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Russian Oil and Gas Companies and Central and Eastern Europe

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Summary

The collapse of the Warsaw Pact in 1989, and of the Soviet Union itself in 1991, heralded a major reduction in Russian influence in Central and Eastern Europe during the 1990s. Russia's armed forces and the Russian economy went into steep decline. In recent years, one key sector of the Russian economy, the Russian oil and gas sector, has shown signs of revival. The Russian energy sector occupies a central place in Russia's economy and political system. In 2000, the energy sector accounted for 16% of Russia's GDP, 29% of the gross value of industrial output, 45%-48% of Federal budget revenues, and 54% of foreign exchange earnings. Its vast financial resources also translate into great political power, although this power is mitigated by infighting among Russian elite groups.

In the past few years, flush with cash from rising energy prices, Russian firms have tried to buy up energy companies in Central Europe, with mixed success. Officials and experts in Central Europe have expressed worries about the political motives of these investments. They have expressed concern that such Russian investment could have a negative impact on the sovereignty of these countries, particularly given the non-transparent way in which these companies have operated and their close links with the Russian government. Some claim that Russian leaders are pushing to control as much as possible while they still have substantial leverage, as opposed to 2004, when NATO and, especially, EU membership will change the political equation. They claim if Russian firms controlled key resources, they could form stronger political client networks within their countries, thereby compromising their sovereignty.

However, some analysts point out that in some cases, the actions of Russian firms appear to be affected by conflicts within the Russian elite. Moreover, there are limits to Russian firms' ability to gain influence in the region. They often face strong resistance from local governments fearing Russian dominance and wanting to protect local companies. Public opinion in these countries strongly favors maintaining independence from Russia, including economic independence.

One way that the United States can help counter the possible negative consequences of the activities of Russian energy firms is to raise the issue with Moscow and encourage the European Union, which is the main player on the issue, to do likewise. The United States and its allies could also encourage the participation of Western companies in the privatization of key firms in the region, which would foster transparency. The United States can help these countries by encouraging diversification of their energy supplies. U.S. investment in Russian energy firms could also be helpful. Investment could both give the United States a greater interest in the success of Russian energy firms and positively influence the behavior of those firms in Central and Eastern Europe. However, Administration officials have also expressed frustration with Russia's slowness to create conditions for foreign investment. This report will be updated as events warrant.

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Russian Oil and Gas Companies and Central and Eastern Europe

Introduction

The collapse of the Warsaw Pact in 1989, and of the Soviet Union itself in 1991, represented a sharp reduction of Russian power in Central Europe. The decline of the Russian armed forces and of the Russian economy weakened Russian influence in the region throughout the 1990s. In recent years, one key sector of the Russian economy, the Russian oil and gas sector, has shown signs of revival. Russian firms in this sector have sought to buy up energy companies in Central Europe, with mixed success.

Some Central European and Western observers have expressed concern that such Russian investment could have a negative impact on the sovereignty of these countries, particularly given the non-transparent way in which these companies have operated and their close links with the Russian government. Some have proposed that the United States should try to limit the power of Russian oil and gas firms in Central Europe. Others downplay the danger, saying this issue should be seen in the larger and possibly more positive context of U.S.-Russian energy cooperation and of Western investment in Russia's oil and gas sector.

Russia's Oil and Gas Companies

The Russian energy sector occupies a central place in Russia's economy and political system. In 2000, the energy sector accounted for 16% of Russia's GDP, 29% of the gross value of industrial output, 45%-48% of Federal budget revenues, and 54% of foreign exchange earnings.[1] Its vast financial resources also translate into great political power, although this power is mitigated by infighting among Russian elite groups.

Before discussing the role of Russian oil and gas companies in Central Europe, it may be helpful briefly to discuss the structure of these industries, in order to suggest both the extent and limits of their ability to serve as instruments of Russian state power in Central Europe.

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[1] Matthew Sagers, "The Russian Energy Sector: Current Conditions and Long-Term Outlook," in *Russia's Uncertain Economic Future*, U.S. Congress, Joint Economic Committee, S. Prt. 107-50, December 2001.

Gazprom

The largest and most powerful company in Russia is Gazprom. It has a monopoly on gas pipelines in Russia and a virtual monopoly on production, accounting for 93% of the gas produced in Russia. It controls over a quarter of the world's reserves of natural gas. Its impact within Russia is even bigger. Its sales alone account for 8% of Russian Gross Domestic Product. It is the single largest contributor to the Russian government's budget, providing over 20% of tax receipts. It also controls banks, a portfolio of industrial holdings, newspapers and television and radio stations. The Russian government holds 38% of Gazprom's shares; private investors hold the rest.[2]

Gazprom has been useful to Russian leaders in several ways. First, it helps to prop up Russia's domestic economy. It provides 70% of its production at a loss (at prices 15% of those in Europe) to Russian companies and consumers, who often cannot or will not pay, thereby helping to ease social pressures. In exchange for subsidizing Russian domestic consumers, Gazprom receives a virtual monopoly on exports to richer customers abroad. Nevertheless, many experts say Gazprom needs to substantially increase domestic prices for gas, if it is ever to become a viable business.[3]

Gazprom has also played a key role in Russian politics, often as a weapon of the Kremlin. For example, in 1996, Gazprom invested heavily in the media conglomerate Media Most, among many holdings. At the time, President Yeltsin desperately needed media help in his election campaign, and businessmen were glad to oblige. However, after Media Most outlets started criticizing President Putin in 2000, Gazprom began to call in the firm's debts and seized control of them, including NTV, the only nationwide television network critical of Putin.

However, despite its support of Putin, Gazprom's future is uncertain. It has been a highly inefficient and opaque organization. Although it provides substantial tax revenue, Gazprom could pay more, according to many observers. Russian officials also want Gazprom to do a better job in collecting payments from domestic customers, although there may be limits to how successfully this can be done.

Another issue is highly dubious transactions by Gazprom executives, presumably aimed at self-enrichment on a massive scale. Gazprom is linked with a large number of ostensibly independent intermediary companies The best known case involves a company called Itera, which started out brokering obscure barter trades for Gazprom and rose to become the second-biggest gas company in Russia. It is suspected that Gazprom assets were covertly transferred to Itera, which may be owned by Gazprom insiders. Perhaps Gazprom's most serious problem, which derives partly from the problems mentioned above, is that production is hampered

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[2] "Russian Energy Restructuring," Energy Information Administration, Department of Energy, November 2002.

[3] Lesley Curwen, "Old Soviet gas giant pumps itself West," *The Observer*, February 9, 2003, 4.

by poorly maintained equipment, and a lack of capital investment over the past two decades.[4]

Putin has therefore been faced with the question of whether and how to reform Gazprom. Some radical reformers in Putin's government would like to see it broken up. Western investors are lobbying to ease limits on foreign ownership. However, reform efforts appear to have slowed, perhaps for political reasons. At least for now, Putin is moving to establish greater state control over the company. He refused to renew the contract of Gazprom CEO Rem Vyakhirev when his contract ended, chipping away at the old guard. In May 2001, Putin put one of his supporters, Alexei Miller, at the head of Gazprom. A number of prominent St. Petersburg figures and ex-intelligence officers allied with Putin have subsequently been appointed to high positions in Gazprom. Miller has had some success bringing some Gazprom intermediaries under control. The government is also seeking to increase the state's share of the company to over 50%. Putin appears to be reluctant to move forward with a radical restructuring of Gazprom, in part because he may fear that the situation will play into the hands of the already powerful oil oligarchs, who could be in a position to take over the gas industry.[5]

Russia's Oil Majors

Russia is the world's second largest oil producer and exporter, after Saudi Arabia, and has the seventh largest oil reserves. The Russian oil industry has followed a somewhat different route from Gazprom in the post-Soviet period. Five large, vertically integrated companies emerged from a decade of privatisations, battles for control, and restructuring: Lukoil, Yukos, Surgutneftegaz, TNK, and Sibneft. Each of them combines exploration, production, refining, distribution and retail operations. The Russian oil companies with the most prominent role in central Europe are Lukoil and Yukos. Russian oil pipelines are state-owned. The crude oil pipelines are administered by Transneft, while refined product pipelines are run by Transneftprodukt. The Russian government's control is enhanced by the fact that it sets the export quotas for the pipelines. Russian oil producers are restricted to exporting 30% of their output.[6]

While they are private companies, the large Russian oil firms are closely connected with government officials. The oligarchs who own and run them received them due to government support in the 1990s. In exchange, they provided political support to the leadership. As in the case of Gazprom, Putin has tried to rein them in, with mixed success. Companies, and factions within the Russian government supporting them, often compete with each other for commercial opportunities. One important way in which the government can influence the large oil companies is by its control of the pipelines. As in the case of Gazprom, the large companies supply

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[4] Sagers, "The Russian Energy Sector," pp. 231-234.

[5] "Putin Aims to Restrain Oil Oligarchs," Oxford Analytica Daily Brief, February 3, 2003.

[6] Department of Energy, Energy Information Administration, *Russia: Oil and Natural Gas Exports*, November 2002.

oil at a loss to domestic consumers in exchange for the right to export to Western markets.

President Putin and factions within the government are reportedly suspicious of the wealth and power wielded by many of the Russian oil "oligarchs." In July and August 2003, Russian prosecutors launched investigations of persons and firms associated with Yukos. Analysts view the investigations as an expression of Putin's displeasure with Yukos CEO Mikhail Khodorkovsky, who he reportedly suspects of having political ambitions, possibly including a desire to succeed Putin after his second term expires in 2008. They also charge that Putin's former KGB associates, who occupy posts in the government, and in Gazprom and Lukoil, are opposed to Western investment which Khodorkovsky favored and want to reverse the Yeltsin-era privatizations that made the oligarchs powerful.[7] In contrast to Khodorkovsky, Lukoil chief Vagit Alekperov enjoys good relations with Putin, possibly because he does not appear to have political ambitions. Moreover, Lukoil aided Putin in forcing the closure of TV-6 in 2002, an independent television network staffed by former NTV journalists that was often critical of the Russian government.[8]

Russian Oil and Gas Firms in Russian Foreign Policy

Russian oil and natural gas firms are important players in Russian foreign policy, particularly those partly or wholly state-owned, such as Transneft and Gazprom. In February 2003, Putin justified his decision to not break up Gazprom in part by noting that the company "is a powerful economic and political lever in the world."[9] In addition to ownership stakes, the conduct of Russian energy firms is linked to Russian foreign policy by a common mindset inherited from traditional Soviet and early post-Soviet Russian foreign policy. This includes a lingering distinction between the "near abroad", which includes the former Soviet republics and the Baltic states, and the "far abroad," which includes Western countries.

The Central European countries appear to occupy a middle ground in Russian thinking; less important than Western countries and somewhat less subject to manipulation than the former Soviet republics. Nevertheless, Central Europe continues to play a significant role in Russian foreign policy, partly due to the needs of the Russian energy industry itself. Russian oil and gas exports to Western Europe flow through the region's pipelines and ports. Russia already supplies over 15% of Europe's total oil and one-quarter of its natural gas.

However, it is often difficult to posit a clear cause-and-effect relationship between Russian foreign policy and the activities of Russian firms. The close, informal connections of Russia's political and economic elites make it difficult to disentangle actions that serve the commercial interests of the firms (or the private

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[7] Ariel Cohen, Code Red, National Review Online [http://www.nationalreview.com], July 31. 2003.

[8] "Oligarchs — Who They Are; How They Function," Oxford Analytica Daily Brief, July 30, 2003.

[9] Interfax news agency dispatch, February 14, 2003.

interests of the firm's managers) from overall Russian foreign policy goals. Additionally, it should be noted that Russian elites are fractured and often work at cross purposes, including on foreign policy issues.

The Activities and Impact of Russian Oil and Gas Firms in Central and Eastern Europe

Observers in Central Europe and the United States have noted with concern accelerated investment by Russian firms in Central Europe in the past several years. Even without Russian acquisitions, the region is highly dependent upon Russian oil and natural gas. Central European industries are inefficient users of energy and have very little in energy resources — Hungary has a little natural gas, and Romania has dwindling oil supplies. Secondly, several countries are dependent on Russia for pipeline transit fees, including Slovakia and the Baltic states.

There are several reasons for increased Russian investment in the region. First, in recent years, Central European countries have been privatizing their energy sectors, in part to prepare for EU membership. This privatization had been delayed because of the political sensitivity of the industry. There has been some effort among local firms to consolidate among themselves, but Russian and Western energy firms have also bought large stakes. Second, after the 10 Central European countries join the EU in 2004, over half of Russia's exports will go to the EU. Therefore, Russian energy firms see EU enlargement as an opportunity, and their investments in Central Europe as an effort to position themselves for that opportunity. Russian subsidiaries in the new member states will have better access to the EU market.[10] Moreover, Central and Southeastern Europe are regions in which Russian firms can carve out significant roles in the refining and retail sectors, given the lack of Western competition and long-standing infrastructure ties and personal relationships. Another reason for the interest of Russian firms in refineries and retail is that they are not globally competitive yet, and Central Europe is one place where they can succeed.

Russian firms are able to exploit this opportunity because they are flush with cash, due to intermittently high oil prices and booming oil production, which is recovering from the sharp slump of the 1990s. Cost competitiveness was enhanced by the ruble devaluation in 1998. As a result, Russian oil firms in recent years have been looking to expand their export markets.

In acquiring Central European energy assets, Russian firms have a trump card: they are often the only source of energy supply. In several places, Russian firms have been able to use this lever to gain control. The efforts of the U.S. firm Williams International to operate the Mazeikiai oil complex in Lithuania are instructive in this regard. Mazeikiai includes a large refinery, the Butinge maritime terminal and a pipeline. It is the largest enterprise in Lithuania and provides vitally-needed tax revenue.

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[10] "A Bear Hug: Russia Capitalizes on EU Expansion," *Business Week*, November 25, 2002, 68.

In 1999, Williams bought a large stake in Mazeikiai and also received the operating rights. The decision was controversial among some Lithuanian politicians, including some with close links to Moscow, who wanted to see Lukoil get the refinery. In response, Lukoil, which supplied the oil to the refinery, slowed supplies to a trickle. As a result, Mazeikiai became increasingly unprofitable. This led Williams, which had financial problems of its own, to sell its stake to Yukos in August 2002. Yukos now has a majority stake and operating rights in the enterprise. The Lithuanian government is currently seeking investment from the European Bank for Reconstruction and Development in Mazeikiai to provide at least some balance to Yukos and to help secure financing for the modernization of the complex. Russian firms have acquired other footholds in Lithuania's energy sector. Gazprom has secured a 34% interest in Lietuvos Dujos, the Lithuanian natural gas company. Lithuania managed to secure the participation of a Ruhrgas-led consortium for another 34%. Ruhrgas is the operator of the company.[11]

Another recent example of a Russian company using its control over energy supplies to support acquisitions occurred in January 2003. The Russian-government controlled Transneft oil pipeline company cut off all oil shipments to the Latvian oil terminal at the port of Ventspils for the first quarter of the year, after having decreased shipments in late 2002. The move is a large blow to Latvia. Ventspils is vital to Latvia's economy, accounting for 10% of GDP. Transneft is diverting the oil shipments to its own Baltic Pipeline System and the Russian port of Primorsk, which it controls. Transneft claims that there is no demand for using Ventspils, a claim viewed with great skepticism by outside observers. Most see the move as a power play by Transneft to secure a controlling share of the firm Ventspils Nafta, which operates the oil terminal.[12]

Russian firms have sometimes used underhanded methods to secure control of firms or engaged in other illegal practices. For example, Gazprom succeeded in obtaining control of large parts of the Hungarian petrochemical industry in 2000 through the use of complicated shell corporations to disguise its role, which would be prohibited by Hungarian law if done openly.[13] In 2000, Gazprom laid fiber-optic cable along with a pipeline it was building through Poland, without the knowledge or approval of the Polish government.[14]

Other acquisitions have occurred in less questionable ways, but still spark concern because of the power they give Russian firms. In 2001, Yukos bought 49% of the Slovak pipeline firm Transpetrol. This will give it control of the southern part of the Druzhba pipeline, the main pipeline for Russian crude oil to Western Europe. This gives Yukos control over oil exports to Hungary and the former Yugoslavia. It also forms part of a plan to connect the Druzhba pipeline with the Adria pipeline, which supplies the Balkans and will permit tanker shipments from Omisalj, a

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[11] Vladimir Socor, "Russia's Energy Giants Muscling Their Way into the Baltics," *IASPS Policy Briefings: Oil in Geostrategic Perspective*, no. 6, November 17, 2002.

[12] Ariel Cohen, "Don't Punish Latvia," *Washington Times*, May 5, 2003.

[13] *Financial Times*, May 27, 2003, 4.

[14] Polish News Bulletin, September 13, 2002.

Croatian port on the Adriatic Sea, bypassing the crowded Bosporus. Transneft will operate the lines. Yukos and TNK will supply the oil. Yukos hopes that this pipeline could decrease transport costs enough to make Russia more of a player as a major oil supplier to the United States.[15]

In some cases, observers have questioned the wisdom of Russian purchases. Lukoil bought Petrotel refinery in Romania in 1998, but had to shut it down in April 2002, due to its unprofitability. Lukoil says it hopes to open a modernized plant there in 2004. Lukoil was reportedly displeased with its treatment at the hands of the Romanian government, claiming that Bucharest had reneged on aspects of the original deal. The Romanian government restored many of the terms of the original deal in August 2002. Lukoil owns the Bulgarian refiner Neftokhim, which controls 85% of Bulgaria's domestic market. However, Lukoil has also suffered substantial losses in Bulgaria. It has continued to expand in purchasing and building gas stations in Romania and Bulgaria, despite losses.[16]

Implications of Russian Investment

Local officials and experts in Central Europe have expressed worries about the alleged political motives of these investments and their domestic impact. For example, Latvian officials have expressed concern that Transneft's move shows that Russia is willing to suffer substantial economic losses to seize greater economic and therefore political power in Latvia. Russian power in Latvia has waned since the withdrawal of Soviet troops in the early 1990s. Latvian officials claim that Russian leaders are pushing to control as much as possible while they still have substantial leverage, as opposed to 2004, when NATO and, especially, EU membership will change the political equation. The possible sale of Ventspils Nafta to Transneft could also have domestic political implications. Ventspils resources have been used by Latvian businessmen to fund several Latvian political parties, including Latvia's Way and the Union of Greens and Farmers. If a Russian firm controlled these resources it could fund parties more congenial to Moscow's views. This fear that Russian firms will form stronger political client networks within countries is also common in Lithuania and other countries in the region.[17]

Russian government officials have generally not openly linked commercial transactions with Russian political goals in the region. However, Russia's ambassador to Latvia has hinted that Latvian concessions on the status of ethnic Russians in Latvia could influence the Russian government to permit crude oil to flow to Ventspils again.[18] It is uncertain whether the fate of the Russian minority in Latvia is a determining factor in Russian government decisions on whether to supply oil to the terminal. Russian oil flowed to Ventspils throughout the 1990s despite

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[15] Interfax News Agency Petroleum Report, December 18, 2002.

[16] "Lukoil's Overseas Excursions Sow Concern," *Weekly Petroleum Argus*, July 29, 2002, 6.

[17] Discussions with U.S. and European officials and analysts.

[18] *Lauku Avize* newspaper, February 6, 2003, 9, as carried by BBC Monitoring.

bitter Russian government attacks on Latvia for its treatment of the Russian minority and for its desire to join NATO.

The Ventspils issue can also be seen as part of the conflict between the oil oligarchs and Putin. The cutoff move was criticized by the five major Russian oil firms — Lukoil, Yukos, Rosneft and Surgutneftgaz and TNK, which want to continue to use and even expand their use of Ventspils. However, Transneft, backed by Russian government officials, has said that it will not restore shipments to Ventspils unless it can buy a stake in the port. The profitability of the big oil firms is dependent on their export capability, and state-controlled access to pipelines is a means for Putin to bring them to heel, if he wishes to do so. In fact, the Russian government has tried to discourage the building of private pipelines controlled by the oil companies. The government has given its approval to the drafting of a feasibility study on the building of key new pipelines to Murmansk (for export to Europe and the United States) and East Asia. However, Transneft may want to own the pipeline, if it is built.[19]

In many countries in the region, Gazprom has tried to secure political influence through local intermediary companies. Bartimpex, a Polish company that received the franchise to import Russian gas into Poland, has 17 former government ministers and senior officials on its payroll, and its owner reportedly has close ties with Russian oligarchs. Bartimpex lobbied against Polish government plans to import gas from Norway to diversify Poland's sources of supply.[20]

In Bulgaria in the early and mid-1990s, Gazprom used close connections with ruling Socialist Party elite and its control or influence over intermediary companies such as Topenergy, Overgas and Multigroup, to try to secure control over Bulgaria's natural gas pipelines. These pipelines supply energy not only to Bulgaria, but to other Balkan countries. Although subsequent pro-Western officials have not been as sympathetic to Gazprom as their Socialist predecessors, the Russian firm is still trying to secure control of state-owned Bulgargas company.[21]

There are limits to Russian firms' ability to gain influence in the region. They often face strong resistance from local governments fearing Russian dominance and wanting to protect local companies. Public opinion in these countries strongly favors maintaining independence from Russia, including economic independence. For example, efforts by Russian companies to buy a large refinery in Gdansk, Poland were stymied due to local political fears.[22] The security provided by EU and NATO membership may help Central European countries ward off excessive Russian economic and political influence. Indeed, many Central Europeans view the benefits of NATO enlargement at least in part in this way, rather than in strictly military

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[19] Catherine Belton, "Pipeline Boss Comes to Terms with Oil Kings," *Moscow Times*, June 24, 2003.

[20] "Comrade Capitalist," *The Economist*, February 17, 2001.

[21] RFE/RL Newsline, February 6, 2003.

[22] Sabrina Tavernise and Peter S. Green, "Oil Concerns in Russia Branch Out," *New York Times*, April 2, 2002, W1.

terms. Others are not so sure, fearing that Russian influence could continue to undermine their sovereignty for many years to come.[23]

This situation can be contrasted to that of countries like Belarus, Ukraine and Moldova, which do not have a western geopolitical anchorage. Their political systems are often less democratic and transparent than those in Central Europe, making it easier for Russian firms and the government to make deals without sparking public opposition. Public opinion in these states is often split on the importance of independence versus a close relationship with Russia. Belarus and Ukraine have been isolated by the anti-democratic and, in the case of Belarus, anti-Western actions of their leaders. Moldova has been made vulnerable by its status as the poorest country in Europe. It is also weakened by the existence of the "Dniestr Republic", a separatist entity within Moldova, which many Moldovans view as Russian-supported, and the continued deployment of a Russian troop contingent there.

The vulnerability of these countries has made them more prone to political pressures from Russia, which Gazprom and other Russian companies have converted more easily to commercial advantage than in Central Europe. For example, Gazprom has taken over the gas pipeline network in Moldova, in exchange for debt forgiveness for unpaid gas bills. Similarly, Gazprom threatened to cut off gas deliveries to Belarus in October 2002. Belarus bowed to the pressure and in November 2002 agreed to reorganize its gas pipeline network as a joint venture with Russia. In Ukraine, Gazprom may have scored its biggest coup. In October 2002, Ukrainian President Leonid Kuchma and Putin signed a deal creating a Russian-Ukrainian consortium to control the Ukrainian pipeline system, the largest in the world. The consortium is a 50-50 split, which could give Russia a veto on key pipeline management issues. Observers believe that Kuchma made the move to bolster support from Moscow for his internationally-isolated regime.[24]

U.S. Policy

Russian investment in the oil and natural gas industries in Central and Eastern Europe may not be negative for the United States and the countries themselves, if the conduct of Russian firms in the region is transparent and is not aimed at reducing the sovereignty of these countries. However, misbehavior by Russian companies could retard U.S. goals of fully integrating the countries of the region into Euro-Atlantic institutions. One way that the United States can help counter potentially troublesome activities of Russian energy firms is to attempt to persuade Russian leaders that Russia's long-term political and economic interests are best served by carrying out a policy of transparency and partnership in the region. In a meeting with President Bush in February 2003, President Bush raised the issue of Ventspils with Latvian

[23] Discussions with Central European officials.

[24] Taras Kuzio, "Moscow's Energy Strategy," *Jane's Intelligence Review*, December 20, 2002.

President Vaira Vike-Freiberga, and reportedly offered to discuss the issue with President Putin.

The United States could also encourage the participation of U.S. companies in the privatization of key Central European firms and encourage these countries to diversify their energy supplies with support from such sources as the U.S. Export-Import Bank, the Overseas Private Investment Corporation (OPIC), and the Trade and Development Agency (TDA). However, this will be a lengthy and expensive process, given the persistence of Soviet-era infrastructure. In June 2003, U.S. Ambassador to Latvia Brian Carlson told Latvian officials that U.S. investors are interested in investing in Ventspils. However, he added that the ownership structure of the company controlling the oil terminal, Ventspils Nafta, is unclear, and that this may worry potential investors. Carlson invited Latvian government officials to visit the United States to promote U.S. investment in Latvia, including at Ventspils.[25]

Another example is the Odesa-Brody pipeline, which was completed by Ukraine in 2001. It runs from an oil terminal in Odesa on the Black Sea to Brody at the Polish border. Odesa-Brody could serve as a way to lessen the dependence of Ukraine and Central European states on Russia, by providing an alternative route for Caspian oil. However, a proposal to run a pipeline though Poland to the Baltic states has languished due to problems with financing, and questions about its profitability. In 2002, TDA financed a study by Cambridge Research Energy Associates and Halliburton, a U.S. energy services and construction firm, on the feasibility of an extension of the pipeline to Gdansk, Poland to carry Caspian oil. In May 2003, U.S. Ambassador to Ukraine Carlos Pascual underlined U.S. support for the pipeline, noting that it would be a cost-effective way to transport Caspian crude to Western Europe, and that U.S.-based firms Conoco Philips and Chevron Texaco support the use of Odesa-Brody to ship Caspian oil.[26]

In June 2003, the European Union announced it will provide \$3.6 million for another feasibility study on an extension to Gdansk. It is estimated that the project would take 3 to 5 years and cost \$589 million. So far, however, the project has been hampered by the reluctance so far of Caspian producers to use the pipeline. Russian firms have expressed interest, but want the flow of the pipeline to be reversed, to allow Russian crude to flow through Ukraine to the Black Sea for export. Ukraine has so far rejected this proposal.[27] In a tactic similar to the one it pursued in Latvia, Transneft cut off oil supplies to Odesa in August 2003, claiming that it lacked the oil to supply the port. However, observers believe the move was in fact undertaken to pressure Kiev to reverse the flow of the pipeline.[28]

U.S. investment in Russian energy firms could also be helpful. Investment could both give the United States a greater interest in the success of Russian energy firms and also positively influence the behavior of those firms in Central Europe.

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[25] RFL/RL Newsline, June 5, 2003.

[26] *Ukrainian Weekly*, June 8, 2008, 3.

[27] FSU *Oil and Gas Monitor*, April 23, 2003, 6.

[28] "Pipeline Politics," Oxford Analytica Daily Brief, August 8, 2003.

The Bush Administration has placed a strong emphasis on U.S.-Russia energy cooperation as a key part of its Russia policy. At the May 2002 Bush-Putin summit, the two leaders signed a Joint Statement on the New U.S.-Russian Energy Dialogue, which advocated greater U.S. investment to modernize Russia's energy sector. In addition to promoting cooperation in energy exploration, production and other issues, the two leaders endorsed the concept of multiple pipelines to move energy to markets in Western Europe and North America.

In October 2002, a U.S.-Russia Energy Summit held in Houston aimed at increasing U.S.-Russian energy cooperation. It resulted in an $300 million Export-Import Bank financing agreement designed to help Russian energy firms purchase U.S. services and equipment. U.S. officials have said that Russian oil exports to the United States could become a significant alternative to Middle Eastern oil supplies.[29] However, Administration officials have also expressed frustration with Russia's slowness to improve conditions for foreign investment, with respect to issues of rule of law, contract sanctity and enforcement of court decisions, as well as legislation on production sharing. Also, U.S. officials are watching the treatment of foreign companies in the Caspian Pipeline Consortium, and of Russian firms' efforts to build an oil pipeline to Murmansk.

One possible ray of light for Western investment in Russia's oil and gas industry is the February 2003 announcement of a deal between TNK and British Petroleum. The deal would merge three Russian oil companies: Sidanko and two firms owned by TNK. BP would acquire one-half of the new company, which would become Russia's third largest oil company, after Lukoil and Yukos. BP would invest up to $6.75 billion in the new company.

Observers have noted that BP invested in Sidanko in the late 1990s, but had to write off $200 million after TNK become embroiled in a legal battle over ownership of some of Sidanko's best fields.[30] Some analysts believe that other Russian oil firms could become targets for acquisition by Western companies. Others are skeptical about whether the TNK-BP deal will come to fruition and whether Russian oil magnates and the Russian government are willing to see a large-scale investment in Russian firms by their Western counterparts. In April 2003, Yukos announced a deal to buy Sibneft, the fifth largest Russia oil company. Observers say that Yukos made the move in part to head off rumored efforts by Royal Dutch Shell and TotalFinaElf to buy a Russian oil company to match BP's acquisition. The merger will make YukosSibneft the largest oil company in Russia, and the fourth largest globally, after BP, ExxonMobil and Royal Dutch Shell.[31]

In September 2003, Exxon Mobil and ChevronTexaco reportedly readied offers to buy a 25% stake in YukosSibneft, valued at about $11 billion. However, experts

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[29] State Department transcript of speech by Secretary Powell to the U.S.-Russia Business Council, October 3, 2002.

[30] Jeanne Whalen and Bhushan Bharee, "Drawn by Russia's Oil Wealth, BP Negotiates a Big Investment," *Wall Street Journal*, February 10, 2003, p. A1.

[31] Dimitry Zhdannikov and Mikhail Yenukov, "Russian Oil Firms to Merge," *Washington Post*, April 22, 2003.

noted that such a deal, if it is in fact under consideration, may require YukosSibneft to improve its corporate governance standards to protect the rights of minority shareholders. Uncertainty created by Khodorkovsky's political conflicts with Putin and factions within the Russian elite may also hinder a deal, at least until those issues are resolved.[32]

[32] Anita Raghavan, Jeanne Whalen, and Gregory White, "Chevon, Exxon to Bid For Yukos Stake," *Wall Street Journal*, September 15, 2003, 3.