

## As Oil Enriches Russia, Tensions Surface in Europe

by Sacha Kumaria

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On July 15, the leaders of the world's eight great industrial nations will convene in St. Petersburg, Russia, to discuss the future of the global economy. Chaired by Russian President Vladimir Putin, it will mark the culmination of Moscow's 20-year transformation from the spiritual home of communism into a major capitalist power.

But the meeting will be held against a backdrop of increasing international tension about Russia's resurgence. Relations between Washington and Moscow are at their lowest ebb in 10 years, and in his recent Address to the Federal Assembly -- equivalent to the State of the Union address -- Putin remarked that "far from everyone in the world has abandoned the old bloc mentality and the prejudices inherited from the era of global confrontation."

The speech as a whole was an intricate balance between the need to arrest Russia's internal societal decline -- one-third of the population, which is shrinking rapidly, lives in poverty -- and a desire to play an ever-greater role in world affairs. Moscow's involvement in the Iranian nuclear affair is a case in point. Its refusal to sanction serious Security Council measures against Tehran is a growing source of concern to the United States and Britain.

This newfound confidence has its basis in Russia's economic resurgence since the collapse of the rouble in 1998, the single largest cause of which is the high (and rising) price of oil. Russia is the world's second-largest producer of oil, and the wealth pouring into Moscow has allowed it to retire most of its foreign debt and build up a \$62 billion "stabilisation fund" to buttress its economy against a fall in oil prices. But if oil is underpinning Russia's economic growth, natural gas is the basis for its geopolitical resurgence. It possesses the world's largest reserves, and through its ownership of Gazprom -- now the world's third-largest company -- the Kremlin exercises a total monopoly on exports.

There is a growing concern in Washington and some European capitals that the actions of Gazprom and RAO UES, the state-owned electricity monopoly, are not solely driven by the profit motive. Both companies are pursuing an aggressive policy of acquiring "downstream" (i.e. distribution) assets in Europe and the Caspian basin to complement their "upstream" (i.e. production) facilities in Russia. For example, RAO UES recently purchased a majority stake in both Georgia's and Armenia's electricity networks in return for the offer of subsidized electricity. And Gazprom is currently purchasing transmission networks and distribution companies, often through middlemen organizations (one of which is being investigated by the Justice Department), in Eastern Europe and Germany. As a consequence, these state-owned monopolists are increasing Europe's structural dependence on Russian energy. And unlike oil, which can be transported anywhere in the world, gas and electricity require considerable investment in infrastructure, and hence long-term supply contracts, to be delivered to the market.

While such dependence has been growing for some years now, it was not until the Ukrainian crisis in December -- when Gazprom cut supplies to Kiev on the basis of an irresolvable

"commercial dispute" -- that Europe and the United States began to question Russia's reliability as an energy partner. Since then, the EU has been scrambling to develop a new energy policy towards Russia, but a consensus remains elusive. Some countries are already too reliant on Russian energy, by dint of pipelines that date from the Soviet era, to ruffle any diplomatic feathers.

The Baltic States, Hungary and the Czech and Slovak Republics all receive more than 80% of their gas from Russia. By contrast, Berlin recently signed an agreement with Moscow to build a pipeline from the vast Shtokman field in the Barents Sea to the north German coast via the Baltic Sea. The plan has provoked a furious response from many Eastern European nations.

The Polish Defence Minister, Radek Sikorski, likened it to the pre-World War II Molotov-Ribbentrop Pact, wherein Nazi Germany and the Soviet Union secretly agreed to divide up Poland. But while such fears are overstated, the fact remains that, if the pipeline is completed, Poland and other Eastern European nations will be more vulnerable to Russia's political machinations because any 'disruptions' to supply won't now have a knock-on effect on the politically powerful Western European markets.

Such concerns were the basis of Vice President Cheney's recent comments in the Lithuanian capital of Vilnius when he accused Moscow of using its energy resources as "tools of intimidation and blackmail" and its "back-sliding on democracy." Europeans share many of the same concerns, and following the rift over the Iraq war, the issue of Russia's growing assertiveness may offer the opportunity for greater transatlantic cooperation. Notwithstanding its traditional antipathy towards Russian authoritarianism, Washington has another considerable reason for weighing in on behalf of Europe: China.

Moscow has rapidly scaled up its diplomatic efforts with Beijing over the last few years -- both are fervent supporters of a multi-polar world order -- and trade tripled to \$16 billion between 1999-2004. China's growing demand for energy, combined with Russia's vast untapped resources in Eastern Siberia, represents an opportunity for a further deepening of relations. However, Russia will struggle to meet both projected Chinese demand and its current European commitments without massive investment in new infrastructure. Such investment is unlikely to come from foreign investors as the climate for business in Russia becomes ever less encouraging, and it will therefore have to come from the Russian government.

If Europe feels that it cannot rely on Moscow as a stable source of energy, it will seek to diversify away from Russian gas and oil toward more expensive forms of power generation including nuclear and renewables, further undermining the continent's weak economic growth. Similarly, investing in exports to China is a very expensive, long-term proposition for Moscow, but one they are willing to undertake if they feel their European market share is sufficiently threatened.

By contrast, a free-market approach would greatly facilitate the trade in energy between Russia and Europe, because it makes eminent economic sense -- the infrastructures already exists, and demand is slowly rising. The EU, therefore, needs the United States' support to pressure Russia toward further integration into global trading system of liberalized markets and the privatization of its vast state-owned energy firms which too often conflate Russia's economic and political interests -- often to the detriment of both.

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