-exporting and energy-importing nations. Energy-rich countries, interested in defending their nondemocratic regimes and in expanding their international influence, will be tempted to play the “energy card” as a tool for achieving these goals; energy-import-dependent countries will be naturally inclined toward using some forms of “defensive” approaches in international energy relations to protect themselves from the risks of dependence on OPEC countries and Russia.

Another factor that has become increasingly important in international energy relations is the rise of “resource nationalism” among energy-rich nations. Backed by the rhetoric of “using the nations’ resources for the benefit of their own people,” governments of energy-rich countries have been pursuing policies focused on nationalizing oil and gas assets, limiting the access of international companies, and providing clear competitive advantages to state-backed energy companies—the so-called national champions.

Although this trend is explained by the need to share more revenues from oil and gas production with the nation, in reality this is not necessarily true, as in the case of Russia (where, for instance, state-owned Gazprom had in 2007 paid about \$7.3 in taxes per barrel of oil equivalent produced, as compared with \$31 to \$34 by private companies Lukoil and TNK-BP; in March 2008, Finance

⁵ Flynt Leverett and Pierre Noel, “The New Axis of Oil,” *National Interest* (July 2006).

Minister Aleksey Kudrin announced \$4 billion in tax cuts for the oil industry for 2009,⁶ immediately after the renationalization of the private oil company Yukos was accomplished).

Resource nationalism creates a very unfavorable atmosphere for cooperation with energy-import-dependent nations, as conflicts between national champions representing energy-rich nations and the international oil and gas majors are becoming routine, adding tensions to intergovernmental relations. Access to resources is given in a totally nontransparent, arbitrary, and politically charged manner, which does not help energy relations between exporting and importing countries. For instance, the geography of countries whose companies recently managed to achieve some form of access to development of Russian oil and gas resources (Germany, Italy, France) suggests that this arbitrary “access granting” appears to be in line with Moscow’s circle of West European allies, whereas companies from countries not considered “allies” have been denied access to such development (like the acquisition of Right Bank block at the North Astrakhanskoye gas field in North Caspian by Naftogaz Ukrainy, which was agreed on by Prime Minister Victor Yanukovich of Ukraine and Gazprom but was terminated amid interference by President Vladimir Putin of Russia).

These two factors—international politics and access to resources—may not be fully connected in the Russian case, but there is definitely a trend that cannot be ignored: companies representing countries that have good relations with Russia have some prospects of expanding business in Russia, whereas those representing countries in more hostile relations with Russia seem to lack such prospects.

An inevitable consequence of “resource nationalism” is the emergence of new wave of counter-protectionism among the Western countries. They are looking for ways to diversify energy supply sources, thus minimizing dependence on certain suppliers like the Middle East or Russia (even if such diversification may impose additional costs) and discussing the new formal and informal mechanisms of protecting the domestic energy assets from acquisitions by companies and sovereign wealth funds of the energy-rich countries. An example of counter-protectionism directly affecting Russian interests is the “reciprocity clause” proposed in September 2007 by the European Commission as part of the third energy liberalization package (this clause limits the ability of the non-EU countries to acquire the EU’s energy grids).

Both “resource nationalism” of energy-rich countries and counter-protectionism of energy-importing countries are counterproductive from an economic point of view, as they impose significant extra costs on both sides (related to building expensive country-bypassing oil and gas pipelines, turning to more expensive alternative suppliers, preventing much-needed investment deals on geopolitical concern grounds). Yet on the other hand, they are apparently inevitable, considering the lack of political trust described above.

⁶ “Oil Extraction Tax Will Not Be Imposed since 2009 on Oil Priced below \$15—A. Kudrin,” PRIME-TASS, March 25, 2008.

All the above emphasizes the risk of significant uneasiness in energy and political relations between the West and some energy-rich countries for decades to come.

Energy relations between Russia and the West project the same global picture on a smaller scale. Although Russia is not yet a global energy supplier (almost 100 percent of the Russian oil and gas are exported to the regional market, Europe, with a lack of physical infrastructure preventing any maneuver), it plays a significant role on the European energy market. Currently Russia supplies about 45 percent of the EU-27 consumption of oil (including refined products) and about 30 percent of the EU-27 consumption of natural gas.

Europe will remain central to Russia's energy market. The possibility of large-scale energy trade between Russia and the United States remains low, at least for the coming decade. Gazprom, the dominant player in the Russian gas market, is quite inactive in development of liquefied natural gas (LNG) supplies. Recently, the Baltic LNG project was canceled; the development of the Shtokman LNG production will probably be delayed by the complexities of the Shtokman project itself. Other far more long-standing LNG opportunities, confronted by multiple challenges and strongly opposed by the well-developed "pipeline construction" lobby inside Gazprom, will not be developed within the coming decade.

It is also hard to imagine Russia's diverting its energy supplies toward China on a large scale within the next 10 years: oil supplies from Russia will be most likely limited to 600,000 barrels a day from 2010, as envisaged by the Sino-Russian agreement of 2001, and the project of gas pipeline from Western Siberia to China apparently seems to be dead, having lost the competition to the planned Turkmenistan-China pipeline (that project seems to be moving forward, with gas supplies scheduled to begin in 2009). China actually does not need two 30 billion-cubic-meter (bcm) gas pipelines from the coming decade, as the projections for net imports of natural gas are quite moderate. According to IEA, Chinese net natural gas imports, just 27 bcm per year by 2015 and 56 bcm per year by 2030, would still constitute only one third of domestic gas consumption,⁷ with two thirds supplied by domestic sources.

Therefore, the European market will remain the center of energy relations between Russia and the West. In Europe, Russian energy influence will only increase further, as it expands its supply volumes, substituting the declining indigenous energy production of the EU countries. Apart from controlling oil and gas supplies to the currently served markets (South-Eastern and Central Europe), Russian companies will find their way to supply new regional markets like North-Western Europe, which at present receives only a very limited amount of Russian energy. This is an inevitable consequence of the decline of indigenous gas production in the North Sea, and Russia takes notice of that perspective: for instance, the planned Nord Stream gas pipeline was designed specifically to substitute declining North Sea gas production with new Russian gas deliveries to North-Western Europe.

⁷ Organization for Economic Cooperation and Development (OECD), International Energy Agency (IEA), *World Energy Outlook 2006* (Paris: OECD/IEA, 2006).

These developments mark a significant change in the scale of Russia's presence, compared with the construction of gas pipelines from the Soviet Union to Western Europe in the 1980s. Many analysts refer to that past as a historic example of "positive practical engagement" with Russia, which had proven productive in spite of U.S. opposition in the 1980s. Some experts tend to use this example as "proof" that Russia has always been a reliable energy partner.

However, the old story is not relevant anymore. In the 1980s, the Soviet Union was not looking at construction of the large-scale gas pipeline infrastructure to Western Europe as a tool of establishing economic and political domination in Europe (limited supplies made this simply unachievable). Rather it was seeking effective monetization of its newly discovered and developed natural gas reserves. In this respect, despite open political confrontation between the Soviet Union and the West, the USSR was motivated to maintain smooth relationships in the area of energy supplies as much as possible.

Besides, the majority of the European countries currently dependent on Russian gas are the East European nations, which, during the 1980s, were members of the Communist bloc; Europe's extreme energy dependence on Russia is thus a relatively new development emerging after the USSR's collapse.

If construction of Soviet gas pipelines to Western Europe in the 1980s is considered a relatively small-scale market entry, today's plans for construction of the new gas pipeline infrastructure from Russia may rather be viewed as the expansion of an already significant market share. The two situations are in no way comparable.

In addition, Russian energy companies are actively trying to expand their role in the European energy market beyond being simply wholesale exporters of energy. Attempts are being made to establish a serious presence in the European downstream energy market through acquisitions of energy distribution assets and important infrastructure, such as the UK Interconnector and Dutch BBL gas pipelines or the Austrian Baumgarten underground gas storage complex. Gazprom is discussing the possibilities of establishing control over incoming energy flows to Europe from other sources beyond Russia, negotiating LNG swap deals with Qatargas, and participating in the construction of a new gas pipeline from Libya to Italy.⁸

The Russian energy presence in the European energy market is inevitably set to become increasingly more pervasive. The developing "energy grip" over Europe is characterized by growing asymmetry: while the EU is discussing further liberalization of its energy markets and privatization of energy companies, the Russian government nationalizes control over energy resources, limits opportunity for foreign investment in its energy sector, and widely uses state powers to back up the commercial interests of state-linked energy companies.

⁸ "Gazprom and Eni Plan Gas Pipeline in Libya," *New York Times*, April 9, 2008.

Is such an environment a stage for cooperation or confrontation? In any case, given the resource gap, it obviously risks creating a strong imbalance in competitiveness between Europe and Russia in the energy area.

Who knows how Russia will use its fundamental and newly gained competitive advantages? There are risks that cannot be easily ignored. During recent years, a particularly disturbing factor had been Russia's increased use of energy as a tool for achieving foreign policy goals.

Some experts claim that certain actions toward Russia's nearest neighbors have been driven solely by justified economic considerations—e.g., the desire to increase energy export price levels to international standards. However, a closer look at the geographical aspects of energy conflicts, as well as careful analysis not only of the price rhetoric of the Russian representatives but of multiple incidents with political implications, suggests that far more than price issues are involved. The incidents include the following:

- permanent tension in gas relations with Ukraine over issues that go beyond the level of gas prices—public accusations of Ukraine's "stealing" of Russian gas from storages and pipelines (never proven true, with some of these accusations clearly proven false), or gas cutoffs that follow the emergence of relatively insignificant and controversial debts and correlate surprisingly highly with government changes in Ukraine;
- complete shutdown of oil supply to Lithuania after the Lithuanian Mazeikiu Nafta refinery is sold to a Polish company rather than to Russian bidders;
- refusal to build the initially planned second line of Yamal-Europe gas pipeline through Poland, substituting it with the Nord Stream gas pipeline via the Baltic Sea, which turns out to be at least five times more expensive in capital costs and about one-and-a-half times more expensive in terms of the gas transportation tariff.

These conflicts do not necessarily involve price disputes; in fact, in most cases prices are not involved at all. Needless to say, all the energy conflicts with neighboring countries took place against the background of certain negative political developments—victory of the orange revolution in Ukraine, appointment of the pro-western Yuliya Tymoshenko as Ukrainian prime minister, the sale of Lithuanian refinery to the competitors of the Russian companies, EU and NATO accession of Poland and the Baltic states, and support by Poland and Lithuania for the Ukrainian orange revolution.

Generally, those experts who suggest that Russia is only "pursuing its legitimate economic interests" in energy relations with neighboring countries fail to analyze the complex nature of Russia's energy relations with these countries, focusing only on the analysis of public rhetoric of the Russian officials connected to the gas conflict with Ukraine of 2005–2006.

In reality, finely tuned analysis suggests that Russia is exerting permanent energy pressure on certain neighboring countries—Poland, Lithuania, Ukraine—that pursue pro-Western policies considered hostile by the Kremlin. Although Russian policies contain economic considerations as well, the political component should not be discounted.

This pressure softens when political forces considered more friendly to Moscow temporarily take precedence—in mid 2006, for instance, after the government of Victor Yanukovich, a Ukrainian politician considered in Moscow as “pro-Russian,” took over in Kyiv, Gazprom immediately agreed to keep the price of Russian gas supplies to Ukraine for the 12 months of 2007 at the level of US\$130 per trillion cubic meters (tcm); earlier, in November 2005, it had been insisting on US\$160 per tcm from January 1, 2006, and since mid December 2005, on US\$230 per tcm (failure to agree on these demands actually led to the gas supply disruption to Ukraine in January 2006).

The objectives of this “energy pressure” are not specified. The big question is whether clear objectives actually exist or whether Moscow is simply using the energy pressure on “unfriendly” countries spontaneously in a demonstration of force. However, this pressure irritates energy relations between Russia and the West for several reasons:

- the West somehow has to protect its easternmost allies from the hostile political actions of energy-supplying countries;
- although the Kremlin is demonstrably constructive and reliable in its relations with Western European energy importers, there are no guarantees that the methods used against East European nations will not be used against them on future occasions;
- deteriorating energy relations between Russia and countries like Ukraine or Poland will continue to directly affect Europe, as Europe is, and will in the long term remain, fundamentally dependent on the transit of energy resources from Russia through these countries.

Russia’s Domestic Situation and Energy Development Potential: Strategic Dilemmas and Choices

The current political situation in Russia, which is characterized by great political self-confidence, assertiveness, and strong economic growth, is surprisingly taking place against the background of multiple imbalances and uncertainties. Russia—putting aside “back-from-its-knees” rhetoric and reflecting its impressive economic recovery of its last eight years under President Vladimir Putin—still faces the same old modernization challenges that it faced in 2000. Most investments during recent years have flowed into the financial sector and nontradable services. The recent decade’s economic growth has turned out to be largely consumption-based, not modernization-based; gross capital formation as a share of GDP had remained virtually flat at around 20 percent, as compared with the 26 percent–28 percent earlier targeted by the Russian government, or with the 33 percent–43 percent of India and China.

This growth was built to a large extent on external supplies of cheap money (first, the revenues from oil and gas exports; then, the massive inflows of cheap foreign loans; and currently, the

partial release of the state's financial resources, accumulated during the first two periods, to the corporate sector). Heavy industry, the transport sector, and social infrastructure remain in deteriorated condition, requiring not only massive investments in refurbishment and development of fixed stock, but, more generally, large-scale structural and governance reforms not carried out successfully during Putin's years.

What was happening in Russia during 2000–2008, apart from the effect of the low-base recovery growth, was the development of a “supermarket economy” driven by growing domestic consumption fueled by cheap money inflows from the outside. This development model is vulnerable: the sectors currently driving the country's economic development—largely nontradable services—produce goods whose demand may rapidly decline if the sources of cheap money fueling the consumption boom dry up. Construction, land development, and retail trade—all consumption-related sectors—will experience major troubles if the sources of funding disappear. However, at present these sectors are key to advancing the country's economic growth: in 2007, when Russia's GDP grew by an impressive 8.1 percent, the largest contributors to value-added growth were construction (16.4 percent) and trade (12.9 percent), with their total share in the country's GDP reaching 26 percent (together with real estate operations, 36 percent), as opposed to the quite modest growth in manufacturing industries (7.4 percent) and mineral extraction industries (0.3 percent).⁹

This picture is in some ways similar to the late Soviet years, when the economy had been growing at nominally high rates, but a substantial part of the growth was associated with the increased production of goods and services not really in demand. Although the present situation is not exactly the same, the growth in consumption-related sectors is unsupported by the increasing competitiveness of domestic manufacturing industries, which have led to surging imports and the shrinking current account balance surplus (still maintained only by constantly growing international energy prices). Whereas the country's GDP increased by 71 percent in 2007 as compared with 1999 and output in mineral extraction industries and manufacturing industries by 47.4 percent and 65.2 percent respectively, retail trade increased by 5.8 times in dollar terms, from US\$73 billion in 1999 to US\$421 billion in 2007! Most of the growth in consumption was based on imported goods and technologies. Non-competitiveness in imported goods is true not only for consumption-related sectors, but for energy-related manufacturing as well: for instance, it is supposed that most of the equipment and materials used in construction of the Nord Stream gas pipeline will be imported.¹⁰

The only factor that allows most analysts to be quite relaxed about the future of the Russian economy is the significant financial reserve accumulated by the authorities (around US\$700 billion accumulated in the form of Central Bank hard-currency reserves and the Finance

⁹ Data from the Russian Federal State Statistics Service, <http://www.gks.ru/wps/portal/english>.

¹⁰ See “All Brought from Europe,” *Vedomosti*, February 19, 2008.

Ministry's Stabilization Fund), which seems to be the only source of the country's future sustainability in the medium term.

This picture suggests a very clear formula describing Vladimir Putin's political legacy: during the eight years of his rule, Russia has prospered financially, but deteriorated physically. Russia needs modernization now more desperately than before, but the authoritarian and wealth-focused political system built during the recent several years lacks the flexibility and dynamism required to address the important modernization challenges faced by the country.

The same is true in the energy sector: whereas Gazprom has been increasing its market capitalization and expanding internationally, domestic gas production has been stagnating, the dependence on Central Asian gas imports has been growing, and the delayed investments in development of new greenfield gas-producing regions (Yamal Peninsula, Arctic offshore) have created a real risk of significantly declining gas production in the coming years.

In the oil sector, which had been substantially rebuilt by private companies from 2000 to 2004, when the capital investments in upstream production averaged at above US\$6 billion a year and average oil well productivity increased by more than a third, the ongoing redistribution of assets in favor of state companies has brought about production stagnation. In 2000–2004, average crude oil output growth reached as high as 8.5 percent, while in 2007 it was brought down to zero if not accounting for the growth of crude oil output by two foreign-led projects—Sakhalin-1 and Salym.¹¹ Since peaking in October 2007 at the level of 9.94 million barrels per day, Russian average daily crude oil output has been steadily declining, bottoming out at a 20-month low, or 9.75 million barrels per day. Considering the bleak upstream capital investment perspectives, this may be an early sign of the beginning of a full-scale freefall of Russian oil production.

This freefall is happening in place of what could have been continuing modest growth, but decline inevitably resulted from the typical “resource nationalism” policies of recent years—partial re-nationalization of the oil industry and limiting access to development of oil and gas upstream for foreign investors.

Re-nationalization of oil and gas assets came at a price: the total debt of state oil and gas companies, Gazprom and Rosneft, totaled more than US\$85 billion after 9 months in 2007, seriously complicating the ability of these companies to invest in new projects. At the same time, new investments required to develop a full-scale industrial base at the Yamal Peninsula are considered to be huge—in June 2008, Gazprom announced that construction costs alone for the Bovanenkovo-Ukhta gas pipeline from Yamal Peninsula are estimated at US\$80–90 billion, which pushes the total Yamal Peninsula fields development budget potentially as high as US\$200 billion (total investments were estimated in 2002 at US\$45 billion). Investments required for

¹¹ The Sakhalin-1 project is operated by an ExxonMobil-led consortium and the Salym project by a Shell-led consortium. Russian crude oil output in 2007 nominally grew by 2.3 percent; without accounting output growth at the Sakhalin-1 and Salym projects, it grew by only 0.06 percent.

development of the Shtokman gas field in the Arctic offshore are estimated at around US\$20 billion, with the actual figure probably turning out to be substantially higher.

Who would invest that money? Russian state companies are plagued with huge debts acquired during the controversial and corrupt re-nationalization process, and private companies prefer not to invest, being exposed to risk of further asset expropriation. For instance, oil company TNK-BP in the first half of 2007 had spent about 80 percent of its net earnings on dividends rather than capital expenditures; the other oil company, Surgutneftegaz, which is linked to the Kremlin by some analysts, had long since accumulated about US\$20 billion in cash—not invested anywhere and presumably kept for financing an upcoming major merger with one of the state companies.

It is not just the source of investment: Russian companies fundamentally lack expertise of working in oil and gas offshore (the national oil and gas upstream development tradition was built around development of the continental fields, unlike the Western companies who have been gaining experience over decades in the North Sea or in the Gulf of Mexico). They have not developed a major new greenfield in more than two decades.

At the same time, the rise of “resource nationalism” and the limiting of direct foreign investments in Russian oil and gas upstream prevent foreign companies from coming in. Even the announced upstream partnerships with foreign companies largely have not delivered any positive results. The upstream deal with E.ON-Ruhrgas still has not gone through, despite years of negotiations. Prospects for development of ex-Yukos gas assets acquired by Italian ENI/Enel consortium in the spring of 2007 are yet unclear; so far, the consortium has been forced to shut down gas production because of lack of access to Gazprom’s pipelines, and managers of the consortium are expecting gas supplies from the field no earlier than 2010.

Another story of concern is the development of Shtokman gas field in the Barents sea. Despite the triumphant remarks of Russian and Gazprom officials on the “end” of the tedious process of foreign partner selection for field development (in the fall of 2007, Total and StatoilHydro were selected as Gazprom’s partners in the development of Shtokman), multiple challenges remain unresolved, with several important factors having the potential to actually block the effective development of Shtokman. These issues include the following:

- the scheme of gas commercialization and revenue-sharing (Shtokman Development Company, or SDC, which will be co-owned by Gazprom and its foreign counterparts, will not be the owner of the produced gas, and, under Russian legislation, the compensation for services to be provided by SDC during field development should be only cost-based);
- field development scheme and technical solutions (Gazprom has already been unilaterally approving the technical schemes of field development and placing orders at Russian factories for the manufacturing of platforms for Shtokman—before even discussing these issues with foreign partners);

- the extent of control over the project that Gazprom would be willing (or unwilling) to share in return for the expected significant financial contributions from Total and StatoilHydro.

With Gazprom's inclination toward total domination over decisionmaking as well as unilateral and non-transparent decisions occurring in the context of severe differences of opinion on technological and revenue-sharing solutions, certain problems may arise in further negotiations on the project implementation scheme. It should be noted that the agreements signed so far between Gazprom, Total, and StatoilHydro are preliminary and not particularly legally binding.

Given the challenges lying ahead of the also preliminary cooperation scheme, it is reasonable to expect that some foreign partners may yet withdraw from the complicated Shtokman project in the future, as happened with the BHP Billiton's withdrawal from joint participation with Gazprom in developing the Prirazlomnoye Arctic offshore field several years ago.

Generally, the redistribution of property in favor of state-affiliated companies, backed by arbitrary use of the government's regulatory powers in favor of "national champions," has delivered a strong institutional blow to the long-term investment climate in capital-consuming sectors—particularly the energy sector. It is a big question whether in the coming decade Russia will be able to cope with the possible decline in oil and gas output. If present policies, focused on monopolization of the strategic industries and ownership redistribution rather than investment, continue, the decade of energy production stagnation (and/or decline) may turn into a longer period.

This raises another question: under such circumstances, can Russia be reliably counted on as a source of additional oil and gas supplies in the future?

It appears that a positive answer depends on whether Russia will be able to switch from the present short-term opportunistic policies to a more responsible and forward looking energy agenda. However, Russia would have to significantly reconsider its current positions and change its "energy egoism" approach, based on re-nationalization and closing doors for foreign investors, into something totally opposite—market opening, competition, and encouragement of direct foreign investments. "Energy egoism does not pay back," wrote President Vladimir Putin in his 2006 article in the *Wall Street Journal*.¹² Indeed it is hard to disagree. The present is a time of testing for Russia—will it be able to resist the temptation of resource nationalism, or "energy egoism"?

As for consequences, thus far the Russian authorities seem quite relaxed about the potential decline in oil and gas output. First, they are used to the traditional Soviet economics of scarcity and are already returning to the old practice of rationing domestic energy demand to maintain the balance between energy supply and demand. Massive planned power and gas supply cuts to domestic consumers have already occurred during several recent cold winters with peak energy

¹² Vladimir Putin, "Energy Egoism Is a Road to Nowhere," *Wall Street Journal*, February 28, 2006.

deficits. This practice is about to receive direct legislative support: in November 2007, a well-known lobbyist of Gazprom, State Duma member Valery Yazev, introduced a draft amendment to the Russian gas supply law, enabling the government to introduce mandatory gas supply cuts for domestic gas consumers “in the periods of cold temperatures of the autumn and winter season.”¹³ Nationalization brings back not only planned economics, but also the scarcity that goes with it.

Russia’s ability to limit energy exports to meet domestic demand is less likely in the longer term, because the government’s strategic priority appears to be ensuring the stability of export supplies.¹⁴ This is why, for instance, government had been pursuing policies of replacing cheap gas at the domestic market with more expensive coal and imported uranium—extra gas volumes were needed for exports. However, limiting energy exports to meet extra domestic demand is likely to happen spontaneously in the periods of peak winter energy deficits, as happened in January-February 2006 during weeks of cold temperatures all over Russia and Europe. But Russian authorities apparently believe that they will be able to get away with relatively small sanctions for peak non-delivery.

At present in Russia, it appears that responsible behavior is losing the policy battle to the temptation of resource nationalism (“energy egoism”) and forward-looking development strategy to opportunistic behavior. This is bad news for both Russian society and the international community. This situation may only change as a result of the country’s full-scale democratization and transfer of power to a more responsible government. How and when such a situation could occur is a topic that goes beyond the scope of this paper.

Until then, domestic developments in Russia will most likely prevent the country’s ability to contribute positively to its international energy profile. Energy production could deteriorate from the lack of modernization; an asymmetric approach to energy policies and a leaning toward “energy egoism” would raise suspicions among Western energy consumers about Russia’s intentions to establish control over Western energy markets. The shadowy presence of a political component in energy relations with foreign countries would fuel those suspicions and does not rule out certain energy-related conflicts.

Is There Room for a Positive Agenda in Energy Relations with the West?

¹³ Russian State Duma, draft amendments to Article 18 of the Federal Law “On Natural Gas Supply,” draft law no. 493443-4.

¹⁴ This is even reflected in the legal documents—for instance, article 19 of the Gas Supply Rules (approved by the Resolution of the Russian Government no. 162 of February 5, 1998, and still valid at present), which suggests that gas export supplies have priority when the limited gas volumes are distributed among consumers during periods of gas deficit.

The main problem in relations between Russia and the West (not only in the energy area, but much more broadly) is Russia's lack of motivation to engage with the West.

Russia's self-confidence, driven by its recent economic successes and their extrapolations for future decades, creates a political atmosphere in which it is increasingly difficult or even impossible to promote the ideas of mutual engagement and cooperation with the West. The West is largely seen by the Russian elites and society as a competitor from many points of view (importantly, the Western liberal democracy model is seen as a competing model with "putinism"), and many in Russia take a hostile view of the West on historic and political philosophy grounds. Because the country's financial strength (mostly materialized in the form of the state's financial reserves) enables Russia to pursue policies often unfriendly to the interests of the Western countries, the country happily makes the choice to do so.

Such policies are not necessarily hostile; but it is important to understand that the appreciation of the state's financial capabilities in Russia is currently so strong (to a large extent risking a significant overestimation) that it is very difficult to explain to a Russian why the country should take account of Western interests and engage the West in some binding cooperation as long as Russia's strength enables it to act with full independence. In some sense, a kind of allergy to any kind of long-term partnership has developed in Russia, driven by such appreciation of Russia's newly developed financial strength.

Such "engagement allergy" creates a risky environment. Although some experts may be right in saying that Russia has no fundamental interests in confrontation with the West, unpredictable and controversial moves from the Russian side cannot be ruled out, whereas finding fundamental solutions in form of long-term binding mutual agreements may be difficult.

In addition, the present Russian authorities have a fundamental reluctance to participate, for instance, in some legally binding international agreements, as they are believed to limit the "freedom of maneuver" for the authorities in certain cases. This was a major reason that Russia was reluctant to ratify the Energy Charter Treaty, or ECT (although there were other circumstances, including the treaty's weaknesses).¹⁵

Importantly, despite the legal background of many officials representing Vladimir Putin's administration, including the newly elected president Dmitri Medvedev, this administration during the previous eight years had done a remarkably strong job of destroying the country's legal institutions and the very principle of the rule of law in favor of the full-scale domination of informal mechanisms of governance.

For instance, draft legislation limiting the presence of foreign investors in Russia's energy sector has still not been adopted, despite years of discussions. At the same time, all foreign energy investors are well aware of the fact that, if they want to work in Russia, they have to get

¹⁵ For more details, see Vladimir Milov, "Russia-EU Energy Dialog: Filling a Vacuum," *Russia in Global Affairs*, no. 4 (October-December 2007).

“informal approval” from the Russian authorities for any major bids or acquisitions. Despite the fact that the demand to obtain such an “approval” is not specified in any formal law, everyone understands that, without getting it, operations in the country would be impossible.

Considering the opportunistic instincts and severe lack of institutionalism in the approaches of the current Russian administration, it is very hard to imagine that Russia would suddenly wish to join any long-term, comprehensive, legally binding international agreements in the area of energy. Realistically, Russia would continue to prefer opportunistic behavior.

In addition, the West generally lacks both ideas and effective tools for pushing Russia toward positive mutual engagement in the energy area. First, the interests of Western Europe and the United States in energy relations with Russia are split. Europe faces growing energy import dependence on Russia; for the United States, energy import dependence is generally far less a problem than for the Europeans. With no physical dependence on Russia, the United States is in a far better position to take tougher views on energy relations between the West and Russia than the obviously more vulnerable Europeans.

While encouraging Europe to diversify its sources of energy imports and minimize its energy dependence on Russia, the United States directly (and successfully) competes with Europe in capturing the long-term supplies of LNG originating from the Middle East, Africa, and other regions and contains the development of European energy cooperation with Iran, a major potential alternative source of gas supplies.

The European Union’s interests and approaches toward Russia are strongly divided. This division is objectively rooted in EU energy dependence while also reflecting a more general split in the EU’s political views on relations with Russia. For instance, the recent report by the European Council on Foreign Relations¹⁶ suggests that the EU is split between two approaches—one views Russia as a potential partner that can be drawn into the EU’s orbit through a process of “creeping integration” and the other sees Russia as a threat and suggests that Russian expansionism and contempt for democracy must be rolled back through a policy of “soft containment.” (The report also suggests an interesting and more detailed division of EU member states by policy approaches to Russia into five distinctive groups—“Trojan Horses,” “Strategic Partners,” “Friendly Pragmatists,” “Frosty Pragmatists,” and “New Cold Warriors.”)

The division of interests and approaches is compounded by the lack of effectively coordinated EU energy policy (as opposed to policies in other areas, like common monetary or competition policies). To overcome this would be a hard matter, given that most of the EU member states view energy policy issues as critical for national security and the economy and would have a tough time sharing any sovereignty over decisionmaking with Brussels.

¹⁶ Mark Leonard and Nicu Popescu, *A Power Audit of EU-Russia Relations* (London: European Council on Foreign Relations, November 2007).

There is also one other fundamental question that should be addressed to the West (and, particularly, Europe) with regard to building sustainable energy relations with Russia: what has the West to offer as a model for such relationships? Does it have a systemic vision of the “road map” for effective energy engagement with Russia?

Apparently, the answer is no. When it comes to discussing the specifics of Russia’s energy engagement, most Western politicians and experts refer to the need for Russia to ratify the Energy Charter Treaty. However, this quite outdated and irrelevant document can hardly be a basis for sustainable energy relations between Russia and Europe; in fact, it is not particularly respected by the European Union itself. In each of the two EU green papers on energy security, dated 2001 and 2006,¹⁷ the ECT is mentioned only once with regard to the need to ensure that its provisions are implemented in the “applicant countries and NIS states.” Therefore, the European Commission had traditionally largely viewed ECT as a document intended for use outside the EU’s borders.

Such an approach, for instance, is reflected in the suggested “regional integration clause,” or Article 20 of the draft Transit Protocol,¹⁸ which was suggested and pushed by the EU. This clause de facto suggests that EU countries should be exempt from the rules of the Transit Protocol, and the protocol rules shall be applied directly only to the non-EU states. This is clearly a double standard from the EU side, which had diverted away the support of the Russian ECT ratification by those in Russia who had initially supported such ratification. Now, with the EU’s lobbying of the “regional integration clause,” hardly a single Russian politician would defend the idea of Russian ratification of the ECT.

Although European politicians have voiced the idea of new comprehensive energy agreement (“energy pact”) between the EU and Russia, one meant to replace the outdated Energy Charter Treaty, no one had really suggested anything practical in this regard. Considering the heated debate currently going on within the EU on Europe’s own energy policy approaches, it would be hard to imagine that Europeans would come up with some well-developed ideas on an energy pact with Russia.

Recent European energy policy documents, for instance, suggest very little on the matter except some very general words. For instance, *Green Paper: A European Strategy for Sustainable, Competitive and Secure Energy*,¹⁹ released in 2006, briefly mentions the need to establish a “new energy partnership with Russia” without really mentioning what is seen as the substance and principles of the partnership. Further communication from the European Commission suggests

¹⁷ European Commission, *Green Paper: Towards a European Strategy for the Security of Energy Supply* (Luxembourg: Office for Official Publications of the European Communities, 2001), and *Green Paper: A European Strategy for Sustainable, Competitive and Secure Energy* (Luxembourg: Office for Official Publications of the European Communities, 2006).

¹⁸ Article 20, “Regional Economic Integration Organization,” of the draft Transit Protocol to the Energy Charter Treaty provides a de facto exemption from the Protocol rules for the countries establishing a Regional Economic Integration Organization, de facto, for the EU member states.

¹⁹ European Commission, March 8, 2006.

only a single, very general statement on Russia: “Enhancing relations with Russia through the negotiation of a new robust, comprehensive framework agreement, including a fully-fledged energy partnership benefiting both sides and that creates the conditions necessary for new investments.”²⁰

Nothing really seems to be behind these general statements.

Besides, a severe “energy policy approach gap” exists between Russia and Europe: while Russia is to an increasing extent shifting toward resource nationalist policies, nationalization, and protectionism, the European Commission is pursuing a policy agenda targeted at liberalization and the opening of energy markets; such a policy imbalance clearly creates a competitive advantage for the national Russian energy companies supported by the authorities.

Do the Europeans facing this imbalance have leverage to respond to the potential crises in energy relations with Russia? Currently it seems they really do not. The “energy interdependence” rhetoric, which can be heard from Europe and is meant to suggest to Moscow an idea that the West has certain tools of “energy response” to Russia, in reality bothers the Kremlin very little. Although Russia receives almost 100 percent of its energy export revenues from the West, it is quite obvious that “interdependence” may work to the point where the resource importers know how to convert it into a real political strength. When the importers have no idea how to do this, “interdependence” just does not work, giving way to outright dependence of consumers on the supplier of a limited resource.

For instance, a coordinated effort by European countries to stop paying Moscow for energy imports seems virtually impossible. Diversification of energy import sources is more likely, but only to a limited extent. Russian leaders are well aware of the advantages delivered by the possession of a limited and highly demanded resource; also, Russia has an important short-term risk protection safety pillar in the government’s accumulated financial resources, the role of which is in some sense similar to the strategic oil stock of the oil-importing countries.

All the rhetoric about “energy interdependence” thus remains mostly virtual, and Russia in reality has much stronger set of tools of market (and, therefore, political) influence on the West as energy supplier, than the West has on Russia as a major energy consumer.

The fact is, however, that Russia—its current financial reserves notwithstanding—cannot afford to engage in an ongoing full-scale confrontation with the West; Russia needs a sustainable stream of export revenues, and it has no practical reasons to pursue such a confrontation.

Some also argue that the West should simply drop the “out-of-date” value-based approach in relations with Russia, focusing on pragmatic aspects of cooperation in energy and other areas and abandoning initial hopes for Russia’s democratization. This would, as proponents of such approach argue, “engage Russia” by removing controversial issues from the mutual agenda and

²⁰ Communication from the European Commission to the European Council and the European Parliament, “An Energy Policy for Europe,” Brussels, January 10, 2007.

give overall relations a positive direction with support for Russia's practical initiatives (e.g., certain oil and gas investment deals or pipeline projects).

There are, however, several problems associated with this “pragmatic” approach. First, it does not make the fundamental risks disappear, and Russia may yet deliver certain unexpected, and sometimes quite unpleasant, surprises (for example, continuing incidents in energy relations between Russia and its nearest European neighbors, such as Ukraine, Poland, or the Baltic countries). A soft “pragmatic” approach does not suggest a solution for these critical situations.

Second, this approach will always be challenged by rigorists and “hardliners” in the West, who will demand a tougher approach in relations with Russia. Russia will hear these voices and take caution, inevitably reacting in a defensive manner, which will prevent the “pragmatic” approach from being particularly productive. In this regard, there is no other way for the West but to take caution of the risks delivered by the current Russian model of development, which may result in a broad range of consequences—energy supply shortages from underinvestment in their development to the use of energy supplies as a tool in political conflicts (to which the West will somehow have to respond) between Russia and certain countries. Therefore, a good risk-management system in energy relations with the current Russia will be much more relevant for the West than lulling invocations about a “pragmatic” approach to energy relations with Russia.

Conclusions

The future of energy relations between Russia and the West can hardly be separated from the global energy environment described above. The recent nationalist trends in Russian politics make it very hard to imagine that Russia will abandon the tempting “energy egoism” path (egoism is traditionally central to the Russian nationalist vision of the world) as resource nationalism becomes the dominant policy trend among the group of energy-rich countries. The only event with the potential to change that attitude is the true re-democratization of Russia, followed by the transfer of power to a more internationally responsible and cooperative government. Such a scenario would give Russia and the West an opportunity to boost cross-border energy relationships by harmonizing energy policy approaches and removing barriers and to build a solid long-term energy partnership based on principles of open trade, open investment, rule of law, and de-politicization of energy relations.

Unless the foregoing scenario comes to pass (not particularly likely in the next five to ten years), the future of the relations between Russia and the West from an energy perspective can be grouped around three basic scenarios:

1. broader cooperation with involvement of new mechanisms specially developed to fit the realities of Russian resource nationalism (best case);
2. low trust cooperation without real confrontation (business as usual);
3. large-scale confrontation between Russia on energy-related subjects (worst case).

The probability of full-scale confrontation can be considered as relatively low for reasons earlier described (good preparation by the energy-import-dependent West for short supply disruptions and the unpreparedness of energy producers for long-term energy wars). Therefore, relations will be most likely built around the first and second scenarios. In any case, Europe will remain Russia's central energy export market, with high-scale geographic diversification of Russian exports highly unlikely.

The "best case" broader cooperation scenario will mean that, though fundamental differences between the West and Russia in the energy area will not disappear, both sides will manage to find a new set of cooperation mechanisms. These mechanisms would pay respect to Moscow's protectionist and nationalist energy policy approaches while ensuring, to a certain extent, long-term stability of energy supplies and access to Russian resources for international consumers. This is the scenario that, at least in words, appears to be preferable for both Western and Russian policymakers.

However, finding the way to develop this scenario would be difficult. It would be complicated by the predatory approach of Russian state-backed companies toward commercial relations and their inclination toward unilateral decisionmaking and use of government regulatory powers to support their business interests (as happens in the specific cases described above). Degrading such institutional frameworks as the rule of law in Russia would complicate international participation in the country's upstream energy projects. In this kind of environment, it will not be easy to move the partnerships forward successfully.

Another problem would be Russia's adventurist and confrontational approach toward the development of oil and gas pipeline projects. The current approach is based on attempts to build new export pipeline routes bypassing certain Eastern European and Baltic countries—like the Nord Stream and South Stream gas pipelines via the Baltic and Black Seas respectively. But this approach, as practice has shown, not only creates political tensions, but also faces the need for agreement on pipeline construction from countries in the exclusive economic marine zones through which the routes are expected to pass. In the case of Nord Stream, Estonia, Finland, and Sweden did not agree to construction of the pipeline in their exclusive economic marine zones (Estonia had rejected the idea, whereas Finland and Sweden had asked Gazprom to study alternative routes).²¹ In the case of South Stream, the irony is in the fact that the pipeline has to pass through the exclusive economic marine zones of either Ukraine or Turkey, the countries that it intends to bypass and that oppose its construction.

It would be also reasonable to expect that Russia will continuously fall into "focused" confrontation with such countries as Poland, Ukraine, the Baltics, and Georgia, and one may well expect some continuing developments in this direction. The best case scenario is thus challenged by the obvious consequences of Russia's current resource nationalist policy approach.

²¹ "Finland Tells Nord Stream to Study Alternative Routes," Reuters, January 21, 2008; "Sweden Says Application for Baltic Pipeline Incomplete," Reuters, February 12, 2008.

Most likely is the development of relations under the business-as-usual, low trust scenario, which is somewhat similar to the type of relations experienced at present. Given the differences among EU member states on policy approaches toward Russia and the objective challenges of building a common European energy policy, it would be hard to imagine that the EU would be able to suggest any effective systemic plan of development of energy relations with Russia in a currently difficult environment. More likely, it would react with non-systemic, spontaneous responses—pursuing certain alternative infrastructure projects (like the Nabucco gas pipeline) or introducing legislative measures like the aforementioned EU “reciprocity clause”—that limit the ability of non-EU companies to acquire EU’s energy grids.

In the “business-as-usual” scenario, countries will not be able to avoid significant extra costs generated by low trust and protectionism (excessive investments in alternative pipelines, development of more expensive and less reliable alternative energy supply sources). At the same time, it would be quite hard to overcome the lack of trust, given the fundamental differences in values and the growing “policy gap” (liberalization in Europe versus resource nationalism in Russia). Only the possible democratization of Russia theoretically has the potential to change the situation.

In an environment of such low trust, the wise strategy for the West would be to pursue positive ideas for energy relations with Russia. At the same time it should focus on a very specific set of practical, depoliticized risk-control measures that range from protection against energy supply disruptions to specific projects targeted at diversification of energy supply sources.