

The 2006 Russian-Ukrainian gas crisis – causes and potential for repetition

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Sammendrag

Denne rapporten diskuterer årsakene til gasskrisen mellom Russland og Ukraina i januar 2006, og analyserer potensialet for at en lignende krise kan oppstå mellom de to landene på et senere tidspunkt. Denne tematikken er ikke bare av interesse for de to involverte landene, men også for europeiske konsumenter som er avhengige av russisk gass som kommer i rørledning gjennom Ukraina. Krisen førte til atskillig bekymring i mange EU-land, den satte diversifisering av energiimport mer ettertrykkelig på den politiske dagsorden, og den fikk mange til å stille spørsmålsteget ved påliteligheten til Russland som energileverandør.

Etter å ha presentert de viktigste fakta ved krisen, går rapporten over til å se i mer detalj på hvordan de to hovedaktørene selv oppfattet konflikten. Videre tar rapporten for seg hvilken plass energi har i russisk utenrikspolitikk, før den ender med en analyse av de seks faktorene som forfatterne mener er de viktigste når man skal vurdere faren for en gjentakelse. Disse seks faktorene er: (1) graden av ukrainsk gassavhengighet av Russland, (2) i hvor stor grad og hvor fort Russland kan være i stand til å redusere sin avhengighet av det ukrainske rørledningssystemet, (3) viktigheten av det europeiske gassmarkedet for Russland sett opp mot andre markeder (Kina, India), (4) eierskapsstrukturen til det ukrainske rørledningssystemet, (5) det generelle forholdet mellom Russland og EU, og (6) det generelle forholdet mellom Russland og Ukraina. Rapporten konkluderer med at en gjentakelse er lite sannsynlig på kort sikt, men at flere av de seks faktorene kan utvikle seg på en måte som gjør en gjentakelse mye mer sannsynlig på lengre sikt.

English summary

This report discusses the causes of the January 2006 Russian-Ukrainian gas crisis, and analyses the potential for a repetition of the crisis at a later date. This topic is of interest not only to Russia and Ukraine, but also to gas consumers in Europe who depend on stable deliveries of Russian gas through Ukraine. The crisis caused considerable concern in Europe, put diversification of energy imports firmly on the political agenda, and blemished Russia's reputation as a dependable energy exporter.

After an initial presentation of the main facts surrounding the crisis, the report takes a closer look at how the two sides interpreted the conflict. Then comes a broader examination of the role of energy in Russia's foreign policy, before the report ends with an assessment of six factors that the authors consider the most important for whether a similar crisis might be repeated in the future or not. These six factors are: (1) degree of Ukrainian gas dependence on Russia; (2) to what extent, and how quickly, Russia is able to substantially reduce her dependence on the Ukrainian pipeline system through the construction of alternative pipelines; (3) the importance of the European market in relation to other gas markets (China, India and others); (4) the ownership structure of the Ukrainian pipeline system, whether it remains Ukrainian, becomes joint, or becomes Russian; (5) the general mood in EU-Russian relations and (6) the general mood in Ukrainian-Russian relations. The authors conclude that a repetition of the crisis is not very likely in the short term, but that developments within the six factors can make a repetition much more likely in the longer run.

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1 Introduction

The Soviet Union, and later Russia, has for decades provided the European continent with large amounts of oil and gas. At a time when energy prices were high and much uncertainty was associated with other oil- and gas-exporting countries, three days of reduced supplies from Russia during the Russian-Ukrainian gas crisis in the first days of January 2006 proved to be a powerful impetus to the debate about Europe's energy security. The crisis between Russia and Ukraine over the terms for deliveries to, and transit through, Ukraine has made an impression on European importers, who push for the liberalization of energy markets.

This study of the gas crisis between Russia and Ukraine attempts to include in its analysis both economic considerations and the parties' geopolitical interests and strategies. While the positions of the European Union and Ukraine will be given attention, the aim of this report is primarily to determine and explain Russia's role in the turmoil as well as to outline the country's future course of action: Why did Russia act the way it did? What are the chances that Russia will seek to use "the energy weapon" against Ukraine in a similar manner in the future?

In the following, we will highlight how Russia's approach to the crisis with Ukraine fits with Russia's long-term energy strategy. Despite Russia's own attempts to portray the crisis with Ukraine solely as a result of conflicting business interests, there cannot be much doubt about the Kremlin's will to use its position as energy supplier for political purposes. Russia under Putin's rule seeks to compensate for lost superpower status by taking advantage of the all-time high energy prices, which increase both Russia's revenues and the world's dependence on Russia. The Kremlin's evident urge to control the energy sector in order to increase state revenues and steer energy relations with other states underpins such an interpretation empirically. The extent to which Russia will succeed with such a policy depends upon several factors that are still subject to speculation: Will the Kremlin manage to control and manage Russia's resources efficiently enough to use them as a political weapon in the long run, or is there an inherent contradiction between Moscow's economic and strategic objectives? Who will be dependent on Russian energy supplies to an extent that allows the Kremlin's use of the energy weapon, and who will not?

A summary of the facts of the Russian-Ukrainian gas crisis will be followed by a presentation of the respective sides' conflicting interests and perceptions. Russia's role will then be scrutinized further by a closer look into how Russia's energy strategy may affect the ability to use energy as an instrument in foreign relations. Finally, we will outline some factors that are likely to determine whether a repetition of the January 2006 crisis is likely in the near, medium or long term future.

2 The Russian-Ukrainian Gas Crisis

2.1 Facts

Roughly one fourth of the gas consumed in Europe is imported from Russia, out of which approximately 80 per cent (126 billion cubic meters in 2004) is imported through pipelines that cross Ukrainian territory.¹ Ukraine itself is highly reliant on Russian and Central-Asian oil and gas supplies for several reasons: First, Ukraine's own petroleum resources are relatively limited and underdeveloped. Its consumption of gas (more than 70 bcm annually) by far exceeds its domestic production (approx. 20 bcm annually). Second, Ukraine's geographic location combined with the lack of new infrastructure implies that importing gas from and through Russia currently is the only viable way of satisfying Ukraine's needs.² Third, energy-intensive (and low-efficient) industries constitute cornerstones of the country's economy, not least metallurgical and chemical heavy industries.³ Moreover, the role as an important transit territory between CIS countries and Europe could probably support ambitions to increase Ukraine's regional power.⁴

In accordance with a deal struck in 2001 and amended in 2002 and 2004, Russia's state-controlled gas monopolist Gazprom used to sell natural gas to its Ukrainian counterpart Naftohaz Ukrainy at a price of USD 50 per 1000 cubic meters, while Gazprom paid USD 1.09 per 100 km transit of 1000 cubic meters, both figures were substantially below market price. Gazprom paid for the transit by bartering gas for transit. Due to disagreement on how the existing deal was to be understood (e.g. concerning the validity period of different parts of the agreement), and due to Gazprom's pressure to increase the price, representatives of Naftohaz and Gazprom met several times in 2005 to negotiate. Gazprom insisted that new terms should apply for Ukraine's import and transit of natural gas from Russia as of January 1, 2006. The negotiations proved to be futile as the sides' respective demands were irreconcilable and the will to make concessions was limited. Naftohaz Ukrainy adamantly insisted it would continue to buy and transit gas according to the conditions defined by the existing contract, claiming the terms agreed upon in 2001 should be valid until 2009. The negotiations broke down and Gazprom announced it would not deliver gas to Ukraine from January 1, 2006.⁵

¹ J.P. Stern, *The Future of Russian Gas and Gazprom*, Oxford University Press 2005: pp 86, 143.

² Energy Information Administration - Official Energy Statistics from the U.S. Government: <http://www.eia.doe.gov/emeu/cabs/Ukraine/pdf.pdf>

Radio Free Europe 12.01.06:

<http://www.rferl.org/featuresarticle/2006/01/ca508b85-a459-4ce7-a85b-4e54176f5148.html>

Nezavisimaya Gazeta 21.06.06: http://www.ng.ru/economics/2006-06-21/5_ukraine.html

³ Radio Free Europe 17.01.06:

<http://www.rferl.org/featuresarticle/2006/1/713D3DF6-BB10-4C3B-8630-2096AAB3F5B0.html>

Nichol et al. CRS Report for Congress: Russia's Cutoff of Natural Gas to Ukraine: Context and Implications, page 4: <http://fpc.state.gov/documents/organization/62625.pdf>

⁴ Oleksandr Sushko provided an assessment of the pro-Western Ukrainian administration's regional ambitions in *Ukraine's Search for a Regional Foreign Policy One Year After the Orange Revolution*.

Ponars Policy Memo No. 377, Dec'05: www.csis.org/media/csis/pubs/pm_0377.pdf

⁵ Mosnews, 31.12.05: <http://www.mosnews.com/news/2005/12/31/russukrgas.shtml>

In the first hours of 2006, Gazprom reduced the flow of gas in the pipelines which cross Ukraine providing Europe with natural gas. The reduction was supposedly meant to equal the amount of gas which Ukraine normally subtracts from the total flow for its own consumption. Gazprom normalized the export volume immediately when new negotiations came to a conclusion on January 4th. The new agreement was complex and originally valid for only six months. In other words, new terms valid from July 1 2006 had to be re-negotiated within a short time. Meanwhile, a Swiss-registered consortium named RosUkrEnergO would mediate a mix of Russian and Central-Asian gas at an average price of USD 95 per 1000 cubic meters on the Russian-Ukrainian border. This consortium would be responsible for transiting and delivering gas to Europe, for which it would pay a transit fee of USD 1.60 in cash per 100 km transit of 1000 cubic meters. Gazprom and privately owned (by Ukrainian businessmen) Centragas Holding figure as owners of a 50 per cent share of RosUkrEnergO each.⁶ Another company, Ukgaz-EnergO, was created to sell gas internally in Ukraine. This latter company is in turn partly owned by RosUkrEnergO.

Russian and Ukrainian negotiators on June 30, 2006 agreed to prolong the validity of the terms defined in the deal struck on January 4 by three months, and in October 2006 the price for RosUkrEnergO-delivered gas was set at USD 130 on the Russian-Ukrainian border for the year 2007.

2.2 Conflicting Perceptions of the Gas Crisis

The political backdrop for the gas crisis was characterized by the tense relations between Kyiv and Moscow that were predominant during the early stages of the presidency of Ukrainian president Viktor Yushchenko, who came to power in January 2005. The West, not least the US, supported pro-Western Yushchenko's candidacy in the 2004 elections, while Russia supported Prime Minister Yanukovich' candidacy, since he favoured closer ties to Russia.⁷ After centuries of Russian dominance over most parts of Ukraine, Russia has come to see Ukraine as a natural part of her strategic heartland and sphere of influence. President Putin argued strongly in favour of Yanukovich on Ukrainian national television shortly before the election, and he publicly embraced Yanukovich during one of two visits to Ukraine before and between the election rounds. Regardless of the beginning uprising among Yushchenko's supporters and the highly critical remarks made by the OSCE's election observers and Western officials, Putin congratulated Yanukovich as the winner of the elections. Following Washington's allegations against Yanukovich of election fraud, Putin accused the US of seeking "to limit Russia's possibilities to develop her relations with neighbouring countries" and "to isolate Russia".⁸ In the end, the controversial election was cancelled as widespread election fraud provoked what became known as the Orange Revolution. Yushchenko was elected in an extraordinary third election round.

⁶ Financial Times 28.04.06, Page 1-2.

⁷ On the US and the 2004 elections in Ukraine, see Volodymyr Dubovyk, *The United States and the Ukrainian Election Political Crisis*. PONARS Policy Memo No. 353, Nov'04:

www.csis.org/media/csis/pubs/pm_0353.pdf

⁸ Quoted by Nezavisimaya Gazeta, 24.12.04

As **Russia** was deeply concerned by Yushchenko's explicit ambition to make Ukraine a member of both NATO as well as the EU, Moscow saw no reason why it should subsidize his government.⁹ A price hike was clearly legitimate due to market developments, and by demanding a quadrupling of the price Russia could in addition demonstrate the costs of geopolitical defection. The price rise would most likely also create problems for the new pro-Western Ukrainian leadership in the run up to the March 2006 Ukrainian parliamentary elections.

In **Ukraine**, the president and the negotiators who on January 4, 2006 signed the agreement on gas deliveries from and through Russia to Ukraine have defended it ever since as mutually beneficial to both Ukraine and Russia. President Yushchenko has repeatedly stated that he sees no potential advantages in re-negotiating the deal. He believes that market orientation of energy relations with Russia is necessary, although he opposes a sudden switch since Ukraine's economy needs time to adapt. Former Ukrainian PM Yulia Tymoshenko on the contrary, characterized the agreement as a "betrayal of national interests" and called to "seriously review" it.¹⁰ Pro-Russia politicians either kept a low profile on the issue or saw the price hike as a natural outcome of the pro-Western government's attempt to distance Ukraine from Russia. Both Ukraine's extremely energy-consuming industry and its economically marginalized population have reacted very negatively to the dramatic price hike entailed by the agreement.

The Ukrainian political forces supporting President Yushchenko were in government at the time of the negotiations with Gazprom and had reasons to fear a worsening of Ukraine's economic situation before the parliamentary elections which were due in March 2006. Many observers expected these elections to have decisive influence on Ukraine's geopolitical orientation. This expectation was strengthened by the fact that parliament, due to constitutional changes passed in December 2004, would increase its powers substantially at the cost of the president.

There is little doubt that the gas crisis affected the outcome of the 2006 elections as it contributed to even more infighting among the former partners of the (pro-presidential) "orange coalition", i.e. Yulia Tymoshenko's bloc on the one side and Yushchenko's bloc Our Ukraine on the other. The latter lost vast amounts of votes on the issue, while the oppositional Party of Regions (whose candidate for PM was Yushchenko's contender in the 2004 elections, Viktor Yanukovich) received more votes than any other in the March 2006 elections, although not more than Yanukovich had received in the presidential elections. After months of chaos in the aftermath of the elections, Ukraine's parliament finally approved a new government. This government was formed by a coalition consisting of Yanukovich' Party of Regions, the Socialist Party and the Communist Party. Their government constellation has, to Russia's satisfaction, slowed down integration with NATO. Some believe the decision this June to leave the terms of 4 January 2006 unchanged for another three months was taken to await the formation of Ukraine's new

⁹ For an overview of foreign policy goals of pro-Western political forces in Ukraine, see Volodymyr Dubovyk, *The Foreign Policy of Ukraine One Year After the Orange Revolution*. PONARS Policy Memo No. 372, Dec'05: www.csis.org/media/isis/pubs/pm_0372.pdf

¹⁰ GZT.ru 22.06.06: <http://gzt.ru/world/2006/06/22/215050.html>

Eurasia Daily Monitor 22.06.2006: http://www.jamestown.org/edm/article.php?article_id=2371206

government before deciding on which price to demand. But even with the terms of January 4 agreement, Ukraine is becoming tremendously indebted vis-à-vis Russia.¹¹ This in turn increases Kyiv's dependence on Moscow.

2.3 Western Reactions and Russia's case

Concerns rose in **the West** as the amount of gas reaching Europe from Ukraine rapidly declined from 1 January 2006. The West generally saw the Russian side as the one to blame, and since Gazprom is largely dictated by the Kremlin, criticism was aimed directly at Russia's political leadership. It was the US who most emphatically held the Russian side responsible for the reduced gas flow. On January 2, the US State Department stated that "such an abrupt step creates insecurity in the energy sector in the region and raises serious questions about the use of energy to exert political pressure".¹² Secretary of State Condoleezza Rice few days later claimed Russia had "an obviously political motive" for the gas shut-off and questioned her willingness to behave as a responsible energy supplier.¹³ The American stance was reiterated by Vice-President Cheney at a conference in Vilnius on May 4. Among other critical comments he made on political developments in Russia, Cheney warned against the use of oil and gas as "tools of intimidation or blackmail, either by supply manipulation or attempts to monopolize transportation".¹⁴ Statements from the EU took a more careful approach, encouraging Moscow and Kyiv to find a solution, but also warned that "any negative action will shake Europeans' confidence in these suppliers".¹⁵

Still, the blame game did not end in a total loss for Russia. The Russian claim that European consumers were hurt partly because Ukraine stole gas that was meant for them has later become widely accepted in the West. There is no doubt that Ukraine took gas from the pipelines also after the Russian decision to limit the amounts of gas it sent into the pipelines, but whether this was theft or not is still open for debate. First, Ukraine was under the existing contract paid for its transport services with gas. Thus, seen from the Ukrainian side, Russia was perceived as saying "we have no agreement on new conditions, we will continue to use your transport services but we will no longer pay for them". This was unacceptable to Kyiv. Second, according to the independent Russian energy expert Vladimir Milov, there were legal arguments legitimising the Ukrainian actions. Paragraph 7 of a 1994 Russian-Ukrainian agreement on the transport of Russian gas to Ukraine can, according to Milov, be interpreted as giving Ukraine a right to do what it did.¹⁶ We do not here attempt to justify the Ukrainian actions, but to point out that how continued Ukrainian consumption of gas should be labelled was never obvious, and that Russia scored a media victory by getting many in the West to accept its position that this was little more than plain theft. Ukraine's history of gas theft from the 1990s (admitted by Ukrainian authorities

¹¹ Vladimir Socor, *Ukraine's State Gas Company Falling Rapidly Into Debt*, Eurasia Daily monitor, 22.06.06: http://www.jamestown.org/edm/article.php?article_id=2371207

¹² Mosnews, 02.01.06: <http://www.mosnews.com/news/2006/01/02/ukrgasupdate.shtml>

¹³ US Department of State, 05.01.06: <http://usinfo.state.gov/eur/Archive/2006/Jan/05-815092.html>

¹⁴ The White House, 04.05.06: <http://www.whitehouse.gov/news/releases/2006/05/20060504-1.html>

¹⁵ EU's foreign policy commissioner Benita Ferrero-Waldner, quoted in Mosnews 02.01.06: <http://www.mosnews.com/news/2006/01/02/ukrgasupdate.shtml>

¹⁶ Speech by Vladimir Milov at the Stephan Batory Foundation, Warsaw, 3 April 2006, text available at <http://www.energypolicy.ru/pv.php?id=1002175>

in the period when Yushchenko was prime minister) undoubtedly contributed to this result.

The EU's foreign policies are constrained by the need for backing from all or most member states, but the fact that the US reacted more sharply to the gas row than the EU probably also reflects that the EU and the US have dissimilar relations with Russia as well as different interests in Ukraine. The US is less dependent on Russia than the EU due to the relatively smaller importance of Russian energy supplies to the US. The US thus felt freer than the EU to voice its sympathy for the Ukrainian side. More importantly, Washington's defence of the pro-Western administration in Kyiv may well be interpreted as a step consistent with the American drive to include Ukraine in NATO and the EU. Just like the competing domestic political forces inside Ukraine, the US and Russia seem to perceive the ongoing struggle to define Ukraine's geopolitical orientation as a "zero-sum game" where one side loses if the other side wins. The zero-sum mindset of Russia and the US is particularly visible in this case due to Ukraine's strategic and historic importance to Russia (but probably also because the relations between Washington and Moscow generally are cooler than in many years).

Old and influential EU members, on their part, focus on creating stability through mutually beneficial economic integration and do not seem to apply the zero-sum perspective to the same extent. The EU's vulnerability to disturbances in the energy supplies from Russia, as illustrated by the Russia-Ukraine crisis, apparently led to increasing EU pressure on Russia to ratify the European Energy Charter. Russia signed onto this charter already in 1994, but it has never been brought before the Duma for ratification. The charter prescribes liberalization of the energy sectors of all signatory states, meaning increased access to one another's energy sectors through dismantling of national monopolies like the one upheld by Gazprom in Russia.¹⁷ The liberalization idea is supported by the US, who states that Russia should open up its oil and gas sector to foreign investment if it wants to be seen as a "world-class energy player".¹⁸ To the West, this is a question of securing stable and predictable Russian supplies as well as an opening of new markets for Western companies.

Russia has consistently denied any allegation that the reduction of the gas flow running to Ukraine was politically motivated. As the gas row with Ukraine culminated and the amounts of gas heading west were reduced, Russia stressed that the crisis had nothing to do with politics. The Russian side claimed to have purely economic motives for its stance in the negotiations, the goal allegedly being to introduce European market standards into Russian-Ukrainian energy relations.¹⁹ When the January 4 deal was struck, President Putin said the new terms were mutually beneficial and that the contracts comprised by the deal "fully serve the interests of a market economy".²⁰ Russia has stood firmly on this position ever since. Former PM and current ambassador to Ukraine, Viktor Chernomyrdin, even responded to Yulia Tymoshenko's urge to re-

¹⁷ About Moscow's stance on the issue of the European Energy Charter, see Kommersant Daily 29.05.06: <http://www.kommersant.com/page.asp?idr=529&id=677269>

¹⁸ William Burns, US Ambassador to Russia, in Moscow Times, 27.06.06.

¹⁹ See e.g. Putin's statements to Russian top diplomats on June 27, quoted by Nezavisimaya Gazeta, 28.06.06: http://www.ng.ru/politics/2006-06-28/1_putin.html

²⁰ Quoted by Kommersant, 12.01.06, page 1.

negotiate the terms of January 4 by claiming “one should not forget that this agreement is beneficial most of all to Ukraine”. He added that “Ukraine’s authorities should be interested in maintaining the validity of these documents [the January 4 agreement]”, implying that a Ukrainian bid to re-negotiate the terms only could lead to a further price-hike.²¹ Few days before the G8 summit in St Petersburg, President Putin slammed the critical comments made by Vice-President Cheney in Vilnius two months earlier, calling them “a failed hunting shot” (with reference to Cheney’s accidental shooting of a friend during a hunt).²²

While Russia’s attempt to influence the outcome of Ukraine’s 2004 *presidential* elections failed, the gas crisis a year later apparently had an effect on the 2006 *parliamentary* elections. To be fair, however, one should question the extent to which Russia actually intended all the consequences of the gas crisis, not least the reactions it caused in the West. Realizing that Russia’s approach to the gas crisis scared Europe and upset Washington, Moscow has explicitly admitted that it did not succeed in passing its message across to the West.²³ In others words, Moscow did not see the need to justify or at least explain the steps they took in the gas crisis. This obviously means that Russia did not understand how strongly its shut-off would antagonize the US and worry the EU. It is worth remembering that Russia is just as dependent on Europe as vice versa, if not even more dependent. At least 80 per cent of Russia’s gas exports are sent to Europe, but this still does not constitute more than approximately one fourth of Europe’s consumption. Since Europe’s energy imports are an extremely important source of incomes for the oil- and gas-dependent Russian budget, Russia has a strong interest in maintaining good working relations with her European customers.²⁴ The logical conclusion is that Russia probably would not have proceeded likewise if the Kremlin had anticipated how much the shut-off would damage Russia’s image as a reliable energy supplier to the West.

Alternatively, the Russians did in fact anticipate the West’s reaction, but estimated their own position more positively than the West did and consequently accepted the risk of frustrating its customers. The gas crisis with Ukraine was only the latest (but arguably the fiercest and most serious) of conflicts with customers within the CIS over terms of transit and delivery. Russia’s dependency on Ukraine as a transit country had long limited Moscow’s ability to put pressure on Kyiv over the terms of delivery, precisely because shut-offs aimed at Ukraine almost inevitably hit large customers further down the pipe. When Russia decided to impose a shut-off on this particular occasion, it may also have been an attempt to put an end to what the Russians see as theft of gas and refusal to concede rightful revenues to Russia. Any “additional positive effects” on Ukrainian politics caused by the crisis would of course be welcome in Moscow.

²¹ Viktor Chernomyrdin, Russia’s Ambassador to Ukraine, quoted by Izvestia, 22.06.06

²² Mosnews, 12.07.06: <http://www.mosnews.com/news/2006/07/12/putinwarning.shtml>

²³ See statements to Western press by Putin’s deputy press secretary, quoted by Radio Free Europe, 09.06.06: <http://www.rferl.org/featuresarticle/2006/06/b81f257c-db2a-4c83-b902-6daf1d081072.html>
See also Putin’s statement to Russian top diplomats on June 27, quoted by Nezavisimaia Gazeta, 28.06.06: http://www.ng.ru/politics/2006-06-28/1_putin.html

²⁴ Gazprom’s earnings from gas export to Europe in 2004 is estimated to USD 19.4 billion. See J.P. Stern, *The Future of Russian Gas and Gazprom*, Oxford University Press 2005: pp 127.

In addition to rational calculations of the kind presented above, one should also not exclude the possibility that emotions might have played a role. The very uncompromising Russian negotiation style can partly have been the result of a desire in the Russian elite to punish Ukraine, and all potential positive and negative consequences were not necessarily always considered at every turn during the crisis.

Relatively few attempts were made in the West to thoroughly examine Russia's argument vis-à-vis Ukraine in the gas crisis, perhaps due to the overwhelming support for the Orange Revolution in Western media and public opinion. Although assumptions of a link between Ukraine's westward political turn and Russia's demand for higher gas prices probably are justifiable, one should acknowledge that what might be labeled "Russia's economic argument" has some strength: First, the price formerly paid by Ukraine for gas was very low compared with the prices paid by many other customers. While Ukraine prior to January 1, 2006 paid USD 50 per 1000 cubic meter, the price of Russian gas is USD 250 for the same amount by the time it reaches the Italian border.²⁵ Second, there is no logical reason for Russia to sponsor Ukraine with exceptionally cheap gas, especially not if the Ukrainian leadership prefers the West to Russia as its closest partner. As President Putin rhetorically asked a German journalist on June 2, "why should German consumers pay \$250 per 1,000 cubic meters and Ukrainians \$50? [...] if you want to present such a gift to Ukraine - pay for it".²⁶ Third, introduction of market principles in economic relations with other former Soviet states would comply with Western ideals since it would require transparency and encourage efficiency.

On the other hand, it is clear that Russia's adoption of "market principles" postulates a rather wrenched understanding of the concept. Energy relations within the former Soviet Union are inherently non-market driven since most production and distribution facilities are subject to monopoly control by state-owned companies. It is hard to see how a functioning market possibly can emerge under such conditions. Even with the new terms, the Russian-Ukrainian gas trade clearly continues to be an example of lacking market relations as the alleged switch to market principles is being conducted in an abrupt and non-transparent manner. Through negotiations between two state-owned monopolists behind closed doors, Russia imposed a more than fourfold increase of the price on Russian gas sold to Ukraine. In accordance with the January 4 deal the gas is mediated to the customer by corporations that are formed ad hoc and owned by obscure business structures surrounded by rumours of corruption. The claim to "market relations" as an objective for negotiations with Ukraine is in other words not entirely convincing.

²⁵ Matthew Wrigley, *The Russians Are Buying*, Russia Profile, Issue 2 Volume III / March'06: Page 29.

²⁶ President Putin, quoted in Johnson's Russia List: <http://www.cdi.org/russia/johnson/2006-129-3.cfm>

3 The Role of Energy in Russia's Foreign Policy

3.1 Links between Energy Strategy and Foreign Policy

Russia's gas crisis with Ukraine may partially be seen as a result of the Kremlin's discontent with the domestic political developments in a strategically important neighbouring country. Russia's policies towards Ukraine are clearly shaped by the emphasis Russia puts on energy in her foreign relations in general. Energy exports are an obvious instrument for the Kremlin to promote Russia's strength and interests on the international arena as world energy prices soar due to increasing consumption and politically unstable suppliers elsewhere. At first glance energy seems to be an instrument for the future since the world's need for oil and gas from comparatively stable suppliers like Russia is bound to increase. Moscow planned that last year's G-8 summit should become a break-through for her ambitions, and listed energy security on top of the summit's agenda to manifest its own power potential.

The Kremlin denies, as we have seen, that Russia intends to use the energy lever as a means to political ends vis-à-vis other states. Allegations that Russia politicises economic issues are bounced back. During a meeting with Russia's top diplomats at the Ministry of Foreign Affairs on June 27, 2006, Putin claimed that not all would like to see "Russia rebuild her economic health and position in the world" and said these actors (unspecified, but with clear address to the West) "even invented energy blackmail". Having reiterated Russia's intention to transform relations with other CIS countries according to "principles common in world economy and trade", he nonetheless declared that what Russia does is to demonstrate "that it is beneficial to be friends with modern Russia".²⁷ Putin also said Russia "has the right to choose friends".²⁸ If "choosing friends" means to treat selected energy customers discriminately, this confirms the Kremlin's odd understanding of market principles.

It might be worth asking whether it is possible for Russia to separate energy from politics at all, even if there is political will to do so. The problem is that trade of natural gas (unless it is liquified) is dependent on fixed infrastructure for export, which subjugates Russia's gas sales to negotiations between a limited number of actors who to a greater or lesser extent are interdependent. Given the importance of gas to all parties involved, price negotiations are arguably politicised per se, especially in cases where the dependency relationship is strong and asymmetrical. Asked about the geopolitical aspect of possessing energy resources, Minister for industry and energy Khristenko says "the economic and political significance of energy is often indivisible", although he denounces attempts to "politicise the settling of energy problems".²⁹ Gazprom's deputy CEO Alexandr Medvedev has expressed that "it is too naive to say that the energy business can be completely separated from foreign policy".³⁰

²⁷ Quoted by Kommersant.ru, 28.06.06: <http://www.kommersant.ru/doc.html?docId=685931>

²⁸ Quoted by Nezavisimaia Gazeta, 28.06.06: http://www.ng.ru/politics/2006-06-28/1_putin.html

²⁹ Interviewed by Russia Profile, Issue 2 Volume III / March'06: Page 22.

³⁰ Quoted in Russia Profile, Issue 2 Volume III / March'06: Page 30.

Even if gas trade is politically charged from the very beginning, the Kremlin does little to try to counter the phenomenon. A fundamental indicator of this inaction is the refusal to encompass energy trade in a multilateral framework with established rules, e.g. by ratifying the European Energy Charter (which Gazprom's deputy chairman Alexandr Medvedev has dubbed "an anti-Russian document"³¹). Russia's de facto rejection of the European Energy Charter confirms that the Kremlin feels comfortable with the status quo, in which energy relations between Russia and its customers are based on deals that are negotiated bilaterally on a case to case basis. Preserving this anarchic "regime" of energy relations increases the chances for negotiations to be hijacked by bilateral political problems.³² Russia is free to act differently in different cases, depending on how the country wishes to conduct policies vis-à-vis its respective customers. This does not mean that Russia will always seek to obtain political objectives in any given negotiations on energy issues. Russia's political leadership does, however, not want to preclude the option to "act politically" if it feels a need to exert political pressure on a customer or group of customers. This is why the Kremlin prefers "an energy charter without formal ratification", i.e. a less compromising modus operandi under which selected foreign actors are granted limited access to the national energy sector based on bilateral understanding between Russia and partner states.³³

The Kremlin's ideological foundation seems clear. President Putin considers that Russia's valuable natural resources to be key to the economic rebuilding of Russia and the reestablishment of her influence in international politics. In an article Putin published already in early 1999 (Yeltsin appointed him as PM in August 1999, Putin became acting president in January 2000) he argues that natural resources, oil and gas in particular, should guarantee the strength of Russia's positions internationally.³⁴ Putin's train of thoughts on this issue has been increasingly influential during his presidency. The official Russian energy strategy, which came in May 2003, prescribes among other things an important role for the energy factor in Russian diplomacy.³⁵

3.2 Russia's Strategic Objectives

The ideas described above have resulted in highly tangible policies, the objectives of which may be roughly divided into three. The achievement of these objectives is thought to maximize Russia's revenues and the Kremlin's ability to influence energy relations with foreign actors. As outlined below, there are nonetheless clear risks to this strategy.

The **first objective** is to strengthen state control over the resource base. Following the attempt by Yeltsin's early reformers (Gaidar, Chubais) to substantially weaken state ownership, Putin turned the pendulum back in favour of state intervention in so-called strategic sectors. Whereas Yeltsin

³¹ Quoted by Kommersant, 29.05.06: <http://www.kommersant.com/page.asp?idr=529&id=677269>

³² J.P. Stern, *The Future of Russian Gas and Gazprom*, Oxford University Press 2005: pp 136.

³³ Putin coined this term having discussed energy relations with Italian PM Romani Prodi in June 2006, see http://kremlin.ru/eng/speeches/2006/06/20/2257_type82914type82915_107481.shtml

³⁴ M. Olcott, *Vladimir Putin i nefitanaia politika Rossii*, *Robochie materialy* No.1, Carnegie Center Moscow 2005, pp 9-12: <http://www.carnegie.ru/en/pubs/workpapers/71963.htm>

³⁵ M. Fredholm, *The Russian Energy Strategy & Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, Defence Academy of the UK, Sept 2005, pp 3.

let mighty private interests have direct access to political power, Putin has gradually thrown out state officials deemed to have private interests running contrary to the ones of the political leadership and inserted loyal state officials into top positions of Russian business.³⁶ Putin is convinced that state-dominated ownership of valuable natural resources is highly necessary to rebuild Russia's economy as well as her influence in international politics. State control over the oil and gas sector is evidently seen as a vital national interest, and Putin himself dubs the energy sector "the holy of holies of our economy".³⁷ The state's take-over of the energy sector through acquisitions of major private corporations has been a clear trend, and companies controlled (i.e. more than 49 per cent owned) by foreigners are banned from participating in auctions on "fields of strategic importance".³⁸

Rather than complete ownership of the sector, the Kremlin's strategy is to concentrate strategic sectors of the economy around large corporations in which the state holds a controlling majority of shares. Meanwhile, minority shares of fields and projects will continue to be sold to private interests also in the future, to attract both investments and technology from private and foreign actors. The most controversial move in the direction of gaining control over the energy sector was the take over of Yukos, followed by state-owned Rosneft's absorption of Yuganskneftegaz.³⁹ Another notable event was Roman Abramovich's sale of Sibneft to Gazprom for USD 13 billion.

Although investors so far have put down large amounts of capital in Russia's energy sector, some claim that Russia and her energy customers should worry more about the depletion of fields that are currently operative since investment in exploration and development of new fields is comparatively sparse.⁴⁰ In this view, the Kremlin's urge to control the energy sector for political purposes induces economic inefficiency because state-run businesses as a rule perform sub-optimally. It also implies additional risks, which will reduce the sector's attractiveness to investors. Moreover, Russia's reliance on imports from Central Asia to meet the customers' needs propels additional doubts about the country's reputation as an energy supplier since energy relations between Russia and Central Asian states (in particular Turkmenistan) are opaque and hard to predict. As a consequence, the long-term viability of state control over energy resources as the guarantor for Russia's political leverage may be at risk. If Russia's production of oil and gas at any point falls short of complying with its commitments to customers, the Kremlin's strategy would be counterproductive since it would ruin Russia's credibility as an energy supplier.

³⁶ M. Fredholm, *The Russian Energy Strategy & Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, Defence Academy of the UK, Sept 2005, pp 9-10.

³⁷ Quoted by Kommersant.com, 26.05.06: <http://www.kommersant.com/page.asp?idr=527&id=676646>

³⁸ M. Fredholm, *The Russian Energy Strategy & Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, Defence Academy of the UK, Sept 2005, pp 9.

³⁹ Critics link this "attack" to several other factors as well, see e.g. Shevtsova in Moscow Times 27.08.03: <http://www.carnegieendowment.org/publications/index.cfm?fa=view&id=1339&prog=zru>

⁴⁰ R.L. Larsson, *Russia's Energy Policy: Security Dimensions and Russia's Reliability as an Energy Supplier*, FOI, Stockholm 2006: pp 36-43.

The **second objective** is to maintain pipelines, including the planning of new ones, under state control. Putin has explicitly stated that the state will stay in control of the pipelines although private investment is welcome.⁴¹ Putin has consolidated the Kremlin's control and determinately removed all speculations that private interests might build their own pipelines. Most notably, Yukos' ambitions to build its own oil export routes from Siberia to Murmansk and China were discarded with the decline of the company.⁴² Transneft and Transnefteprodukt, which analysts suggest could be merged into a single state-owned pipeline company, are the state's main vehicles of control over oil pipelines. Gazprom owns all long-distance gas pipelines, while local distribution networks are owned either by Gazprom or by Rosgazifikatsia (also state-owned). Moreover, the exclusive right to export gas from Russia was recently given to Gazprom by law, effectively formalizing the Kremlin's monopoly.⁴³ Combined with control over the resource base, control over oil and gas pipelines enables the state to distribute energy to domestic consumers at low prices and, at least in theory, define the conditions of delivery to customers outside Russia.

If the Kremlin's control over domestic infrastructure is firm, the management and development of export infrastructure remain a considerable challenge. Russia's ability to alter the destination of its gas exports is currently highly constrained since exports routes are relatively few. The lion's share of Russian gas exports run through Ukraine. Belarus follows as the second most important transit country, but is insignificant in comparison. Russia's dependence on Ukraine as a transit country has enabled the latter to accumulate large debts to the former. Besides failing to pay back debts for gas deliveries that were sold according to contracts, Ukraine illegitimately siphoned off Russian gas in the 1990s.⁴⁴ As a countermeasure, Russia has repeatedly sought to gain control over the pipelines running through Ukraine. Kyiv's latest step to prevent this was to pass a law forbidding the sale of gas infrastructure to foreign interests. The Ukrainians may nonetheless have to cave in if the debt burden vis-à-vis Moscow grows too big. Due to extreme economic and political dependence on Russia, Belarus is even more disposed to give away control over transit infrastructure than Ukraine, and the 31 December 2006 gas agreement with Gazprom includes a Belarusian obligation to pay for some of the gas with shares in the Beltransgaz company that owns the Belarusian pipeline system.⁴⁵

The purpose of planning and building new export routes for Russian gas seems to be twofold; Russia seeks to increase the capacity of the export infrastructure and to reduce her dependence on individual transit countries. In this respect, the building of the North European Pipeline (NEP) is the most notable project which so far has materialized. Connecting Russia's gas fields directly

⁴¹ M. Fredholm, *The Russian Energy Strategy & Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, Defence Academy of the UK, Sept 2005: pp 9.

⁴² I. Gorst, *Russian Pipeline Strategies: Business Versus Politics*, James Baker III Institute for Public Policy of Rice University, October 2004, pp 2:

http://www.rice.edu/energy/publications/docs/PEC_Gorst_10_2004.pdf

M. Fredholm, *The Russian Energy Strategy & Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, Defence Academy of the UK, Sept 2005, pp 7,11-13

⁴³ See Johnson's Russia List / Moscow Times, July 6 2006 for details:

<http://www.cdi.org/russia/johnson/2006-152-12.cfm>

⁴⁴ J.P. Stern, *The Future of Russian Gas and Gazprom*, Oxford University Press 2005: pp 87.

⁴⁵ *ibid*: pp 97.

with the highly important German market (with future extension as far as to the UK), the NEP alone will at full capacity possibly enable Russia to export as much as 55 bcm per year bypassing potentially troublesome transit countries.⁴⁶ If Russia manages to reduce her dependency on transit countries, she will be freer to put political pressure on these countries, So far, however, there are few prospects that Russia can attain such a freedom vis-à-vis Ukraine anytime soon. Moreover, there are fears that the NEP is a blow for the efforts to make the EU act concertedly in its energy policies towards Russia. If the Germans with the NEP feel reassured that their future energy needs will be met, other EU states would rather have pressurized Russia harder to create a multilateral framework based on the European Energy Charter. This is why the Polish minister of defence, whose government often applies anti-Russian rhetorics, was provoked to say that the deal to build the NEP is in “the Molotov-Ribbentrop tradition”. He also demanded “no monopolies or blackmails, price-fixing or the use of energy as a tool of politics”.⁴⁷ Russia also considers pipeline projects bypassing Ukraine to the south. A Russian-Italian (Gazprom-ENI, 50/50) partnership has built the Bluestream pipeline which connects Russia with Turkey crossing the Black Sea. Russia pushes for an extension of the line to Europe via the Balkans, but the line’s current maximum capacity is limited to relatively moderate 16 bcm per year.⁴⁸

For the Kremlin, it would be even better to gain leverage vis-à-vis the West by reducing Russia’s dependence on Europe as a whole. One way to accomplish this would be to build new export routes for gas to East Asia. Or, as Putin did during a visit to Germany in September 2005, Russia can try to enlarge its room for maneuver by simply claiming that such export routes are under planning. The President announced that the less flexible Europe is in its treatment of Russia, the quicker the export flows would be rerouted: “Russia desires, plans and will very soon begin constructing new pipeline systems in the eastern direction, and we will select the tempo of implementing these projects in accordance with the way our agreements with European partners are carried out”.⁴⁹ However, the threat, which these projects represent currently, appears as rather far-fetched. Constructing several thousand kilometre long pipelines running through extremely inhospitable areas clearly requires immense investments (a gas pipeline from Siberia to China is estimated to cost at least USD 10 billion) and long time. For several years still, Ukraine will thus continue to be the by far most important channel for export of Russian gas, even with the NEP running at full capacity.

As with the state monopoly over the resource base, economic inefficiency is a fundamental risk associated with the state monopoly over the distribution of oil and gas. Capped prices on the domestic gas market drastically limit the profit potential in the internal transmission sector. The fixed prices on gas transmission combined with state ownership of the infrastructure reduce or remove the incentive for independent investors to contribute to the building and/or refurbishment

⁴⁶ I. Tomberg of the Russian Academy of Sciences claims ‘to offset transit risks’ through bypassing Ukraine is the reason why the NEP is built. See *The North European Gas Pipeline Project in the Geopolitical Context* in *International Affairs*, Vol 52 No.2, 2006, pp 96-97.

⁴⁷ Quoted by Washington Post on July 11, 2006:

http://www.washingtonpost.com/wp-dyn/content/article/2006/07/10/AR2006071001218_pf.html

⁴⁸ Russian Energy Weekly, No.44 (189), Nov 28 2005.

⁴⁹ Quoted by Russian Energy Weekly, No.35 (180), Sept 26 2005.

of pipelines and storage facilities.⁵⁰ As to the export of gas, the profits available abroad should be an incentive for Gazprom to manage the infrastructure well and to build new facilities, but it is beyond doubt that the company's monopoly per se is conducive to inefficiency. The monopoly is moreover, regardless of the theoretical welcoming of privately owned minority shares, a de facto rejection of private initiatives.⁵¹ It is a paradox that so few new pipelines are constructed despite the fact that the independent business community and observers alike are convinced that investments in infrastructure are highly needed. Lacking investments are detrimental to the prospects of developing new fields since viable routes of distribution from several areas of potential exploration are non-existent. In other words, the (long-term) output of Russia's oil and gas sector is affected negatively by the Kremlin's pipeline management, which in turn will reduce the clout and credibility of Russia's desired energy weapon.

Losing control over exports from Central Asia is another potential risk to the Kremlin's pipeline management. Central Asia is currently totally dependent on Russia for the export of the region's gas production. In the short run, this clearly gives Russia a heavy hand vis-à-vis Central Asian states whose economies are mainly driven by gas (Turkmenistan) or oil and gas (Kazakhstan). However, Gazprom's monopoly to export gas from Russia combined with the lack of infrastructure which would enable Central Asian countries to export gas independently of Russia gives Central Asian countries a strong incentive to build new export routes which would bypass Russia. The plans to build pipelines directly to countries like China and Iran can in the long run lessen Russia's influence in the region as well as Gazprom's revenues and ability to serve customers in Europe.

The **third objective** is linked to the second but is literally more far-reaching as it aims at increased Russian participation further down in the chain of supply. Gazprom devised a strategy to increase its downstream presence already during the late 1980s, and the Kremlin's efforts to increase Gazprom's shares in distributors of gas on foreign markets are stronger than ever.⁵² The goal is to capture a larger share of the profits earned from sales of Russian gas abroad by reaching foreign customers directly. Besides acquisitions in the former Soviet Union and Eastern Europe, Germany is one of the markets where Gazprom has gained most access. The company's effort to swap assets with German gas distributors has been intensified as the construction of the NEP is starting to materialize. Gazprom and Russian oil companies have also bought into energy corporations or created joint ventures with local partners in countries like the UK, Finland, Denmark, Italy, and the US.

While the urge to increase Russian participation in downstream projects abroad is mainly economically motivated, the Kremlin also hopes it will improve Russia's image as a reliable

⁵⁰ J.P. Stern, *The Future of Russian Gas and Gazprom*, Oxford University Press 2005: pp 37.

⁵¹ M. Fredholm, *The Russian Energy Strategy & Energy Policy: Pipeline Diplomacy or Mutual Dependence?*, Defence Academy of the UK, Sept 2005, pp 37.

I. Gorst, *Russian Pipeline Strategies: Business Versus Politics*, James Baker III Institute for Public Policy of Rice University, October 2004, pp 1:

http://www.rice.edu/energy/publications/docs/PEC_Gorst_10_2004.pdf

⁵² J.P. Stern, *The Future of Russian Gas and Gazprom*, Oxford University Press 2005: pp 111.

energy supplier since it ostensibly increases mutually beneficial interdependence. Russian attempts to acquire assets in the energy sectors of European economies have nonetheless been met by significant scepticism, as when Gazprom considered making a bid for Centrica (major British distributor of gas). Some fear Russian entrance into European downstream markets will increase Russia's revenues on unequal terms. The most obvious fear is that Russia's export monopoly will try to give its own subsidiary distributors in Europe preferential treatment. It is of course also noteworthy how Russia, while actively seeking to maximize her own participation in Europe, heavily restricts the role of foreign interests in her own energy sector. European leaders can probably feel confident that the Inner Market provides them with rules and tools to deal with any illegitimate Russian transactions in the European energy sector. But successful Russian entry into European downstream markets without concessions to foreign actors wanting to enter Russia would in any case signify the latter's evasion of the European Energy Charter's demand for formally approved reciprocity within a multilateral framework.

4 A New Russian-Ukrainian Gas War?

Russia will probably, as demonstrated by the December 2006 compromise with Belarus, apply shut-offs more carefully in the future. The January 2006 gas crisis with Ukraine displayed how the energy supplier should have taken its own level of dependence on the customer into account when devising its strategy. An outright shut-off of energy supplies is a highly tangible measure which in some cases may produce quick results, but it is likely to strike back on the supplying side to the extent that the supplier is dependent on the customer. In the case of Ukraine, Russia was clearly able to hit the customer hard by cutting off gas supplies, but such a shut-off was apparently not in Russia's long-term interest as long as Russia is dependent on transiting the bulk of its gas exports through Ukraine.

In our opinion, the likelihood that the January 2006 events will be repeated, and that European customers will suffer as a result, will largely depend on six factors. These are, in order of decreasing importance according to our view:

1. The degree of Ukrainian gas dependence on Russia.
2. The extent to which, and how quickly, Russia is able to substantially reduce her dependence on the Ukrainian pipeline system through the construction of alternative pipelines and/or LNG export facilities.
3. The importance of the European market in relation to other gas markets (China, India and others).
4. The ownership structure of the Ukrainian pipeline system (whether it remains Ukrainian, becomes joint, or Russian).
5. The general mood in EU-Russian relations
6. The general mood in Ukrainian-Russian relations

There are three ways that Ukraine can decrease its dependence on Russian gas: alternative suppliers, domestic production and decreased consumption. The country is at present trying all three, but none are likely to free Ukraine of its gas dependence on Russia anytime soon. Turkmenistan, Kazakhstan and Uzbekistan are at present the main alternative suppliers, and

Ukraine is unyieldingly trying to increase these countries' share of its gas import. However, all the gas that Ukraine receives from these countries arrives through Russian pipelines, and the effect on Ukraine's degree of dependence is therefore limited. Ukraine is also trying to increase domestic extraction, and promising new discoveries have been made, both onshore and offshore, but they can help to alleviate the gas dependence only in the longer run. The way that shows most promise is probably to decrease domestic consumption. Especially Ukrainian industrial gas consumption is high and very inefficient. In this area the January 2006 crisis seems to have had an effect, and substantial investments are now underway to modernise and make major parts of Ukrainian industry more energy efficient.

Most experts agree that Russia will be highly dependent on the Ukrainian pipeline system for at least the near to medium term future. All the present alternative projects under construction taken together cannot alter that. However, in the longer term one cannot exclude that alternative pipelines can reduce the Russian dependency on Ukraine to a degree that shut-offs can hurt Ukraine without simultaneously also hurting Russian supplies to EU countries. In this situation gas shut-offs would again become a most powerful weapon for the Kremlin in its dealings with Ukraine.

The situation is broadly similar on the issue of the relative importance of the European gas market. Although geopoliticians in the Kremlin dream of increased Russian power in Europe brought forward by threats to sell the gas to China and India instead, and despite the fact that such thoughts occasionally have been mirrored also in Putin's speeches, these are not prospects for the near and medium term future. Such pipelines take many years to construct, and most attempts to reach agreement with, in particular the Chinese, have so far not been very successful.

Russia is currently in the process of taking over ownership of the Belarusian pipeline system, and a similar acquisition of the Ukrainian system has long been a desire in the Kremlin. Today, however, all significant political forces in Ukraine oppose such a development, and continued national control over the pipelines is even written into the Ukrainian constitution. Ukraine is ready for joint ownership with Russia in the construction of new pipelines, but not of the existing ones. However, one cannot exclude that the Ukrainian political leadership at a later stage might find itself so pressured by Russia that it might become willing to compromise even on this issue. That is probably what happened in the December 2006 Belarusian-Russian negotiations.

The potential effect of Russian ownership of the Ukrainian pipelines on possible future shut-offs are hard to judge. Legally speaking, such ownership would entail that Russia could shut off gas to Ukraine without hurting supplies to Europe, because the Russian ownership of the pipelines in principle would prevent Ukraine from even touching them. Thus, Ukraine would not be able to take gas anyway, as it did in January 2006.

This would make it more likely that Russia again could use shut-offs to pressure Ukraine. However, uncertainty would remain with regard to whether Ukraine would respect Russia's property rights in a situation where she felt "illegitimately" bullied by Russia. This would have to

figure centrally in the Kremlin's calculations of whether or not to use shut-offs or not. In this situation it would further be significant to what extent Russia would be able to exert control over the pipelines beyond the legal sphere, either by the instalment of technical devices that would prevent the Ukrainians from accessing the gas or in the more extreme version by employing some kind of armed force to protect the pipelines. In sum, Russian ownership of the pipelines would make it more likely that Russia could use shut-offs against Ukraine again, but the effect might not be as strong as the legal argument would suggest.

The final two factors have more to do with emotions than with the rational calculation of future material costs and benefits. Russia could decide to punish both Ukraine and the EU with shut-offs, even if this had strong negative economic consequences for Russia. This would be in situations where the Russian leadership felt that one or more of these countries had behaved in a way towards Russia that just could not be tolerated. We would be talking about a Russian equivalent of the 1972 oil boycott from the Arab world. The Russian leadership would be willing to endure severe financial and political costs in order to maintain the country's self respect and independence.

Taken together these six factors suggest that a repetition of the January 2006 crisis is not very likely in the short to medium term, but that several of these factors could change so as to make repetitions much more likely in the longer term.