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Energy Security in the Baltic-Black Sea Region: Energy Insecurity Sources and their Impact upon States

Over the past twenty years, the biggest challenge to the national security of the independent states from the Baltic to the Black Sea region has been in the energy sector. The problem has mostly been the failure to secure stable energy resource provisions. This is mostly due to systemic and historical as well as internal political factors. This paper examines the problems related to the energy security of the following three ex-Soviet bloc countries: Lithuanian, Belarus and Ukraine. The main energy problem areas discussed here are oil and natural gas resources. Because the three countries have pursued very different internal and foreign security policies, their energy needs are equally divergent. Therefore, the paper presents case study for each state. Each case study, firstly, identifies a number of possible threats to energy security, secondly, examines the influences that these threats may exact on national as well as foreign policies and, thirdly, discusses how different national and foreign policies influence the resolution of energy security problems.

Introduction

The former Soviet bloc countries of the *Intermarum* region[1] have been unable so far to decrease their dependence on imports of energy resources from the Russian Federation even though it has been more that twenty years since the Soviet Union fell apart. In the region, Russia remains the primary and in some cases the only supplier of energy resources. The energy resource dependence was created in the twentieth century as a result of the Soviet policy carried out in the 70s and 80s seeking to expand its energy supply infrastructure. According to the

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[1] Geopolitical term defines the states located between the Baltic and the Black Seas. The exact borders of the region may vary according to different authors although general consensus holds that the principal area is comprised of states that now exist within the territory of the former Polish-Lithuanian Commonwealth.

policy there were no alternative energy supply established for Soviet Russia's satellite states. The Soviet Union supplied the states with its own energy resources as the Soviet Union was world's leader in energy resource production and exploitation. However, the primary energy resource supply was designed to be one way only, running from the Eastern, as well as Central Asia regions, to the West. The lack of any alternative supply routes made the satellite states inevitably dependent on Russia.

Energy dependence on Russia does not present any direct danger to the ex-satellites states *per se* however, a high level of dependency upon one single supplier increases the vulnerability of energy and national security[2]. The threat arises as a result of the fact that Russia views and seeks to use its energy resources as a tool of foreign policy as well as a weapon that would allow it to increase its power and influence through the manipulation of energy resource supply level and prices in the Eastern European geo-energetic area[3]. Russia's active manipulation of energy resources in an attempt to increase its power and influence can be defined as energy diplomacy. In this paper the definition of energy security corresponds to Danyel Yergin's definition: namely, "[the ability] to assure adequate, reliable supplies of energy at reasonable price and in ways that do not jeopardize major national values and objectives[4]". It can be seen that the states in the region are vulnerable in the energy security area. Domination of Russian energy companies in the ex-Soviet bloc presents a clear opportunity for Russia to reclaim its former power and influence. Russian energy diplomacy policy often opposes the national and foreign interests of the states in the region and, as a result, influences their policy developments.

The purpose of this paper is to explore and discuss the reasons, processes and effects of the energy insecurity in the three states of the Intermarum region—Lithuania, Belarus and Ukraine—since the collapse of the Soviet Union until 2011. In order to investigate the origins of energy insecurity and its impact, a historical, descriptive, comparative analysis of three states was conducted. The reasons for the particular three countries being chosen are the shared energy dependence on Russia, similar historical background and geographical proximity. However, the states' internal differences also allow broader analysis of the causes of energy related violations and threats and their consequences, as these are influenced by internal factors.

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[2] The term in the liberal sense ulnerability was used in Barry Buzan's book: *People, States and Fear: international security studies after the Cold War.* It refers to the attributes of security and/or the attributes of subjects related to security that could potentially damage security.

[3] "No legitimate interest is served when oil and gas become tools of intimidation or blackmail, either by supply manipulation or attempts to monopolize transportation". Dick Cheney, US Vice President May 4, 2006 Vilnius Conference. Woehrel S., *Russian Energy Policy Toward Neighboring Countries,* Congressional Research Service, 2 September 2009, p.14-15, http://www.fas.org/sgp/crs/row/RL34261.pdf, 17 06 2011.

[4] Yergin, D., "Energy security in the 1990s", *Foreign Affairs,* 67 (1), 1988, p. 110-132, p. 111.

All three countries have different political regimes: a consolidated democracy was anchored in Lithuania; Belarus was seen as an increasingly authoritarian regime; while Ukraine had troubles establishing a stable democratic regime. In addition, they also pursued different foreign policy directions: Lithuania, immediately after the independence, sought the policy for integration into Euro-Atlantic zone; Belarus focused almost exclusively on Russia, but in some cases, in order to have a more balanced relationship, it also sought an increasing co-operation with the European Union (EU) and its Member States; Ukraine pursued multivectoral foreign policy, primarily it centred on Russia, the EU, and, to a lesser extent, the United States. Lithuania has successfully integrated into the EU and the North Atlantic Treaty Organization (NATO). On one hand, Belarus belongs to the Commonwealth of Independent States (CIS) as of 1996 and is cooperating with Russia in the process of building the Union State. In addition, as of 2010, it has also become a part of Russia, Belarus and Kazakhstan Customs Union. Ukraine is maintaining its multivectoral foreign policy, only nominally belongs to the CIS and avoids deeper integration with the EU or Russia. Therefore, these factors imply that the analysis of structural power is very different. All three states differ in their energy resource needs[5] and the importance in energy resource transit from Russia to Europe and its capacity[6]. The specific choice of the subject for this case study firstly allows a wide in-depth analysis of energy insecurity of causes and origins, and, secondly, explains why one country faced specific energy security issues when compared with others. A lot of attention is given to Lithuanian, Belarusian and Ukrainian relations with Russia. Nevertheless, Russia is not the only source of energy insecurity as the processes that take place, within the states studied, often can lead to energy and national insecurity. The paper focuses on the region's energy insecurity resulting from two types of primary energy resources: oil and natural gas. Processes associated with other types of energy resources in the analysis will only be considered as long as they influence the energy security related to natural gas and oil.

The historical comparative method of analysis used for the three state case studies in analysing energy security is a new phenomenon in Lithuania's energy

[5] According to "BP Statistical Review of World Energy June 2011", in 2009, Lithuania imported 2,5 billion m^3, Belarus 17,6 billion m^3, Ukraine 37,8 billion m^3 of natural gas exclusively from Russia. In 2010 Lithuania consumed 2,7 million tones, Belarus 6,6 million tones and Ukraine 11,6 million tones of crude oil over the year, not including its refined products their export. The main bulk of crude oil came from Russia while crude oil imports from other suppliers do not provide even the minimal viable alternative.

[6] Lithuania is only important in ensuring natural gas transit to Kaliningrad oblast, with the maximum capacity of up to 2,5 billion m^3 in 2010. Belarus is capable of providing transit capacity of up to 51 billion m^3, whereas Ukraine has the transit capacity of up to 117 billion m^3. Druzba crude oil pipeline infrastructure spanning across Belarus and Ukraine, is one of the most important supply chains in delivering crude oil from Russia to European states with the capacity of 1.2 to 1.4 million barrels per day.

security and international relations studies. The authors analyzing the energy security, such as G. Vitkus, T. Janeliūnas, or A. Molis, present detailed analyses of threats to Lithuania's energy security; however, they do not consider other examples in the region[7]. The comparative three cases analysis method makes it possible to identify the causes of energy security threats, their differences and advantages, and how energy security affects economic, social and political processes. In addition, it allows evaluating the evolution of the energy security of each country specifically, while identifying general trends at the same time

1. Lithuanian Case Study

1.1. Energy Insecurity at the Beginning of the Independence of the Republic of Lithuania and Its Consequences for the Further Development of the State

Lithuania's energy security issue arose immediately after its declaration of independence. On March 11, 1990, Lithuania declared the restoration of its independence and in the period between the 20th of April and the 2nd of July of that year, Moscow suspended oil supplies to Lithuania[8]. Moscow was convinced that the economic and energy dependence of the Soviet republics on the Soviet Union will maintain its own integrity. In turn, Moscow's oil embargo and political pressure forced Lithuania to declare moratorium on the Independence Act. However, the disintegration of the Soviet Union became inevitable after the August Putsch in Moscow in 1991. Despite the disintegration of the Soviet Union, Russia has sought to maintain its influence through economic and energy measures in the ex-Soviet bloc region.

In 1992 Russia seized oil supplies to Lithuania again, this time for four days, asking to pay for energy resources in "hard currency" rather than goods and

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[7] For more details see: Janeliūnas T., Molis A., "Energy Security in Lithuania: Challenges and Perspectives", *Lithuanian Political Science Yearbook 2005*, 2006, p. 200-233; Vitkus G., "Russian Pipeline Diplomacy: A Lithuanian Response", *Acta Slavica Iaponica*, 26, 2009, p. 25 – 46; Budrys K. "Bendradarbiavimo su Lenkija įtaka Lietuvos energetiniam saugumui", *Lietuvos metinė strateginė apžvalga 2007*, 2008, p. 213-240; Janeliūnas T., "Lithuanian energy strategy and its implications on regional cooperation", in Sprūds A., Rostoks T., eds., *Energy: Pulling the Baltic Sea Region together or apart,* Riga: Zinatne, 2009, p. 190 – 222. Analysis of the cases studies, of Lithuania and Belarus is being done by the "Comparative assessment of energy security in Lithuania and Belarus from cross disciplinary perspective" project at the Centre for Energy Security Research of Vytautas Magnus University and was financed by the Lithuanian Research Council.

[8] Janeliūnas T., "Lithuanian energy strategy and its implications on regional cooperation", in Sprūds A., Rostoks T., eds., *Energy: Pulling the Baltic Sea Region together or apart,* Riga: Zinatne, 2009, p. 190 – 222, p. 191.

products[9]. Russia began to sell oil at market price to the Baltic States, while CIS members purchased the oil at much lower "subsidized" price[10]. Between July and August in 1992, Russia again seized the supply of oil to Lithuania and reduced the natural gas supply by 55 percent because of the debt for energy resources. Russia also banned Lithuania form re-exporting oil[11] as the re-export of oil would have allowed the acquisition of "hard currency", which would facilitate the settlement of energy imports. In autumn of 1992 Russia suspended oil supplies to Lithuania, where there is the only oil refinery in the Baltic countries, Mažeikiai, causing it to suspend its operations[12]. Suspension of energy resource supply in winter of 1992 - 1993 and a fourfold increase price facilitated the growth of economic, social and political unrest. Suspension of supply, higher prices, together with the parallel processes of economic downturn, declining standard of living, the growth of unemployment and lack of policy stability increased dissatisfaction with the Sąjūdis government and increased the popularity and subsequent election of the former communist party, renamed the Lithuanian Democratic Labour Party, in the premature parliamentary elections in autumn 1992[13].

Resource supply suspensions between 1990 and 1993 to Lithuania produced internal political affects. By interrupting the resources supply, Moscow sought to preserve the Soviet Union, and as that failed it then manipulated the political process in the Baltic countries. According to the statement by the then Russian Foreign Minister's First Deputy Vitalii Churkin, energy supply interruptions were Russian policy "one of the probable options" in Estonia, Latvia and Lithuania[14]. These types of statements indicate that Moscow, immediately, after the disintegration of the Soviet Union, realized that energy resources were perceived as foreign policy tools to maintain and expand Russia's influence abroad.

Russian manipulation of energy supplies and prices affected the price increase of Lithuanian goods. This, along with other economic factors, such as low attractiveness of Lithuanian goods on the Western markets and the inability to

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[9] Larsson R. L., *Russia's Energy Policy: Security Dimensions and Russia's reliability as Energy Supplier*, Stockholm: FOI-Swedish Defence Research Agency, 2006, p. 184-185.
[10] Lieven A., *Pabaltijo revoliucija: Estija, Latvija, Lietuva – kelias į nepriklausomybę* ['The Baltic Revolution: Estonia, Latvia, Lithuania and the Path to Independence'], Vilnius: Atviros Lietuvos fondas, 1995, p. 350 (in Lithuanian).
[11] Larsson,(note 9), p. 185.
[12] *Ibidem*, p. 185.
[13] Lietuvos Respublikos Seimas, *1992 - 1996 m. Seimas: Lietuvos demokratinės darbo partijos frakcija* ['Seimas: Lithuanian Labour Party faction'], http://www3.lrs.lt/pls/inter/w5_show?p_r=4506&p_d=54366&p_k=1, 17 06 2011 (in Lithuanian).
[14] Larsson, (note 9), p. 190.

compete, was leading the state towards economic and social crises[15]. Lithuanian economic recovery was long and complicated. Energy price shock forced Lithuania to transform and modernize its economy and develop energy-efficient industries[16]. Energy price shock had a negative effect in the short term, but it led the industry to become more efficient, in the long term, Lithuania became less vulnerable to energy price changes. Another possible assumption is that almost exclusive purchases in cash, with some exceptions of barter exchange, partially limited Russia's ability to manipulate Lithuania using energy supplies and their prices, reducing Lithuania's national security vulnerability.

1.2. The Energy Insecurity in the Oil Sector: Mažeikiai Oil Refinery Privatization Process

Between 1993 and 1998 there were comparatively serious political tensions between Lithuania and Russia over the issue of the Russian military withdrawal from Lithuania and the Kaliningrad region transit problems[17]. Lithuania also declared ambitions to join the EU and NATO, which opposed Russian interests in the Baltic region. Lithuania's aspiration to integrate into NATO defied Russia's ambition to maintain influence in its "traditional zone of influence" and its security interests. However, in the period of 1993 to 1998, there were no significant energy conflicts between Russia and Lithuania. This was determined by the fact that the Russian government lost its power in the energy sector due to its privatization and the creation of independent energy companies[18]. In addition, Russian primary focus in that period was primarily the expansion of their influence in the priority area: Belarus, Ukraine, South Caucasus and Central Asia.

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[15] The GDP levels were up again in 2004, to their previous high of 1991 when compared with the GDP levels of 2000. Lietuvos statistikos departamentas, *M2010201: Bendrasis vidaus produktas (BVP). Požymiai, metai,* http://db1.stat.gov.lt/statbank/SelectVarVal/saveselections.asp, 17 06 2011.

[16] Energy efficiency doubled when compared to the 1991 data. Enerdata, *Energy intensity of GDP at constant purchasing power parities Year: 2009*, http://yearbook.enerdata.net/energy-intensity-GDP-by-region.html, 17 06 2010.

[17] Vitkus G., *Diplomatinė aporija: tarptautinė Lietuvos ir Rusijos santykių normalizavimo perspektyva* ['Diplomatic Aporia: International Perspective for Normalization of Lithuanian and Russian Relations'], Vilniaus universiteto leidykla, 2006, p. 30 (in Lithuanian).

[18] State power is a component of the national power, which the state can utilise in furthering its own goals and interest. Privatisation reduced the Russian government's ability to directly use Russian energy resources as a foreign policy tool, however, with the rise of Putin increased the government's direct influence in the Russian energy sector and strengthened Russia's state power to utilise energy resources in order to pursue its foreign policy interests. One of the first popular uses of the term *state power*, is attributed to Fadreed Zakaria in his book *From Wealth to Power: The Unusual Origins of America's World Role* (Princeton University Press, 1998). The term *state power* is translated in Lithuanian as *vyriausybinė galia.*

Conflicts in the energy field between Russia and Lithuania renewed, when Lithuania declared its plans to privatize the oil refinery. The Russian oil company Lukoil sought to privatize the oil refinery, but the Lithuanian government took the position expressed by the Minister for Economy Vincas Babilius' "not to allow Ivan [Russia] to the pipe" [19]. As a result, the Lithuanian government sold the oil refinery company in conjunction with the Būtingė oil terminal including pipeline infrastructure throughout Lithuania, to a U.S. corporation, Williams International. Such a broad privatization of the oil infrastructure would have greatly expanded Russia's influence, since the processing plant was and remains the largest tax contributor to the Lithuanian budget[20] [21]. The company owning the processing plant has the capacity to influence political processes in Lithuania; therefore, it was natural that Lithuania was inclined to allow the privatization of the refinery to the American company, as the U.S. is its key strategic partner as well as key NATO member.

The Russian state-owned oil company Transneft halted oil supplies to Lithuania nine times between 1998 and 1999[22]. The oil supply disruptions meant financial losses. As a result of oil supply disruptions the oil refinery became unprofitable. The oil supply suspensions by Transneft showed that profitability mostly depends not on the owner of oil processing plant, but rather the supply reliability. In 2002 Williams International decided to withdraw from the oil refinery. Lukoil sought again to buy the oil processing plant, but the Lithuanian government this time decided to sell to the Russian oil company Yukos. Yukos positioned itself as a company independent from the Kremlin, interested only in economic benefits and not representing Russian foreign policy[23]. The Lithuanian government found this Yukos position agreeable. Yukos managed Mažeikiai from 2002 to 2006; however, in 2003, at beginning of the Yukos affair the Kremlin planned to take over Yukos' assets, nonetheless Lithuanian government was the first to take over Yukos-controlled oil refinery stocks[24]. Lithuania's government

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[19] ELTA, *V. Babilius niekada nesakė "neprileisiu Ivano prie vamzdžio", tvirtina A. Kubilius* ['V. Babilius Had Never Said "I will not Allow Ivan to the Pipe'], 28 September 2005., http://www.verslobanga.lt/lt/spaudai.full/433a4b57c73c5, 17 06 2011.

[20] ELTA, *Mažeikių nafta" sumokėjo 135 mln. litų pelno mokesčio*, September 2005, http://www.sekunde.lt/content.php?p=read&tid=22421, 17 06 2011 (in Lithuanian).

[21] Ramoškaitė I., *Didžiausi Lietuvos mokesčių mokėtojai šiemet biudžetą papildė beveik 0,4 mlrd. Lt mažiau* ['The Biggest Tax Payers in Lithuania Contributed to the Budget at least 0,4 billion Litas Less'] , 9 November 2010., http://vz.lt/2/straipsnis/2010/11/09/Didziausi_Lietuvos_mokesciu_moketojai_siemet_biudzeta_p, 17 06 2011 (in Lithuanian).

[22] Larsson, (note 9), p.185.

[23] Vitkus G., "Russian Pipeline Diplomacy: A Lithuanian Response", *Acta Slavica Iaponica* (26), p. 25 – 46., p.30

[24] Kononczuk W., *The 'Yukos Affair', its Motives and Implications,* Warszaw: Centre for Eastern Studies, 2006, p. 40., http://www.osw.waw.pl/sites/default/files/PRACE_25.pdf, 18 06 2011.

goal was to avoid the oil refinery being controlled by the Russian government. International energy companies such as TNK-BP, Conoco Philips, Kazmunaygaz and PKN Orlen, also wanted to buy the Yukos share of the oil refinery. The Kazakh company Kazmunaygaz was one of the most realistic investors as it was capable of supplying its own oil, but Russia pressured Kazmunaygaz not to invest in Lithuania. Transneft, thus, nullified a ten-year oil supply contract with Kazmunaygaz[25]. Transneft again, just as in 1998, sought to create a favourable environment for Lukoil to acquire the refinery. The Lithuanian government in 2006 as in 1998 took the same position: to prevent the privatization of the oil refinery by a Russian company which is linked to the Kremlin. The Lithuanian government even planned to nationalize the oil refinery, if the Russian government had taken over the whole of Yukos' assets[26].

In May 2006 the Lithuania government approved the sale of Yukos-owned oil refinery shares to the Polish company PKN Orlen. The sale of the oil refinery was finalized in December of that year, but before the completion of the sale, on the 29th of May 2006, Transneft announced likely oil supply disruptions. The oil supply was interrupted in July due to the technical accident on Druzhba-2 oil pipeline and the oil spill. International rating agency Finch Ratings said that the reasons behind the disruption were of a political nature and the technical accident served only as a pretext[27]. There have been suggestions that the oil supply disruptions to Lithuania were planned even before the accident in July 2006[28] [29]. The Russian delegation promised that the pipeline repair plans will be prepared and submitted to Lithuania before 2007, but these plans were never submitted[30]. In the spring of 2007, Russian officials said that oil supplies will not be renewed, and the Russian Ambassador to Lithuania Vladimir Chikikvadze proposed that Lithuania itself should repair the pipeline. After the oil supply disruptions on Druzhba-2, Lithuania was

[25] Baltic Times, *Intrigue Arround Mazeikiu Nafta Sale Increases as Kremlin Puts Squeez on Kazakh Bidder*, 2005 November 23d., http://www.baltictimes.com/news/articles/14091/, 17 06 2011.

[26] Pakalkaitė V., *A.Brazauskas: „Jukos" parduoda „Mažeikių naftą" Lenkijos kompanijai* ['A.Brazauskas: "Yukos" sold "Mažeikių nafta" to a Polish Comapny'], 23 May2006., http://www.delfi.lt/news/economy/business/abrazauskas-jukos-parduoda--mazeikiu-nafta-lenkijos-kompanijai.d?id=9634192, 18 06 2011 (in Lithuanian).

[27] Vitkus (note 23), p. 23.

[28] Trenin D., "Energy Geopolitics in Russia-EU Relations" in Barysch K., ed., *Pipelines Politics and Power: The Future of EU-Russia Energy Relations,* London: Centre for European Reform, 2008, p. 15 – 24., p 23.

[29] DELFI, *WikiLeaks: „Družbą" užsuko Rusijos vicepremjeras* ['Druzhba was Closed by the Prime Minister], 19 January 2011 d., http://verslas.delfi.lt/energetics/wikileaks-druzba-uzsuko-rusijos-vicepremjeras.d?id=41025105, 18 06 2011 (in Lithuanian).

[30] BNS, *Politologas A.Molis: „Rusija parodė Lietuvai alternatyvų kelią* ['Political Scientist A.Molis: "Russia Showed an Alternative Way for Lithuania"], 22 July 2008., http://www.lrytas.lt/-12167312921214387953-politologas-a-molis-rusija-parodė-lietuvai-alternatyvų-kelią.htm, 17 06 2011 (in Lithuanian).

only able to import oil only through the Butingė and Klaipėda oil terminals and via railway from Russia. Considering the rising cost of transport and the fact that the cheapest oil transport is via pipeline, this reduces the now PKN Orlen owned oil refinery's profitability.

Uncertainty in Lithuania's energy and the national security arises due to the categorical statements circulating in the media concerning the investments from Russia to Lithuanian energy sector, which are propagated by various government representatives. These assessments provided opportunities for fear manipulation in Lithuania. PKN Orlen privatised Mažeikiai and wanted to buy Klaipėda Nafta (Klaipėda oil) shares also. By controlling Klaipėda Nafta, PKN Orlen could have restricted competition in the oil sector, thereby increasing the oil refinery's production and profitability. Klaipėda oil terminal allows for balancing the oil market in Lithuania and its import and export capabilities are of a strategic importance[31]. As of 2010, the Polish company, in a way, was using blackmail by claiming in the press that the refinery could be sold to one of Russia's energy companies, such as TNK-BP, Rosneft or Surgutneft, if the Lithuanian government was not going to allow privatisation of Klaipėda Nafta[32] [33]. It is doubtful whether the sale of the Mažeikiai refinery would have been beneficial in the long term for PKN Orlen. The Mažeikiai refinery acquisition was more important to PKN Orlen as it allowed them to reduce the competitive pressure of the Russian companies on the Polish fuel market[34]. Nonetheless, PKN Orlen, through the media, sought to maximize pressure on the Lithuanian government. At the same time, there are indications that the view of Russia as a threat to the energy security, at least in the public opinion, is changing; however, an overall general view on Russian investments remains unchanged. In 2010 Lithuanian President Dalia Grybauskaitė said that the oil refinery is no longer of a strategic importance to Lithuania, so it can be sold to Russian investors[35]. However, Mažeikiai oil refinery in Lithuania remains

[31] Budrys K., "Bendradarbiavimo su Lenkija įtaka Lietuvos energetiniam saugumui" ['The Impact of Cooperation Between Lithuania and Poland on Lithuania's Energy Security], *Lietuvos metinė strateginė apžvalga 2007*, 2008, p. 213-240., p.258-259 (in Lithuanian).

[32] Lrt.lt , *Mažeikių naftos įmone domisi TNK-BP* ['TNK-BP is Interested in Mažeikiai Comapny'], 28 February 2010., http://www.bernardinai.lt/straipsnis/2010-02-28-mazeikiu-naftos-imone-domisi-tnk-bp/41139, 18 06 2011 (in Lithuanian).

[33] BNS, *Rusija derasi su Lenkija dėl galimybės pirkti Mažeikių naftos perdirbimo gamyklą* ['Russia is Negotiating with Poland on Posibilities to Buy Mažeikiai Oil Refinery'], 11 February 2010., http://www.bernardinai.lt/straipsnis/2010-02-11-rusija-derasi-su-lenkija-del-galimybes-pirkti-mazeikiu-naftos-perdirbimo-gamykla/40304/comments, 18 06 2011 (in Lithuanian).

[34] Budrys (note 31), p.255 – 256.

[35] ELTA ir lrytas.lt, *D.Grybauskaitė: „Naftos gamykla Mažeikiuose nėra ekonomikai strateginė įmonė* ['D. Grybauskaitė: "Oil Refinery in Mažeikiaiis not a Strategic Company for Lithuanian Economy"] , 25 August 2010d., http://www.lrytas.lt/-12827214201281572201-d-grybauskaitė-naftos-gamykla-mažeikiuose-nėra-ekonomikai-strateginė-įmonė-video.htm, 18 06 2011 (in Lithuanian).

important economically because its income is the highest in Lithuania, meaning it is the largest tax payer[36]. Therefore, the largest company engaged in the strategic resources processing, such as oil, certainly has political implications. In addition, Transneft's decision to suspend the supply of oil illustrates that Russia perceives the oil refinery as a strategically important. The change in rhetoric is likely focused on minimizing tensions with Russia. This more moderate rhetoric is expected to indirectly reduce the possibilities of attempts against Lithuania's vulnerability of energy security.

Oil supply interruptions were not linked to market mechanisms, but rather to economic and political interests. The sale of the oil refinery to Russian oil companies would not only have increased their capacity and profitability, but would have also increased Russian influence in the Lithuanian energy sector and the overall economy of Lithuania. Lithuania sought to prevent Russian energy companies, associated with the Kremlin, such as Lukoil, which is considered "the Russian ambassador", from dominating the domestic market[37]. Oil supply disruption only further entrenched the government's positions of not selling the refinery to Lukoil. Privatisation of the Mažeikiai refinery by a Russian company, linked to the Kremlin, would have not only created supply monopoly, but would have also allowed it to control singlehandedly the strategic oil and gas sectors. This would have created a critical dependency of Lithuanian economical and political spheres on Russia. Lithuania's integration into the EU would have only been *de jure* as Lithuania would have become a *de facto* colony of the Russian economy, as its policy would have been mostly influenced by the Russian energy companies. This explains why the Lithuanian government made an effort to limit the participation of the Russian companies in the Lithuanian energy sector.

[36] Janeliūnas T., "Lithuanian energy strategy ands its implications on regional cooperation" in Sprūds A., Rostoks T., eds., *Energy: Pulling the Baltic Sea Region together or apart?,* Riga: Zinatne, 2009, p.190-222., p. 191.
[37] Grost I., *Lukoil: Russia's Largest Oil Company,* Rice University: James A. Baker III Institute for Public Policy, 2007, p. 28., http://www.rice.edu/energy/publications/docs/NOCs/Papers/NOC_Lukoil_Gorst.pdf, 18 06 2011.

1.3. Energy Insecurity Due to Natural Gas and the Growth of Energy Dependence

In 2004 Gazprom, the Russian gas company, acquired Lietuvos Dujos, the major natural gas importer and distributor in Lithuania. Gazprom bought 34 percent of the shares for 37 million U.S. dollars[38]. According to analysts, Gazprom acquired Lietuvos Dujos at a lower price than the company was actually worth[39]. Later, Gazprom increased its stake in Lietuvos Dujos to 37.1 percent[40]. The largest part of the Lietuvos Dujos shares - 38.9 percent was owned by the German energy giant E. ON Ruhrgas International, which together with Gazprom, is constructing a gas pipeline under the Baltic Sea known as Nord Stream and, depending on the time, holds anywhere between 2 to 6 percent of Gazprom shares. In Lietuvos Dujos there are often conflicts between Gazprom and the Lithuanian government, which owns 17.7 percent of the shares, about natural gas prices. The Lithuanian government and Gazprom, particularly disagrees over natural gas prices in Lithuania and the EU's 3rd Energy Package, approved in 2009, which stipulates the separation of ownership in supply and transmission of natural gas and electricity. In order to protect their interests, Gazprom means to put pressure on Lithuania through higher natural gas prices as well as by means of a submitted appeal to Stockholm Arbitration seeking to prohibit the Lithuanian courts from investigating Lietuvos Dujos activities. Successful implementation of the 3rd Energy Package would allow the development of alternatives to natural gas import and transport, avoiding the Lietuvos Dujos participation in these projects and to reduce Lietuvos Dujos major shareholder's influence in the Lithuanian natural gas sector.

Lithuania's natural gas sector is known for its corruption, which hurts Lithuania's energy security. Since 1993, various intermediary gas trading companies were established in the Lithuanian gas sector, which bought gas at cheaper price from Gazprom and sold it to other consumers and the then state own enterprise, Lietuvos Dujos. Companies such as Jangila, Stella Vitae and Dujotekana had the financial capacity to influence the political processes in Lithuania[41]. It is worth noting that Lithuanian politicians, law enforcement and security services failed to remove intermediaries, whose actual need for existence remains questionable,

[38] Smith K. C., *Russian Energy Politics in Poland, Ukraine and Baltic States,* Washington: Centre for Strategic and International Studies, 2004, p. 2-3., http://csis.org/files/media/csis/events/041019_smith.pdf, 18 06 2011.

[39] Molis A., *Kar tas ruduo Lietuvos energetikai* ['Hot Autumn for Lithuanian Energy'], 22 November 2010., http://www.geopolitika.lt/?artc=4346, 18 06 2011 (in Lithuanian).

[40] Lietuvos dujos, *AB „Lietuvos dujos" akcininkų struktūra* ['Structure of Shareholders of Lietuvos Dujos'], 2010 m. June 30., http://www.dujos.lt/index.php/investuotojams/akcininkai/607, 18 06 2011 (in Lithuanian).

[41] Vitkus (note 23), p. 34-35.

from the energy market chain as that in turn would have allowed Lietuvos Dujos to purchase gas directly from Gazprom without mediators. The mediators' business influence was in part abolished by Gazprom's decision to sell gas to all customers at the same price[42]. Interestingly, the mediators' collapse coincided with Gazprom's successful share acquisition in Lithuanian gas sector - Lietuvos Dujos.

The second most important importer of natural gas to Lithuania was Dujotekana, which used to import up to a quarter of all natural gas to Lithuania is also indirectly controlled by Gazprom[43]. Unlike other natural gas importers in Lithuania, Dujotekana buys natural gas indirectly through a Swiss-registered intermediary called LT Gas Stream AG, which, in turn, purchases its gas from Gazprom. The former U.S. Ambassador to Lithuania Keith C. Smith and the Lithuanian media point out that the main Dujotekana shareholder is a former KGB officer. This increases the vulnerability of national security, because Dujotekana repeatedly sought to lobby Lithuanian politicians[44]. Smith also notes that there were questionable ties between the former Lithuanian Prime Minister Algirdas Brazauskas and Lukoil CEO Vagit Alekperov [45]. Robert L. Larsson points out that the questionable ties between Lithuanian officials and politicians and the Russian companies Gazprom and Lukoil impact the energy insecurity, saying that "unbroken links" with the Russian government creates vulnerability of the energy issue and ability to influence policy through bribery[46]. Russian owned energy giants control their subsidiary energy companies in the Lithuanian natural gas and electricity sectors[47], which, in turn sponsor politicians and political parties[48]. While monitoring the press, it is clear that certain political parties are protecting the interests of the energy companies that have close ties to Russian companies, which contradict the state interests[49]. The remaining strong links between politi-

[42] Ibidem, p. 35.
[43] BNS, *Dujotekanos" pelnas pernai smuko daugiau nei 3 kartus* ["Profit of Dujotekana fell Threefold'] , 21 July 2009., http://www.alfa.lt/straipsnis/10282781/?Dujotekanos.pelnas.pernai.smuko.daugiau.nei.3.kartus=2009-07-21_17-00, 18 06 2011 (in Lithuanian).
[44] Smith, (note 38) p. 2-3.
[45] Smith K. C., *Russian energy politics in the Baltics, Poland and Ukraine: A New Stealth Imperialism?,* Center for Strategic & International Studies, 2005, p. 38.
[46] Larsson, (note 9), p. 189.
[47] Inter Rao Lietuva, *Apie mus* ['Inter Rao Lietuva, About Us'], http://www.interrao.lt/index.php/apie_mus/trumpai_apie_bendrove/15, 18 06 2011 (in Lithuanian).
[48] LRVK, *Dalia Grybauskaitė: Aukotojų sąrašas* ['Dalia Grybauskaitė: Donors' list'], http://www.vrk.lt/rinkimai/403_lt/PolitiniuKampanijuFinansavimas/Dalyvis3984/Dalyvio3984AukotojuSarasas.html, 18 06 2011.
[49] BNS, *Socialdemokratai kaltina Vyriausybę rusų ir vokiečių valdomos „Lietuvos dujų" bendrovės ignoravimu* ['Socialdemocratic Party Blames Government for Ignoring Interests of Lietuvos Dujos that is controlled by Russian and German Investors'], 2 October 2010., http://www.delfi.lt/news/economy/energetics/socialdemokratai-kaltina-vyriausybe-rusu-ir-vokieciu-valdomos-lietuvos-duju-bendroves-ignoravimu.d?id=37138267, 18 06 2011 (in Lithuanian).

cians and energy companies do not favour the policy decisions that primarily reflect the interests of the State of Lithuania; thus, vulnerability in the political sphere remains high however indirect it may be. This creates a situation where at the state level there is a need to increase energy security and diversify energy supplies, but on the individual level self-interest serves to increase vulnerabilities in energy and national security. It can be assumed that the energy security project underdevelopment relates specifically to corruption, which increases the energy vulnerability in a long and very long term.

Lithuania should have achieved energy security in the natural gas sector once it had started paying the same price for natural gas as the other EU countries. However, Russia, by having a dominating position in the market, retains the ability to manipulate energy prices. Gazprom discriminates against Lithuania when compared to the other gas importers. Lithuania for natural gas pays on average 30 U.S. dollars more than Germany[50], while Lithuania is geographically closer to Russia, and therefore closer to the natural gas resources, than Germany. That means lower transit expenses compared to Germany. This illustrates that Gazprom's gas prices are at odds with economic rationality. Every single energy price manipulation by Gazprom that does not comply with the logic of the market pricing may be regarded as politically motivated, as it hampers the competitiveness of the state's economy. The lack of transparency in determining natural gas prices and the fact that Lithuania is ready to purchase it at a price paid by the other users, create for Lithuania the cause for appeal to the EU and other partner countries, seeking to include them in the conflict resolution over the price of energy resources in order to gain political support for the projects that increase energy independence development and to exert political pressure on Russia.

Lithuania's energy insecurity also stems from the 1994 commitment to close the Ignalina NPP as a result of the European Bank for Reconstruction and Development financial assistance agreement in exchange for improving the Ignalina NPP safety. This obligation was transferred to Lithuania's negotiations for accession to the European Union. In 1999 Lithuania committed to closing the Ignalina NPP by 2010 in exchange for financial support granted for the closure of NPP[51]. Lithuania agreed to close it while aware that joining the EU would provide more

[50] In December 2010, Lithuania paid about 345 U.S. dollars per 1000 cubic meters of for natural gas, while natural gas price for Germany was at about 314 U.S. dollars per 1000 cubic meters. Valstybinė kainų ir energetikos kontrolės komisija, *Gamtinių dujų kainos struktūra buitiniams vartotojams* ['Structure of Natural Gas Price for Domestic Consumers], http://www.regula.lt/lt/dujos/duju-kainos/index.php, 19 06 2011 (in Lithuanian).

[51] Vitkus G., *Europos Sąjunga: Enciklopedinis žinynas* ['European Union: Encyclopaedia'], Vilnius: Eugrimas, 2008, p. 198 (in Lithuanian).

economic and political benefits more than the prolonging of the Ignalina NPP operation, at the same time increasing its national security. If Lithuania would have not closed the Ignalina NPP by 2010, unavoidably it would have had to close later nonetheless, but then it would have been without the EU funding. NPP closure negatively affected the energy security of Lithuania because it increased Lithuania's dependence on energy resources imported from Russia. As well Lithuania began to import electricity generated in Russia. Lithuanian dependence on Russian energy resource imports in 2010 reached 79.4 percent[52]. Russian energy dominance in Lithuanian economy increases Lithuania's vulnerability, as the use of energy diplomacy by Russia becomes more efficient. However, the main vulnerabilities to energy and national security stem from the fact that Lithuania has passively developed energy diversification projects.

Over the twenty years of its independence, Lithuania only slightly reduced its energy dependence on Russia by diversifying its energy supplies and developing its own renewable resources. The projects that would have reduced Lithuania's energy dependence, such as the 2003 initiative for a liquefied natural gas terminal, a new NNP initiative of 2006, the electrical connections with Western Europe and Scandinavia initiative of 1995, the natural gas storage initiative of 2004 or natural gas pipeline to Poland initiative of 2004 remain unfinished or only in their initial development phases. The only successful project so far has been the Butingė oil terminal, which was launched in 1999, after the oil pipeline Druzhba-2 closure. Butingė and Klaipėda terminals are the main components of the oil imports to the Lithuanian oil refinery. The position on the building of Butingė terminal was not consistent. Immediately after the interruption of oil supply between 1990 and 1993 the support for the project was huge, but declined when the oil supply to Lithuania was constant in the period between 1993 and 1998[53]. This illustrates that the energy security projects were discussed in the light of ongoing processes, not specifically looking at the long term effects. However the 15th Lithuanian government is actively pursuing energy security projects, compared with the preceding governments. It is worth noting that Lithuania's energy security is increasing due to its increasing integration into the EU. The EU financial assistance, joint institutions, policy of solidarity and a united energy policy is presenting advantages when it comes to guaranteeing energy security when compared to Belarus or Ukraine.

[52] Lietuvos statistikos departamentas. *Energetikos statistika: 2010 m. keitėsi šalies kuro ir energijos sąnaudų struktūra 2010* ['Energy Statistics: The Structure of Fuel and Energy Consumption had Changed in 2010], http://www.stat.gov.lt/lt/news/view/?id=9044, 12 07 2011 (in Lithuanian).
[53] Vitkus (note 23), p. 28.

2. Belarusian Case Study

2.1. Energy Insecurity from Independence until the End of the Boris Yeltsin Era

When Belarus became independent, it lacked the national identity of a sovereign state, and this significantly influenced the development of Belarus. Leonid Zaiko writes that Belarus was prone to see itself as a part of the Russian Empire or the Soviet Union, and its domestic, foreign and security policy was dominated by provincially predisposed nomenclature[54]. Independence in Belarus was associated with negative impacts, as it created a lack of goods and products as well as energy resources, which it had previously received from the Soviet Union, that were necessary for the continuation of its trade and economic activities.

After the disintegration of the Soviet Union, Belarus joined the CIS. Russia has been supplying energy to CIS countries at lower prices than for other importers, and the price for Belarus was even lower. Nevertheless, already in 1993, Belarus owed Gazprom about 100 million U.S. dollars. As a result, Gazprom seized supplying gas. Belarus borrowed funds from the International Monetary Fund (IMF) to pay for the gas debt[55]. In order to maintain low-cost energy supplies Belarus in 1994 authorized the deployment of Russian troops on its territory[56] as an exchange for the continued discount. Belarus did not see the establishment of Russian military bases as a threat to its national security and sovereignty, because Belarus was seeking closer integration with Russia.

The president of Belarus, Alexander Lukashenka, began to encourage socialist-oriented economic development. This type of economy was met with popular support as Belarusian people were accustomed to a similar economic system in times of the Soviet Union; as a result this increased the support for Lukashenka. However, the socialist-oriented economic development increased the financial pressure on the public budget. In 1995, Belarus owed 428 million U.S. dollars for natural gas, the price of which was much lower than for other importers and

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[54] Заико Л. Ф., "Система и структура национально-государственых интересов" ['System and Structure of National – State Interests'] in Заико Л. Ф., ed., *Национально-государственные интересы Республики Беларусь* ['National – State Interests of the Republic of Belarus'], Минск: Стратегия, 1999, p. 31-46., p. 32 in (Russian).

[55] Chloe, B., *Friction of fiction? The gas factor in Russian-Belarusian relations,* Chatham House: Russian and Eurasian Programme, Briefing Paper, 2005, p. 2., http://kms1.isn.ethz.ch/serviceengine/Files/ISN/18935/ipublicationdocument_singledocument/4e9a1d39-e793-46f6-9938-e9194a2a4a55/en/RusBel+REP+BP+May+2005(01).pdf, 19 06 2011.

[56] Larsson, (note 9), p. 221.

equal to the price applicable to the Russian domestic consumers[57]. Nevertheless, Belarus did not experience disruptions in natural gas supply, in contrast to the Baltic States. Russia did not interrupt energy supplies for three major reasons: firstly, Russian Belarus Customs Union was in its initial stages of formation, secondly, negotiations on Yamal-Europe natural gas pipeline project were under way, and thirdly, the idea to create a Union State between Russia and Belarus was being developed[58]. Russia was willing to forgo Belarusian debts for greater political and economic influence in Belarus and the promotion of the integration process. For example, in 1996 Gazprom threatened to terminate the supply of natural gas, but the Belarusian debt was written off in exchange for increased number of Russian troops in Belarus. Once again Belarus managed to reach a favourable agreement by exploiting Russia's geopolitical, rather than pragmatic way of thinking, and Russia's aims of deeper integration. Russian internal political processes were important to Belarusian energy security. Boris Yeltsin's re-election as the Russian President was important to Gazprom, and Yeltsin's election campaign focused on the importance of good relations with the CIS countries; therefore, the energy conflict between Gazprom and Belarus and the deterioration of bilateral relations would have negatively affected his re-election chances[59].

Since 1997, the situation changed since the Russia-Belarus Union was not going anywhere while the Belarusian government continuously pursued the policy of "promises for energy privileges". Gazprom's situation had also changed as it needed income to pay taxes it owned to the Russian state reaching in excess of 1.2 billion U.S. dollars[60]. Gazprom made a hard-line decision and, subsequently, three times in that year reduced the supply of gas by 50, 30 and 40 percent respectively[61]. In exchange for a debt write-off Belarus was ready to continue with the integration and to sign additional contracts to further integration. For these reasons, the Union State creation in 1998 was back on the agenda of Russia-Belarus bilateral relations. Belarus received 200 million U.S. dollars in loans from Russian banks to pay its debt to Gazprom. The money from Gazprom was transferred to the Russian Defence Ministry which in turn purchased the Belarusian goods for the Russian military. The remainder of the debt was covered by commodities, currency and government bonds[62]. This type of debt write-off was beneficial for Belarus in the short term as it erased the debt while at the same time stimulating the economy. This case also

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[57] *Ibidem,* p.221

[58] Chloe (note 55), p. 4-5.

[59] Larsson (note 9), p. 222.

[60] Chloe (note 55), p. 5.

[61] *Ibidem*, p. 5.

[62] *Ibidem,* p. 6.

illustrates the closeness of cooperation between Gazprom and the Russian government, even when the government's control of the company was in decline[63].

2.2. Belarus and Gazprom Energy Conflicts: the Beltransgaz Privatization

Once Vladimir Putin became the president of Russia, relations with Belarus began to change. Geopolitical policy which had dominated since Yevgeny Primakov became the Russian Minister of Foreign Affairs gave way to Putin's pragmatic foreign policy approach. Changing Russia - Belarus relations particularly affected gas prices for Belarus. Belarusian gas debt allowed Russia to expand its energy diplomacy. As a result of the 260 million U.S. dollars debt to Gazprom it temporarily cut the gas supply by 40 percent to Belarus in year 2000 and Gazprom reached an agreement with Belarus whereby as of 2001 Belarus was to pay 30 U.S. dollars per 1,000m^3 of natural gas; however it was to make huge concessions in gas transit rates, which turned out to be three times lower than the rates that Ukraine or Moldova were charging. These agreements with Belarus were alluding to the Russian-Ukrainian energy conflict, as the gas transit routes were being reoriented to bypass Ukraine[64].

As part of the deal to establish the Union State, Belarus, in 2001, was willing to sell 50 percent of the shares of Belarus state owned natural gas pipeline operator company Beltransgaz to Gazprom in exchange for natural gas prices close to those offered to the Russian domestic consumers for a five-year period. The Russian ambition was to seek to structure the Union State similarly to the EU or, alternatively, Belarus was to be fully integrated into Russia. Once Lukashenka figured this out, he was dissatisfied. As a result, the Union State project came to a dead end, as well as bargaining on Beltransgaz. However, as Russia sought to expand its influence in Belarus, it was important for it to take over Beltransgaz because that would increase the pressure on the Belarusian government. In order to further press Belarus to allow for the takeover Beltransgaz, Russia cut natural gas supplies by 50 percent and called for a full Beltransga privatisation for the reasons being that Belarus had gone over the maximum agreed quote in gas usage by 15 to 20 percent. In response to the pressure, the Belarusian parliament repealed the restrictions on the privatization of Beltransgaz[65].

[63] In 1998 m. Russian Federation controlled 38,37 percent of Gazprom stocks. Gazprom, *Information for Gazprom's shareholders (regarding the presentation of information on personal data updating),* http://www.gazprom.com/investors/faq/, 20 06 2011.
[64] Chloe (note 55), p. 7.
[65] *Ibidem*, p. 8.

In autumn 2003, Gazprom again demanded for Beltransgaz privatization, in order to acquire a controlling stake and higher prices for gas. Belarus and Gazprom reached an agreement to lease Beltransgaz for 99 years in exchange for an increased natural gas supplies and the potential of re-export, but no agreement was ratified by the Belarusian parliament[66]. In 2004 Gazprom seized gas supplies to Belarus in order to increase the pressure. Belarus arranged on the natural gas supply with Itera, SIBUR and Transnafta. All these companies are connected to Gazprom as all these companies trade Gazprom's extracted natural gas and distributed via the Gazprom owned infrastructure, so perceived diversification was an illusion[67] [68] [69] [70]. In February, Itera and Transnafta stopped natural gas supplies due to the end of short-term contracts and the Belarusian debt owed to those companies[71]. In addition, the Russian government also favoured the termination of gas supplies to Belarus[72]. The termination also affected Lithuania, Latvia and Poland, as the pressure in pipelines fell within their territories. In trying to meet its gas consumption needs, Belarus began siphoning gas form the transitional Yamal-Europe gas pipeline. Finally, Belarus and Russia agreed that the natural gas price for Belarus would increase reaching up to 47 U.S. dollars per thousand m^3, which still was considerably lower than for the other importers in Europe, Russia has also provided 200 million U.S. dollar loan to enable Belarus to pay the debt[73]. Russia allowed Belarus to have lower natural gas prices but that meant that Belarus remained more vulnerable to price manipulation and at the same time it increased its economic dependence. The Russian government, through Gazprom's gas supply interruption, in the long term demonstrated Russia's ability to expand its influence by exploiting the long-term energy supply outages.

Because of the discontinuation of the integration process and the lack of real influence development it was not useful for Russia to continue subsidizing the Belarusian economy[74]. At the end of 2006, Gazprom began negotiations on

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[66] Larsson (note 9), p. 224.

[67] Bloomberg Buisnessweek, *Gazprom: Russia's Enron? Gazprom and PricewaterhouseCoopers are under fire*, 18 February 2002 ., http://www.businessweek.com/magazine/content/02_07/b3770079.htm, 20 06 2011.

[68] Kupchinsky R., *Russia: Does Gazprom Have A Master Pipeline Plan?*, 30 January 2006., http://www.rferl.org/content/article/1065233.html, 20 06 2011.

[69] Trans Nafta, *About us / Company History*, http://www.trans-nafta.com/about_english.html, 20 06 2011.

[70] Radio Free Europe, *Will Belarus Abandon „Agreements" With Russia over Gas Dispute?*, 19 February 2004., http://www.rferl.org/content/article/1143100.html, 20 06 2011.

[71] Larsson (note 9), p. 224.

[72] Stern J. P., *The Future of Russian gas and Gazprom,* Oxford Institute for Energy Studies, 2005, p. 99.

[73] Kononczuk W., *Difficult „Ally" Belarus ir Russia's foreign policy,* Warsaw: Centre for Eastern Studies, 2008, p. 41., http://osw.waw.pl/files/PRACE_28.pdf, 20 06 2011.

[74] Whitmore B., *Russia/Belarus: Possible Gas Price Hike Could End Warm Ties*, 1 June 2006., http://www.rferl.org/content/article/1068824.html, 20 06 2011.

gas prices for the year 2007 and demanded from Belarus to pay 200 U.S. dollars per thousand m^3, which was the price close to what Lithuania was paying[75]. At the same time, Gazprom offered to supply gas at 120 to 140 U.S. dollars per thousand m^3, if Belarus was to agree to sell 50 percent of Beltransgaz shares to Gazprom[76]. By Gazprom estimates Beltransgaz was worth 3.5 billion U.S. dollars. Finally, on 18th May 2007, agreement was reached whereby Belarus was to sell 50 percent of the Beltransgaz shares in instalments over four year period for which 2.5 billion. U.S. dollars will be paid. Belarus was also to pay 75 percent for the price of gas in currency while the remainder 25 percent were to be deducted from the negotiated 50 percent share sale price. In addition, gas transit tariffs were to be increased by 70 percent. The agreement also stipulated that Belarus was going to gradually pay higher price year by year until by 2011 it was similar to the price that was being paid other importers in Europe[77]. By acquiring the 50 percent Beltransgaz stake, Russia expanded its economic and political influence in Belarus and retained the ability to manipulate natural gas prices. However, for Belarus, this deal is also satisfactory, since it still retained the possibility to negotiate natural gas prices and to offer political deals in exchange for more favourable gas prices.

There were no serious conflicts between Russia and Belarus concerning the privatization of the two refineries at Mozyr and Novoplock. In 1994, the joint Russian-Belarusian company Slavneft acquired 42.6 percent of Mozyr oil refinery shares. Today, the 99.7 percent of Slavneft is owned equally by TNK-BP and Gazprom Neft. More than 90 percent of Novoplock refinery shares remain state owned. However, Lukoil has repeatedly expressed interested in privatizing Belarusian oil refineries, and it is likely that it supported Lukashenka's re-election in 2001 in exchange for promises that Novoplock oil refinery would be sold to Lukoil[78]. Lukashenka stated that he does not plan to privatize oil refineries.

The end of 2006 saw the beginning of negotiations on natural gas prices and a Beltransgaz takeover as well as the start of the conflict between Russia and Belarus over oil export duty, which increased the pressure on Belarus. In 1995 Belarus and Russia agreed that Russia will not apply customs duties on oil exports to Belarus in exchange for 85 percent of the profit from the refined Belarusian oil products exported to third countries. In 2001, Belarus violated this agreement and

[75] Valstybinė kainų ir energetikos kontrolės komisija, *Lietuvos Respublikos elektros energijos metinė ataskaita Europos Komisijai* ['The Annual Report of Electric Energy of the Republic of Lithuania to the European Commission'], Vilnius, 2007, p. 16., http://www.regula.lt/lt/publikacijos/metine-ataskaita/Ataskaita_EK_2006_LT.pdf, 20 06 2011 (in Lithuanian).
[76] Костюгова В., *Белорусский ежегодник 2006* ['Annual Belarus Report'], Вилнюс, 2007, p. 345 – 346 (in Russian).
[77] *Ibidem,* p. 361.
[78] Balmacaeda M. M., *Belarus: Oil, Gas, Transit Pipelines and Russian Foreign Energy Policy*, GMB Publishing Ltd., 2006, p. 30.

continued exporting refined oil products to European markets, while retaining all the profits. Nevertheless, Russia continued with its side of the agreement and its obligations. Russian oil companies refined oil in Belarus and exported it to the European markets. As a result of this scheme, the Russian budget revenues derived from oil processing decreased while the Belarusian oil refining sector became very attractive to Russian companies. On 16th December 2006, Russia introduced a $ 180 per tonne export duty on oil exported to Belarus[79]. Russia sought to stop subsidizing the Belarusian economy and boost its oil processing capabilities, thus increasing its own economic capacity.

In response to Moscow's actions Belarus introduced a fixed oil transit tax, in addition to the transit rate, as high as U.S. $ 45 per tonne[80]. Transneft stopped oil supplies via Druzhba pipeline on the grounds that in the oil trade there is no such type of practice where a transit country applies a fixed transit tax. In response to this Belarus began siphoning oil from the transit pipelines destined for other countries. On 10 January 2007 Belarus and Russia agreed to resume the normal oil supply, but exports taxes were introduced on exported oil and its products to Belarus, in addition Belarus also had to introduce export taxes on oil and its products exported to the third countries to match the applicable Russian taxes.

This conflict resolution made the Belarusian oil refining industry unattractive to the Russian companies, and reduced the Belarusian state income from oil refineries and oil and oil products exports, which in 2006 amounted to 5.4 billion U.S. dollars[81]. Belarus could have avoided this type of scenario and received extra income from oil and its re-export, if it would have respected the 1995 agreement. This agreement did not significantly increase the revenue from oil and its re-export; however, it allowed Belarus to import oil for domestic consumption at a lower price, thus increasing the competitiveness and profitability of the budget. Russia's decision to impose an export duty for oil exported to Belarus should be seen as a consequence of the Belarusian policy, which in turn allowed Russia, in furthering its own political and economic interests, to exploit the fact that Belarus failed to upkeep its end of the bargain. Russian political motivation is exposed by the fact that it choose not to introduce oil export duties on oil to Belarus for more than five years after the contract violation. Russia could have imposed sanctions earlier or seek through negotiations to return to the *status quo*, but Russia saw a

[79] Tonjes C., de Jong J. J., *Perspectives on Security of Supply in European Natural Gas Markets,* The Hague: Clingendael International Energy Programme, 2007, p. 14., http://www.clingendael.nl/publications/2007/20070800_ciep_misc_toenjes.pdf, 20 06 2011.

[80] *Ibidem, p.* 14.

[81] Tax contributions to the budget from the oil sector were close to 5.4 ml. US dollars. Kononczuk (note 73), p. 42.

political advantage in allowing Belarus to violate the agreement and subsidizing the Belarusian economy.

2.3. Belarus-Russia Energy Conflicts over a Partial Beltransgaz Takeover and Energy Security Expansion

After a takeover of Beltransgaz, Gazprom repeatedly threatened to terminate the supply of natural gas to Belarus. In August 2007, Gazprom threatened to cut natural gas supplies to Belarus by 45 percent, if it did not repay 456 million U.S. dollars in debt[82]. However, Belarus was able to repay the debt within the specified period of time. In June 2010, Gazprom threatened gas supply cuts, if it was not paid back 200 million U.S. dollars debt for gas. In turn, Belarus demanded payments of 217 million U.S. dollars in debt for natural gas transit[83]. Then, natural gas supplies to Belarus were reduced by 60 percent, which also resulted in reductions of gas supply to Lithuania by 40 percent[84]. The conflict was resolved when both sides agreed to settle their debts to each other. The gas conflict was purely politically motivated. Russia pressured Belarus to sign the Russia, Belarus and Kazakhstan Customs Union treaty[85]. Lukashenka, however, was exploiting the conflict in order to boost support for himself in the (then) upcoming presidential elections in 19th December 2010[86].

The 2010 conflict was the result of non-transparent gas pricing. In the first quarter of 2010, Gazprom demanded payments of 169.20 U.S. dollars per thousand m^3 as Belarus was paying only $ 150 as this being the price paid by Belarus in 2009[87], which was half the price paid by Germany. Transparency in energy resource trade between Russia and Belarus would eliminate, or at least reduced energy conflicts, but the current situation satisfies both sides, because they retain the ability to use non-transparent pricing to achieve political goals. It is likely that

[82] Zhdannikov D., *UPDATE 4-Gazprom to halve gas to Belarus in debt row*, 1 August 2007., http://www.reuters.com/article/idUSL019104720070801, 20 06 2011.
[83] BBC, *Belarus 'to pay for Russian gas debt' within two weeks*, 21 June 2010., http://www.bbc.co.uk/news/10369300, 20 06 2011.
[84] ELTA and lrytas.lt, *Gamtinių dujų tiekimas į Lietuvą per Baltarusiją stabilizuotas* ['Natural Gas Supply to Lithuania via Belarus was Stabilised'], 24 June 2010., http://www.lrytas.lt/-12773724031276605526-gamtinių-dujų-tiekimas-į-lietuvą-per-baltarusiją-stabilizuotas.htm, 20 06 2011 (in Lithuanian).
[85] EurActiv, *Russia, Kazakhstan agree customs union minus Belarus*, 31 May 2010., http://www.euractiv.com/en/east-mediterranean/russia-kazakhstan-agree-customs-union-minus-belarus-news-494671, 20 06 2011.
[86] ELTA and lrytas.lt, *Ekspertai: „Dujų konfliktas su Baltarusija - Rusijos spaudimas dėl Muitų sąjungos* ['Experts: "Russia Presses Belarus to Join Customs Union Through Natural Gas Conflict"], 21 June 2010., http://www.lrytas.lt/-12771868051276623342-ekspertai-dujų-konfliktas-su-baltarusija-rusijos-spaudimas-dėl-muitų-sąjungos.htm, 20 06 2011 (in Lithuanian).
[87] BBC, (note 83).

Russia will not increase gas prices for Belarus to match the prices charged other importers in Europe. Lower prices maintenance enables Russia to better manipulate the pricing to suit its political and economic goals. Lukashenka, while exploiting lower gas prices, gains the advantage of ensuring public support and Belarusian trade competitiveness. However, political stability that is maintained through low energy prices is actually a vulnerable political system and in addition it does not provide incentives for energy-efficient economic development and technological innovation. If the energy resource price would be made equal to that of the other importers in Europe it would limit Russia's opportunities to expand its political influence. Belarus does not object to it as long as it is beneficial to its public system, as its priority is socialist-oriented economic development, rather than energy and national security.

Belarus did not look for alternative energy supplies while Russian companies did not try to take over Beltransgaz and the relations with Russia were in line with its interest. As Russia started to aggressively expand its own interests using of energy resources, Belarus began looking for alternatives. However, the NPP project, which has been undergoing since 2008, cannot be seen as an alternative, because Belarus is planning for the plant construction to be financed and carried out by Russian companies, the reactors to be installed are assembled and made in Russia, while the power plant is to be provided with a Russian nuclear fuel and personnel[88] [89]. This would reduce the need for Russian natural gas, but would increase the threat to Lithuanian national security as the power plant is planned just 50 kilometres from the capital Vilnius, and the reactors are likely to be cooled with the water from the river Neris. The power plant project in Belarus complicates the realization of the Lithuanian Visaginas NPP project and its electricity price competitiveness on the market.

The Yamal-Europe transit gas pipeline has strengthened Belarusian energy position in respect to Russia; however, in 2007 Russia has abandoned its plans to build the second Yamal-Europe transit gas pipeline, which would have further increased the importance of Belarus to Russia and would have strengthened the Belarusian negotiating position[90]. In order to increase the energy independence, Belarus is implementing projects aimed increasing its own local and renewable resources, with particular emphasis on electricity and heat generation capacities. At

[88] Naviny.by, *Russia to provide loans to Belarus for construction of nuclear power plant*, 6 February 2009., http://naviny.by/rubrics/inter/2009/02/06/ic_news_259_305905/, 20 06 2001.
[89] Rakhley M., *Iran is ready to provide assistance to Belarus in construction of nuclear power plant, ambassador says*, 27 February 2008., http://naviny.by/rubrics/inter/2008/02/27/ic_articles_259_155775/, 20 06 2011.
[90] Rianovosti, *Russia drops second leg of gas pipeline via Belarus*, 1 November 2007., http://en.rian.ru/russia/20071101/86223448.html, 20 06 2011.

the end of 2011, the Grodno oblast intends to complete the 17.8 MW hydroelectric power plant and expand biomass preparation and use operations. Even though local and renewable resources will grow, most of the Belarusian energy resources will still have to be imported. Thus, Belarus intended to import 10 million tons of oil annually from Venezuela between 2011 and 2013[91]. This amount of oil would meet domestic Belarusian consumption needs, but it is not enough for the re-export of oil and oil products to third countries. The agreement with Venezuela temporarily increased the Belarusian energy security and improved its bargaining position with Russia. However, the Venezuelan oil could not bring significant revenue to the Belarusian budget as Venezuelan oil prices are higher than those imported from Russia, and in addition, the supply is to be done via oil tankers through the neighbouring port of Odessa in Ukraine and Odessa-Brody pipeline, while the transportation oil form Venezuela is much more costly than the pipelines from Russia[92]. Russia, in response to Belarusian cooperation with Venezuela, was ready to cancel export duties on oil and natural gas since 2011, on the condition that Belarus would agree to ratify the Single Economic Space Treaty[93]. This type of customs union, though, allows Russia, as the largest and economically most capable state, to extend its economic muscle on other union members and through tariff restrictions regulate their trade with third countries.

There is no doubt that energy trade between Russia and Belarus is affected by corruption. Assumption is supported by the Transparency International Corruption Perceptions Index data showing that corruption in Belarus is high[94]. To explore the impact of corruption on the energy security of Belarus is difficult due to character of its political system. It can be assumed, though, that corrupt practices are associated with the highest state authorities and these institutions are well protected and defended, thus, corruption cases mostly remain undetected. Dependent law enforcement and judicial authorities, the weakness of the opposition and lack of independent media, all create an environment in which corruption cases cannot be objectively tested and evaluated.

Nonetheless, while energy prices for Belarus have been lower, energy efficiency in Belarus increased, yet it still remains low, almost twice as low as in

[91] Rianovosti, *Belarus to annually buy 10 mln tons of oil in Venezuela in 2011-13*, 16 October 2010., http://en.rian.ru/business/20101016/160981777.html, 20 06 2011.
[92] Telegraf.by, *Regular Oil Deliveries through Odessa-Brody Pipeline to Start in 2011, BOC*, 26 November 2010., http://telegraf.by/2010/11/regular-oil-deliveries-through-odessa-brody-pipeline-to-start-in-2011-boc.html, 20 06 2011.
[93] Belarus.by, *No duties, quotas, restrictions on oil, gas supplies in Customs Union*, 10 December 2010., http://www.belarus.by/en/press-center/news/no-duties-quotas-restrictions-on-oil-gas-supplies-in-customs-union_i_0000001836.html, 20 06 2011.
[94] Transparency International, *Corruption Perceptions Index 2010 Results*, http://www.transparency.org/policy_research/surveys_indices/cpi/2010/results, 20 06 2011.

Germany[95]. Increasing energy efficiency directly influences the reduction of fuel and energy consumption, which produces a lesser need to import energy resources and attaches greater importance to local and renewable resources in the final balance of energy consumption. Russia will remain the main energy supplier in a long run as geopolitical position of Belarus isolates any other possible energy supply alternatives. If it attempted to develop its energy and geopolitical orientation to the West, its energy and national security could be particularly negatively affected by Russia, and especially in the short and medium terms, because Belarus would not be able to abruptly re-orientate its energy supply infrastructure.

3. The Ukrainian Case Study

3.1. Ukraine-Russia Energy Relations before Major Energy Conflicts

Upon the disintegration of the Soviet Union, Ukraine joined the CIS, yet it was keen to keep its multivectoral foreign policy. After the disintegration, the price of oil for Ukraine reached world market price, but natural gas prices were being fixed by bilateral agreement with Russia. The price of gas for Ukraine, as for a CIS state, was lower than for other European consumers[96]. Lower natural gas prices stimulated the Ukrainian economy, but like Belarus, Ukraine's gas debt to Russia rose. The debt allowed Russia to demand a takeover of the Ukrainian energy infrastructure in exchange for the debt write-off[97]. As a result of debts, Russia periodically discontinued natural gas supplies to Ukraine in 1992, 1993 and 1994. Thus, the debt issue and the possible suspension of gas supply were included in the agenda of bilateral talks[98]. Gas supply suspension created a favourable political and economic environment for the expansion of Russian influence in Ukraine.

After the Soviet Union broke apart, some nuclear weapons remained in Ukraine; however, the U.S. and Russia did not want another nuclear power state to exist. Therefore, the U.S. and Russia applied pressure on Ukraine to return the nuclear weapons to Russia or dismantle them[99]. Nonetheless, from 1991 to 1994

[95] Enerdata (note 16).
[96] Pirani S., *Ukraine's Gas Sector,* Oxford Institute for Energy Studies, 2007, p.18., http://www.oxfordenergy.org/wpcms/wp-content/uploads/2010/11/NG21-UkrainesGasSector-SimonPirani-2007.pdf, 30 06 2011.
[97] *Ibidem,* p. 18.
[98] *Ibidem,* p.19.
[99] Globalsecurity.org, *Ukraine Special Weapons*, http://www.globalsecurity.org/wmd/world/ukraine/index.html, 25 06 2011.

Ukraine sought to take control of the nuclear weapons in its territory or at least retain some of these weapons[100]. In 1993 Russia issued an ultimatum demanding a full return of Ukraine's nuclear weapons arsenal and the transfer of the Black Sea fleet of Russia. One week prior to the negotiations, as means of increasing pressure, Russia reduced natural gas supplies by 25 percent on the grounds of Ukrainian debt[101]. Russia also threatened further subsequent energy supply suspension, if Ukraine fails to implement the Russian requirement. At the same time, Russia proposed to write off the debt, if Ukraine would agree with the demands. President of Ukraine Leonid Kravchuk failed to pass the agreement with the then Russian president Yeltsin because of the political opposition.

From 1994 to 1995 Ukraine's debt for natural gas amounted from 4 to 4.5 billion U.S. dollars. It was seeking to write off the debt in exchange for Gazprom takeover of Ukraine's natural gas transmission pipeline. The feasibility of a joint Russian - Ukrainian gas transit company in exchange for partial debt write-off was also considered. The Parliament of Ukraine opposed Leonid Kuchma's initiatives and barred the Russian energy companies from Ukraine's natural gas infrastructure sectors.

In 1995 Russia also sought to consolidate the former republics of the Soviet Union in order to expand economic and political influence by creating the CIS Customs Union. Therefore, in 1995, Russia raised export duties on oil exported to Ukraine, as a result, Ukraine ended up paying more than market price for its oil from Russia. Increase of oil export duty was to make Russia the Ukraine to join the CIS Customs Union[102]. By increasing the duties, Russia hoped this will lead eventually to Ukraine's accession as a full member of CIS Customs Union, but Ukraine joined only as an observer.

From independence until 2000, Ukraine and Russia did not apply market principles to natural gas trade. In 2000 Viktor Yushchenko became the Ukrainian Prime Minister, he and the Deputy Prime Minister for Energy Yulia Tymoshenko wanted apply market principles to Ukraine's energy sector, but these attempts were not successful due to the oligarchy's resistance[103]. In addition, Ukraine was not a reliable gas transit partner, as when, for example, in 2000 Ukraine's state energy company Naftogaz Ukrainy, (further Naftogaz), siphoned 8.7 billion m^3

[100] *Ibidem.*
[101] Larsson (note 9), p. 202
[102] Balmacaeda M. M., "Gas, Oil and the Linkages between Domestic and Foreign Policies: The Case of Ukraine", *Europe-Asia Studies,* Vol. 50, No. 2, 1998, p. 257-286.
[103] "Tymoshenko faces criminal charges", *Publication: Monitor*, Volume: 7 Issue: 11, 17 January 2001., http://www.jamestown.org/single/?no_cache=1&tx_ttnews%5Btt_news%5D=22713&tx_ttnews%5BbackPid%5D=215, 25 06 2011.

of natural gas destined for European consumers. Ukraine's actions contributed to Russia's search for an alternative transit; thus, increasing its natural gas transit through Belarus seeking to develop alternative transit pipeline projects like the North Stream via the Baltic Sea and the Blue Stream via the Black Sea. Eventually Ukraine's actions negatively affected the whole of Eastern Europe and the Baltic region's energy and national security. Pipelines passing via the Baltic and the Black Seas, the development of Primorsk port in the Baltic Sea and the development of the Baltic Pipeline System II, made the Intermarum region more vulnerable to the Russia's energy foreign policy. Russia, thus, is becoming less dependent on transit countries while, at the same time, it is increasing its dominance of those transit countries, furthering their asymmetric dependence.

3.2. Ukraine's Orientation towards the West in the Ukrainian-Russian Energy Conflict of 2006

The period of 2005 - 2010 was marked by intensive energy conflicts with Russia, which were mostly politically motivated. During this time, Russia sought to influence Ukraine's pro-Western orientation, and keep it in their area of influence by supporting the pro-Russian government. As a result, Russia was manipulating the natural gas supply and prices for these reasons. The indication of this is the different Russian energy policy practices at different times as for example during the presidency of the pro-Western Viktor Yushchenko, on one hand, and pro-Russian President Viktor on the other.

Before the 2004 Ukrainian presidential elections, Gazprom supported a Yanukovych-led government by offering low natural gas prices. At that time, Gazprom sold gas to Ukraine at 50 U.S. dollars per thousand m^3, while the average price of natural gas for European consumers was 140 U.S. dollars for the same amount. However, after the "Orange Revolution" in 2005, Yushchenko won the presidency and Ukraine-Russia energy relations changed radically.

In December 2005, Gazprom decided to increase the price of natural gas for the ex-Soviet states. Gazprom proposed a gas price increase in the area of 160 to 230 U.S. dollars per thousand m^3 for Ukraine, while at the same time providing an alternative proposal that the gas price could be lowered if joint consortium between Gazprom and Naftogaz were to take over management of the transit pipelines[104]. The proposed consortium idea did not satisfy Yushchenko and in addition he suggested that the consortium ought to build new pipelines, rather than seek to control the existing pipelines[105]. Thus, Ukraine was ready to pay the natural gas price paid by the other users, but requested for the price to be increased gradually and in 2006 agreed to pay only 80 U.S. dollars per thousand m^3 [106]. A sudden increase in gas prices would have forced Ukrainian industry into bankruptcy as Ukrainian industrial sector, with its developed chemical and metallurgical industries made up about 42 percent of Ukraine's GDP and consumed a lot of energy; therefore, Ukraine was very sensitive to changes in energy prices[107]. This economic structure means that Ukraine is the second largest importer of Russian gas in Europe[108]. Putin at the same time expressed the view that Russia should stop subsidizing Ukraine, because the cheap prices of energy resources are costing Russia a billion dollars annually[109]. The decision to increase gas prices for Ukraine can be seen as politically motivated, since for the previous eight years the gas price for Ukraine had been stable and had not been considered a subsidy. Only after the political changes in Ukraine did Moscow's assessment of the gas prices for Ukraine change.

In order to meet the payments for gas, Kiev proposed a barter exchange of Ukrainian made weapons[110]. Ukraine was not ready to begin currency settlements and forego the barter exchange arrangements. Gazprom was not interested in the proposal since for the company it was not viable to acquire weapons and then resell them to the Russian military, and besides Russian military needs new type of weapons and technology not the Soviet-design weapons offered. In addition, it would have not been in the Russian interests to stimulate the Ukrainian arms industry.

Gazprom proposed that Ukraine set up a joint company that would manage the transit pipelines and Gazprom would then hold shares in it[111]. Such Gazprom

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[104] Stern J., *The Russian-Ukrainian gas crisis of January 2006,* Oxford Institute for Energy Studies, 2006, p. 3., http://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/01/Jan2006-RussiaUkraineGasCrisis-JonathanStern.pdf, 25 06 2011.

[105] *Ibidem*, p. 4.

[106] *Ibidem*, p. 7.

[107] Uiboupin J., *Industrial clusters and regional development in Ukraine: the implications of foreign direct investments and trade*, 2006., http://www.compiler.fi/idankaupan/tutkimukset/PEI-9e.html, 25 06 2011.

[108]BP, *BP Statistical Review of World Energy June 2010*, London: BP p.l.c., 2010, p.30., http://www.bp.com/liveassets/bp_internet/globalbp/globalbp_uk_english/reports_and_publications/statistical_energy_review_2008/STAGING/local_assets/2010_downloads/statistical_review_of_world_energy_full_report_2010.pdf, 25 06 2011.

[109] Kolesnikov A., *Vladimir Putin Charged Ukraine*,2005 December 9 d. http://www.kommersant.com/page.asp?id=633921, 25 06 2011.

[110] Larsson (note 9), p. 214.

[111] Nataliya Grib, "Gas Main Is Main," (14 December 2005) // http://www.kommersant.com/p635142/r_1/Gas_Main_Is_Main/, 06 10 2010

gas transit operator schemes already began operating as Polish Europol GAZ, Slovakian Slovrusgas and Hungarian Panrusgas[112]. According to this type of business scheme, the energy supplier ends up paying itself for the transit of its own resources. Gazprom, by controlling over 48 percent of Europol GAZ, effectively manages the Yamal - Europe gas pipeline that passes through the territory of Poland and, as a result pays, itself for the transit almost half of the transit price, which is 2.1 U.S. dollars per thousand m^3 over a hundred kilometres, so it receives 48 percent of that company's total profit[113].

Natural gas conflict between Ukraine and Russia escalated as both sides did not seek common solutions. Ukraine threatened Gazprom with partial natural gas appropriation on the grounds that the contract did not specify how much of the transit gas moving across Ukraine was to reach Europe[114]. Gazprom, in turn, threatened to terminate the gas supply agreement on price was not reached. Gazprom and Naftogaz agreement stipulated that the conflicts and disputes over natural gas supplies and prices should be dealt with in Stockholm Arbitration Court, but Gazprom chose not to appeal[115]. This suggests that the gas conflict was politically motivated, while the Stockholm arbitration decision, likely, would have not been favourable for Gazprom.

Russia also sought to restrict Ukraine's economic development, by offering to settle the conflict by means of 3.6 billion U.S. dollars loan from the European and the U.S. banks that it would arrange for, so that Ukraine would be able to cover the price difference for the gas purchased from Russia while it then would be able to maintain the unchanged price for its domestic customers[116]. This type of loan would have had a negative impact on the Ukrainian economy because it would not only end with a price increase but would also need to pay the loan interest.

In addition to the price factors, the natural gas conflict was also being provoked by Ukrainian Naftogaz. In 2005 Naftogaz sold or stole 7.6 billion m^3 of Gazprom-owned natural gas which had been in Ukrainian storage facilities[117]. Ukraine and Gazprom failed to agree on damages settlement for the missing gas.

On January 1, 2006, Gazprom seized gas supplies to Ukraine. On the same

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[112] For further reading see: Orban A., *Power, Energy and the New Russian Imperialism,* Praeger Security International, 2008.

[113] Europol GAZ, *The Firm: Comapny Management*, 21 April2010., http://www.europolgaz.com.pl/english/firma_wladze.htm, 25 06 2011.

[114] Socor V., *Kremlin has Upper Hand in Gas Negotiations with Ukraine*, 12 December 2005., http://www.jamestown.org/programs/edm/single/?tx_ttnews%5Btt_news%5D=31210&tx_ttnews%5BbackPid%5D=176&no_cache=1, 25 06 2011.

[115] Larsson (note 9), p. 205.

[116] *Ibidem*, p. 205.

[117] *Ibidem*, p. 203.

day Gazprom recorded a decrease in gas pressure in its transit pipelines and accused Naftogaz of siphoning gas destined for Europe. A little later Naftogaz admitted it[118]. This incident, once again, showed that Ukraine is not a reliable gas transit partner and prompted European users to search and support alternative pipeline development projects which would bypass Ukraine and other transit countries. Such actions had a lasting negative impact on Ukraine's energy security, on its role as a transit country and on its geopolitical importance.

On January 4, a five-year gas supply contract was negotiated; however, it only stipulated the price for the upcoming a six-month period. According to the Gazprom and Naftogaz agreement, they were to trade through an intermediary, the RosUkrEnergo company, which was to purchase gas from Gazprom at 230 U.S. dollars per thousand m^3 and mix it with a cheaper gas from Turkmenistan and Kazakhstan and then, sell it to Naftogaz at 95 U.S. dollars per thousand m^3. Under this scheme, RosUkrEnergo had to buy annually 16 billion m^3 of Gazprom's gas and 40 billion m^3 of gas from Turkmenistan and Kazakhstan, which ranges in price from 50 to 65 U.S. dollars per thousand m^3. The agreement, also, stipulated that the transit rate would be increased to 1.6 U.S. dollars per thousand m^3 over one hundred kilometres. Some analysts say that RosUkrEnergo could not be financially viable if it were to respect the stipulated sales and purchase volumes and prices[119]. Thus the Ukrainian-Russian agreement lacked transparency and it also created opportunities for energy conflicts in the future.

The lack of RosUkrEnergo's operational transparency adversely affected Ukraine's energy security. 50 percent of the company's shares are owned by Gazprom through an intermediary Rosgas Holding AG, while the remaining 50 percent belongs to the Centragas Holding AG[120]. Centragas Holding AG was managed by two Ukrainian businessmen, Dmitry Firtash and Ivan Fursin, both are suspected to have links to organised crime[121]. These links have been highlighted by Ukrainian Prime Minister Tymoshenko[122]. The activities of Centragas Holding AG were also investigated by the U.S. Department of Justice[123]. Ariel Cohen

[118] BBC, *Ukraine takes extra Russian gas*, 24 January 2006. http://news.bbc.co.uk/2/hi/europe/4642684.stm, 25 06 2011.

[119] Самсонов С.,Бороздина С., *Сухой остаток газового спора* ['Dry outcome of Gas Conflict'], 4 January 2000., http://www.gazeta.ru/2006/01/04/oa_183744.shtml, 25 06 2011 (in Russian).

[120] Прибыловский В., *Сомнительный посредник* ['Questionable Mediator'], 6 January 2006., http://www.democracy.ru/article.php?id=1057, 30 06 2011 (in Russian).

[121] Unian.net, *Nemtsov: Russian part in RosUkrEnergo looks as improper as Ukrainian one*, 2008 March 18 d. http://www.unian.net/eng/news/news-241453.html, 30 06 2011.

[122] BBC, *The High Price of Gas: Transcript*, 6 November 2006., http://news.bbc.co.uk/2/hi/programmes/panorama/6121508.stm, 30 06 2011.

[123] Izvestia.ru, *Кто владеет украинским газом* ['Who Controls Ukrainian Gas'], 26 April 2006., http://www.izvestia.ru/news/313258, 30 06 2011 (in Russian).

said: “[RosUkrEnergo] company is a shady entity with allegedly illicit ties, and is an intermediary that benefits businessmen and government officials who prefer anonymity”[124]. Energy relations between countries cannot be transparent when they involve a company with a questionable reputation. However, certain government officials and businessmen are interested in this type of company’s involvement. These companies allow Gazprom to extend its influence through corruption while government officials and entrepreneurs profit from it.

3.3. The Ukrainian – the Russian Gas Conflict of 2009 and the Return to Multi-Vector Policy

2007 - 2009 period was marked by constant conflicts between Gazprom and Ukraine, which often arose as a result of short-term agreements on gas prices and Ukraine’s inability to pay for gas in a timely manner. Poor coordination between Ukrainian government authorities and energy companies in Ukraine determined its weaker bargaining position, especially when it was negotiating for the price of gas that it had already consumed.

In November 2007, natural gas prices reached 180 U.S. dollars per thousand m^3 [125]. In February 2008 the Russian and Ukrainian presidents decided the mediator RosUkrEnergo to replace by jointly managed company under the control of Gazprom and Naftogaz, Ukraine also committed to pay for gas in advance[126]. Gazprom continued its threat to reduce natural gas supply by 25 percent on the grounds that the availability volumes of gas from the Central Asian had dropped, and as a result Gazprom had to compensate for the decrease with the more expensive Russian gas[127]. For this reason, the Ukrainian debt for gas rose rapidly and the gas supply was reduced[128]. However, Gazprom and Naftogaz managed to reach an agreement, yet the cabinet refused to ratify the previously reached agreement by the Russian and Ukrainian presidents that called for the establishment of Gazprom and Naftogaz jointly managed company and to pay

[124] Cohen A., Graham O., *European Security and Russia’s Natural Gas Supply Disruption*, 2009 January 8 d., http://www.heritage.org/research/reports/2009/01/european-security-and-russias-natural-gas-supply-disruption, 30 06 2011.
[125] Unian.net, *Ukraine, Russia, settle gas debt dispute (Update)*, 12 February 2008., http://www.unian.net/eng/news/news-235920.html, 30 06 2011.
[126] Unian.net, *Yushchenko called Tymoshenko’s policy a policy of risky ventures and intrigues*, 7 March 2008., http://www.unian.net/eng/news/news-240060.html, 30 06 2011.
[127]France24.com, *Gazprom cuts gas to Ukraine by 25%*, 3 March 2008., http://www.france24.com/en/20080303-gazprom-cuts-gas-ukraine-25-russia-ukraine&navi=MONDE, 30 06 2011.
[128] BBC, *Gazprom cuts Ukraine gas supply*, 3March 2008., http://news.bbc.co.uk/2/hi/business/7274380.stm, 30 06 2011.

for gas in advance[129]. Eventually, in October 2008, Russian Prime Minister Putin and Ukrainian Prime Minister Tymoshenko signed a three-year agreement, which stipulated that Ukraine will pay a higher price for natural gas, but Ukraine's gas transit rates will also increase. Later on, Gazprom and Naftogaz came to different arrangements from the agreement signed by the Prime Ministers[130]. This shows the lack co-ordination between the political institutions and energy companies. Different positions prevailed not only between the Ukrainian and the Russian governments, but also between the two state owned energy companies. The biggest problem was that there was a difference of opinion on the issue between the two executive branches of the Ukrainian government, as well as, the difference in opinion between the Ukrainian executive government's position as a whole and the position of the energy companies. Therefore the lack of unified bargaining position was increasing the vulnerability of energy security.

At the end of 2008, Gazprom demanded payments for the consumed gas, as well as to pay the debt that has resulted from the cost difference between Russian and Central Asian gas, however, due to the lack in transparency, there was a disagreement between Gazprom and Naftogaz on the actual amount owed[131] [132]. Ukraine argued that it owed only for two months and said it was not going to pay it in 2008. Gazprom refused to postpone the debt payments until 2009, which shows an inflexibility and possible political motives to increase the pressure on Ukraine. At the same time, it must be taken into consideration that the Global Financial Crisis (GFC) had particularly severely affected Ukraine's financial capacity, but Gazprom did not agree on providing alternatives. Therefore, GFC strengthened Russia's ability to exploit economic and financial measures to enhance its influence on Ukraine.

Gazprom again seized gas supplies to Ukraine on the 1st of January 2009; however, the supply of gas to European countries continued as usual. Thus, Ukraine's gas needs were met from its own natural gas reserves[133]. President Yush-

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[129] Unian.net, *Tymoshenko refused to execute gas agreements of Presidents*, 6 March 2008., http://unian.net/eng/news/news-239931.html, 30 06 2011.

[130] Pirani S., Stern J., Yafimava K., *The Russo-Ukrainian gas dispute of January 2009: a comprehensive assessment*, Oxford Institute for Energy Studies, 2009, p.13- 14., http://lepii.centredoc.fr/opac/doc_num.php?explnum_id=125, 30 06 2011.

[131] Unian.net, *Ukraine has no gas debt to Russia – Tymoshenko*, 21 November 2008., http://www.unian.net/eng/news/news-285883.html, 03 06 2011.

[132] Rianovosti, *Gazprom to receive Ukraine's $1.5 bln gas debt payment Jan. 11*, 2 January 2009., http://en.rian.ru/russia/20090102/119335474.html, 30 06 2011.

[133] Paxton R., Zawadzki S., *Ukraine draws on gas reserves in prolonged row*, 13 January 2009., http://www.reuters.com/article/idUSTRE50C4W120090113?sp=true, 30 06 2011.

chenko appealed to the EU Commission regarding the suspension of gas supply[134]. The EU took no effective action until January 4, when it noticed the drop in gas pressure being delivered through transit pipelines coming from Ukraine[135]. The EU became more involved in seeking the energy conflict resolution only after it had affected the EU Member States. This shows that the EU is not really concerned which state in Eastern Europe has the greatest geopolitical influence as long as the region is stable and does not affect the EU Member States interests.

On January 5, Gazprom, with the approval of Prime Minister Putin, reduced natural gas supplies to Europe by the amount equal to that of the transiting gas Ukraine used for the technical purpose of transportation and pressure maintenance[136]. On January 6, Gazprom claimed that Ukraine was blocking three of the four transit pipelines. Both sides sought to exploit the energy conflict in their own favour and win the support of the EU[137]. Both sides blamed each other for the natural gas supply termination to EU Member States. On January 7, it was announced that Gazprom was suspending all natural gas supplies, as Ukraine had suspended the gas transit. Naftogaz, in turn, announced that it suspended transit because Gazprom had, in the first place, stopped supplying gas[138]. In order to restore natural gas supplies to the EU Member States, the EU became a moderator between Russia and Ukraine. The EU proposed to establish a gas monitoring mission on the Russian-Ukrainian border. Ukrainian Prime Minister Tymoshenko demonstrated a lack of competence and responsibility when, to an already negotiated and drafted protocol regarding the EU Monitoring Mission, he suddenly added a piecemeal declaration which stated that Russia was singlehandedly responsible for the crisis. Russia immediately rejected the protocol[139]. In turn, Tymoshenko's actions prolonged the crisis and showed the inability of Ukrainian politicians to achieve conflict resolution.

Eventually, after the protocol had been signed on January 12, the EU Monitoring Mission was still unable to begin work. Ukraine had changed the direction of one of the transit pipelines so that it could supply its gas consumers in the eastern regions; hence, the transit pipeline became unsuitable for gas transit to Europe. The restoration of the pipelines direction would have meant the end

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[134] Interfax.com.ua, *Ukraine asks EU to take part in settlement of Ukrainian-Russian gas dispute*, 1 January 2009., http://www.interfax.com.ua/eng/main/4213/, 30 06 2011.
[135] Eu2009.cz, *EU calls for urgent resumption of gas supply from Russia through Ukraine to Member States*, 4 January 2009., http://www.eu2009.cz/en/news-and-documents/news/yx-4651/, 30 06 2011.
[136] BBC, Russia to cut Ukraine gas supply, 2009 January 5 d., http://news.bbc.co.uk/2/hi/europe/7812368.stm, 30 06 2011.
[137] Pirani S., Stern J., Yafimava K., (note 130), p. 21-22.
[138] *Ibidem,* p. 22.
[139] *Ibidem,*p. 22-23.

of gas supply to Ukraine's eastern regions[140]. Gazprom then began to specifically insist on using that particular transit pipeline, which direction had been changed, in order to recommence the gas transit to the EU as that particular transit pipeline was exactly what was preventing them from being able to deliver gas to the EU[141]. This incident showed that Russia was reluctant to resolve the conflict and was not willing to be flexible on the issue. Russia also sought to exploit its position to encourage the EU to increase pressure on Ukraine.

On January 18, Ukrainian and Russian Prime Ministers signed a ten-year agreement on natural gas supply. In 2009, Ukraine had to pay 80 percent of gas prices compared to European consumers, and since 2010, Ukraine had to pay the same price as other European consumers. It was also agreed that Gazprom was going to sell gas directly to Naftogaz without any intermediary, and the transit rate was also increased.

This agreement with Russia was unfavourable for Ukraine as it negatively influenced Ukraine's financial capabilities, and increased public debt. For Ukraine, higher natural gas prices prolonged the economic crisis, caused a decrease in the competitiveness of its goods and products, and reduced its domestic consumption[142]. Yushchenko had assessed the agreement as discriminatory agreement which must be renegotiated in the future[143]. The agreement had an effect on the internal political situation. Higher gas prices, GFC and domestic political instability reduced Ukrainian popular support for pro-Western parties. Subsequently, these factors led to Yushchenko's defeat in 2010 presidential election.

When Yanukovych was elected President of Ukraine, Ukraine's position on Russia changed strongly; it returned to the former foreign policy of the Kuchma presidency. Russia, once again, began to be viewed as a strategic partner. The increased Russian influence was related to energy resources as well. Former President Yushchenko was opposed the continuation of the Russian military deployment at the Sevastopol naval base after the contract expires in 2017. Yanukovych's position was that the deployment contract of Russian military at the base could be extended in exchange for lower natural gas prices. On April 21, 2010, Ukrainian and Russian Presidents signed an agreement according to which the price of natural gas for Ukraine was decreased by 30 percent. In addition, Ukraine leased

[140] Interfax.com.ua, *Naftogaz acknowledges it couldn't take Russian gas*, 13 January 2009., http://www.interfax.com.ua/eng/main/4987/, 30 06 2011.
[141] Pirani S., Stern J., Yafimava K., (note 130), p. 22-23.
[142] *Ibidem,* p. 28-29.
[143] Pirani S., Stern J., Yafimava K., (note 130), p. 30.

of the Sevastopol naval base to Russia until 2047[144]. Ukraine's decision to allow the lease extension for Russia's naval deployment in Sevastopol in exchange for cheaper gas will have long-term consequences on Ukraine's geo-political position, actions and orientation. Through this agreement, Russia increased its influence in Ukraine's economic, political and military spheres, this will naturally cause Ukraine to orientate itself to and gravitate towards Russia, even if it will be instituting multivectoral foreign policy.

Yanukovych maintained that the agreement was the only way, without the reduction of public expenditure, to limit the federal deficit as demanded by the International Monetary Fund (IMF)[145]. This shows the Yanukovych's inclination for Ukrainian to become a Russian satellite rather than his determination to implement unpopular economic and political reforms[146]. Public expenditure cuts would increased the government's efficiency and reduced public debt. However, these actions would reduced popular support for leading political parties and the president, especially, among low-income groups. Ukraine still remains one of the most energy inefficient countries[147]. Higher natural gas prices would prompt a reform of Ukraine's economic structure, the development of lower energy consuming segments of the economy and an increase in energy efficiency. These changes would adversely affect the Ukrainian economy, social and political environment in the short term. In the long run, it would develop more energy efficient economy, which would lead to lower energy imports and enhance energy independence; also, local and renewable energy resources would become more significant in terms of the total energy consumption.

During Ukraine's pro-Western orientation, pipeline projects that would allow alternative supply of energy resources were being created. However, given the change of government and the presidency, it is unlikely that the current White Stream pipeline project, which was presented in 2007 Vilnius Energy Security Conference, connecting Azerbaijan, Georgia and Ukraine via the Black Sea, which would allow the supply of gas bypassing Russian territory, will be built. By maintaining the pro-Russian policy, Yanukovych does not support the development of the pipeline. As early as 2008, Yanukovych objected to the idea of the project[148].

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[144] Watson I., Tkachenko M., *Russia, Ukraine agree on naval-base-for-gas deal*, 2 April 2010., http://www.cnn.com/2010/WORLD/europe/04/21/russia.ukraine/index.html?hpt=T2, 30 06 2011.

[145] Reuters, *Yanukovych snipes at opponent, defends fleet move*, 13 May 2010., http://www.kyivpost.com/news/nation/detail/66624/, 30 06 2011.

[146] Harding L., *Viktor Yanukovych promises Ukraine will embrace Russia*, 5 March 2010., http://www.guardian.co.uk/world/2010/mar/05/ukraine-russia-relations-viktor-yanukovych, 30 06 2011.

[147] Enerdata, (note 16).

[148] For-UA, *Yanukovych against the construction of white stream*, 6 February 2008., http://for-ua.org/ukraine/2008/02/06/164714.html, 30 06 2011.

3.4. Ukraine's Oil Sector and Corruption Problems

After the disintegration of the Soviet Union, Ukraine inherited a large and capable, but aging oil infrastructure. Ukraine has six oil refineries capable of processing 0.87 million barrels of oil per day, but some oil refineries were built before the Second World War, and oil processing depth did not exceed 50 percent. Therefore, they needed to be modernized, requiring huge investments, which Ukraine did not have. In addition, it was difficult for Ukraine to secure an adequate supply of oil to its refineries.

Ukraine's total fuel consumption needs made up only 30 percent of its oil refining capacity, but the refineries were not sufficiently loaded. In the last decade of the twentieth century, Ukraine's refineries did not manage to satisfy its internal needs due to insufficient crude oil supply from Russia. In order to increase oil supplies the Ukrainian government sold part of its refinery shares to oil supplying companies. In 1999 Lukoil managed to acquire 51.9 percent of Odessa refinery shares and later increased its stake to 99.57 percent[149]. In July 2000, the Russian company Tiumenskaja Neftianaja Kampania (TNK), through its subsidiary TNK – Ukraine, acquired 67 percent of Lisichansk refinery shares and, in October of the same year, it increased its stake to 94 percent[150]. Kremenchuk, the largest oil refinery in Ukraine, had been operated by Ukrtatnafta company since 1994; its shareholders included the Ukrainian state owned Neftegaz company, Russia's Tatneft company and its subsidiaries and the Government of Tatarstan. The Ukrainian government and Tatneft were at odds over the control of Ukrtatnafta shares, as 18 percent of Ukrtatnafta shares were transferred to offshore companies, which were associated with Tatneft, the Ukrainian government; in turn, they insisted that these shares should in reality be considered as part of Neftegaz shares. In 2010 Ukraine's Naftogaz took control of the largest stake of Ukrtatnafta, and sold part of it to the Ukrainian business Privat Group, whose activities included finance, metallurgy, energy, food and media. The group managed several businesses in Dnepropetrovsk, which were associated with Tymoshenko. In total, 46.9 percent of Kremenchuk refinery shares were held by Privat, 43 percent were held jointly by Ukrtatnafta and Naftogaz, while 10.1 percent belonged to Tatneft[151].

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[149] Oil News, *Акционеры Одесского НПЗ 27 августа сменят состав набсовета* ['Shareholders of Odessa Oil Refinery on the 27th of August will Change Supervisory Board'], 27 July 2010., http://www.oilnews.com.ua/news/article5350.html, 03 11 2011 (in Russian).

[150] Ukraine's Oil and Gas Sector http://www.thedeanegroup.com/Refining.html 3 November 2011.

[151] Lenta.ru, *Украина потеряла контроль над крупнейшим НПЗ страны* [Ukraine has lost control of the country's largest refinery'], 2 March 2010., http://lenta.ru/news/2010/03/02/privat/, 03 11 2011(in Russian).

In 2011, the Kremenchuk oil refinery became the largest purchaser of Azeri crude oil in Ukraine[152]. The Drogobych and Nadvirna oil refineries are also controlled by the Ukrainian Privat Group, the Ukrainian State Property Fund, and smaller shareholders. The imports of Azeri crude oil, through the Odessa terminal, partially offset the deficit of Russian crude oil. In 1999, Kherson oil refinery, the oldest in Ukraine, was privatized by Alliance Group, the Russian company, and in 2007, sold to Kontinum Group for 32 million U.S. dollars, owned by Igor Eremeev, a former member of the Verkhovna Rada of Ukraine. Since 2005 the refinery has been shut down and is now being rebuilt[153]. Oil refineries, which were directly owned by Russian companies, were processing 390 thousand barrels of oil per day. Then, since 2001, Russian companies' share of Ukraine's oil refining sector began declining, while that of the Ukrainian private companies' share began increasing, mainly as a result of the Privat Group's purchases.

The Odessa-Brody oil pipeline, which was dedicated to the transit of Caspian oil to Brody and Plock in Poland, was completed in 2002. However, as of 2003, the pipeline was operating in a reverse mode to deliver Russian oil exports to world markets via the port of Odessa. Then, at the beginning of 2011 the pipeline began operating as it was intended, namely, for importing Venezuelan oil to Belarus[154] and for Azeri oil imports to Ukraine and Belarus. The Druzhba oil pipeline project development cannot be considered an energy resource supply diversification project. The Druzhba oil pipeline expansion increases Ukraine's importance as a transit country for Russia, as well as makes Russia dependent on Ukraine. Russia's growing dependence on the transit states allows a partial balance of the dynamics of energy dependence and increases energy security of the transit states, which, in turn, allows them to use the transit network as a tool of political pressure by suspending the transit of energy resources. Such policy can be used only in extreme cases, as it increases the likelihood of exporters and importers applying political pressure on the transit state.

Corruption has a huge, negative impact on Ukraine's energy security. This is demonstrated by the origins of the energy conflicts of 2006 and 2009, which could be associated with corruption issues. Lukoil had corrupt dealings with Viktor Pinchuk, former Ukrainian President Kuchma's son-in-law, and Yury Boyko, former head of Naftogaz. Former Prime Minister Pavlo Lazarenko was prosecuted in

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[152] Socor V., Odessa-Brody Pipeline Operating On Azerbaijani Oil, *Eurasia Daily Monitor* Volume: 8 Issue: 59, 5 March 2011., http://www.jamestown.org/single/?no_cache=1&tx_ttnews%5Btt_news%5D=37701&tx_ttnews%5BbackPid%5D=512, 03 11 2011.
[153] UBR, *Херсонский НПЗ начнут восстанавливать в октябре?* ['Reconstruction of Kherson Refinery will Start in October?'], 2011 m. saplio 4 d., http://ubr.ua/market/industrial/hersonskii-npz-nachnut-vosstanavlivat-v-oktiabre-106008, 03 11 2011 (in Russian).
[154] Telegraf.by, (note 92).

the U.S. for bribes received for the support of the Itera company on the Ukrainian market. Former Energy Minister Serhiy Yermilov said that state-owned company Ukrtransnafta represented the Transneft stakeholder interests[155]. The established state-owned venture of Naftogaz Ukrainy, for the two years, from 1998 to 2000, failed to provide any financial information to the auditors. The company also managed a private slash fund for Kuchma's political purposes[156]. In 2001, Tymoshenko was accused of illegal financial operations for gas imports and trade in last decade of 20th century. Tymoshenko's government was also accused of improper use of 378 million U.S. dollars generated from the sale of Ukrainian carbon quota to Japan[157]. Privat Group's links with politicians and former politicians as well as its acquisitions energy sector are also likely related to corrupt practices. Greater transparency would help avoid conflicts over energy resources or at least to resolve them quicker. Ukraine's corruption perception index in 2010, according to Transparency International, was only 2.4—Ukraine is seen as a highly corrupt country.

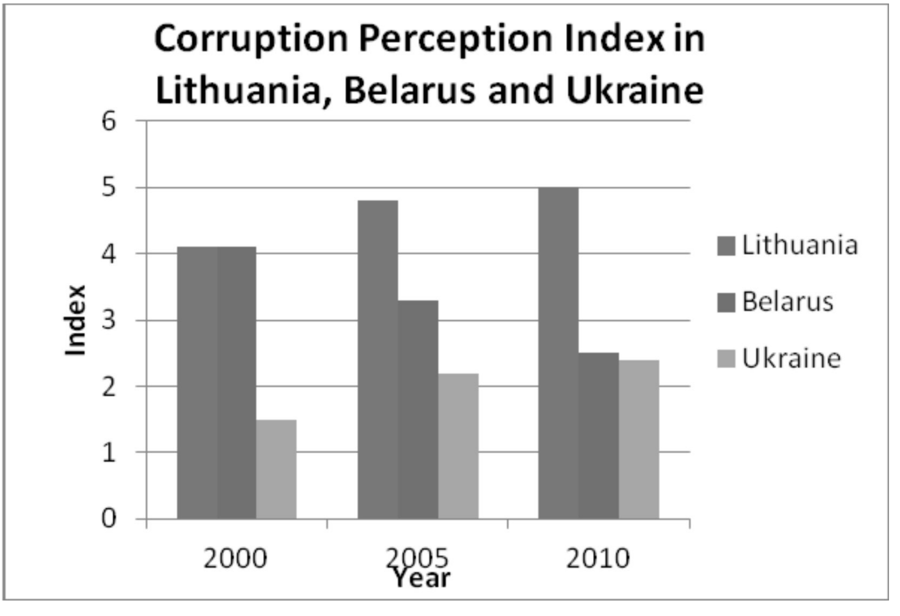

Figure 1. **Corruption Perception Index in Lithuania, Belarus and Ukraine** [158]

[155] Smith, (note 45), p.3.
[156] Pirani, (note 96), p. 23.
[157] Radio Free Europe, *Ukraine Prosecutors Reopen Tymoshenko Criminal Probe*, 12 May 2010., http://www.rferl.org/content/Ukraine_Prosecutors_Reopen_Tymoshenko_Criminal_Probe/2039791.html, 30 06 2011.
[158] According to the data available from Transparenct International.

Corruption in Ukraine does not allow it to reduce its energy dependence on Russia and to diversify its energy supplies. The Transparency International Corruption Perception Index shows that the threat posed to Ukraine's energy security by corruption is twice as high as that in Lithuania, and in Belarus the situation is constantly deteriorating, but due to the specifics of the political regime in Belarus it is difficult to assess the reliability of the data available. During the period of orientation towards the West and when Yushchenko held key government positions, Ukraine was pursuing greater energy independence from the Russian government. However, energy security was being hampered by the political and private business groups and their non-transparent dealings.

Conclusion: External and Internal Sources of Energy Security in the Baltic-Black Sea Region

In general, the origins of energy insecurity in Lithuania, Belarus and Ukraine can be divided into two groups. The first group consists of the external factors causing energy insecurity stemming from the main energy supplier's, more precisely Russia's energy and foreign policy. The second group are the internal energy importing agents which cause insecurity and are far less emphasised than the external factors in analytical and political debate. Respective individual analyses of these two factors are not possible, since the two spheres are interconnected. Thus, energy security and vulnerabilities are the result of the interaction between the internal and the external factors.

The energy insecurity environments of Lithuania, Belarus and Ukraine were developed by Russian manipulation of energy resource prices and supply. Russian energy resources are sold at different prices to different individual states. These prices are determined by the state's predisposition towards Russia. Igor Torbakov, a Kremlin strategist, assess there to be two types of the former Soviet Union republics: pro-Western and pro-Russian. The author argues that the West will seek maintain the policy of "spreading democracy", which would inevitably lead to the fact that more and more countries will be "torn out of Russia's ambit". In order to avoid erosion of Moscow's influence, the Kremlin has to transform Russia's economic influence in the ex-Soviet bloc into its political influence[159]. Russia's energy diplomacy allowed it to extend its political influence using energy

[159] Torbakov I., *Kremlin Energy Policy in Ukraine: Unwieldy Combination of Strategic Objectives and Private Interests*, 6 January 2006., http://www.jamestown.org/single/?no_cache=1&tx_ttnews%5Btt_news%5D=31250, 30 06 2011.

resources as leverage. Energy prices for Belarus were lower while it participated in the creation of the alliance under the conditions laid down by the Russia. Russia supplied Ukraine with natural gas at a lower price, while Ukraine maintained multivectoral foreign policy and its government was pro-Russian. Natural gas prices were higher for Lithuanian than for other European countries because of its Western-oriented foreign policy.

Russia does not apply market principles to the energy resource trade in order to maintain flexibility and to create opportunities for political manipulation. Long-term natural gas supply contracts with Russia provide it with opportunities to manipulate natural gas prices and affect the buyer's domestic and foreign policy, expanding its influence. In an effort to negotiate the lowest price possible for natural gas, state, when compared to their neighbours, create a favourable environment that allows for the manipulation of the inter-state relationships to achieve economic and political goals. Application of the market principles to energy resource trade, such as the SPOT price[160] that is applied in trade of oil and liquefied natural gas, would allow more transparent energy resource trade and increase the consumer's energy security. The market principles would eliminate the Russian policy that, in 2005, was summarised by its State Duma Foreign Affairs Committee Chairman Konstantin Kosachyov whereby "Moscow will continue to subsidize energy supplies to its 'allies'. At the same time, it will promote 'purely market mechanisms' in bilateral relations with those neighbours that are not sufficiently loyal and that display a 'suspicious' geopolitical orientation"[161]. Market mechanisms are not beneficial to Russia's interests, as well as to the interests of today's Belarus and Ukraine, as this would violate the interests of governmental groups' that greatly benefit from opaque resource trade. Wider cooperation between the consumer countries in the region, in order to expand market principle application to energy resource trade, is not possible due to the competition among them for lower energy prices and favourable supply conditions. Belarus is an example of this as it allowed increasing gas transits through its territory from Russia, during the Russia-Ukraine energy crisis of 2009, to generate more revenue.

Gazprom's requirements to take over the Belarusian and Ukraine gas transit pipelines are in conflict with market principles. Abandoning barter exchange for energy resource and the transition to currency only settlements would increase energy availability and national security. Currency settlements in a transparent

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[160] The market price for a currency or commodity that is quoted for immediate settlement (payment and delivery) (i.e. immediate transaction).

[161] Torbakov I., *Kremlin Uses Energy to Teach Ex-Soviet Neighbors a Lesson in Geopolitical Loyality*, 2 December 2005., http://www.jamestown.org/single/?no_cache=1&tx_ttnews%5Btt_news%5D=31169, 30 06 2011.

environment would limit Russia's state influence in takeovers of strategically important energy infrastructure. However, Belarus and Ukraine are not likely to refuse to barter. Currency settlements would allow Russia to accumulate only the financial capabilities, but would restrict the development of its political influence.

Reductions and seizures of energy resource supplies were last resort measures to pressure Lithuania, Belarus and Ukraine to adopt domestic and foreign policy that would be favourable for Russia. Most of these cases occurred when Russian energy companies sought to expand their influence and as a result that would lead to Russian state influence expansion through the companies. Furthermore, Russia used energy supply interruptions as a way to punish the states for overzealous pro-Western orientation, or create a favourable environment for pro-Russian political groups. This Russian policy has been used in Lithuania in 1992 to 1993 and Ukraine in 2005 to 2010.

Russian gas pipelines, through the Baltic and the Black Seas, Nord Stream and South Stream, allow Russia to supply 118 billion. m^3 of gas annually, which will be almost identical to the Russian capabilities of natural gas supply to Europe of 2007[162 163164]. The pipelines, by the Baltic States, Belarus and Ukraine, are perceived as Russia's bid to isolate the area by maintaining energy resource supply monopoly and increase the vulnerabilities for natural gas supply manipulation, because the gas pipeline will supply natural gas to European countries, while at the same time it will enable Russia to seize the natural gas supply to the Baltic States, Belarus and Ukraine[165]. In terms of energy dependence issues, Russia is seeking to increase the asymmetric dependence of the consumers.

Nord Stream and South Stream gas pipelines are useful to Russia not only geopolitically. Russia is dependent on the transit countries, politically and financially, hence, the new pipelines will reduce its dependence on Belarus and Ukraine, which in 2004 and in 2009 tried to manipulate the supply of gas to Europe. The pipelines are also important to Gazprom financially as the company has to pay transit fees. Calculations show that the Nord Stream gas pipeline construction will pay off in 7.25 years, just as a result of it being tariff-free, as Gazprom currently pays for transit to Poland and Belarus.[166] The decreasing dependence on transit countries allows Russia to expand its' relative power in the Intermarum region.

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[162] South Stream, *Facts and Figures*, http://south-stream.info/index.php?id=14&L=1, 30 06 2011.
[163] Nord Stream, *The Pipeline*, http://www.nord-stream.com/en/the-pipeline.html, 30 06 2011.
[164] Noėl P., *Beyond Dependence How to Deal With Russian Gas*, European Council on Foreign Relations, 2008, p.5., http://ecfr.eu/content/entry/commentary_the_eu_and_russias_gas/, 30 06 2011.
[165] Spiegel.de, *Denmark Approves Russian Baltic Pipeline*, 20 October 2009 d., http://www.spiegel.de/international/europe/0,1518,656229,00.html, 30 06 2011.
[166] "Gazprom" pays the fee of US$1.88 for 100 kilometers transit of 1000 m^3 natural gas to Belarus and to Poland it pays the fee of US$2.1 for 100 kilometers transit of 1000 m^3 natural gas.

Opposition to the Nord Stream project was expressed only after the decision for the project to start had been taken[167]. The Nord Stream gas pipeline's leg to Kaliningrad oblast will reduce the importance of Lithuania and Belarus in conveying gas to the Kaliningrad oblast of Russia and expand its capacity to act in these countries through manipulation of natural gas supply.[168] If Russia were to extend the Nord Stream to the United Kingdom, the Netherlands and France, then Russia would be able to cooperate with these countries in economic and political spheres more actively. This is not in the interest of Intermarum region, as the strengthening of the Western European and Russian co-operation would mean that the Western powers would be unlikely to prioritize cooperation with the Intermarum region rather than Russia. Most EU Member States support the Nord Stream and South Stream pipelines, because the majority of EU countries do not care what state dominates Eastern European geopolitical space, so long as the majority of EU energy and economic needs are secure. This was demonstrated by the 2009 Russian-Ukrainian energy conflict.

The analysis shows that Lithuanian, Belarusian and Ukrainian domestic political factors did not significantly increase energy security, but the differences between these three countries is evident. Belarus and Ukraine can be considered short-term interest maximizers, since while they were aiming to secure cheaper energy resources, they chose the pro-Russian policies, and relinquished their sovereignty to Russia. Russia can be seen as a long-term interest maximizer, since it chose to subsidize energy while losing part of its potential income in exchange for political influence expansion. Belarus and Ukraine, being short-term interest maximizers, through their actions created a favourable environment for Russia to expand its influence there. According to Larsson, economic and political dimensions are important for Russia and they cannot function in isolation from Russian goals[169]. Lithuania should be seen as a long-term interest maximizer. Lithuania sought to preserve its sovereignty from Russia and integrate itself into the West, and because of that it was seen by Russia as having an anti-Russian orientation. For these reasons, Russian energy resources to Lithuania were more expensive than to other European countries. Lithuania chose financial loss in order to maintain their freedom in terms of foreign policy choice. Events between 1990 and 1993 caused

[167] Nord Stream gas pipeline infrastructure project was initiated in 1997 and afterwards Poland's Minister for Defence Radislav Sikorski eqqauted it to the Molotov–Ribbentrop Pact of 1939. in 2006 Voanews, *Polish Defense Minister's Pipeline Remark Angers Germany*, 2006 gegužės 3 d., http://www.voanews.com/english/news/a-13-Polish-Defense-Minister-Pipeline-Remark-Angers-Germany.html, 30 06 2011.
[168] hydrocarbons-technology.com, *Nord Stream Gas Pipeline (NSGP), Russia-Germany*, http://www.hydrocarbons-technology.com/projects/negp/, 30 06 2011.
[169] Larsson, (note 9), p. 218.

an increase in energy prices in Lithuania which forced it to reform and increase energy efficiency of its economy. The Belarusian economy marginally increased the energy efficiency of its economy, but it was still less efficient than Lithuania. Ukraine's economy remains energy inefficient. Because Lithuania can import oil from the world market through the Baltic Sea oil terminals, it applies market principles to the oil trade, but continues to import oil from Russia. Lithuania is also planning to apply market principles to the natural gas trade by implementing the EU 3rd Energy Package principles. The application of market principles will be effective only when Lithuania will have natural gas supply options. Belarus seeks to diversify oil supplies, while Ukraine was not observed as taking any steps towards diversification.

Over the twenty-year period Lithuania only partly succeeded in diversifying its energy supplies, while Belarus and Ukraine had even less success. In 2009, the closure of the Ignalina NPP reduced Lithuania's energy security and increased its dependence on Russia. After it joined the EU, it now can hope to more easily develop alternative energy supply projects due to the financial and political support from the EU. However, implementation of projects in cooperation with the Baltic and Scandinavian countries and Poland, that had been previously initiated, intensified only recently. Belarus and Ukraine have fewer opportunities to develop energy security projects which would encourage the development of closer cooperation with the EU.

Countries in the region failed to find constructive alternatives in response to the energy and national security-damaging actions, such as Nord and South Stream gas pipeline infrastructure. The states failed to convince the EU and Russia to extend Gintarinis pipeline (*Eng. Amber Pipeline*) in the Baltic States and to build the second Yamal - Europe gas pipeline. The intensity of regional cooperation on planning and development for the alternative energy projects fluctuates. The most prominent result of cooperation was the Odessa-Brody-Plock oil pipeline project, but the project was implemented only partially, because the Brody-Plock section was not built and the Odessa-Brody pipeline only became operational in its projected direction in 2011, rather than exporting Russian oil.

External factors, lack of transparency in energy relations between suppliers and consumers, and corruption were the main causes of energy insecurity in the region among others. Russian energy companies established themselves in Lithuanian natural gas and electricity sectors, allowing them to influence Lithuanian political processes. Through means of corruption, Russia's energy companies were increasing their influence in Ukraine. Due to the specifics of the Belarusian political system, it is difficult to assess the impact of corruption on the energy security of Belarus. Lack of transparency in pricing of natural gas and oil exports and constantly changing export duty fees create greater energy insecurity and affect the economic development of Belarus.

Kaunas, August 2011