The 2006 Russia-Ukraine Natural Gas Dispute: A mechanisms based approach

by

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Authors Declaration

I hereby declare that I am the sole author of this thesis. This is a true copy of the thesis, including any required final revisions, as accepted by my examiners.

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Abstract

This thesis addresses the factors which lead the Russian government to increase natural gas prices for Ukraine in 2006. Through the use of methodological individualism, an explanation which links system, state, and individual levels of analysis is constructed. The system level variables concerned include global energy prices and the increasing importance of Turkmen natural gas to Russia and other regional gas consumers. State level variables, include changes in Russia's patrimonial society (changing source of rents, increased authoritarianism); and increasing state control over Russia's natural gas industry. Changes in these conditioning factors influence individuals' beliefs about their preferred source of rents, and the nature of their rent seeking and distributing. The resulting actions bring about variations in Russia's natural gas price for Ukraine. This framework is tested over three time periods (1995-1999, 2000-2004, 2004-2008) selected based on the nature of the conditioning variables over those years. Evidence from these case studies suggests that the above mentioned factors played a large role in the Russian government's decision. Further, it is concluded that methodological individualism offers a way to bring together system, state, and individual levels of analysis when explaining this event, and perhaps other events in international politics.

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Chapter 1: Introduction

Since the turn of the century most discussions about Russian foreign policy eventually turn to energy, specifically oil and natural gas. Consequently, the 2006 cutoff of gas exports to Ukraine is almost always mentioned. This supply cutoff, unlike others in the 1990's, is given more attention because it led to noticeable disruptions of supplies to European states. The cutoff stemmed from the Russian government's decision to sharply raise the price of natural gas exports to Ukraine, and the Ukrainian government's refusal to accept the new prices. With the aim of explaining the cutoff from the Russian point of view, the main question this project attempts to answer is: what brought about the steep price increase for natural gas shipments from Russia to Ukraine in 2006? This question offers an opportunity to look at an event in Russia's foreign policy that has great practical importance, and is also theoretically interesting and challenging.

This project makes a contribution to the literature concerning the practical implications of the Russia-Ukraine natural gas dispute in 2006, and to the literature concerning multi-level analysis in international relations theory. In terms of this issues practical importance, a better understanding of what brought about the Russian price increases can shed light on the role that natural gas plays in Russia's foreign policy. In terms of international relations theory, this project serves as an example of how methodological individualism can be used to bring together individual, state, and system level variables when explaining events in international politics.

This chapter will begin with a discussion of the 2006 cutoff and provide some background information on the European and Eurasian natural gas trade. This will be followed by a discussion of the theoretical challenge this research question poses, the mechanisms based approach employed in this projects answer to overcome this challenge, and some of the key components of the explanation proposed.

The Dispute and Context

Ukraine paid relatively low prices for Russian gas imports until 2006 when it eventually faced pressures to pay increased prices. Ukraine paid $50 USD per 1000 cm (thousand cubic meters) of natural gas imported from Russia from as early as 1999, but in the final days of 2005 Gazprom attempted to increase the price of Russian natural gas to $230 USD per 1000 cm.[1] The conflict began in March 2005 when the Ukrainian government suggested that it might increase the transit fee charged to Russia for shipping gas to Europe. These actions led the Russian side to reconsider other aspects of the 2002 contract which governed gas trade between the two states, specifically price.[2] Gazprom followed in June 2005 by suggesting that it would raise prices over the next three years to bring the prices that CIS (Commonwealth of Independent States) customers paid in line with the prices paid by states in Europe. This statement was matched by the passage of a bill in the Russian Duma which called on CIS customers to begin paying higher prices for gas imported from Russia.[3] From this point onwards the Russian government insisted that the price paid by Ukrainian importers should rise to $160 USD per 1000 cm in 2006. Ukraine claimed that it was only able to pay $80 USD per 1000 cm in 2006.[4] This resistance from the Ukrainian government

[1] Simon, Pirani, "Ukraine's Gas Sector," *Oxford Institute Of Energy Studies*, June 2007, 28, http://www.oxfordenergy.org/pdfs/NG21.pdf, Accessed January 15 2009. Also see: Andreas Heinrich, "Gazprom's Pipeline Policies: The Russian Ukrainian Gas Crisis Of January 2006," (Paper Presented at International Conference on International Relations in Eastern Europe, Berlin, Germany March 16-18 2006), 10.
[2] Andreas Heinrich, "Gazprom's Pipeline Policies: The Russian Ukrainian Gas Crisis Of January 2006," (Paper Presented at International Conference on International Relations in Eastern Europe, Berlin, Germany March 16-18 2006), 6.
[3] Ibid., 7.
[4] Jonathan Stern, "The Russian Ukrainian Gas Crisis of January 2006" *Oxford Institute of Energy Studies,* Jan 16 2006, 6, http://www.oxfordenergy.org/pdfs/comment_0106.pdf, Accessed April 8 2008.

led the Russian side to threaten supply disruptions, and to raise the potential export price to $230 USD per 1000 cm.[5] After the Russian government cutoff gas supplies to Ukraine due to its refusal to pay the new prices, Ukraine continued to siphon gas from the pipelines transiting Ukrainian territory, leading to supply shortfalls in Europe.[6] A deal was eventually reached whereby Ukraine bought a mixture of Russian and Central Asian gas through an intermediary (partially owned by Gazprom), which purchased gas from Gazprom and Gazprom subsidiaries and then sold it to Ukraine for $95 USD per 1000 cm.[7]

Figure 1.1 European and Eurasian Natural Gas Infrastructure[8]

E.U. Natural Gas Market

Natural gas makes up roughly 25% of the E.U.'s total energy mix. [9] This number is expected to increase over the next 20 years by roughly 10%, making growth in natural gas

[5] Andreas Heinrich, "Gazprom's Pipeline Policies: The Russian Ukrainian Gas Crisis Of January 2006," (Paper Presented at International Conference on International Relations in Eastern Europe, Berlin, Germany, March 16-18 2006), 8.
[6]Ibid.
[7] Ibid., 9-10.
[8] Energy Information Agency, "Country Analysis Briefs: Ukraine," August 2007, http://www.eia.doe.gov/emeu/cabs/Ukraine/NaturalGas.html, Accessed May 12 2009.

consumption greater than that of any other currently available fuels.[10] Given the inability of North Sea reserves to meet this growing demand, Europe's dependence on imported natural gas is expected to increase from its current 50% reliance on imports, to more than 80% reliance on imports over the next 20 years.[11] This has heightened the E.U.'s sensitivity to issues surrounding security of supply. Currently, the E.U. is reliant on the Russian Federation for more than a quarter of its imported gas. While the exact figures vary, Russia is expected to supply the E.U. with roughly 70% of its imported natural gas by 2020.[12] These factors have placed issues surrounding access to natural gas at the heart of discussions surrounding E.U. energy security. Given Russia's role as a crucial exporter and Ukraine's role as a major transit route, these two states are found at the heart of most discussions surrounding E.U. access to natural gas.

Russia

Russia holds roughly 26% of the world's proved natural gas reserves while holding a share of 21% of global production and 28% of the world's total exports.[13] These statistics suggest that Russia is the most important gas exporting country in the world. Furthermore, natural gas exports provide crucial budget revenues and cheap internal gas prices can serve as

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[9]Gawdat Bahgat, "Europe's Energy Security: Challenges and Opportunities," *International Affairs,* 82 no. 5 (2006), 3.
[10]Gawdat Bahgat, "Europe's Energy Security: Challenges and Opportunities," *International Affairs,* 82 no. 5 (2006), 3.
[11]Ibid.
[12]Christain von Herschhausen, Berit Meinhart, Ferdinand Pavel, "Transporting Russian Gas to Western Europe," *Energy Journal,* 26 no. 2, (April 2005), 52.
[13]Reports and Publications, "British Petroleum Statistical Review of World Energy 2007" British Petroleum, 22. http://www.bp.com/liveassets/bp_internet/globalbp/globalbp_uk_english/reports_and_publications/statistical_energy_review_2007/STAGING/local_assets/downloads/pdf/statistical_review_of_world_energy_full_report_2007.pdf, Accessed on June 7 2008.

a major advantage for Russian industry. Both of these factors have been integral to Russia's economic revival.[14]

Natural gas exports from the Russian Federation are now controlled by the state controlled multinational corporation Gazprom, and decisions regarding export, transportation, and investment are essentially controlled by the government.[15]

Though Russia's position as an important natural gas supplier is evident, the state also faces challenges regarding diminishing increases in production, and a lack of investment in the industry which is necessary to sustain production and exports at their current rates. Though Russia has increased its gas production since 2002, the rate of the increase has been low and is declining.[16] The major production fields of Western Siberia (Yamburg, Urengoy, and Medvezhe) which provide much of the gas exported to the E.U., Ukraine, and Belarus are all in decline, and investment is required to slow this decline. Investment is also required to start extraction from large fields on the Yamal Peninsula, which can take advantage of already existing pipeline infrastructure.[17] This slowdown of production increases has meant that without imports and then re-exports of gas from third parties, Gazprom will be unable to meet its domestic and international contractual obligations.

Russia sends roughly 60% of its total natural gas exports to states of the E.U.[18], and given the constrains posed by the inflexibility and cost of pipelines required for export, there is little alternative short term demand for these supplies. Couple this with the fact that E.U.

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[14]Filippos Proedrou, "The EU-Russia Energy Approach Under the Prism of Interdependence," *European Security*, 16 no. 3, (Sept/Dec. 2007), 333.

[15]Ken Koyama, "The Energy Dimension in Russian Global Strategy," *The James A. Baker III Institute for Public Policy of Rice University* (October 2004), 13-14.

[16]Fiona Hill, Florence Fee, "Fuelling The Future: Prospects for Oil and Gas," *Demokratizatsya*, 10 no. 4 (Fall 2002), 471.

[17]Jonathan Stern, *The Future of Russian Gas and Gazprom* (New York: Oxford University Press, 2005), 6-10.

[18]Filippos Proedrou, "The EU-Russia Energy Approach Under the Prism of Interdependence," *European Security*, 16 no. 3 (Sept/Dec. 2007), 335.

states pay the highest prices for Russian gas exports and it becomes clear that Russia needs the E.U. market.[19] Important to this study is the fact that more than 80% of Russian exported gas to Europe must traverse Ukrainian pipelines. This makes E.U. supplies vulnerable to supply disruptions as a result of breakdowns in Russia's relationship with Ukraine, and makes an explanation of these breakdowns important for empirical reasons.

Ukraine: a gas bridge to Europe

Ukraine, since the collapse of the Soviet Union, has attempted to diversify its gas supplies to become less reliant on Russian production. In the mid 2000's imports from Russia totalled between 20-25 bcm (billion cubic meters) per year, while 35-37 bcm were provided by Central Asian countries, primarily Turkmenistan, and 18-20 bcm were produced domestically.[20] This diversification has not limited the role of Russia in gas exports to Ukraine as Russia's Gazprom controls all the export pipelines out of Central Asia leading to Ukraine; however, until recently the Ukrainian government has been able to negotiate bilateral arrangements regarding prices with Turkmenistan. The trade between Turkmenistan and Ukraine, facilitated by Russia, has been characterized by the use of intermediary companies which buy Turkmen gas from Gazprom, use Gazprom pipelines to ship the product, then sell that gas to Ukraine. These intermediaries, until recently, have been able to operate outside the direct control of Gazprom and the Russian government.

Russia and the E.U. are reliant on Ukraine for transit of natural gas. The Ukrainian gas transit system is majority controlled by Naftogaz, which is majority owned by the Ukrainian

[19] Filippos Proedrou, "The EU-Russia Energy Approach Under the Prism of Interdependence," *European Security*, 16 no. 3 (Sept/Dec. 2007), 335.

[20] Simon, Pirani, "Ukraine's Gas Sector," *Oxford Institute Of Energy Studies* (June 2007), 28, http://www.oxfordenergy.org/pdfs/NG21.pdf, Accessed January 15 2009.

government.[21] The Trans-Ukrainian pipeline network ranks among the world's largest and serves users inside and outside the E.U. including Romania, the Balkans, Turkey, Slovakia, Poland, and Hungary.[22] Many of these states pass some of that gas onto users further west, predominantly Germany, France, and Italy. In all, from 2000 to 2005, 37,800 km of pipelines transited an average 128.7 bcm (billion cubic meters) of natural gas through Ukraine per year.[23]

Figure 1.2 Ukrainian Pipeline Infrastructure[24]

Turkmenistan

Turkmenistan plays a substantial role in Russia's gas dealings with former Soviet states, Ukraine in particular. Turkmenistan has the world's twelfth largest natural gas proved reserves, and had exports in 2007 of 58 bcm per year, making it the seventh largest gas

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[21]Simon, Pirani, "Ukraine's Gas Sector," *Oxford Institute Of Energy Studies* (June 2007), 73, http://www.oxfordenergy.org/pdfs/NG21.pdf, Accessed January 15 2009.
[22]Ibid.
[23]Ibid, 28.
[24] Offnews.info, "This is not all about Moscow, Germany has a stake as well," http://www.offnews.info/verArticulo.php?contenidoID=2694, Accessed May 26 2009.

exporter in the world.[25] While Russia depends on Ukraine for natural gas transit to Europe, Russia's role is reversed in the case of Turkmenistan, and it becomes the transit state controlling the only major[26] export channels for Turkmen natural gas. The Central-Asia-Centre (CAC) pipeline system, built during the Soviet period, is the principal export route for Turkmen gas. Though several alternative pipeline routes have been proposed, specifically the Trans-Afghan pipeline project and the Trans-Caspian Pipeline project, the unstable future of the Afghan security situation, and the unsettled legal status of the Caspian Sea, have respectively stopped these alternative routes from materializing. Turkmenistan's ability to supply enough gas to meet the needs of these pipelines and fulfil their agreements with the government of Russia is uncertain at best.

Coordinating the Russian-Turkmen-Ukrainian natural gas trade has proven difficult during the post Soviet period. The Russian government's desire to control Turkmen resources and use them to maximize the profitability of Russian gas exports to Europe has been apparent,[27] as has been its desire to keep Turkmen export prices to Russia low.[28] This has been a difficult hurdle for the Turkmen government to overcome as their only major recourse has been to cutoff supplies. The use of intermediary companies rather than direct dealings with Gazprom has further complicated the issue concerning trade with Ukraine.

Intermediaries in Russian Ukrainian Gas Trade

As outlined above, Ukraine does not get all of its natural gas imports from Russia. Ukraine currently relies on imports from Turkmenistan to meet over half of its domestic

[25] CIA World Fact Bbook, "Turkmenistan," CIA, https://www.cia.gov/library/publications/the-world-factbook/rankorder/2183rank.html, Accessed June 8 2008.
[26] There is also a pipeline from Turkmenistan to Northern Iran which can transit roughly 10 bcm per year.
[27] David Victor, Amy M. Jaffe, Mark H. Hayes, *Natural Gas and Geopolitics From 1970 to 2040 (* New York: Cambridge University Press, 2006), 224.
[28] Ibid., 223-224.

natural gas needs.[29] This creates a transit problem as the only way to transit gas from Turkmenistan to Ukraine is through Gazprom controlled pipelines.[30] The question of why an intermediary company is needed has been hotly debated as Gazprom alone seems capable of facilitating gas trade between Turkmenistan and Ukraine. The rationale for the intermediary companies runs along two tracks. The first track suggests that due to the heavily politicised nature of Gazprom, private intermediaries are better suited for debt collection and better able to enforce commercial rules and decisions without risking heightened political tensions.[31] The second track suggests that the main goal of these intermediary companies is to create, capture, and distribute resource rents.[32] These companies have come and gone but their ownership structures have always been opaque, and their deals in many cases are questionable from both economic and sometimes legal perspectives.[33] For the purposes of the framework presented in the next chapter the economic and legal legitimacy of these company's actions is less important than the variation in the control Gazprom has had over them, and their involvement in the trade between Russia, Turkmenistan, and Ukraine.

Corruption and The Russia-Ukraine Natural Gas Trade

The corrupt nature of Russia's business climate poses many challenges for researchers. Where rent distribution is concerned since, as Wallderan suggests, corruption is a core feature

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[29] Global Witness, "It's a Gas: Funny Business in the Turkmen-Ukrainian Gas Trade," *Global Witness Publishing*: Washington DC. (April, 2006), 21, http://www.globalwitness.org/media_library_detail.php/479/en/its_a_gas._funny_business_in_the_turkmen_ukraine_g, Accessed May 8 2008.
[30] Ibid, 32.
[31] Ibid.
[32] Celeste A. Wallander, "Russian Transimperialism and its Implications," *The Washington Quarterly,* 30 no. 2 (Spring 2007), 111.
[33] Global Witness, "It's a Gas: Funny Business in the Turkmen-Ukrainian Gas Trade," *Global Witness Publishing*: Washington DC. (April 2006), 32, http://www.globalwitness.org/media_library_detail.php/479/en/its_a_gas._funny_business_in_the_turkmen_ukraine_g, Accessed May 8 2008.

of Russia's patrimonial system[34] it can be difficult to track the flow of rents. There is no accounting of under-the-table transactions, bribes paid, or profits illegally moved into foreign accounts. Nonetheless, Russia has consistently ranked very low on Transparency International's Corruption Perception Index since 1996, frequently ranking amongst the most corrupt third of countries appearing in the survey.[35] Other states of concern in this project fare little better on this index, with Ukraine also ranking in the bottom third of the list from 1998 to present, and Turkmenistan, which only appeared on the list in 2005, ranking consistently lower than Russia or Ukraine.[36] Further, the intermediary companies discussed above are generally shrouded in secrecy. These intermediary companies play an important role in the Russia-Turkmenistan-Ukraine natural gas trade, and while some information is available about their ownership, it is generally difficult to discern who controls these companies, and who benefits from their activities. If these companies' purpose is to capture rents, as many leading corruption experts suggest[37], not knowing who controls the companies can be problematic.

With this said, the goal of this project is not to untangle the web of corruption that almost certainly ensnares the Russian natural gas industry; rather, it focuses on illustrating as well as possible the patterns of rent capture and distribution, and the role this pattern played in natural gas price hikes for Ukraine, given the information available. Where issues of privatization (1995-1999) are concerned, more information has been made available over time, which allows some of the corrupt dealings that took place during privatization to be

[34] Celeste A. Wallander, "Russian Transimperialism and its Implications," *The Washington Quarterly,* 30 no. 2 (Spring 2007), 116.

[35] Transparency International, Corruption Perception Index, 1996-2008, http://www.transparency.org/policy_research/surveys_indices/cpi, Accessed May 10 2009.

[36] Ibid.

[37] Celeste A. Wallander, "Russian Transimperialism and its Implications," *The Washington Quarterly,* 30 no. 2 (Spring 2007), 111.

highlighted. Moving into the new century, much less information is available about the clandestine destination of resource rents under the Putin administration. This being the case, rather than speculating on the corrupt dealings of natural gas industry officials this paper focuses on overt indications of natural resource rent capture and distribution by the Russian state during the period 2000 to 2009. This is not ideal, as surely some information surrounding corruption in Russia's natural resource sectors could shed additional light on the issue at hand; however, in order to avoid too much speculation this project not cepts corruption in the capture and distribution of natural resource rents, but does not seek to detail or explain it in relying instead on aspects of government spending. This government spending could in some cases be classified as corrupt in nature but not in all cases.

The Deterioration of Ukrainian-Russian Relations in the Period Prior Up to the Price Increase

The natural gas price increases that are the focus of inquiry of this research project are often attributed to the shift in Ukrainian foreign policy expected and perceived after Viktor Yushchenko came to power on the heels of what has become known as the Orange Revolution. The presidential elections that took place in Ukraine in late 2004 pitted a Kremlin favourite, Viktor Yanukovych, against the western-backed opposition candidate Yushchenko. After the second round of the election it appeared initially that Yanukovych had been victorious by a slim margin, and he was declared the winner by the Ukrainian Central Electoral Commission. Yushchenko's supporters, claiming that rampant election fraud brought Yanukovych to power, took peacefully to the streets demanding that the result be voided, and that another election round should take place.[38] After votes in the Ukrainian

[38] BBC News, "Timeline: Battle for Ukraine," January 23, 2005, http://news.bbc.co.uk/2/hi/europe/4061253.stm, Accessed April 4 2009.

parliament nullified the second round of voting, and paved the way for a third round, protests were scaled down and a new round of election campaigning began. In the third round of voting on December 26, Yushchenko garnered close to 52% of the votes and on January 11 2005 he was declared the winner by the Ukrainian Electoral Commission.[39]

Since Putin strongly supported Yanukovych, even in the face of Ukrainian and western condemnation of the apparent election fraud that brought him victory in the second round of the election, it is not unreasonable to suggest that the Orange Revolution marked a low point in Russian-Ukrainian relations. Combine this with the fact that Yushchenko openly championed closer ties with European states and the United States, while Yanukovych was certainly perceived to be pro Russia in his foreign policy approach, and it is impossible to deny that the Kremlin came up with the short end of the stick after the dust settled. Further, Yushchenko's election victory certainly marked a European and Western oriented foreign policy shift for Ukraine.

Since the initial demand for an increase in the price of natural gas exported from and through Russia to Ukraine came less than a year after this deterioration in Russian-Ukrainian relations, the Orange Revolution probably played some role in the Russian government's decision to raise prices. Even under the pro-Kremlin president Leonid Kuchma, however, Ukrainian officials openly announced their desire to join NATO in 2002[40], and talks took place with the European Union regarding Ukrainian membership as early as 1999.[41] Thus

[39] BBC News, "Timeline: Battle for Ukraine," January 23, 2005, http://news.bbc.co.uk/2/hi/europe/4061253.stm, Accessed April 4 2009.

[40] Terry Terriff, Stuart Croft, Elke Krahmann, Mark Webber, Jolyon Howorth, "One in All in? NATO's Next Enlargement," *International Affairs*, 78 no. 4, (Oct., 2002), 713.

[41] Europa, Press Release Rapid, "President Prodi meets President Kuchma of Ukraine on 5 December 1999," December 6, 1999,

Yushchenko's intentions to join these institutions do not represent a clear break from the policies of his supposedly pro-Kremlin predecessor. Further, Ukraine was a member of the United States dominated 'coalition of the willing,' which took on the task of invading Iraq and removing Sadam Hussein from power in 2003. Ukraine sent more than 1,600 troops to the region, in the face of the Russian government's opposition to the operation. These actions represent a certain pro-Western orientation on the part of President Kuchma, and raises questions about the degree to which Yushchenko's election would alter Ukraine's basic foreign policy course.

The moderately pro-Western foreign policy orientation of Yushchenko's predecessor, when considered in conjunction with gas price increases for states apparently still loyal to the Kremlin (Belarus), bring in to question the role that the Orange Revolution played in the Russian government's decision to increase natural gas export prices to Ukraine. For these reason the foreign policy orientation of Ukraine will not be considered in the following explanation. This will allow for other factors to come to light which surely had a bearing on the decision of the Russian government, illustrating that even in the absence of the Orange Revolution, and a more Western oriented foreign policy, prices increases for Ukraine would almost surely have been introduced.

The 2006 Russia-Ukraine Gas Dispute: a Challenge for International Relations Theory

A cursory inquiry into what brought about the 2006 cutoff would likely yield an explanation that suggests the price increase was the Russian government's punishment for a drift in Ukrainian foreign policy toward institutions such as NATO and the E.U., and away

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http://europa.eu/rapid/pressReleasesAction.do?reference=IP/99/944&format=HTML&aged=0&language=EN&guiLanguage=en, Accessed April 3 2009.

from Russia, especially after the so-called Orange Revolution of 2004-2005. This explanation is favoured foremost by the media. While this explanation is simple and popular, it fails to capture other noteworthy trends in Russian politics and foreign policy that also contributed to this event. These trends include Russia's historically patrimonial society, the increased rent generating potential of natural gas extraction and export, changes in the personnel managing the Russia's natural gas industry, the Russian government's increasing control over the natural gas industry, and the increasing importance of Turkmen gas exports in the regional natural gas mix. These factors conveniently represent the three levels of analysis generally considered to be important in international relations theory: the individual, the state, and the system. Some of these issues are touched on in the academic literature discussing the nature of Russia's foreign policy and political economy. Many of these works touch on the 2006 cutoff, but the analysis is generally fleeting, and multi-level analysis is rare. The challenging part of providing an explanation for the cutoff is bringing these multiple levels of analysis together in a coherent fashion.

For international relations theorists the question of which level of analysis to study, and when, has been a lingering one. Though there have been calls for greater attention to theory synthesis[42] and some attempts at unifying the individual, state, and system levels of analysis into theories and frameworks,[43] these attempts have been limited, and have not been applied to the 2006 Ukrainian-Russian gas crisis. While this paper deals with the price increase due to its empirical importance, it also attempts to build a framework that takes all of these levels of analysis into account when explaining the Russian government's decision to

[42] Robert D. Putnam, "Diplomacy and Domestic Politics: The Logic of Two Level Games," *International Organization*, 42 no. 3 (Summer 1988), 427-460.
[43] Gideon Rose, "Neo-Classical Realism and Theories of Foreign Policy," *World Politics* 51 no. 1 (October 1998), 144-172.

raise natural gas export prices to Ukraine in 2006. In this pursuit, the mechanisms which bring together macro level events such as increasing global energy prices and changes in the Russian state's capabilities will be investigated, while the actions of individuals will be explored using the logic of methodological individualism.

The Virtues and Challenges of Methodological Individualism

Before moving forward the meaning of the word mechanism in the context of this study should be clarified. A mechanisms based approach assumes that a correlation between events and variables is insufficient to fully explain an event. Put another way, if there is a non random relationship is observed between A and B, there must also be a mechanism M which brings about the relationship, and this is of great significance in the social sciences.[44] Essentially, to provide as detailed and accurate an explanation as possible of one event bringing about another it is important to specify the "social cogs and wheels that have brought the relationship into existence."[45]

How methodological individualism relates to this paper's overall argument will be dealt with more in the next chapter; for now the concept itself will be explored. The application of this approach to political science was laid out by Headstrom and Swedburg in a 1996 article entitled "Social Mechanisms."[46] According to Headsrom and Swedburg, "methodological individualism is motivated by the core idea . . .[that]. . . understanding is obtained or enhanced by making explicit the underlying generative mechanisms that link one state or event to another . . ."[47] At its core the principle of methodological individualism

[44] Peter Hedstrom, Richard Swedburg, "Social Mechanisms," *Acta Sociologica,* 39 no. 3 (1996), 288.
[45] Ibid., 286.
[46] Ibid.
[47] Ibid., 290.

assumes that individuals are the causal agents in the social sciences.[48] This makes identification of individual's intentions, beliefs and preferences, along with the causes and consequences of their action, essential to any attempt at a mechanism based explanation.[49] For this approach to be successful, well reasoned assumptions regarding the preferences and intentions of individuals that cannot be observed, other than through their effects, must be made.[50] This can certainly be a difficult process as it is impossible to climb inside the thoughts and feelings of an individual and determine the exact cause of his/her actions. In this sense, mechanisms are "theoretical constructs that provide hypothetical links between observable events."[51]

Headsrom and Swedburg, go on to offer a more illustrative conception of social mechanisms and the use of methodological individualism which highlights three specific types of mechanisms. First is the "situational mechanism" which links a social structure to the beliefs, desires, and opportunities of individuals (condition → belief). This covers the transition from the macro level event to its manifestation at the micro or individual level. The second mechanism, the "individual action mechanism," shows how individuals' desires, beliefs, and opportunities generate specific actions (belief → action). This mechanism covers why individuals act the way they do. The third mechanism is the "transformational mechanism" which shows how the actions of individuals come together and transform into collective outcomes (action → outcome). This covers the transition from the actions of individuals (micro level) to collective macro outcomes.[52] This approach's relationship to the question at hand will be further identified in the next chapter. For now, however, it can be

[48] Hedstrom, Richard Swedburg, "Social Mechanisms," *Acta Sociologica,* 39 no. 3 (1996), 290.
[49] Ibid.
[50] Ibid.
[51] Ibid.
[52] Ibid., 297.

seen that this approach offers a way to bring together the different levels of analysis generally used in international relations theory.

The mechanisms outlined above are not themselves variables. The mechanisms represent the relationships between variables and in some ways are reliant on the same variables, but they do not vary as the variables do in this explanation. The variances in the variables, especially condition, are what influence the outcomes these mechanisms, which retain their initial character throughout, produce, and are what bring about changes in beliefs, actions, and outcomes.

This paper will provide a mechanism based explanation for the Russian government's price increases. The thrust of the argument is that the macro level event, the Russian government's decision to increase the price for which it exports natural gas to Ukraine, is determined by a number of other macro level phenomena. These phenomena include: the patrimonial authoritarian nature of Russia's political structure; a change in the object of rent seeking and distribution in this patrimonial situation; increased state control over the natural gas industry; and the increasing regional importance of Turkmen gas. It is further argued that devoting greater attention to the causes and consequences of human action and reaction is the best approach to take to explain these macro level phenomena and how they influenced the Russian government's decision to raise prices. The remainder of this chapter will discuss the key variances in the condition of Russia's political and economic organization, the patrimonial nature of Russian society and the nature of rents in the Russian context. These variances can be highlighted as the two major changes which are keys to the explanation of the Russian government's price increases for natural gas exports to Ukraine.

Patrimonialism and Rents in Russia

Patrimonialism simply defined is a political system based on the capture of rents by a patron to be distributed to clients in return for political support.[53] The history of patrimonialism in Russia has been discussed by a number of authors. Hedlund suggests that the lasting outcome of post-Soviet economic reform in Russia has been a "return to traditional Muscovite games of neglasnost and vicious in-fighting over seats close to the tsar, coupled with remuneration for 'service' that takes place via a host of informal clandestine channels."[54] The result is a political system in which linkages are vertical and rewards for political support are best ensured through close links to domestic elites, most prominently the President. Wallander suggests that Russia's current domestic political configuration rests on the creation and distribution of rents in return for political support. Under this system "the patron remains in power by rewarding clients, and the clients are rewarded by supporting their patron. The patron requires support from his clients, and he must access and distribute rents for that support."[55] While these are characterizations of the state of Russian patrimonialism after the dissolution of the Soviet Union other authors, most prominently Richard Pipes, have highlighted the patrimonial nature of the Soviet and pre-Soviet systems of rule.[56] Though patrimonial rule is characteristic of Russian politics and appears to have changed very little since the Soviet collapse, the source of rents has varied since Russian independence, as has the authoritarian nature of the ruling regime. It is this variance in the source of rents, and the role the state plays in capturing and distributing them, that are of great consequence to this project.

[53] Celeste A. Wallander, "Russian Transimperialism and its Implications," *The Washington Quarterly,* 30 no. 2 (Spring 2007), 116.
[54] Stefan Hedlund, "Rents, Rights and Service: Boyar Economics and the Putin Transition," *Problems of Post Communisim,* 55 no. 4 (July/August 2008), 39.
[55] Celeste A. Wallander, "Russian Transimperialism and its Implications," *The Washington Quarterly,* 30 no. 2 (Spring 2007), 116.
[56]Richard Pipes, *Russia Under the Old Regime* (Toronto: Penguin Publishing, 1974).

Rents in the Russian Context

There are many definitions of rents. For this project two simple definitions of rents are used. Where natural resources (specifically natural gas) are concerned one definition comes from the Clifford Gaddy and Barry Ickes article "Resource Rents and the Russian Economy (2005)."[57] Gaddy and Ickes take rents to equal revenue received from sales minus the cost of production (assuming that production is efficient, there is free market entry, and taking into account a "normal" return on investment including labour).[58] Taking into account the lack of free entry into the market and chronic inefficiency in the Russian natural gas industry the rents generated are likely greater than this definition allows for. These two authors suggest that rents generated by the extraction and sale of natural resources can be distributed over five categories. These categories consist of excess cost of production, price subsidies, formal tax, informal tax, and after tax profit.[59]

Rents can also be distributed in the form of property and such distributions took place throughout the 1990's. In a March 2000 working paper produced for the World Bank, Ethan Kapstein and Branko Milanovic illustrate a formula whereby rents are equal to the market price of an asset minus what it is actually sold for.[60] They further highlight the balancing act that Yeltsin played in the 1990's, essentially distributing property and tax concessions to

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[57] Clifford G. Gaddy, Barry W. Ickes, "Resource Rents and the Russian Economy," *Eurasian Geography and Economics,* 46 no. 8 (2005), 559-583.
[58] Ibid., 560.
[59] Clifford G. Gaddy, Barry W. Ickes, "Resource Rents and the Russian Economy," *Eurasian Geography and Economics,* 46 no. 8 (2005), 565.
[60] Ethan Kapstein, Branko Milanovic, "Dividing The Spoils: Pensions, Privatization, and Reform in Russia's Transition," *World Bank Development Research Group Poverty and Human Resources* (May 2000), 4, http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2000/03/21/000094946_00022905315633/Rendered/PDF/multi_page.pdf, Accessed April 23 2009.

business elites in return for electoral support, while decreasing transfers to pensioners and government employees.[61]

While obviously different in form, these two definitions illustrate the key characteristic feature of rents; profits above and beyond what could be attained under a perfect market situation. Macro level events such as increased demand for natural resources or revolution can influence the form in which rents are available, which will in turn alter the actions of rent seekers and distributers. For the President to capture rents it is imperative that the state control the segment of the economy in which those rents are generated.

The Way Forward

This chapter has introduced the question of why the Russian government drastically increased natural gas export prices to Ukraine at the beginning of 2006. Through discussion of the nature of the European and Eurasian natural gas markets, with specific reference to Russia, Ukraine, Turkmenistan, and the E.U., the context in which the Russian government's decision took place has also been presented. Furthermore, corruption in the Russian natural gas industry and the deterioration of Russian-Ukrainian relations prior to the gas crisis, have been briefly discussed. The answer this study proposes has been touched on, along with a brief discussion of the mechanisms based approach and the logic of methodological individualism, that will be employed in this project. The next chapter will deal more thoroughly with the answer to this question, specifically referring to its theoretical background, the role mechanisms play in the explanation, the assumptions it rests on, and the method for testing the

[61] Ethan Kapstein, Branko Milanovic, "Dividing The Spoils: Pensions, Privatization, and Reform in Russia's Transition," *World Bank Development Research Group Poverty and Human Resources* (May 2000), 28, http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/2000/03/21/000094946_00022905315633/Rendered/PDF/multi_page.pdf, Accessed April 23 2009.

framework. The third chapter will survey the existing academic literature that has offered explanations for this development. The fourth, fifth, and sixth chapters will explore the explanation provided in Chapter Two with reference to three time periods: 1995-1999, 2000-2004, and 2005-2008. The final chapter will consider some of the implications of this study's findings for international relations theory, and for the Russian natural gas industry and its relationship with Russian foreign policy.

Chapter Two

Framework and Methodology

This chapter will begin by outlining the assumptions and theoretical background that underpin the brief explanation of price increases presented in the first chapter. The focus will then shift to the situational, individual action, and transformational mechanisms, as well as the factors influencing these mechanisms, specifically with respect to natural gas export prices charged to Ukraine. Further, this chapter will touch on other ideas in international relations theory literature which are illustrative of each of the outcomes the mechanisms mentioned in Chapter One produce. Finally, the case study methodology which will be used to test the theory will be justified, and the evidence being used will be discussed.

Identifying Mechanisms

According to Headstrom and Swedberg, a mechanism based explanation must meet three criteria. First, it must be based on the principle of direct causality. This principle essentially strives to detail the relationship among phenomena in the best as possible fashion. Second, it must be based on the principle of limited scope. This is the idea that the social sciences should not try to establish universal laws but rather seek explanations aimed at explaining a limited range of phenomena. Third and finally, it must be based on the principle of methodological individualism. This principle essentially holds that it is individuals and not macro level variables that play the role of actors in the social sciences, and it is the actions of individuals which bring about macro level phenomena. The three mechanism discussed in the first chapter is a corollary to this last principle and maps the way forward for this explanation.[62]

While the principle of direct causality is somewhat loosely defined by Headsrom and Swedberg, an attempt at opening the “black box” is surely exemplified in this project’s approach. While the chain of macro level events identified as important to this project correlate well with the Russian government’s export price increases, assumptions regarding the rent seeking tendencies of individuals provide deeper insights beyond macro level black box variables. This is more like shrinking the black box than opening it, as it is still necessary to make assumptions regarding individual preferences. Further, while an explanation of the change in The Russian government’s natural gas pricing for Ukraine in 2006 requires an explanation that more generally covers Russian natural gas export pricing to Ukraine over time, not simply in 2006, the scope of the overall project is still rather limited. Finally this project looks at individuals as causal agents, and attempts to explain macro level phenomena through the study of individual action, the essence of methodological individualism.

Situational Mechanism and Conditions

As discussed earlier the situational mechanism links social structure to the beliefs, desires, and opportunities of individuals. Wallander lays out the essential structure of Russian society quite succinctly, suggesting:

> The political system is based on the political control of economic resources in order to enrich those within patron-client clans. The patron remains in power by rewarding clients, and the clients are rewarded by supporting their patron. The patron requires

[62] Peter Hedstrom, Richard Swedburg, “Social Mechanisms,” *Acta Sociologica,* 39 no. 3 (1996), 298-299.

> support from his clients, and he must access and distribute rents for that support. . . Each of these individuals' clients in turn has his own set of clients, who are in turn patrons of their own clans, and so on, creating a complex web of relationships that sustain political power and distribute patronage rents.[63]

The changes in the conditions guiding individual actors in Russia are the main cause of the initial decrease and eventual increase in the cost of natural gas exported from Russia to Ukraine. The patrimonial nature of Russian society varied between 1995 and 2008 in four ways. First, the source of rents changed from property to rents generated by the extraction and sale of energy resources. Second, from 2000 onward Russia's ruling regime became more authoritarian. Third, the state's ability to control the natural gas industry decreased from 1995 to 1999, while it increased from 2000 to 2008. Fourth, Turkmen natural gas grew in importance and competition for access to this gas increased from 2005 to 2008. It is these variations that caused outcomes in the Russian natural gas industry which affected the Russian government's natural gas export prices to Ukraine. Attention to the individual action mechanism will illustrate why, but first the changes in the conditions influencing the situational mechanism mentioned above should be given further attention.

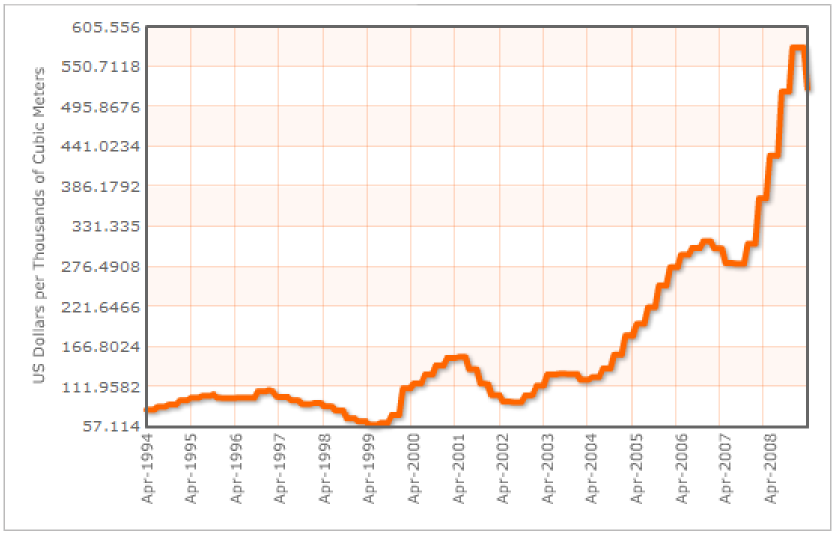
Global Oil Prices, Russian Natural Gas, and Rents

While there is no "global market price" for natural gas, Russia and other states often price their natural gas exports in reference to world oil prices. Different producers index their gas prices in reference to a variety of fuel baskets; what is important for our purposes here is simply the fact that a decline in oil or alternative fuel prices will usually bring about a decline in the price of natural gas over the medium term. The late 1990's saw oil prices decrease

[63] Celeste A. Wallander, "Russian Transimperialism and its Implications," *The Washington Quarterly,* 30 no. 2 (Spring 2007), 116.

substantially, bottoming out in 1999 due to depressed demand likely stemming from the economic crisis across Asia and the former Soviet Union. 1999 saw increases, but barely enough to bring prices back to pre-1995 levels. Russian natural gas pricing at the German border followed a similar pattern. A comparison of the pricing history of the two commodities over time will illustrate the point.

Russian Natural Gas Prices at German Border 1994-2008 (figure 2.1)[64]



World Oil Prices 1994-2008 (figure 2.2)[65]

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64 Index Mundi "Russian Natural Gas Monthly Price 15 Years," Commodity Data, http://indexmundi.com/commodities/?commodity=russian-natural-gas&months=180, Accessed March 31 2009.

65 Index Mundi "Crude Oil (Petroleum) Monthly Prices 15 years," Commodity Data, http://indexmundi.com/commodities/?commodity=crude-oil&months=180, Accessed March 31 2009.

It can be seen quite clearly by comparing figures 2.1 and 2.2 that Russia's natural gas prices for Europe follow the same general trend as world oil prices. This is important as it illustrates the low value of natural gas in the late 1990's. Oil prices were down so there was little upward pressure on natural gas prices.

With lower prices there are obviously fewer rents to capture. Conversely, when prices are high natural gas can generate more rents. Thus an external systemic force causes variance in the situational mechanism. When prices are low there are fewer rents to distribute, and in a patrimonial society this means that other rents must be found. During the 1990's, when natural gas prices were low, Yeltsin distributed rents in the form of property, as state property was plentiful and there was internal and external support for privatization. When Putin came to power at the turn of the century, oil and natural gas prices rebounded and their rent generating possibilities increased. Putin in turn sought to capture and distribute these rents.

Three further changes in the situational mechanism are important to this project's argument. First, the authoritarian nature of Russia's ruling regime varied somewhat between Yeltsin's term as president and Putin's term. While Yeltsin's power was constrained somewhat by influential business elites, independent regional leaders, and a relatively powerful parliament, upon his accent to President Putin was able to marginalize these groups and secure a more vertical power structure with increased power for the President.

Second, from 1995 to 1999, since individuals were seeking and distributing rents in the form of property, the Russian state lost control over some of the natural gas industry and the markets which it served. With increasing energy prices at the turn of the century this trend was reversed and those controlling the state successfully sought to increase the state's control over the natural gas industry. This is not only a change in the conditions influencing the situational mechanism, but also a result of the individual action mechanism and the transformational mechanism, given the increased rent generating potential of natural gas.

Third, another systemic force closely, but not wholly, linked to increasing global energy prices altered the situational mechanism. This was the increasing regional importance of Turkmen natural gas after 2004. Although, as the case studies that follow will show, the importance of Turkmen gas grew throughout the early 2000's, competition for access to this gas increased later in the decade. When combined with other changes to the situational mechanism discussed above, this factor becomes very important in explaining the Russian government's natural gas price increases for Ukraine.

Individual Action Mechanism: Beliefs and Actions

Before the discussion of individual action continues it is important to note that the individuals being discussed, and not just the individuals' actions, varied over time. At the turn of the century Vladimir Putin replaced Boris Yeltsin as president of the Russian federation, and the individuals who controlled Gazprom during Yeltsin's rule were replaced. This is of great consequence as one might expect individuals to act differently, especially in a patrimonial society, when the person that appoints them is different and has different goals. It might be more telling of the impact of the changes to the situational mechanism if the individuals doing the acting did not vary over time; however, that is not what took place, and thus this paper must proceed taking this into account.

Although the individuals do vary, their actions are similar in two ways. First, both appear to seek rents based on what is most available and lucrative. There were ample rents for the president to distribute in the form of property during the 1990's, and the gas industry officials at the time sought these rents during privatization, and distributed them further to their own clients. During Putin's rule, privatization was put on hold and natural resources began to generate greater rents due to higher prices and greater demand. Putin and those he appointed to control the natural gas industry, specifically Gazprom officials, acted to maximize the state's share of those rents.

Second, appointees appear to have supported the President, their patron. Yeltsin was able to purchase electoral support in 1996 by distributing property to Russia's business elites in return for political support, and privatization was only made possible through concessions to powerful Soviet managers who had connections to the State Duma. Putin made little secret of his belief that the state should play a major role in Russia's natural resources industry, and his appointees to Gazprom supported and pursued this goal. Further, at the request of the President, they stayed removed from opposition politics. These two patterns remain fairly constant over time and appear to be consistent with respect to different individuals, though Yeltsin and his appointees were seeking and distributing different rents than Putin and his team. The variation in the object of rent seeking and distribution brought about a variation in Russian policy outcomes.

Rational Choice Institutionalism

The individual action mechanism shows how individuals' beliefs, desires, and opportunities bring about specific actions.[66] Given the difficulty of determining the beliefs and desires that form the preferences of individuals, the individual action mechanism requires assumptions to be made about those preferences. This project's explanation rests on assumptions about individuals first and foremost. In the vein of rational Choice institutionalism it is assumed that individuals have a given set of preferences. Further, it is

[66] Peter Hedstrom, Richard Swedburg, "Social Mechanisms," *Acta Sociologica,* 39 no. 3 (1996), 297.

assumed that individuals act to maximise these preferences. Two more assumptions are borrowed from the perspective of rational choice institutionalism regarding the structure of the political system. First, political decision making is assumed to consist of a series of collective action dilemmas. It should be said that even in Putin's Russia it takes one to speak and one to listen. Second, institutional rules play an important part in political outcomes.[67] Though inherently corrupt, a patrimonial system has a structure and therefore rules.

The patrimonial structure described in the situational mechanism section is not an institution in the formal sense; rather, it is a system of associations among individuals governed by loose rules. These rules in turn will influence the actions of individuals. Interestingly, Wallander's conceptualization of patrimonial authoritarianism offers some clues concerning the nature of individual preferences in this type of system. This will be the subject of discussion below.

Preferences

While individual preferences are obviously difficult to enumerate, in a patrimonial system it could be assumed that rent maximization is a key preferences for both patrons and clients. The drive for rent maximization will, in turn, cause patrons to seek state control over rent generating activities, and clients to seek to maximise their share of the rents being distributed from the top by supporting their patron. So at least three main preferences for individuals can be highlighted based on the patrimonial nature of Russian society: 1) patrons and clients will both seek to maximize the rents they control; 2) patrons will seek to maximize

[67] Peter A. Hall, Rosemary C. R. Taylor, "Political Science and the Three New Institutionalisms," *Political Studies*, 44 no. 5 (1996), 945.

rents through increasing state control over rent generating sectors of the economy; and 3) clients will seek to maximize their rents by supporting their patron.

Transformational Mechanism: Actions and Outcomes

The transformational mechanism is evident when a number of individuals act and interact with one another, and it shows how individual action produces collective outcomes.[68] The transformational mechanism identified in this project consists of the collective actions of rent seekers. The actions of individuals, conditioned by their preferences for rent seeking, result in transformations at the macro level. When the situational mechanism is defined by patrimonialism through the distribution of property, and a less authoritarian system, this should lead to weakened state control over the natural gas industry, and when Turkmen gas is less important regionally the outcome should be lower prices for Ukrainian natural gas imports from Russia. When the situational mechanism is defined by patrimonialism through the distribution of resource rents and a more authoritarian system the results should be increased state control over the natural gas industry. When combined with the increased regional importance of Turkmen gas the outcome is eventually an increase in the Russian government's export price for natural gas to Ukraine.

Summary of Mechanisms

The way forward for examining the Russian government's decision to increase the price for natural gas it exports to Ukraine is now clear. The questions that must be asked are: 1) what is the nature of the situational mechanism over time?; 2) How did individuals act based on the situational mechanism, assuming, as one might in a patrimonial society, a

[68] Peter Hedstrom, Richard Swedburg, "Social Mechanisms," *Acta Sociologica,* 39 no. 3 (1996), 298.

preference for rent seeking?; 3) What impact did the collective action of individuals have on Ukraine's natural gas prices?

Methodological Individualism and International Relations Theory

This project attempts to provide the answer to an empirical question, but as stated from the outset, it also hopes to show how methodological individualism can bring together the levels of analysis most prevalent in international relations theory and the study of foreign policy. This section will deal with theories in international relations that address the issues at the heart of the mechanisms identified above.

Levels of Analysis and The Three Images – Approaches in International Relations Theory

The father of Neo-Realism, Kenneth Waltz, best described the level of analysis question in international relations in his renowned work Man, The State and War through the use of three images. It is useful to start by situating the problem being studied in relation to these images. The three images include: 1) human behaviour (first image); 2) internal structure of states (second image); 3) the structure of the system (third image).[69] The first image interprets the causes of action in the area of foreign policy as derived from human behavior.[70] The second image looks for causes of action in foreign policy as products of state organization.[71] The third image looks to the international state system and power distribution amongst actors in the system for explanations of outcomes in international relations. The question the third image approach seeks to answer is not why states adopt certain foreign policies, but why the outcomes of state-to-state interactions take the form that they do.[72]

[69] Kenneth Waltz, *Man, The State and War (*New York: Columbia University Press., 1954).
[70] Ibid., 16.
[71] Ibid., 81.
[72] Ibid., 160.

Waltz, when attempting to build a theory of international politics in the third image, suggests that "a theory at one level of generality cannot answer questions about matters at a different level of generality."[73] A mechanisms based approach using the logic of methodological individualism brings this claims truth into question, and for the purpose of a richer explanation this project's explanation looks to Putnam who suggests "it is fruitless to debate whether domestic politics really determine international relations or the reverse. The answer to that question is clearly 'both, sometimes.'"[74] Milner argues that "domestic politics and international relations are inextricably interrelated."[75] In this light the explanation provided here focuses on not only the external system which colours Russian foreign policy formulation and execution, but also the integration of the first and second images of the individual and the state respectively. This project is about explaining a Russian foreign policy decision and according to Waltz' third image view would not be considered a study of international relations.

State Organization

In international relations theory the idea that state organization affects a state's foreign policy is exemplified by the work of Katzenstien. He suggests that the purpose of a state's foreign economic policy is to "establish basic compatibility between domestic and external policy objectives."[76] He also contends that "ruling coalitions" made up of dominant social classes and political power brokers "find their institutional expression in the party system and

[73]Kenneth Waltz, *Man, The State and War (*New York: Columbia University Press, 1954), 16.
[74] Robert D. Putnam, "Diplomacy and Domestic Politics: The Logic of Two Level Games," *International Organization*, 42 no. 3 (Summer 1988), 427.
[75]Helen V. Milner, Interests, Institutions, and Information: Domestic Politics and International Relations (New Jersey: Princeton University Press, 1997), 3.
[76]Peter J. Katzenstien, "Introduction: domestic and international forces and strategies of foreign economic policy," *International Organization,* 31 no. 4 (Autumn 1977), 587-588.

in a variety of institutions a step removed from electoral politics."[77] These ideas suggest that as the nature of Russia's domestic politics and political economy change so should its foreign economic policies. This informs this project's view that change in the situational mechanism will change outcomes in Russian foreign policy making.

Individuals in International Relations

Classical Realism as put discussed by Morgenthau in his work Politics Among Nations, has been among the most influential first image interpretations of international relations. Simply, but powerfully, the main thrust of Morgenthau's argument is that individuals seek power, and this is exemplified by his first principle of political realism, which states that "political realism believes that politics, like society in general, is governed by objective laws that have their roots in human nature."[78]

In a similar vein, according to Allison foreign policies are determined by who is making the decisions, what each decision maker's stand is on a specific issue, each decider's relative influence, and how the bargaining game combines decision makers, their stands, and influence in order to bring about government decisions and actions.[79] For the purposes of this project, Allison's ideas are important as they highlight the effect changes in individual decision makers can have on policy outcomes. The main thrust of Allison's "Bureaucratic Politics" model was that as individuals come together to form policy, differing stands, relative influence, and the rules of the game tend to bring about unintended results for all parties. This is not the outcome in this framework. While Allison focused on the "pulling and hauling" of

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[77] Peter J. Katzenstein, "Conclusion: domestic structures and strategies of foreign economic policy," *International Organization,* 31 no. 4 (Autumn 1977), 892.
[78] Hans J. Morgenthau, *Politics Among Nations: The Struggle For Power and Peace* (New York: Knopf, 1949), 6.
[79] For a full explanation of Allison's model see : Graham Allison, *The Essence of Decision* (Boston: Little, Brown and Company, 1971), 164-182.

individuals in the decision making process which bring about resultants, there is very little pulling and hauling in the case of Russian gas policy formation in 2005.

After the removal of Yeltsin-era officials under Putin and their replacement with Putin's clients, policy outcomes tended to be dictated in a top down manner from the president to the presidentially appointed bureaucrats that implement the policies. Allison's treatment of individuals in foreign policy formulation is important to this explanation as it emphasizes that different individuals may act differently in similar situations. As the case studies below will illustrate this is not, however, characteristic of the situations described in this project.

State Capabilities and Foreign Policy

Katzenstein, like the Neoclassical Realists, views "state power" as a key variable in explaining foreign policy strategies.[80] State power is reflected in domestic structures (as discussed above), and the instruments at the disposal of a government to deal with a specific problem affect the chosen solution. Recently, the idea that the strength of a country's state and its relationship to society bear on foreign policy outcomes has been put forward by Zakaria.[81] Zakaria suggests that foreign policy is made by the nation's government, not a nation itself, and it is therefore important to study state power rather than simply national power. State power is the portion of national power that the government can extract for its purposes, and "reflects the ease with which central decision makers can achieve their ends."[82]

In the context of this study, the state power variable is very important. As will be seen in Chapters Five and Six, after the election of Vladimir Putin and the appointment of his loyalists to top positions within the Russian gas industry, the role of the state in natural gas

[80] Peter J. Katzenstein, "Conclusion: domestic structures and strategies of foreign economic policy," *International Organization,* 31 no. 4 (Autumn 1977), 879-881.
[81] Gideon Rose, "Neo-Classical Realism and Theories of Foreign Policy," *World Politics,* 51 no. 1 (October 1998), 161.
[82] Ibid., 162.

exports increased and so did the policy instruments and capabilities at the government's disposal in the area of natural gas exporting. With increased capabilities it could be assumed that price setting for exports to Ukraine would become easier.

Shifting Relative Power

The idea of power has a long tradition in the field of international relations theory. Realists of every generation have used power as an organizing principle for explanations of international political actions and interactions. It must be said that while individual and state power are percieved in many ways by many scholars, relative power for Waltz, for Neoclassical Realists, and for this framework is conceived of as the material capabilities of a state relative to other states.[83] When considering natural resource power, in this case natural gas, this pertains to variances in prices along with volumes produced and exported relative to other states and relative to the demand from importers. The shift in relative power discussed here will be illustrated in the following chapters. At this point it is important to note first that natural gas prices, tied to global oil prices, varied substantially between 1995 and 2008, and that demand Europe and Eurasia has increased throughout the past decade while Russia's share of supply has gone down. Further, some of Russia's share of supply has been captured by certain states of Central Asia, particularly Turkmenistan. This constitutes a shift in the structure of the European-Eurasian natural gas trade, and affects Russia's relative power in the regional natural gas market.

The Framework Summarized

Before moving on, it is now worth presenting a summary of this explanation's theoretical background. This paper argues that there are three primary mechanisms which

[83]Gideon Rose, "Neo-Classical Realism and Theories of Foreign Policy," *World Politics,* 51 no. 1 (October 1998), 161.

drive price increases as well as decreases in Russia's natural gas export prices to Ukraine. These are the situational mechanism, the individual action mechanism, and the transformational mechanism. It is further argued that while individuals' rent seeking preference, encompassed in the individual action mechanism, remains unchanged, changes in the situational mechanism, specifically a move from patrimonialism based on rents gained through cheap property to patrimonialism based on natural resource rents, and the increasingly authoritarian nature of Russia's ruling regime will provoke different reactions from individual rent seekers. This will also alter the transformational mechanism, leading to more state-centric outcomes. This will have an effect on state control of the natural gas industry. When combined with the increasing importance of and competition for Turkmen gas, the collective action of Russian rent seekers (specifically in the natural gas industry) led to Gazprom's purchase of most of Turkmenistan's exportable natural gas, and price increases for Ukraine. The key differences between the period of low prices and the period of high prices, are essentially the authoritarian nature of Russia's political regime, the source of rents in Russia's patrimonial society, the extent of state control over the natural gas industry, and the importance of Turkmen natural gas production and exports.

Case Studies and Evidence

A mechanisms based approach to Russian natural gas pricing policy formation is necessary to provide an explanation that links together important events at the individual, state, and system levels of analysis prior to and following the 2006 price increase. Events are clearly taking place at all of these levels of analysis which affected the Russian government's decision to raise prices in 2006, and a full explanation requires that they all be addressed.

By engaging in thorough examination of the Russian natural gas industry between 1995 and 2008, the situational, individual action, and transformational mechanisms discussed above can be illustrated and it can be shown that a variation in the situational mechanism can be specifically linked to the Russian government's decision to raise natural gas prices for Ukraine.

This project will proceed using a case study methodology. Given the limited scope of the question being answered and the mechanisms based approach outlined earlier, this is the best way to move forward. An examination of Russian politics from 1995-1999 will illustrate the relatively less authoritarian nature of the Russian regime and the prevalence of rent distribution in the form of cheap property. This discussion will rely on several studies of the privatization process that took place under Yeltsin. These studies include David E. Hoffman's The Oligarchs: Wealth and Power in the New Russia,[84] Chrystia Freeland's Sale of the Century: Russia's Wild Ride From Communism to Capitalism,[85] and Boris Kagarlitsky's Russia Under Yeltsin and Putin.[86] Evidence will also be drawn from news sources and a number of academic articles. Further, the limited value of natural gas over this period will be demonstrated through references to global oil prices and Russian natural gas prices acquired from the Index Mundi commodity price data base.[87]

The transformational mechanism will be illustrated by an examination of the effects that property distribution had on the state's control over the natural gas industry. Evidence of this is provided from news articles detailing the privatization of Gazprom, details from the

[84] David E. Hoffman, *The Oligarchs: Wealth and Power in the New Russia* (New York: Public Affairs, 2002).
[85] Christya Freeland, *Sale of the Century: Russia's Wild Ride From Communism to Capitalism* (New York: Crown Business, 2000).
[86] Boris Kagarlitsky, *Russia Under Yeltsin and Putin: Neo-Liberal Autocracy* (London: Pluto Press, 2002).
[87]Index Mundi, "Commodity Prices," http://indexmundi.com/commodities/, Accessed April 30 2009.

Gazprom web site,[88] information gleaned from the aforementioned studies of Russia's privatization process, and a report published by the Carnegie Endowment for International Peace.[89]

The role that Turkmen gas plays in the regional natural gas trade will be illustrated by means of an examination of British Petroleum historical data on natural gas production and consumption.[90] Further, the role Turkmen gas played in the Ukrainian natural gas mix will be gleaned from news articles published at the time detailing negotiations between the two states. The reaction of individual rent seekers to the limited importance of Turkmen gas can be gleaned from a number of news sources reporting on natural gas deals signed between Russia, Ukraine, and Turkmenistan. Finally, the transformational mechanism can be further shown through an examination of Russia's natural gas prices for Ukraine. The price which the Russian government charged Ukraine for natural gas during this period will be determined using news articles which detail the natural gas contracts the two states signed over this period.

The second case study presented here, dealing with the time period 2000-2004, will draw on studies which have detailed Vladimir Putin's rise to power and the nature of his regime. These include Lilia Shevtsova's Russia Lost in Transition: The Yeltsin and Putin Legacies,[91] Andrew Jack's Inside Putin's Russia,[92] Stephen White's edited volume Politics

[88] Gazprom web site, http://www.gazprom.com/, Accessed April 30 2009.
[89] Caroline McGregor, "Gazprom and Itera: A Case Study In Corporate Misgovernance," *Carnegie Endowment For International Peace,* March 18, 2002, http://www.carnegieendowment.org/events/?fa=eventDetail&id=468&prog=zgp, Accessed March 15 2009.
[90] BP historical data 2007, "Gas Production from 1970, Gas Consumption from 1964," http://www.bp.com/productlanding.do?categoryId=6929&contentId=7044622, Accessed March 15 2009.
[91] Lilia Shevtsova, *Russia Lost in Transition: The Yeltsin and Putin Legacies* (Washington D.C.: Carnegie Endowment for International Peace, 2007).
[92] Andrew Jack, *Inside Putin's Russia* (New York: Oxford University Press, 2004).

and The Ruling Group in Putin's Russia,[93] and Marshal Goldman's Petrostate: Putin, Power, and the New Russia.[94] To illustrate the changing value of natural resource rents during this period, historical trends in oil and gas prices presented in Index Mundi will again be used.[95]

To illustrate the transformational mechanism (the increased state capture of natural resource rents), tax reform information provided by Jonathan Stern's The Future of Russian Gas and Gazprom[96] will be used. This work, along with those mentioned above, as well as journal articles and business publications, including Gazprom's web site, will provide the basis for demonstrating increasing state control over natural gas rents and the natural gas industry.

To make clear the pattern of rent distribution during this period, information on Russian employment and wage statistics will be drawn from the Russia's Federal State Statistics Service and Labrosta's internet service.[97] Statistics found here will illustrate the growth of the state bureaucracy and the wages these employees were paid from 2000-2004. Information regarding increases in Russia's international reserve position and Russia's state stabilization fund will also be used to illustrate the capture of resource rents by individuals controlling the state.[98]

The same BP historical data used in the first case study will be used here to illustrate the role Turkmen gas played in the regional natural gas trade. This case study will also draw on news articles, and several academic publications, to further illustrate individual actions with regard to the role of Turkmen gas in the region. Finally, price data for Russian exports to

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[93] Stephen White, ed., *Politics and the Ruling Group in Putin's Russia*, (New York: Palgrave Macmillan, 2008).
[94] Marshal Goldman, *Petrostate: Putin, Power, and the New Russia* (Toronto: Oxford University Press, 2008).
[95] Index Mundi, "Commodity Data," http://indexmundi.com/commodities/, Accessed April 30 2009.
[96] Jonathan Stern, *The Future of Russian Gas and Gazprom*, (New York: Oxford University Press, 2005).
[97] Labrosta, "Statistics by Country," http://laborsta.ilo.org/, Accessed May 15 2009.
[98] Central Bank of the Russian Federation, http://www.cbr.ru/eng/, Accessed May 28 2009.

Ukraine over this period, further exemplifying the transformational mechanism, are provided by Simon Pirani's "Ukrainian Gas Sector," a 2007 publication from the Oxford Energy Institute.[99]

Most of the data used in the final case study covering 2005 to 2008 will be drawn from the same materials as the previous case study. The aforementioned studies detailing the nature of politics in Putin's Russia will be used to illustrate increasingly authoritarian trends as well as increased state control over the natural gas industry. The Mundi Index, detailing historical oil and natural gas prices, will again provide evidence of the increasing rent generating potential of natural gas. Gazprom's web site will also be used to illustrate increased tax revenues for the state. Labrosta labour market statistics will be used to illustrate the growth of Russia's legislative and executive class, and Russia's Federal State Statistics Service for information on salaries. These statistics will demonstrate the state controlled pattern of resource rent distribution. The role of Turkmen gas in the region will be shown using BP historical data, and increased competition for these supplies demonstrated by referring to a number of news reports. Individual rent seeker's reactions to this increased importance and competition can be determined by using of information available on Gazprom's website and other news and business publications. To further illustrate the transformational mechanism, natural gas prices for Russian exports to Ukraine will be drawn from news articles and Simon Pirani's "Ukrainian Gas Sector."

Summary

[99] Simon, Pirani, "Ukraine's Gas Sector," *Oxford Institute Of Energy Studies*, June 2007, 28, http://www.oxfordenergy.org/pdfs/NG21.pdf, Accessed January 15 2009.

In this chapter the quest for the identification of the social mechanisms which brought about increases in the Russian government's gas prices for Ukraine have been discussed. The situational, individual action, and transformational mechanisms identified in this project's explanation have been discussed. It has been shown that many theories of international relations provide a clue concerning what is important when formulating an explanation. Further, it has been shown that while international relations theory may provide road signs to guide this explanation it is the logic of methodological individualism which maps out the route that integrates these theories of international relations. Finally, the case studies that make up the majority of the remainder of this thesis have been discussed. Before moving on to the first case study, the next chapter will cover the academic literature which relates to the increases in the Russian government's gas prices for Ukraine.

Chapter 3

Literature Review

The theoretical foundation for this study, and the literature it is based on, has been discussed in the previous two chapters. For this reason this literature review section will focus on works that have attempted to explain the Russian government's decision to increase natural gas prices for Ukraine, and other works which do not purport to offer an explanation, but none the less throw light on the factors which this project highlights as important. There is a large and ever growing literature on Russia's energy resources, some of which considers the implications of these resources for the country's foreign policy, but there have been few attempts to explain the Russian government's decision to increase export prices to Ukraine. The attempts that have been made tend to focus on specific causes of the event, especially changes in Ukrainian foreign policy, and fail to link multiple possible causes together for a complete account for the price increases. Further, there is literature that focuses on the factors bringing about the price increases that this project draws on, specifically Russia's patrimonial society, the role of individuals in the decision to raise prices, the increased capabilities of the Russian state in the natural gas industry, and the growing importance of Turkmenistan's natural gas reserves. These accounts, however, tend not to provide an explanation of the Russian government's decision to raise natural gas prices for Ukraine.

Competing Explanations

The Orange Revolution

The media has probably been the biggest proponent of the explanation that price increases in 2006 were the result of Ukraine's foreign policy shift after the Orange Revolution. A number of accounts of the 2006 crisis highlight this as the main cause. A WPs report in late 2005 suggests that there were "big-time politics" behind the price increases. The report goes on to suggest that against the backdrop of the Orange Revolution the move looks like punishment.[100] The Washington Post ran an article in December 2005 quoting 'industry analysts' as suggesting the price increases were punishment for seeking closer ties to the West.[101] Commentary from a Financial Times article run prior to the cutoff also links price increases to the Orange Revolution, and compares this situation to that of Belarus which, through concessions not mentioned in the article, was able to retain a lower price.[102]

The above examples are only a small sample of news articles which paint the entire price increase issue as a form of political punishment or coercion. As has already been stated it is impossible to rule this out as an explanation altogether; however, to limit the explanation to this is an oversimplification of a very complex issue. There have been, however, media representations of the conflict which delve a little deeper into the issue and highlight other contributing factors. A good example of this is the January 2006 article in Gas Matters where the role of control over Turkmen gas, and increased prices for Turkmen gas, are reported to have influenced the Russian government's decision to raise prices. Further, the article

[100] "Russia punishes unfriendly CIS countries with high gas prices: Russia raises gas prices for Georgia Moldova and Ukraine," *WPS: What the Papers Say,* December 8, 2005.
[101] Michael Mainville, "Gazprom quadruples gas cost for Ukraine: Moscow seen punishing ex-allies," *The Washington Times*, December 15, 2005.
[102] Neil Buckley, "Moscow seeks to use petro-power as political tool," *Financial Times*, December 22, 2005.

questions the impact of price increases, suggesting that overall the increases are small and would hardly be felt in the first year of the new pricing scheme.[103]

The mass media may be the most obvious proponent of the punishment explanation, but more academic assessments have yielded similar interpretations. Lilia Shevtsova in her 2007 work Russia Lost in Transition: The Yeltsin and Putin Legacies, suggests that after the 2005 CIS summit the Kremlin began to categorize its neighbours as either loyal or disloyal. Being on the disloyal list, as Ukraine was, simply meant natural gas price increases. [104] This clear example of the same sort of punishment explanation for the crisis as the previously discussed media reports. Shevtsova appears to contradict her own assessment, however, when she goes on to highlight the fact that by 2007 all Russia's neighbours, loyal or otherwise, were being asked to pay market prices.[105] Shevtsova's explanation for the conflict is mirrored by other Russia watchers as well.

When addressing the issue of Russian natural gas prices in his book Petrostate: Putin, Power, and the New Russia Marshal Goldman makes reference to comments made by Putin at a meeting among Putin, himself, and others suggesting a link to Ukrainian President Yushchenko's Western oriented foreign policy. The passage reads "As Putin told a group of us in September 2004, Yushchenko was welcome to seek a closer alliance with the West [. . .] but he should understand that if he did so, Russia was under no obligation to continue to subsidize its exports to Ukraine.[106]" This statement contradicts many public statements about the price hikes made by Putin, and Goldman's followup comparison to Belarus's continuation

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[103]"The geopolitics of the Russian gas dispute with Ukraine," *Gas Matters,* January 31, 2006.
[104] Lilia Shevtsova, *Russia Lost in Transition: The Yeltsin and Putin Legacies* (Washington D.C.: Carnegie Endowment for International Peace, 2007), 190.
[105]Ibid., 191.
[106]Marshal Goldman, *Petrostate: Putin, Power, and the New Russia,* (Toronto: Oxford University Press, 2008), 144-145.

of subsidized prices demonstrated a misunderstanding of the Russia-Belarus pricing issue, where low prices were contingent on the sale of Belarusian transit infrastructure to Gazprom, and resulted only in delayed price increases.

Energy as a Weapon

Bertil Nygren offers an insightful account of the Russian government's use of its "energy weapons" in a summer 2008 article entitled "Putin's Use of Natural Gas to Reintegrate the CIS Region."[107] In this work Nygren is careful to differentiate between two types of 'energy weapons' used by Russia and other states. He first identifies the 'tap weapon' which is essentially "do as I tell you or I shut off the tap or pay my price or I shut off the tap."[108] Nygren considers that this weapon was used in the 2006 dispute between the governments of Russia and Ukraine over pricing. While the "pay my price or I shut off the tap" tactic is evident in Russia's dealing with Ukraine, Nygren offers little in the way of evidence, aside from the timing of the cutoff, to support the "do as I tell you or I shut off the tap" argument.

The second weapon identified by Nygren is the 'transit weapon', which is essentially pressure to "Sell me your natural gas for the price I offer, or Pay me the transit price I want."[109] The use of this weapon is highlighted in the Russian government's dealings with Central Asian countries, Turkmenistan in particular. Nygren argues that the fact that a trans-Caspian gas pipeline has failed to materialize has left the Russian government free to set the price level for Turkmen gas, and the Turkmen government can either accept it or export no

[107] Bertil Nygren, "Putin's Use of Natural Gas to Reintegrate the CIS," Problems *of Post-Communism*, 55 no. 4, (2008), 3-15.
[108] Ibid., 5.
[109] Ibid.

gas.[110] This hardly appears to be the case as will be seen in the forthcoming case studies, as Russia has actually become reliant on Turkmen gas supplies and become vulnerable to the tap weapon wielded by Turkmenistan. This reality has led the Russian government to concede to paying not only higher but global prices for Turkmen gas.

Nygren concludes that Russia is well on its way to establishing control over the regional natural gas industry.[111] This assessment is difficult to disagree with, however, on the whole Nygren's article does not delve into the nature of domestic politics in Russia that makes this a desirable goal, and he appears to overstate the Turkmenistan's willingness to acquiesce to the Russian government's demands along with the success of the transit weapon to coerce Turkmen policy makers into agreements favourable to the Kremlin.

Market Pricing

The most focused attempt to explain the 2006 Russia-Ukraine natural gas crisis is that of Andreas Heinrich. Heinrich highlights the role that Ukraine's Orange Revolution may have played in the Russian government's decision to increase prices for Ukraine, along with Gazprom's desire to control transit infrastructure in energy dependent states, but does not consider these issues to be at the heart of the price increases.[112] Heinrich suggests that the price increases represent a paradigm shift in Russia's energy relations with Ukraine, moving from political to market pricing.[113] While this appears to at least partially capture the truth of the matter, Heinrich does not endeavour to explain what has brought about this shift, nor does

[110] Bertil Nygren, "Putin's Use of Natural Gas to Reintegrate the CIS," *Problems of Post-Communism*, 55 no. 4, (2008), 10.
[111] Ibid., 14.
[112] Andreas Heinrich, "Gazprom's Pipeline Policies: The Russian Ukrainian Gas Crisis Of January 2006," (Paper Presented at *International Conference on International Relations in Eastern Europe, Berlin, Germany* March 16-18 2006), 10.
[113] *Stefan Hedlund, "Rights, Rents, and Service: Boyar Economics and the Putin Transition," Problems of Post-Communism,* 55 no. 4, (July/August 2008), 11.

he seek, in any substantial way, to link the state of Russia's patrimonial political system, the growing importance of Turkmen gas, or the state's increased control over the natural gas industry to his explanation.

The Role of Patrimonialism and Rents

In his article entitled "Rents, Rights, and Service: Boyar Economics and the Putin Transition" Stephen Hedlund touches on a number of points that are highlighted in this work's explanation of the Russian government's natural gas price increases for Ukraine. The crux of Hedlund's argument is that the renationalization of Russia's energy resources was undertaken to ensure Kremlin control over the rents which it generates. Further, he argues that these developments are rooted in Russia's history, dating back to the late1600's and early 1700's. The two characteristics of this system highlighted by Hedlund were the complete lack of accountability constraining those in power, and the absence of enforceable property rights.[114] This fostered a tradition in Russia "that rests on the rule of men rather than on the rule of law, rules and regulations will always be trumped by personal friendships and loyalties."[115] Hedlund concludes by suggesting that the lasting outcome of the systemic change that took place in Russia after the fall of the Soviet Union is a return to a traditional pattern of rule whereby individuals fight over seats close to those in power, and receive remuneration for their services via a host of informal channels.[116]

Hedlund makes no attempt to extend his interpretation of Russia's political economy to the issue of the Russian government's natural gas price increases for Ukraine, but his approach informs this work's interpretation of Russia's patrimonial situational mechanism.

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[114] *Stefan Hedlund, "Rights, Rents, and Service: Boyar Economics and the Putin Transition," Problems of Post-Communism,* 55 no. 4, (July/August 2008), 33.
[115] Ibid., 36.
[116] Ibid., 39.

Further it highlights three factors that are of great importance to this project: increased state control over the Russian natural gas industry; the role that desire for rent capture plays in this increasing control; and the role that Russia's patrimonial state system plays in bringing about the first two factors.

Another work focusing on patrimonialism in Russia and natural resource rents which this project's interpretation draws on is Celestial Wallander's "Russian Transimperialism and its Implications." In this article Wallander, though not directly addressing natural gas prices for Ukraine, endeavours to explain and describe what she sees as the true nature of Russian foreign policy under Putin. Wallander highlights the newly assertive nature of Russian foreign policy in the second half of this decade, citing Russia's engagement in 'frozen conflicts' in Georgia and Moldova leveraged on international norms based on the principle of self determination, Russia's ability to block Western advances into states such as Belarus and Uzbekistan by forging partnerships with the leaderships of these countries, and Russia's support for Iran's nuclear program.[117] Wallander is of the opinion that this new assertiveness is a result of high energy prices, but emphasises that Russian policy makers must and indeed do have a play to capitalize on this good fortune.[118] Wallander concludes that the Russian strategy defies the general discourse centered on whether Russia is a post-imperialist state or a neo-imperialist one. She then puts forward an interpretation of Russian actions that links domestic political conditions in Russia with foreign policy, which she terms Transimperialism.[119]

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[117]Celeste A. Wallander, "Russian Transimperialism and its Implications," *The Washington Quarterly,* 30 no. 2 (Spring 2007), 107.
[118] Ibid., 108.
[119] Ibid., 117-118.

In the same vein as this paper Wallander characterizes Russia's domestic political system as patrimonial authoritarianism. This is, as discussed earlier, a system based on centralized control of the elite, patron client relationships, and rent seeking and distribution.[120] Given this domestic state of affairs Wallander views Russian action internationally as "the extension of Russian patrimonial authoritarianism into a globalized world."[121] This means creating "patron client relations, dependency, and rent seeking and distribution at the transnational level."[122] This includes a focus on creating transnational elite networks which allow the state to access rents internationally.[123]

Though not directly addressing the issue of price increases to Ukraine Wallander's work can provides clues to the answer being sought here. By making the link between patrimonial authoritarianism and rent seeking on an international level explicit, it is only a short step to see the end of subsidized prices for Ukraine as an attempt to capture more resource rents for the state.

Individuals and Russian Gas Policy

Much of the literature concerning individuals and Russian policy, both foreign and domestic, has revolved around the Siloviki and the Liberal-Technocrats. These two groups have been identified as clans competing for influence within the Kremlin by a number of authors.[124] While the former consists of former and current military and security service personnel, the latter are drawn from the ranks of more liberal-minded individuals who worked

[120] Celeste A. Wallander, "Russian Transimperialism and its Implications," *The Washington Quarterly,* 30 no. 2 (Spring 2007), 116.
[121] Ibid., 118.
[122] Ibid.
[123] Ibid.
[124] Ol'ga Kryshtanovskaya, Stephen White, "Inside the Putin court: A research note," *Europe-Asia Studies*, 57 no. 7 (2005), 1065 — 1075. And: Ian Bremmer, Samuel Charap, "The Siloviki in Putin's Russia: Who They Are and What They Want," *The Washington Quarterly*, 30 no. 1 (2006-2007), 83–92.

with Putin in St. Petersburg in the mid 1990's.[125] The two groups, and the individuals who fill their ranks, have been differentiated only by the more liberal leanings of the Technocrats versus the more authoritarian heavy handed tendencies of the Siloviki.[126] This project does not require differentiation between the policies of the two groups, especially where natural gas policy is concerned, as it is assumed that individuals from both groups seek to maximize the rents they control through support for the president. Further, where natural resources as a whole are concerned, while there has been some variance between the tactics of the two groups while seeking to renationalize the nation's energy infrastructure, this variance has been limited, and in some instances appears not to exist at all.

It is true that Rosneft, which is chaired by Igor Sechin (a member of the Siloviki clan), has appeared in some instances to act more coercively and in a heavy handed fashion when attempting to regain state control over the oil industry (the Yukos case is a good example). Dmitry Medvedev and Alexei Miller (two Liberal-Technocrats) have in some instances looked more liberal (e.g. paying close to market price for Sibneft), but in others appeared very coercive (e.g. restricting pipeline access for competitors). Because of these inconsistencies the differentiation between these two groups and the resulting implicit policy differentiation are not a focus of this project.

Research on individuals and their role in Russian foreign policy formation has been conducted by Jorgan Staun. In a 2007 report to the Danish Institute for International Studies entitled the "Siloviki Versus Liberal-Technocrats: The Fight for Russia and Its Foreign Policy" Staun looks at the individuals brought into top positions by Putin and seeks to

[125] Ian Bremmer, Samuel Charap, "The Siloviki in Putin's Russia: Who They Are and What They Want," *The Washington Quarterly*, 30 no. 1 (2006-2007), 85.
[126] Ibid.

differentiate their actions based on their background as either Siloviki (military, KGB/FSB, police) and Liberal-Technocrats (more liberal minded appointees, many of whom worked with Putin in St. Petersburg). Staun concludes that "Russia's foreign policy is best described as the outcome of varying overlapping bargaining games among players arranged hierarchically inside and outside government structures." Guiding these games are individual and institutionalized interests and foreign policy strategic thinking.[127]

Staun also offers an explanation of the Russian government's natural gas price increases, suggesting two possible scenarios. One, the price increases could be the result of the private interests of those who control Gazprom and two, it could be part of a neo-imperial strategy designed to consolidate interests in the former Soviet space.[128] These two possibilities are somewhat contradictory; however, Staun goes to great lengths in this work to discuss multiple possible answers for a number of questions. Regardless, Staun's work is relevant to a core feature of this project, that being the role of individuals in the decision to eliminate natural gas subsidies for Ukraine. Staun does not, however, delve specifically into the role that state organizations played in determining individual interests surrounding gas prices to Ukraine, or the regional supply and demand pressures facing Gazprom at the time of the decision.

Increased State Capabilities in the Russian Natural Gas Industry

As highlighted by Hedlund the Russian state, since Putin became president, has gained substantial control over Russia's oil and natural gas supplies. This has been highlighted as a

[127] Jorgen Staun, "Siloviki Versus Liberal-Technocrats: The Fight For Russia's Foreign Policy," *Danish Institute For International Studies,* (2007), 54, http://www.diis.dk/graphics/Publications/Reports%202007/diisreport-2007-9.til%20web.pdf, Accessed May 14 2008.
[128] Ibid., 36.

major theme in many works dealing with Russia and its energy resources. Marshal Goldman in an article entitled "The New Imperial Russia," and in his previously mentioned book, has highlighted the role that "national champion" companies advocated by Putin have played in the exploitation of Russia's natural resources.[129] In Petrostate he also provides an outline of many of the actions of Putin, and those he put in charge of potential national champions, which increased state control over the energy sector.[130]

In their fall of 2002 article "Fuelling the Future: The Prospects for Russian Oil and Gas" Fiona Hill and Florence Fee address the issue of increased state involvement in the oil and gas sectors. Though their final assessment suggests that excessive optimism concerning Russia's role as an energy super power is misplaced[131], they refer to a "creeping renationalization" of Russia's energy sector. They suggest that Russian energy firms will play a greater role on the international stage, and that they will become a tool for promoting Russian foreign policy.[132]

This project does not intend to fully discuss all of the literature that makes reference to increased state control over Russia's oil and gas resources, but the above examples provide a representative sample of what is found throughout the literature. The following case studies will explicitly illustrate the transition of Russian gas industry to privatization and back. For now it is worth mentioning that while many works make reference to the increased nationalization of Russia's energy resources, few link this to natural gas price increases for Ukraine.

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[129]Marshal Goldman, "The New Imperial Russia," Demokratizatsiya, 16 no. 1 (2008), 15. AND: Marshal Goldman, *Petrostate: Putin, Power, and the New Russia,* (Toronto: Oxford University Press, 2008), 97-99.
[130]Marshal Goldman, *Petrostate: Putin, Power, and the New Russia* (Toronto: Oxford University Press, 2008), 99-135.
[131]Fiona Hill, Florence Fee, "Fuelling The Future: Prospects for Oil and Gas," *Demokratizatsya*, 10 no. 4 (Fall 2002), 483.
[132]Ibid, 464.

Turkmen Gas and The Great Game

There is a growing literature dealing with global competition for the natural resources of Central Asia. A precursor to this literature is H. J. Mackinder's 1904 article "The Geographical Pivot of History" in which he identifies a major portion of modern day Russia and Central Asia (the pivot point or heartland), as vital geopolitical territory which may tip the balance of world power in favour of the civilization that controls it.[133] This is the thinking that led Mackinder to advise the allies, during the negotiation of the Treaty of Versailles, "Who rules East Europe commands the Heartland: Who rules the Heartland commands the World-Island: Who rules the World-Island commands the World."[134]

While the modern literature on geopolitics rarely refers to the Ukrainian-Russian gas price dispute, Mackinder's ideas can be modified to take into account the growing importance of the fossil fuel resources in the region, and provide some insights into this topic. Thus in her article "Great Game or Grubby Game? Struggle for Control of the Caspian," Sarah L. O'Hara argues that the underlying desire to control the heartland is being played out through a competition for control of the region's energy resources.[135] Her idea is essentially that "who controls the export routes, controls the oil and gas [in the region]; who controls the oil and gas, controls the heartland."[136] Whether control over the oil and gas of the Caspian region implies control over the region itself remains unclear, but as has been suggested, and will be further illustrated in the coming case studies, it has become the policy in Moscow to control

[133] H.J. Mackinder, "The Geographical Pivot of History (1904)," *The Geographical Journal*, 170 no. 4 December (2004), 313.
[134] Francis P. Sempa, "Mackinder's World," H.J. Mackinder, http://www.unc.edu/depts/diplomat/AD_Issues/amdipl_14/sempa_mac2.html, Accessed April 15 2009.
[135] Sarah L. O'Hara, "Great Game or Grubby Game? The struggle for control of the Caspian," *Geopolitics,* 9 no. 1 (2004), 139.
[136] Ibid., 148.

these energy resources as they grow in importance and this, along with other factors, has led to sharp price increases for natural gas exported to Ukraine from and via Russia.

Adam N. Stulberg, in his article "Moving Beyond the Great Game: The Geoeconomics of Russia's Influence in the Caspian Energy Bonanza" plays down the uniformity of the Russian government's approach and influence in the competition for Caspian energy resources. He suggests that Russia has been influential in some areas, but not on a consistent basis, and further that the policy followed by Moscow in the region has been somewhat inconsistent.[137] Analysis over time suggests that this assessment is correct. He does note however, that ". . . Russia retains geoeconomic levers of regional influence, especially in the gas sector, that cannot be matched at low costs by other states . . ."[138] Stulberg also highlights the success the Russian government has had in using Gazprom's economic power in its dealings with Turkmenistan in order to secure national interests in the Caspian energy contest.[139]

Though neither Stulberg nor O'Hara directly link price increases for Ukraine to the contest for Turkmen/Caspian energy riches, they highlight pipeline policies and gas purchase policies which are consistent with evidence in the following case studies. Further, it is easy to link their ideas, along with Mackinder's, to issues surrounding Ukrainian gas supplies, as Ukraine has consistently and increasingly found more of its natural gas coming from Turkmenistan, but has had less control over the terms under which this gas is supplied.

Summary

[137] Adam Stulberg, "Moving Beyond the Great Game: The Geoeconomics of Russia's Influence in the Caspian Energy Bonanza," *Geopolitics*, 10 no. 1, (2005), 19.
[138] Ibid.
[139] Adam Stulberg, "Moving Beyond the Great Game: The Geoeconomics of Russia's Influence in the Caspian Energy Bonanza," *Geopolitics*, 10 no. 11, (2005), 15.

It can be seen in this brief literature review that many of the explanations for the Russian government's decision to raise natural gas prices for Ukraine focus on the role that Ukrainian foreign policy may have played. Those works that do not accept this as an adequate explanation tend to focus on individual factors that likely played a role in the price increases, and do not seek to link these singular factors together to provide a more complete explanation of the event. While there is a growing literature focusing on the factors highlighted by this project as components of an explanation for the price increases, the authors rarely venture to extend their analysis to the specific event of concern to this project. This being the case, there is surely a need to draw together these fragments of a possible explanation for the price increases. As laid out in the previous chapter, this project's purpose is to use a mechanisms based approach based on methodological individualism to shed light on how the four factors mentioned above came together and led to Russia's natural gas price increases for Ukraine.

Chapter Four

Factors Determining Russian Natural Gas Prices for Ukraine 1995-1999

Introduction

The following chapter will detail the mechanisms identified in the previous chapter and illustrate how these mechanisms brought about low prices for natural gas exported from Russia to Ukraine. The time frame under consideration is 1995-1999. The chapter will begin by illustrating the situational mechanism, in other words, the distribution of rents in the form of state property in Russia's patrimonial political system. The patrimonial character of the privatization of the Russian economy, and specifically the privatization of Russia's natural gas industry, will be underlined. Next, the individual action mechanism, individuals' actions based on rent seeking and distributing preferences, will be explored given the existence of large rents in the form of property. Following this, the transformational mechanism--the collective action of individual rent seekers--will be explored. The results of this collective action for the state's control over Russia's natural gas industry will then be covered. An examination of the importance of Turkmen natural gas (contributing to the situational mechanism) in the regional natural gas trade will follow. Finally, the impact of all these factors on Russia's natural gas export prices for Ukraine will be examined.

The Patrimonial the Situational Mechanism and Rents in The Form of Property

The patrimonial nature of Russian society in the 1990's can be clearly illustrated by examining of the post-Soviet privatization process. The period of privatization that followed the collapse of the Soviet Union is often referred to as chaotic. Even in the early years of economic reform, however, a distinctly patrimonial pattern can be discerned. The earliest round of the privatization of the Russian economy began before the dissolution of the Soviet empire (pre-1991). During this early privatization, directors of state enterprises were given property rights to their enterprises, and were often able to capture the profits of these enterprises for themselves.[140] This early system of privatization showed some of the first signs of patrimonialism in the form of property handouts. As the chief architect of reform, Yegor Gaidar, frankly put it, "his government saw one of its tasks as being precisely 'the exchange of nomenklatura power for property.'"[141] Policy makers at the top simply declared that property rights would be granted to well-placed industrial directors within the communist party. Oleg Smolin, a deputy of the State Duma at the time, stated that in order to speed up privatization, create a base of social support, and guarantee their own material interests, those who organized privatization privileged those who were part of the managerial apparatus both officially and unofficially. [142] The results of this "spontaneous privatization" amounted to what the head of the drive for privatization in Russia, Anatoly Chubais, called the "theft of state property" and a system of benefits which rewarded factory managers and political elites.[143]

After the collapse of the Soviet Union it was the intention of Chubais', then Minister responsible for the Committee on State Properties, that privatization of state assets be conducted in as fair a fashion as possible; however, it soon became clear that in order to ensure that the privatization process continued, compromises with industrial insiders would have to be made. The term 'insiders' is prevalent in the literature regarding the privatization of the Russian economy and for all intents and purposes it refers to the Soviet-era managers of

[140] Boris Kagarlitsky, *Russia Under Yeltsin and Putin: Neo-Liberal Autocracy* (London: Pluto Press, 2002), 92.
[141] Ibid.
[142] Boris Kagarlitsky, *Russia Under Yeltsin and Putin: Neo-Liberal Autocracy* (London: Pluto Press, 2002), 93.
[143] David E. Hoffman, *The Oligarchs: Wealth and Power in the New Russia* (New York: Public Affairs, 2002), 186.

industry and the workers who worked in the factories they managed.[144] The first step in promoting insider privatization was the formulation of a legal basis under which privatization could take place. It was impossible for the interests of insiders to be ignored while attempts were made to create a legal framework for privatization, as Soviet era managers (red directors) still dominated the Supreme Soviet (parliament) which would have to approve any legislation on privatization.

In an attempt to purchase the support of the insiders Chubais offered a deal which guaranteed 'red directors' and workers a 40% stake in their companies, while the rest could be sold off to outsiders.[145] The Supreme Soviet then tabled a counter-offer which guaranteed insiders a 51% stake in their enterprises. Recalling later that "there would be no privatization if the directors didn't support it," as these bosses were still strong and the government relatively weak, Chubais relented, and on June 11 1992, with the blessing of President Boris Yeltsin, the Supreme Soviet approved a bill on privatization which, among other things, guaranteed insiders a 51% stake in their enterprises.[146] The most profitable post-Soviet enterprises were divided up in a manner that ensured the best assets for insiders.[147] This is a clear example of how property, or at least access to it, was used to gain support for the broader goals of the Yeltsin administration, exemplifying the situational mechanism.

What followed the period of 'spontaneous' privatization and the creation of a legal framework to move privatization forward was the 1992 formulation of a voucher program to facilitate the mass privatization of state assets. Under this plan a voucher would be given to each Russian citizen, and this voucher could then be traded at an auction for a stake in a

[144] David E. Hoffman, *The Oligarchs: Wealth and Power in the New Russia* (New York: Public Affairs, 2002), 191.
[145] Ibid.
[146] Ibid., 192.
[147] Boris Kagarlitsky, Russia *Under Yeltsin and Putin: Neo-Liberal Autocracy (* London: Pluto Press, 2002), 92.

company. The merits of this type of program are not of importance here, but this program lent at least the trappings of a market solution to the privatization issue.

When the voucher auctions got under way one thing was clear; state assets were being sold off cheaply.[148] One stark example of this was the auctioning off of the Bolshevik Biscuit company. As dictated by the Supreme Soviet's law on privatization, 51% of the company was sold to management and workers while the other 49% was offered to the public in exchange for vouchers.[149] Ultimately Bolshevik Biscuit was sold for $654,000. In contrast, a similar cookie company in Eastern Europe was sold to Pepsi for $80 million.[150]

While low enterprise valuations may seem misplaced there is evidence to suggest that privatization by other means, at this early stage in Russia's transition to a market economy, could not have taken place. [151] The argument here is that the available capital for the purchase of productive industries in the Russian Federation at this time did not exceed 150 billion Rubles, while the assets available for privatization were valued at 2 trillion Rubles.[152] Essentially, for privatization of the Russian economy to take place those assets up for sale had to go cheap or there would be no capital with which to purchase them. What this system of privatization amounted to was a "giant programme of gift giving."[153] The need to sell assets well below their market value essentially equated the large but limited pool of state assets to rents which could be distributed. This is another sign of a patrimonial political economy in Russia whereby rents in the form of cheap property were distributed to ensure support for Yeltsin from workers and managers. This was far from the end of property distribution in

[148] Boris Kagarlitsky, *Russia Under Yeltsin and Putin: Neo-Liberal Autocracy (*London: Pluto Press, 2002), 199.
[149] Ibid.
[150] Ibid.
[151] Ibid., 94.
[152] Ibid.
[153] Ibid.

return for political support. As we will see in the following section, the next round of mass privatization took on a much more distinctly patrimonial nature.

Privatization in 1995-Rent Capture and Distribution under Yeltsin

The first two rounds of Russia's industrial privatization, spontaneous privatization and voucher privatization, exhibited a patrimonial nature. Insider support for Yeltsin's economic reforms had been purchased through the distribution of rents and state assets at extremely low prices to managers and workers, and the scraps were left for those with the skill and foresight to take advantage of them. The second round of mass privatization, beginning in 1995, would assume an even clearer patrimonial nature whereby the Yeltsin administration gained quick and badly needed cash and political support in exchange for some of Russia's most prized industries.

It is important to note the time frame and context within which this round of privatization took place. At this point voucher privatization was almost complete, though some companies were still in state hands, and the Russian macroeconomic outlook was bleak. Inflation was up, the ruble's value was down, and the government was in desperate need of cash.[154] Further, parliamentary (Duma) elections where scheduled for late 1995, and presidential elections were set for the middle of 1996. Yeltsin was in great danger of losing these elections to a revitalized communist party leader, Gennady Zyuganov. There was fear throughout Yeltsin's administration, the newly developing capitalist class, and western capitals, that if Zyuganov was to win, Russia's move toward a market economy would not

[154] Christya Freeland, *Sale of the Century: Russia's Wild Ride From Communism to Capitalism* (New York: Crown Buisness, 2000), 172.

only be stalled, but sent hurtling in reverse. It was in these circumstances that Russia's infamous loans for shares auctions/scams were hatched.

The loans-for-shares scheme was essentially an exchange of property in return for political support.[155] The plan dictated that a number of powerful bankers and businessmen, including Mikhail Khodorkovsky, Vladimir Potanin, and Boris Berezovsky, would furnish the government with loans and support in the upcoming elections.[156] The government for its part would put un-privatized state assets up as collateral for these loans, and after the loans ran out the government would be left with two options. The first option was to pay back the loans and reclaim the shares put up as collateral, an option broadly understood to be impossible;[157] the second was to default on the loan and sell off the shares that were put up as collateral. The second option also stipulated that the lender would become the sales agent for the auctioning off of the collateral.[158] In order to ensure the loyalty of the lenders throughout the 1996 presidential election a "dual key system" was introduced. Under this part of the plan the lenders were given their enterprises in trust prior to the elections, and only after the elections were they given formal control of the state assets. [159] Assuming that if the Communists were to win the presidential elections this second part of the plan would be cancelled, the lenders had ample motivation to help ensure a Yeltsin victory.

In August 1995 President Yeltsin signed a decree authorizing the loans for shares scheme.[160] Foreign lenders were deterred from bidding by the intentionally vague rules which

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[155]Christya Freeland, *Sale of the Century: Russia's Wild Ride From Communism to Capitalism* (New York: Crown Buisness, 2000), 169.
[156] Ibid., 170.
[157] Neela Banerjee, "Russia's Communist Exploit Loan Plan," *Dow Jones International News*, February 13, 1996.
[158] Christya Freeland, *Sale of the Century: Russia's Wild Ride From Communism to Capitalism* (New York: Crown Buisness, 2000), 180.
[159] David E. Hoffman, *The Oligarchs: Wealth and Power in the New Russia* (New York: Public Affairs, 2002), 313.
[160] Ibid.

governed the auctions, presenting a risk that in the event of a disagreement they would be unable to retain their shares. [161] Though a facade of competitiveness was maintained up until the auctions, in reality the government picked the winners and Khodorkovsky, Potanin, and Berezovsky won their desired prizes quite easily. This outcome was greatly facilitated by the fact that the banks which were organizing the auctions were also bidding on the shares being auctioned off. For example, Menatep Bank (owned by Khodorkovsky) organized the auction for Yukos (the largest of Russia's oil companies) for which it was the chief bidder and eventual winner.[162]

The loans for shares auctions took place between November 3 and December 28, 2005. The majority of auctions, like the Yukos auction, were won by the banks that organized them.[163] Further, the shares were traded for loans which were barely greater than the initial asking price at the auction, and a fraction of the enterprise's actual value. A 38% stake in Norilsk Nickel was auctioned off for 170 million one hundred thousand dollars USD to Vladimir Potanin; the initial asking price was 170 million USD. This was paltry sum for a company which recorded profits in 1995 of 1.2 billion USD.[164] Khodorkovsky, bidding through a front company called Laguna, won a 45% stake in Yukos by offering $9 million USD more than the $150 million USD starting bid, and acquired 33% of Yukos shares by winning an investment tender offering $125,000 USD more than the $150 million USD starting price.[165] Boris Berezovsky, with the help of fellow tycoon Alexander Smolensky, captured a substantial share in another Russian oil company, Sibneft, with a bid of just $300,000 above the initial asking price of $100 million. Sibneft had a market capitalization of

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[161] David E. Hoffman, *The Oligarchs: Wealth and Power in the New Russia* (New York: Public Affairs, 2002), 313.
[162] Ibid., pg 314.
[163] Ibid., pg 315.
[164]Ibid., 315.
[165] Ibid., 318.

over 1 billion dollars just a few years later.[166] These results were typical of the loans for shares program and amounted to Yeltsin's purchase of a constituency which could gain him re-election in 1996.

1996 Election – Supporting The Patron

The 1996 presidential election was preceded by parliamentary elections in late 1995. The latter underlined the possibility of a return to communist rule in Russia. The Communist Party of Russia won 99 of 225 seats in the Duma. Determined to secure that which they had gained from the loans for shares program, the "winners" of the early rounds of privatization, including Potanin, Khodorkovsky, and Berezovsky, resolved to ensure that Yeltsin would be re-elected. This was no small task. It required an end to old rivalries and the formation of a new alliance among a number of Russia's new business tycoons, reformers from the Yeltsin administration, and Yeltsin himself.

The major role the new Russian business elite played was that of banker for the campaign. The tycoons hired Anatoly Chubais to oversee Yeltsin's re-election and provided him with 3 million dollars to pay his salary and set up an election team.[167] Further, they ensured that throughout the campaign bills were paid on time.[168] In addition to their role as financers these businessmen, particularly Berezovsky and Vladimir Guzinsky, used their media holdings to provide positive coverage for the president and blocked many of his rivals, including the Communists, from gaining access to fair media coverage. In the end Yeltsin was re-elected, garnering 53% of the vote in the second and final round of the election. This

[166] David E. Hoffman, *The Oligarchs: Wealth and Power in the New Russia* (New York: Public Affairs, 2002), 320.
[167]Christya Freeland, *Sale of the Century: Russia's Wild Ride From Communism to Capitalism* (New York: Crown Buisness, 2000), 197.
[168] Ibid., 212.

was three times the support he had at the beginning of the campaign, before the assistance of the new Russian business elite.[169]

The 1996 election illustrated the rent-seeking behaviour of Russia's business elite, the President's willingness to trade rents (cheap property) for support, and the support of Presidential clients for their patron. It would not take long, however, for cracks in this tactical alliance between economic wealth and political power to show. What was not anticipated by Yeltsin or his administration was the weakening effect that the short-term purchase of support with state assets, of great value over the long term, would have on the Russian state and economy. It was impossible to create a stable patrimonial system which would serve the interests of the state with such a limited pool of rents to distribute. Once property was given away or sold off, there was no way to control the business elite, aside from threatening to take away its gains and thus reverse privatization. This patrimonialism in Russia's natural gas industry resulted in a period of unchecked wealth accumulation by a few through the privatization of state profits, the selloff of some of the richest natural gas assets in Russia, and other concessions to those well connected to the individuals who basically ran the Russian natural gas industry during this period.

The Individual Action Mechanism and Privatization of the Natural gas Industry

While many state oil companies were broken up and sold off to private individuals during voucher privatization and the loans-for-shares program, the fate of the state natural gas monopoly, Gazprom, was different. Two key differences were evident. First, while the state oil industry was broken up into several different companies including Sibneft, Lukoil, Yukos,

[169]Christya Freeland, *Sale of the Century: Russia's Wild Ride From Communism to Capitalism* (New York: Crown Buisness, 2000), 237.

and Rosneft, the structure of Russia's natural gas monopoly, Gazprom, remained intact with production, processing, and transit fused within one company. Second, no components of the Russian natural gas industry were distributed through the loans for shares program, and they did not fall into the hands of Russia's new business elite. The portion of Gazprom that was privatized was privatized through voucher auctions and piecemeal selloffs by the state, leaving Soviet-era managers in a powerful position.

The "Privatization" of Gazprom

In 1989 then Soviet gas minister and future prime minister of the Russian Federation Viktor Chernomyrdin organized the entire Soviet natural gas industry into one large company. Chernomyrdin was its chairman until he became prime minister in 1992. At that point he handed the company's reins over to his former deputy Rem Vyakhirev, who oversaw the privatization process.[170] In accordance with a November 1992 presidential decree Gazprom was transformed into a joint stock company in 1993.[171] The privatization of the company began in 1994 as part of the first round of voucher privatization. Roughly 28% of Gazprom was reserved for residents of 60 oil and gas producing regions in Russia. These auctions were held regionally, and a passport indicating residency in the respective region whose portion of the shares was on offer was required to participate. A 15% stake was earmarked for gas industry employees, 10% was reserved for individuals employed directly by Gazprom, and just over 5% was reserved for individuals living in the Yamal Nenets region of western Siberia where many of Gazprom's gas extraction activities take place. About 40% of the

[170] Christya Freeland, *Sale of the Century: Russia's Wild Ride From Communism to Capitalism* (New York: Crown Business, 2000), 74.
[171] "Gazprom Becomes a Joint-Stock Company," *BBC Summary of World Broadcasts*, February 26, 1993.

company was retained by the state.[172] While the initial privatization was relatively successful in some respects, putting close to 60% of the company into private hands, it was individual Soviet 'red directors' in powerful positions, such as Chernomyrdin and Vyakhirev, who benefited the most.

Gazprom's path to privatization was similar to that of the many other enterprises auctioned off during the period of voucher privatization, and was indicative of the situational mechanism described in Chapter Two. The main beneficiaries of the rules governing the company's privatization were the company's management, and individuals with direct ties to the Russian natural gas industry. Jeffery Sachs, world-renowned economist, characterized the privatization of Gazprom as theft from the Russian people.[173] What took place followed the same patrimonial pattern as the rest of the privatization drive--the distribution of property in exchange for short-term support for reform initiatives. The effects of this type of patrimonialism on individual action can be illustrated through an examination of some of the actions taken by those who controlled Gazprom, and therefore the industry, throughout the 1990's.

Individuals at Gazprom - Chernomyrdin

It has been suggested by many that Viktor Chernomyrdin, a close friend of then president Boris Yeltsin, used his clout in the natural gas industry to enrich himself and his close associates rather than the state or the Russian people. It is rumoured that Chernomyrdin

[172] Leslie Shepherd, "Russia Moves to Privatize Natural Gas Monopoly," *Associated Press*, April 5, 1993.
[173] Christya Freeland, *Sale of the Century: Russia's Wild Ride From Communism to Capitalism* (New York: Crown Buisness, 2000), 75.

made between a billion and five billion dollars through the privatization of Gazprom.[174] These allegations were never proven, but the fact that he did not sue over the reports lends support to the rumours.[175] Further, during the mid and late 1990's Gazprom and Vyakhirev (Chernomyrdin's close associate and successor at Gazprom) benefited from generous tax concessions including exemptions from export taxes, some import tariffs, and Russia's VAT, which were made possible by Gazprom's close connections to Chernomyrdin's cabinet. These concessions amounted to billions in lost revenues for the state.[176]

Giving tax breaks to Gazprom and promoting friends within the company may appear unseemly and patrimonial, but these examples fail to fully illustrate the individualistic rent seeking and distribution pattern discussed in Chapter Two. The case of the companies Horhat and Interprocom provide an even more glaring example. In 2001 documents obtained by the Moscow Times showed that during the 1990's directors at Gazprom transferred valuable assets to their family members in a series of opaque transactions.[177] At the center of these allegations was Interprocom, a company registered in Hungary.

Formerly a partially state-owned enterprise, Interprocom was registered in 1989 and became a fully private firm in the 90's with majority stakes owned by former Soviet gas executives Mikhail Rakhimkulov and Oleg Veinorov.[178] Gazprom transferred a 10% stake in Panrusgas, a Gazprom-Hungarian company, a 1.5% stake in Gazprom's telecommunications subsidiary, and a stake in Intergazkomplekt, an importer of gas distribution equipment, to

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[174]Christya Freeland, *Sale of the Century: Russia's Wild Ride From Communism to Capitalism* (New York: Crown Buisness, 2000), 293.
[175] Igor Semeneko, "Gazprom's Books Reveal Mixed Message" *St. Petersburg Times*, June 15, 2001.
[176]Christya Freeland, *Sale of the Century: Russia's Wild Ride From Communism to Capitalism* (New York: Crown Buisness, 2000), 75.
[177] Florain Hassel, "Gazprom Assets a Family Affair," *Moscow Times*, May 21, 2001.
[178] Ibid.

Interprocom.[179] Then in October of 1997, 100% of Interprocom was transferred to a company called Horhat (KhorKhat, or ChorChat). Initially Horhat was registered to Rakhimkulov's wife, and a woman with the same address as Veinorov.

In November 1998 18% stakes in the company were sold to Rakhimulov's son Ruslan, Chernomyrdin's son Vitaly, Vyakhirev's daughter Tatyana Dedikova, and his deputy's daughter Yelena Dmitriyeva for 8.1 rubles per 18% stake. In total the 90% stake in Horhat was sold off for $2.50.[180] Interprocom and its owners further benefited from loan guarantees from Gazprom totalling 524 million dollars.[181] These are clear examples of asset stripping and privileges which benefitted the families of Gazprom management, who through privatization had been given control of one of Russia's largest companies at the expense of Russia's state capabilities. They also represent good examples of patrimonialism through the capture and further distribution of state assets and property.

Vyakhirev

Rem Vyakhirev took the reins at Gazprom in 1992 after Chernomyrdin's ascent to the position of Prime Minister of Russia. In his role as Gazprom Chairman Vyakhirev managed the 40% government stake in Gazprom with few restrictions.[182] Accused by Forbes magazine of running the company like "his own personal fiefdom," Vyakhirev was counted as one of the richest men in Russia by 2004, with a net worth of 1.2 billion dollars.[183] Vyakhirev presided over some of the most questionable business dealings in Gazprom's relatively short

[179] "The Gloves Come off at Gazprom," *Energy Intelligence Group*, May 25, 2001.
[180] Florain Hassel, "Gazprom Assets a Family Affair," *Moscow Times,* May 21, 2001.
[181] "Russian Gas Monopoly Gave Millions to Insiders," *Washington Post*, June 15 2001.
[182] "Accord on Control of State-Held Gazprom Shares Concluded," *TASS*, December 22, 1997.
[183] "Forbes: World's Richest People," Forbes. February 6, 2004, http://www.forbes.com/finance/lists/10/2004/LIR.jhtml?datatype=&passListId=10&passListType=&passYear=2004&uniqueId=F3J7, Accessed January 26 2009.

history. During his time with the company Gazprom offered domestic consumers gas at prices less than one tenth of world levels, making the domestic gas market utterly unprofitable for the company, but provided the government with domestic support.[184] This fails, however, to fully illustrate the destructive nature of Vyakhirev's tenure at the head of the company. For a clearer illustration of Vyakhirev's rent distributing during his time at Gazprom one must take into consideration his aforementioned ties to Horhat, and examine his relationship with the independent U.S. registered company Itera.

The relationship between Gazprom and Itera during the 1990's was unusually close for supposed competitors. Itera began participating in the export of Turkmen and Russian gas in 1994 and within a few years became a major natural gas supplier to Ukraine, Belarus, Georgia, parts of Russia, and the Baltic states.[185] This is the result of a series of very dubious concessions made to Itera while Vyakhirev was the head of Gazprom. These concessions included granting access to Gazprom's usually fiercely protected gas transmission network, the transfer of a Gazprom subsidiary, Purgaz, to Itera's control for a fraction of its actual worth ($1,200 rather than $566 million),[186] and the transfer of licences to exploit the New Urengoi and East Urengoi gas fields on the Yamal peninsula. [187] In total, under the watch of Vyakhirev, Gazprom sold off 5.805 billion dollars worth of assets for just 325 million dollars

[184] Christya Freeland, *Sale of the Century: Russia's Wild Ride From Communism to Capitalism* (New York: Crown Buisness, 2000), 75.
[185] Andreas Heinrich, Julia Kusznir, "Independent Gas Producers in Russia Working Paper: 2" (2005), *Koszalin Institute of Comparative European Studies*, 15, http://www.kices.org/downloads/KICES_WP_02.pdf, Accessed June 15 2008.
[186] Caroline McGregor, "Gazprom and Itera: A Case Study In Corporate Misgovernance," *Carnegie Endowment For International Peace,* March 18, 2002, http://www.carnegieendowment.org/events/?fa=eventDetail&id=468&prog=zgp, Accessed March 15, 2009.
[187] Elena Ivanova, "Gas Industry 1991-2000,"*Kommersant,* March 4, 2004. http://www.kommersant.com/p295882/r_33/Gas_Industry_1991-2000/, Accessed March 15 2009.

to Itera, turning it into one of the largest natural gas companies in the world.[188] Vyakhirev also lobbied the government during his time at Gazprom to reduce its ownership share in the company from roughly 40% to 25%, perhaps seeking more rents to distribute.[189]

Further, a 2001 state audit found that Gazprom, under the management of Vyakhirev, was guilty of selling gas produced in the Yamal-Nenets region at a notably reduced price to Itera, amounting to low prices benefitting a non-affiliated company.[190] This sale of gas took place through a three-way transaction involving Gazprom, Itera, and the Yamal-Nenets regional government. Essentially Gazprom offered the government of the Yamal-Nenets region gas valued at 2-4 dollars per 1000 cm as compensation for unpaid taxes. The regional government then sold the gas to Itera for the same price. Itera went on to sell the gas on the open market for between $30 and $90 dollars per 1000 cm. Sold on the open market, just 5% of the gas given to the regional government could have provided Gazprom with enough revenue to pay its tax bill.[191] All of this amounts to policies, during Vyakhirev's reign at Gazprom, which distributed state assets he gained control of during privatization to Itera, and served to weaken the state's control over Gazprom, as well as Gazprom's control over the Russian natural gas industry.

The Transformational Mechanism and the Russian State's Declining Control Over the Natural Gas Industry

[188]Caroline McGregor, "Gazprom and Itera: A Case Study In Corporate Misgovernance," *Carnegie Endowment For International Peace,* March 18, 2002, http://www.carnegieendowment.org/events/?fa=eventDetail&id=468&prog=zgp, Accessed March 15 2009.
[189] Nikolai Okhotin, "Gazprom Wants to Get Rid of Government Grip," *Kommersant Daily*, November 25, 1997.
[190]Elena Ivanova, "Gas Industry 1991-2000,"*Kommersant*, March 4, 2004. http://www.kommersant.com/p295882/r_33/Gas_Industry_1991-2000/, Accessed March 15, 2009.
[191] Caroline McGregor, "Gazprom and Itera: A Case Study In Corporate Misgovernance," *Carnegie Endowment For International Peace,* March 18, 2002, http://www.carnegieendowment.org/events/?fa=eventDetail&id=468&prog=zgp, Accessed March 15, 2009.

The period between 1994 and 2000 saw the Russian state lose a relatively large amount of control over Gazprom and consequently the Russian natural gas industry. Relative to many other states Russia's control over the natural gas industry remained large; however, this period sticks out as an anomaly in the brief history of Gazprom. From its inception until the beginning of voucher privatization in 1994, Gazprom was a wholly state-owned enterprise. After the initial rounds of privatization the state's share of Gazprom was reduced to 40%. This is significant as it gave the state only 5 seats on the 11 seat board of directors, and thus no majority.[192] Further weakening the state's position was the 1997 agreement which allowed Rem Vyakhirev to manage the state's share of the company. [193] The reassertion of state control over Gazprom and the Russian natural gas industry will be further discussed in the next section of this case study, but for now it will suffice to say that under President Vladimir Putin the state took back control of the company and increased its share to 51%, giving state representatives a majority on the board of directors.

Beyond the obvious decrease in the Russian government's share of ownership in Gazprom, the asset stripping by company management discussed earlier reduced Gazprom's monopoly position in the natural gas industry. First, the sale and/or transfer to Itera of Rospan, Purgaz, Tarkosaleneftegaz, Sibneftegaz, Achimneftegaz, Vostokgaz, and Severneftegazprom, along with the rights to New Urengoi and East Urengoi gas fields by Vyakhirev, which took place between 1997 and 2001, amounted to a 10% reduction in Gazprom's proven reserves.[194] When one considers the size of Gazprom's reserves, 25% of

[192] "Gazprom Board Defeats Outsiders," *Associated Press World Stream*, June 28, 1997.
[193] Lilia Kuznetsova, "Gazprom to Manage State Owned Shares on Trust," *Tass*, September 14, 1997. And: "Accord on Control of State-Held Gazprom Shares Concluded," *Tass*, December 22, 1997.
[194] Caroline McGregor, "Gazprom and Itera: A Case Study In Corporate Misgovernance," *Carnegie Endowment For International Peace,* March 18, 2002, http://www.carnegieendowment.org/events/?fa=eventDetail&id=468&prog=zgp, Accessed March 15 2009.

global reserves, this number is striking. Second, Gazprom conceded its monopoly over export pipelines to and from CIS states and granted access to gas traders and gas producers including Itera. This allowed independent companies access to Central Asian gas which they could then export through Gazprom pipelines to states in Eastern Europe. Hermitage Capital estimates that between 1996 and 2002 Gazprom gave up more than 50% of the FSU gas market to Itera.[195]

A great deal of controversy has surrounded Gazprom's dealings with Itera, but nothing illegal was ever discovered in audits (the audits were conducted by Gazprom's accounting agency, Price Waterhouse Coopers). It is not necessary, however, to prove illegal activities to show the effect the relationship had on Gazprom's control over the natural gas industry. Access to gas reserves was given away or sold at extremely low prices, and market share was ceded to Itera, leaving Gazprom in a position weaker than its position in the early 1990's. This is typical of the transformational mechanism, whereby individual rent seeking and distribution lead to a collective outcome weakening the state's control over the industry.

Finally, and perhaps most importantly, the Russian state had difficulty gaining any benefits from Gazprom's gas sales due to a weak and inefficient tax system. Prior to 1998 Gazprom ran up unpaid federal and regional tax bills that totalled over 2.8 billion dollars.[196] Eventually the government took action and began to freeze Gazprom's assets, demanding that its arrears be paid. Since the state owed an almost comparable debt to Gazprom for gas used

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[195] Global Witness, "It's a Gas: Funny Business in the Turkmen-Ukrainian Gas Trade," *Global Witness Publishing*: Washington DC. (April, 2006), 35, http://www.globalwitness.org/media_library_detail.php/479/en/its_a_gas._funny_business_in_the_turkmen_ukraine_g, Accessed May 8 2008.

[196] David McHugh, "Gazprom Pledges to Pay All of Its Taxes for 1998," *Moscow Times*, October 10, 1998.

by state-controlled companies, an eventual compromise saw Gazprom getting tax breaks, essentially for holding government debt.

The total sum of the state's losses are difficult to evaluate, but what is clear is that over the period 1994-2000, under the management of Chernomyrdin and Vyakhirev, Gazprom lost/gave away 10% of its natural gas reserves, its monopoly over gas transit in and out of Russia, and over 50% of the FSU natural gas market. Further, over this period the state lost majority control over the company, and proved incapable of collecting taxes from the monopoly. All this amounts to a loss of state capability to control the natural gas industry. Next we examine the ability and resolve of the Russian government and Gazprom to maintain a monopoly position over natural gas exports to Ukraine given individual preferences for rent seeking and distribution, and structural shifts in the regional natural gas trade.

Eurasian Natural Gas Trade in the 1990's

This section examines the roles Russia and Turkmenistan played as suppliers of natural gas to Europe and Eurasia from 1995 to 1999. Specific reference will be made to natural gas consumption and production in the entire region, Russia's and Turkmenistan's respective shares of regional production, their consumption relative to their production, and the role each played in exporting gas to Ukraine. This will produce a picture of a regional gas market that could, and was, forced to rely heavily on Russian production and export while Turkmen production and exports dwindled due to Russia's restrictions on pipeline access. It also highlights the increasing role Turkmenistan played in exporting natural gas to Ukraine over this period and suggests reasons for this.

Concerning production and consumption of natural gas, European and Eurasian production decreased between 1990 and 1995 by 71.5 bcm, from 973.5 bcm to 902.2 bcm.[197] At the same time, Russia's share of regional production decreased from 64.1 % to 61.5%. Turkmenistan's share of regional production decreased from 9.1% to 3.3% during the first five years of the decade. Over this same period total European and Eurasian consumption shrank by 64.7 bcm from 994.1 bcm to 929.4 bcm. [198] This reduction was largely the result of decreased consumption in states of the former Soviet Union, especially Russia and Ukraine, which accounted for 42.3 bcm and 51.6 bcm of decline respectively. [199] Consumption increased notably over this period in Germany, which increased consumption by 14.5 bcm per year, and Great Britain, which saw an increase of 18.1 bcm per year.[200] Needless to say, over this period Turkmen gas played a minor role in the European and Eurasian natural gas mix.

During the period from 1995 to 1999 the trends evident in the first half of the decade seemed to persist in some areas while in other areas they were reversed. Total natural gas production for Europe and Eurasia increased by 30.6 bcm from 904.2 bcm in 1995 to 934.8 bcm in 1999. This was a reversal of the trend evident in the first half of the decade, but it failed to bring consumption back to the levels of 1990.[201] Meanwhile, Russia's share of regional production continued to decrease, from 61.4% of production in 1995 to 56.8% in

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[197] BP historical data 2007, "Gas Production from 1970, Gas Consumption from 1964," http://www.bp.com/productlanding.do?categoryId=6929&contentId=7044622, Accessed March 15 2009.
[198] BP historical data 2007, "Gas Production from 1970, Gas Consumption from 1964," http://www.bp.com/productlanding.do?categoryId=6929&contentId=7044622, Accessed March 15 2009.
[199] Ibid.
[200] Ibid.
[201] Ibid.

1999.[202] Turkmenistan's share of regional production continued to decrease during the first four years of this period, from 3.3% in 1995 to 2.3% in 1999.[203]

On the consumption side, total regional consumption increased by 52.4 bcm from 929.4 bcm in 1995 to 981.8 bcm in 1999. Russia's total consumption over this period remained close to constant. There were slight increases in 1996 and 1998, matched by small decreases in 1997 and 1999. In the end, 1995 figures over 1999 figures show a decrease in consumption of 14.2 bcm.[204] Meanwhile Turkmen consumption increased by 3.3 bcm between 1995 and 1999. Increased consumption was driven by small increases across most Western and Central European states as well as small increases in Turkmenistan and Uzbekistan. Italy showed the largest increases over this period, from 49.9 bcm in 1995 to 62.2 bcm in 1999.[205]

Arguably the most important figure that can be discerned from the data available is Russia's share of consumption relative to its production. The period of concern in this section, 1995 to 1999, showed a decrease in the amount of production Russia consumed from 68% - 65.9%.[206] Turkmenistan's total consumed production in 1995 was 26.5%, while this share increased to 53% by 1999. While Russia's exportable gas volumes remained relatively constant over this period, Turkmenistan's fell sharply. The decrease in Turkmenistan's production was due in large part to two factors. One, Turkmenistan had difficulties collecting payments from states such as Ukraine and Georgia during this period leading to supply

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[202] BP historical data 2007, "Gas Production from 1970, Gas Consumption from 1964," http://www.bp.com/productlanding.do?categoryId=6929&contentId=7044622, Accessed March 15 2009.
[203] Ibid.
[204] Ibid.
[205] Ibid.
[206] "Russia Energy Profile," Energy Information Agency, http://tonto.eia.doe.gov/country/country_time_series.cfm?fips=RS#ng, Accessed March 15 2009.

cutoffs, and second, prolonged difficulties in arranging transit agreements with Gazprom left Turkmenistan with few export channels for the gas it produced. Regardless of the reasons behind Turkmenistan's decreased production and exportable volumes, these numbers illustrate that Turkmen gas played a minor role in the European and Eurasian gas market between 1995 and 1999.

Another important structural consideration is that while on a regional level natural gas exports from Turkmenistan appeared to play a minimal and decreasing role, Turkmen exports were also playing a decreasing role in Ukraine's natural gas balance, falling from 29.5% in 1996 to 11% in 1999. This was in large part due to Gazprom's reluctance to provide pipeline capacity to transit gas to Ukraine. It is also important to note that over the period in question trade between Ukraine and Turkmenistan in the area of natural gas was governed by direct agreements between the governments of the two respective states and private trade intermediary Itera, which controlled the export of Turkmen gas to Ukraine from 1994 to 2002. Separate arrangements for the transit of the gas over Russia's territory were worked out between the three governments and the independent gas trader. This was not always a smooth process, as can be seen by cutoffs of Turkmen supplies to Ukraine in 1994, carrying over into 1995,[207] further cuts in March of 1997 lasting until early 1999,[208] and supply cuts in mid 1999 as well.[209] These cutoffs originated in Ukraine's inability to pay for the gas it was importing, leading to multimillion dollar debts. During these cutoffs Russia increased the volumes of gas

[207] "Deputy Premier Tells Parliament Fuel and Energy Supplies in a State of "Emergency,"" *BBC Monitoring Service*: *Former Soviet Union*, January 3, 1995.
[208] "Turkmenistan supplied to Ukraine 3 bln cub.m of gaz via Russia in Jan and Feb 1999," *TASS Energy Service*, March 5, 1999.
[209] "Turkmenistan halts gas deliveries to Ukraine," *Reuters News*, May 21, 1999.

it exported to Ukraine to make up for some of the shortages[210]; however, during the 1997-1999 cutoff Ukraine was forced to decrease its domestic consumption due to lack of supplies.

Rent Seeking and the Marginalization of Turkmen Gas

While it seems that Russia may have played a constructive role during these supply disruptions, a closer examination shows that while the cutoffs were due to Ukraine's inability to pay Turkmenistan for the gas it imported, cutoffs were prolonged by disputes between Turkmenistan and Russia over transit prices for gas across Russian territory.[211] A glaring example of this was the meeting on the resolution of the March 1997 cutoff which took place in January of 1998 and guaranteed Ukraine 20 bcm of gas a year until 2005. The resumption of supplies was delayed for another year due to disagreements between Russian and Turkmen officials over the price to be paid for transit across Russian territory.[212]

This lengthy negotiation process saw an attempt by Russia to purchase Turkmen gas outright at $32 per 1000 cm and sell it to Ukraine for a profit, while Turkmenistan was unwilling to sell at a price lower than $42 per 1000 cm, a price which Ukraine had agreed to pay.[213] Further, during this period both Turkmenistan and Ukraine called for a decrease in their reliance on Gazprom to facilitate trade between the two countries, and discussed the creation of a joint trading house which would facilitate the transit of gas between the two countries through Gazprom pipelines, and fulfill the debt clearing function that Itera had been facilitating.[214] This surely would have hurt Itera, as the transit of Turkmen gas to Ukraine was

[210] "Deputy Premier Tells Parliament Fuel and Energy Supplies in a State of "Emergency,"" *BBC Monitoring Service*: *Former Soviet Union*, January 3, 1995.And, "ITERA-UKRAINE to Supply Gas from Russia." *Delovoi Mir*, July 23, 1997.
[211] "Turkmen '98 gas exports depend on Gazprom deal," *Reuters News*, May 10, 1998.
[212] "Gazprom says no deal with Ukraine on Turkmen gas," *Reuters News,* December 28, 1998.
[213] "Turkmen '98 gas exports depend on Gazprom deal," *Reuters News,* May 10, 1998.
[214] "Both Turkmenistan and Ukraine are Interested to Exclude Gazprom from Their Gas Trade," *Kommersant,* May 6, 1997.

its main business function.[215] Gazprom, and Vyakhirev, eventually relented and agreed to ship Turkmen gas through Gazprom pipelines to Ukraine, citing the commercial advantages of the arrangement.[216] In sum, the nature of this dispute underlines three important points: first, Russia was in a position to increase its exports to Ukraine by preventing the transit of Turkmen gas across its territory; second, Russia had an interest in purchasing Turkmen gas at low prices in order to sell it to Ukraine for an increased profit; and third, when Itera's interests were in a position to be damaged, Vyahkirev was willing to compromise.

This illustrates the rent seeking and distributing nature of Vyakhirev's policies, and also the declining role for the Russian state in natural gas transit with respect to Turkmen exports. This is also an example of the relative power which Russia enjoyed in the European and Eurasian natural gas market, as it was able to deny Turkmenistan access to export pipelines while still meeting its domestic consumption and export obligations and actually selling more gas. Next, it is important to examine the impact that this trade structure, Russia's diminished state capabilities, and individuals' preferences for rent seeking and distribution had for the prices Ukraine paid for its natural gas imports from the Russian Federation.

The Transformational Mechanism-Gas Prices for Ukraine 1995-1999

Beginning in 1995, Ukraine actually paid more for its natural gas imports from Russia than most European states did, an average of between $80-$90 per 1000 cm.[217] These prices

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[215] Global Witness, "It's a Gas: Funny Business in the Turkmen-Ukrainian Gas Trade," *Global Witness Publishing*: Washington DC. (April, 2006), 35, http://www.globalwitness.org/media_library_detail.php/479/en/its_a_gas._funny_business_in_the_turkmen_ukraine_g, Accessed May 8 2008.

[216] "Interview With Rem Vyakhirev, Rao Gazprom Board Chairman," *Nezavisimaya Gazeta*, February 19, 1999.

[217] "Ukraine Taps Into Russian Gas Supplies to Western Europe" *BBC Summary of World Broadcasts,* May 26, 1995. Also see: Margarita M. Balmaceda, "Gas, Oil and the Linkages Between Domestic and Foreign Policies: The Case of Ukraine," *Europe-Asian Studies,* 50 no. 2 (March, 1998) 259.

persisted throughout 1996 and 1997,[218] although the situation began to change in 1998. An agreement reached in late 1997 saw Ukraine decrease its transit tariff for Russia's gas exports headed to Europe from $1.75 per 1000 cm per 100 km to between $1.01 and $1.09 per 1000 cm per 100 km. In return, Russia decreased the price Ukraine paid for deliveries of 50 bcm of natural gas to $50 per tcm.[219] Gas outside of this contract, such as the gas supplied as a supplement for undelivered Turkmen gas, was still sold at $80 per tcm. This arrangement remained constant throughout 1999 and into 2005.

While the substantial decrease in Russia's natural gas export prices to Ukraine coincided with a decrease in Ukraine's transit tariffs, and a sharp decline in global oil prices, the fact that Ukraine was actively seeking to diversify its gas exports away from Russia should not be overlooked. Although Turkmen gas was cutoff to Ukraine when the agreement to reduce prices was made, this was largely due to the inability of Turkmenistan and Ukraine to reach a gas transit deal with Russia's Gazprom. Further, Itera, a favourite location for Rem Vyakhirev's rent distribution, as discussed above, would have lost substantially if it was no longer able to participate in the transit of Turkmen gas to Ukraine.

In sum, over the period from 1995 to 1999 Russia and individuals at Gazprom lacked the desire to maintain a monopoly of exports of natural gas to Ukraine. This allowed Turkmen and Ukrainian officials to reach their own accords on pricing, and allowed for some competition with respect to export pricing. It is therefore probable that it was not only decreasing world energy prices and tariff concessions from Ukraine that led to this price

[218] "Gazprom and Ukraine Reach Agreement on 1996 Gas Supplies," *BBC Summary of World Broadcasts*, November 3, 1995. AND: "Gas Prices Pegged at 1996 Levels," *BBC Summary of World Broadcasts*, December 20, 1996.
[219] "Russia, Ukraine Agree to New Transit Terms For 1998," *BBC Summary of World Broadcasts*, December 19, 1997.

decrease, but also the rent distribution impulse of Vyakhirev at play in the price negotiations, and the resulting level of competition presented by Turkmen exports.

Summary

Thus it appears that the exchange of state property for short term political support had a weakening effect on the Russian state as a whole and on the state's control over the natural gas industry specifically. Such a conclusion can be derived from an examination of the actions of the individuals who were conditioned by these types of exchanges. Individuals who were given control over Russia's natural gas industry by the state may have furnished the state with some support. However, through their own rent seeking and distribution they began to enrich themselves and their clients at the expense of the state's capabilities. Actions which amounted to decreasing state control of Gazprom, and Gazprom's control over Russia's natural gas industry as a whole, provide evidence of the pattern discussed in Chapter Two. Further, when faced with competition in the export of natural gas to Ukraine individuals at Gazprom, specifically Rem Vyakhirev, chose to protect the interests of their clients rather than those of the government, which may have had plans for a monopoly over gas exports to Ukraine. This pattern of rent seeking and distribution, combined with falling global energy prices, the limited regional importance of Turkmen gas, and favourable transit agreements with Ukraine, appear to have brought about a drop in the price of Russian gas exported to Ukraine in 1998 which held throughout the rest of the decade.

Chapter 5

Factors Determining Russia's Natural Gas Prices for Ukraine 2000-2004

Introduction

This chapter will begin by detailing the variation in Russia's patrimonial political structure, making specific reference to the greater role played by natural resource rents and the increasingly authoritarian nature of Vladimir Putin's regime. The actions of individual rent seekers, specifically President Putin and those he appointed to head Gazprom, will be discussed next. Attention will be paid here to increased resource rent capture by the state, and rent distribution to state employees. The effects of these individual actions on collective outcomes will then be addressed, highlighting the increased control by the state over Gazprom and the Russian natural gas industry as a whole. This will be followed by a discussion of Turkmen natural gas production and exports in the regional and Ukrainian contexts, along with an examination of Gazprom management's reaction to the importance of these production and export volumes. Finally, the impact of changes in Russia's patrimonial society, individual rent seeking actions, greater state control of the natural gas industry, and the still limited role of Turkmen gas in the regional natural gas trade on the price of Russian natural gas exports to Ukraine will be considered.

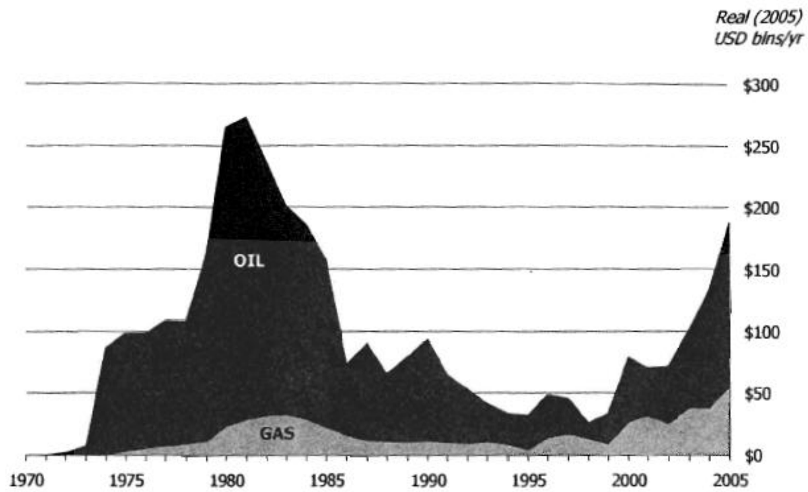
Variation in Russia's Patrimonial System, the Situational Mechanism, and Natural Resource Rents

A brief look at the evolution of energy prices during Putin's first term in office shows a large increase in the rent generating potential of Russia's natural resources, specifically oil and natural gas. Recall that world oil prices bottomed out just before Putin took power in early 1999, and by the end of his first term in office they had increased nearly fourfold (see figure 2.2, Chapter Two, World Oil Prices 1994-2008). The price of Russian natural gas at the German border followed a similar trend over the same period. Russian natural gas export prices to Europe hit their 1990's low in April of 1999 and then moved upwards, increasing 2.5 times by the end of 2004 (see Figure 2.1, Chapter Two, Russian Natural Gas Prices at the German Border 1994-2008).

Determining what this means for the rent generating potential of Russian oil and natural gas is in some ways simple, and in others more complicated. If one holds the cost of production constant, any increase in the price of oil or natural gas leads to an increase in the rents they generate. In reality the costs of production, both natural (perfectly competitive) and reported costs of production (costs actually incurred) vary, and it is difficult to provide good estimates. Gaddy and Ickes, whose definition of natural resource rents was discussed earlier, provide an estimate of the rents derived from Russia's oil and gas production between 1970 and 2005.[220] When making this estimate it was necessary for the two authors to make simplifying assumptions, holding the cost of production at a constant $8 per barrel of oil and $18 per 1000 cubic meters of natural gas. Using a mixture of EIA data and Ural blend crude prices for oil, and net-back prices for Russian exports to Western Europe, they produced a graph illustrating estimates for the total rents derived from oil and natural gas:

[220] Clifford G. Gaddy, Barry W. Ickes, "Resource Rents and the Russian Economy," *Eurasian Geography and Economics,* 46 no. 8 (2005), 561.

Figure 5.1 Total Oil and Natural Gas Rents 1970 -2005[221]



With the darker portion of the graph representing oil rents and the lighter natural gas rents, these data show an unmistakable rise in both oil and gas rents after 1999. This increase in rents combined with Putin's preference for state, as opposed to private, capture of rents conditioned the individuals Putin put in control of the natural gas industry to seek greater state control of the industry and a greater share of rents for the state. Before this issue is discussed, it is important to explore the rise of Putin and the marginalization of influential political groups which were prominent during the 1990's. These events illustrate the power of Putin as president, and the somewhat more authoritarian nature of his rule.

Yeltsin Leaves the Scene – A Trend Toward Authoritarian Rule

Yeltsin began to speak of early retirement by mid 1999.[222] With his health deteriorating, his reform agenda discredited by the previous year's economic turmoil, and growing public disillusionment concerning corruption scandals within his administration, it

[221] Clifford G. Gaddy, Barry W. Ickes, "Resource Rents and the Russian Economy," *Eurasian Geography and Economics,* 46 no. 8 (2005), 562.
[222] Andrew Jack, *Inside Putin's Russia* (New York: Oxford University Press, 2004), 87.

was obvious to most that power over the country was slipping through his grasp. The main concern of Yeltsin and his inner circle was the loyalty of the individual who would take Yeltsin's place. They were not in search of a fall guy, but someone who would ensure their physical and economic safety once they left office. They found their loyal man in a relatively unknown individual, Vladimir Putin.

Putin's rise to the Presidency was swift and interesting in its own right; however, it is not the intent of this case study to detail the intricacies of that rise. What is of concern here is the nature of Putin's regime once he took office. When discussing Yeltsin's regime, Lilia Shevtsova of the Carnegie Endowment for International Peace characterizes it as "evolv[ing] into a neo-patrimonial regime that was based on a leader that holds all power and delegates its functions and authority to an entourage and to competing clans."[223] Though the competing clans have changed under Putin, some becoming more powerful and some less, what appears to have remained constant is individual preferences for rent seeking and distribution, as well as the tendency of these individuals to support their patron. Before discussing the specific issue of rent capture and distribution, the evolution of authoritarian rule under Putin should be briefly explored.

Restoration of the Vertical

There is little doubt that Vladimir Putin's regime was distinctly more authoritarian than that of Yeltsin. A brief examination of how the powerful, and often dissenting, groups Putin inherited when he came into office were dealt with provides evidence of this.

[223]Lilia Shevtsova, *Russia Lost in Transition: The Yeltsin and Putin Legacies* (Washington D.C.: Carnegie Endowment for International Peace, 2007), 5.

Putin came to power with a relatively fractured political elite system in place. There were no fewer than five power groups vying for control over Russian politics.[224] These groups consisted of Yeltsin's 'Family', the Oligarchs, regional leaders, the Siloviki (power ministries--the FSB, internal affairs, military), and reform-minded bureaucrats from St. Petersburg (liberal technocrats).[225] The 'Family' was the term used to refer to Yeltsin's inner circle, which consisted of his heads of the Presidential Administration Valentin Yumashev and Alexander Volshin, his daughter Tatiana Dyachenko, and wealthy oligarchs Roman Abramovich and Boris Berezovsky.[226] Other oligarchs who were still powerful at the time of Putin's ascendance include Vladimir Gusinsky, Mikhail Khodorkovsky, and Vladimir Potanin. These two groups were essentially holdovers from the Yeltsin period. The leaders of Russia's federal districts, who were still popularly elected at the time, were at first the only power group which did not see Putin as an agent of their personal interests.[227] The Siloviki and the Liberal Technocrats rode Putin's coattails to power. Putin, needing to create his own power base, appointed these individuals to the top levels of his administration. This was not necessarily because of their security or reform backgrounds, but because Putin knew them personally from his days with the KGB and his time in the St. Petersburg Mayor's office, and he trusted them.[228] Putin bemoaned the decentralizing trends in Russian politics throughout the 1990's, and believed that the vertical chain of command had to be restored.[229] Subsequently, he spent his first term in office chipping away at the political power of Yeltsin period holdovers.

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[224]Stephen White, ed., *Politics and the Ruling Group in Putin's Russia* (New York: Palgrave Macmillan, 2008), 48.
[225]Ibid.
[226]Andrew Jack, *Inside Putin's Russia* (New York: Oxford University Press, 2004), 81.
[227]Stephen White, ed., *Politics and the Ruling Group in Putin's Russia* (New York: Palgrave Macmillan, 2008), 48.
[228]Lilia Shevtsova, *Russia Lost in Transition: The Yeltsin and Putin Legacies*, (Washington D.C.: Carnegie Endowment for International Peace, 2007), 44.
[229]Marshal Goldman, *Petrostate: Putin, Power, and the New Russia* (Toronto: Oxford University Press, 2008), 78.

The Oligarchs

Putin began reconstructing Russia's vertical power structure by stripping political power away from Russia's new business elites. In late July 2000, a meeting was arranged between the newly inaugurated President of Russia and a number of the so-called business oligarchs who made their wealth during the 1990's privatization. This meeting was presaged by a series of actions taken by the Putin administration whereby businesses, controlled by some of these very elites, had inquires launched against them concerning tax evasion, irregularities in the manner in which the enterprises fell into the hands of their current owners, and accusations of illegal sales of shares to foreigners.[230] Vladimir Gusinsky, media mogul and critic of the President's revived war in Chechnya, was brought under investigation and detained for three days prior to the meeting.[231] At this meeting the President offered 21 of Russia's wealthiest businessmen a truce. The authorities would not review the outcomes of the privatization of the Russia's economy in the 1990's provided all of the businessmen stayed out of opposition politics.

While no official transcripts are available from the meeting, the President's press release stated that the President made it clear that "it was unacceptable for competing companies to use state structures and law enforcement agencies to achieve their goals."[232] Nor is it likely that an explicit deal was offered. As Kakha Bendukidze, who was present at the meeting, put it, "I do not think this meeting draws any line. The President asked us whether we were prepared to abstain from installing our people into the government

[230] Andrew Jack, *Inside Putin's Russia* (New York: Oxford University Press, 2004), 191.
[231] Ben Aris, "Putin declares victory over Russian oligarchs: Old scores settled: But businessmen allowed to keep companies they won," The Daily Telegraph, July 29, 2000.
[232] Andrew Jack, *Inside Putin's Russia* (New York: Oxford University Press, 2004), 195.

structures, and then he himself answered – no, you are not ready."[233] Moscow-based financial commentator Peter Ekman described the meeting in more cynical terms, suggesting "It was a play produced for public consumption, not necessarily a reflection of reality. Many questions remain [such as whether] the show was just a cover for installing new, more Putin-friendly, oligarchs[. . .]"[234] It seems likely in retrospect that the deal was implicit rather than explicit, but that the message was relatively clear: if you (oligarchs) want to keep your ill gotten gains, start paying your taxes and do not oppose the Kremlin. Further, Ekman does not appear far off the mark as the oligarchs, with no power to oppose the President, provided at least implicit support to him. As Hoffman, author of The Oligarchs: Wealth and Power in New Russia puts it, "Putin's approch to oligarchic capitalism during his first year was not to change the system. He just wanted to get control of it."[235]

It is not the intention of this section to suggest who was guilty and who was innocent in the contest between Putin and the oligarchs. It appears that those who Putin targeted had committed indiscretions during privatization in the 1990's; however, the selective nature of the attacks, and the questionable legal means employed, reflect negatively upon the Russian legal system and President Putin's intentions.

The intricacies of Putin's assault on the oligarch's power are too significant to be dealt with fully here. For now it should suffice to say that those business elites who threw their support behind the President and the state were able to keep their ill-gotten spoils from the 1990's while those like Mikhail Khodorkovsky, Vladimir Gusinsky, and Boris Berezovsky

[233] Ben Aris, "Putin declares victory over Russian oligarchs: Old scores settled: But businessmen allowed to keep companies they won," *The Daily Telegraph*, July 29, 2000.
[234] "Putin: Era of 'Oligarchs' Over," *Margaret Coker Cox News Service*, July 29, 2000.
[235]David E. Hoffman, *The Oligarchs: Wealth and Power in the New Russia* (New York: Public Affairs, 2002), 476.

who were critical of the President and his policies were investigated, charged, and forced into exile (Gusinsky and Berezovsky) or imprisoned (Khodorkovsky).

What is clear is that Putin, upon assuming office, did issue a warning of some kind to Russia's new business elite requesting they stay out of opposition politics and begin acting in what Putin saw as the interests of the state. What is also clear is that those who took instructions from the Kremlin were generally spared investigation by the state, while those who criticized Putin and his policies had their assets seized, and were arrested or forced to flee the country.

The examples made of Khodorkovsky, Gusinsky, and Berezovzky soured other oligarchs to the taste of politics, and as Boris Nemetsov, the man credited with coining the term oligarch in the Russian context, put it, "The oligarchs do not want to be oligarchs anymore, they just want to be respected and fairly patriotic businessmen."[236] Sending the state's two most prominent media moguls, and architects of his rise to power, into exile, and imprisoning Russia's richest, and at one time most powerful businessman, signalled the end of the oligarchs as an opposition political force in Putin's Russia. This was a stated goal of Putin at the outset of his time in office, and it appears he was successful. It was clear to all that opposition to Putin would bring the heavy hand of the state security and legal apparatus to bear upon the offender. This certainly signalled a more authoritarian turn in Russian politics under Putin, but the 'oligarchs' were not the only group that Putin sought to marginalize.

Governors

[236] "Russian "Oligarchs" On The Wane Says Man Who Coined The Term," *BBC Monitoring Former Soviet Union,* July 29, 2000.

A second step in the recentralization of power, and the recreation of a vertical power structure in the Russian Federation, was the reform of Russia's upper house of parliament, the Federation Council. The 1993 Russian constitution provided for popularly elected regional governors in Russia's 89 regions, and throughout the 1990's these governors acted rather independently from the state. Immediately upon taking office Putin moved to weaken the power of these regional leaders. First, he created 7 regional districts to which the President appointed leaders and to whom the 89 elected regional leaders were to report.[237] In August of 2000 another law was passed limiting the powers of regional governors by removing them from the upper chamber of parliament, and stripping them of their immunity from prosecution.[238] Putin's final act was to put an end to the popular election of regional governors. A bill passed in September of 2004 stipulated an end to popular elections for regional leaders from the beginning of 2005, and also stipulated that the appointment of regional leaders would become the purview of the Kremlin.[239] This more or less put an end to the regional governors as a force independent of the President.

The 'Family'

While Putin moved quickly to neutralize the power of the Oligarchs and the regional governors, aside from Berezovzky, Yeltsin's ruling circle, the 'family', retained some power and influence within the Kremlin during the first few years of Putin's administration. Putin's first act as President was to grant Yeltsin immunity from prosecution, protecting him from legal action that some believed might be taken against him and his inner circle for corrupt dealings throughout the 1990's. Further, Alexander Voloshin was kept on as head of the

[237] Stephen White, ed., *Politics and the Ruling Group in Putin's Russia* (New York: Palgrave Macmillan, 2008), 48.
[238] "Russian President Sign Law on Upper House Reform," *Xinhua,* August 7, 2000.
[239] "Russia's Regional Leaders woo Putin as Elections are Scrapped," *The Daily Telegraph,* September 24, 2004.

Presidential Administration and Valentin Yumashev, another member of Yeltsin's inner circle, was allowed to keep his office in the Kremlin for most of Putin's first term.[240] These remnants of the past would also fall by the wayside, however, and the formal powers of this group became greatly diminished during the final years of Putin's first term.

Siloviki and the Technocrats

While the early years of Putin's rule were characterized by a clampdown on some of the more powerful groups that carved out niches in the 1990's, it was also characterized by the rise of two groups within the Kremlin, the Siloviki and the Liberal Technocrats. Loosely defined, the term Siloviki refers to the heads of Russia's 'power' ministries, generally those with a background in the security services, police, or the military. The second group, known as the Liberal Technocrats and/or the St. Petersburgers, consists of friends of Vladimir Putin with whom he worked in the St. Petersburg Mayor's office under Anatoly Sobchak. While broadly stated these loosely defined groups agree that Russia should be governed by a strong and centralized executive, the Liberal Technocrats are more sensitive to the importance of the rule of law and the impact that forced renationalization has on the investment climate in Russia.[241] Both of these factions were brought to power by Putin, and as we will see in the next section the Liberal Technocrats have come to dominate Russia's natural gas industry.

Liquidation of the "Gasoviki" – Changing Individuals

In a fashion similar to that of his predecessor, Putin placed individuals loyal to him in high level positions in the natural gas industry. While Viktor Chernomyrdin was already a

[240] Andrew Jack, *Inside Putin's Russia* (New York: Oxford University Press, 2004), 192.
[241] Jorgen Staun, "Siloviki Versus Liberal-Technocrats: The Fight For Russia's Foreign Policy," *Danish Institute For International Studies,* (2007), 31, http://www.diis.dk/graphics/Publications/Reports%202007/diisreport-2007-9.til%20web.pdf, Accessed May 14 2008.

well positioned manager within the Russian natural gas industry when Yeltsin came to power, it was nonetheless with presidential approval that he and his predecessor Rem Vyakhirev managed Gazprom throughout the 1990's. Putin, upon entering office, was faced with the fact that it was Yeltsin's men who were running Gazprom. Further, considering the asset stripping, non-payment of taxes, and cosy relationships with non-state gas companies that these men fostered when at Gazprom, it was never likely that they would retain their positions.

Chernomyrdin

Chernomyrdin oversaw the creation of Gazprom and managed it as CEO until he assumed the post of Prime Minister in 1992. After his term as Prime Minister ended, Chernomyrdin was appointed Chairman of the company in 1999. Only three months into Putin's first term as president Chernomyrdin resigned his newly acquired post at Gazprom. Analysts suggested at the time that Chernomyrdin had lost his influence over the company when Putin took office.[242] Chernomyrdin suggested as much when after his resignation he stated that he was unhappy with his role as "advisor."[243] Speculation that Chernomyrdin was in fact fired[244] was likely fuelled by the fact that he had a closed door meeting with Putin the day before his resignation.[245]

Dmitry Medvedev

When Chernomyrdin first left Gazprom in 1992 he had the pleasure of appointing his own successor. This time, however, his successor would be chosen by Putin. Chernomyrdin's replacement was, at the time, a relative unknown--Dmitry Medvedev.

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[242] Vladimir Afanasiev, "Chernomyrdin to quit gas post," *Upstream*, June 30, 2000.
[243] "Russia's Chernomyrdin Quits As Gazprom Chairman – TV," *Dow Jones International News*, June 29, 2000.
[244]Marshal Goldman, *Petrostate: Putin, Power, and the New Russia* (Toronto: Oxford University Press, 2008), 101.
[245] Vladimir Afanasiev, "Chernomyrdin to quit gas post," *Upstream*, June 30, 2000.

Medvedev was elected Chairman of the Board of Directors of Gazprom at the end of June 2000. Prior to taking the post Medvedev was deputy head of the presidential administration and worked closely with Putin at the St. Petersburg mayor's office under Anatoly Sobchak. This was one of the first steps taken by the Russian state to reign in the Soviet-era managers who controlled Gazprom throughout the 1990's. The move was seen as a decrease in the power of Soviet-era management on the board of directors, as their representation shrank from five seats to four. The number of seats held by state representatives increased from four to five.[246] This advantage would soon come in handy when Putin began further attempts to reform the company and its relationship with the state.

Rem Vyakhirev

While Chernomyrdin appeared to leave Gazprom with little in the way of a fight, his protégé Rem Vyakhirev was less willing to be pushed aside. Apart from his attempts to block independent shareholders from voting with regard to his future position[247], there has also been some credible speculation that Vyakhirev attempted to further strip Gazprom of assets before his contract expired at the end of May 2001.[248] Prior to the May 30th Board of Directors vote there were attempts by both management and independent share holders to block one another from participating. It is widely speculated that Gazprom management initiated legal proceedings which attempted to block roughly 2% of the company's voting shares, held by

[246] "Russian government tightens control over gas monopoly," *BBC Monitoring: Former Soviet Union*, June 30, 2000.
[247] Sabirina Tavernise, "Judge in Russia Freezes Some Shareholder Votes in Struggle Over Gazprom," *The New York Times*, May 12, 2001.
[248] "Time nearly up for Gazprom leadership," *Gas Connections,* May 3, 2000.

minority share holders, from being represented at the meeting. Further, old management attempted to block minority shareholder's nominations to the board.[249]

In similar proceedings minority shareholders attempted to block Gazprom management's 5.5% of voting shares, and ban their six candidates for the Board of Directors elections. In the end the government stepped into the dispute and essentially decreed that all voting shares would be represented and that no nominees would be banned from the elections.[250] While the government eventually mediated the situation this conflict illustrates two things: first, the hostility that each side held for the other, and second, that some representatives of management at Gazprom were in no hurry to see the departure of Vyakhirev.

In hindsight, the future of Vyakhirev at Gazprom appears to have been sealed when in mid-May 2001 Russia's Federal Securities Commission denied an application for the extension of the trust agreement that saw Vyakhirev manage the government's shares in the company from 1998 onwards.[251] In the end voting was unanimous and Vyakhirev also voted to terminate his contract and step 'upstairs' to a largely ceremonial position.[252] One should not put too much stock in the unanimous decision to oust Vyakhirev as, with the government holding five of the eleven seats and independent shareholders hostile to current management holding two more, there was no point to showing dissent and displeasing Putin or the new CEO.

Alexey Miller

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[249] Guy Chazan, "Court Bars Re-Election Of Gazprom Director --- Minority Holders May Lose Influence Over Firm --- Shares of Russia's Biggest Company Decline 4.6%," *The Asian Wall Street Journal*, May 14, 2001.
[250] "Russian Deputy Energy Minister Appointed Gazprom Chief," *Daily Business Report,* May 30, 2001.
[251] "Rem Vyakhirev Loses Voting Right for GAZPROM State Shares," *Novecon*, May 17, 2001.
[252] "R.Vyakhirev replaced by new Gazprom chief executive," *AK&M*, May 30, 2001.

Vyakhirev's replacement was voted on at the same May 30th 2001 meeting, and just as Chernomyrdin was replaced, a close associate of Putin's was voted into the vacant CEO position. Alexey Miller, Putin's apparent choice to succeed Vyakhirev, was born in Leningrad and worked on the public relations committee at the St. Petersburg Mayor's office from 1991-1996, alongside Putin and under Sobchak. After Sobchak was voted out of office, Miller worked as the director for development and investment at the St. Petersburg Sea Port from 1996 to 1999. From 1999 to 2000 he was the general director of the Baltic Pipeline System, and from 2000 until his move to Gazprom he was Russia's deputy energy minister.[253] He has been reported to be a close confidant of Putin. A closer look at Putin's opinions on the Russian natural resource sector, and the state's role in it, provides a starting point for what should have been expected from the individuals he appointed.

The Putin Thesis

Putin's views on the state's role in the Russian energy sector might have been inconsequential had it not been for the sharp increases in the price of energy at the turn of the century. Putin's accession to the position of Prime Minister took place in August of 1999, and oil prices bottomed out in December of 1998 at $10.40 per barrel and began an eight year upward trend. As a result Putin's perception of the government's role in Russia's increasingly profitable gas sector assumed considerable importance. Putin sketched a rough road map for the role of the state in exploiting Russia's energy and mineral wealth even before taking office. In a thesis submitted to the St. Petersburg Mining Institute in 1997, and in a subsequent article, Putin outlined how he saw the relationship between the state and natural resources. Essentially, Putin linked the future of the Russian economy to harnessing its

[253] "Russian Deputy Energy Minister Appointed Gazprom Chief," *Daily Business Report*, May 30, 2001.

natural resource extraction potential.[254] He viewed state control over these resources as necessary to ensure that the benefits they bring could be harnessed by the state and put to work for it.[255] The centerpiece of this plan was the concept of national champion companies which, with state support, could compete internationally.[256] Gazprom and Rosneft are two good examples of Russian national champions. An analysis of rent seeking and distributive actions taken by Putin and his team, along with Medvedev's and Miller's support the of Putin thesis from 2000 to 2004, will illustrate a change in the situational mechanism away from distributing property rents to the capture and distribution of resource rents. This change, and its implications, will be the next subject of discussion.

The Individual Action Mechanism – Rent Seeking and Distribution in a New Environment

The close relationship among Medvedev, Miller, and Putin cannot be understated. Both were brought from obscurity into the halls of power by Putin and as a result it was unlikely that their interests would diverge significantly from his. This general trend can be seen even in their statements upon assuming their positions. Medvedev, upon taking on the position of Gazprom's Chairman, noted that his role would be to "fulfill the laws of the company and protect the interests of shareholders, first and foremost the government."[257] Miller was also reported to have told gas industry officials prior to assuming Gazprom's top job that the Government was to play a stronger role at Gazprom.[258]

The commitment these two men demonstrated to the Putin thesis is underlined by their actions. While Vyakhirev's control of Gazprom was characterized by the sale of assets to

[254]Vladimir Putin, "Mineral Natural Resources in the Strategy for Development of the Russian Economy," Problems *of Post-Communism*, 53 no. 1 (January/February 2006) 48–54.
[255]Ibid.
[256]Marshal Goldman, *Petrostate: Putin, Power, and the New Russia* (Toronto: Oxford University Press, 2008), 97-99.
[257] "Russia Gazprom Holders Pick Kremlin's Medvedev Chrmn," Dow *Jones International News,* June 30, 2000.
[258] "Russian Government Wins Control of Gazprom Board," *Reuters,* June 29, 2001.

companies outside government control, pipeline concessions to private companies, and tax evasion, Miller and Medvedev's first years at the helm were characterized by the reversal of these trends. This was true in the domestic market, and in European and CIS export markets.

Rent Capture for The State

In line with Gaddy and Ickes' division of rents discussed earlier in this chapter, an examination of the policies of Putin, Medvedev, and Miller shows a trend towards increasing the natural gas rents captured by the state. This was accomplished by gaining control over the Gazprom board of directors, tax reform, regaining lost market share, and the renationalization of productive assets lost in the 1990's. These moves increased the state share of formal taxes, its control over excess costs of production, and its share of after tax profits.

Control of Gazprom

Though between 2000 and 2004 the state's share of Gazprom shares remained constant at just over 38%, this number does not take into account the state's increased representation on the company's board of directors (from 4-5 of 11 directors) or the acquiescence of the board's independent members to Gazprom's moves to recapture as much production capacity and market share as possible. Interestingly over the first few years of the new millennium independent shareholder interests and state interests appear to have coincided nicely. While increasing the government's ownership share in Gazprom was the easiest way to increase the after tax profit share of rents generated through the extraction and export of natural gas, increasing the state's representation on the board of directors gave the individuals representing the state a much freer hand in determining Gazprom policies and more control over the creation and distribution of rents, including channelling excess production costs to benefit

Putin's goals. This greater control can be seen through other policies that further increased the state's control over natural gas rents.

Control of Pipelines

While throughout the 90's most of Russia's low-pressure domestic distribution system remained outside the control of Gazprom, after new management took over Gazprom gained control of over 90% of this network.[259] By 2003, Gazprom controlled, or had a stake in, over 75% of all domestic distribution organizations which served over 70% of the Russian domestic market.[260] Further, while in the 1990's these gas distribution organizations were able to profit from the difference between the price at which they purchased gas from Gazprom subsidiaries and the price they received from consumers, by 2003 they were forced to pay this portion of their profit margin to the subsidiary from which it purchased the gas, thus capturing more after tax profit for the individuals controlling the state and Gazprom.[261] Throughout his time as CEO Miller fought to keep the production and distribution units of the company together, arguing that any such division would endanger domestic supplies.[262] In the face of declining Gazprom production at the beginning of the century, Gazprom management began allowing independent producers access to Gazprom pipeline capacity; however, these concessions only extended to the domestic market, and were contingent on the amount of excess capacity in the system.[263]

Recapturing Lost Assets

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[259] Andreas Heinrich, Julia Kusznir, "Independent Gas Producers in Russia Working Paper: 2" (2005), *Koszalin Institute of Comparative European Studies*, 6, http://www.kices.org/downloads/KICES_WP_02.pdf, Accessed June 15 2008.
[260] Ibid.
[261] Ibid., 7.
[262] Ibid., 9.
[263]Ibid.

In what appears to have been an effort to stem this decline in production, almost immediately after Miller's and Medvedev's ascent to Gazprom's top spots the Board of Directors began a crusade to recapture assets lost to independent producers under the previous management team. A year later, in 2002, Gazprom and Itera reached an agreement which saw Itera sell 32% of Purgaz back to Gazprom, and swap 52% of Severneftegazprom for small shares in companies already controlled by Itera. Further, Itera lost its share of the Rospan production unit and Severneftegazprom parent company Zapsibgazprom.[264] Itera's losses between 2001 and 2004 amounted to over 1 trillion cubic meters in natural gas reserves, much of which was captured by Gazprom.[265]

Recapturing Market Share

Aside from regaining production assets that were lost in the 1990's, Miller and Medvedev also set out to recapture the share of the CIS export market Gazprom gave up to Itera in the 1990's. Through the denial of pipeline access and the repatriation of some of Itera's productive assets, Gazprom successfully squeezed Itera out of the CIS export market. In 2002 Gazprom increased its share of Russian gas deliveries to Estonia from 75% to 100%, its share of deliveries to Lithuania from 78% to 92%, and its share of deliveries to Latvia from 74% to 84%.[266] In 2003 Gazprom also returned to the abandoned markets of the south Caucusus, launching deliveries to Georgia, Armenia, and Azerbaijan at the same time that it

[264]Jonathan Stern, *The Future of Russian Gas and Gazprom* (New York: Oxford University Press, 2005), 16.
[265] Ibid.
[266]Andreas Heinrich, Julia Kusznir, "Independent Gas Producers in Russia Working Paper: 2" (2005), *Koszalin Institute of Comparative European Studies*, 13, http://www.kices.org/downloads/KICES_WP_02.pdf, Accessed June 15 2008.

blocked Itera access to export pipelines serving these states. This essentially removed Itera from these markets.[267]

Interestingly, while Gazprom executives were able to remove Itera from the European CIS market, they were unable to capture Itera's entire market share for themselves, specifically in the Ukrainian market. In November 2002 Gazprom began to limit the quantities of gas Itera was allowed to supply to Ukraine. The deputy chairman of Gazprom suggested that "the transit contract of Central Asian gas to Ukraine may be fulfilled by Gazprom itself."[268] Eventually the Itera contract was terminated altogether. This appeared to leave the door open for Gazprom to take full control over Central Asian gas exports to Ukraine; however, that did not turn out to be the case, as will be seen later.

Tax Reform

Further, while not tied directly to the new management of Gazprom, those controlling the state took steps to increase the share of revenue they received from the increasingly profitable export of natural gas. In 2004, the methods of taxing the natural gas industry changed substantially. Excise duties on natural gas were abolished while the mineral extraction tax was changed from 16.5% to a flat tax of 107 rubles per 1000 cubic meters produced. The tax on exports was drastically increased from a mere 5% to 30%.[269] Complete figures on the government tax revenues for natural gas production export and sale are not readily available; however, Gazprom produces some statistics on the subject.

[267] Andreas Heinrich, Julia Kusznir, "Independent Gas Producers in Russia Working Paper: 2" (2005), *Koszalin Institute of Comparative European Studies*, 13, http://www.kices.org/downloads/KICES_WP_02.pdf, Accessed June 15 2008.
[268] Global Witness, "It's a Gas: Funny Business in the Turkmen-Ukrainian Gas Trade," *Global Witness Publishing*: Washington DC. (April, 2006), 36, http://www.globalwitness.org/media_library_detail.php/479/en/its_a_gas._funny_business_in_the_turkmen_ukraine_g, Accessed May 8 2008.
[269] Jonathan Stern, *The Future of Russian Gas and Gazprom* (New York: Oxford University Press, 2005), 57.

Figure 5.2 Taxes Paid By Gazprom 2000 – 2007 in Billions of Rubles[270]

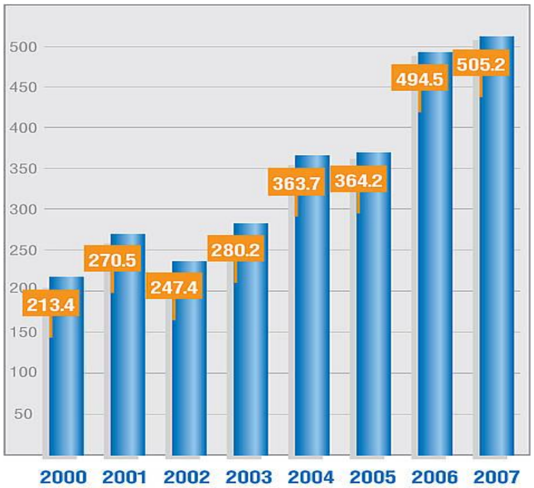

Figure 5.2 shows a large increase in the taxes Gazprom reports to have paid between 2000 and 2004, having paid 213.4 billion rubles of taxes in 2000 and increasing this sum to 363.7 billion rubles by 2004.[271] This is perhaps the clearest indication of increased rent capture by those controlling the Russian state.

It is not difficult to determine from the information provided above that, although not wholly successful in monopolizing natural gas rents, Gazprom's new management took an approach to Gazprom's role in the Russian natural gas industry that differed greatly from that of Soviet holdovers of the 1990's. Whereas Chernomyrdin's and Vyakhirev's period at the helm of the company saw Gazprom lose market share and productive assets through concessions to supposed rival Itera, Miller's and Medvedev's first years at the helm saw much of this process reversed. Further, this new assertive approach at Gazprom was directly in line with Putin's strategy of the state controlling the industry. Putin placed individuals close to

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[270]Gazprom Web Site, "Gazprom Questions and Answers 2008," 66, http://eng.gazpromquestions.ru/fileadmin/template/docs/ALL_Eng_72.pdf, Accessed May 1, 2009.
[271]Ibid.

him at the head of Gazprom and they fulfilled his strategy seemingly to the letter, engaging in resource rent capture for the state.

Rent Distribution by the State

While tracking the distribution of natural resource rents is more difficult than tracking the distribution of property, some statistics show that a greater share of rents which were captured by the state were distributed to state employees. Statistics from Russia's Federal Statistics Service show sizable increases in the salaries of individuals working in public administration, defence, and receiving social security payments. From 2000 to 2004 the average monthly nominal accrued wages in this sector increased almost threefold from 2.712 million rubles to 7.898 million rubles.[272] Further, this sector's share of the overall Russian workforce fell from 7.4% in 2000 to 6.9% in 2004.[273] The wages of educators, and health and social workers followed a similar trend, each growing by roughly 3.4 times over this period,[274] while their representation in the work force increased from 15.8% to 16.3%.[275] Assuming these wage increases were made possible by increased revenue from natural resources, and it is hard to see where else they may have come from, this shows that at least some of the rents captured by the those controlling the state and Gazprom through the extraction of natural resources, including natural gas, were used to increase the salaries of state employees.

Though illustrative of the pattern of resource rent distribution which characterized Putin's first term, the above statistics fail to illustrate the growth of Russia's bureaucracy

[272] Russian Federal Statistics Service, "Average Monthly Nominal Accrued Wages of Employees of Organizations by Kinds of Economic Activities," http://www.gks.ru/bgd/regl/b08_12/IssWWW.exe/stg/d01/07-07.htm, Accessed April 28 2009.
[273] Labrosta Internet, "Russia - Total Employment by Economic Activity 1997-2007," http://laborsta.ilo.org/STP/guest, Accessed April 27 2009.
[274] Russian Federal Statistics Service, "Average Monthly Nominal Accrued Wages of Employees of Organizations by Kinds of Economic Activities," http://www.gks.ru/bgd/regl/b08_12/IssWWW.exe/stg/d01/07-07.htm, Accessed April 28 2009.
[275] Labrosta Internet, "Russia - Total Employment by Economic Activity 1997-2007," http://laborsta.ilo.org/STP/guest, Accessed April 27 2009.

characterized by Shevtsova in one of her most recent works, Russia Lost in Transition: The Yeltsin and Putin Legacies, as "burgeoning officialdom."[276] Moving away from pensioners and public administrators into more specifically defined occupational categories, the trend highlighted by Shevtsova becomes more evident. The share of the Russian workforce made up of legislators, senior officials, managers, including senior government officials, corporate managers, and general managers increased from 4.3% in 2000 to 6.7% in 2004.[277] These numbers more clearly illustrate the growth of the bureaucracy during Putin's first term, and the pattern of resource rent distribution that would be expected from individuals operating under the Putin thesis.

Interestingly, individuals employed in electricity, gas, and water supply occupations grew as an absolute number by over 500,000 from 2000 to 2004, and as a share of the Russian working population from 2.5% in 2000 to 2.9% in 2004. The increase in the number of individuals working in these occupations is less stark than that of legislators and managers, but still demonstrates the growth in rents distributed to these industries, and hints at an increase in rent distribution in the industry through an increase in the cost of production, another destination of resource rents highlighted by Gaddy and Ickes.

Russia's Foreign Reserves

While rent distribution to state officials and employees is apparent between 2000 and 2004, all of the rents were clearly not distributed. In fact, a good deal were saved in the form of international financial reserves including foreign exchange and gold. Russia's reserve

[276]Lilia Shevtsova, *Russia Lost in Transition: The Yeltsin and Putin Legacies*, (Washington D.C.: Carnegie Endowment for International Peace, 2007), 59.
[277] Labrosta Internet, "Russia – Total Employment by Occupation 1997-2007," http://laborsta.ilo.org/STP/guest, Accessed April 27 2009.

position stood at 27.9 billion U.S. dollars at the end of 2000.[278] This figure increased substantially by 2004, reaching a level of 123.5 billion U.S. dollars by year's end.[279] That represents more than a fourfold increase in Russia's international reserve position in only four years. If we go back to the late 1990's this increase looks even sharper as Russia's reserve position stood at 17.7 billion U.S. dollars in 1997, 12.2 billion U.S. dollars in 1998, and 12.4 billion U.S. dollars in 1999.[280] Thus, from a low in the late 90's of 12.2 billion in international reserves, Russia saw a more than tenfold increase in its international reserve position by 2004.

Stabilization Fund

Though it was not a direct product of natural gas rents the Russian government set up a stabilization fund in early 2004. This fund accumulates the revenues gained from oil export duty and the tax on oil extraction operations when the price of Urals blend crude oil exceeds 27$ U.S. per barrel.[281] This fund is essentially designed to capture and save oil rents for distribution at a later date. By the end of 2004 the fund reached a level of 522.2 billion Rubles.[282] The government would not set up the National Wealth Fund, which would also draw on natural gas revenues, until 2008. While the increase in the number of state officials and their pay is funded by more than just natural gas rents (a greater share can probably be attributed to oil revenues), as were the increases in Russia's international reserve position and the creation of a stabilization fund, natural gas rents did play a role, and this is more evidence

[278] Bank of Russia Statistics, "Gross International Reserves of the Russian Federation 1997-2008," http://www.cbr.ru/eng/statistics/credit_statistics/, Accessed April 29 2009.
[279] Ibid.
[280] Ibid.
[281] Russian Finance Ministry, Stabilization Fund of the Russian Federation, "About the Fund," http://www1.minfin.ru/en/stabfund/about/, Accessed April 29 2009.
[282] Finance Ministry of the Russian Federation, "Stabilization fund of the Russian Federation: Funds flow on the Federal Treasury's account in the Bank of Russia in rubles in 2004," http://www1.minfin.ru/common/img/uploaded/library/no_date/2007/rub2004_eng.pdf, Accessed May 4 2009.

that the state has been able to capture natural resource rents and use them, or save them, for its own purposes.

Summary of Individual Action

Three results of the situational mechanism (patrimonialism through the distribution of resource rents) have been illustrated in the preceding section. First, the President has sought to maximize the state's share of increasing natural resource rents as outlined in the Putin thesis. Second, individuals appointed by Putin have sought to maximize the rents they control, in this case by controlling Gazprom and natural gas rents, by supporting Putin's policy of increasing the state's role in the industry, and further by directing the execution of policies aimed at this end. Third, the rents that have been captured by the state, at least in part, have been redistributed to public administrators, government officials, corporate managers (often appointed and controlled by the state), lower level managers, gas industry workers, and pensioners. This is in stark contrast to the position of business elite and Soviet era managers who were the main beneficiaries of Yeltsin's patrimonialism. Further, some of these funds have been placed in government controlled coffers for use at a later date. The impacts of these individual actions on macro level outcomes will now be discussed.

The Russian States Increasing Control Over the Natural Gas Industry

Miller and Medvedev were successful in regaining a large portion of the reserve base Gazprom lost through the 1990's, regaining the portion of Purgaz essentially given to Itera in the late 1990's along with Severneftegazprom and its parent company Zapsibgazprom. Management at Gazprom was also able to gain control over a larger share of the domestic low pressure gas transport system and limit the use of this system, as well as the high pressure high capacity export system, by non-state parties. As far as market share is concerned, though in the early years of the decade Itera controlled over 50% of the total gas exported to the CIS, this changed sharply in 2003. In 2002 Gazprom exported 42.3 bcm to the CIS and Itera exported 44.9 bcm. In 2003 Gazprom exported 44.1 bcm to the CIS while Itera only 14.08 bcm. This drop in Itera's market share is reflective of its loss of the contract to export Turkmen gas to Ukraine, and its lost market share in the Baltic states and the Caucusus. As discussed above this did not translate into a direct gain of Ukrainian market share for Gazprom, as it did not take over the contract directly, leaving UralTransGas with a share of around 20 bcm for 2003 and 2004, in accordance with the deal reached by Ukraine and Turkmenistan in 1998.

In sum, from 2000 – 2004 Gazprom management was able to wrestle back a large portion of the reserve base that was lost in the 1990's, gain greater control of Russia's natural gas transit system, and individuals controlling the Russian state were able to increase their influence substantially within the company. This put Gazprom in a better position to fulfil domestic and export demand, but did not translate directly into a drastically increased share of the Ukrainian market. The company still maintained a monopoly over exports to Europe during this period which, given the rising price of natural gas in that market, translated into a sizable increase in profits, and with a large increase in export taxes the state was able to capture a much larger share of the spoils. This allowed for the swelling of Russia's foreign reserve holdings, the start a new stabilization fund, and an increase in the number of and salary paid to government officials. Before moving on to the transformational mechanism's effect on natural gas prices for Ukraine, the next question that must be addressed is the role that Turkmen natural gas played in the regional natural gas trade, and specifically in Ukrainian imports.

Eurasian Natural Gas Trade and the Role of Turkmenistan 2000-2004

In the year 2000, European and Eurasian natural gas production reached 959.5 bcm, its highest level since 1989.[283] This was an increase of close to 25 bcm over 1999. The increases continued throughout the first half of the decade, reaching 1055.6 bcm by 2004.[284] Over four years this constituted an increase of 96.1 bcm of production, more than three times the increase seen from 1995 – 1999.[285] Russia's share of regional production, which stood at 56.8% in 2000, continued its slow decline, falling to 55.9% by 2004.[286] Turkmenistan's share of regional production grew slightly over this period, from 4.6% in 2000, up from 2.3% in 1999, to 5.1% in 2004.[287]

As far as consumption is concerned, European and Eurasian natural gas consumption increased from 1013.5 bcm in 2000 to 1101.2 in 2004, making for an increase of 87.7 bcm, the biggest five year jump since the collapse of the Soviet Union.[288] Russian domestic consumption saw a much greater increase than it did over the previous four years, moving from 377.2 bcm in 2000 to 401.9 bcm in 2004, an increase of 24.7 bcm.[289] Turkmenistan's

[283] BP historical data 2007, "Gas Production from 1970, Gas Consumption from 1964," http://www.bp.com/productlanding.do?categoryId=6929&contentId=7044622, Accessed March 15 2009.
[284] Ibid.
[285] Ibid.
[286] Ibid.
[287] Ibid.
[288] Ibid.
[289] Ibid.

domestic consumption grew as well over this period, beginning in 2000 at 12.6 bcm and ending in 2004 up almost 3 bcm at 15.5 bcm. [290]

Consumption relative to production in Russia stood at 69.2% in 2000, an increase over 1999 numbers, and decreased slightly to 68% by 2004.[291] Turkmenistan's share of production consumed fell sharply between 1999 and 2000 from 53% to 28.7%.[292] Between 2000 and 2004 Turkmenistan's consumption of production decreased ever so slightly to 28.4%.[293] What is clear from these numbers is that while the late 1990's saw Turkmenistan consuming more than half the gas it produced, the onset of the new century saw that number decrease substantially, leading to an increase in the volumes of gas Turkmenistan had to export, and increasing its overall contribution to the European and Eurasian gas balance.

Russia's contribution to the overall regional balance remained close to stagnant, and actually decreased slightly. With an increase in regional consumption of 63 bcm, when Russia is removed from the equation[294] it becomes clear that Turkmenistan, with an increased share of regional production and increased export capacity, becomes more important to fulfilling increasing regional demand. This is in sharp contrast to the 1995-1999 period that saw Turkmenistan's share of regional production shrink along with its export capacity. Russia, though still a major producer and exporter in absolute terms was, between 2000 and 2004, unable to increase its export capacity and unable to capture a larger market share in the

[290] BP historical data 2007, "Gas Production from 1970, Gas Consumption from 1964," http://www.bp.com/productlanding.do?categoryId=6929&contentId=7044622, Accessed March 15 2009.
[291] Ibid.
[292] Ibid.
[293] Ibid.
[294] Ibid.

face of growing demand. For example, in 2001 Gazprom was forced to import natural gas from Turkmenistan to fulfil its supply contract with the Netherlands.[295]

While it is apparent that Turkmenistan gas exports became a larger part of the European and Eurasian natural gas trade, the importance of these volumes can be overstated if they are not examined in the context of pre-Soviet collapse numbers. In 1989, for example, Turkmen natural gas production made up 8.7% of regional production, a much greater share than that attributed to it in 2004.[296] Further, Turkmenistan's consumed share of production in 1989 was 17.4%, much less than the 28.7% consumed in 2004. This means that even by 2004 Turkmenistan had less gas to export than it did in 1989, as part of the Soviet Union.

In sum, production and consumption numbers for 2000 to 2004 show an increase in Turkmenistan's share of regional production, and an increase in the volumes it had available for export. While this suggests a growth in the importance of Turkmen gas regionally, a comparison of 2004 numbers with 1989 numbers shows that while Turkmenistan's share of production and exports increased by 2004 they still remained below their levels in 1989. Thus although increasing in importance, Turkmen gas supplies were still of small, albeit growing importance for the region as a whole.

Turkmen-Ukraine Bilateral Gas Deals-Business as Usual

As in the late 1990's, the early 2000's saw Turkmenistan and Ukraine signing deals over pricing and supply, and a reliance on Gazprom and intermediary companies for the

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[295] Andreas Heinrich, Julia Kusznir, "Independent Gas Producers in Russia Working Paper: 2" (2005), *Koszalin Institute of Comparative European Studies*, 9, http://www.kices.org/downloads/KICES_WP_02.pdf, Accessed June 15 2008.
[296] BP historical data 2007, "Gas Production from 1970, Gas Consumption from 1964," http://www.bp.com/productlanding.do?categoryId=6929&contentId=7044622, Accessed March 15 2009.

transit of the gas.[297] In 2000 Ukraine's non-payment for gas from Turkmenistan once again forced the latter to cutoff supplies. During this supply disruption Gazprom management once again agreed to supply Ukraine with more gas than originally contracted, 5 bcm, at $80 per 1000 cm.[298] Agreements on Ukrainian debt were reached in July of 2000, and Turkmenistan and Ukraine struck a deal that would resume the shipment of 20 bcm of natural gas to Ukraine at a price of $42 per 1000 cm. This agreement also envisioned an increase in the amounts exported to Ukraine over the next 10 years to 50 bcm per year.[299]

There is not enough space here to provide a full account of the negotiations that took place between Russia, Ukraine, and Turkmenistan regarding Turkmen exports to Ukraine from 2000 to 2004, but what is important is that during the 5 years in question in this section Ukraine still purchased gas through direct talks with Turkmenistan and third party intermediary companies, and did not buy all of its gas directly from Gazprom.

The bilateral structure of Ukrainian Turkmen gas negotiations did not change over the period of time in question, but the intermediary that handled the transportation of this gas did. In November of 2002 Gazprom reduced the amount of gas Itera could supply to Ukraine and at the end of this month Gazprom official Aleksandr Ryazanov is quoted as saying "the transit contract of Central Asian gas to Ukraine may be fulfilled by Gazprom itself. We will supply Turkmen gas to Ukraine on the same terms as Itera, and maybe even better. . . Why should

[297] "Turkmenistan Agrees Gas Sales To Russia, But Not Ukraine," *Petroleum Report*, January 5, 2000.
[298] Gazprom Had To Sign Gas Deal With Ukraine – Itera Chief," *Daily Petroleum Report*, February 18, 2000.
[299] "Turkmenistan and Ukraine Strike Gas Deal, Settle Old Debts," *Agence France-Presse*, July 26 2000.

Itera make super profits using the facilities of Gazprom?"[300] This was the end of Itera as the intermediary between Turkmenistan and Ukraine.

While Ryazanov's statement appeared to indicate Gazprom's desire to more closely control Turkmen exports to Ukraine from 2002-2004 this did not materialize. Instead, another intermediary, EuralTransGas, was set up. This company was supposed to be a 50-50 joint venture between Gazprom and Naftohaz Ukrainy, however, these companies' involvement never materialized.[301] Once again the profits from the transit of Turkmen gas to Ukraine were being captured by a private company with an unclear ownership structure, and were not being directly returned to either Ukraine or Russia. While there is little evidence to indicate why Gazprom and Naftohaz were unable or unwilling to take control of this intermediary, what is clear is that while Gazprom management was able to increase the rents it captured from the export of natural gas between 2000 and 2004, they were not able, or did not care to capture the rents generated by the sale of Turkmen gas to Ukraine. Of course, in Russia's corrupt business climate there is always a chance that those controlling Gazprom were benefitting personally in some way. Further, given the still limited importance of Turkmen gas regionally, dominating the Ukrainian-Turkmen gas trade may have been less of a priority than the recapture of productive assets and pipeline control.

Another interesting trend that revealed itself during this period was the Turkmen government's desire to raise the prices at which it exported natural gas to both Ukraine and Russia. Throughout most of the period from 2000 to 2004 both states purchased Turkmen gas

[300]Global Witness, "It's a Gas: Funny Business in the Turkmen-Ukrainian Gas Trade," *Global Witness Publishing*: Washington DC. (April, 2006), 36, http://www.globalwitness.org/media_library_detail.php/479/en/its_a_gas._funny_business_in_the_turkmen_ukraine_g, Accessed May 8 2008.
[301]Ibid., 37.

for between $42 and $44 per 1000 cm. At the end of 2004 Turkmenistan sought to raise this price to $60 per 1000 cm.[302] Ukraine and Russia both demanded that the price remain the same for 2005, and Gazprom actually sought at one point to see the price decreased to $25 per 1000 cm.[303] These disputes triggered a brief cutoff of Turkmen gas to Ukraine and Russia in the early days of 2005. The dispute was settled on the Ukrainian side when Ukraine agreed to pay $58 per 1000 cm.[304] On the Russian side there were no such concessions over pricing, and Russia saw no Turkmen supplies into mid 2005.[305]

One other point of consequence over this period was the signing of a long term gas supply contract between Turkmenistan and Russia. Under the terms of this 2003 contract, by 2007 Gazprom would purchase all Turkmen gas bound for Russia and Europe. Under the contract Russia would import 5-6 bcm in 2004, 6-7 bcm in 2005, 10 bcm in 2006, and 60-70 bcm in 2007.[306] This contract was likely the final nail in the coffin of Ukraine's direct purchase of natural gas from Turkmenistan, but this did not become apparent until after 2004.

The Transformational Mechanism and Gas Prices for Ukraine 2000-2004

While Turkmen gas, at a price of $44 per 1000 cm, was playing a much larger role in Ukrainian consumption, Russia sold gas to Ukraine at an average price of $50 per 1000 cm from 2000 to 2004.[307] The gas Ukraine received over this period, totalling between 26 and 28 bcm per year, was paid for by the transit of Russian gas to Europe through Ukrainian

[302] Irina Reznik, "Turkmenistan Announces Gas Ultimatum," *Bizekon-Russica Ivestia*, December 29, 2004.
[303] "Gazprom Wants to Pay $25/1,000 Cubic Meters For Turkmen Gas," *Interfax: Petroleum Report*, December 22, 2004.
[304] "Turkmenistan said to Resume Gas Exports to Ukraine, Russia," *BBC Monitoring Newsfile*, January 11, 2005.
[305] "Gazprom Admits Halt in Gas Supplies from Turkmenistan," *Interfax Central Asia News*, March 23, 2005.
[306] "Turkmenistan, Ukraine Long-Term Gas Export Agreement Postponed," *Prime-TASS Energy Service*, April 28, 2004.
[307]Simon, Pirani, "Ukraine's Gas Sector," *Oxford Institute Of Energy Studies*, June 2007, 28, http://www.oxfordenergy.org/pdfs/NG21.pdf, Accessed January 15 2009.

pipelines.[308] Any gas in excess of this, including gas illegally siphoned off during transit across Ukrainian territory and increased amounts supplied by intermediaries above and beyond the contracted quantities, was sold for the same price per 1000 cm as in the late 1990's ($80 per 1000 cm).

Russia's gas pricing for Ukraine from 2000-2004 seems somewhat anomalous considering Putin's, Miller's, and Medvedev's preferences for rent capture for the state. All other things being equal one would expect that these individuals would have sought to increase the rents that Gazprom and the state received from the export of gas to Ukraine by eliminating subsidies. Over this period all other things were not equal, however, and Ukraine and Turkmenistan had existing deals which prevented Russia from monopolizing the Ukrainian market for imports. Also, while natural gas prices rose substantially over this period, these increases would be dwarfed by skyrocketing increases over the next four years. Further, the unexplainable role that UralTransGas played in the transit of Turkmen gas to Ukraine prevented Gazprom's management from controlling the intermediaries which shipped Turkmen gas to Ukraine, and capturing the rents this trade generated. Finally, although Turkmen gas was becoming more important regionally it had still not regained the share of regional production and export that it enjoyed during the late Soviet period. This limited importance likely played a role in Gazprom management's decision not to disrupt the bilateral nature of Ukrainian-Turkmen natural gas agreements.

Summary

[308] Simon, Pirani, "Ukraine's Gas Sector," *Oxford Institute Of Energy Studies*, June 2007, 28, http://www.oxfordenergy.org/pdfs/NG21.pdf, Accessed January 15 2009.

Major changes took place in Russia between 2000 and 2004. These changes altered the patrimonial situational mechanism identified in Chapter Two to a great degree. Increasing global energy prices increased the rent generating potential of Russia's natural resources, and the new Russian President Vladimir Putin, inclined to rule in a more authoritarian manner, sought to capture and distribute these rents in order to strengthen the state, in return for political support. While Yeltsin had a vast pool of state property to distribute through patrimonial networks, Putin was blessed with increasing resource rents which could be distributed.

Putin himself outlined the role he believed the state should play in the extraction and sale of these resources quite clearly, and he appointed clients who supported this vision to positions at the head of Gazprom. These clients, Miller and Medvedev, sought to increase the rents they controlled and supported their patron's goals by recapturing assets and the market share Gazprom and the Russian state lost during the 1990's, and by increasing taxes charged on natural gas extraction and export activities. Theoretically this is what should have been expected given the change in the situational mechanism from patrimonialism based on property distribution to one based on natural resource rent distribution. One result of these individual actions was an increase in the rents those in charge of the state were able to control, distribute, and save. A second result was an increase in the state's control over Gazprom and the Russian natural gas industry.

What did not change over this period was the price that Ukraine paid Russia for natural gas exported by the latter. Prices, for both contracted and extra volumes, remained the same from 1998 to 2004. This can be at least partially attributed to the continuation of Ukrainian-Turkmen bilateral gas trade agreements, and Gazprom's continued reluctance to pay what was necessary to purchase all of Turkmenistan's exportable gas volumes. One can only surmise that Russia and Gazprom allowed these bilateral agreements to continue, and refused to pay higher prices for Turkmen gas, due to the still relatively minor role Turkmen gas played in European and Eurasian regional trade, and the still relatively low, though growing, prices for natural gas in Europe.

While price increases were not seen directly after the aforementioned changes in the situational mechanism, the individual action mechanism (the rent seeking and distribution preferences of individuals) was apparent and did result in macro level changes in the state's capabilities relating to the natural gas industry, and also altered the flow of rents away from powerful private business entities toward state employees and bureaucrats. What will be seen in the next chapter is that with further increases in global energy demand and prices, along with increased interest in Turkmen gas exports from European nations--constituting a change in the situational mechanism--the actions of those who controlled Gazprom changed once more, and capturing rents generated by Turkmen gas export and extractions became a higher priority. This had a great impacct on natural gas prices for Ukraine

Chapter 6

Factors Determining Russia's Natural Gas Prices for Ukraine 2005 - 2008

Introduction

This chapter will begin with a discussion of the further variation in Russia's patrimonial political structure between 2005 and 2008; specifically, the increasing value of resource rents which the regime relies on and the increasingly authoritarian nature of Putin's regime. This will be followed by an examination of the actions taken by Gazprom management to increase the rents which the company and the state controls, and will be followed by a discussion of the impacts these actions had on the state's control over the Russian natural gas industry. Further, reference will be made to rent distribution to state employees through increased wages, and the channelling of some of these rents into state savings accounts. All of this will be followed by a discussion of the increasing role of Turkmen gas in the regional energy mix, and moves by Ukraine and European states to wrestle control of this gas from Russia and Gazprom. Gazprom management's reaction to these moves will then be highlighted, followed by an examination of the effect that the above-mentioned developments had on the price of gas exported through Russia to Ukraine.

Further Variation in Russia's Patrimonial System, The Situational Mechanism, and Natural Resource Rents

The trends influencing the core features of Russia's patrimonial system did not change during Putin's second term. Global oil prices, and natural gas prices tied to them, spiked more sharply than during the previous four years, and the increasingly authoritarian nature of Putin's leadership was unmistakeable. In this section we will begin with a brief discussion of global energy prices over this period and then discuss authoritarian trends in Russia between 2005 and 2008.

Natural Resource Bonanza

From 2000 to 2004 world oil prices and Russian natural gas export prices at the German border increased substantially; however, these increases pale in comparison to increases from 2005 to 2008. By the end of 2004 Russian natural gas prices at the German boarder reached 156.24 USD per 1000 cm, this number shot upward in January 2005 to 182.16 USD per 1000 cm.[309] This spike, rather than representing a temporary increase, marked the trend for the following four years. By the beginning of 2006 the price of Russian gas at the German border reached 275.76 USD per 1000 cm, reaching 302.40 USD per 1000 cm by the beginning of 2007, and topping out at 576.72 USD per 1000 cm by the end of 2008.[310] While the period from 1999 to 2004 saw roughly a 2.5 fold price increase, the much shorter period from the end of 2004 to the beginning of 2006 (the onset of Russian price increases to Ukraine) saw prices increase by 1.75 times (see figure 2.1 Chapter Two).[311] Further, by the end of 2008 the 2004 price had increased by almost 3.7 times. This shows that while natural gas was growing in monetary value between 2000 and 2004 these increases were small compared to the increases seen from 2005 to 2008.

The increases in natural gas prices were largely due to the fact that global oil prices were also on the rise over this period, and Russian natural gas sales to Western Europe are tied to oil prices. From the end of 2004 to the middle of 2008 world oil prices ballooned by

[309] Index Mundi "Russian Natural Gas Monthly Price 15 Years" Commodity Data, http://indexmundi.com/commodities/?commodity=russian-natural-gas&months=180, Accessed March 31 2009.
[310] Ibid.
[311] Ibid.

nearly 3.4 times (see figure 2.2 Chapter Two).[312] These were the sharpest increases since the late 1970's and the early 1980's. Analysis of these increases illustrates the increasing value of oil and natural gas exports from Russia, and also suggests a large, even larger than 2000-2004, increase in the rent generating potential of these natural resources.

Rents and Natural Gas

While Gaddy and Ickes provide an estimate for natural gas rents up until 2005, no such estimates exist for 2006 onwards. It is beyond the scope of this project to rigorously estimate these rents, but it can be safely assumed that from 2005 until 2008 the potential rents generated by the extraction and sale of Russian natural gas increased substatially. This assumption is lent weight by the increase in revenue Gazprom received from foreign and domestic gas sales, which essentially doubled between 2004 and 2007.[313] It must be stated that some of these increases are likely due to price increases for Ukraine and other former Soviet states that took place over this period, but it is prudent to remember that these increases brought prices for these states in line with those in the rest of the region. This has been the Kremlin's justification, from the outset, of the increases, and without global and regional energy price increases, justifying the price increases would have been even more difficult.

Authoritarian Trends in Putin's Russia

[312] Index Mundi "Crude Oil (Petroleum) Monthly Prices 15 years" Commodity Data, http://indexmundi.com/commodities/?commodity=crude-oil&months=180, Accessed March 31 2009.

[313] www.Gazprom.com, "Gazprom Financial Statements 2004-2007," http://www.gazprom.com/eng/articles/article20163.shtml, Investor Relation/Reports Gazprom, Accessed December 8 2008.

As Shevtsova has aptly stated, "Russia's post communist evolution can serve as a textbook case of failed democratic transition."[314] Shevtsova goes on to label Russia an imitation democracy in which a facade of democratic institutions shield from view the authoritarian, bureaucratic, or oligarchic tendencies that are present.[315] This assessment appears to capture the reality of Putin's regime quite well.

The marginalization of powerful political groups including the business elite, regional governors, and Yeltsin-era confidants was covered in the previous chapter. Authoritarian trends evident in Putin's dealings with these groups continued into his second term and are exemplified by the strategic modifications he made to the parliamentary electoral system over this period. Most of the modifications made between the 2003 and 2007 parliamentary elections were encapsulated by a package of reforms passed by the Duma in early July 2005.[316] Under the new rules, which were proposed by the president and passed by the Duma, independents were barred from running for Duma election and the minimum membership that a political party required to participate in elections was raised from 10,000 to 50,000. Further, all deputies were now to be elected by proportional representation, rather than partly through proportional representation and partly through direct election, as provided for in the 1993 constitution.[317]

It is in some ways counterintuitive to point to increased proportional representation as an authoritarian trend. Proportional representation is often associated with more representative government and the fractionalization of political party systems. The question

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[314] Lilia Shevtsova, *Russia Lost in Transition: The Yeltsin and Putin Legacies* (Washington D.C.: Carnegie Endowment for International Peace, 2007), 49.
[315] Ibid., 50.
[316] Ivan Rodin, "Russian Duma completes election reform, alarms opponents," *Reuters News*, July 6, 2005.
[317] "FACTBOX-Changes to Russia's election rules," *Reuters News,* July 19, 2005.

then lingers, why did Putin believe a purely proportional electoral system would serve his interests?[318] In a 2005 paper entitled “More Proportional But Less Fair: Electoral System Reform in Putin’s Russia” Bryon Moraski argues that “the answer could be that Putin [who benefits from one party rule] believes it will further weaken the political influence of regional politicians and create a more institutionalized party system.”[319] He further qualifies this answer, suggesting that although United Russia won a clear majority in the 2003 parliamentary elections, its future success would be more certain under a totally proportional system. Moraski goes on to offer evidence that shows gaps in support for United Russia in the 2003 elections, and points to Putin’s electoral reforms, specifically the elimination of single member districts, as a strategy for closing these gaps. [320]

Putin’s party, Untied Russia, was created following Putin’s first election victory in 2000. In the 2003 parliamentary elections United Russia won 120 proportional seats and 106 single member district seats.[321] This secured the party a majority in the Duma, while the Communist party of the Russian Federation, United Russia’s next closest competitor, gained just 52 seats in total.[322] Further, victorious independents and members of smaller parties joined United Russia after their election. This gave United Russia two thirds of the seats in the duma, and enough votes to change the constitution.[323] This appears to be an overwhelming victory and surely raises questions of why would the President change the electoral system when his party is performing so well under it?[324] The answer that Moraski

[318] Byron Moraski, “More Proportional But Less Fair: Electoral System Reform in Putin’s Russia,” Paper prepared for the 2005 American Political Science Association Annual Meeting September 1-4, 2005 in Washington DC., 12, http://www.allacademic.com/meta/p41380_index.html, Accessed Feb 2 2009.
[319] Ibid.
[320] Ibid., 16.
[321] Ibid., 17.
[322] Ibid.
[323] Ibid., 19.
[324] Ibid., 18.

points to is that in the case of Russia single member district seats, increase rather than decrease the plurality of electoral results.[325] He further suggests that rather than simply increasing the quantity of seats for United Russia, Putin was interested in a qualitative change favouring consistently loyal representatives, rather than political opportunists.[326] In the end Moraski concludes that while in the short term Russia's electoral reform may increase the disproportionate nature of election results, the removal of single member districts should eventually lead to party consolidation and alleviate the disproportionate nature of outcomes.[327] Moraski, however, also points to other electoral reforms beyond the switch to a completely proportional system which may institutionalize United Russia as the party of power in Russia.[328] These other reforms will be the next subject of discussion.

The package of laws passed in 2005 outlined other changes. These changes included banning the formulation of blocs within the Duma, and forbidding legislators from switching parties after the election. The threshold for parliamentary representation was increased from 5% to 7% and rules on party and election financing were changed increasing state funding for registered parties, and also increasing the restrictions placed on external party funding. Whereas in 2003 anonymous donations and donations from foreign entities were allowed, these provisions were removed. Donations from foreigners were banned, and the identification of all donors became a requirement. [329]

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[325] Byron Moraski, "More Proportional But Less Fair: Electoral System Reform in Putin's Russia," Paper prepared for the 2005 American Political Science Association Annual Meeting September 1-4, 2005 in Washington DC., 18, http://www.allacademic.com/meta/p41380_index.html, Accessed Feb 2 2009.
[326] Ibid., 21-22.
[327] Ibid., 23.
[328] Ibid., 23.
[329] News,"FACTBOX-New rules for Russia's parliamentary elections" Reuters, December 1, 2007, http://www.reuters.com/article/newsOne/idUSL2887100220071201, Accessed May 2 2009.

The registration process for elections changed as well over this period. Under the new rules, parties already in the Duma automatically qualify for the election, while those not represented are required to gather 200,000 signatures, or make a cash deposit. The cash deposit requirement increased from 35 million rubles in 2003 to 60 million rubles in 2007. Further, it has been suggested by some that the new registration process involves so much burdensome red tape that smaller parties, with limited resources, are effectively removed from the electoral process.[330]

Finally, rules on the conduct of elections changed from 2003 to 2005. In the 2005 elections "negative information" regarding other parties was not allowed to be televised. New legislation also broadened the definition of extremist statements, and toughened the punishment for those convicted of making such statements.[331]

These changes, combined with the state's increasing control over television media, state crackdowns on opposition party protests[332], the assassinations of journalists[333], and elections which have failed to meet the standard for fair and free elections by many accounts[334], point to the increasingly authoritarian nature of the Putin regime since 2004. This assessment should not, however, be confused with the assumption that the Putin or post Putin regimes are or will be stable. Many authors point to the inherent instability of Russian

[330] News,"FACTBOX-New rules for Russia's parliamentary elections" Reuters, December 1, 2007, http://www.reuters.com/article/newsOne/idUSL2887100220071201, Accessed May 2 2009.
[331] Ibid.
[332] Peter Finn, "Police in Moscow Overpower Opposition Rally," *Washington Post Foreign Service,* April 15, 2007, http://www.washingtonpost.com/wp-dyn/content/article/2007/04/14/AR2007041400383_pf.html, Accessed February 9 2009.
[333] Lilia Shevtsova, *Russia Lost in Transition: The Yeltsin and Putin Legacies* (Washington D.C.: Carnegie Endowment for International Peace, 2007), 285.
[334] Freedom House, "On Eve of Election, Russia Further From Democracy," Press Release, March 5, 2004, http://www.freedomhouse.org/template.cfm?page=70&release=56, Accessed Jan 31 2009. AND: Daisy Sndelar, "Russia: Freedom House Downgrades Country to 'Not Free' Status," Radio Free Europe/Radio Liberty, December 24, 2005, http://www.cdi.org/russia/336-8.cfm, Accessed April 15 2009.

politics, highlighting the increasing power of the bureaucracy,[335] backroom infighting amongst Russia's political elites,[336] the failure of capitalism to satisfy the needs of the Russian people,[337] the rise of right-wing nationalist forces,[338] and Russia's reliance on high natural resource prices[339] as factors possibly leading to growing instability in Putin's vertically integrated power structure. It is not the intent of this brief section to question the possibility that these factors could destabilize Russia's political situation. This section points to the short term effects this authoritarian trend has on the pattern of rent capture and distribution in Russia, regardless of the long-term prospects for instability it almost surely sows.

Summary of the Situational Mechanism 2005-2008

The preceding section has illustrated two trends which affected the patrimonial nature of Russian society from 2005 to 2008. First, with rapidly increasing global energy prices the rent generating potential of oil and natural gas increased substantially between 2005 and 2008, in many instances outpacing the growth seen during the previous four years. Second, it has been seen that Putin's regime has become more authoritarian by increasing the dominance of the Kremlin-backed party United Russia, and through a series of electoral reforms. These reforms were designed to block or hamper independent forces from competing in parliamentary elections, and to increase the costs associated with forming a new political party. Next it is important to provide more details about how Putin and the individuals he

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[335]Lilia Shevtsova, *Russia Lost in Transition: The Yeltsin and Putin Legacies* (Washington D.C.: Carnegie Endowment for International Peace, 2007), 53-54.
[336]Stephen White, ed., *Politics and the Ruling Group in Putin's Russia* (New York: Palgrave Macmillan, 2008), 91.
[337]Ibid., 84.
[338]Lilia Shevtsova, *Russia Lost in Transition: The Yeltsin and Putin Legacies* (Washington D.C.: Carnegie Endowment for International Peace, 2007), 286.
[339]Ibid., 269. And: Marshal Goldman, *Petrostate: Putin, Power, and the New Russia* (Toronto: Oxford University Press, 2008), 206.

appointed to top positions at Gazprom acted to capture an even greater share of these increasing rents.

Individual Action – Rent seeking and Distribution in Resource Rich and Authoritarian Russia

Recapturing Gazprom

The drive for rent capture exhibited by individuals in the Russian natural gas industry, specifically Vladimir Putin, Alexei Miller, and Dmitry Medvedev, changed little during the period from 2005 to 2008. If one difference could be discerned it would likely be the intensity with which they sought to increase the state's, and therefore their own, share of the spoils. The first step taken to this end was the purchase of just over 10% of Gazprom's shares from independent share holders in mid 2005. The deal saw Rosneft (Russia's state owned oil company), headed by Putin appointee and loyal friend Igor Sechin with the support of Miller and Medvedev, purchase a 10% stake. With that the state captured a 51% majority share of the company.[340] This stake was also purchased at a discount as Rosneft paid 7.15 billion USD, while independent share holders appraised the stake at 10.5 billion USD, and Morgan Stanley, Gazprom's advisor on the matter, pegged the price at 8.5 billion USD.[341] This acquisition not only increased the state's voting rights on the company's board; since dividends are paid out per share they were also able to capture a greater share of Gazprom's after tax profits.

Gazprom's New Acquisitions

[340] "Gazprom agrees to state offer," *The Daily Telegraph,* June 17, 2005.
[341] Andrew Neff, "Shareholders, Russian Government at Odds over Value of 10.7% Gazprom Stake," *Global Insight Daily Analysis,* June 10, 2005.

The trend between 2000 and 2004 was for Gazprom to reassert control over assets lost to Itera during the 1990's. Beginning in 2005, Miller and Medvedev set out to further reacquire assets lost to independent companies, as well as acquire new assets. The first of the new assets came in the form of a 51% stake in NorthGas, a formerly independent Russian gas producer. Gazprom lost control of NorthGas and its licence to exploit the 330 bcm Severo-Urengoi field in northern Siberia in 1999, but 51% of the company was given back to Gazprom in 2005 after a lengthy legal battle.[342] This would be just the first of many acquisitions by Gazprom between 2005 and 2008.

Gazprom's biggest acquisition during this period was an oil company rather than a natural gas producer. In November of 2005, a deal was finalized between Gazprom and Roman Abramovich under which Gazprom acquired a 72.6% share in the oil company Sibneft for a reported 13 billion USD.[343] It appears that Abramovich's initial intention may have been to sell the company to a foreign firm, but a visit from the state tax authorities brought about an abrupt change in his plans.[344]

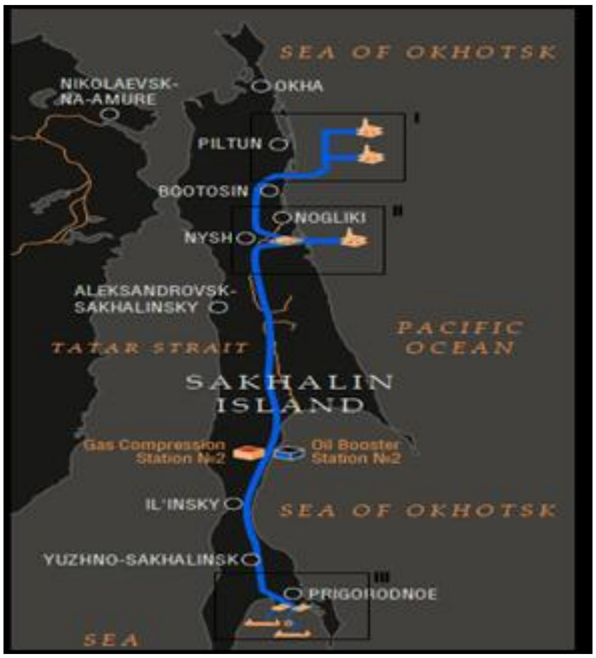
Removing Foreign Enterprises from the Equation: Sakhalin I, Sakhalin II,TNK-BP

Prior to 2005 foreign enterprises were able to participate in the development of, and export of gas from, a number of projects in Russia's Far East. Sakhalin Island, off Russia's eastern coast, was one of these projects. Owing to the technical challenges posed by the location of the island off the east coast of Russia (see map below), the Russian government brought in foreign partners to assist with the Sakhalin I and Sakhalin II natural gas projects.

[342] Catherine Belton, "Gazprom Wrests Back Control Over Northgas," *The Moscow Times*, June 14, 2005.
[343] Pravada.ru, "New Takeover to make Russia's giant Gazprom one of world's largest oil and gas corporations," November 1, 2005, http://english.pravda.ru/main/18/89/356/16232_Gazprom.html, Accessed January 21 2009.
[344] Marshal Goldman, *Petrostate: Putin, Power, and the New Russia* (Toronto: Oxford University Press, 2008), 123.

Under the production-sharing agreements signed in the 1990's the Russian government would not see any profit from the projects until the companies involved had recoup the initial fixed costs of the projects.[345] As the costs of each project rose, along with the value of the oil and natural gas that was to be extracted, the Russian government began to second guess the deals.

Figure 6.1 Sakhalin Natural Gas Projects[346]



I = Sakhalin I project
II = Sakhalin II project

The Sakhalin II project was initially to be a joint enterprise between Royal Dutch Shell, Mitsui, and Mitsubishi. After cost overruns in the initial stages of the project to the tune of over 10 billion USD, and apparent environmental regulatory infractions, the Russian government and Gazprom managemet pressured Shell and its partners into rewriting the production sharing agreement (PSA) they had signed in the 1990's. Shell and its partners

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[345] Marshal Goldman, *Petrostate: Putin, Power, and the New Russia* (Toronto: Oxford University Press, 2008), 128-129.
[346] Gazprom Web Site, "Gazprom Questions and Answers," 31, http://eng.gazpromquestions.ru/fileadmin/template/docs/ALL_Eng_72.pdf, Accessed May 1 2009.

eventually sold half of the plus one share of the project to Gazprom for 7.45 billion USD.[347] This was about 3.55 billion USD less than had already been invested in the project by the original partners.[348] This put Gazprom at the helm of the project, and served to increase the company's share of the growing East and South East Asian markets.

Similarly, Exxon Mobil has faced pressure to renegotiate its PSA for the Sakhalin I project after the authorities accused the company of not adhering to environmental regulations. Further, Exxon has also been accused of cost overruns which effect profits for the government. At the heart of the still ongoing negotiation is the destination of the project's gas. Originally, Exxon, its Russian partner Rosneft, and Japan's Itochu had signed an agreement with the Chinese government to supply 8 bcm independent of Gazprom. Citing the need for those gas volumes domestically, Gazprom management has been fighting to purchase all of the gas produced by the Sakhalin I project, and block independent sales to China. As of today no gas has been shipped to China, and only small volumes have been used domestically.[349]

British Petroleum (BP) found itself in a similar situation with regards to its joint project with Tyumen oil (TNK), an independent Russian oil producer. The two companies, which joined forces in a 2003 deal in which BP purchased 50% of TNK, creating BP-TNK, acquired the licence for the Kovykta natural gas field in Eastern Siberia. By 2007 the field was not producing the agreed-upon 870 million cubic feet a day, and the Russian authorities were threatening to revoke the licence without any compensation. The cause of the

[347] Guy Faulconbridge, Mikhail Yenukov, "Gazprom, Shell agree $7.45 bln Sakhalin-2 deal," *Reuters*, December 21, 2006, http://www.alertnet.org/thenews/newsdesk/L21838009.htm, Accessed April 15 2009.
[348] Marshal Goldman, *Petrostate: Putin, Power, and the New Russia* (Toronto: Oxford University Press, 2008), 131.
[349] Vladimir Soldatkin, "Russia's Sakhalin-1 2009 budget totals $2 bln," *Thomson Reuters*, April 16, 2009, http://www.forbes.com/feeds/afx/2009/04/16/afx6299957.html, Accessed May 4 2009.

production shortfall however was Gazprom management's refusal to allow TNK-BP access to its export pipeline network. Subsequently, TNK-BP could only sell gas to a neighbouring community, which could only consume roughly 240 million cubic feet per day.[350] To meet the production quota set by the government TNK-BP would have had to flare the rest of the gas. In addition to wasting an increasingly valuable resource, this would have put the company in direct violation of Russian law.[351] Rather than lose the licence without compensation TNK-BP relented and sold a controlling share of the Kovykta project to Gazprom for a mere 900 million USD. This price is a far cry from the estimated 12 billion USD value of the stake.[352] BP has been put under further pressure to relinquish control of its stake in TNK-BP to the state, a battle that is ongoing.[353]

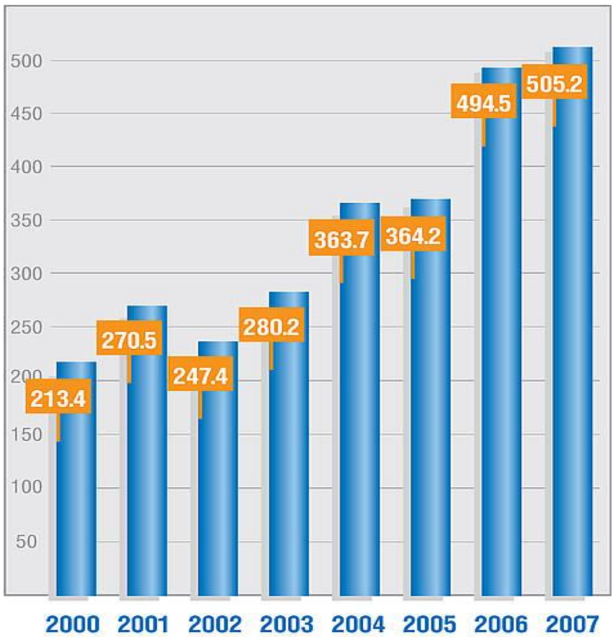
The moves by Gazprom management and individuals heading the Russian state to limit or eliminate foreign and independent participation in the Russian natural gas industry have further increased the control that Gazprom has over Russian natural gas, especially exports. Also, by increasing Gazprom's and therefore the state's share in these projects, the rents which they generate are more easily captured and redistributed by individuals controlling Russia's natural gas industry and the state. The moves have also made clear the difficulties that face foreign companies when they do business in Russia.

Taxation

[350] Marshal Goldman, *Petrostate: Putin, Power, and the New Russia* (Toronto: Oxford University Press, 2008), 131.
[351] Ibid.
[352] Ibid. And: "Gazprom Makes BP Offer It Can't Refuse," *International Petroleum Finance,* July 6, 2007.
[353] Marshal Goldman, *Petrostate: Putin, Power, and the New Russia* (Toronto: Oxford University Press, 2008), 126.

As has been seen in the previous chapter shows the amount of tax paid by Gazprom to the state increased substantially between 2000 and 2004. These increases continued and became more significant between 2005 and 2007.

Figure 6.2 Taxes Paid By Gazprom 2000 - 2007[354] (Billions of Rubles)



As the above graph illustrates, while the increase between 2004 and 2005 was minimal, less than a billion rubles, the increase in 2006 was a substantial 130.3 billion rubles, and the increase in 2007, though modest, amounted to a little over 10 billion rubles. In total these increases amount to a 141.5 billion ruble increase in taxes paid by Gazprom from 2004 to 2007, and clearly illustrates an increase in the rents captured by those controlling the Russian state through formal taxes. Data are not yet available for 2008.

Rent Distribution

[354] Gazprom Web Site, "Gazprom Questions and Answers," 66, http://eng.gazpromquestions.ru/fileadmin/template/docs/ALL_Eng_72.pdf, Accessed May 1 2009.

For evidence of rent distribution by individuals heading the state and Gazprom through state structures, information on employment and salaries will once again be used. As during the preceding four years, from 2005 to 2007 the wages of individuals working in public administration and defence, and those receiving social security payments, increased substantially. While at the end of 2004 the average monthly accrued wages of workers in these sectors stood at 7.898 million rubles, by 2005 this number increased to 10.985 million rubles. Increases continued through 2006 and 2007, reaching 13.477 million rubles and 16.899 million rubles respectively.[355] This shows a more than two-fold increase in wages paid to this sector from 2004 to 2007. While this sector shrank slightly as a share of the Russian working population between 2000 and 2004, it remained constant between 2004 and 2007. In 2004 public administrators, defence officials, and pensioners made up 6.9% of the total work force. This number grew to 7% in 2005 and 2006 before retreating back to 6.9% in 2007.[356] The wages of those working in the education and health sectors more than doubled between 2004 and 2007,[357] while their representation as a portion of the total workforce remained virtually the same.[358] These figures are indicative of resource rents being distributed to individuals who work for and rely on the state.

Turning to more specific occupational categories, the portion of the workforce made up of legislators, senior officials, and managers increased in absolute terms from 4,531,000 in

[355] Russian Federal Statistics Service, "Average Monthly Nominal Accrued Wages of Employees of Organizations by Kinds of Economic Activities," http://www.gks.ru/bgd/regl/b08_12/IssWWW.exe/stg/d01/07-07.htm, Accessed April 28 2009.
[356] Labrosta Internet, "Russia - Total Employment by Economic Activity 1997-2007," http://laborsta.ilo.org/STP/guest, Accessed April 27 2009.
[357] Russian Federal Statistics Service, "Average Monthly Nominal Accrued Wages of Employees of Organizations by Kinds of Economic Activities," http://www.gks.ru/bgd/regl/b08_12/IssWWW.exe/stg/d01/07-07.htm, Accessed April 28 2009.
[358] Labrosta Internet, "Russia - Total Employment by Economic Activity 1997-2007," http://laborsta.ilo.org/STP/guest, Accessed April 27 2009.

2004 to 4,868,000 in 2007, but they did not increase as a share of the total workforce.[359] As far as workers in the natural gas, water, and electricity occupations are concerned their numbers showed only minor absolute increases from 2004 to 2007 and showed minor decreases as a share of the total working population. These workers did, however, experience substantially increased wages over this period. Average monthly accrued wages for natural gas electricity and water supply workers increased from 8.642 million rubles in 2004 to 15.664 million rubles in 2007.[360] This once again illustrates an increase in the share of the spoils for those who work in the largely state-controlled natural gas and electricity sectors, and much like the data presented in the previous chapter, hints at rent distribution via increased costs of production.

Russia's Foreign Reserves

As outlined in the previous chapter, all of the resource rents captured by the state from 2000 to 2004 were not distributed. Some of the rents captured were saved by the state for future use in the form of international currency and gold reserves. While this trend continued from 2005 to 2007, there was a sharp increase in the volume of funds saved. At the end of 2004 Russia's reserve position stood at 123.5 billion USD.[361] By the end of 2005 this number had increased to 168.3 billion USD.[362] This was a large increase of more than 40 billion USD but is small in comparison to the increases of the following years. By the end of 2006 Russia's reserve position increased to 289 billion USD, an increase of over 120 billion

[359] Labrostat Internet, "Russia – Total Employment by Occupation 1997-2007," http://laborsta.ilo.org/STP/guest, Accessed April 27 2009.
[360] Russian Federal Statistics Service, "Average Monthly Nominal Accrued Wages of Employees of Organizations by Kinds of Economic Activities," http://www.gks.ru/bgd/regl/b08_12/IssWWW.exe/stg/d01/07-07.htm, Accessed April 28 2009.
[361] Bank of Russia, Statistics, "Gross International Reserves of the Russian Federation in 2004," http://www.cbr.ru/eng/statistics/credit_statistics/print.asp?file=inter_res_04_e.htm, Accessed April 28 2009.
[362] Bank of Russia Statistics, "Gross International Reserves of the Russian Federation in 2005," http://www.cbr.ru/eng/statistics/credit_statistics/print.asp?file=inter_res_05_e.htm, Accessed April 28 2009.

USD.[363] In 2007 this number larger to 463.5 billion USD, an even larger increase than seen in 2006, and totalling 174.5 billion USD.[364] Russia's reserve position grew further still in the first three quarters of 2008, peaking in August at 582.2 billion USD.[365] From this point on Russia's reserves began to decline as the central bank attempted to support the ruble in the face of the mounting global economic crisis. Though forced to burn through a large portion of its currency reserves in late 2008 and 2009, the sharp increases in Russia's reserve position before August of 2008 provides a good illustration of the extent of the increased rents captured by individuals controlling the state, as Russia has few alternative sources of foreign currency.

Stabilization Fund

Russia's Stabilization Fund, designed to capture oil rents, increased between 2005 and 2006 as well. While at the end of 2004 the fund stood at 522.2 billion rubles, by the end of 2005 that number had increased to 960.6 billion rubles. Since the Russian government used the fund to pay down 524.6 billion rubles in foreign debt over this period, the amount of rents captured by this fund in 2005 is striking.[366] After 2005 the government began channelling most of the inflows to the fund into foreign currency investments, and the fund was reduced to zero by the end of each subsequent year.[367] A similar pattern was followed with regard to the

[363] Bank of Russia Statistics, "Gross International Reserves of the Russian Federation in 2006," http://www.cbr.ru/eng/statistics/credit_statistics/print.asp?file=inter_res_06_e.htm, Accessed April 28 2009.
[364] Bank of Russia Statistics, "Gross International Reserves of the Russian Federation in 2007," http://www.cbr.ru/eng/statistics/credit_statistics/print.asp?file=inter_res_07_e.htm, Accessed April 30 2009.
[365] Bank of Russia Statistics, "Gross International Reserves of the Russian Federation in 2008," http://www.cbr.ru/eng/statistics/credit_statistics/print.asp?file=inter_res_08_e.htm, Accessed May 1 2009.
[366] Finance Ministry of the Russian Federation, "Stabilization fund of the Russian Federation: Funds flow on the Federal Treasury's account in the Bank of Russia in rubles in 2005," http://www1.minfin.ru/common/img/uploaded/library/no_date/2007/rub2005_eng.pdf, Accessed May 4 2009.
[367] Finance Ministry of the Russian Federation, "Stabilization fund of the Russian Federation: Funds flow on the Federal Treasury's account in the Bank of Russia in rubles in 2006," http://www1.minfin.ru/en/stabfund/statistics/balances/index.php?id4=4369, Accessed May 4 2009.

National Wealth Fund, which was set up in 2008 and also accumulates revenues from natural gas sales.[368] This goes some way to further explain the huge increases in Russia's reserve position from 2006 on, and also more clearly illustrates resource rent distribution to national savings accounts by individuals controlling the state.

Summary of the Individual Action Mechanism – Rent Capture and Distribution

As during the period from 2000 to 2004, from 2005 to 2008 three patterns, which would be expected in a patrimonial system based on resource rents, can be observed. First, Putin has sought to increase the state's control over natural gas rent producing projects and enterprises. Second, Putin's appointees, Alexei Miller and Dmitry Medvedev, have sought to maximize the rents they control by supporting their patron's goal and directing Gazprom and state policies to this end. Third, some of the rents captured have been further distributed through increased wages for legislators, bureaucrats, managers, gas industry workers, and other state employees, while another portion has been saved by those in power for future use. As suggested at the outset, the intensity of these actions likely is responsible for the greatest variation between these two time periods, although this reflects an evolutionary rather than revolutionary process. Next, the influence of these individual actions on macro level outcomes will be discussed.

Further Increased in the Russian States Control Over the Natural Gas Industry

It is clear, after the description above of the actions of those who control Gazprom, that these actions resulted in a Russian natural gas industry dominated even more extensively

[368] Finance Ministry of the Russian Federation, "Stabilization fund of the Russian Federation: Funds flow on the Federal Treasury's account in the Bank of Russia in rubles in 2006, 2007, 2008," For 2006: http://www1.minfin.ru/en/stabfund/statistics/balances/index.php?id4=4369, For 2007: http://www1.minfin.ru/en/stabfund/statistics/balances/index.php?id4=4374, For 2008: http://www1.minfin.ru/en/stabfund/statistics/balances/index.php?id4=5654, Accessed May 4 2009.

by the state and the individuals that control it. Moreover, under these terms these individuals were able to gain a controlling share of Gazprom, and Gazprom was able to gain controlling shares in natural gas projects and companies throughout Russia on terms that were generally quite favourable. After Rosneft's purchase of a 10% stake in Gazprom the Russian state, for the first time since the privatization of Gazprom, held a majority stake in the natural gas monopoly. With the purchase of Sibneft by Gazprom the Russian state was able to gain control of 30% of Russia's oil production, to match its almost total control over oil transport infrastructure.[369] Furthermore, the reacquisition of North Gas gave Gazprom control over an estimated 367 bcm of natural gas reserves which had earlier been intended to be developed independently.[370]

Individuals controlling Gazprom and the government not only bullied Russian companies into submission, but in a departure from previous trends, they also took on major western oil and gas companies. While gaining and regaining assets from Russian companies has clearly given Gazprom even more control over the Russian natural gas industry, the increased intensity of these individuals' drive for resource rent capture is illustrated by its willingness to take on some of the largest energy companies in the world. Gaining control of the Sakhalin II project from Royal Dutch Shell gave Gazprom control over 518 million tonnes of oil reserves, and over 634 bcm of natural gas.[371] The Kovykta project, in which Gazprom gained a controlling share, at the expense of TNK-BP, contains reserves of over 2 trillion cubic meters of natural gas.[372] Furthermore, by blocking the sale of gas produced by the

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[369] Marshal Goldman, *Petrostate: Putin, Power, and the New Russia* (Toronto: Oxford University Press, 2008), 123.
[370] North Gas, "Projects and Reserves," http://www.northgas.ru/en/projects/reserves, Accessed May 6 2009.
[371] Sakhalin Energy, "Annual Overview 2006" http://www.sakhalinenergy.com/en/documents/2006%20annual%20review%20eng.pdf, Accessed May 6 2009.
[372] TNK-BP, "Kovykta Project," http://www.tnk-bp.com/operations/exploration-production/projects/kovykta/, Accessed May 4 2009.

Sakhalin I project to China, part of the original agreement, the individuals controlling Gazprom have been able to maintain a virtual monopoly over gas exports to East Asia, and the rents they generate.

The rent-seeking actions of the individuals controlling Gazprom have had a clear impact on the Russian state's capabilities in the natural gas industry. Through the purchase and takeover of previously private enterprises, Gazprom was been able to significantly increase its reserve levels between 2004 and 2008. As of 2004 Gazprom's natural gas reserve base stood at 28.92 trillion cubic meters.[373] This number increased to 29.131 trillion cubic meters in 2005,[374] and 29.854 trillion cubic meters in 2006.[375] While 2007 showed a small decrease in reserves to 29.785 trillion cubic meters,[376] by the end of 2008 Gazprom's reserves increased by 11.1% to 33.1 trillion cubic meters.[377] Given that the reserve numbers take into account depletion due to production over these years a 4.18 trillion cubic meter increase is impressive, and is illustrative of the increased control over the Russian natural gas industry that the individuals controlling Gazprom and the Russian government enjoyed between 2005 and 2008.

Gazprom also increased its control over the Turkmen-Ukraine natural gas trade by once again changing the company which acts as the intermediary for this trade, and this time taking some control of it. UralTransGas, the company which had been serving as

[373] "Gazprom SPE Reserves Down 2%, ABC1 – Up 3%," *Interfax Weekly Business Report,* May 20, 2005.
[374] "Gazprom Proven 2005 Gas Reserves 16.0 Tln CM – Agency," *Dow Jones International News,* October 16, 2006.
[375] "Gazprom Raised Reserves, Replaced Output in 2006," *Reuters News*, May 22, 2007.
[376] "Gazprom's ABC 1 Gas Reserves Decline in 2007 Due to Exclusion of Shtokman Section (Part 2)," *Russia & CIS Energy Newswire*, June 6, 2008.
[377] "Russia's Gazprom A, B, C1, Gas Reserves up 11.1% in 2008," *Prime-TASS Energy Service,* April 29, 2009.

intermediary between 2002 and 2004, lost its contract to do so in 2005.[378] RosUkrEnergo had already been created by the time UralTransGas lost its contract, and became the intermediary for Russian sales to Ukraine in 2005. Unlike the intermediaries before it, RosUkrEnergo was half owned by Gazprom. The other half of RosUkrEnergo is owned by CentraGas Holding, which in turn is owned by Swiss company Raiffeinsen Investment. Raiffeinsen claims that it is managing the company on behalf of "a consortium of Ukrainian businessmen and companies," and has refused to divulge further information on the company's ownership.[379] There has been speculation that CentraGas Holdings has ties to the former intermediary UralTransGas, as well as to a number of British businessmen; however, these links have been denied by those accused of involvement.[380] As was stated at the outset, it is not the goal here to untangle the mysteries surrounding intermediaries who facilitate the transit of natural gas from Turkmenistan to Ukraine. However, the 50% ownership Gazprom enjoys in the newest intermediary company, which took control in 2005, is a clear indication of the increased control over the Ukrainian gas market that Gazprom management attained prior to the 2006 dispute. Further, since Gazprom holds 50% of RosUkrEnergo's profits on its books, it is clear that Gazprom has been able to capture some of the rents created through the roundabout intermediary schemes which have characterized the Ukrainian Turkmen gas trade for the last decade. This is important since 2005 saw for the first time an intermediary which was partly controlled by Gazprom, and from which Gazprom has been able to profit.

[378] "PGNiG Selects RosUkrEnergo To Supply Gas Under Contract With Naftohaz Ukrainy From March 1 Instead of Eural Trans Gas," *Ukrainian News,* March 2, 2005.
[379] Global Witness, "It's a Gas: Funny Business in the Turkmen-Ukrainian Gas Trade," *Global Witness Publishing*: Washington DC. (April, 2006), 59, http://www.globalwitness.org/media_library_detail.php/479/en/its_a_gas._funny_business_in_the_turkmen_ukraine_g, Accessed May 8 2008.
[380] Ibid., 54-55.

Before moving on to the outcomes, the impact of the collective actions of individual resource rent seekers on natural gas prices for Ukraine, the importance of Turkmen gas for the European and Eurasian natural gas market, and for Ukraine specifically, over this period, must be addressed.

The Eurasian Natural Gas Trade and the Role of Turkmenistan 2005-2008

Total European and Eurasian gas production reached 1055.2 bcm in 2004, and increased slightly in 2005 to 1060.6 bcm.[381] In 2006 total regional production increased to 1076.3 bcm, before falling slightly in 2007 to 1075.7 bcm.[382] Russia's share of regional production, which amounted to 55.9% in 2004, increased slightly to 56.3% in 2005.[383] This figure increased slightly in 2006 as well, reaching 56.8% of the regional total, before falling to 56.4% in 2007.[384] On the whole, between 2004 and 2007, Russia's share of regional production remained close to constant. The story was entirely different for Turkmenistan, as 2005 saw its share of regional production increase from 5.1% in 2004 to 5.5% in 2005.[385] Turkmenistan's share continued to increase over 2006 and 2007 to 5.7% and 6.2% respectively.[386] Turkmenistan's 2007 percentage share increase was the largest in the region between 2006 and 2007, and between 2004 and 2007.

Regional consumption of natural gas also increased between 2004 and 2005, growing from 1104.3 bcm to 1128.3 bcm.[387] From 2005 to 2007 this number increased by 27.4 bcm to

[381]BP historical data 2007, "Gas Production from 1970," http://www.bp.com/productlanding.do?categoryId=6929&contentId=7044622, Accessed March 15 2009.
[382]Ibid.
[383]Ibid.
[384]Ibid.
[385]Ibid.
[386]Ibid.
[387]BP historical data 2007, "Gas Consumption from 1964," http://www.bp.com/productlanding.do?categoryId=6929&contentId=7044622, Accessed March 15 2009.

1155.7 bcm.[388] This is a smaller increase than that seen between 2000 and 2004, but still illustrates growing natural gas demand throughout Europe and Eurasia. From 2004 to 2007 Russia's domestic gas consumption continued growing, increasing from 401.9 bcm in 2004 to 438.8 bcm in 2007, an increase of 36.9 bcm.[389] This is a larger increase than was seen between 2000 and 2004. Turkmenistan's domestic consumption increased over this period as well, growing from 15.5 bcm in 2004 to 21.9 bcm in 2007.[390]

Russia's consumption relative to production decreased slightly between 2004 and 2005, from 68% to 67.7%.[391] In 2006, however, this number increased to 70.5%, and increased again in 2007 to 72.2%.[392] These numbers illustrate quite clearly that in the face of increasing domestic consumption and decreasing production Russia had less gas available to export by 2006 than it had in previous years. Turkmenistan's consumed share of production, which stood at 28.4% in 2004 showed a minor decrease in 2005 to 28.2%.[393] In 2006, however, this figure jumped to 30.3%, and in 2007 the number edged up again to 32.5%.[394]

Russia's Gas Deficit

It is often assumed that Russia, with its huge natural gas reserves, has to rely little on outside sources of gas to meet domestic consumption needs and export requirements, but an examination of BP production and consumption figures, along with Russian Central Bank figures regarding exports, paints a different picture. These data taken together show that

[388] BP historical data 2007, "Gas Consumption from 1964," http://www.bp.com/productlanding.do?categoryId=6929&contentId=7044622, Accessed March 15 2009.
[389] Ibid.
[390] Ibid.
[391] Ibid.
[392] Ibid.
[393] BP historical data 2007, Gas Production from 1970, Gas Consumption from 1964, http://www.bp.com/productlanding.do?categoryId=6929&contentId=7044622, Accessed March 15 2009.
[394] Ibid.

throughout the last decade Russia has been running a gas deficit, where domestic production does not meet combined domestic consumption and export numbers.

Table 6.1 Russia's Natural Gas Balance in BCM

Russian	2000	2001	2002	2003	2004	2005	2006	2007
Production bcm[395]	545	542.2	555.4	578.6	591	598	612.1	607.4
Domestic Consumption bcm[396]	377.2	372.7	388.9	392.9	401.9	405.1	432.1	438.8
Exports bcm[397]	193.9	180.9	185.5	189.4	200.4	209.2	202.8	191.9
Natural Gas Balance bcm	-26.1	-11.2	-19	-3.7	-11.3	-16.3	-22.8	-23.3

The above table shows that between 2000 and 2007 Russia consistently consumed and exported more natural gas than it produced. Although the deficit begins to shrink over the early part of the decade, bottoming out in 2003 at -3.7 bcm, it begins a steady rise after 2003, reaching – 23.3 bcm in 2007. This is a clear indication that Russia has relied on gas imports to meet its needs over the past decade, and further that leading up to the decision to raise natural gas export prices to Ukraine, Russia's gas deficit appears to have been growing.

Regardless of Turkmenistan's increased consumption of production, its exportable volume of gas increased over this period. This fact along with the above numbers provide an indication that Turkmenistan's natural gas became a more important part of the European and Eurasian natural gas trade between 2005 and 2007, increasing as an overall share of regional production and export capacity. The threat that, in the face of rising regional demand, Russia might lose its control over Turkmen gas begining in 2007, is highlighted by two proposals made by potential Turkmen gas consumers, Ukraine and the E.U.

Ukraine and Turkmenistan- Extending Cooperation?

[395] BP historical data 2007, Gas Production from 1970, Gas Consumption from 1964, http://www.bp.com/productlanding.do?categoryId=6929&contentId=7044622, Accessed March 15 2009.
[396] Ibid.
[397] Bank of Russia, Statistics, "Russian Federation: Natural Gas Exports, 2000-08," http://www.cbr.ru/eng/statistics/credit_statistics/print.asp?file=gas_e.htm, Accessed April 1 2009.

As noted in previous chapters, from the early 1990's until 2004 Turkmenistan and Ukraine signed intergovernmental agreements on natural gas supplies. The purchase and transit of gas over this period was arranged with Russia and Gazprom by one or both sides, and intermediaries controlled by private entities (often clouded in secrecy). In March of 2005, during a summit with his Turkmen counterpart, the President of Ukraine Victor Yuschenko made clear his intention to seek to purchase more Turkmen gas after the deal covering supplies until the end of 2005 expired.[398] This summit coincided with a continuing dispute between Russia and Turkmenistan regarding prices that led to a complete cutoff of Turkmenistan's supply to Russia.[399] Preliminary discussion of the terms of such a contract included the suggestion that Turkmenistan could supply Ukraine with 60-70 bcm of gas per year beginning in 2006, at a price of 58 USD per 1000 cm.[400] Considering Turkmenistan's yearly production only amounted to 58.8 bcm at the time, this was surely a lofty estimate of possible supplies. If there was no agreement on pricing terms with Russia, however, Turkmenistan would be in need of a buyer for any production not consumed domestically. These supplies would not likely reach the 60 – 70 bcm level, but they would be substantial, approximately of 40 – 50 bcm per year.

In the end, no agreement was reached on a new long-term supply contract between Ukraine and Turkmenistan; it was decided that Turkmenistan would supply Ukraine with 36 bcm in 2005 under the existing price arrangement.[401] Though no agreement was signed, the door for a future long term deal was left open. These developments illustrate a challenge Gazprom's control over Turkmen gas supplies, as they were becoming more important

[398] "Ukraine Interested In Gas Supply Agreement With Turkmenistan For 20-30 Years," *Ukrainian News,* March 23, 2005.
[399] "Gazprom Admits Halt in Gas Supplies from Turkmenistan," *Interfax Central Asia News*, March 23, 2005.
[400] "Ukraine Seeks Long-term Gas Supply Accord with Turkmenistan," *RosBusiness Consulting,* March 23, 2005.
[401] "Ukraine, Turkmenistan Fail to Agree on Natural Gas Contracts," *International Oil Daily,* March 24, 2005.

regionally. This was not the only challenge Russia faced in 2005 concerning its control of Turkmen gas, as increased interest in Europe for an alternative to Russian-controlled gas was growing, and plans for a pipeline to carry Caspian Sea supplies of natural gas, including Turkmen supplies, bypassing Russia, was building momentum.

Nabucco Pipeline – Bypassing Russia

The idea of a pipeline that could draw on supplies of gas from the Caspian Sea region was not new in 2005. A pipeline had already been constructed that brought gas from Azerbaijan through Georgia into Turkey, where it could then be transited to European states further west.[402] This pipeline did not, however, include a plan to access Turkmen gas. In 2005 a consortium of companies was set up to begin the construction of a pipeline that would eventually see Turkmen gas piped across the Caspian Sea, then through Azerbaijan, Georgia, Turkey, and on to Europe. The project is known as the Nabucco Pipeline (see map below). Discussion of this pipeline began as early as 2002; however, it did not appear as though it would be a reality until 2005 when Turkey, a necessary partner for geographic reasons, signed on.[403] Potential customers for gas transited via this line would include Bulgaria, Romania, Greece, the Balkan states, Hungary, and possibly states further west. Planned capacity for the entire project is between 25.5 and 31 bcm.[404] If this pipeline is built, it would provide European states with access to increasingly important Turkmen gas without the use of Russian transit pipelines. Russia would then lose the stranglehold on Central Asian gas supplies that it had held since before the dissolution of the Soviet Union. If Russia was the omnipotent energy power it was often believed to be this may not have been of concern to its leaders, but

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[402] Today. Az, Business, "Over 10 billion cubic meters of gas produced from Shah Deniz field," April 27, 2009, http://www.today.az/news/business/51808.html, Accessed May 6 2009.
[403] "Turkey signs participation in gas pipeline project Nabucco," *BBC Monitoring European,* June 29, 2005.
[404] Stela Nenkova, "Nabucco Gas Pipeline Route Mapped Out," *PARI Daily*, June 3, 2005.

as an analysis of Russia's natural gas balance over the last decade has illustrated, this was not the case.

Figure 6.1 Nabucco Pipeline's Possible Routes[405]

Since the Russian gas deficit has existed since at least 2000, there is no clear indication that concerns over the deficit directly caused price increases to Ukraine. Still if combined with the fact that Russia has relied on Turkmen and other gas from Central Asia to fill this deficit, and that monopoly access to these supplies was under threat from the Nabucco project, then one could see how individuals in Russia's natural gas industry and government, dependent on natural gas rents, might be alarmed. If Russia was not able to maintain a monopoly over these gas volumes, the rents they generate could be captured by other states and private enterprises. This would also lead to increased competition on the European gas market, and possibly price decreases. Furthermore, Russia would no longer be able to ensure Europe's dependence on its gas supplies.

[405] www.stratfor.com "Nabucco Pipeline's Possible Routes." http://www.stratfor.com/files/mmf/b/7/b7e4632ea8ee98145b0999a4a8055c880db1749e.jpg, Accessed May 6 2009.

Rent Seeking and Reaction to Challenges--Individual Action in the Face of Structural Change

Individuals at Gazprom reacted swiftly to these two indications of increasing interest in Turkmen gas. Their strategy to maintain control over Turkmen gas was twofold. First, with regards to Ukraine and supplies for the proposed Nabucco project, Russia came to terms with Turkmenistan regarding pricing and future supply. On December 29th 2005, during the Russian Ukrainian price dispute, and prior to Russia cutting off supplies, Gazprom agreed to purchase 30 bcm of natural gas from Turkmenistan in 2006 at a price of 65 USD per 1000 cm.[406] This was an increase in the amount of supply agreed upon originally, up from 10 bcm dictated by the 2003 deal, and an increase in price, which Gazprom management had previously staunchly resisted, from 44 USD per 1000 cm. The 65 USD price tag was also larger than the 60 USD Turkmenistan was seeking to receive from Ukraine. The increase in supply left Ukraine, which had been buying 36-37 bcm of gas from Turkmenistan, with only 16-17 bcm of Turkmen gas to purchase. This deal also brought into question the feasibility of the Nabucco project, as with Russia purchasing essentially all Turkmen gas supplies, sources of gas for the pipeline began to look limited.

Further agreements between Gazprom and Turkmenistan were forged in 2006, 2007 and 2008, and all three dictated price increases. The price Gazprom paid for Turkmen gas in 2007 increased to 100 USD per 1000 cm, though the original 2005 agreement did not envisage new price negotiations until 2009.[407] Gazprom management agreed to pay more for gas in 2008 as well, agreeing in early December to pay 130 USD per 1000 cm during the first half of

[406] Dmitry Zhdannikov, "Update-1 Russia Buys Turkmen Gas, Tightens Screws on Ukraine," *Reuters News*, December 29, 2005.
[407] "Turkmen-Russian Breakthrough," *World Gas Intelligence*, December 5, 2007.

2008, and 150 USD per 1000 cm during the second half of the year.[408] The volumes dictated by this deal were roughly 50 bcm per year. In mid 2008, in a prelude to another Russia-Ukraine price disagreement, Gazprom agreed to pay for Turkmen gas based on average gas prices in the European market, and secured the majority of Turkmen gas supplies until 2028.[409] This amounted to roughly 340 USD per 1000 cm as of the beginning of 2009.[410]

The timing of these contracts, and the large price increases which they dictate, are a clear indication of the concern of Russian natural gas and state officials that they may lose control over Turkmen natural gas supplies. By substantially increasing the price Gazprom paid for Turkmen gas supplies, management was able to retain control over these supplies, and forge new long-term contracts with the Turkmen government that would result in Gazprom control of Turkmen gas supplies throughout the next two decades.

The second component of Gazprom management's strategy to retain control over Turkmen natural gas supplies involved wooing potential Nabucco customers into accepting Russian gas supplies instead. The tactics used by Gazprom management involved the enlargement of and creation of new pipeline routes through which they could transport Russian and Central Asian gas to Europe, serving potential Nabucco customers. These projects include the NordStream pipeline, the SouthStream pipeline, and a new Central Asian pipeline.

The NordStream project began to take shape in 1997 as a joint venture between Gazprom, Finnish company Neste Oil, and German company Rurgas. Little in the way of

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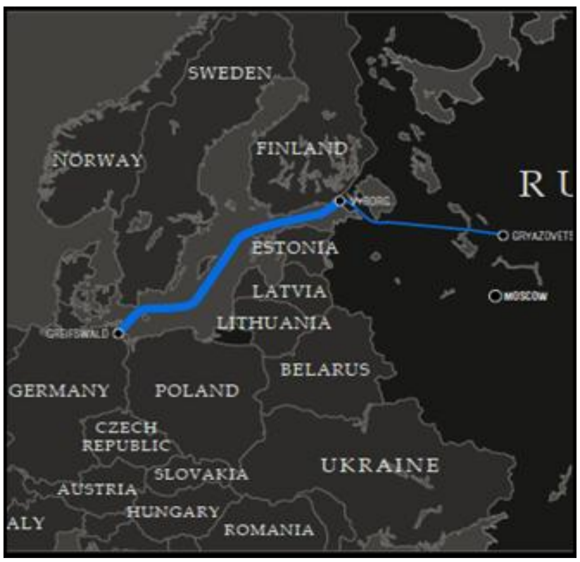
[408] John C. K. Daly, "Turkmenistan, Natural Gas, and the West," Jamestown Foundation, December 14 2007, http://www.jamestown.org/single/?no_cache=1&tx_ttnews%5Btt_news%5D=33246, Accessed April 29 2009.

[409] "Russia/Central Asia industry: Gazprom signs contracts with Uzbekistan, Turkmenistan, and Kazakhstan," *Economist Intelligence Unit – ViewsWire,* January 8 2009.

[410] "Gazprom Agrees on Terms of Delivery of Turkmen Gas in 2009," Itar-Tass, January 2, 2009, http://www.itar-tass.com/eng/level2.html?NewsID=13441147&PageNum=81, Accessed January 2 2009.

solid results materialized until 2005 when E.ON, another German company, BASF, and Gazprom agreed to begin construction of the line in 2006.[411] The pipeline will transit gas from Russia to Germany underneath the Baltic Sea, bypassing transit countries in eastern and central Europe (see map below). The line was to have a capacity of 27.5 bcm per year by 2010 and the consortium managing the pipeline signed contracts with Germany, Netherlands, and France regarding supply.[412] In 2006 a further agreement was inked which would see a twin pipeline built by 2013, doubling the project's total capacity to 55 bcm per year.[413]

Figure 6.3 NordStream Pipeline[414]

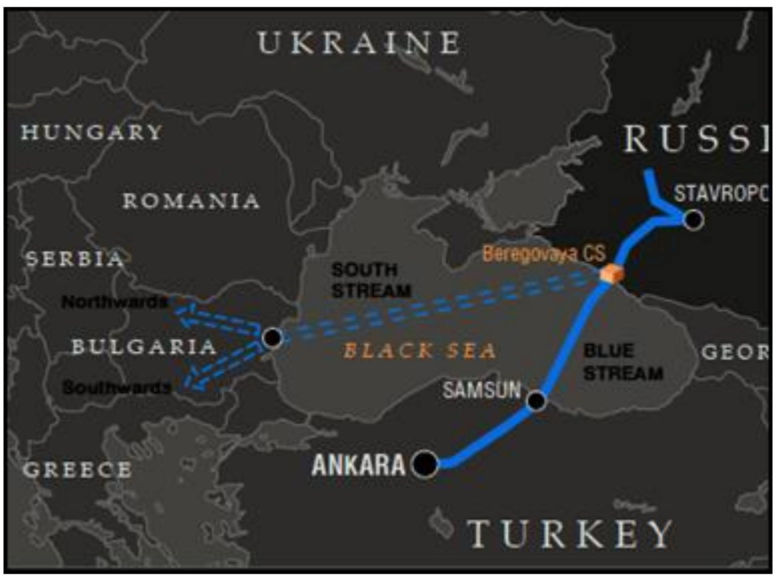


The Southstream project would potentially service many of the same consumers as the proposed Nabucco line including Bulgaria, Greece, the Balkans, and Hungary (see map below). A branch is also planned to link Italy to the project. The off-shore portion of the line

[411]Stefan Lochner, David Bothe, "From Russia With Gas: An analysis of the Nord Stream pipeline's impact on the European Gas Transmission System with the Tiger-Model," *Institute of Energy Economics at the University of Cologne,* EWI Working Paper, 7 no. 2 (September 2007), 3.
[412] Gazprom Web Site, "Gazprom Questions and Answers," 59-60, http://eng.gazpromquestions.ru/fileadmin/template/docs/ALL_Eng_72.pdf, Accessed May 1 2009.
[413] "Nord Stream deal finalized," *Platts Energy in East Europe,* September 15, 2006.
[414]Gazprom Web Site, "Gazprom Questions and Answers," 59, http://eng.gazpromquestions.ru/fileadmin/template/docs/ALL_Eng_72.pdf, Accessed May 1 2009.

has a planned capacity of 31 bcm per year,[415] while the onshore portions truncate as they pass through consuming markets. This line is seen by many as a direct challenge to the Nabucco project as it is unclear, given the limited amounts of natural gas currently consumed by the aforementioned states, if there would be enough demand to make both lines feasible. Construction has yet to begin on this project, and it is still unclear, given the potential cost of the project, whether it will be feasible.

Figure 6.4 Proposed Southstream Pipeline[416]



In what may have been the final blow to the Transcaspian portion of the Nabucco pipeline project Russia, Turkmenistan, and Kazakhstan signed an agreement in May 2007 to build a new pipeline from Turkmenistan, through Kazakhstan, into Russia. The planned capacity of the pipeline is 20 bcm per year, and it is expected to operational by 2012.[417]

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[415] AFX News Limited "Gazprom Mulls Plan To Boost South Stream Capacity," January 28, 2009, http://www.downstreamtoday.com/news/article.aspx?a_id=14870&AspxAutoDetectCookieSupport=1, Accessed May 8 2009.

[416] Gazprom Web Site, "Gazprom Questions and Answers," 58, http://eng.gazpromquestions.ru/fileadmin/template/docs/ALL_Eng_72.pdf, Accessed May 1 2009.

[417] "Update: Russia, Kazakhstan, Turkmenistan to build new gas line," *Platts Commodity News*, May 14, 2007.

According to Russian officials this pipeline will increase the amount of gas Russia is able to buy from Turkmenistan to 90 bcm.[418] With this new line in place it is difficult imagine that Turkmenistan would be capable of providing gas to both the new Central Asian pipeline and the Nabbucco pipeline. The construction of this pipeline also brings into question the availability of Turkmen gas for a proposed export pipeline to China.

Figure 6. 5 New Central Asian Pipeline Route[419]

The response from Gazprom's management to the potential loss of Turkmen supplies is what one might expect from individuals seeking to maximize the rents they control. Faced with the prospect of losing control over Turkmen gas supplies, Miller and Medvedev increased the price they were willing to pay Turkmenistan for gas supplies, and by doing so have apparently secured the majority of the country's exports for the foreseeable future. This

[418] "Update: Russia, Kazakhstan, Turkmenistan to build new gas line," *Platts Commodity News*, May 14, 2007.
[419] Stratfor Global Intelligence, "Kazakhstan's Energy Shift," August 21, 2008, www.stratfor.com/analysis/kazakhstan_energy_shift, Accessed May 11 2009.

has brought potential gas supplies for the Nabucco line into question, and ended Ukraine's purchase of Turkmen gas through bilateral contracts. Though likely not totally contingent on the Nabucco project, new Russian-backed pipelines serving the north and south of Europe, and transiting Central Asian gas to Russia, have certainly led to challenges for the Nabucco project concerning the volumes of gas available for the pipeline and potential markets for the gas it would transport. The next section will focus on the impacts of these developments, when combined with Russia's patrimonial social structure, reliance on resource rents, and increased state control over the Russian natural gas industry, on Russian natural gas prices for Ukraine from 2005 to 2008.

The Transformational Mechanism and Gas Prices for Ukrainian 2005 – 2008

2005 was the last year that Ukraine received Russian gas at a discounted price. The average price for natural gas provided by Russia to Ukraine in kind for transiting gas to Europe in 2005 was once again 50 USD per 1000 cm. This was also the last year that Ukraine purchased Turkmen gas under agreements made by the two governments.

The period up to and following Russia's cutoff of natural gas supplies to Ukraine in 2006 is often considered one of the most dramatic developments concerning Russian natural resources since the collapse of the Soviet Union. As discussed in the first chapter, the beginning of 2006 was marked by a complete cutoff of natural gas exports to Ukraine through Russia. The dispute was brought about by a disagreement over the price of exports through and from Russia to Ukraine. Gazprom management initially requested an increase in the price of gas for Ukraine to 160 USD per 1000 cm, but after resistance from Ukraine this sum increased to 230 USD.[420] After a brief but dramatic cutoff of supplies, which affected downstream consumers in Europe, a final agreement saw the price of a blend of Russian and

[420] "The Geopolitics Of The Russian Gas Dispute With Ukraine," *Gas Matters,* January 31, 2006.

Central Asian gas (made up mostly but not exclusively of Turkmen gas) being sold to Ukraine set at 95 USD per 1000 cm. This is almost double the average price for Russian gas in 2005, and an increase in the cost of Turkmen gas which, after transit fees, was roughly 74 USD per 1000 cm at the Russia-Ukraine border. Considering the large increases in global energy prices around this time a 21-45 USD increase may appear small, but combined with the increases in the years that follow the total increases between 2005 and 2008 are quite large.

The price of Russian and Russian-controlled natural gas exported to Ukraine in 2007 grew from 95 USD per 1000 cm to 130 USD per 1000 cm.[421] In late 2007 and early 2008 a disagreement over Ukraine's gas debt, totalling over 1.5 billion USD, saw Gazprom reduce Ukrainian gas supplies by 25%,[422] but an end to the disagreement was reached that saw Ukraine's debt apparently paid off, and prices for Russian exports increase to 179 USD per 1000 cm for 2008.[423]

Between 2005 and 2008 the price of Russian gas exports to Ukraine grew from 50 USD per 1000 cm to 179 USD per 1000 cm, but by the end of 2008 Gazprom was once again pressing for price increases. While 2009 is outside the time frame of this case study, it deserves some attention as the price increases over this period were the largest in 20 years, and the Russia-Ukraine disagreement over pricing lead to prolonged supply disruptions for European customers. Gazprom suspended deliveries to Ukraine on January 7th 2009 and supplies were not restored until January 21st 2009. The agreement which led to the end of the gas cutoff dictated that Ukraine would begin to pay European market prices by 2010, and that in 2009 it would receive gas at European prices with a 20% discount. For the first quarter of

[421] RIA Novosti, "Ukraine to reach 2008 gas price deal with Russia before Nov. 20," World, November 11, 2007, http://en.rian.ru/world/20071102/86501347.html, Accessed May 8 2009.

[422] BBC News, "Gazprom cuts Ukraine gas supply," March 3, 2008, http://news.bbc.co.uk/2/hi/business/7274380.stm, Accessed May 8 2009.

[423] "New Natural Gas Price For Ukraine – 179.5 per 1000 cum," Novecon, December 5, 2007.

2009 this price translated into about 380 USD per 1000 cm.[424] This amounts to a doubling of prices over a one year period, and appears to have marked the end of Russian subsidized natural gas prices for Ukraine.

In sum, from 2005 to 2009 Ukraine saw large increases in the price it pays for natural gas coming from Russia. This was a stark departure from the previous 10 years of decreasing and then stable low prices. While in 2005 Ukraine received Russian gas in kind at an average price of 50 USD per 1000 cm, and Turkmen gas at about 74 USD per 1000 cm, with Gazprom's purchase of virtually all of Turkmenistan's exportable gas Ukrainian prices became closely tied to the price Gazprom paid for Turkmen gas. This factor lead to a total price increase over the four years in question of about 330 USD per 1000 cm, and it led to disputes over pricing that led to cutoffs in 2006 and 2009.

Summary

Some things changed between 2005 and 2008 while other things remained the same. Authoritarian trends that emerged in Putin's regime between 2000 and 2004 continued, and while natural resource rents remained the basis for Putin's patrimonial system of rule, their increased value led to greater attempts by Gazprom management and the Russian government to capture these rents. The efforts to capture a greater share of the rents created by the production and sale of natural gas included: increasing the state's ownership of Gazporm; taking over gas and oil companies from other Russian companies; and forcing major foreign companies to sell portions of their enterprises to the state. These actions generally reflected developments during the 2000 to 2004 period; however, the aggressive dealings with foreign

[424] BBC News, "Gas to flow' after Moscow deal," January 18, 2009, http://news.bbc.co.uk/2/hi/europe/7834796.stm, Accessed May 1 2009.

oil and gas companies reflect the increased intensity of Gazprom management's rent maximizing activates. These moves led to increased control by Gazprom of the Russian natural gas industry, and increased control over Gazprom by the state, outcomes directly in line with the goals laid out by Putin.

Just as during the period from 2000 to 2004, 2005 to 2008 saw increases in the average wages paid to public administrators, defence workers, pensioners, and gas and electricity industry workers. Furthermore, the state's foreign reserve holdings ballooned during this period, out-pacing the increases of 2000 to 2004. Both of these outcomes are indicative of the distribution of rents captured by those controlling Gazprom and the state, through the structures of the state to benefit state officials, and to fill state controlled coffers.

As far as Russia's patrimonial system is concerned little changed other than the intensity of the authoritarian nature of the regime and the rent maximizing and distribution activities, but there were changes in other areas. The change most obviously affecting the price Ukraine paid for natural gas from Russia over this period was the increasing importance of Turkmen gas supplies. In the face of the growing importance of these gas volumes both Ukraine and states of the E.U. attempted to secure access without reliance on Gazprom or Russia. In a move to ensure that rents generated through the transit and sale of Turkmen gas were not captured by other non-Gazprom entities, Gazprom management began offering increased prices to Turkmenistan for its gas supplies. This allowed Gazprom to secure the majority of Turkmen gas supplies for at least the next two decades, ending the bilateral trade deals that had previously governed the Turkmen-Ukrainian gas trade. Russia and Gazprom controlled Turkmen gas supplies from 2006 on henceforth Ukraine purchased its gas from a Gazprom-controlled intermediary company, RosUkrEnergo, which purchased the gas directly from Gazprom and Gazprom subsidiaries. This is in stark contrast to the 2000 to 2004 period, when deals on gas supplies were arranged between the Turkmen and Ukrainian governments and facilitated by third party intermediaries with no direct ties to Gazprom.

The result of these changes for Ukrainian natural gas prices was dramatic. With Gazprom now the sole price setter for Ukrainian imports, and with Gazprom now paying much more for Central Asian gas in order to gain control of these supplies, the next logical step was increases in the price Ukraine paid for the gas it imports from and through Russia. This is exactly what happened, as the years 2006, 2007, 2008, and 2009 all saw large price increases for Ukrainian gas imports from Russia. In the face of resistance to these price hikes, Russia and Gazprom cutoff gas supplies to Ukraine in 2006 and 2009.

Chapter 7

Conclusion

The preceding case studies have revealed a great deal about changes in Russian politics, the natural gas industry, and the structure of European and Eurasian as well as global energy markets. The impact that these changes have had on Russia's natural gas pricing policy for Ukraine has also been clarified. This chapter will summarize these variances, along with the mechanisms which translated them into price increases for Ukraine. One can then examine the ability of a mechanisms based approach, using the logic of methodological individualism, to bring together these macro level phenomena to provide an explanation for the Russian government's decision to raise natural gas prices for Ukraine in 2006. Attention will then turn to the ability of this approach to synthesize the three levels of analysis prevalent in international relations theory into complete explanations for certain phenomena in international politics. Finally, attention will turn to the implications of this explanation for the Russian natural gas industry and its relationship with Russian foreign policy.

Results

From 1995 to 2008 the patrimonial nature of Russian politics and society changed very little. Two key variances do however present themselves. First, there was a change in the object of rent seeking and distribution from property to natural resource rents. The second change was the more authoritarian nature of the Putin's regime as compared to the Yeltsin's regime, and consequently the role the played by the state in rent capture and distribution.

Variation in the Source of Rents

From 1995 to 1999 energy prices remained relatively low, and reached a 20 year low in late 1999. Furthermore, the state had a large pool of property and a mandate to privatize it. This is an important for at least two reasons. First, although the pool of state property to be privatized was large, it was limited in comparison to the rents generated from natural resource extraction and sale. This meant that while the Yeltsin administration was able to distribute property rents for political support, once these rents were distributed there was no way to replenish the pool of property rents, save renationalization. Second, the distribution of rents in the form of property led to the privatization of some of the state's natural resource assets. Consequently there was a decrease in the state's overall capabilities with respect to the natural gas industry.

2000 to 2004 saw a large increase in the rent-generating potential of Russia's natural resources, specifically oil and natural gas. Global oil prices bottomed out in the late 1990's and Russian natural gas export prices to Europe fell along with them. By 2000, however, the situation began to change and by the end of Putin's first term in office world oil prices had increased fourfold. Russian natural gas exports to Europe followed a similar trend, increasing 2.5 times by the end of 2004. When Putin came to power it was clear that he envisioned a central role for the state in capturing and distributing these rents. Those he appointed to top positions at Gazprom, Alexey Miller and Dmitry Medvedev, supported Putin's vision as good clients should, and directed their policies to further this end.

Prior to and following the 2006 Russia-Ukraine natural gas crisis the trends apparent from 2000 to 2004 increased in their intensity. Oil and natural gas prices, regionally and globally, grew at an even faster rate, increasing their rent generating potential even more substantially from 2005 to 2008 than from 2000 to 2004. From the end of 2004 to the middle of 2008 oil prices continued their upward swing, increasing by nearly 3.4 times. Concurrently, Russian natural gas prices at the German border increased 3.7 times. This is a clear indication of the increased rent generating potential of natural gas during this period, and underlines the main source of rents in Russia's patrimonial society during this period was oil and natural gas.

Varying Degrees of Authoritarianism

While it would be inappropriate to suggest that under the leadership of Boris Yeltsin Russia was a democracy, during his term of office politics was certainly more pluralistic than under President Putin. As noted in Chapter Five there were no less than four influential political groups in Yeltsin's Russia. These groups included Yeltsin's inner circle, regional governors, Russia's increasingly powerful business elite, and the state Duma, which at the onset of privatization represented the interests of Soviet-era managers. What this produced over the 1995 to 1999 period was rent distribution to groups outside of the control of the state, and a withering of state control over rent capture and distribution, especially in the natural resource sector.

As was also discussed in Chapter Five Putin set about marginalizing these influential groups during his first term in office, and installing to high ranking positions people with whom he had worked with during his career with the FSB/KGB and in St. Petersburg. During the first four years of Putin's presidency, through selective reviews and reversals of the privatization process in the case of those who did not support him politically, Putin was able to marginalize Russia's business elite as a political force. Further, by changing election laws, restructuring Russia's upper house of parliament, and ending the direct election of regional governors, Putin was able to all but eliminate the political clout of regional leaders. Finally, although initially remaining in positions of power, members of Yeltsin ruling circle were eventually removed from power prior to 2004. This resulted in increased rent capture and distribution by the state.

The 2005 to 2008 period also saw a hardening of the authoritarian nature of Putin's regime. Through changes to election laws governing party formation and the formulation of blocs within the Duma, the elimination of single-member district seats for Duma elections, and increased restrictions on negative campaigning during elections, the dominance of United Russia, Putin's party of choice, has been solidified in Russia's lower house of parliament. Given this increasingly authoritarian structure the state once again played a major role in rent distribution during this period.

Consequences for Russian Patrimonialism

From 1995 to 1999 Boris Yeltsin distributed rents in the form of state property in return for political support. Examples of this include concessions made to prior to the Soviet-era managers to the first round of privatization and the loans for shares auctions before to the 1996 election. In turn, those who were appointed to top positions in the natural gas industry further distributed the state property granted to them to their own clients. Examples of this include the involvement of Chernomodryn, Vyakhirev, and their families with Horhat and the concessions Vyakhirev made to Itera during his term as the head of Gazprom.

From 2000 to 2004 Russia's new president Vladimir Putin sought to capture and distribute rents generated from the nation's natural resources, specifically but not exclusively oil and natural gas, and distribute them to state employees, and save them for future use. His appointees to top positions in the natural gas industry supported and directed these moves. Examples of this include the increased taxes demanded of and paid by Gazprom to the state, along with moves by Gazprom's management to recapture assets lost to private companies, specifically Itera, during the late 1990's. Examples of state controlled distribution of rents include the increased salaries for state employees and sharp increases in Russia's foreign currency reserve position.

2005 to 2008 saw, overall, a continuation of the resource rent capture and distribution patterns evident during the previous four years. Those heading the state and Gazprom continued to ensure that the resource rents generated from oil and natural gas were channelled into the pockets of state employees, and state savings accounts. The rents those controlling the state could acquire continued to be maximized by recapturing the assets lost to private companies in the 1990's, and by squeezing foreign companies out of natural gas projects in Russia.

While Russia's political system remained patrimonial throughout, there were obvious differences between the time periods in question, especially 1995 to 1999 and 2000 to 2008. Two important differences in Russian patrimonialism present themselves, one being the source of rents, and the second being the authoritarian nature of the Putin regime in comparison to that of Yeltsin. According to Katzenstien these kinds of variances in a state's political structure should bring about variations in its foreign economic policies. The case studies previously presented appear to bear this out. These two differences also had an impact on the Russian state's capabilities in the Russian natural gas industry, the next topic of concern.

Variance in State Capabilities

Beyond the changes in the nature of Russia's patrimonial society, differences in the Russian state's control of Russia's natural gas industry over time were highlighted at the outset as an important factor affecting natural gas export prices to Ukraine. As was suggested in Chapter Two, a change in a state's capabilities should lead to a change in its foreign policy. On the whole a decrease in the state's capabilities in this area appears to have resulted in decreased prices for Ukraine in 1998, while an increase in the state's capabilities in this area resulted in an increase in prices from 2006 to 2008.

From 1995 to 1999 there were many indications that the Russian state was losing control over the Russian natural gas industry. During this period the state's stake in Gazprom decreased to less than 40%, and its representation on the company's Board of Directors to four out of eleven. Gazprom also experienced a 10% reduction in the reserves it controlled during this period, allowed independent companies access to the pipeline infrastructure it controlled, and gave up about 50% of the FSU gas market to Itera. Furthermore, the state had substantial difficulties collecting taxes from Gazprom over this period. This was in large part due to the fact that individuals controlling the industry were distributing rents in the form of property rather than rents generated by natural gas extraction and sale.

During the years from 2000 to 2004 a substantial shift in the direction of increasing the state's control over the natural gas industry. During this period the state's representation on Gazprom's board of directors grew from four to five on the eleven member board, and for the most part the state gained the acquiescence of independent board members to most of its policies. The state also reformed the tax system which governed natural gas extraction and sale. These tax reforms led to a sizable increase in the taxes paid by Gazprom to the state. Furthermore, Gazprom's level of control over Russia's domestic low pressure natural gas distribution system increased to 90% over this period, and by 2003 it had taken control of, or gained a stake in, 75% of Russia's domestic distribution companies and organizations. Many of the assets Gazprom lost/gave to Itera during the late 1990's were also regained, including a 32% stake in Purgaz, a 52% stake in Severneftegazprom, and stakes in Rospan and Zapsibgazprom. In all, Itera lost over 1 trillion cubic meters in reserves during this period and Gazprom captured most of these reserves. During this period Gazprom was also able to take over a greater share of Russian exports to the Baltic states, and in 2003 again began to supply the states of the Caucusus. While successful in regaining much of the CIS market lost in the 1990's, during this period Gazprom did not gain control over the intermediary company UralTransGas, which facilitated the sale of Turkmen gas to Ukraine. These increased capabilities can be attributed, in large part, to the increased rent generating potential of Russia's natural gas resources and Putin's resolve to see those rents captured by the state.

From 2005 to 2008, prior to and following the Russia-Ukraine gas crisis of 2006, the determination of those controlling the Russian state to gain control over Russia's natural gas industry increased. The state was able to take over a controlling share (51%) of Gazprom in 2005. This move increased the state's voting rights on the board of directors and the state's share of Gazprom's after tax profits. Under even greater state control Gazprom management continued to recapture assets lost in the 1990's, and gained some new ones. In early 2005 Gazprom regained control over 51% of NorthGas and the over 300 bcm of natural gas reserves it controlled. Gazprom also bought into the Russian oil industry during this period, purchasing a 72% stake in one of Russia's largest oil enterprises, Sibneft. Possibly the biggest shift in the policies of Gazprom management during this time period could be seen in its treatment of foreign companies working in Russia. Royal Dutch Shell, Mitsubishi, and Mitsui were forced to sell a controlling share in their Sakhalin II project to Gazprom, while Exxon Mobil was pressured into renegotiating its production sharing agreement with the Russian government, and was prevented from selling to China the gas which its Sakhalin I project produced. In a similar fashion, in mid 2007 TNK-BP was force to sell a controlling share of its Kovykta project to Gazprom due to its failure to meet production quotas. These takeovers amounted to a 4.18 trillion cubic meter increase in Gazprom's reserves from 2005 to 2008, and an obvious increase in the state's control over the domestic natural gas industry. Furthermore, in 2005 Gazprom was able to remove UralTransGas as the intermediary company supplying Turkmen gas to Ukraine, and replace it with RosUkrEnergo, in which it held a 50% stake. All of these moves, just as those in the previous four years, can be attributed to the increased value of Russian natural resources and Putin's resolve to see the state dominate the capture of the rents they generate.

It is apparent that while the period from 1995 to 1999 saw the Russian state's control over the natural gas industry decrease substantially, this trend reversed between 2000 and 2008. These variances correlate well with price increases and decreases for Ukraine, but considering that there were no price increases between 2000 and 2004, while there were increases in the state's control over the natural gas industry, they cannot serve as the sole explanation. This is not surprising, as it was stated from the outset that a fourth factor played a role in the decision of individuals controlling the Russian state and Gazprom to raise natural gas export prices for Ukraine. That fourth factor is the regional importance of Turkmen natural gas, a subject that will be revisited in the next section.

Varying Importance of Turkmen Natural Gas

Much like the other factors highlighted as important to the Russian government's decision to increase natural gas export prices to Ukraine, especially in 2006, the role that natural gas from Turkmenistan has played in the European and Eurasian natural gas trade has varied quite substantially during the period under consideration. While throughout the 1990's this gas source was relatively insignificant on a regional level, it grew in importance throughout the first half of the new millennium's first decade, and by the second half of the decade the competition for Turkmen gas amongst Russia, European states, and Ukraine began to heat up.

From 1995 to 1999 Turkmenistan's share of regional production shrank from 3.3% to 2.3%. Total European and Eurasian consumption over this period decreased as well. Furthermore, Turkmenistan's share of production consumed domestically increased from 26.5% in 1995 to 53% in 1999. While Russia's share of regional production decreased over this period as well, its share of production consumed domestically fell. These factors illustrate the decreasing role that Turkmen natural gas played in regional trade during this period. This being the case, and given that gas industry officials, specifically Rem Vyakhirev, were conditioned to seek and distribute rents in the form of property, it is not surprising that a serious attempt by Gazprom to monopolize these supplies was not seen. It should also be considered that Vyakhirev favourite Itera held the contract to transit Turkmen gas to Ukraine. It is likely that this is why Gazprom did not attempt to block Turkmen supplies over the long term. Due to these factors Turkmenistan and Ukraine were able to forge bilateral gas deals somewhat independently of Russia over this period.

Over the years from 2000 to 2004 Turkmenistan's natural gas began to play a greater role in the regional natural gas trade. While regional production grew over this period, so did Turkmenistan's share of regional production, reaching 5.1% in 2004. This was a substantial increase from the 2.3% share it garnered in 1999. Regional natural gas consumption was also on the increase during this period. This made Turkmenistan's exportable natural gas supplies more important regionally. More than half of Turkmenistan's production was consumed domestically in 1999 but by 2004 this figure was less than 30%. This fact is illustrative of Turkmenistan's increased role in the regional natural gas trade, as in the face of increased regional consumption Turkmen exportable volumes grew. Though initial discussion of a pipeline which could draw on Turkmen gas and bypass Russia began in 2002, there was little hope of the pipeline becoming a reality at that time as the necessary partners (specifically Turkey) had not signed on to the project. Apart from this preliminary discussion of the Nabucco pipeline there was no prospect over this period of breaking the virtual transit monopoly Russia enjoyed over Turkmen natural gas exports to Europe. It is quite possible that this lack of competition for Turkmen gas is why Gazprom remained reluctant to pay increased prices for Turkmen gas, which is a key contributing factor explaining the continuation of bilateral natural gas trade relationship between Ukraine and Turkmenistan. As during the period from 1995 to 1999, the bilateral nature of the Ukraine-Turkmenistan natural gas trade relationship likely affected Russian export prices to Ukraine. With continued competition from Turkmen gas, more expensive Russian gas would have been uncompetitive on the Ukrainian market.

From 1995 to 2004, there was little competition for control over the transit of Turkmen gas from Central Asia to Europe. With the increasing importance of Turkmen gas supplies throughout the middle and late 2000's, competition for control over the transit of this gas began to heat up. Total regional production increased between 2004 and 2007; however, from 2006 to 2007 total production actually decreased. Turkmenistan's share of regional production continued to increase over this period, growing from 5.1% in 2004 to 6.2% in 2007. Regional consumption also increased over this period. When increased consumption is matched with declining production, it becomes clear that the exportable volumes of gas nations have become more important. Though Turkmenistan's share of production consumed domestically grew over this period, its total exportable volumes also grew from 39 bcm in 2004 to 46 bcm in 2007.

From 2005 to 2008 the states of the European Union and Ukraine competed with Russia for control over these gas volumes. In 2005, saw Ukraine and Turkmenistan come close to a long-term agreement on natural gas supplies. 2005 also saw the potential Nabucco pipeline project inch closer to reality with Turkey signing onto the project, and the development of a consortium of companies to build the pipeline. These developments likely triggered Gazprom management's decision to pay Turkmenistan more for the gas it imports from that country. This concession allowed Russia to ink a long term deal for the majority of Turkmen natural gas supplies for the next 25 years. This undercut attempts to haveTurkmen gas flow through the Nabucco pipeline. It also removed the prospect of bilateral Ukraine-Turkmen gas deals, and removed competition from the Ukrainian import market. This tipped the scales in Russia's favour as Gazprom could now charge Ukraine practically whatever it believed Ukraine could pay for its natural gas imports. Gazprom also launched and expanded pipeline plans to serve markets in northern and southern Europe, and to bring more gas to the

Russian pipeline system from Turkmenistan. These moves have dampened hopes for a pipeline that could bring Central Asian and Caspian gas to Europe while bypassing Russia.

It is now apparent that four macro level factors influence to Russia's natural gas price increases for Ukraine. The first two factors can be characterized as changes in Russia's patrimonial political and social system. These include a change in the source of rents available in the Russian economy, and the increasingly authoritarian and state-centric nature of Vladimir Putin's regime. These changes made natural resource rents the object of rent seekers, and fixed the state as the lynchpin in the capture and distribution of these rents. The third factor was the growing state domination of the natural gas industry which began in the early 2000's and reached its zenith in the latter half of the decade. The increased capabilities of the state in this area clearly allowed the individuals who controlled it a freer hand in determining policy and shaping it to achieve their desired ends. The fourth factor, the increasing importance of Turkmen natural gas, clearly played a role as it was the elimination of bilateral agreements between Ukraine and Turkmenistan over natural gas sales that brought an end to competition in the Ukrainian import market, eventually leading to price increases for Ukraine.

As was stated at the outset, it is not enough to point out that these macro level events correlate with the Russian government's gas price increases for Ukraine. For a full explanation it is important to show how these macro level events interrelate to bring about the price increase for Ukraine. To accomplish that task a mechanisms based explanation which relies on the logic of methodological individualism was chosen. This next section will examine the success of this approach in synthesizing these macro level events into a full explanation.

A Mechanisms Based Approach and Methodological Individualism

Three mechanisms were outlined at the beginning of this project which explained how the macro level events discussed above brought about Russia's natural gas price increases for Ukraine. These were the situational mechanism, the individual action mechanism, and the transformational mechanism. These mechanisms deserve some final attention here.

The changes in Russia's patrimonial society, the source of rents and the authoritarian nature of Russian rule, the increased capabilities the state enjoyed in the natural gas industry, and the growing importance of Turkmen gas regionally, are all changes in the situational mechanism which link social structure to the beliefs, desires, and actions of individuals. These variations have been dealt with above and require little further attention; however, it should be remembered that these variations bring about changes in the actions of individuals, along with changes in the outcomes of the collective actions of these individuals. Now it is time to move on to the individual action mechanism, and the impacts of changes in the situational mechanism on individual action.

Individual Action Mechanism

This study chose the logic of methodological individualism to underpin an explanation for Russia's natural gas price increases for Ukraine in 2006. This assumes that individuals are the causal agents of consequence in the social sciences. In view of this the most powerful explanatory tool this project has is the individual action mechanism. The purpose of the individual action mechanism is to show how individual beliefs and desires bring about specific action. This requires assumptions to be made about individuals and how they formulate their beliefs and desires. For this study three assumptions were made about the actions of individuals, along with the assumption of three main preferences. First, in the vein of rational institutionalism, it was assumed that individuals act to maximize a given set of preferences. Two other assumptions were borrowed from rational institutionalism, one being the idea that political decision making is a series of collective action dilemmas and two, that institutional rules play an important part in political outcomes. Beyond these assumptions three sets of preferences of individuals were proposed based on the patrimonial nature of Russian politics. These preferences included: 1) Patrons and clients seek to maximize the rents they control; 2) Patrons do this by maximizing state control over rent generating sectors of the economy; and 3) clients do this by supporting their patron. These preferences and assumptions make up the heart of the individual action mechanism.

These assumptions about individuals proved powerful as explanatory tools in this study as exemplified by the previous case studies. Patrons and clients seeking to maximize the rents they control by seeking control over rent generating segments of the Russian economy and supporting their patron respectively, accurately explain two macro level changes. First it explains the moves by individuals to decrease and increase the state's control over the natural gas industry throughout the time periods in question; and second, it plays a crucial role in explaining the reaction of gas industry officials to the decreasing and increasing importance of Turkmen natural gas supplies. Explaining how the actions of individuals in the face of changes in the situational mechanism brought about increased state control over the Russian natural gas industry and price increases for Ukraine is a task for the transformational mechanism.

Transformational mechanism

This mechanism shows how the collective actions of individuals can bring about macro level changes such as Russia's price increases for Ukraine. As suggested in Chapter Two, this mechanism is dependent somewhat on the situational mechanism as the situational mechanism lays out the institutional rules that govern the outcome of collective action dilemmas, which then result in macro level change. When the nature of Russia's patrimonial ruling regime is less authoritarian and centered around rents as property, as it was from 1995 to 1999, outcomes will be governed less by the state, and rent seeking and distribution will take the form of property seeking and distribution. When Russia's patrimonial regime is more authoritarian and is centered around natural resource rents, as it was from 2000 to 2008, outcomes are more likely to be dictated by the state, and rent seeking and distribution will take the form of resource rent seeking and distribution.

With the macro level changes and mechanisms pertaining to the 2006 crisis detailed, it can now be suggested that a mechanisms based approach relying on methodological individualism captured quite well the relationship between the changes in the situational mechanism and Russia's natural gas price increases for Ukraine. The original situational mechanism evident during the period from 1995 to 1999, less authoritarian patrimonialism based on rents in the form of cheap property, weakened state control over the natural gas industry, and Turkmen gas supplies that were of limited importance regionally, produced lower natural gas prices for Ukraine. This was due to the willingness of individual rent seekers to forgo less lucrative natural resource rents in favour of capturing and distributing property rents and the limited role of the state in distribution of rents, beyond the initial property transfer.

In the face of changes in the situational mechanism, the core assumptions about individual preferences and actions did not change, but the actions individuals took varied quite substantially. From 2000 to 2004 natural resources became much more lucrative and the ruling regime in Russia more authoritarian. This shifted the source of rents which Russia's patrimonial social and political structure relied on from cheap property to rents generated from the extraction and sale of oil and natural gas, and it amplified the role of the state in rent capture and distribution. Putin, who became president at the turn of the century, was quite clear in his conviction that the state should play a major role in the capture and distribution of these rents. For this to take place the state would have to increase its control over Russia's oil and natural gas industries. Putin installed new individuals at the state natural gas monopoly Gazprom, and these individuals supported their patron, in the interests of maximizing their share of the rents, directing their policies to achieve the goal of greater state control over the natural gas industry. The collective actions of these individuals resulted in increased state control over the Russian natural gas industry; however, this control was not total and given the still limited regional role Turkmen gas was playing, price increases for Ukraine did not transpire.

From 2005 to 2008 changes in the situational mechanism increased in intensity. Natural resource rents became even more lucrative, and Putin's regime even more authoritarian. The state's control over the natural gas industry increased even further, and the state continued to play a large role in the capture and distribution of these rents. What changed rather drastically was the importance of Turkmen gas in the regional energy trade. With increased demand in Europe and Eurasia, and stagnating supply, the competition for exportable volumes from Turkmenistan began to heat up. European states began looking for ways to access Turkmen gas while bypassing Russian territory, and Ukraine sought long term contracts with Turkmenistan in order to limit or eliminate its dependence on Russian gas. The Individuals controlling Gazprom and the Russian state saw this competition as a potential threat to their control of rents generated by their monopoly over the transit and trade of these gas volumes.

With increased control over Gazprom and the domestic natural gas industry those controlling the Russian state had a much freer hand to dictate the policies followed by actors in the industry, and they were able to ensure that these policies matched state goals. The rent maximizing actions of these individuals led Gazprom management to concede to Turkmenistan's request for higher gas prices in order to ensure their monopoly over the transit and sale of Turkmen gas. This meant large increases in the cost of Turkmen gas for Russia, and it eliminated bilateral trade deals between Turkmenistan and Ukraine. This also eliminated competition in the pricing of imports in Ukraine and allowed Gazprom's management to pass on the increased costs of Turkmen gas to Ukrainian consumers in order to maximize the rents Gazprom and the Russian state gained from its sale.

It is evident that the rent-seeking preferences of individuals controlling the Russian state and Gazprom served to link changes in the situational mechanism governing their beliefs and actions to the increase in natural gas export prices for Ukraine in 2006 and beyond. While each of the changes in the situational mechanism offer insights into the Russian government's decision to raise prices, it is the assumptions about individual preferences for rent seeking which complete the picture, illustrating how the price increases came about. Before moving on to the final section and discussing what this explanation may mean for the Russian natural gas industry as a whole, methodological individualism's ability to synthesize the three images of international relations theory deserves some final discussion.

Methodological Individualism and the Three Images

In Chapter Two three approaches to the study of international relations and foreign policy were discussed. These approaches were the study of individuals (first image), the study of the state (second image), and the study of the structure of the international system (third image). In the same chapter it was suggested that the logic of methodological individualism offered an opportunity to synthesize these different levels of analysis into multilevel explanations of developments in international politics. After completion of this mechanisms based explanation of the Russian government's decision to increase natural gas prices for Ukraine in 2006 it would be fair to say that the role that methodological individualism can play in synthesizing these approaches is promising.

This project began by making reference to a number of developments in Russian and global politics and political economy which appeared to have had some relation to the Russian decision to increase natural gas prices to Ukraine. These developments correlated well with the above mentioned levels of analysis. There were changes in the individuals who were making decisions both in the Russian government and at Gazprom and, furthermore, the actions of these individuals varied between times of high and low prices for Ukraine. This obviously falls within the realm of the first image approach. There were changes in the degree of authoritarianism present in Russia's patrimonial system, as well as the source of rents which this system rested on. These clearly fall within the second image approach. Also, the state's control over the natural gas industry varied between times of high and low prices. The capabilities of the state as far as the natural gas industry is concerned would also fall under issues relevant to a second image approach. Finally, there were changes in the structure of the international and regional system, which included increased global natural resource prices, and tightening European and Eurasian supply and demand conditions which led to the increasing regional importance of Turkmen gas. Clearly this would be something of importance to a third image approach.

While it may have been possible to provide an adequate explanation of Russia's price increases with reference to only one of these levels of analysis, a full explanation requires attention to be paid to all of them. Through the use of methodological individualism the role that individual action played in linking all of the aforementioned developments has been made explicit. By assuming that individuals seek to maximize the rents which they control it has been shown how macro level events affecting state organization, such as changes in the source of rents and the authoritarian nature of Russia's ruling regime, have conditioned the actions of individual rent seekers. It has further been demonstrated how changes in the structure of the international system have also altered the actions of individual rent seekers. By referring to the transformational mechanism it was then shown how these factors came together to bring about price increases for Ukraine. This is an explanation that takes all the levels of analysis into account and is also able to show how they relate to one another. It is thus fair to suggest that methodological individualism can provide a link between multiple levels of analysis in international relations theory and produce robust explanations of events in international politics.

Russian Foreign Policy and Natural Gas

With an explanation for the Russian government's decision to increase natural gas prices for Ukraine in 2006 based on changes in Russia's patrimonial political structure, the state's increasing capabilities in the natural gas industry, the increased importance of Turkmen gas, and the rent seeking nature of individual decision makers laid out, it is worth suggesting some implications this has for how Russia's natural gas industry can be viewed in relation to its foreign policy. At the outset it was suggested that there was a counterfactual component to this explanation. By holding constant the possibility that it was strained Russian-Ukrainian relations after Ukraine's Orange Revolution that led Russia to increase natural gas prices to Ukraine, we have been able to identify other factors that surely played a large role. This section will suggest what this means for Russian natural gas and foreign policy.

The belief that Russia was punishing Ukraine for its drift toward institutions such as NATO and the E.U. paints a picture of a coercive Russian foreign policy which uses its vast energy resources as blunt tool to beat misbehaving states back into line. Implicit in this argument is that Russia is acting from a position of strength which it gains from its vast natural resource wealth and the infrastructure which it controls. If one subscribes to the punishment explanation that is quite prevalent in the literature surrounding the 2006 gas crisis, then one is likely to view Russia's natural gas industry as a tool controlling those which depend on Russian gas. The explanation provided here paints the relationship between Russian foreign policy and Russian natural gas quite differently. Given this project's explanation it appears that rather than working from a position of strength, and using natural gas resources as a weapon/tool of control, to a great degree Russia is working from a position of weakness, and its foreign policy is controlled by the natural gas reserves it holds.

With a patrimonial state in which the state must capture and distribute rents in order to maintain control, the quest for the rents generated by natural gas sales and extraction has become a preoccupation of Russia's foreign policy. The need to control natural gas rents has led Gazprom to push private and foreign companies out of Russia's natural gas market. This has hurt the investment climate in the entire Russian economy and the natural gas industry specifically. These developments are worrisome because as current natural gas fields decline in new fields must be found. These new fields require technology and knowhow that Russian industry experts and companies do not appear to possess, and investment dollars which the state and Russian investors cannot furnish. This presents the very real possibility of a widening gas deficit in Russia which may jeopardize its future as a key supplier to the states of the European CIS and the E.U.

The quest to maintain control over the rents generated by Turkmen gas exports has caused Russian policy makers to sign deals under which they pay high prices for large volumes of Turkmen gas, which if faced with falling demand domestically and in Europe they may not even need. If the Russian government chooses to limit the amount of gas it purchases from Central Asian states it may alienate Turkmenistan and other Central Asian gas producing states, and drive them out of the Russian sphere of influence. Also, in order to pay higher prices for Turkmen and other Central Asian gas the Russian government may have given up one of its best levers of influence it had in former Soviet states, low energy prices. This runs counter to the idea that the Russian government is using its energy resources to rebuild the lost Soviet empire.

Another consideration is that pipeline deals designed to secure Turkmen and Central Asian gas supplies my not in the end be economically feasible. These pipeline proposals have been a major issue on the Russian agenda when dealing with the European Union, and pushed legitimate concerns surrounding diverse supply and export channels throughout the region on to the Russian and E.U. policy back burners. Further pipeline deals with Turkmenistan and Kazakhstan, signed to secure access to increased amounts of Turkmen gas, may eventually bring more gas to Russia and Europe than the market can bear at times of economic downturn.

Finally, Russia's economic wagon appears firmly hitched to the horse of global energy prices. These global energy prices are determined externally, and this gives Russia little say over its economic future. This suggest that Russian economic success or failure will be tied to what other states produce and how they produce it for the foreseeable future. Granted, increases in Russia's foreign currency reserves have afforded the government some breathing space with respect to international debt and ruble stability, but this does not represent long term insulation from energy price variances, and it simply burns through savings while attempting to keep the economy afloat. This reliance on energy resource revenue will ensure that capital flight is a recurring problem for the Russian economy, and makes Russia more vulnerable than many to external economic shocks.

This is the relationship between Russian natural gas and Russian foreign policy that is implicit in the explanation provided by this project. This is a relationship where rather than controlling and using natural gas supplies to achieve foreign policy objectives, Russia's foreign policy is controlled by the need to create and capture natural resource rents to the eventual detriment of the Russian state, economy, and possibly its broader foreign policy goals. This surely paints a picture of a Russia that is dealing from a position of weakness rather than a position of strength, and brings into question the assumed coercive role that natural gas plays in Russia's relations with those who rely on its natural gas supplies.

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