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OIL AND GAS IN THE HIGH NORTH - A PERSPECTIVE FROM NORWAY

by Ole Gunnar Austvik

RUSSIAN ENERGY POLICY AND ITS CHALLENGE TO WESTERN POLICY MAKERS

by Keith Smith

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Oil and gas in the High North – a perspective from Norway[1]

The land and sea areas of the European High North are dominated by Norway and Russia (Figure 1). The first licenses for oil and gas exploration in the Norwegian Barents Sea were awarded in 1980, leading to the discovery of Snøhvit in 1984. On the Russian side, seismic surveying started in the 1970s, leading to the discovery of giant fields like Shtokmanovskoye, Ledovoye and Ludovskoye. Further south in the Pechora Sea many smaller fields were identified. More than 100 wells have been drilled in total, and the assessment is at present that there is some 5-6000 mtoe (million tons of oil equivalents) in the Barents Sea, some 80 % of this on the Russian side. In the Kara Sea, to the east of Novaya Zemlya, Russians have discovered two other giant gas fields (Leningradskoye and Rusanovskye). In addition there is also potential for oil and gas deposits in the disputed area between Norway and Russia, where no drilling has as of yet taken place. The seismic surveying conducted in the area by the Soviet Union prior to 1982 provided cause for optimism (Moe 2004).

So far only one field (Snøhvit) has been considered commercially viable (and is under development). But exploration activities have not been very intensive on either the Norwegian or the Russian side. The assessment of the reserves is accordingly somewhat vague. The assertion that 25 % of world reserves are to be found in the Arctic (US Geological Service) remains unfounded. But there is no doubt that reserves are substantial in a global context. Some ¾ of these are expected to be natural gas. The exploitation of most of these resources depends, inter alia, on the availability of new subsea technologies and concepts, substantial amounts of capital, political will and, on the Russian side, a predictable legal and political framework.

Figure 1: Petroleum Reserves and Borders in the Barents Sea

The reason for energy consuming countries' interest in Barents Sea oil and gas is heavily linked to current high international oil (and other energy) prices. The high energy prices are predominantly driven by high economic growth in Asia, coupled with concentration of resources and a lack of sufficient production increases in the Persian Gulf, or elsewhere. Demand is growing faster than supply and has given us a 4th oil shock. Political unrest and war in the Middle East creates an additional pressure on prices. Consequently, there is a desire from consuming countries to increase and diversify the supply of fossil fuels.

High prices create the prospect of expensive field developments that in a low price scenario would not be profitable. Development of Barents Sea oil and gas depends on higher prices than for example North Sea oil and gas. High prices, and company interests in attaining profit, are together with energy consuming countries' push for more energy, heavily influencing domestic petroleum policies and contributing to a speeding up of field developments in both Norway and Russia.

This article provides an overview of challenges for Norwegian petro-

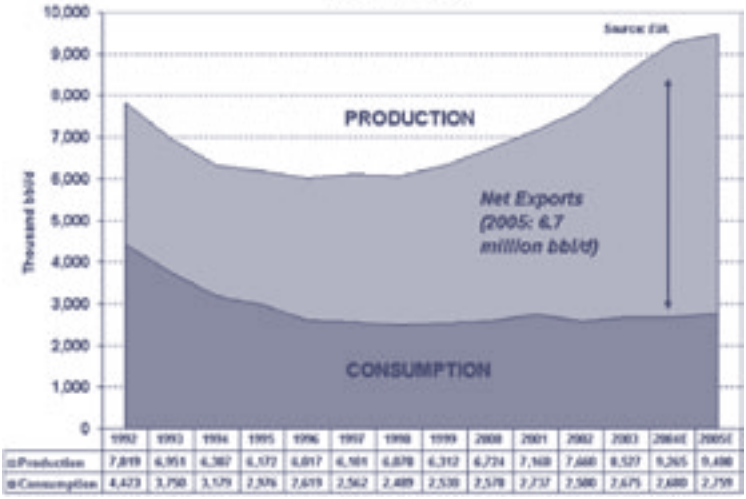
leum policy during expansion into the Norwegian and Russian Barents Sea. The main focus is natural gas. The first section of the paper focuses on positions of major powers Russia, US and the EU. The second section focuses on challenges for Norway. Norwegian areas of interest discussed are related to the petroleum industry, rent & control, the environment, regional matters, fishery, jurisdictional problems, security-of-energy-supply, foreign relations and military security. The closing comments draw together aspects of present challenges.

Interests of major powers

Russia

After years of production decline during the transition period following the Soviet break-up, a significant recovery in Russian oil production has taken place (Figure 2). In 2005, it reached some 9.5 mbd (million barrels per day), of which almost 7 mbd were exported. It is believed that Russia will be able to expand its oil production still further. Oil reserve figures indicate that Russia can be one of the world's key oil producers for at least the next 40 years.

Figure 2: Russian Total Liquids Production and Consumption (1992-2005E)



Reserves of Russian natural gas are even more abundant than oil and estimated to be available for the next 100 years at current production levels. With almost no decline after the break-up, Russia produced 600 BCM (billion cubic meters) natural gas in 2005 (7.5 times more than Norway). Production is projected to increase in the coming years and reach some 900 BCM by 2020 (EIA 2006).[2] Russia is now the world's largest producer and exporter of natural gas, and the second largest of oil, making it the major single energy producing country in the world.

The Ukrainian gas dispute[3], that reached a preliminary climax in January 2006, added to the Russian's feeling that they were politically and economically locked in. Russia needs foreseeable terms of trade and transit with CIS (Commonwealth of Independent States) countries. Russia also needs more alternative transportation routes. The dependency on petroleum exports for foreign currency earnings make these issues a top Russian political priority.

Norway and Russia have competed in energy markets since the 1970s, but their adherence to opposite economic and political poles oriented exports to a large extent to different markets. Norwegian oil and gas was almost entirely directed to Western European countries (and some oil to the U.S.), while more than half of Soviet exports were devoted to Eastern Europe and the Soviet Republics. After the break-up, Russia has notably increased its exports to Western Europe. The political awareness of joint interests in market developments, prices and contractual terms between Norway and Russia became stronger in the 1990s.

As Russia moves (slowly) towards a market economy and integration into the EU and world economy, she is converging with Norwegian petroleum policies in some areas (Austvik & Tsygankova 2004). Even though Russia has no EEA agreement with the EU, she is integrated into EU energy markets (although not in such a one-sided manner as Norway), and been influenced in similar ways as Norway by downstream market changes and policy measures, such as market regulation and taxation. While Russian gas policies are not "domestified" within the EU, she has been able to arrange her petroleum industry in a rather independent manner. As a result Gazprom has not been forced to unbundle its activities, and instead strengthened its position over the past years as a producer and transporter of gas within Russia. The government has made efforts to

strengthen the direct control of the company.[4]

The fact that Russia is not fully integrated in the international economy, as for example in terms of membership in the World Trade Organization (WTO), has had some negative impacts on Russia. Relatively low competitiveness of Russian products and a number of out-dated production technologies developed during the Soviet era are still in operation, giving her a technological disadvantage.[5] On the other hand, free trade allows for the import of competitive technology to Norway as a full member of the international trade system, and has contributed to the development of the high-tech Norwegian petroleum industry.

The restructuring of the Russian petroleum industry has not reached completion. There are however significant differences between the oil and gas sectors. There is a struggle over competence between the government and the oil companies, while there may be less political interest in changing the non-competitive structure of the natural gas industry. Any heavy involvement of international oil companies will take time, although the need for it is increasingly apparent. So far foreign companies' participation in Russian oil and gas sector has been very limited. The new German-Russian consortium to build the Baltic gas pipeline may be a signal from the Russians that from a capital and technological perspective they may involve themselves more directly with foreign companies in the future.

The crucial differences in size of the two countries and geographical positions, and not least, in cultural and historical features, create some rather different perspectives. Norway, as a small country, has a relatively insignificant influence on the world community. Russia with its vast territory located in the "middle of the world" and with its enormous natural resource reserves, will inevitably profit from combining economic as well as geo-political goals (as in the Soviet era). The Russians may, hence, from a power perspective more easily than Norway play evenly with the EU, EU countries and the US.

With the development of offshore fields in the Barents Sea, Norway and Russia share interests in the development of infrastructure and industrial technology. Being a small neighbouring country, this may lead the Russians to invite Norwegian companies to participate in the development of high-tech fields in the area, such as the Shtokman field. Given cooperation, Norway will need alliances and partnerships with non-Rus-

sian parties in dealing with her greater neighbour, as when a "mouse goes to bed with a bear". Such cooperation will be especially challenging if cooperation taking place within the disputed area if it remains unsettled (cf. Figure 1 and later comments).

It is however important to notice that the Barents Sea poses only one of several options for the Russians in their desire to increase (oil and) gas production. Even more abundant resources are located in Western Siberia, mostly onshore, cf. Figure 3. Many fields are also located in Eastern Siberia and can serve Chinese and other Asian markets in quite near future. Because of the anticipated lower costs of these fields, their relative proximity to fast growing energy-needing Eastern markets, as well as the Russians' long expertise in mastering land based gas projects without the help of foreign companies (although often inefficient), it is not certain that they will choose to develop Barents Sea gas first. Although Gazprom expresses a desire to expand in several markets simultaneously, and is planning for extensive field and infrastructural developments, the Russian may run the risk of an "imperial overstretch" as the world energy superpower. This may be part of the reason for the continuous postponement of announcing partners in the Shtokman field development.[6]

Figure 3: Oil and Gas Development in Northern Russia

The United States

In the 1980s the U.S. interest in Norwegian petroleum policy was predominantly founded on super-power rivalry with the Soviet Union. The break-up of the Soviet Union and the evolving global economy in the 1990s changed U.S. interest in Norwegian petroleum. With the end of the Cold War and the internationalization of the economy and globalization of markets, U.S. energy policy has become more global and comprehensive. The geopolitics of energy has become more important for international affairs and U.S. foreign policy. Norwegian oil and gas is now of prime importance for the overall global energy balance, as part of U.S. interests and worldwide foreign policy.

Planned supplies from the Barents Sea directly to the U.S. create however a bilateral interest in the development of the Norwegian (and Russian) natural gas sector. The US Ambassador to Norway expressed in a speech in Stavanger on January 26 2005 a desire to speed up Barents Sea gas developments on both the Norwegian and Russian sides (Lie 2005).

In a situation with high energy prices and no specific restrictions on Norwegian production, as opposed to in the 1970s and 1980s when the US pressured for higher Norwegian gas production (Austvik 2003:174-193), the energy-relations between U.S. and Norway is at present not controversial. Rather the two countries may work together to realize projects. If, however, Norway should choose to delay decisions and exploration activities where field developments are commercially possible, one might expect American pressure to change Norwegian policy.

The European Union

Until Snøhvit gas is produced and gas is used for power production in Norway, all Norwegian gas will continue to be sold to EU countries. Germany is the most important country in terms of economic and political size, energy consumption and geographical location in the market as a transit country for both Norwegian and Russian gas. EU countries have an interest in Barents Sea developments both from a security-of-supply and industrial perspective. From both perspectives they will have an interest in participating in projects, including industrial cooperation and partnership.

Norwegian – EU processes from the 1970s and 1980s were in many

respects replaced by a "domestification" of Norwegian policies by EU policies from the mid-1990s. The relationship between Norway and the EU has changed and political arrangements are not only negotiated at the international EU-Norway table anymore. The EEA agreement from 1994 made laws and regulations in the EU more or less automatically Norwegian law. The influence of EU policies is however not limited to the EEA agreement. The market integration of Norwegian gas into EU single energy markets is also important. As economic integration leads to political integration, Norway is affected by EU policies, irrespective of the EEA agreement. This is however to some extent true also for Russia.

The initial rather orthodox form of gas market liberalization that took place within the EU was possible because processes for the most part took place when energy prices were modest and international affairs calm. The power that Norway and other resource-rich states were assumed to have in the 1970s and 1980s were in Europe to a large degree replaced by EU power to regulate markets and pass taxes in the 1990s and beyond. The jura and norms for regulating the market(s) were however not directed towards the particularities of (oil and) gas as a non-renewable resource. On the contrary, general competition principles were laid down to guide the regulation of the natural gas market.

The reciprocal dependence between Norway and the EU and EU countries is not symmetrical, and seems to change in favour of Norway when markets are tight and in favour of the EU when markets are weak. In tight markets, resource ownership gives Norway (and Russia) high profits and a leverage to influence the terms of exchange, while in weak markets the EU is stronger in formulating market regulations and taxation on general competition principles.

When oil prices started to increase from 2000 and world politics became tense after 11th September 2001, the issue of security-of-supply returned to the top of the political agenda, as it was in the 1970s and 1980s. This started to modify EU energy policies, and it shifted the balance of dependence somewhat back to (oil and) gas producers. The EU-Russian and German-Russian energy dialogues are examples of policy change; speeding up as supply and transit problems through Ukraine and other countries have come increasingly into focus.

The EU will need much more natural gas over the next decades and

most of it must come from "new" production areas. In this context, the EU and EU countries are those with the most direct interest in speeding up the development of Barents Sea gas. As with the Americans, Norway may find useful partners in these activities with European companies, EU countries and the EU. If however activities are slowed down or delayed, one would expect a pressure on Norwegian policy in the direction of speeding up developments from the EU as well as from the Americans.

Challenges for Norway

Already, Norway and Russia share the dominant positions in the European gas market, with Russia as the leader. Norwegian gas production reached 85 BCM in 2005. While Norwegian oil production is expected to have peaked at 3.3 mbd in 2004, its potential for natural gas production is higher than 100 BCM per year in a few years time. Market shares are expected to grow to between 30 and 40 percent in important countries like Germany, France and Belgium. Together with high oil production and high oil prices, the growth in natural gas exports will give the petroleum sector an even more important role in the Norwegian economy. Figure 4 shows the historical development of Norwegian oil and gas production since the beginning in 1971 and expectations towards 2030.

There is now less conflict between the international interest in increasing natural gas production and domestic interests as previously expressed in politics. In the 1970s and 1980s, a specific Norwegian production ceiling was set; 50-90 mtoe combined oil and gas production as opposed to an actual production of 223 mtoe in 2005. As first of all the Ministry of Finance earlier put restrictions on production levels in order to avoid "Dutch disease" problems in the Norwegian economy, the creating of the Petroleum Fund in the 1990s removed much of their cautiousness against too high production levels.

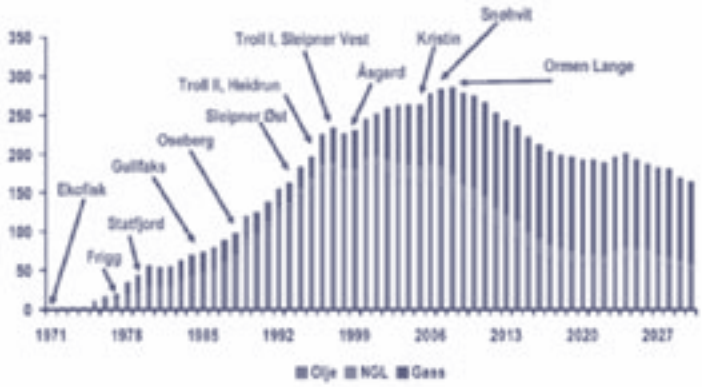
Norway has developed and maintained a highly professional petroleum administration led by the Ministry of Petroleum and Energy. The ministry and the bodies under it, together with the Ministry of Finance, have been rather successful in making industrial arrangements efficient and to the interests of the Norwegian government and companies. Industrial interests seem however to have become more important in the definition of a relevant Norwegian production level. Furthermore, other governments

express a desire to speed up developments from a security-of-supply perspective, making an influence on the Ministry of Foreign Affairs and it to be an explicit part of Norwegian foreign policy.

The definition of what is a "national interest" is ambiguous and changes with the constellation of domestic actors (Putnam 1988). As Norwegian national interests (implicitly) are defined today, there seem at present not to be any strong political domestic "macro" - force against a further increase in production levels and the development of the Barents Sea, except for environmentalist group.

The situation however poses huge challenges domestically, with respect to creating macroeconomic, social and alternative industrial policies. Apart from the petroleum industry and some regional interests, Norwegian domestic economic interests may not necessarily share the logic and emphasize on expanding the petroleum sector still further. Instead, they desire the creation of a more competitive industry in other sectors and the development of society at large. Some of this is shown in a gradually more intense debate about how to use the Petroleum Fund domestically, i.e. for infrastructural purposes. One should expect rivalries between such interests in the future, if political actors do not balance them well.

Figure 4: Total Norwegian Petroleum Production and Start-Up of Important Fields 1971-2030



Kjelde: OED/OD

Industrial interests

Both the maturing of the Norwegian petroleum industry and international economic and political integration processes led to its internationalization. The industry became competitive at home, and a strong interest in competing abroad emerged. With the privatization of Statoil in 2001 the profit horizon became shorter, with the consequence that the company is interested in higher production and new licenses faster than before.

The highly competent and specialized Norwegian petroleum "cluster" is well positioned to the development of fields on both Russian and Norwegian sides (Hydro, Statoil, Aker Kværner and others). The sub-sea technologies developed at Ormen Lange and Snøhvit, horizontal drilling expertise, laying of long-distance sub-sea pipelines, LNG-technology and other innovations are important elements with respect to "know-how". Parts of this Norwegian technological leadership are shared by sub-contractors in a European and international network. Capital needs are another element where other international companies and financial institutions may contribute, including holdings in the fields, as in other parts of the NCS (Norwegian Continental Shelf).

If engaged on the Russian side, however, the Norwegian industry needs to be supported politically in order to achieve stable and predictable law making, taxation policies, political good will, and infrastructural development, secure sub-deliveries etc. Norwegian authorities must provide this support, but the industry could also need the support of EU countries and the US. EU and American companies may become partners with Norwegian companies and / or suppliers to projects on both Norwegian and Russian sides.

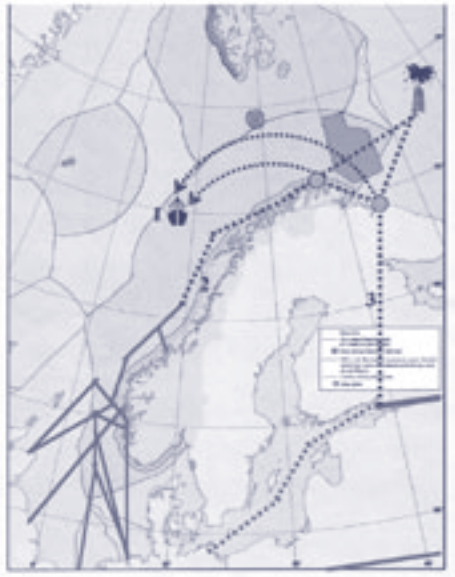
Although Russians primarily seem to wish to develop oil and gas fields by their own efforts, political objections may be outweighed by technological advantages in the West. For Norway, if Norwegian companies were engaged on the Russian side, it would improve the chances of efficient regulation and protect the environment and sustainable resource extraction.

The question of knowledge, good relations and confidence building becomes important for how Norway and Russia can cooperate in the Barents region (in line with the ideas of the established Barents Cooperation since 1993). To further such a demanding integration between the two

in the field of petroleum, there could be reasons to invite the Russians to participate on the Norwegian sector (such as on Snøhvit and Ormen Lange). It would improve communications on a practical level, enhance the competence of the Norwegian petroleum system and possibly help exporting it to (parts of) the Russian system. Likewise, the Russians could invite a Norwegian company to play the role as operator of a field (such as Shtokman) in order to introduce not only technological, but also managerial and organisational, competence to its development and operation.[7]

Another aspect of industrial cooperation could be the transportation of natural gas from the Barents area. Apart from LNG projects, gas must be transmitted in pipelines. With the Russian-German Baltic line now planned, one additional route for Siberian gas to Germany will be established (Figure 5). This line could also supply gas from the Barents area if a link between Kola and St. Petersburg is build. One alternative is however to link Barents Sea gas to an extended Norwegian pipeline system which at present reaches Mid-Norway. Besides the industrial interest of serving as a transmitting country for Russian gas, Norway would gain a more important political position in Europe's most important energy market, and the Russians would further diversify her export routes.

Figure 5: Possible Transportation Routes for Natural Gas from the Barents Sea



Rent distribution

Most countries share Norwegian interests in price and market stability and predictability, but in terms of rent distribution, producing and consuming countries are on opposite sides of the table. Rent can end up with producing companies, the treasuries of producing countries, downstream companies or consuming countries' treasuries. It may also end up as consumer surplus. Rent may be redistributed when prices change, industries are re-organized, ownership changes, market power change, taxation either in producing, transit or consuming countries, law-making, regulation etc.

In this respect Norway should embark upon a dialogue with the Russians – but also with receiving countries like Germany and other EU countries - to create mutual understanding of common interests, so that Norway can attain the maximum sustainable price over time. Norway has an interest in price stability and price levels in order to invest in huge, remote and expensive fields and infrastructure ("security of demand"). As most gas will be delivered to EU countries, Norway has an interest that downstream companies and governments also work for a stable market development, providing a basis for a stable investment climate.

Environment

The Barents area with its cold climate and waters represents a rather vulnerable environment, concerning wildlife, bio-diversity, fisheries and nature. In 2003, the Norwegian government decided to continue oil and gas exploration in the southern parts of the Barents Sea minus some areas defined as especially vulnerable. Environmental regulations are stricter than further south on the NCS. A more integrated plan for the entire Barents Sea concerning resource management, the environment and economic and political interests was presented in spring 2006 (Ministry of Environment 2006). There are no plans so far for the opening of northern parts of the Norwegian Barents Sea.

The biggest environmental threats at present are considered to come from the Russian side. There is already a risk of oil spills from the increased traffic of Russian oil tankers off the Norwegian coast. There are also threats from nuclear accidents and handling waste in the area. The additional concerns raised by an increased petroleum activity, lead to

calls for greater cooperation with the Russians. The industry has argued that the best way of influencing Russian environmental standards and practices is by showing practically how it can be done on the Norwegian side, and by offering partnerships based upon environmentally sound practices on the Russian side. This would reduce environmental risks for the Norwegian coastline and waters as well. However, the situation also demonstrates a need to create a broader European and international understanding about these challenges.

Within Norway, environmental issues have been a cause of controversy between political parties, as shown in the September 2005 election. If the "green side" of the present Government eventually gains a stronger controlling hand on activities in the area, developments on the Norwegian side may be regulated by stricter environmental standards.

Fisheries

In 1977 the Russian-Norwegian management system for fisheries in the entire Barents Sea was established. It entailed the introduction of a 200-mile exclusive economic zone (EEZ), according to United Nations Convention on Law of the Sea (UNCLOS). As fishes do not know the borderlines of international waters, the two countries, and states that have received a Barents quota from one of them, may take part of this quota in the EEZ of the other. The proportion of catch between Norway and Russia is fixed (mostly 50/50) but the total catch is negotiated yearly. There have been disagreements over what is a sustainable catch in the area, where the Russians has argued for higher catches than Norway.

Fisheries and oil activities were in the 1970s heavily debated politically in Norway. The evidence seems however that such conflict is first of all related to problems if an accident occurs and seawaters are heavily polluted. Obviously, in this area with its cold water, oil spills may have greater impact on the environment than in warmer waters.

Regional issues

Development of oil and gas activities in the Barents Area in Northern Norway mostly seen as highly beneficial by politicians (although environmental concerns have been emphasized by some). They look forward to increased activity in the construction periods, benefits of terminals and

supply centres where these are established, and moving the development of the Northern areas higher up the political agenda in Oslo and elsewhere. The Barents Euro-Arctic Region (BEAR) has become a framework for many co-operative projects on the regional level across Norway, Sweden, Finland and Russia.

Security-of-energy-supply

Easier access to pipelines, new pipelines and LNG facilities built, along with expanded storage facilities should all improve security-of-supply for purchasing EU countries. North Sea transportation infrastructure is continuously expanding and is now developed from mid-Norway to England, Germany, Belgium and France (these countries represent almost half of total EU energy consumption). Simultaneously, the first LNG plant connected to the Snøhvit field in the Barents area will soon begin operating. With expanded LNG processing plants the Barents area becomes increasingly more important for the U.S. interest in diversifying their expected increased natural gas import need.

On the other hand, more volatile, uncertain and periodically lower producer prices could lead to a drop in large investment projects and weaken supply security in the long run. Consequently, in terms of economic security-of-supply, it is difficult to see how the EU (countries) can simultaneously offer lower gas prices to consumers, achieve high tax revenues from gas usage, and meet growth in both expected demand and supplies. It will be important for Norway (and Russia) that EU policies are based on the particularities of non-renewable resources, not least with their enormous investment costs in the High North.

The interest in avoiding over-supply of the EU gas market and maintaining a reasonable price are now shared by Norway and Russia. Due to EU interests in ensuring that the European gas market is sustainable over time, and the renewed focus on security-of-supply issues, there could now be room for negotiations between suppliers and the EU on how the market should be organized. EU requirements to increase competition on the supply side have already affected the structure of Norwegian gas industry and changed government control. With only one Russian seller, Russia maintains a stronger bargaining power towards the market and the EU than Norway, leaving Gazprom as the single most important player

on the supply side of the European gas market, with Norwegian gas as a competitive fringe player.

Security-of-Supply is in economic terms often a question of understanding the dynamics of the political economy of oil and gas. Norwegian policies are challenged domestically in establishing this understanding, and together with the Russians, the EU and EU countries and the US, to develop this understanding in a way that is beneficial to security-of-supply for consuming nations, and at the same time also to Norwegian interests.

Jurisdictional issues

The disagreement over the marine delimitation of the economic zone and the continental shelf between Norway and Russia has not been settled. Norway maintains that it should follow the median line principle, while Russia argues that it should follow the sector line principle. The difference represents some 175.000 square kilometres, an area larger than the Norwegian North Sea south of the 62nd parallel (Figure 1 & 6). Negotiations have been going on for 30 years.

Russia has argued that some sort of condominium could be established in the area without settled borders. Norway have maintained that cooperation in the area can only be established when a delimitation line is drawn. For fisheries however, an interim arrangement was made in 1978 in the so-called "Grey Zone", regulating the parties' right to inspect vessels in the area. As shown in Figure 6, this zone covers some, but not all, of the disputed area within 200 miles, but also some undisputed Norwegian and Russian waters

There is no international disagreement about Norwegian sovereignty over the Spitsbergen Archipelago (Svalbard). Through the Spitsbergen Treaty of 1920, Norway was granted "full and absolute sovereignty" over the islands, defined by coordinates and shown in Figure 6 as the Svalbard zone (often called the "Svalbard box"). However, according to the Treaty, Norway cannot discriminate subjects of other signatories and cannot impose higher taxes than needed for the administration of the islands.

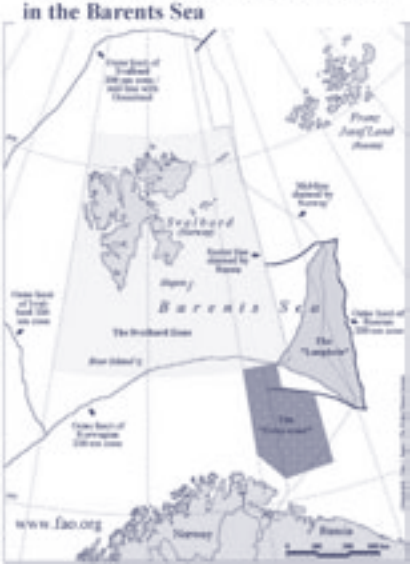
There is some controversy pertaining to the provisions of the Spitsbergen Treaty; especially when it comes to the sea areas beyond territorial waters and the ocean floor. It is not known whether or not there are promising

areas for petroleum activities here. Norway maintains however that the provisions of the Treaty do not apply to the economic zone around the islands, and instead provide unrestricted Norwegian jurisdiction. The continental shelf around Svalbard is a continuation of the continental shelf of mainland Norway (except for the 12 mile territorial waters around the coastline of Svalbard). Some signatories have, contrary to this, argued that Svalbard is entitled to its own economic zone, governed in the same way as the islands.

Norway established a 'Fisheries protection zone' of 200 miles around Svalbard with non-discriminatory regulations in 1977 (same principle as the economic zone but so far only valid for fishery).[8] Those with a Barents Sea quota should accept Norwegian inspections (catch, size etc) in the Protection zone. Several countries deny the Norwegian interpretation of her rights in the area.

The "Loophole" is an area between Norwegian and Russian EEZs and the fishery protection zone around Svalbard, and is judicially international water. The Norwegian-Russian management system for fisheries has sought to include control of vessels also in this area. It a however a lack of clarity as to the authority to perform inspections in the area, and regulations must therefore be done through diplomatic channels to the countries were the vessels are registered.

Figure 6: Zones and Disputed Areas in the Barents Sea



Foreign and security policy

The oil crises around the Persian Gulf and the conflict connected with the construction of the Soviet gas pipeline in the 1980s are examples that energy was one of the most central objectives for great power rivalry during the cold war. Access to petroleum resources, trade and prices had great significance both for the military systems and for the development of Western societies. After the fall of the Berlin Wall and the Soviet Union, international politics have changed character with the U.S. as the only global superpower, but with many regionally strong states. The petroleum resources of the world are however still found in countries with considerable political instability, with room for major market disturbances.

For Norway, security political dimensions to the oil and gas activities have been particularly in focus in connection with the possibilities of production in the polar areas. Because of the vulnerable nature in the area, environmental concerns will be a limiting factor for production and transportation of petroleum. The continued great strategic significance of the Kola bases implies that petroleum activity may seem negative for the operational conditions of the Russian Northern fleet, and particularly for its strategic submarines.

Norway's involvement of Western allies in negotiations about the unsettled issues in the Barents Sea is of especial interest. If allies are concerned first of all with settling an agreement about the encouragement of greater oil and gas activities, but are more neutral as to who gets the benefit, they could also pressure Norway to get a settlement not necessarily optimal for her.

Petroleum activities can influence military air and sea operations in the Barents area. Submarines will more easily remain undetected, as noise from petroleum activities may be stronger. The larger submarines must pass between Bear Island and Norway because of sea depth. Activities in this area make it easier for submarines to pass to and from Russian Barents Sea. This can, of course, be a disadvantage and advantage to both sides. Furthermore, platforms can be used for radar equipment, electronic warfare, and helicopter bases, meteorological and oceanographic data collection. Probably, these elements, together with consequences also for surface vessels and aircrafts, will lead the Russians to adjust their strategy for their Northern fleet. They will most likely be negative towards any at-

tempt at limiting their access to the Atlantic Ocean.

As Norway is so small and Russia is so big, it is necessary for Norway to co-operate with other countries in securing her interests. The question of Norwegian control becomes a central one. Obviously, Norway needs relevant military capability in this area, as a minimum for doing sufficient "police work" at sea and to remain credible to the Russians and other countries.

Norwegian exports of energy have created new types of dependency on other countries. States that are strategically vulnerable to a loss of Norwegian energy production, such as Germany and the UK, form a new resource for military assistance that might be exploited. Those countries that receive Norwegian gas, plus the US concerned over global energy balances, have a clear interest in the shaping of Norwegian foreign and petroleum policy, and helping to secure the area. Joint military interests can also be developed with the Russians, except in those areas that are related directly to Norwegian-Russian controversies.

Closing comments

The large export of petroleum has increased Norway's international economic and strategic significance and moved the country into an exceptional position within the OECD area. An international image of Norway is now that of a petro-economy. In addition to Norway's traditional interests shared with the industrialized world, she now also shares interests with other petroleum exporting countries. These countries are in most cases quite different from Norway in general economic and political affairs, including Russia.

Norway's role as a major petroleum exporter is, accordingly, relevant not only for her industry and economy, but also for her diplomacy, including security and defence policies. This challenge is particularly apparent for the gas sector, as expensive pipelines link buying, transmitting and selling countries closely together.

During the Cold War security issues dominated Norway's policies in the North, under the US and NATO umbrella. After the break-up of the Soviet Union, international economic and political integration processes have become more comprehensive in depth and scope than ever before.[9] The role of a major gas (and oil) exporter is a challenge for a small state, which otherwise considers herself to be of limited economical and politi-

cal significance to others. As a basis for Norway's national and international petroleum policy, in general, and for the gas sector, in particular, it will be important to have an independent understanding and analysis of how economic mechanisms and political actions and actors work. It is also important to understand how domestic and international commercial and political players can influence the situation. Norway's political and commercial partnerships should be chosen in a way that her mixtures of interests are supported over time.

The Norwegian petroleum cluster, including Hydro, Statoil and Aker Kværner, is pushing developments in the High North ahead in line with security-of-supply considerations from consuming countries. The interest in co-operation from for example German, French, British and American companies is pushing development in the same direction. On the technological level, this includes areas where Norway is considered to have an advantage, such as in horizontal drilling, sub sea technologies and plants for conversion to LNG.

In developing a strategy to handle this situation Norway must anticipate the attention of other nations. As a Western European country, Norway is relatively isolated in her interests as a natural gas exporter, although she may find partners in many single areas. Developments in EU and EU countries as well as in Russia and other gas exporting countries are important. Gazprom as a single company and market leader is of great importance. Market developments and economic interests will have to become part of Norway's traditional foreign and security relations. This will also be expected from foreign companies and governments.

To defend the large economic interest Norway has in securing the value of both present and future gas contracts in a more liberal market environment, authorities and companies should adjust their way of thinking and acting. Policies in the EU are adjusting to the new environment. The present energy crisis has forced the EU to be concerned about the long-term supply of energy. A renewed focus on long-term-contracts may emerge in line with the desire to speed up developments in the Northern areas. The assets of oil and gas that Norway possesses, in a situation where there is a lack of energy, give her the possibility to a larger extent to set business and political terms for their development.

One challenge for Norway is to mark a line of delimitation with the Russians. A settling of the line would add stability to the region and ease

the development of oil and gas resources. When Norway wants to secure a balance with the EU, various EU countries and the US with respect to maintaining sovereignty in the area, she may also face a pressure to settle an agreement. If Russian relations with the West are good, this pressure may work against Norway. Russia will remain the biggest and most important actor in supplying more energy to both Europe and the world, and be of higher importance to the West than Norway. Norway should accept (and possibly expect) the processes still to take much time to be finished. The speeding up of development in the Northern waters obviously involves environmental risks, if plans are not well enough developed. Of special interest will be the issue of transportation. There are plans to build a 2 mbd oil pipeline to Murmansk. This would increase the traffic of oil vessels along the Norwegian coast substantially, and demonstrates the need for proper Norwegian regulations.

For natural gas, a LNG plant on the Kola Peninsula is likely to supply the US market, besides Europe. But gas may also be transported towards European markets through pipelines. Two main options are to link either to the new Baltic line from Vyborg to Greifswald in Germany, or to the Norwegian sub -sea network (cf. Figure 5). Alternative transport solutions for natural gas from the Barents Sea should be studied more closely, and is an example of a possible joint Norwegian - German project to enhance knowledge about the development of petroleum resources in the area.

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Footnotes

[1] This paper was prepared for the Norwegian – German Willy Brandt Foundation and presented at Gesprächkreis, Nördliche Gebiete in Berlin March 15 2006. It is slightly updated for the purpose of this publication.

[2] In this forecast it is anticipated that much of Russia's natural gas production growth will come from independent gas companies such as Novatek, Itera, and Northgaz, although Gazprom will also expand.

[3] See Stern 2006 for a discussion of various aspects of this conflict.

[4] See Stern 2005 for a comprehensive discussion of Gazprom positions and developments.

[5] On the other hand, Russian entry into the WTO will require an increase in domestic oil and gas prices in accordance with world energy prices. As long as there is such high energy intensity in the Russian economy the competitiveness of her products in both international and domestic markets may deteriorate as a WTO member in the short and medium term. Russian governments have been cautious with respect to changing domestic energy policies.

[6] Two Russian companies hold licenses to develop Shtokman (discovered in 1988): Sevmorneftegaz (a subsidiary of Rosneft) and Gazprom. In September 2005, Gazprom selected five companies on a "shortlist" of finalists in a search for partners to develop the field: Statoil and Norsk Hydro from Norway, Total from France and Chevron Corporation and ConocoPhillips from the US. The final choice has been postponed several times. Development costs are estimated at USD 15 billion to USD 20 billion.

[7] When the Norwegian petroleum industry was in its infant stage, the American company Mobil was in 1973 assigned the role as operator of the huge Statfjord field, although it owned only 15 % of it. Statoil owned 50 % but did not, at the time, have the competence to do the job. However, in 1987, Statoil competence had improved to such an extent that the company (according to agreement) took over as operator of the field. The arrangement proved to be very important as part of building the Norwegian petroleum cluster (see i.e. Ryggvik 1997).

[8] The Svalbard Treaty regulates fisheries in territorial (12 miles) and inner waters.

[9] Brunstad et.al. (2004) present three rather different scenarios for the future of Barents Russia as part of these processes.

Russian Energy Policy and its Challenge to Western Policy Makers

By Keith Smith

Conference on EU-Russian Energy Relations. Tallinn, Estonia

Conclusions

- The U.S. and the EU have too long ignored Kremlin's non-transparent and monopolistic energy policies and its use of energy to exert control over the new democracies of Central and Eastern Europe.
- The Ukraine-Russian "gas war" in January was only a continuation of pipeline-politics, that started with the fall of the Soviet Union in 1990.
- The U.S. and Europe's tolerance of these coercive policies and non-transparent business practices by Russian companies have helped signal to the Kremlin that the West believes that it needs Russian energy exports more than Russia needs the West's export revenue, energy financing and technology.
- The West must cooperate to make Russian energy policies and actions more transparent, competitive and reciprocal, by following internationally accepted business practices. Western tolerance of Moscow's imperialistic use of energy resources and pipeline monopolies only prevent Russia's own development into a genuine strategic partner.
- Recent developments in German-Russian relations raise serious questions about the future of European energy cooperation.
- The U.S. and EU should assist Ukraine, Georgia and Moldova to develop alternative pipelines and sources of energy supply.
- Central European countries can improve their own security by increasing domestic energy storage, by boosting indigenous supplies of gas and oil and by creating a welcoming and transparent environment for foreign investors.
- Central European Governments should not weaken an attempt to form a unified energy policy toward Russia through side deals with Moscow.
- The policies listed above are not anti-Russian. On the contrary, they are designed to integrate Russia into the international economy and to create the conditions for greater cooperation across the board by Russia, Europe and the United States.

A Delayed Wake-up Call

Gazprom's January 1st cutoff of natural gas to Ukraine was a much delayed wake-up call for Western Europe and the United States regarding Moscow's willingness not only to use in a coercive fashion its energy resources as political leverage in Europe.[1] Russia's recent sharp increases in natural gas prices to Ukraine, Georgia, Armenia and Moldova, and its increasing control over Europe's gas pipeline systems, raise fresh issues concerning Russia's foreign economic policies and the security implications for Europe. Russia's energy strategy also raises the stakes regarding America's own growing dependency on energy imports, and should lead us to question expectations that Russian supplies of gas will help Europe and America's energy security. Unfortunately, the U.S. and Western Europe have largely ignored this problem until recently because Russia's pipeline-politics has largely been confined to East Central Europe and Central Asia.

For many new EU member states such as Poland, Latvia, Lithuania, and for new democracies, such as Ukraine, Georgia, and Moldova, Russian energy control is an old problem. Central European attempts to raise this issue in Western capitals have until recently been brushed aside. The rapid acceptance in 2005 by the EU Commission of the Russian-German undersea gas pipeline project was a serious mistake and raises questions about Europe's ability to implement a common foreign and security policy. The concerns voiced by the Central Europeans should have been examined in detail both in Brussels and in European capitals. More attention should have been focused on the agreement's implications for Europe's long-term energy security, and on the ability of the new EU members in Central Europe to resist Moscow's political and economic influence.

The European Commission and the United States have only started looking seriously at the risks to Europe and the West of dependency on Russia after the cut off of gas to Ukraine in January of this year. Nevertheless, the slowness of our response is leaving Russian companies plenty of time to stitch together additional bilateral deals with Western governments, all anxious to help their companies gain an investment foothold in Russian energy production. A re-examination of EU policy may be made more difficult by the curious fact that Russia plays an important role in the EU's own Energy Treaty Commission (ETC). This is the case, even though Moscow has refused to ratify and implement the Energy Charter,

and particularly the draft Transit Protocol. Ratification and implementation of this agreement would have resulted in greater competition in Russia's energy transportation sector. In spite of pressure from the EU to ratify the Charter, Gazprom's Deputy CEO Medvedev has labeled it as a "stillborn document." [2]Gazprom believes that its bargaining position outweighs that of the EU or U.S. as a result of high energy prices and of instability in producer countries. In any case, the long-term political and security significance of the Putin Government's assertive energy policies warrants much closer study by Western governments, including by the United States.

There is an unrealistic expectation in some circles in the U.S. that Russian natural gas supplies from the Russian Far East or from off-shore in the Barents Sea will fill the gap created by declining domestic and Canadian production and by political instability in Latin America, Nigeria and the Middle East. The reality is that Russian oil and gas exports are not growing at the pace they were just 3-4 years ago. In addition, investment in Russian exploration and development has declined from the level that existed before the systematic destruction of Yukos began in 2003 and paralleled the increased centralized control of almost all oil and gas resources under the Kremlin Administration. Another factor to consider is that Russia, as it has in Europe, will demand easy non-reciprocal access to U.S. "downstream" facilities as a price for U.S. company participation in Russian energy production, particularly in the giant Shtokman gas field in the Barents Sea.

Pipeline Politics and Western Vulnerabilities

The Putin Government has made it clear that it intends to use its energy export power to regain Russia's Cold War influence around the world. Former Kremlin economic adviser, Andrei Illarionov, who was pressured into resigning last December, has cited Russia's increasing tendency to use energy as a weapon in its relations with other countries. This warning by a former Kremlin insider should be taken seriously by Western governments.[3] Gazprom's recent takeover of the Armenian and Moldovan gas pipeline systems and its actions in Ukraine demonstrate Russia's willingness to use its considerable energy muscle to secure control of the energy infrastructure in neighboring states for political purposes.[4]

EU ambassadors in Moscow were recently warned by Gazprom's CEO, Alexei Miller, that Russia could divert natural gas now going to Europe to China and the U.S. if the company were not allowed more freedom to buy European downstream energy facilities. Miller was not offering similar access to Russian energy markets. This comment was quickly followed by a similar threat from President Putin. Little attention was given in the Western press to the fact that Russia does not allow Western firms the same degree of access to Russian facilities that Russian state energy companies already have in Europe and the United States. Moscow clearly believes that the tight world energy market and high prices provide it with enough leverage over the West to pursue non-reciprocal policies and to continue to follow monopolistic, non-transparent business practices.

"Pipeline imperialism" by Moscow dates back to 1990, when it interrupted energy supplies to the Baltic States in a futile attempt to stifle their independence movement. The "energy weapon" was again used against the Baltic States in 1992, in retaliation for Baltic demands that Russia remove its remaining military forces from the region. In 1993 and 1994, Russia reduced gas supplies to Ukraine, in part, to force Kiev to pay for previous gas shipments, but also to pressure Ukraine into ceding more control to Russia over the Black Sea Fleet and over Ukraine's energy infrastructure.[5] Even Belarus, and indirectly Poland and Lithuania, suffered supply disruptions in 2004 from the Kremlin's effort to take over Belarus' gas pipeline system. From 1998 to 2000, in an attempt to stop the sale of Lithuania's refinery, port facility, and pipeline to the Williams Company of Tulsa, Oklahoma, Transneft, Russia's monopoly transporter of piped oil, stopped the flow of crude oil to Lithuania *nine* times.

Russia's Gazprom, with the help of Germany's Ruhrgas, exercises control over the gas facilities and pipelines in the three Baltic States, where they also have monopoly control of the domestic gas markets in all three Baltic States.[6] Media outlets in the West have generally ignored Transneft's refusal to allow Kazakhstan to supply oil to Lithuania's Mazeikai Refinery through the Russian pipeline system. Kazakhstan's oil company has the legal right to ship crude oil to the Baltic coast, based on their transit agreement with Transneft agreed to last fall.[7] Moscow is determined to prevent any but a Kremlin approved company from taking over the Yukos ownership of Lithuania's facilities. Three years ago, Russia stopped all

piped shipments of oil to Latvia in an effort to gain control over the oil port at Ventspils. Now, Moscow is again attempting to keep non-Russian companies from buying Lithuania's Mazeikai Nafta Refinery and the port at Butinge, on the Baltic Sea. This use of pipeline imperialism is ignored in the West even though Latvia and Lithuania are EU and NATO members.

The Russian pipeline monopolies of Gazprom (natural gas) and Transneft (oil) have been given free rides in terms of the open-market requirements of WTO and the EU's own Energy Charter. The EU's agreement with Russia on WTO in effect gave Moscow's increasingly monopolistic pipeline and production companies carte blanche to avoid following accepted Western business practices.[8] The WTO agreement with the EU (not challenged by the U.S.) also allowed Russia to maintain a trade advantage in industrial goods by keeping its domestic energy prices at a fraction of world market prices.

German–Russian Energy Relations

Russia stands to greatly increase its market share and its leverage in Germany and the rest of Europe through the construction of the expensive undersea **Northern Europe Gas Pipeline (NEGP)**. The construction of a parallel pipeline to the Yamal I line that runs through Poland would have been a much cheaper alternative (now estimated at $10.5 billion for NEGP vs $2.8 billion for Yamal II)[9]. In addition, the enlargement of the Yamal line would have given both Central and Western European energy consumers greater political and economic security.[10] The increased costs of the NEGP will be passed on to Western consumers to the benefit of Russian and German gas suppliers and the German banking community.

Chancellor Merkel struck a cautious tone during her December visit to Warsaw when referring to the NEGP project. She said; "We want this project to be accessible to everyone…and the interests of all involved parties should be taken into account."[11] Later however she announced her full support for the original deal, as signed by former Chancellor Schroeder one week before leaving office. This deal involving Russia and Germany, included the granting of a 1 billion dollar loan guarantee by the German government for the pipeline's construct. With the recent signing of agreements between Russian companies and BASF, EON and Ruhrgas, it appears as if the new government in Berlin will be supporting Gazprom's aggressive ownership inroads into German gas and electricity companies. German energy policies

have created significant anxiety among Central Europeans concerning the West's willingness to help protect their newly won sovereignty.

The Russian-German agreement, unless modified, will give Russia's state-run Gazprom a significant voice in German domestic energy policies, and indirectly over the gas markets in all of Central Europe. Germany as an energy market and a source of bank financing, however, is crucial to Russian development. Germany should follow through on Chancellor Merkel's promise to implement a German energy policy that takes into account the security interests of the Baltic States and Poland. If changes are not made in the Schroeder-Putin agreement on the Baltic pipeline, Germany may face an increasingly insecure neighborhood to its east. Germany may also down the road confront the same Russian control of its domestic energy markets that face the newly independent states who so recently emerged from Soviet domination.

No single country wields more influence in Moscow than does Germany. The trade and financial ties between Berlin and Moscow are important to the sustained development of both nations. Although many outside of Germany were disappointed with Chancellor Schroeder's support for President Putin's domestic policies, everyone recognizes the value to European security of a close, constructive German-Russian relationship. Good friends, however, should not avoid frank discussions of latent imperial tendencies in Russia's foreign policies. Germany continues to become more dependent on Russian gas imports (now over 44% of all the gas that Germany imports). This import dependence could well grow to 80% after the completion of all phases of the Northern Europe Gas Pipeline (NEGP).

Is the West Paying Attention?

Europe's energy relationship with Russia has for the past several years been directed by only a few of the larger member countries. The leaders of these countries have too often praised President Putin's democratic credentials while ignoring Russia's backsliding on democracy and the coercive use of Russian energy power. The U. S. has also been until quite recently more eager to secure energy supplies from Russia than to pressure the Kremlin into reforming its economy. The EU and the U.S. have ignored the noncompetitive and political aspects of Russia's energy export policies. This is due in part to competition by Western companies

for exploration and production rights in Russia. Although the EU recently initiated a more comprehensive study of the Community's energy security, the large countries of Europe continue to resist submitting to a common EU energy policy. Meanwhile, Russian companies are rapidly locking up non-transparent business deals with individual European nations.

Although Moscow's exercise of "petro-politics" was a subject for discussion at the G-8 summit, the non-Russian members were unable to move the Putin Government into making its policies more transparent or competitive. This vital issue also needs more discussion within the EU Commission, and between the Commission and other importing countries such as the United States and Japan. Russia's Deputy Prime Minister and Gazprom Deputy CEO, Alexander Medvedev, told the British daily, The Guardian, in January, that "politics is always there" when one is doing energy business.[12] This is no surprise, but our relying on energy from an increasingly authoritarian government intent on increasing Russian political influence in neighboring countries, is troubling. If on the other hand Russia's energy wealth were more transparently and competitively managed, it would dramatically increase domestic Russian living standards, bring Russia real international respect and help cement a Europe that would feel more unified and secure.

Europe as Hostage to Russian Energy

The importance of good relations between Russia and the West, and particularly between Germany and Russia cannot be underestimated. Nevertheless, it is a mistake for us to give Moscow the impression that we believe that the West needs Russian energy supplies more than Russia needs the oil and gas revenue that comes from the Western markets. Nor is it wise to let the Putin Government believe that its authoritarian domestic policies are acceptable in the West as long as there is an expectation of increasing exports of Russia's energy resources. Simply stated, Russia is not able to develop its vast energy fields in Siberia, the Pacific Coast and in the Barents Sea before the middle of the next decade without Western capital and technology.

There are growing indications that Russia will be unable to meet European, Chinese, Japanese and American expectations for significant increases in energy imports unless Russia offers foreign investors a signifi-

cantly greater participation in exploration and development of Russia's new gas and oil fields. Russian gas exports to the West are already dependent on Gazprom's ability to monopolize and control gas exports from Turkmenistan, Kazakhstan and Uzbekistan.[13] This Russian dependency on Central Asia will increase over the next 7-10 years, until there are substantial gas flows from the Shtokman field in the Barents Sea, and from new wells in the Sakhalin and Siberian fields. In the past, Gazprom has neither had a reputation in the industry for innovation nor for productivity increases in exploration and development. With the company now under tighter control by the Kremlin, there are good reasons to question whether Gazprom and the increasingly powerful Rosneft will have the managerial skills, financing and technology necessary to meet Russia's export goals through increased domestic production.

There has been no coordinated push by either the EU or the U.S. to require that Russia open its energy market to foreign investors in the same way that Western companies and markets are open to Russian investors. Lukoil has been allowed to buy 100% of Getty Petroleum in the U.S., along with 1,500 gas stations. U.S. energy companies can, according to Russian law, only own 49% of a Russian company and in practice 20% ownership appears to be the ceiling set by the Kremlin. We should be using our considerable leverage to force Russia to play by the same transparent, competitive rules that guide business in the West. Western governments should not have acquiesced to this uneven playing field, but should have demanded full reciprocity with Russia in their investment policies. This would help promote the kind of investment that would increase, rather than decrease, economic reform and a more balanced growth in Russia itself. President Putin has compared the new Gazprom colossus to Norway's Statoil, but the latter has real domestic competition, its exports are divorced from foreign policy and it is a totally transparent company.[14] Gazprom, with its interlocking ties to the Kremlin Administration and its gas pipeline monopoly, cannot be compared to any Western firm.

The pipeline monopolies of Transneft and Gazprom are contrary to the Energy Charter signed by the EU and Russia. Where is the pressure on Russia to ratify and implement the charter?[15] Following the destruction of Yukos, Russian officials declared that private companies would not be allowed to build pipelines in their country.[16]

Former Siloviki Making Energy Policy

Former intelligence officers (siloviki) in the Putin administration and in Russia's energy companies have a strong role in determining national energy policy. The head of Rosneft is a former KGB associate of President Putin, and he helped engineer the breakup of Yukos and his company's seizure of the most valuable assets of Yukos.[17] Former KGB and GRU officers sit on the boards of almost all the country's major energy companies. In 1999, Moscow went so far as to send a former KGB/FSB officer as ambassador to Lithuania, in an attempt to provide behind-the-scenes support to Lukoil's negotiations with the Lithuanian Government and the Williams Company. Before assuming the job, the ambassador had been the FSB's official liaison officer with Lukoil.

A few former intelligence officers are quite progressive in their views. The majority of them, however, oppose any weakening of the state through the growth of a transparent, independent private sector. They find the idea of a win-win energy deal with a Western company to be an alien concept. Granting majority control to a Western energy firm is viewed by most former intelligence officers as a danger to Russia's national security interests. Even the Western managers of TNK/BP are no longer permitted to see their company's own seismic data. President Putin's use of Matthias Warnig, a former East German Stasi officer and now Dresdner Bank executive, to play a central role in financing and managing the undersea Baltic pipeline system only added, perhaps unfairly, to suspicion that the project is more politically than commercially motivated.[18] Mr. Warnig, who was earlier proposed by Gazprom to sit on its board, will work directly under former Chancellor Schroeder in managing the Baltic pipeline system.[19]

Ceding Too Much Control to Gazprom

More thought should be given by Western governments to the potential power of Gazprom to control the gas markets in Central Europe following the completion of the Baltic pipeline system in 2011-12. Under the German-Russian agreement, Gazprom will be able to buy significant shares in Germany's gas companies.[20] Will this allow Gazprom to veto shipments of gas from Germany to Poland if the Poles have a dispute with Gazprom over price or availability and Russia decides to reduce or cut off the flow of gas? Could the increased power of Gazprom be used to stop liquefied natural gas (LNG) receiving plants from being constructed

in Poland, Latvia, or even in Germany? How much more political influence will Moscow have in Berlin as a result of Germany's growing energy dependency on Russia and of Gazprom's large ownership stake in Ruhrgas?

The EU has proposed that member states increase their levels of natural gas storage. This may become more difficult now that Poland and the Baltic states are being bypassed by the NEGP. Russian purchases of gas from Turkmenistan, Uzbekistan, and Kazakhstan are designed to deny the West, including countries such as Ukraine, the ability to buy oil and gas directly from Central Asia or at prices negotiated between producer and consumer, rather than working through Gazprom.[21] The company buys Central Asian gas at $55 a cubic meter and sells Russian gas in Europe for over $240. Monopoly control of the pipelines out of Central Asia is extremely profitable - for Russia. There is a question as to whether this coercive pipeline policy of the Kremlin is compatible with WTO membership. Considering our experience with China's WTO compliance, there are good reasons to doubt that Russia will let up its monopolistic pressure on Central Asian gas shipments after it has been admitted to the WTO. More open and competitive energy policies by Moscow before WTO membership would be wiser than repeating the China experience.

Gazprom is attempting to pressure Bulgaria into breaking a binding agreement on gas price and availability that would be in force until 2010.[22] It is important for the EU to give this soon-to-be member state political support, perhaps using the forum of the Common Security and Defense Policy. So far, there is no sign that Brussels will intervene. Perhaps Bulgaria, as a member of NATO, should put the issue of energy security on NATO's agenda as suggested by Poland. NATO members have historically used the Alliance to examine issues that go beyond narrow questions of military defense.

EUROPE'S GAS PIPELINE NETWORK
Source: *Inogate (EU oil and gas transport co-operation program) via BBC News*

No Big Winners in the Russia–Ukraine "Gas War"

This brings us to the Russia-Ukraine "gas war," that was allegedly resolved to the satisfaction of both sides on January 4. Russia's political agenda in using gas prices to punish the pro-Western Yushchenko government seems quite clear from statements made by Russian supporters of Moscow's hard line toward Kiev and from remarks by Russia's few remaining reformers[23]. Moscow was obviously surprised and displeased by the December 2004 election of Victor Yushchenko and unhappy with his policies of moving Ukraine closer to the EU and NATO. This provoked Moscow into demanding revisions of the 2004 gas agreement that was written at Moscow's insistence in order to help Viktor Yanukovich's presidential aspirations. It is highly unlikely that Moscow would have demanded that Ukraine immediately pay "world market prices" for Russian energy imports if the pro-Moscow Viktor Yanukovich had taken power after the earlier rigged elections. It should not surprise anyone that the cut off of natural gas by Gazprom came in the middle of one the coldest winters in recent Ukraine memory and less than three months before crucial Ukrainian parliamentary elections.

Not many people familiar with political and economic relations between Russia and Ukraine believe that the current natural gas agreement will last very long.[24] And we would also be naïve to think that the present agreement will last beyond the next year without a Russian demand for revision and price increase. Moscow's requirement that all gas to Ukraine be contracted through the nontransparent company RosUkrEnergo, the direct successor to the even less-transparent EuralTransGas, raises questions about the reliability of future gas supplies that originate in Central Asia or in Russia itself[25]. It is not likely that the newly formed UkrGazEnergo will be any more transparent than the companies mentioned above, particularly in light of the continued lack of transparency in Gazprom and Naftogaz Ukrainy, and the fact that RosUkrEnergo remains a player under the "final agreement" signed by both sides on January 4. It is not a good omen that five or six agreements signed on January 4 between Ukraine and Russia was not made public by officials of either side. The reported "revelation" regarding the Ukrainian partners in RosUkrEnergo by a Gazprom owned newspaper should not be taken at face value. Over the past thirteen years, Moscow has clearly signaled that its intentions are

to control Ukraine's gas pipeline system, just as it now controls the gas pipelines in the Baltic States, Belarus, Poland, Armenia, and Moldova.

No one should have been surprised by Moscow's tough stance towards Kiev. Russia's willingness to stop energy shipments to Ukraine for political reasons goes back more than ten years. Nevertheless, one can make a good case that Russia has the right to charge importing countries market prices. An equally good case can be made that it is in the long- term interest of Ukraine and other importers to move in the direction of paying world prices. Once market prices are reached, Moscow's political leverage will decrease. A four-fold overnight increase in price from $50 to $230 per 1,000 cubic meters as originally demanded by Russia last December, however, was not justified, particularly in light of the 2004 agreement between the Kuchma Government and Gazprom, which locked prices in until 2010.[26] Both sides should have taken the dispute over the agreement to international arbitration.

Part of the Kremlin's present strategy is to rapidly increase prices to weak neighboring states in the hope that they will build up large debts, be unable to pay for the gas, and ultimately have to cede control over their domestic gas pipelines to Gazprom or Transneft to pay for the arrearages. This is what has happened in Belarus, Armenia and Moldova and is currently being threatened in Ukraine, Bulgaria, Belarus and Slovakia. The West should also be concerned with Gazprom's move to monopolize all gas supplies from Turkmenistan, Kazakhstan and Uzbekistan. This monopoly position increases Moscow's political leverage in East Central Europe and may increase prices in the medium term in all of Europe.

It would help if we knew what the real market price of Russian gas and oil would be if a transparent situation existed within Russia's exporting companies. If Russian consumers were forced to pay prices that were significantly more than one-fifth of what Moscow claims to be the world market price, domestic demand would drop and additional Russian oil and gas would be placed on the international market. Does the $47 per 1,000 cubic meters charged to Belarus have any relationship to the market, or does the Kremlin consider this an "internal price?" These are all questions that need greater discussion and scrutiny in European capitals, in Washington and in the EU Commission.

Ukraine Needs to Act to Strengthen its Own Hand

Ukraine's politicians, however, deserve some of the blame for the country's present situation. Kiev has allowed corrupt oligarchs to continue their control over gas deliveries from Russia and many of the domestic oil and gas fields. Even more damaging in the long run is the Yushchenko Government's lack of movement in developing fair and just conditions for both domestic and foreign energy investors. Here again, a few powerful individuals, most of them with close ties to Russia, have successfully kept out Western competitors. Ukraine could substantially reduce its dependency on Russia through rapid reforms that would permit more open tenders for exploration rights and a welcoming atmosphere for legitimate foreign energy investors. Seismic studies demonstrate that the country possesses considerable gas both on-shore, in the Black Sea and possibly in the Sea of Azov.

The present government in Kiev did inherit a situation in which there was little transparency in the entire energy market. Two thirds of Ukraine's refineries, processing three-fourths of the country's oil, were already owned by Russian companies.[27] Almost 100% of the refined product that is exported is produced in Russian-owned companies. Ukraine's nuclear plants depend on Russian nuclear fuel rods. Former Russian Prime Minister Victor Chernomyrdin, who was also CEO of Gazprom, has for many years been Moscow's ambassador to Kiev. He has effectively promoted Russian energy interests.

The cozy relationship between Russian and Ukrainian energy interests persists, even after the New Year's Day reduction of gas supplies. Talk by the Yushchenko Government over the past year about diversifying imports and stopping corruption in the energy sector has resulted in some progress, but it has been too slowly implemented [28]. The economics of the proposed Odessa-Brody oil pipeline are still in question, although it may be needed for security reasons. The NABUCCO gas pipeline project, which would go from Azerbaijan through Turkey to Austria, is a realistic alternative to gas shipments that go to Ukraine through Russia. A more immediate need is for the current Yekhanurov government to embark on an urgent program to improve energy efficiency, and to open the country's oil and gas fields to Western investors. Unfortunately, negotiations to form a new government after Ukraine's parliamentary elections in March

have still not been successful, thereby perpetuating paralysis is much of the country's decision making apparatus.

Western acceptance of Russia's "neo-colonial" policies in Eastern Europe, the Caucasus and Central Asia are not in the long-term interests of Russia itself. Acquiescing to Moscow's more "robust" regional policies has only contributed to greater tension in Russian-East European relations and has slowed the development of democratic governments in the Caucasus and Central Asia. This in turn encourages and strengthens non-democratic elements in Russia that believe that their country's strength and prestige stems from control of the neighborhood – a large neighborhood at that.

Time for the West to Lead on Energy Policy

The EU should take the lead in building a more secure network of electricity inter-connectors between the countries of Western, Central and Eastern Europe. The EU could help marshal the international banks, such as the EBRD and EIB to take equity positions in the pipeline systems of Ukraine, Bulgaria, Moldova and Poland. This would help these countries modernize their pipelines and it would provide a "neutral" party that could keep the pipelines from being controlled by non-transparent Russian companies and guarantee competition in gas and oil transportation. International financing for the proposed NABUCCO natural gas line from Azerbaijan would offer Central Europe needed energy security, as would the building of the Odessa-Brody oil pipeline system.

The United States should re-examine its long-term energy relationship with Russia. Support for American investment in Russia's energy resources should not prevent us from demanding more transparent energy policies and a level playing field for foreign investors. We should expect a loosening of Russia's monopoly pipeline system and demand that Central Asian energy producers have direct access to Western markets. We are not being hostile toward Russia when we insist that there be reciprocity in Russian-European-U.S. energy relations. It would be foolish on our part not to see Russia evolve into an economically successful democracy. Everyone would gain. Russians are going through a difficult period psychologically. They are highly suspicious of America's motives in Central Europe and Central Asia and tend to believe that the U.S. and NATO are

intent on "surrounding" Russia with hostile states; part of a grand scheme by the West to keep Russia weak economically and marginalized in international affairs. It is necessary for us to address these issues head on with our Russian colleagues, and at the same time work to counter Russian efforts to acquire psychological security by creating insecurity in Europe.

The West, led by cooperation between the EU and the U.S., needs to quickly rethink its energy and non-energy policies with Russia. The two cannot be separated. The world does Russia no favor by ignoring the monopoly and noncompetitive nature of this energy relationship. All sides would benefit if Russia were to become more transparent and commercial in its foreign energy policies. Meanwhile, neither EU nor U.S. should allow Moscow to threaten the security of Europe, particularly the new democracies of Central Europe through neglect or unwillingness to face down the new imperial mindset in the Kremlin. As Yuri Schmidt, the famous Russian human rights lawyer told audiences in Brussels in October, "Yes, Russia needs something from you. It needs your silence, and it is ready to pay you for it, too." The January 1 wake-up call to the West was also an opportunity for those who want to see Russia build a modern, democratic state that is linked to Europe by mutually beneficial political and economic ties.

ACTION RECOMMENDATIONS

- Recognize that only increased Western cooperation on an energy policy toward Russia will succeed in forcing Moscow to adopt more transparent and market oriented energy policies.

- The U.S. and EU should consult urgently with EU and NATO member states regarding measures to counter Moscow's growing use of energy resources to coerce its neighbors in Central Europe. Some issues that could be discussed are:

  - Impact on the security of Russia's neighbors and the West of the Kremlin's centralized control of the country's energy companies. Examine the degree to which Russian companies are in violation of Western competition, anti-trust and anti-monopoly laws.
  - Include transit countries of Poland, Ukraine, Slovakia, Romania

and Bulgaria in all EU-Russian energy dialogues in order to ensure that the interests of all of Europe are better protected.
- Measure that would provide Russia's Central European neighbors greater security of energy supply.
- Cooperation with Norway and other non-Russian gas regarding providing alternative supplies of gas to East Central Europe, and in creating a European-wide energy market.
- Accelerate pipeline construction, such as NABUCCO, Caspian Sea Gas Pipeline and Odessa-Brody oil pipeline.
- Examine methods of sharing alternative and energy efficiency technologies developed by DOE and its European counterparts with Central European countries most dependent on energy imports.
- Draw up clear proposals to Central Europeans that would result in improved incentives for increased domestic and foreign investment in the energy sector.

- The U.S. Secretary of Energy, the EU's Director General of Transportation and Energy and Russian Energy Minister should meet at least biannually to talk about competition and monopoly use of facilities ownership and pipeline use. The goal of the meetings should be balance energy security for both export and import countries.

- The U.S. and EU could offer to share with Russia breakthroughs in energy technology as an incentive to greater cooperation in building a transparent and competitive energy market.

- Initiate U.S.-EU-German discussions regarding the impact of the Russian-German Northern Pipeline system on the security of Poland, the Baltic States and Western Europe. The talks could include an examination of the impact on Europe of additional downstream ownership by Gazprom of energy companies and facilities in Germany and other European states.

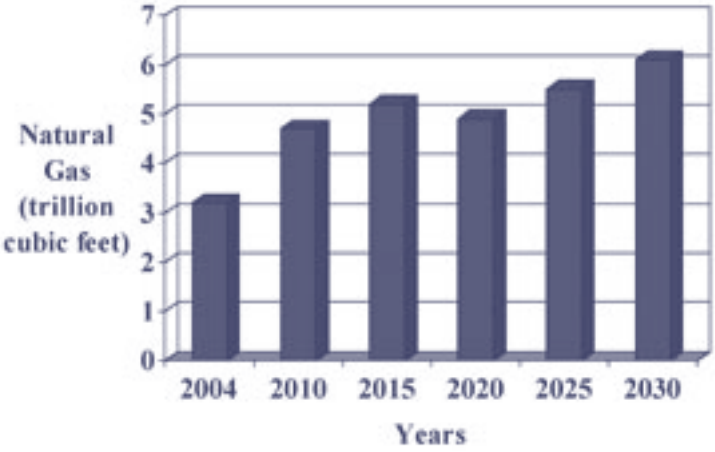
- Press for the implementation of energy investment policies that are reciprocal. Russian ownership in upstream and downstream operations should be limited to minority shares as long as the same situation exists for Western firms in Russia.

- Russia should be required to implement the Energy Charter, and particularly the Transit Protocol, as a requirement for WTO membership. This could reduce the coercive nature of Russia's pipeline politics.

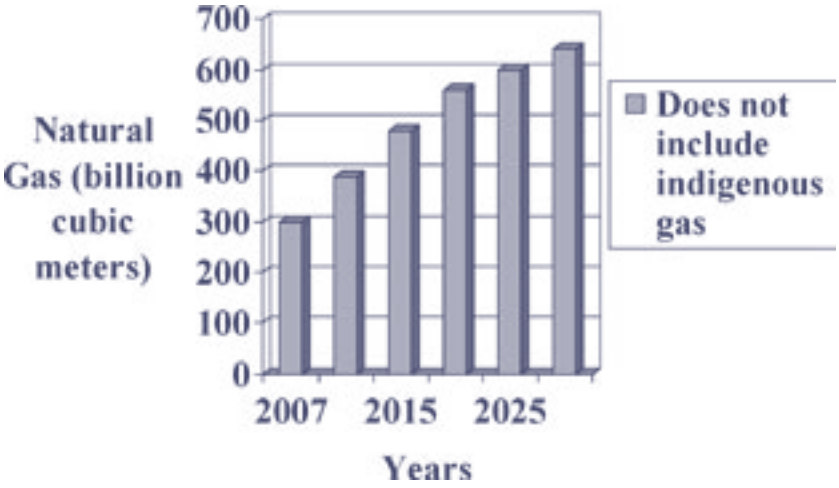
- U.S. and European leaders should insure that their expectation regarding the timetable for significant additional supplies of Russian oil and gas reaching the world market is realistic. Some statements by Western leaders indicate that they are not familiar with recent slowdowns in the growth of Russian production, or are aware that much higher world energy prices provide an incentive to stabilize production at lower levels than would be the case with lower prices.

Appendix

Projected U.S. Net Gas Imports
2004–2030



Projected Natural Gas Imports EU-30
2007–2030



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About the authors:

Ole Gunnar Austvik is educated as an economist from University of Oslo (Cand. oecon 1980). He is also Master i Public Administration from John F. Kennedy School of Government, Harvard University (1989). He worked with Statistics Norway 1981-85 and Norwegian institute of international affairs (NUPI) 1985-91. Since 1991 his main affiliation has been with Lillehammer University College. He has longer adjunct affiliations with the Norwegian School of Management (BI) and Europa-programmet (now: Norwegian institute for strategic studies). He has published numerous articles and books about petroleum policy and international economics. Homepage: www.oga.no

Keith Smith is a senior associate in the CSIS (Center for Strategic and International Studies) Russia and Eurasia Program. From 2000 to 2002, he was a consultant on international energy affairs. Mr. Smith retired from the U.S. Department of State in 2000, where his career focused primarily on European affairs. From 1997 to 2000, he was U.S. ambassador to Lithuania. His additional posts in Europe include Hungary (twice), Norway, and Estonia. In addition to several other State Department assignments, he most recently served as director of policy for Europe, senior adviser to the deputy secretary of state for support of East European democracy (the SEED Program), and director of area studies at the Foreign Service Institute.

DEN NORSKE ATLANTERHAVS KOMITE
THE NORWEGIAN ATLANTIC COMMITTEE

Fridtjof Nansens plass 6
N-0160 Oslo
Tel: +47 22 40 36 00
Fax: +47 22 40 36 10

post@dnak.org
www.dnak.org