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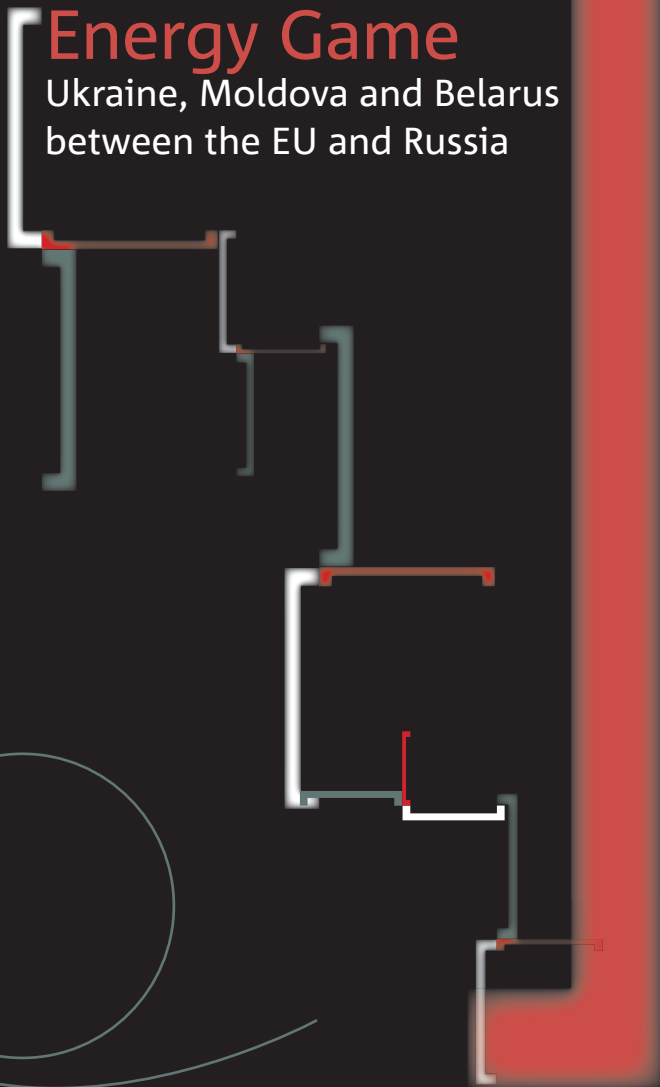
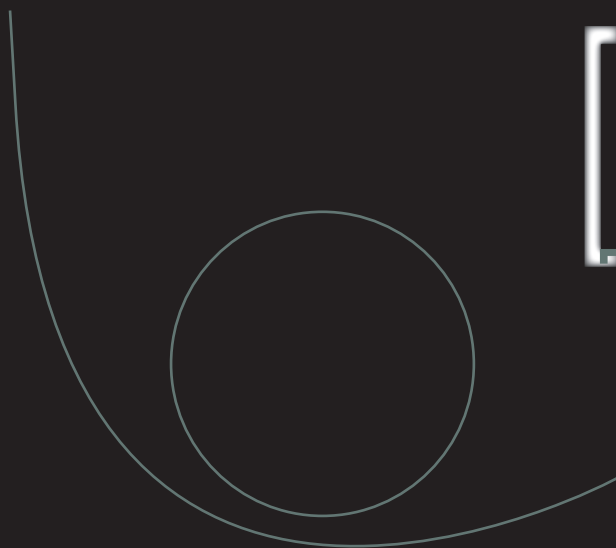


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More than Neighbours

# Energy Game

Ukraine, Moldova and Belarus  
between the EU and Russia



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# Introduction

The future of Ukraine, Moldova and Belarus, states lying between the European Union and Russia, to a large extent depends on how they resolve their energy-related problems. They are in a special situation because, on the one hand, they are the principal transit countries for Russian resources (gas and oil) that make their way to the EU market, and on the other, they greatly depend on the supplies of gas and oil from Russia, which is of key importance to them, for example because of their economies' high level of energy consumption.

Therefore, these countries must find the answer to several questions: How large should Russia's shares of their energy sectors be? To what extent should they integrate with the EU in energy matters? How long can they remain 'between' the EU and Russia?

More than a decade's experience shows that the countries between the EU and Russia find it extremely difficult to define themselves in energy matters. Often, the lack of a considered strategy can be seen, and casual benefits gained by those in power and various interest groups take precedence.

External players – Russia and the EU – are very important to the future of Ukraine, Moldova and Belarus in energy matters. For years, Russia has been striving to take control of their energy sectors. Action with that aim in mind was visible as early as the 1990s. This seems even more important

to Moscow now. The position of Russian corporations, most of which are controlled by the Kremlin, is already very strong, especially in Moldova. The fundamental question is – will Russia succeed in increasing its stake in the future?

It might be said that the EU is still not devoting its neighbours sufficient attention in energy issues. The countries are of great interest only sporadically, for example, when there are conflicts with Russia about prices of energy resources, when the continuity of supplies of gas and oil to recipients in the EU is threatened. However, it would be an over-simplification to judge the EU's actions negatively, because the EU is proposing close co-operation with those countries, and even integration with the Community's internal market. But will those proposals be implemented? What role will individual member states and corporations from EU countries play in the territory between the EU and Russia? These are just some of the questions that need to be asked.

Certainly, for the European Union, the issue of the future of energy in Ukraine, Moldova and Belarus is crucial, because its Eastern neighbours are, as already mentioned, transit countries for gas and oil exported from Russia to the EU.

However, from the EU's perspective, it is not just a question of transit. At least two other issues are of great importance to the EU. Firstly, the EU has declared that it wishes to have closer relations with its neighbours through the European Neighbourhood Policy (ENP). Much indicates that without close co-operation in energy matters, the ENP will be doomed to fail. Secondly, there is the EU's relationship with Russia, which continues to consider that the countries of the CIS are within its sphere of influence. Russia is unwilling to see EU involvement in this area. As one of the most major problems for the EU and Russia, as well as for the countries between them, energy must play a key role in the EU-Russian dispute concerning their common neighbours, a dispute which is inevitable in the next few years and probably also over the long term.

From the point of view of the European Union, then, a thorough appraisal of the situation of Ukraine, Moldova and Belarus in energy matters, Russia's policy and the actions of the EU itself towards them, is essential. Only such an appraisal will allow the EU to determine how it should proceed towards Ukraine, Moldova and Belarus in energy matters.



# Energy sectors of former Soviet countries covered by the ENP

'Gas sector in Ukraine is a magnet for corruption'<sup>1</sup>.  
*World Bank Report*

'...this key sector is the most criminalised,  
according to the opinion of all experts. It is also too politicised'<sup>2</sup>.  
*President Leonid Kuchma*

## Dependency on supplies from Russia

The lack of diversification of gas and crude oil supplies is one of the most important reasons for the politico-economic problems of Ukraine, Moldova and Belarus with Russia. Gas and oil imported from Russia or, as in the case of gas for Ukraine, via Russia from Central Asian countries through the intermediary of Russian corporations, satisfies a huge part of demand for these resources.

Of the three countries, only Ukraine has gas deposits that satisfy part of its demand for gas (19.1 billion m<sup>3</sup> of the 66.4 billion m<sup>3</sup> consumed in 2006). Ukraine and Belarus also extract small quantities of the crude oil they need

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<sup>1</sup> *Ukraine: Challenges facing the gas sector*, World Bank, September 2003, <http://siteresources.world-bank.org/INTECAREGTOPENERGY/34004325-1112025344408/20772948/ukrainegassector.pdf>

<sup>2</sup> Quoted in: *It's a Gas. Funny Business In the Turkmen-Ukraine Gas Trade*, 'Global Witness', April 2006, p. 22, [http://www.globalwitness.org/media\\_library\\_get.php/296/its\\_a\\_gas\\_april\\_2006\\_lowres.pdf](http://www.globalwitness.org/media_library_get.php/296/its_a_gas_april_2006_lowres.pdf)

(3 million tonnes and 1.8 million tonnes, respectively). Moldova does not have its own resources. Hence, most of these countries' gas and oil must be imported from or via Russia (see Table 1).

**Table 1. Gas and crude oil consumption in Belarus, Ukraine and Moldova (2006).**

	Gas (billion m <sup>3</sup> )	Crude oil (millions of tonnes)
Belarus	19.6	8.0*
Ukraine	66.4	15.0
Moldova**	2.68	0.67

\*It should be stressed that in its refineries Belarus processes almost 20 million tonnes annually, exports most oil products and only about 1/3 of the oil is used domestically.

\*\* 2005

Data from: *BP Statistical Review of World Energy 2007, International Energy Agency.*

Dependency on Russia is heightened by the fact that natural gas and, to a lesser extent, crude oil, are basic resources in the energy balance of each of those countries (see Table 2).

**Table 2. Energy balance of Belarus, Ukraine and Moldova (2004).**

%	Crude oil	Natural gas	Coal	Nuclear energy	Electric energy (import)
Belarus	31.9	64.7	2.3	0	1.1
Ukraine	12.8	47.2	23.7	16.3	0
Moldova	20	67.7	2.5	0	7.5

Data: International Energy Agency.

Gas has a special place in the energy balance of each of those countries: it is used to generate 67.7%, almost 65% and 47% of all energy in Moldova,

Belarus and Ukraine, respectively. This goes a long way to explaining why the issue of resources in Ukraine's, Moldova's and Belarus' relations with Russia is not so much an economic problem as a political one.

Despite their high dependency on Russian supplies of energy resources, Ukraine and Belarus can at least partly counterbalance this dependency thanks to the control they have over the pipelines transporting Russian gas and oil to the West. Ukraine and Belarus are crucial to the transport of Russian gas because almost all gas exported from Russia to the EU – 25% of the gas consumed in the EU<sup>3</sup> – travels through their territory. The most important route for the transport of Russian oil to the EU – the Druzhba pipeline – also crosses Ukraine and Belarus. Moreover, some Russian oil is transported via oil terminals at sea ports in Ukraine (mainly Odessa, Pivdenniy and Theodosia).

Dependency on oil and gas supplies from Russia is a throwback to the time those countries were part of the USSR and hence part of the internal energy market of the Soviet empire. When referring to the high degree of dependency on Russian supplies of resources, it is worth pointing out that some of the member states of the EU are in a similar situation, especially those that were part of the USSR, such as Lithuania, Latvia and Estonia, or that depended on the USSR, such as Poland, the Czech Republic, Slovakia, Hungary, Romania and Bulgaria.

### High level of energy consumption and inefficiency

For Ukraine, Belarus and Moldova, Russian gas and oil have strategic significance; their economies, which have high levels of energy consumption, depend on them. The natural gas consumption per capita in Ukraine and Belarus is among the highest in the world. The principal gas consumers are enterprises with strategic significance to the economy that account for

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<sup>3</sup> Of those EU states that use Russian gas, only Finland, Estonia and Latvia do not import it through Belarus, Ukraine or Moldova.

a large part of GDP and export revenues. Gas consumption in the metallurgical and chemical sectors, key sectors of the Ukrainian economy, is 25–30% higher than the average in the EU, according to World Bank estimates. The very low efficiency of the Belarusian, Ukrainian and Moldovan economies makes them less competitive. At the end of the 1990s, 25% of the costs of manufacturing a product in Ukraine were represented by the price of energy, which was eight times higher than in France<sup>4</sup>. To date, those figures have not appreciably changed. All three countries are forced to bear the consequences of lack of reforms in the most important sectors of their economies and the effects of failing to introduce market prices in the 1990s, like Central Europe did.

Households are also major gas consumers. For example, in Ukraine they consume 20 billion cubic meters annually, which accounts for ¼ of the country's gas consumption. Gas consumption there is much higher than it could be because of the very high losses of energy, for example in the heating of buildings. In all three countries, modern energy-saving technologies are still rarely used in households. The result of the lack of energy efficiency is easy to foresee. Any increases in the prices of gas and oil must severely affect the economies of these countries and could each lead to an economic crisis.

### Political and financial significance

The energy sectors of former Soviet countries are also typically politicised and corrupt because no other sector of the economy provided such a rapid route to wealth as energy. In the case of Belarus, where the state has retained its dominant role, supplies of oil and gas from Russia ensured huge profits for Lukashenka's regime and this has become a foundation of the stability of his authority, especially in recent years, because the Belarusian

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<sup>4</sup> M. Balmaceda, *Explaining the management of energy dependency in Ukraine: possibilities and limits of a domestic-centered perspectives*, Mannheimer Zentrum für Europäische Sozialforschung, 'Working papers', no. 79, 2004.

regime earned high revenues from processing oil imported from Russia at well below world prices, and then exporting it to the countries of the EU (as oil products) at market prices.

In the case of Ukraine, the exploitation of vague rules on trading in energy resources led to the creation of powerful oligarchic groups with political ambitions. According to Ihor Bakay, the first chairman of Naftohaz, ‘everyone who is rich in Ukraine became rich by trading in gas’. Even if his opinion is exaggerated, to a certain degree it still reflects the reality of independent Ukraine. Wealth through trading in gas was made possible by the theft of huge quantities of gas from the transit pipeline (this underhand trade, estimated at 6–7% of Ukraine’s then GDP, did not cease until 2000<sup>5</sup>) and the result of using barter schemes to pay for Russian and Central Asian gas to avoid paying of taxes<sup>6</sup>. The ease with which high profits were made by trading in energy resources means politicians became dependent on the energy business.

The best example of the interdependence of the energy business and politics is former Ukrainian Prime Minister Pavlo Lazarenko, who in 1999, two years after his resignation, was arrested in the USA and accused of laundering money originating, in part, from gas trading. Yulia Tymoshenko, former Ukrainian Prime Minister and currently leader of the strongest opposition party, also traded in Russian gas in dealings that remain unclear. In turn, in 2000 Ihor Bakay was dismissed under suspicion of corruption, but shortly thereafter he was appointed to an important post in President Kuchma’s administration. In 2004, after proceedings were brought against him, he left for Russia, where he obtained citizenship ‘for services to Russian culture and art’. Individual politicians and political groups in Ukraine greatly benefited from the continued depend-

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<sup>5</sup> See: *Economic Reform in Ukraine: The Unfinished Agenda*, <http://www.carnegieendowment.org/events/index.cfm?fa=eventDetail&id=228>

<sup>6</sup> J. Dodsworth, P. Mathieu, C. Shiells, *Cross-Border Issues in Energy Trade in the CIS Countries*, ‘IMF Discussion Paper’, Washington 2002, p. 13, <http://www.imf.org/external/pubs/ft/pdp/2002/pdp13.pdf>

ency on Russia for energy and so they were interested in retaining the status quo. The most recent example of ambiguous conduct is Ukrainian fuel and energy minister Yuri Boyko (in 2002–2005 he was chairman of Naftohaz). He is considered a ‘lobbyist’ for the interests of RosUkrEnergo, and the gas agreements he signed are considered controversial and to Ukraine’s disadvantage.

### Lack of transparency

The desire to earn undisclosed amounts of income by trading in gas and oil with Russia has led to the creation of a system whose basic feature is lack of transparency. In the case of Belarus this is understandable, bearing in mind its authoritarian regime, which attempts to conceal its revenue. Yet lack of transparency is also a problem in Ukraine and is caused, among others, by insufficient information on the ownership structures of the companies involved in the import of energy resources. Almost from the beginning of Ukraine’s independence, supplies of gas from Russia and Central Asia were handled by companies acting as intermediaries in the transactions, with little known about their owners. The first intermediary (from 1994) was Itera. In 2003, it was replaced by Eural Transgas, and in 2006 – under the Russian-Ukrainian gas agreement – by RosUkrEnergo<sup>7</sup>.

It is unclear why Gazprom decided to supply gas to Ukraine for many years through intermediaries when it has its own subsidiary that usually handles this (Gazpromexport). It seems that the intermediary companies enable representatives of the political and business elites of both sides to benefit financially. Current intermediary RosUkrEnergo is most certainly a link necessary for ensuring supplies of gas to Ukraine. When in March 2007, the Ukrainian opposition attempted to remove the company, its man-

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<sup>7</sup> After the Ukrainian-Russian gas contract of 4 January 2006 was signed, President Yushchenko, asked what he knew about RosUkrEnergo’s shareholders, stated on television ‘The founders of RosUkrEnergo could have been anybody ... anybody’. *It’s a Gas...*, *op. cit.*, p.58

agement issued a statement that ‘the stability of gas supplies to Ukraine depend on RosUkrEnergo’<sup>8</sup>.

The gas agreements signed with Russia are also obscure. Unfortunately, neither the Orange Revolution nor the pro-Western policy of the Moldovan authorities has altered negative practices. Lack of transparency continues.

### Need for a purge

The lack of transparency of Ukraine’s, Moldova’s and Belarus’ fuel sectors is a serious obstacle in the modernisation of these countries. Unfortunately, consecutive Ukrainian and Moldovan governments, and in particular Lukashenka’s regime, have done nothing to alter the vague relationships or to ensure greater efficiency in energy consumption. Even after the Orange Revolution, the new Ukrainian authorities soon gave up revising gas and oil trading schemes<sup>9</sup>. Basically, without a thorough purge in the energy sector of each of these countries and changes to how they import Russian resources (especially gas), no reform of their economies will be possible. Ukraine, Moldova and Belarus should first of all decrease the high level of their industries’ energy consumption. This could be achieved through energy-saving programmes and more efficient energy consumption. Making their economies dependent on supplies of resources at ‘concessionary prices’ has meant that they remain partially dependent on Russia and vulnerable to Russia’s blackmail in energy issues.

8 Yulia Tymoshenko *ispytyvayet koalitsiyu na razryv kontraktov s RosUkrEnergo*, ‘Kommersant – Ukraina’, 13.03.2007.

9 In June 2005, an investigation of RosUkrEnergo began in Ukraine. Yulia Tymoshenko, then Prime Minister, publicly stated that the company was ‘a criminal enterprise’ and called for President Yushchenko’s faction not to replace the old energy trading schemes of Kuchma’s era with new ones that would not, in fact, differ from the old ones. After the dismissal of Tymoshenko’s government in September 2005, the investigation of RUE was closed. R. Kupchinsky, *Ukraine: A Conflict Over Gas And Power*, ‘RFE/RL’, 12.09.2005.

Ukraine could also increase the quantities of gas extracted from its own deposits. In February 2006, the then Prime Minister Yuri Yehanurov announced that Ukrainian companies were capable of extracting up to 30 billion cubic meters of gas annually (compared to approx. 19,000 million m<sup>3</sup> currently extracted). These plans seem realistic because Ukraine has significant stocks of gas, estimated at 1.2–1.5 billion cubic meters, which at the current level of consumption would be sufficient for 20 years.

Paradoxically, Russia's systematic move towards market prices could be an advantage, because it would lessen the opportunities for Moscow to exploit the resources to achieve its political aims. In the case of Ukraine, it would also lessen the oligarchic effect on politics and the economy.



# 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).**

	2005	2006	2007
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 JES' 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 succeeded in taking control of Ukrtatnafta, 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

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<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.

# EU policy towards Ukraine, Moldova and Belarus

'I believe that further consideration could also be given to those of the European Neighbourhood countries that are willing to engage in the reform process in their energy sector and apply the principles of the EU internal energy market'<sup>22</sup>.  
*Andris Piebalgs, EU Energy Commissioner*

## Less involvement

The European Union is far less involved than Russia in the energy matters of their common neighbours. This should not be surprising, if only because the EU still has no common energy policy, including such a policy towards non-EU countries, while Russia is implementing a well thought-out energy policy towards CIS countries. This does not mean that the EU is not taking any action at all. In recent years, attempts to draft a common energy policy that would address the necessity of the EU's cohesive action towards its neighbours have been increasing. Energy matters are also present in the EU's European Neighbourhood Policy (ENP), which covers, among others, Ukraine, Moldova and Belarus. The Action Plans concluded by the EU with individual ENP countries, signed by Ukraine and Moldova in February 2005, are an example of this.

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<sup>22</sup> <http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/06/712&format=HTML&aged=1&language=EN&guiLanguage=en>

Energy issues occupy an important place in the Action Plans negotiated by the EU with Ukraine and Moldova and also with three other former Soviet countries – Georgia, Azerbaijan and Armenia. Belarus is an exception because of its frosty relations with the EU (caused by the authoritarian governments of Alyaksandr Lukashenka) and has not even begun talks concerning the Action Plans.

Energy was most fully discussed in the EU-Ukraine Action Plan. In addition to general terms on the necessity of strengthening co-operation in energy issues, the Action Plan also contained terms concerning more detailed proposals to bring Ukrainian provisions of law more in line with EU regulations on energy and suggestion of Ukraine's participation in EU gas and energy forums. The EU is ready to take part in upgrading the existing transport network and reducing its high level of consumption and in the construction of new pipelines, e.g. the Odessa – Brody – Płock pipeline<sup>23</sup>.

The terms of the Action Plans indicate that the EU wishes to partially integrate the countries covered by the ENP with the painstakingly created common energy policy. It is worth stressing that the EU is offering even Belarus, which has not signed an Action Plan, co-operation in the field of energy, on condition the country becomes a democracy<sup>24</sup>.

A European Commission document dated December 2006 on the need to strengthen the ENP is a supplement to the Action Plans. It emphasises, among others, the significance of multilateral action in energy matters in which the EU's neighbours should take part<sup>25</sup>, but it seems that the most far-reaching proposal to the countries lying between the EU and Russia is the possibility of Ukraine's and Moldova's joining the Energy Community,

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<sup>23</sup> EU/Ukraine Action Plan, [http://ec.europa.eu/world/enp/pdf/action\\_plans/ukraine\\_enp\\_ap\\_final\\_en.pdf](http://ec.europa.eu/world/enp/pdf/action_plans/ukraine_enp_ap_final_en.pdf).

<sup>24</sup> See: What the European Union could bring to Belarus, Non-Paper, November 2006, [http://ec.europa.eu/external\\_relations/belarus/intro/non\\_paper\\_1106.pdf](http://ec.europa.eu/external_relations/belarus/intro/non_paper_1106.pdf).

<sup>25</sup> '[...] consideration of multilateral agreements in energy and transport and strengthening of existing ones; work for the extension of the EU transport and energy networks to neighbouring countries as well as interoperability'. See: *On Strengthening the European Neighbourhood Policy*, p. 9, [http://ec.europa.eu/world/enp/pdf/com06\\_726\\_en.pdf](http://ec.europa.eu/world/enp/pdf/com06_726_en.pdf).

in which they already have observer status. The proposal that Ukraine and Moldova join this structure appeared in the statements of EU politicians in 2006. The Energy Community, the aim of which is to expand a common electricity and gas market to the Western Balkan countries, was set up in 2005<sup>26</sup>. The EU's proposal was nothing other than a placing of Ukraine and Moldova on the same footing in energy matters as the Western Balkan countries, which the EU has promised full integration. The list of potential Energy Community members does not, however, include other ENP countries from the Southern Caucasus or Mediterranean countries. It is worth stressing that countries that have been invited to the Energy Community also include Norway and Turkey, i.e. a country that could at any moment join the EU and a country that is negotiating accession.

It is currently difficult to establish unequivocally to what extent the EU is determined to become involved in the energy issues of its neighbours and have Ukraine and Moldova join the common energy policy, but at least it can be said that the EU has noticed the problem.

Clearly, energy matters are not only a concern of the EU, but are also an issue that above all is the responsibility of its Member States and private corporations. This is because the Member States want a great deal of freedom in energy matters for at least two reasons: firstly, energy issues are fundamental to state security, and secondly, many Member States continue to doubt the effective operation of the EU as a whole in energy matters. In

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<sup>26</sup> 'At present, the full participation in the Energy Community is limited to the countries of South East Europe. However, on the occasion of the last week's Ministerial Council of the Energy Community held in Skopje, an observer status was granted to four countries: Moldova, Norway, Turkey and Ukraine. This opens new horizons for the Energy Community's extension'. Andris Piebalgs, Energy Commissioner, *External projection of the EU internal energy market*, Opening speech at the External Energy Policy Conference, Brussels, 20.11.2006, <http://europa.eu/rapid/press-ReleasesAction.do?reference=SPEECH/06/712&format=HTML&aged=1&language=EN&guiLanguage=en>. 'Ensuring the implementation of the Energy Community Treaty, with a view to its further development and possible extension to Norway, Turkey, Ukraine and Moldova' – *Presidency Conclusions*, Council of the European Union in Brussels, 8–9 March 2007, p. 19, [http://www.consilium.europa.eu/ueDocs/cms\\_Data/docs/pressData/PL/ec/93142.pdf](http://www.consilium.europa.eu/ueDocs/cms_Data/docs/pressData/PL/ec/93142.pdf).

turn, energy corporations are often linked to the state or, as international structures, want the greatest possible freedom to act.

Different approaches to the countries situated between the EU and Russia are noticeable in Member States. It seems that some of them are inclined to closely co-operate with Russia, to the exclusion or marginalization of ENP countries, while other EU Member States try to maintain a dialogue with ENP countries, especially Ukraine (e.g. Poland on the issue of the Odessa – Brody – Gdańsk pipeline), but also with Belarus, an example of which is the Lithuanian-Belarusian talks concerning crude oil supplies to Belarus via Lithuania, carried on after the crisis in the relations between Minsk and Moscow at the end of 2006 / beginning of 2007<sup>27</sup>.

Both Poland and Lithuania are interested in creating a coalition of states that would enable the supply of Caspian oil without the intermediary of Russia. An example of an attempt to create such a coalition was the 2007 meeting in Cracow devoted to energy issues, in which presidents of Ukraine, Georgia, Azerbaijan, Lithuania and Poland took part. So far, however, Lithuania's and Poland's actions have been unsuccessful, both in bilateral talks with ENP countries and in multilateral negotiations.

Unlike Russian corporations, corporations from Member States still show little interest in the domestic markets of CIS transit countries (unlike oil and gas producers). Exceptions can be found, for example Shell's operations in Ukraine. Shell became involved in exploring new gas deposits in eastern Ukraine, together with Ukrhazvydobuvannia (UGV), i.e. part of the state-owned Ukrainian Naftohaz (agreements in 2005 and 2006). Shell also entered the market for the retail sale of petrol after it set up a joint venture in 2007 with Russia's Alliance Group, co-owner of the refinery in Kherson. Shell acquired 51% of the shares, taking over 150 petrol stations that will operate with its logo. This involvement is still relatively small, barely 3% of the Ukrainian market, but the new company intends to increase its share to

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<sup>27</sup> Lithuanian-Belarusian talks in February 2007, See: Kommersant, 15 February 2007.



10%<sup>28</sup>. Shell's involvement in Ukraine cannot be considered inconsequential, but should be perceived as well thought-out action, probably with the intention of long-term investments.

Another effort to enter the Ukrainian market, which failed, was PKN Orlen's December 2005 attempt to buy 32.9% of the shares in Ukraine's Drohobych refinery near the Polish border<sup>29</sup>. British Petroleum (BP) is also present on the Ukrainian market, though not directly, but through TNK-BP Ukraine, belonging to Russia's TNK-BP in which the British partner holds 50%. TNK-BP has a refinery in Lysychansk and 51 petrol stations.

There are at least several reasons why corporations from the EU have not shown a willingness to get involved in investments in neighbouring Eastern European countries. One of them is certainly the lack of transparency in the energy sectors of those countries, the conviction that this is the area where Russian companies operate and the fact that the authorities in Moldova, Belarus and Ukraine do not encourage investors to enter the market, which brings huge profits for a very small select circle of 'members'. Moreover, energy is sometimes treated as a strategic sector that should not be sold off to foreign investors. Networks of pipelines for the transport of both gas and oil are protected against take-overs.

But Shell's involvement could be a breakthrough, or at least an important factor in other companies' making the decision. It is an example that it is worth investing in this market as one with prospects. Currently, though, this only applies to Ukraine. Moldova seems too small a market and is much poorer than Ukraine, while for political reasons Belarus is to all intents and purposes closed to Western companies.

Corporations from the EU countries, particularly Germany, have been willing for years to take part in investments in a network of transit pipelines, especially gas lines. They always wanted to invest together with Gazprom

<sup>28</sup> See: [www.bfai.de/fdb-SE,MKT20070426105531,Google.html](http://www.bfai.de/fdb-SE,MKT20070426105531,Google.html).

<sup>29</sup> Along with the refinery in Nadvirna, the refinery in Drohobych is one of the smallest refineries in Ukraine – it is capable of processing 3.22 million tonnes of oil per year (in 2004 67.9% of its production capacity was used, and in 2005 – approx. 50%).

and were supported by the German government. Since 2003, a concept of setting up a trilateral – Ukrainian-Russian-German – consortium has been considered, which would take control of the network of gas transit pipelines in Ukraine.

It seems that the political elite in Ukraine is still unwilling to progress with the idea because of the strategic importance of the transport lines to its relations with Russia. This continues to be one of Kyiv's most important bargaining tools in negotiations with Moscow. Ukrainian politicians fear that a trilateral or even a bilateral consortium (with only an investor from the EU) might in the future be taken over by Russian companies (at present, both in the case of gas and oil, this means the Kremlin, in fact).

### Unresolved dilemma

It seems that a dilemma still remaining unresolved is the question whether for the European Union and/or individual Member States it would be better if common neighbours were quite simply part of the Russian energy system or were integrated with the EU energy system being created. This dilemma seems to have unprecedented importance because of Russia's conflicts, first with Ukraine and then Belarus, regarding supplies of energy resources, and this has affected the continuity of gas and oil supplies from Russia to the EU.

It might be supposed that some of the large corporations in Member States (especially those that receive Russian resources, primarily gas) are interested in the Kremlin's having control of the oil and gas transport routes from Russia, because they are counting on this removing the risk of interruptions in supplies of resources following disputes between Russia and countries like Ukraine or Belarus. Hence, Moscow's control would have a positive effect on the security of oil and gas supplies from Russia to the EU.

What the view of the political elites of individual Member States is remains unknown. Major differences are visible between individual Member States, but it is certain that politicians, to a greater extent than corporations,

are currently more interested in the CIS countries having greater independence from Russia in energy issues.

From the point of view of certain Member States and corporations, a partial solution to this dilemma would be to build new transport routes for Russian gas that would avoid the ENP countries. That is why certain corporations and Member States are interested in building new gas transport routes that would avoid transit countries – one example is the Nord Stream gas pipeline supported by Germany (Germany's BASF and E.ON each have 24.5% of the shares, but Gazprom holds 51%). In turn, Italy is interested in the South Stream – a gas pipeline from Russia across the Black Sea to Bulgaria, ending at the Apennine Peninsula.

Representatives of corporations from Germany and Italy and also many politicians in those countries appear to believe that eliminating transit countries from the equation will increase the security of supplies of Russian resources (especially gas).

Another serious problem is the still unclear policy of the EU's Eastern neighbours where co-operation with the EU in energy matters is concerned. This applies not only to Belarus, which has no normal relations with the EU, but also to Ukraine and Moldova. The above-mentioned ambiguous relations with Russia and the scheming of interest groups put a question mark over the intentions of the political elites of those countries where co-operation in energy issues is concerned. This situation certainly makes the advisability of the involvement of the EU as a whole, individual Member States and corporations in the energy issues of their neighbours, dubious.

To summarise, the involvement of the EU, whether as a whole or as individual Member States and corporations, in the energy issues of ENP countries is still insufficient. Yet, it would be a mistake to say that there is no interest in this on the EU's part.

# Proposals for the EU's future actions

Relations in energy issues with the countries situated between the EU and Russia are certainly a difficult problem for the EU. It seems the EU has three ways of solving the problem.

The first scenario assumes the EU accepts Russia's dominance in this area in energy matters. This would mean, in fact, also accepting Russia's political dominance over their common neighbours, because energy issues play a key role in relations between Kyiv, Chisinau, Minsk and Moscow.

This option would assume consent to the Kremlin's acting on its own terms in the transit countries. In exchange, Russia would guarantee stable supplies of its resources, which would be transported via CIS countries. The EU would in fact declare that it is not interested in the energy issues of its neighbouring states. This would be contrary to the EU's endeavours to include its neighbours in the common energy market as expressed in EU documents. It would also be contrary to the EU's efforts to have Russia follow European guidelines in energy issues. If Russia were allowed to act on its own terms in countries that are Russia's and the EU's common neighbours, it would be even less reasonable to expect Russia to act according to European standards on its own territory. Consequently, Russia's position vis-à-vis the EU in energy issues would be inevitably strengthened.

The second way would be common management of the transit routes by Russia, the transit countries and the EU (Member States, corporations), without attempts to include the transit countries in the European energy policy. The weakness of this solution lies in the ambiguous terms on which such a consortium would operate. Who would set the rules of common management of the pipelines? There would certainly be a high risk of lack of transparency. Bearing in mind Russia's strength in this area in energy issues, it can be assumed that Moscow would make the rules.

In this case, the equal participation of all the stakeholders seems unreal. Accepting this solution would mean accepting a long-term Russian dominance. The end result would be similar to that in the first scenario.

Also, the transit countries (particularly Ukraine) might not be interested in this solution because they would lose a real bargaining tool – the transit pipeline – in their relations with Russia. Forcing such a solution on them would certainly be action in defiance of at least some of the political elites of these countries.

The third scenario would be to gradually integrate the ENP countries into the emerging common energy market of the EU. This would be the most preferable of the three possible scenarios for at least four reasons.

Firstly, it is impossible to gradually strengthen the EU's ties with its Eastern neighbours without energy playing a part. The success of the ENP depends on the success of the EU's co-operation with its neighbours in energy matters. Irrespective of whether the ENP countries are seen in the future in a ring of friends remaining outside the EU or as EU members, co-operation in matters concerning energy, because of its importance, is essential for the achievement of any of these aims. The gradual integration of the ENP countries into the emerging common energy market of the EU would mean expanding the area covered by European standards in a very important sphere of economy and politics.

In turn, for the ENP countries it would mean having to implement fundamental reforms of their energy sectors, primarily by introducing transparency rules (including clear, stable rules governing investment by foreign investors) and efficiency. It is worth emphasising that the first two scenarios would not bring about any transparency or efficiency in the energy sectors of ENP countries.

Secondly, implementing this scenario would boost the EU's credibility because it would be offering ENP countries, especially Ukraine and Moldova, a great deal in energy-related matters – the opportunity for these two countries to join the Energy Community, terms in the Action Plans, general statements in the emerging EU energy policy. For the EU to be credible, these proposals cannot remain rhetorical; they must be implemented.

Thirdly, only this scenario would afford the opportunity of long-term, secure investment by EU corporations in ENP countries. These three countries, especially Ukraine, could be attractive markets for energy corporations.

Fourthly, implementing this scenario would give the EU a stronger position in talks on energy issues with Russia. It would be possible to convince Russia to accept (even partly) European rules in the ENP countries. This could be a sort of experiment for energy co-operation with Russia according to European rules and would also be useful in the case of Russian companies' participating in the internal EU energy market.

However, this scenario has many problems, two of which seem major.

First of all, there are significant differences between the ENP countries. The EU does not have normal relations with Belarus, hence the possibility of exerting any influence in energy matters in this country is non-existent. Despite ambiguities, Ukraine and Moldova do want to co-operate with the EU, but in energy matters, even between these two countries, there are large differences. Russia controls the transport infrastructure in Moldova, but does not have such control in Ukraine.

In addition, Russia's opposition is inevitable. It will treat the EU's involvement in the energy matters of their common neighbours as a threat to its influence in the CIS. Strong resistance from the Kremlin should be expected. The reason for this view is that the Russian authorities see the energy issue as their basic tool helping them maintain their influence in ENP countries.

To implement the third scenario, it would be necessary to overcome the problems indicated. This would require the following action.

Firstly, it would be necessary to exert constant pressure on neighbouring states to have them reform their energy sectors. The EU should clearly state that integration with the EU cannot be achieved without the reform of the energy sectors. EU assistance (including financial aid) could be used to encourage improvements in the energy efficiency of those countries' economies.

Secondly, the approach to different neighbours would have to be different. Ukraine would certainly play a key role in the EU's policy towards its neighbours. The third scenario suits Ukraine best of all. In the case of Moldova, Gazprom's current dominance should not mean that the EU should not show any interest in Moldova's energy matters. From the EU's point of view, where the third scenario is concerned, Belarus is in the worst situation because of the lack of a proper dialogue with Lukashenka. The EU has no influence over Russia's actions, which are intensifying, in Belarus.

Thirdly, attempts to moderate Russia's opposition would have to be made. It must be assumed that Russian capital, which is either legally or in fact controlled by the Kremlin, will continue to be the predominant foreign capital in the energy sectors of the ENP countries. Evidently, with such a significant (and often dominant) participation of Russia in individual ENP countries, the capital from EU countries will remain in the minority. It would

be necessary to constantly repeat to the Russian authorities that the EU's actions are not aimed at removing Russian capital from the energy sectors of the ENP countries; to the contrary – on transparent terms it would be possible to achieve beneficial co-operation (in economic and technological terms) between EU and Russian corporations in ENP countries, with, of course, those countries' consent to such action.

However, there would definitely be tensions between Russia and the EU in energy matters concerning their common neighbours, so it would not be so much a question of leading to situation of no conflict as minimising a conflict.

The EU's consistent policy towards its neighbours to promote their closer relations with the EU would be better for EU–Russia relations than a policy of partial concessions and inconsistencies. This also applies to energy matters. Moderating Russia's opposition should not be based on concessions, but on putting the case forward clearly and seeking benefits for all three parties, while ensuring transparency.

Fourthly, action to the creation of an EU energy policy would be necessary. In an internal EU discussion, it would be necessary to continually stress that a common EU energy policy is also essential to the success of the ENP.

Fifthly, the actions of the EU as a whole, individual Member States and EU-based corporations, would be necessary in neighbouring countries.

Only combined efforts, i.e. on the one hand, including ENP countries in the EU energy policy, and on the other, involving Western corporations, will help bring about real reforms of the energy sectors of the ENP countries and bring them closer to European standards. If efforts are not combined, corporations could be tempted to act according to the current, vague rules, while merely including the ENP countries in the EU energy policy could prove insufficient to allow European standards to become established in ENP countries. The participation of corporations with specific investments is essential to this.



## Annex Map of pipelines and refineries



Map prepared by Wojciech Mańkowski

# Selected publications of the Stefan Batory Foundation

## Publications on energy issues

**Belarusian–Russian Energy Conflict: The Game is Not Over (2007)**; Report by Wojciech Konończuk, which analyses the Russian-Belarusian energy conflict of 2006. The report was published in English and Polish and is available only in electronic form.

**Between Need and Dependency. Russian Gas in the Energy Balance of the Enlarged EU (2002)**; by Grzegorz Gromadzki, in co-operation with a group of experts. The report was published in English, Polish and Russian.

## Recent publications on international issues

**Putin's Empire (2007)**; The book contains 11 articles written by leading experts on Russian issues from France, Poland, the United States and, primarily, Russia itself. The texts concern three problems: authority in Russia, relations between the authorities and society and Russia as an empire. The publication is also available in English and Russian electronic versions.

**Polska i świat (2007)**; The publication is devoted to Polish politics since 1989 and the challenges that face Polish diplomacy. It contains statements made

by all the ministers of foreign affairs of the Republic of Poland to date. The text is available only in Polish.

**Belarus: Neither Europe, nor Russia. Opinions of Belarusian Elites (2007);**

The book features interviews with 30 Belarusian politicians, journalists, third sector activists, cultural figures and artists carried out in Minsk in spring 2006. The interviewees, representing both the opposition and the circles loyal to Lukashenka's regime, were asked nine questions concerning Belarusian identity and Belarus' relationship with Russia and the European Union. The book was published in English. The publication is available in Belarusian and Russian on the website of Belarusian publishing house 'Arche': <http://arche.bymedia.net/2007-knihi/zmiest01.htm> and [http://arche.bymedia.net/2007-knihi/zmiest01\\_ru.htm](http://arche.bymedia.net/2007-knihi/zmiest01_ru.htm).

**Belarus after the 'election'. What future for the Lukashenka regime? (2006);**

The report concentrates on an appraisal of Belarus' internal and international situation several months after the presidential election and attempts to forecast the development of events in the country and the EU's and Russia's policy towards Belarus. The text was prepared in co-operation with the Association for International Affairs, Prague. The publication is available in English, Belarusian and Polish.

**Polska w strefie Schengen – wyzwanie dla polityki wizowej (2007);**

The publication analyses the restrictions that will be implemented in Poland's visa policy towards citizens of neighbouring countries once Poland joins the Schengen zone. The text is available only in electronic form in Polish.

**Questionable Achievement: EC-Ukraine Visa Facilitation Agreement (2006);**

The text sets forth the advantages and disadvantages of the new visa facilitation agreement negotiated by the EU and Ukraine for Ukrainians entering the EU. The publication is available in English and Polish in electronic form only.

**Neighbours and Visas. Recommendations for a Friendly European Union Visa Policy (2006);** The text analyses EU visa policy based on research carried out in 2005. The report contains recommendations on changes necessary to the EU's visa policy. The analysis is available only in English.

All publications are available on the website  
<http://www.batory.org.pl/mnarod/pub.htm>.