

TANKS HAVE LEFT, GAZPROM IS BACK:  
RUSSIAN ENERGY COMPANIES' EXPANSION TOWARDS  
POLAND, SLOVAKIA AND HUNGARY BETWEEN 1991 AND 2004

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Of

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## Curriculum Vitae

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- 2003 Visiting lecturer at the Rajk László School of Advanced Studies at the Corvinus University and Centre for European Studies at Pázmány Péter Catholic University, Budapest
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- Summer 2001 Research Associate, Hudson Institute, Washington, DC
- Summer 2000 Foreign Policy intern, The Heritage Foundation, Washington, DC
- 1999-2001 Teaching assistant, Tufts University, Department of History, Medford, MA

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- International Security Studies Fellowship, Fletcher School, 2002-03, 2003-04
- Outstanding Contribution to Undergraduate Education Award, Tufts University, 2001
- Graduate Student Excellence Award, Tufts University, 2001

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- Ran a weekly op-ed column in one of the leading Hungarian political weeklies (*Heti Valasz*) for a year, currently has a monthly column in that journal (published over 100 op-ed pieces)
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- “Transatlantic Relations – the End of NATO?” *Külügyi Szemle*, 2002/4

## Other Associations/Experience

- Member of the editorial board of *Budapest Analyses*
- Member of the Forum of the Brzezinski Chair of Scholars, a forum run by the Washington-based think tank, CSIS
- Founder of a Apponyi Albert Foreign Policy Association for young professionals in Hungary
- Presented at several conferences in Budapest, Berlin, Boston, London, Warsaw, Milan and Ljubljana
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## Abstract

A casual observant of post-Soviet Russian corporate activity in Central Europe finds a hectic behavior of Russian companies in the Polish, Hungarian and Slovakian economies. There were times when these companies showed great interest toward the region, followed by periods of non-activity. To solve the puzzle, the study tests neoclassical realist theory in explaining Russian corporate propensity to expand into Central Europe. Neoclassical realist theory argues that the relative distribution of power in the international system (independent variable) through the perception of state leaders (intervening variable) together with state power, to be defined as power to mobilize the necessary resources (intervening variable), explain foreign political outcomes (dependent variable). The dissertation draws the following hypothesis from neorealist theory: When the Russian leadership perceives that Russia's relative influence vis-à-vis the West is low and Russia possesses enough state power to mobilize the necessary resources, Russian energy companies will manifest expansionary moves into Central Europe. When Russia does not perceive its influence low and/or does not possess enough state power, Russian companies will not manifest any expansionary moves into Central Europe.

To test the hypotheses the study uses the case study methodology. There is one case examined: Russian energy companies' activity in Central Europe between 1991 and 2004. The study splits this period into five sub-periods which correspond with the widely accepted milestones of post-Soviet Russian foreign policy: 1991-1993 Early Atlanticism, 1994-1996 Facing Nato Enlargement, 1996-1998 Against a Unipolar World, 1998-2000 Instability and Uncertainty, and 2000-2004 The First Putin Presidency. Russian energy companies were very active in two sub-periods: between 1994 and 1996, and between 2000 and 2004. However, they showed little to no interest for expansion in the other three sub-periods: 1991-1993, 1996-1998 and 1998-2000. In Chapters Four and Five the study examines in detail Russian perceptions about Russia's place in the world, changes in its state power and the Russian energy companies' activity in Central Europe where it is applicable. It finds that in the "active periods" (between 1994 and 1996 as well as between 2000 and 2004) Russian leadership assessed the relative power distribution in the international system to be disadvantageous for Russia and at the same time had considerable state power to mobilize. These two variables were not present together in the three "inactive periods". That is to say, the energy companies' Central European activities were consistent with what the hypothesis drawn from neoclassical realist theory would predict.

The study proves the validity of neoclassical realist theory in explaining post-Soviet Russian foreign policy. Additionally, in the Russian studies today it is conventional wisdom that Vladimir Putin turned Russian energy companies into tools of his country's foreign policy vis-à-vis its neighbors. However, this study shows that the phenomenon is neither new, nor dependent on the current Russian president; moreover, it has never been limited to the countries of the former Soviet Union. In fact, ever since 1991, Russian corporate expansion in Central Europe has been driven by the highs and lows of Russian state power and its key decision makers' perceptions about their country's relative power vis-à-vis the West.



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I also would like to thank friends who trusted me in this process and helped me with their experiences. Constance Putnam was my soul mate during the PhD years, just had finished her PhD not long time before I started mine and gave me tips and hints on how to proceed. She was the one who was there when I was tired of the process, who listened to my complaints, supported, encouraged and gave practical advice. I am indebted to Hugo Bedau who spent long hours on reading the very first draft of the dissertation, making recommendations, comments, polishing the

style and language and asking the right questions which made me rethink the argument. I thank Susan Fink Yoshihara and Toshi Yoshihara, two Fletcher PhDs were always helpful when I needed them, shared with me their dissertations, their presentations for the defense and instructed me over the phone several times on what to do and how to proceed further. My great friends Susan Fink Yoshihara and Margaret Sloane were my hosts when I went back to Boston to do research and shared their apartments with me and thus made my stay and work a very pleasant experience. I thank you both very much.

I would like to thank Alexander Gudzowaty, Bogdan Goralczyk and Wojciech Roszkowski for setting up amazing interviews in Poland and giving me several materials on my research.

Of course I am mostly indebted to my family. I thank my children (Bogi, 3 and half, and Gyszi, 17 months) for their unbelievable patience which they showed during the Ph.D. process. Bogi came with me to five research trips to Poland and Slovakia under my belly, and was already on this Earth during the whole time I wrote the dissertation. I finished writing the first draft a week before Gyszi was born, the sound he heard most in the womb was the clicking of the keyboard. Both of them needed to lack me when discovering new toys and adventures while I was working on the dissertation.

The dissertation could not have been accomplished without the so generous help of my parents and my in-laws. I moved with the children to my parents' house for weeks when they took care of the children to enable me to work quietly on the dissertation. My in-laws took the children away for days, weekends and weeks also to give me quiet time to write. Any time I asked, I had more than one grandparent volunteering to assist me even when I gave short notice. Bogi and Gyszi love all of their grandparents which made it easier for me to give up time with

them and focus on work. They would not be as lovely and emotionally rich children as they are if it is not also for the grandparents.

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Anita Orban

Budapest, Hungary

April 2007

## CHAPTER I: INTRODUCTION

The first day of 2006 took Europe by surprise. Russia cut off gas supplies to Ukraine. Even though the move aimed at forcing Ukraine into certain concessions, gas supplies to third countries (Hungary, Italy and so on) became substantially lower during the days of the Ukraine-Russia dispute. Europeans were even more surprised to learn that it was President Putin and along with his aide, Gazprom chairman Dmitrii Medvedev who together authorized stopping the flow of natural gas. Throughout the whole crisis President Putin was in charge. He gave instructions to Gazprom on how to conduct its negotiations with Ukraine and the gas monopoly's officials reported him on a daily basis. The direct subordination of Gazprom to the Kremlin in this particular case could not have been more obvious.

The dispute got settled within couple of days on unfavorable terms to Ukraine. First, the agreement, which was presented as an interstate one between Russia and Ukraine, had a third co-signer, RosUkrEnergo, a subsidiary of Gazprom. Second, RosUkrEnergo managed to agree on establishing a joint venture with Naftohaz Ukraini, which earlier had had the monopoly wholesale rights for natural gas on the Ukrainian market. From February 1, 2006 Gazprom delivers gas to this joint venture half owned by a Gazprom subsidiary. That is to say, Naftohaz Ukraini was coerced to give up half of the proceeds it enjoys as a state-owned monopoly in natural gas in Ukraine to Gazprom. Third, Ukraine gave up on the possibility of importing gas from Turkmenistan, an alternative source to Russian gas.<sup>1</sup> "In fact, the Moscow-triggered dispute over gas is not about commercial issues, but rather about Ukraine's national independence and form of governance; the agreement signed on January 4 almost certainly marks but a stage in that

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<sup>1</sup> Vladimir Socor, "Controversial Aspects of Russia-Ukraine Gas Agreement Disclosed in Kyiv," *Eurasia Daily Monitor*, Volume 3, Issue 4, January 6, 2006

ongoing dispute; and the agreement itself -- including the elements that continue to surface -- signifies a massive setback to market economics.”<sup>2</sup>

Russian behavior in the early days of January 2006 rang an alarm bell in the rest of Europe. The leverage of the Kremlin over Gazprom could not have been any more visible. Putin’s stated foreign policy objectives about gaining back Russian influence in the world together with European dependency on Russian gas supplies made Brussels start thinking about European energy security and thus national security.

Later developments reinforced the previously latent threat to European energy security. Since 1991 Russia was selling crude oil to Belarus at rates well below world market prices, as a payback for its Russian-friendly policies. However, during the course of 2006, President Lukashenko started to become less loyal and defied Russian requests openly several times. In response, Trasnft, the Russian state-owned oil monopoly introduced substantial extra charges on crude oil supplies to Belarus in January 2007, almost doubling the price of oil for Minsk. Russia did not retreat even though Minsk threatened to cut off the flow of oil through the Druzhba oil pipeline, the main pipeline supplying the European Union from Russia. The European Union protested intensively and pleaded for the parties to settle their dispute. Finally, Belarus did not make good on its threat and agreed to pay substantially higher prices than before.

The crisis made clear that Russia is not reluctant to use energy and energy companies as direct tools of its foreign policy. Moreover, it also became obvious that the European Union is very much exposed to blackmail in matters of energy supply and holds few and weak short term cards for dealing with such challenges. Finally, it seems that the assumption of mutual dependence between a supplier and a transporter country is illusory if the latter does not have

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<sup>2</sup> Vladimir Socor, “Market Economics Takes a Drubbing in Russia-Ukraine Gas Deal,” *Eurasia Daily Monitor*, Volume 3, Issue 5, January 9, 2006

alternative sources of supply. That is to say, even though in theory Belarus had been able to retaliate for Russian blackmail with cutting off the pipeline that generates large revenues for Russia, in practice, the short term loss for Belarus, lack of oil during winter, would have been so much higher than any losses for Russia that the former had no chance but to give in.

While the Ukraine-Russia and the Belarus-Russia disputes made Russian intentions and tools obvious for the general public, as well, they should not have come as surprise for people following the events more closely. Russian energy companies have already made substantial inroads into not only the former Soviet Union, but also Central Europe in the last few years and there is reason to believe that their moves are determined not by the forces of the market or profit interest but by factors affecting the Russian state and its leaders.

### **I.1. Introduction to the Problem**

With the collapse of communism in Europe, the Soviet Union withdrew its occupying forces from the countries of Central Eastern Europe. By 1993 the last tanks had left the region. Thus the military occupation of the region ended. The years of occupation were followed by a cold peace. On the one hand, due to historical mistrust Central European states wanted to escape the Russian orbit and attempted to sever political, economic, and military ties with Moscow as much as possible. The primary goal of these countries' foreign policy was to integrate with the West, which materialized in an attempt to gain membership in Western organizations, like NATO and the EU. On the other hand, Moscow considered the relationships with both the 'Near Abroad' and the West more important than the ones with Central Europe. As a result, official Russian foreign policy paid dramatically less attention to the latter region than during Soviet times. Its primary goal regarding Central Europe was to keep it as a demilitarized neutral zone between

Russia and the West. Central Europe remained among the lesser issues of Russian foreign political priority in the 1990s. However, a whole new approach was developed under President Putin when diplomatic relations between Russia and countries in the region again intensified.

While right after the collapse of the Soviet Union state attention towards Central Europe was rather low, Russian energy companies paid special attention to Central Europe. The first wave of Russian energy companies arrived in Central Europe in the mid-1990s. At that time Russian investors started to penetrate the natural gas industries of the Central European countries, most notably the gas import monopolies, the gas transit systems, and the gas wholesale companies. The second wave of Russian investments started in 2000 and continued throughout the first Putin presidency. This time companies penetrated not only the natural gas sector, but the oil and petrochemical industries as well. At the same time, there was no expansion of Russian energy companies towards Central Europe before 1993 or between 1997 and 2000. The two waves of expansion are well demarcated from those of non-expansion. Why do Russian energy companies move into Central Europe in these two periods and not in the others? What motivates their expansion? How can we understand the two waves of expansion and the lack of it at other times? Is there any relationship between Russian foreign policy and company expansions? Is the one a cause or consequence of the other? These questions drive the study. Answers to these questions could shed some light on post-Soviet Russian foreign policy, on elements of continuity, and elements of change. It also would help to understand Russian foreign policy towards Central Europe better and the role of Russian energy companies. Additionally, it serves to contribute to a better understanding of the characteristics of economic expansion. Furthermore, these answers are of primary interest to policy makers in the countries affected, and as a result, answers for them could have direct policy consequences.

In the Russian foreign policy literature there is agreement between historians and political scientists that throughout its history Russia has always been expansionist. The Russian state came about as a result of a continuous expansion of *Muscovy*. Moscow expanded because of security considerations. It believed that it would be better suited to defend its inner core the further it extended the periphery. Until the collapse of the Soviet Union, there has also been agreement in the Russian/Soviet foreign policy literature that realist theory is best suited to explain Russian/Soviet foreign policy. More recently, unit level theories started to dominate the research on Russian foreign policy. However, none of them has offered a satisfactory explanation so far in explaining the causal links between unit level actors, such as companies, and changes in Russian foreign policy. Even though in current IR theory unit level explanations are more in vogue, it is equally important to test whether realist theory or any of its derivatives is well suited to explain the role Russian companies play in post-Soviet Russian foreign policy towards Central Europe. I find that the neoclassical realist theory offers the most plausible explanation for the economic expansion towards Central Europe. Neoclassical realist theory argues that the relative distribution of power in the international system affects a state's behavior through two intervening variables: the perception of its leaders and the state power they can mobilize. The leaders' perception and the state power they are able to mobilize translate into the foreign policy of a given state. A primary purpose of this dissertation is theory testing, namely testing the usefulness of neoclassical realist theory in explaining Russian company moves into Central Europe between 1991 and 2004.

In the dissertation, I analyze how Russian leaders assessed the current place of Russia in the international system, and whether they perceived Russia's influence in world affairs to be satisfactory. I find that Russian leaders thought that their country's influence was in line with their expectations between 1991 and 1993, however, deemed it low afterwards. The abyss came



in the period between 1998 and 2000. I also analyze state power in the period examined. I use federal tax revenue as percentage of GDP to measure how much state power existed in Russia between 1991 and 2004. I find that Moscow possessed considerable state power to mobilize in the first half of the 1990s, even though federal tax revenues declined gradually after 1991. In the second half of the 1990s state power first declined, then collapsed. Starting in 2000 there is a sharp, continuous rise in federal tax revenues in Russia, which I equate with a continuous rise in state power. I find a correlation between negative perceptions about the world order and considerable state power on the one hand and Russian energy companies' Central European expansion on the other. In periods when I find Russia to view its influence in the world low and additionally to possess high enough state power, there is Russian economic expansion towards Central Europe. Moreover, I also find that in periods when either of the two criteria (perception of Russia's influence being low in world affairs and enough state power) is missing, there is no corporate expansion in the energy sector. I conclude by suggesting that Russian energy companies' moves into Central Europe represent expansion of the Russian state by economic means to counter the relative balance of power in Europe which Moscow perceives to be disadvantageous for Russia.

## **I.2. Methodology**

To reach the above conclusions I use the case-study methodology. I have one significant case, that of Russian foreign policy towards Central Europe between 1991 and 2004. I split this period into five sub-periods, which reflect the milestones of Russian foreign policy commonly identified in the literature. I use primarily the congruence procedure type 2 to do within-case comparison. I identify the periods of Russian energy companies' expansion (dependent variable) and examine

whether there is any correlation between Russian leaders' perception and state power on the one hand and Russian corporate moves towards Central Europe on the other. I also rely on process tracing by offering a detailed description of my cases. Additionally, I will draw some comparisons between Russian economic expansions towards Poland, Slovakia, and Hungary by using the controlled comparison method.

### **I.3. Case Selection**

Since the collapse of the Soviet Union, Moscow has replaced the Soviet 'bloc approach' towards Central Europe with a heterogeneous policy tailored to individual countries. As a result, it is necessary to differentiate between Russian conduct vis-à-vis each of the individual states. To examine my hypothesis, I will trace the actions of the Russian state and Russian companies in three countries of the region: Hungary, Slovakia, and Poland. Because Hungary is my home country, I am very familiar with the domestic politics, language and have contacts with key people. It is crucial to include Poland in my analysis of the region. Poland is the biggest country in terms of population among the former satellites; moreover, it is located on the transit route between Russia to Western Europe, which makes it especially important for the oil and gas industries. Additionally, Poland is far the richest case in terms of data. Russian companies have made several attempts to penetrate the Polish natural gas and crude oil industries.

Slovakia's case is very special. During the reign of Vladimir Meciar, prime minister of Slovakia between 1993 and 1998, Bratislava oriented its foreign policy more toward the East than towards the West. As a result, a special relationship developed between Moscow and Bratislava, which was many times complimented by Russian ambassadors to Slovakia. In the mid-90s, Russian companies entrenched themselves in the Slovakian economy. Even though after

1998 the new government balanced the overly pro-Russian foreign policy agenda of the Meciar government by reorienting the country towards integration in Western organizations, politically Slovakia remained the least suspicious country towards Russia in the region. This is reflected by the fact that the new government sold two key companies in the oil and gas industry to Russian companies in 2002. Such a sale could not have occurred in Poland or in Hungary. Slovakia serves to examine further questions whether the way Russian companies' moves into Central Europe are executed depends on the atmosphere in the target countries or not.

Since the collapse of the Cold War, the term "Central Europe" has usually referred to the above three countries plus the Czech Republic. It has been used to separate these four countries from the other post-communist countries on the basis of closer historical, cultural, and societal ties to Western Europe. Indeed, Hungary, Slovakia, and the Czech Republic, as well as Southern Poland have all been parts of the Habsburg Empire and later the Austro-Hungarian Monarchy. Yet, my research does not cover the case of the Czech Republic. For while these four countries do constitute a special entity politically and culturally, from the perspective of Russian energy companies the Czech Republic is in a different category. The reason is quite simple: geography.

The energy business, especially land-based natural gas and oil distribution, as well as oil refinery capacity, the segments that Russian energy companies focus on in the region, are all about physical distances and sovereignty. The further these raw materials need to travel from their point of exploration and/or refining, and the more countries' territory they need to cross, the more costly and vulnerable they become, and consequently the less control the up-stream company has. Poland, Hungary, and the Slovak Republic are all bordering countries that Russia views as its Near Abroad, i.e. its direct sphere of influence. They are also transit countries toward the most important Western European markets, Germany and Italy. However, the Czech Republic is neither. First of all, it does not border any of the Near Abroad countries, and any Russian

pipelines reaching the Czech Republic need to go through the more hostile territories of Poland, Slovakia, or Hungary. Second, the Czech Republic is not a necessary transit country toward any markets. As a result, it is both less important and less attractive from the Russian energy companies' point of view than the other three countries of Central Europe.

That is why I decided to focus my research on the three as opposed to the four countries. For the sake of simplicity, throughout the dissertation the term 'Central Europe' refers to the three countries which are the subject of my research: Hungary, Poland, and Slovakia.

#### **I.4. Sources**

English language sources about the topic are scarce. The major sources of information are Russian and Central European wire services, journal and newspaper articles, which I acquired by using primarily the ISI Emerging Markets Database. Altogether, there were only a few primary sources publicly available. As a result, I find it necessary to rely on other types of information in addition, of course, to primary materials. Contracts concluded in the gas, oil, and petrochemical industries are not available publicly. These are high-stake industries involving significant amounts of money and many spheres of interest and influence. As a result, most of the negotiations in the industry take place behind closed doors in extreme secrecy. As Janos Csak, the former Chairman of the Board of Directors of the Hungarian oil and gas monopoly Mol phrased it, there is a tremendous amount of money at stake in the industry. Actors move very cautiously, before major decisions, as they conduct several backdoor informal inquiries.<sup>3</sup> Consequently, proceedings of these meetings are not publicly known.

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<sup>3</sup> Interview with former Chairman of the Board of Directors of the Hungarian oil and gas company Mol Janos Csak, September 2005, Budapest

I conducted a large number of interviews in all these countries to fill in gaps of information. While trying to set up interviews and conducting them, I encountered several difficulties. First, exactly because of the high stakes involved, some interviewees asked for discretion, many did not allow me to tape the interview, and did not authorize me to disclose their names. In the most extreme cases, some potential interviewees refused to receive me at all. For example, Cambridge Energy Research Associates issued a statement saying that nobody in the company will answer my questions on the research subject. Second, I was able to receive little information compared to the invested time and effort from talking with the interviewees which I could not have collected from reading the newspapers. Nevertheless, I managed to receive pieces of information which helped to fill in gaps in my knowledge. However, I did not encounter the smoking gun I was looking for. This failure could have several reasons. 1: my interviewees were not carefully chosen. However, a look at the list of my interviewees shows that I managed to get access to many people who were directly involved in many transactions and decisions. 2: my interviewees did not know more than was written in the papers. This could be part of the answer, however, this in turn also suggests that I did not have access to those who are aware of all the information. But this explanation could also suggest that the topic is indeed difficult and multi-faceted and each player had only a portion of the whole story and thus could fill in my knowledge with information only on that particular aspect. 3: the interviewees did not want to disclose any more information because of fear or distrust. This is a plausible explanation indeed exactly because of the high financial and political stakes involved. Many times I also encountered examples when the interviewees were more interested in what I knew about the topic than in sharing information with me.

I did not find any book on my subject matter per se. I rely on books which deal with one aspect of the topic under investigation. I also use publications, studies, and working papers

written by think tanks in the region. Political research institutes which have done substantial work on Russian-Central European relations include the German Institute for International Politics and Security (SWP), the Finnish Institute of International Affairs (UPI), the Norwegian Institute of International Affairs (NUPI), the Slovak Foreign Policy Association (SFPA), the Institute for Eastern Studies (OSW) in Poland, and the Institute for Strategic and Defense Studies in Hungary.

### **I.5. Contribution to the Field**

I believe that the dissertation makes several contributions to the field. To the best of my knowledge, it is the first scholarly attempt to test neoclassical realist theory on a certain aspect of post-Cold War Russian foreign policy. This study validates the explanatory power of neoclassical realist theory in helping to explain one aspect of the post-Soviet Russian foreign policy. Because neoclassical realism is a relatively new derivative of the Realist School, it has not been tested in a sufficient number of cases so far. Any new systematic test of the theory is a valuable contribution to the field.

Additionally, my findings underscore that Realist theory and its derivatives have legitimacy in explaining a certain aspect of post-Soviet Russian foreign policy. Today, it is fashionable in the field to apply unit-level theories to explaining Russian foreign policy. Even though traditionally it was realist theory which offered the most plausible explanation to the several hundred years of Russian foreign policy, today theories that seek explanations in domestic variables have become more popular and thus are used more widely. This study should shed light on the validity of the realist theory and its derivatives in explaining Russian foreign policy. Additionally, the dissertation highlights a further area of development for realist theory, which is

the significance of economic capability and its convertibility into power as well as the role of corporate expansion in foreign policy.

This dissertation is intended to contribute to the field of Russian foreign policy studies. To the best of my knowledge this is the first attempt to examine systematically Russian foreign policy towards Poland, Hungary, and Slovakia between 1991 and 2004. This is the first attempt to examine systematically facts, documents, and trends in post-Soviet Russian foreign policy towards Central Europe. Even though the primary purpose of this dissertation is to test neoclassical realist theory, I rely heavily on description sometimes even in details not necessitated by a theory testing dissertation. The reason is that the period and topic on which I test the theory has not been described before. As the first, I needed to uncover as many facts as possible and to share them with the readers. This study could also serve as background for scholars who intend to test other theories in explaining post-Soviet Russian foreign policy toward Central Europe.

This study also examines Russian companies' conduct towards Central Europe. Until recently scholars who were interested in examining the role Russian companies played in Russian foreign policy relied almost exclusively on cases of the post-Soviet states. The role of Russian companies in Russia's relations vis-à-vis Ukraine and Belarus, the Caucasus countries, Central Asia, and the Baltic states received heavy attention. However, I did not encounter any study on the role Russian companies have played in Russia's relations with Central European countries. In this case as well, I rely on description to fill in the gap resulting from the lack of information on Russian corporate conduct in Poland, Slovakia and Hungary. I put together a chronological account of each instance of a Russian energy company's move in Central Europe by collecting information mostly from newspaper articles and wire services, but also from interviews. Testing neoclassical realist theory requires a detailed knowledge of the evolution of a state's foreign policy. To

understand to which extent perceptions affected outcomes, chronological accuracy and sequencing of events are essential.

Still many times the description of Russian corporate moves is most likely more detailed than is required even for testing neoclassical realist theory. With the details I did not intend to frighten my readers, but my intention was to do the empirical research which then could serve as a basis for other scholars to test other theories. I expect a renewed interest by scholars after the Russian-Ukrainian affair in January 2006 in examining the role that Russian energy companies play in Russian foreign policy. It is equally important that scholars extend their research beyond the post-Soviet area. Any findings of similarity or difference in Russian corporate expansion towards Central Europe and post-Soviet countries could be an invaluable contribution to the field.

Furthermore, I did not encounter any study that would apply IR theory to explaining Russian companies' moves outside the territory of the Russian Federation. Already in the mid-90s many studies called attention to the fact that energy companies may play an increasing role in Russian domestic and foreign policy. However, most stopped short of applying international relations theory to explain their particular moves and role. This study attempts to establish a cause-effect link between Russian energy companies' presence in Central Europe, on the one hand, and Russian perceptions about the world order and Russian state power to mobilize the necessary resources, on the other.

## **I.6. Policy Implications**

This study has several policy implications for Central European countries and for the European Union as well. Russian companies are primarily interested in investing in the strategic industries of the Central European countries, that is the natural gas, oil, and petrochemical industries. Because of the strategic nature of these industries, foreign investments in them should



not be considered by the host countries purely on their economic merits but also for their political implications. The study asserts that Russian economic expansion in the area relates with Russian perceptions about the country's influence in the world and changes in Russian state power. If that is so, then Russian investments in Central European strategic industries should be examined by the policy makers of these countries from this perspective.

The findings of the study have indirect consequences for the European Union as well. If Russian energy companies' investments in the European Union correlate with Russian leaders' perceptions about Russian influence in the world as well as state power to mobilize the necessary resources, then they should be viewed not as pure business investments. The European Union should devote resources to understanding the policy implications of the Russian energy companies' moves into Central Europe (new EU countries).

### **I.7. Chapter Progression**

Chapter II reviews the relevant literature on Russian foreign policy by examining the elements of continuity and change in Russian foreign policy studies. It focuses on studies of Russian foreign policy that apply IR theory, and concludes that it was Realist theory which offered the most plausible explanation for Russian foreign policy. Additionally, it concludes that the literature on the systematic application of IR theory to explaining Russian foreign policy is not sufficient. The second half of the chapter reviews Realist theory and its derivatives and examines the explanation each would give to explain the phenomenon under study, which is the expansion of Russian energy companies into Central Europe. The final pages of the chapter are devoted to examining the alternative explanation that neoliberal institutionalists would offer.

Chapter III offers a brief abstract on the Russian leadership's views on the relative distribution of power in the international system. It offers an estimate of changes of state power

in Russia throughout the period. It measures state power based on federal tax revenues as a percentage of GDP for each year since 1991. At the same time, it analyzes whether energy-related revenues could serve as a good proxy for measuring state power. Finally, it summarizes what the hypotheses would predict based on the two variables (perception and state power) in general and for my case in particular.

Chapter IV and Chapter V contain the case study of Russian foreign policy towards Central Europe between 1991 and 2004. The case is then split into five sub-periods: 1991-1993 Early Atlanticism, 1993-1996 Facing NATO Enlargement, 1996-1998 Against a Unipolar World, 1998-2000 Instability and Uncertainty (in Chapter IV) and 2000-2004 The First Putin Presidency (in Chapter V). Each examines Russian views on world affairs in the particular period, from foreign policy thinking through official foreign policy to bilateral diplomatic relations with Poland, Hungary, and Slovakia. A substantial part of the two chapters (where it is appropriate) is devoted to describing and analyzing Russian energy companies' moves into Central Europe. I examine in each sub-period whether the actual cases are in line with the predictions of the hypotheses. The sub-periods compare the extent to which changing perceptions about the world order and variations in the state power affect Russian economic activities in Central Europe.

Chapter VI offers conclusions by evaluating the findings of the case study, offers judgments about the usefulness of the model applied, and reviews some theoretical and policy implications of the findings.

## **CHAPTER II: THEORY AND LITERATURE REVIEW**

“Keep a weather eye on Russia. Russia has often experienced rapid shifts in relative power with dire international consequences.” /William C. Wohlforth, “Realism and the End of Cold War,” *International Security* 19, no. 3. (Winter 1994-1995), 129./

This study aims to answer the question of why Russian energy companies expand into Central Europe in certain times and not in others. To answer this question I rely on two fields of literature: that of Russian foreign policy studies and that of international relations. In the first section of the chapter, I examine the arguments about the applicability of Western theories of International Relations for the study of Russian foreign policy. After concluding that there are no firm reasons to reject the assumption that such a study may be possible, I will provide an overview of the IR theories that might be applicable for explaining the timing and intensity of Russian energy companies’ expansion into Central Europe. After assessing these theories’ explanatory potential, I conclude that neoclassical realist theory provides the best theoretical framework for my analysis.

### **II.1. Applying Western Theories of International Relations for Russia**

#### ***II.1.1. Historical Overview***

Most accounts on Russian/Soviet foreign policy were written by historians from a historical perspective. During the 1930s and 40s there were few attempts to analyze Soviet foreign policy from an International Relations theory perspective. Before WWII, “the study of Soviet foreign

policy remained outside the trends of early International Relations theory.”<sup>1</sup> Later the Traditionalism/Scientism debate influenced the Soviet foreign policy studies through only a small group of scholars. While the Third/Fourth debate within International Relations theory was never really felt in Soviet foreign policy studies, “it is only recently that some of its traits could be found in Russian foreign policy studies.”<sup>2</sup> The case is very similar regarding the quantity of International Relations literature on post-Soviet Russian foreign policy. “Explicit application of some International Relations paradigm to the careful study of Soviet or Russian foreign policy is far from the mainstream, however. So far this trend within post-Sovietology has been connected mainly with efforts to understand and explain the end of the Cold War and the Soviet Union’s voluntary withdrawal from its former satellites, and less with efforts of understanding the post-Cold War Russian foreign policy.”<sup>3</sup> The vast majority of the International Relations literature on the Soviet Union and Russia was preoccupied with explaining post hoc the end of the Cold War and the failure of IR theory to predict the end of the bipolar system.<sup>4</sup>

The few attempts to apply IR paradigm to a detailed study of post-Cold War Russian foreign policy present a skewed sampling of theoretical approaches, as trends in the field of International Relations affect the study of post-Soviet Russian foreign policy as well. According to Pursiainen,

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<sup>1</sup> Christer Pursiainen, *Russian Foreign Policy and International Relations Theory* (Hampshire, England: Ashgate Publishing Company, 2000), 38.

<sup>2</sup> *Ibid.*, 39-47.

<sup>3</sup> *Ibid.*, 66-67.

<sup>4</sup> Examples of this literature are (short of being a full list): Andrew Bennett, *Condemned to Repetition?: The Rise, Fall, and Reprise of Soviet-Russian Military Interventionism, 1973-1996* (Cambridge, MA: MIT Press, 1999); Stephen G. Brooks and William C. Wohlforth, “Power, Globalization, and the End of the Cold War: Reevaluating a Landmark Case for Ideas,” *International Security*, Vol. 25, No. 3. (Winter 2000-2001): 5-53; Jeffrey T. Checkel, *Ideas and International Political Change* (New Haven, Conn.: Yale University Press, 1997); Robert D. English, *Russia and the Idea of the West: Gorbachev, Intellectuals, and the End of the Cold War* (NY: Columbia University Press, 2000); Matthew Evangelista, *Unarmed Forces: The Transnational Movement to End the Cold War* (Ithaca, NY: Cornell University Press, 1999); Robert G. Herman, “Identity, Norms, and National Security: The Soviet Foreign Policy Revolution and the End of the Cold War,” in *The Culture of National Security*, ed. Peter J. Katzenstein (NY: Columbia University Press, 1996), 271-316.; Richard Ned Lebow and Thomas Risse-Kappen, eds., *International Relations Theory and the End of the Cold War* (NY: Columbia University Press, 1995); Sarah E. Mendelson, *Changing Course: Ideas, Politics, and the Soviet Withdrawal from Afghanistan* (Princeton, NJ: Princeton University Press, 1998); John E. Mueller, *Quiet Cataclysm: Reflections on the Recent Transformation of World Politics* (NY: HarperCollins, 1995)

because of their current popularity, theories which predominantly use domestic variables in explaining foreign policy outcomes are more widely used to explain current Russian foreign policy than theories of the Realist school. “In the study of contemporary Russian foreign policy ... the traditional belief system orientation, or the study of foreign policy thinking, doctrines, concepts, and debates, predominates usually without any explicit theory of the causal impact of this thinking on Russia’s behaviour.”<sup>5</sup>

Especially during the mid-90s several books were written that analyzed the organization of Russian foreign policy decision making, the foreign policy decision making processes within Russia and the influence of the different interest groups (lobbies, economic and military interest groups, unions, political parties and public opinion).<sup>6</sup> However, they hardly made the causal link between the analyzed variables, i.e. the agenda of the different interest groups and Russian foreign political outcomes. Additionally, both some internal and external factors changed dramatically from the Russian point of view at the end of the 90s and the beginning of the new millennium which made these studies rather less relevant. The most important of these factors were the emergence of the new Russian leadership under President Putin from early 2000 and the seemingly unstoppable rise of energy prices. Scholars agree that the domestic variables which may explain Russian foreign policy changed dramatically from the Yeltsin period to the Putin era. Fiona Hill argues that “Putin put an end to the freewheeling and chaotic foreign policy of the Yeltsin period ... As of 2004, freelancing had been eliminated to the extent that the President and

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<sup>5</sup> Pursiainen, 67.

<sup>6</sup> Examples of this literature are: Neil Malcolm, Alex Pravda, Roy Allison, and Margot Light, eds., *Internal Factors in Russian Foreign Policy* (Oxford, Oxford University Press, 1996), Celeste Wallander, *The Sources of Russian Foreign Policy After the Cold War* (Boulder, Colo: Westview Press, 1996). The latter one distinguishes among five analytical approaches to the subject: regime types, ideology, elite politics, interest groups, and reactions to external events.

the Presidential Administration could be said to be in charge of the foreign policy agenda.”<sup>7</sup>

There is also agreement in the literature that very high crude oil prices changed Russian capabilities, opportunities, and ambitions dramatically in the last several years. “Russia is back on the global strategic and economic map. Russia has since 1999 benefited immensely from the combination of international concern about energy security, instability in the Middle East, and dramatically rising oil prices...As a result, Russia has transformed itself from a defunct military (although still nuclear) superpower into a new energy superpower.”<sup>8</sup> Russia in 2004 (end of the time period under investigation in the dissertation) in terms of its economic capabilities and the organization of its domestic decision making structure is markedly different from that of Russia in mid-late 1990s. Both the domestic and external environments of Russia changed significantly enough to claim that studies about post-Soviet Russian foreign policy done in the mid-90s have lost much of their explanatory value for post-Soviet Russian foreign policy.

### ***II.1.2. Is It Possible at All?***

Before trying to apply any Western theory to explain Russian energy companies’ presence in Central Europe, it is important to weigh one more consideration: to which extent are Western theories of international relations applicable to explain Russian foreign policy. It is reasonable to ask whether the relatively low number of cases when IR theory was applied to explain Russian/Soviet foreign policy can be explained by the fact that Western IR theories are not applicable to Russia. Based on their answers, scholars can be divided into three groups. There are those who believe that Russia is unique. As a result, Western IR theories are not applicable to explaining Russian behavior in the international arena. Sergei Medvedev and Henrikki Heikka

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<sup>7</sup> Fiona Hill, *Energy Empire: Oil, Gas and Russia’s Revival* (London: The Foreign Policy Centre, September 2004), 18-19.

<sup>8</sup> *Ibid.*, 1.

consider Russia a special social, political, cultural and geographical entity. For Medvedev, for example, Russia's uniqueness is in its vast territory: "Russia's territory is not just quantitatively vast, it is qualitatively infinite, amorphous, and contradictory."<sup>9</sup>

There is the second group of scholars, such as William Wohlforth, who believe that Russia is like any great power and thus Western theories of IR are able to explain Russian foreign policy. Wohlforth predicted in 1998 that "if Russia does manage against the odds to fashion an effective state that can facilitate economic growth, she is sure to become a revisionist power in world politics and thus present the most traditional of all security challenges."<sup>10</sup> He has applied the neoclassical realist paradigm to explain the expansionist bias in Russian/Soviet history.

Historians Donaldson and Noguee argued similarly that throughout its history "as a general rule of statecraft, Russia has pursued balance-of-power policies." "The enduring goals pursued by Russia through its foreign policy have placed primary emphasis on ensuring national security, promoting the economic well-being of the country, and enhancing national prestige. In this respect, Russia's behavior is not markedly different from that of most great powers, but how these goals have been interpreted and achieved has changed with time and circumstances."<sup>11</sup> They point out that regarding post-Soviet Russian foreign policy "in Europe, an example of Moscow's continuing pursuit of balance-of-power policies is Russia's opposition to NATO expansion."<sup>12</sup>

The third group takes a middle ground. Constructivist Finnish scholar Christer Pursiainen argues that Russia has certain peculiarities which need to be taken into account, but those are far from being sufficient in explaining everything what Russia does. Moreover, Pursiainen holds that

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<sup>9</sup> Sergei Medvedev, "Power, Space, and Russian Foreign Policy," in *Understandings of Russian Foreign Policy*, ed. Ted Hopf (University Park, Pennsylvania: The Pennsylvania State University Press, 1999), 16.

<sup>10</sup> William C. Wohlforth, "New Security Challenge or Old? Russia's Catch-22," *GCSP – ISS at Yale University Workshop Papers: „Old and New Security Issues: Research and Policy Ramifications”* (The Geneva Centre for Security Policy, August 1998)

<sup>11</sup> Robert H. Donaldson and Joseph L. Noguee, *The Foreign Policy of Russia: Changing Systems, Enduring Interests* (Armonk, NY: M.E. Sharpe, 2005), 4.

<sup>12</sup> *Ibid.*

it is primarily changes in the international system and the state's capabilities that define Russian/Soviet foreign policy. "The possibility of a qualitative change between Russia of today within the present international system and the Soviet Union in the Cold War international system – would be a clear 'no'. The only difference can be seen in the new distribution of power in the world, that is, in the weakened relative power of Russia compared to that of the Soviet Union. The point of interest should, therefore, be focused on quantitative rather than qualitative factors."<sup>13</sup>

However, a theory should be parsimonious to keep its explanatory value. As soon as a scholar allows many more variables and exceptions, the theory may lose its explanatory value. Even Pursiainen acknowledges that "the combination of contemporary study of Russian foreign policy and International Relations theory is still far from mainstream and is conspicuously underdeveloped ... International Relations theory, if applied explicitly to the study of Russian foreign policy, has much to add to the tradition of Sovietology, as well as to the existing mainstream within the field."<sup>14</sup> One could argue, as Medvedev and Heikka do, that Western theories are not applicable to Russian/Soviet studies. However, IR theories were not applied systematically to explain Russian/Soviet foreign policy enough to be able to falsify the applicability of Western IR theory in Russian/Soviet studies. As a result, it cannot be concluded that they are non-applicable.

Before anyone would attempt to build new theories on Russian/Soviet foreign policy incorporating some assumed Russian peculiarities, Western theories of International Relations should be tested in the case of Russia.

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<sup>13</sup> Pursiainen, 130.

<sup>14</sup> Ibid., 3.



### ***II.1.3. The Key Challenge: Continuity versus Change***

Interpreting the history of Russian foreign policy through Western theories is challenging not only because of the inherent difficulty of explaining such a long and tumultuous history, but also because of the two regime changes that altered the course of Russian history in the last century. Is it possible to claim that the Soviet Union had the same interests, challenges and means as its predecessor, Tsarist Russia? How different is post-Soviet Russia from the Soviet Union? Can these be considered to be the same countries from an IR point of view? What factors are continuously present in Russian foreign policy and which placed Russian foreign policy into new directions? The “continuity and change” debate is the key challenge of Russian foreign policy studies.

As Robert Donaldson and Joseph Noguee put it, “there are elements of both continuity and change always at work. Over the course of time, Russian foreign policy has exhibited many profound shifts in direction. Perhaps less obvious has been the continuity in behavior of governments headed by tsars, commissars, and presidents.”<sup>15</sup> The central question of the part of Sovietology which researched the foreign policy of the Soviet Union was whether the Soviet Union represented a new kind of foreign policy, one of a communist state that is interested in promoting world revolution, or did it behave like any other state, promoting its national interest and security in its foreign policy. Research on Soviet foreign policy concentrated on finding elements of continuity with the foreign policy of Tsarist Russia and identifying new elements in Soviet conduct. The question was whether and how ideology shaped the foreign policy of Tsarist Russia.

A basic pattern which is identified in the literature throughout Russian/Soviet history is Moscow’s relentless lust for territorial expansion. “Like a cumbersome and nervous amoeba,

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<sup>15</sup> Donaldson and Noguee, 3.

[Muscovy] expanded to fill the space it was able to dominate, and was impelled into a perpetual dynamic of conquest.”<sup>16</sup> This expansion was primarily motivated by Moscow’s perception of insecurity. Moscow perceived that the way to defend the core was by pushing the limits of the state. The continuous expansion - of course together with periodic retrenchments - was accepted by historians and political scientists as well, as a starting point in understanding Russian/Soviet foreign policy. “The view that the Soviet Union at a very early stage sacrificed the Marxist-Leninist utopian goal of world revolution in favor of national interests, seemed to be the dominant one in both the early and later tradition of historical research.”<sup>17</sup> In the historical theories Soviet expansion was interpreted as a continuation of Russian imperialism. Most of these historical approaches with their focus on the perceived expansionist bias in Russian history implicitly apply classical realist and/or offensive realist arguments. They argued that the Soviet Union was expansionist not because it wanted to spread world revolution but because it behaved as Tsarist Russia did, relying on relative power considerations, and merely continued the foreign policy of Russia. As Edward Crankshaw suggested “what was happening here, disguised by a smoke screen of Communistic terminology, was a resurrection of the old Russian strategic imperialism of Ivan the Terrible and Peter the Great.”<sup>18</sup>

As Michael T. Florinsky phrased it “the Soviet Government has sacrificed much of the Marx-Lenin theory on the altar of expediency and Realpolitik.”<sup>19</sup> It became a dominant view in Soviet studies that the Soviet Union early on gave up its goal of world revolution based on Soviet ideology and that ideology was superseded by realpolitik considerations. Historian David J.

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<sup>16</sup> Geoffrey Hosking, *Russia: People and Empire, 1552-1917* (Cambridge, MA: Harvard University Press, 1997), 4.

<sup>17</sup> Pursiainen, 37.

<sup>18</sup> Edward Crankshaw, “Russia’s Imperial Design,” in *Readings in Russian Foreign Policy*, eds. Robert A. Goldwin, et.al. (NY: Oxford University Press, 1959), 713.

<sup>19</sup> Michael T. Florinsky, “Soviet Foreign Policy,” in Goldwin, 191.

Dallin argued similarly. Soviet expansion was motivated by “the demands of strategy and defence, and not the desire to promote the world revolution.”<sup>20</sup>

E.H. Carr argues that “of the two complementary factors in the dual policy of the Soviet regime – the encouragement of world revolution and the pursuit of national security – which had been in potential conflict ever since the days of the Brest-Litovsk treaty, the second seemed to have established a clear claim to priority.”<sup>21</sup>

Geopolitical theories that have been frequently applied to the study of Russian foreign policy history, also stressed the continuous presence of expansion in Russian/Soviet foreign policy. In these theories, one can trace implicit offensive realist arguments in explaining Russia’s perceived geographically determined destiny to expand. They argued that a country’s foreign policy is influenced by its geographic location, size and its opportunities and limitations. Within the geopolitical school there were different explanations for the Russian/Soviet drive of expansion. George Gressey explained Russian/Soviet foreign policy as a constant drive to the sea. “The Russian bear will not be content until it finds warm water, and this is equally true regardless of whether the government be a czarist autarchy or Soviet socialism.”<sup>22</sup>

Another dominant view in the geopolitical school emphasized the Eurasianism of Russia to understand its continuous quest for expansion.<sup>23</sup> While Eurasianism is predominantly an ideological and cultural school of thought, it has geopolitical aspects as well. Based on Eurasianism, Georgy Vernadsky argued that Russia being located between East and West was

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<sup>20</sup> David J. Dallin, *Soviet Russia’s Foreign Policy 1939-1942* (New Haven: Yale University Press, 1942), 127.

<sup>21</sup> E. H. Carr, *A History of Soviet Russia* (NY: MacMillan, 1964), 5.

<sup>22</sup> George B. Gressey, *The Basis of Soviet Strength* (NY: McGraw-Hill Book Company, Inc. 1945), 242.

<sup>23</sup> Eurasianism was comprised of the following elements: 1. the very origins of Russians and the Russian statehood was in the east; 2. Russia-Eurasia constitutes a different civilization; 3. hostility towards eurocentrism in Russian foreign policy; 4. the connection with God and the orthodox religion marked the foundation of the society; 5. the reality of Bolshevik power; 6. the state should be founded on the grounds of the higher idea. O.D. Volkogonova, “Yevraziistvo: evolutsiia idei,” *Vestnik Moskoskogo Universiteta, Serii 7, Filosofiia*, 4/1995: 38.

under constant pressure from both. However, it was able to expand in the east as there were no geographical barriers there, making the east Russia's natural direction of expansion.<sup>24</sup> As opposed to this, Robert Strausz-Hupé argued that the natural direction of expansion of Russia was to the west. It did not aim to conquer Europe but did expand to defend the country.<sup>25</sup> In Strausz-Hupé's argument there is the implicit assumption that Russia expands because of security considerations.

The same argument can be found in the Soviet literature in explaining the motivation to conquer Central Europe in the 1940s. According to the prevailing view, the conquest of Central Europe was driven by security concerns at the beginning of the Cold War. Moscow pushed out its periphery to secure the defense of the core. However, the Soviet Union kept this outward posting even after its primary utility for security purposes declined as the center had acquired second-strike nuclear capabilities. Scholars looked for explanations to learn why the Soviet Union did not withdraw from Central Europe after that.

William Wohlforth offers three explanations for keeping Central Europe under Soviet occupation even after this time: 1.) the SU converted its territorial control into greater influence on European security matters, 2.) the old imperial problem of retrenching having a spiralling effect on the inner empire, and 3.) retrenchment was calculated to be quite costly.<sup>26</sup> Even though keeping the empire was costly as well, the high oil prices of the 1970s offered enough revenues to the center to maintain the external empire. The real problem arose in the 1980s when declining crude oil prices and the increasing costs of keeping the empire came into conflict with each

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<sup>24</sup> George Vernadsky, *Political and Diplomatic History of Russia* (Boston: Little Brown and Company, 1936)

<sup>25</sup> Robert Strausz-Hupé, "The Western Frontiers of Russia," in *New Compass of the World*, ed. Hans W. Weigert (NY: The MacMillan Company, 1949)

<sup>26</sup> William C. Wohlforth, "The Russian-Soviet Empire: A Test of Neorealism," *Review of International Studies*, 27, (2001): 232-233.

other.<sup>27</sup> According to Alex Pravda, “what the Soviets wanted was to reduce the escalating economic burden of subsidies and other costs associated with their position in Eastern Europe...Had the citizens in Eastern Europe not organized to overthrow the existing regimes, the Soviet leadership – Gorbachev included – would have been quite happy to hold on to it. Ultimately, what changed was the Soviet willingness to pay high costs to maintain the status quo.”<sup>28</sup>

The authors and theories discussed above focused most of their attention on whether there is continuity between Tsarist Russia and the Soviet Union and answered the question with affirmation. However, very little systematic work has been completed on the issue of continuity versus change between the Soviet Union and Post-Soviet Russia. While there is ample reason to believe that such continuity does exist, more studies need to be written before the case can be settled. Without such firm theoretical foundations, one should be cautious about explaining Russian foreign policy before and after the collapse of the Soviet Union with the same theoretical framework.

This dissertation takes a small step towards filling the above discussed large gap in the field. It uses a Western IR theory for explaining an element of the foreign policy of post-Soviet Russia. With limiting my focus on post-Soviet times, I avoid the problems with regard to the issue of ‘continuity and change’. This study is among the first to apply neoclassical realist theory for the study of post-Soviet Russian foreign policy towards Central Europe. The dissertation finds that this particular Western theory of International Relations is very much applicable to understanding one aspect of post-Soviet Russian foreign policy.

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<sup>27</sup> Ibid., 233.

<sup>28</sup> Quoted in Stephen G. Brooks and William C. Wohlforth, “From Old Thinking to New Thinking in Qualitative Research,” *International Security*, 26, No. 4 (Spring 2002): 98.

## II.2. International Relations Theory

Realist theory was the prevailing theory to explain the Cold War, the balance of power between the United States and the Soviet Union. After the Cold War ended, there were several attempts to downplay the significance of realist theory. When Francis Fukuyama wrote about “the end of history” in his influential book, he argued that “large-scale conflict must involve large states still caught in the grip of history, and they are what appear to be passing from the scene.”<sup>29</sup> The expectation was that security considerations (a basic tenet of the Realist paradigm) will be overridden by other considerations. Consequently, military power did not seem to be the key variable explaining a state’s place in the international system, and that concerns about economic security will prevail over those of military security.<sup>30</sup> As Fukuyama phrased it, “there is no struggle or conflict over ‘large’ issues, and consequently no need for generals or statesmen; what remains is primarily economic activity.”<sup>31</sup> The peace dividend seemed to prevail in thinking. Belief in a new world order dominated not only scholarly thinking but policy makers as well. In 1997, President Clinton dismissed the idea that great power territorial politics of the 20th century will dominate the 21st. Instead he talked about shared values and cooperation.<sup>32</sup>

However, Kenneth Waltz asked “what sort of changes would alter the international political system so profoundly that old ways of thinking would no longer be relevant? Changes *of* the system would do it; changes *in* the system would not.”<sup>33</sup> “If the basic structure of the system has not changed since 1990, we should not expect state behavior in the new century to be much different from what it was in past centuries. In fact, there is abundant evidence that states still

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<sup>29</sup> Francis Fukuyama, “The End of History?” *The National Interest*, no. 16. (1989): 5.

<sup>30</sup> James E. Dougherty and Robert L. Pfaltzgraff, *Contending Theories of International Relations: A Comprehensive Survey*, Fourth Edition (Addison, Wesley, 1997), 3.

<sup>31</sup> Fukuyama, 18.

<sup>32</sup> “In Clinton’s Words: ‘Building Lines of Partnership and Bridges to the Future,’” *New York Times*, July 10, 1997

<sup>33</sup> Kenneth N. Waltz, “Structural Realism after the Cold War,” *International Security*, 25, No. 1 (Summer 2000): 5.

care deeply about power and will compete for it among themselves in the foreseeable future.”<sup>34</sup>

Similar thinking was expressed by Joseph Nye, one of the leading scholars of institutional theory that posed so far one of the most credible challenges to the Realist school. Nye wrote that “it has become fashionable to say that the world after the Cold War has moved beyond the age of power politics to the age of geoeconomics. Such clichés reflect narrow analysis. Politics and economics are connected. International economic systems rest upon international political order.”<sup>35</sup>

Thus, post-Cold War changes were rather changes in the system, appearing at the unit level. The international system as such did not change. This dissertation argues that the Realist paradigm and its derivatives have a prevailing explanatory value in explaining post-Soviet Russian behavior vis-à-vis Central Europe.

The underlying question in this dissertation is the following: why do Russian energy companies move into Central Europe in certain times and not in other times? To answer the question I have to examine whether there is any correlation between Russian state activity in Central Europe and Russian energy companies’ expansion in the region. The literature identifies the following potential answers: the primary motivation of states is to pursue power and to dominate others (the Realist school), the structure of the international system compels a constant balancing from states (the Neorealist school), states are aspiring for influence which is derived from the structure of the international system and altered by the intervention of domestic incentives (the Neoclassical Realist school). This part of the chapter reviews these three schools and the different explanations they give for the above phenomenon. Further, I devote attention to

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<sup>34</sup> John J. Mearsheimer, “Realism, the Real World, and the Academy,” in *Realism and Institutionalism in International Studies*, eds. Michael Brecher and Frank P. Harvey (Ann Arbor: The University of Michigan Press, 2002), 23-33.

<sup>35</sup> Joseph S. Nye Jr., “East Asian Security: The Case for Deep Engagement,” *Foreign Affairs* 74, no. 4. (1995): 90.

describe how the three schools appear in Russian/Soviet studies. Additionally, I offer an answer that each of them would give for the phenomenon under investigation in the dissertation.

### **II.2.1. Realist Theory**

Realist theory has a “state-centric” view of international relations, which means that according to realists in the international system the key actors are nation-states.<sup>36</sup> The central concept of realist theory is power. The Realists believe that the international system is in anarchy where the primary motivation of the different actors, i.e. nation-states, is power and security, with a greater emphasis on the former. Hans J. Morgenthau, the father of modern Realist theory, originates the argument that competition among states results from human nature. States are constantly striving to dominate others as those who make decisions on behalf of states are human beings, and humans are aggressive who are aspiring to dominate each other. Morgenthau defined national interest in terms of power and said that nation-states pursue their national interest as an objective. As a result, for the Realist school pursuit of power is an end in itself.<sup>37</sup> Pursuing national interest manifests itself in the continuous struggle for power. The states continuous quest for power explains their behavior and makes predictions possible.<sup>38</sup>

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<sup>36</sup> Representatives of the classical realist literature are: Hans Morgenthau, *Scientific Man Versus Power Politics* (Chicago: University of Chicago Press, 1946), Hans Morgenthau, *Politics Among Nations: The Struggle for Power and Peace* (NY: Knopf, 1948), Henry A. Kissinger, *A World Restored: Castlereagh, Metternich and the Restoration of Peace, 1812-1822* (Boston: Houghton, Mifflin, 1957), Edward Hallett Carr, *The Twenty Years' Crisis* (NY: Harper & Row, 1946), Raymond Aron, *Peace and War: A Theory of International Relations* (NY: Praeger, 1966), Reinhold Niebuhr, *Christian Realism and Political Problems* (NY: Charles Scribner's Sons, 1953), George F. Kennan, “The Sources of Soviet Conduct,” *Foreign Affairs*, July 1947, Thucydides, *History of the Peloponnesian War* (Oxford: Clarendon Press, 1895), Niccolo Machiavelli, *The Art of War* (Indianapolis: Bobbs-Merrill, 1965), Thomas Hobbes, *Leviathan* (Cambridge: Cambridge University Press, 1996)

<sup>37</sup> Hans J. Morgenthau, *Politics Among Nations: The Struggle for Power and Peace*, 6th ed. (NY: Knopf, 1985), 36.

<sup>38</sup> Kenneth Waltz writes, “in anarchy, security is the highest end. Only if survival is assured can states safely seek such other goals as tranquility, profit, and power.” Kenneth Waltz, *Theory of International Politics* (Reading, MA: Addison-Wesley, 1979), 126.; Raymond Aron contends that “politics, insofar as it concerns relations among states, seems to signify – in both ideal and objective terms – simply the survival of states confronting the potential threat created by the existence of other states” Raymond Aron, *International Relations: A Theory of Peace and War* (Garden City, N.J.: Doubleday, 1973); Robert Gilpin asserts “all these noble goals [truth, beauty, justice] will be lost



In this struggle states rely on their capabilities, which are not like those for the different nation-states. Of these capabilities, military ones have paramount importance. When Realists argue that the external environment has a pivotal role on state behavior, they have the balance of military capabilities as the primary external factor in mind. In summary, the two key factors for understanding international politics according to the Realist School are the interests of states (which is a continuous quest for power) and their military capabilities. States are constantly aspiring to maximize their power by actively looking for opportunities to enhance it over other nations primarily by military means whenever they have the chance.

However, all of the above fail to answer “one of the enduring questions of power and political behavior: To what extent can the intentions of states as political actors be inferred from the capabilities in their possession? Is there a causal relationship in which the possession of capabilities shapes the intentions of their possessors and their propensity to use power? Or, can a powerful state refrain from using its power?”<sup>39</sup> Morgenthau’s answer is that a powerful state cannot resist using its power over a weak state.<sup>40</sup> Realists believe that states are inherently on the offensive.

Power is a key concept in the Realist School, not only for classical realists but neorealists and neoclassical realists as well. There are several definitions in use for power. For Morgenthau, power is an end in itself, and it means domination: one’s “lust for power would be satisfied only

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unless one makes provision for one’s security in the power struggle among groups” Robert Gilpin, „The Richness of the Tradition of Political Realism,” in *Neorealism and Its Critics*, ed. Robert O. Keohane (New York: Columbia University Press, 1986), 305. John Mearsheimer writes that the international system is a “brutal arena where states look for opportunities to take advantage of each other ... International relations is not a constant state of war, but is a state of relentless security competition.” John Mearsheimer, “The False Promise of International Institutions,” *International Security* 19., no. 3. (Winter 1994-95): 10.

<sup>39</sup> Dougherty and Pfaltzgraff, 68.

<sup>40</sup> Morgenthau, *Politics*, 43.

if the last man became the object of his domination.”<sup>41</sup> Kenneth Waltz characterizes power as “the old and simple notion that an agent is powerful to the extent that he affects others more than they affect him.”<sup>42</sup> For Waltz, a causal conception is not a necessary condition of power. Waltz identifies the different capabilities of a state which together determine its power. These capabilities include economic capability, but for Waltz and the neorealists it is the military capability which is dominant.<sup>43</sup> Robert Gilpin argues that power encompasses resources: military, economic, and technological capabilities of states.<sup>44</sup> Moreover, he was among the first to understand power in relative terms. He used relative power as the ordering principle to understand state behavior.<sup>45</sup> International economist Charles P. Kindleberger defines power as “strength capable of being used efficiently.”<sup>46</sup> In Kindleberger’s definition, power has two necessary parts: strength and the capacity to use it effectively. It means that strength/capability does not automatically result in power. He does not separate the political and economic realms of international existence but sees them as intertwined. The key concept in Klaus Knorr’s analysis is interdependence. He maintains that power, influence and interdependence are interrelated, and says that conflict and cooperation can be achieved at the same time vis-à-vis the same state: while in some issues states are in conflict with each other, in others they may cooperate. In either case, whether they cooperate or are in conflict with each other, they are interdependent. Regarding power, interdependence indicates the ability of one state to influence the other in some respect. Knorr asserts that if interdependence is mutual, both states could damage each other and

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<sup>41</sup> Hans J. Morgenthau, *Scientific Man Versus Power Politics* (Chicago: University of Chicago Press, 1946), 193.

<sup>42</sup> Waltz, *Theory*, 192.

<sup>43</sup> *Ibid.*, 131.

<sup>44</sup> Robert Gilpin, *War and Change in World Politics* (NY: Cambridge University Press, 1981), 33.

<sup>45</sup> Gideon Rose, “Neoclassical Realism and Theories of Foreign Policy,” *World Politics* 51, no. 1 (October 1998): 155.

<sup>46</sup> Charles P. Kindleberger, *Power and Money: The Politics of International Economics and the Economics of International Politics* (NY: Basic Books, 1970), 56.

themselves by ceasing the relationship between them. He uses the term power for the exercise of coercive influence only.<sup>47</sup>

In the Realist school of thought, states are unitary, rational actors, and since the principal actors in the international system are sovereign states, the Realist paradigm assumes that non-state actors derive their significance from states. This school of thought does not think that non-state actors can have independent influence on the system. The significance of non-state actors derived from the state can go in both directions: the non-state actors influence the policies and behavior of the state or the state uses them as policy instruments.<sup>48</sup>

#### *Realist Theory in Russian/Soviet Foreign Policy Studies*

Hans Morgenthau in “The Real Issue Between the United States and the Soviet Union,” argued that the US was most concerned about Russian imperialism and not about the idea of world revolution in its relations with the Soviet Union, the latter one using the idea of world revolution only for its imperialistic purposes.<sup>49</sup>

Today realism has its renaissance, says Pursiainen. “The reason is clear. If Soviet leaders used to proclaim that Marxist-Leninist ideology... functions as the ‘theoretical basis for analyzing, evaluating and predicting international relations and concrete foreign policy situations as well as for the development of the strategy and tactics of foreign policy’, then in the contemporary vocabulary of Russia’s political leadership, the concept of ideology is replaced by that of ‘national interest’.”<sup>50</sup> Even the foreign policy doctrine of the Russian Federation of 1992 stated

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<sup>47</sup> Klaus Knorr, *The Power of Nations: The Political Economy of International Relations* (NY: Basic Books, 1975), 3-10.

<sup>48</sup> Dougherty and Pfaltzgraff, 28.

<sup>49</sup> Hans J. Morgenthau, *In Defense of the National Interest: A Critical Examination of American Foreign Policy* (NY: Knopf, 1951)

<sup>50</sup> Pursiainen, 59. The quotation within the quotation is from A. A. Gromyko, et al., eds., *Diplomaticheskii slovar*. Tom III, (Moskva: Nauka, 1986), 457.

that the foreign policy of Russia is not driven by any ideology any more but “the real distribution of power” in the world.<sup>51</sup> This phrasing could not be any closer to the presumptions of the realist school of thought of international relations.

#### *Realist Explanation for Russian Energy Companies' Presence in CEE*

The Realist school's explanation for the Russian energy companies' presence in Central and Eastern Europe would be that it is driven by the inherent motivation of states to pursue their national interest, which manifests itself in pursuing power. Realists understand that states differ in their capabilities. For Russia today, its economic capability through its energy companies (non-state actor) is the primary means to achieve power. Russian behavior is driven by its quest for power on the one hand, and by the fact that it cannot resist the weakness of the Central European states on the other.

Even though this seems plausible explanation, realist theory would expect a military build-up. It gives little explanation why Russia reacted with economic means and not otherwise. For their imperialistic objectives, states use their capabilities: military, economic and cultural. Morgenthau claims that economic imperialism is not as effective as military imperialism, but if the latter cannot be used for achieving influence over a state, economic imperialism may serve the purpose.<sup>52</sup> He pays little attention to economic imperialism or the economic base of national power. Still Morgenthau's answer for the initial question would be that we are experiencing Russian economic imperialism in Central and Eastern Europe, as using its military power vis-à-

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<sup>51</sup> Strategiiia dlia Rossii. *Nezavisimaia Gazeta*, August 19, 1992 (In converting cyrillic I used the rules of the Library of Congress.)

<sup>52</sup> Morgenthau, *Politics*, 64.

vis CEE is not a viable option for Moscow.<sup>53</sup> In the realist explanation the Russian state uses its economic capabilities, Russian non-state actors, to enhance its power over Central and Eastern Europe.

Samuel Huntington, although not a Realist himself, points towards a possible way of interpreting economic expansion through the lens of Realism. He underscores the importance that economic issues will play in the post-Cold War world. “In the coming years, the principal conflicts of interests involving the United States and the major powers are likely to be over economic issues.”<sup>54</sup> Huntington importantly maintains that economics is not necessarily a non-zero-sum game. Economic relations are not only about absolute gains because in many instances relative gains matter. It means that a state may refrain from economic cooperation if it believes that the other may gain relatively more from the cooperation than it does. “Economic activity is a source of power as well as well-being. It is, indeed, probably the most important source of power, and in a world in which military conflict between major states is unlikely, economic power will be increasingly important in determining the primacy or subordination of states.”<sup>55</sup> Huntington uses the example of Japan to illustrate that for decades it pursued a strategy to maximize its economic power at the expense of its economic well-being consistent with what realist theory

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<sup>53</sup> Even though realists focused overwhelmingly on military power, they were far from being ignorant on economic one. Already Thucydides talked about the interaction of international economics and politics in the *History of the Peloponnesian War*, as well as, the political use of economic leverage and conflict over energy resources. Alexander Hamilton claimed that national power rests upon industrialization and economic self-sufficiency. E. H. Carr talked to a great extent about economic power. “The essential argument of most realists with respect to the nature and functioning of the international economy, I would venture to say, is that the international political system provides the necessary framework for economic activities. The international economy is not regarded as an autonomous sphere, as liberals argue, nor is it in itself the driving force behind politics, as the Marxists would have us believe.” “Economic forces...always work in the context of the political struggle among groups and nations. When the distribution of power and international political relations change, corresponding changes may be expected to take place in global economic relations.” Robert G. Gilpin, “The Richness of the Tradition of Political Realism,” *International Organization* 38, no. 2 (Spring 1984): 293-294., 295.

<sup>54</sup> Samuel P. Huntington, “Why International Primacy Matters,” *International Security* 17, no. 4 (Spring 1993): 71.

<sup>55</sup> *Ibid.*, 72.

would expect. One exception is the realist theory's focus on military power. "Abjuring military power, it has acted precisely as realist theory would predict in the pursuit of economic power."<sup>56</sup> Economic power is an essential contribution to a state's power base. Economic power is the most fungible as it can easily be converted into military power. "'Economics,'" as Daniel Bell has said, "is the continuation of war by other means." Economic primacy matters because economic power is both the most fundamental and the most fungible form of power."<sup>57</sup> If Realist theory substituted military for economic power, it would be well-suited to explain post-Soviet Russian behavior vis-à-vis Central Europe.

Accordingly, realist theory would suggest that the energy companies' expansion should take place when Russia is not strong enough militarily to assert domination, yet it is becoming relatively stronger than the CEE region in economic terms. Only half of this prediction stands the trial of facts, however. Russia left CEE exactly because of its relative military weakness and NATO's expansion into the region reinforced this new military balance of power. However, the economic expansion has been taking place during a time when CEE has manifested much more robust GDP growth and more solid economic fundamentals than Russia. That is to say, Russia's relative economic power vis-à-vis CEE has been declining during the Russian companies' expansion, and this is contrary to what Realist theory would suggest.

In summary, it is possible to find Realist reasoning for explaining Russian energy companies' foray into Central and Eastern Europe, but even this argument would not be sufficient to account for the timing of the expansion.

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<sup>56</sup> Ibid., 72-73.

<sup>57</sup> Ibid., 81.

### **II.2.2. Neorealist Theory**

Neorealism, or structural realism, was phrased by Kenneth Waltz in his book, *Theory of International Politics* in 1979.<sup>58</sup> Neorealist theory assumes the same anarchical structure as realist theory does. The primary actors in the international system are states which act as independent sovereign units. The theory puts structure into the forefront, which means that structural constraints are the primary drivers of the actors and not their own priorities. Waltz ignores human nature (Morgenthau) as a motivation of states and claims that states are driven merely by survival in the anarchical system. The international structure is the primary constraint on state behavior, and as a result, different states behave similarly in the structure (as opposed to Innenpolitik theories which derive foreign policy from domestic factors). Neorealism “addresses two questions: (1) Why do balances of power recurrently form in international politics and (2) which of two gross distributions of power (bipolarity or multipolarity) is more prone to great power war?”<sup>59</sup>

Neorealists do not claim that states should always behave according to the worst case scenario, i.e. war, but that in case of consistent disregard for this option, the system will punish them. The most extreme punishment is the disappearance of the state. In neorealist theory, there is basic distrust among states that are concerned of the relative gains of power vis-à-vis each

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<sup>58</sup> Representatives of the Neorealist literature are: Barry Buzan, “Peace, Power, and Security: Contending Concepts in the Study of International Relations,” *Journal of Peace Research* 21, no. 2 (1984): 109-125., Barry Buzan, Charles Jones, and Richard Little, *The Logic of Anarchy: Neorealism to Structural Realism* (NY: Columbia University Press, 1993), Robert G. Gilpin, *War and Change in World Politics* (NY: Cambridge University Press, 1981), 9-11., Joseph M. Grieco, “Anarchy and the Limits of Cooperation: A Realist Critique of the Newest Liberal Institutionalism,” *International Organization* 42, no. 3 (Summer 1988): 485-507., John J. Mearsheimer, *The Tragedy of Great Power Politics* (NY: W.W. Norton, 2001), Jack Snyder, *Myths of Empire: Domestic Politics and International Ambition* (Cornell University Press, 1991), Stephen Walt, “Keeping the World „Off-Balance”: Self-Restraint and U.S. Foreign Policy,” in *The Future of the Balance of Power*, ed. John G. Ikenberry (NY: Cornell University Press, 2002), “The Progressive Power of Realism,” *The American Political Science Review* 91, no. 4 (December 1997): 931-935. For analyses: Keohane, ed., *Neorealism*, Barry Buzan, Charles Jones, and Richard Little, *The Logic of Anarchy: Neorealism to Structural Realism* (NY: Columbia University Press, 1993)

<sup>59</sup> Jeffrey W. Taliaferro, “Security Under Anarchy: Defensive Realism Reconsidered,” working paper, International Studies Association, 40th Annual Convention, February 16-20, 1999. Accessed July 7, 2006. Available from Ciaonet, 3.

other. However, cooperation is possible as long as the relative gains deriving from cooperation are acceptable for those involved.

For Kenneth Waltz, it is structure that determines the way unit level actors are arranged in the international system. Waltz does primarily structural level analysis and mostly excludes the unit level. He says that at the unit level there are two possible sources for change in the international system: “the attributes of the units and the interactions among them.”<sup>60</sup> Waltz does not look at how power is employed, but is interested in the outcome of the interaction among the units in the international system. While Waltz explains systemic changes, he does not offer a theory on foreign policy. Neorealists only look at the outcome and they fail to explain foreign policy decisions.

[A] theory of international politics...can describe the range of likely outcomes of the actions and interactions of states within a given system and show how the range of expectations varies as systems change. It can tell us what pressures are exerted and what possibilities are posed by systems of different structure, but it cannot tell us just how, and how effectively, the units of a system will respond to those pressures and possibilities.<sup>61</sup>

While the dependent variable of Waltz’s theory is the pattern of outcomes of state interactions, it does not explain the behavior of a specific state. Additionally, Waltz relies in his analyses primarily on the distribution of military capabilities in the international system.

Broadening the concept of security to include economic factors simply cannot be accomplished within the neorealist framework, since it would require dismantling the underlying assumptions that provide neorealism with its internal coherence...Waltz ultimately concludes that it is possible, indeed productive, to ignore the economic domain when theorizing about international behavior.<sup>62</sup>

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<sup>60</sup> Dougherty and Pfaltzgraff, 86.

<sup>61</sup> Waltz, *Theory*, 71-72.

<sup>62</sup> Stephen G. Brooks, “Dueling Realisms,” *International Organization* 51, no. 3 (Summer 1997): 453.



### *Neorealist Theory in Russian/Soviet Foreign Policy Studies*

According to neorealist theory, Russia and the Soviet Union throughout its history adapted to the prevailing balance of power. The main drive behind a state's foreign policy is its national interest, which is defined as power. As a result, neorealists did not think that the Soviet Union had a distinct foreign policy from that of Tsarist Russia. In their interpretation, Soviet ideology served only as a showcase, but it did not have a significant influence on foreign policy. The Soviet Union's foreign policy was a result of the balance of power in the international system. Kenneth Waltz finds that the Soviet Union's actions were more benevolent than its internal character or ideology would have suggested. It acted like a status quo power and this was a result of the pressure of the bipolar international system.<sup>63</sup> For Waltz, it is the international system that explains Soviet foreign policy. He underscores those views which claim that realpolitical considerations soon superceded ideological ones during Soviet times.

Regarding post-Soviet Russia, Waltz maintains that the basic structure of the post-Cold War international system remains anarchic.<sup>64</sup> The realm of international politics will be characterized by competition. While military competition will be important, he stated in 1993 that economic competition will be as important in the international system as military capabilities.<sup>65</sup> The rank of great powers "depends on how they score on a combination of the following items: size of population and territory, resource endowment, economic capability, military strength, political

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<sup>63</sup> Kenneth Waltz, "The Spread of Nuclear Weapons: More May Better," *Adelphi Papers*, no. 171, (London: International Institute for Strategic Studies, 1981)

<sup>64</sup> Kenneth Waltz, "The Emerging Structure of International Politics," *International Security* 18, no. 2, (Autumn 1993), 59.

<sup>65</sup> *Ibid.*

stability and competence.”<sup>66</sup> Even though Russia is a great power in the military sense, economically it is insignificant.<sup>67</sup>

The Soviet Union, like Tsarist Russia before it, was a lopsided great power, compensating for economic weakness with political discipline, military strength, and a rich territorial endowment. Nevertheless, great power status cannot be maintained without a certain economic capability. In a conventional world, one would simply say that the years during which Russia with its many weaknesses will count as a great power are numbered, and that the numbers are pretty small ones.<sup>68</sup>

However, the capabilities of Russia are dramatically different in 2006 from those of 1993.

Waltz maintains that the international system is shaped by the distribution of different types and levels of capabilities among states. Energy is a very important one among these capabilities. The high energy prices after 1999 changed the relative capabilities of Russia in the international system as well as its opportunities significantly. Today, Russia relies extensively on its energy capabilities to balance against the United States. Waltz also maintains that capabilities can be used to change the system. President Putin expressed several times his desire to do so. Putin’s foreign policy markedly attempts at building up an alternative power base against that of the United States. In that endeavor, Putin is able to rely extensively on energy which is a key capability in itself but revenues from the sales of energy are easily convertible into other capabilities as well.

#### *Neorealist Explanation for Russian Energy Companies’ Presence in CEE*

Waltz would expect a rational Russia to balance constantly vis-à-vis the United States in military capabilities, for the international structure would compel Russia to do so even in the short-term. The neorealist worst-case expectation would suggest that Moscow must be prepared

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<sup>66</sup> Ibid., 50.

<sup>67</sup> Ibid.

<sup>68</sup> Ibid.

for the possibility of a coercive US action against Russia. Waltz would ignore economic capabilities in balancing, but Russian behavior today seems to contradict Waltzian expectations. Neorealists would say that in the long-run Russia will be punished by the system for its current failure to balance vis-à-vis the United States. Even though neorealism may explain international political outcomes, it is not a foreign policy theory. As a result, explaining Russian foreign policy vis-à-vis Central Europe is beyond the realm of Waltzian neorealism.

However, other scholars applied the neorealist model to individual state behavior as well as to international outcomes. As a result, two theories of foreign policy emerged: offensive and defensive realism. They share the assumptions of neorealist theory: the primary actors of an anarchic international system are unitary and rational states that seek security. Since the international system is anarchic in nature, analysis should start from the system level.<sup>69</sup>

### **II.2.3. Offensive Realism**

As John Mearsheimer argued, “my theory of offensive realism is also a structural theory of international politics...Offensive realism parts company with defensive realism over the question of how much power states want.”<sup>70</sup> For John Mearsheimer, security in the international system is scarce.<sup>71</sup> As a result, states aim at achieving security by maximizing their relative power because

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<sup>69</sup> There are competing views in the literature about terms and the place of offensive and defensive realisms within the realist school. The terms offensive/aggressive realism and defensive realism were introduced by Snyder, *Myths of Empire*, 11-12. There were later further attempts to recategorize the literature. Stephen Brooks calls defensive realism post-classical realism. (See more about this below) Andrew Kydd introduces the term “motivational realism” for his and Randall Schweller’s work and compares that to offensive and defensive realisms. Andrew Kydd, “Sheep in Sheep’s Clothing: Why Security Seekers Do Not Fight Each Other,” *Security Studies* 7, no. 1 (Autumn 1997), 114-155. Furthermore, disagreement prevails about the place of offensive and defensive realist schools within realist theory. I deal with them in the neorealist section because they share the basic tenet of neorealist paradigm that is they start their analysis at the systemic level.

<sup>70</sup> Mearsheimer, *The Tragedy*, 21.

<sup>71</sup> Representatives of the offensive realist literature are: John J. Mearsheimer, “Back to the Future: Instability in Europe after the Cold War,” *International Security* 15, no. 1 (Summer 1990): 5-56., John J. Mearsheimer, *The*

offensive military action often contributes to security.<sup>72</sup> (As opposed to this, Waltz believes that states should not aspire to maximize their power but for an “appropriate” amount of power.<sup>73</sup>) Even though states may start with benign motives, they are often forced to act offensively because of the structure of the international system. Domestic characteristics of the different states are not important in this regard, since it is the structure which makes states even with different domestic characteristics behave similarly. To understand state behavior, offensive realists suggest to examine a state’s “relative capabilities and its external environment, because those factors will be translated relatively smoothly into foreign policy and shape how the state chooses to advance its interests.”<sup>74</sup>

Even though survival is the primary goal of states, John Mearsheimer acknowledges that states sometimes pursue non-security goals, like economic prosperity, as long as they do not contradict the balance-of-power logic. Moreover, the non-security goals often supplement the security related goals. For example, economic prosperity creates wealth (productive base) which can easily be transformed into military capability. However, Mearsheimer does not offer any explanation for why states would pursue non-security goals.<sup>75</sup> He quotes Adam Smith in suggesting that when the quest for security and wealth conflict, the former always supercedes the

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*Tragedy of Great Power Politics* (NY: W. W. Norton & Company, 2001), Randall L. Schweller, “Neorealism’s Status Quo Bias: What Security Dilemma,” *Security Studies* 5, no. 3 (Spring 1996): 90-121.

<sup>72</sup> Stephen G. Brooks claims that offensive realists implicitly adhere to Morgenthau. While Morgenthau emphasizes aggression as human nature, offensive realists emphasize wariness and anxiety. According to Brooks, it is fear that drives states in the offensive realist theory to aspire for survival and security all the time. Offensive realists “may adopt a worst-case/possibilistic perspective precisely because they implicitly accept Morgenthau’s argument that actors are inherently aggressive.” According to Brooks, offensive realists rely as much on human nature as Morgenthau does, only use a different aspect: fear instead of aggression. Stephen G. Brooks, “Dueling Realisms,” *International Organization* 51, no. 3 (Summer 1997): 449-450.

<sup>73</sup> Kenneth N. Waltz, “The Origins of War in Neorealist Theory,” in *The Origin and Prevention of Major Wars*, ed. Robert I. Rotberg and Theodore K. Rabb (NY: Cambridge University Press, 1989), 40.

<sup>74</sup> Rose, 149.

<sup>75</sup> John J. Mearsheimer, “Power and Fear in Great Power Politics,” in *One Hundred Year Commemoration to the Life of Hans Morgenthau (1904-2004)*, ed. G.O. Mazur (NY: Semenenko Foundation, 2004), 184-196.

latter, and when forced to choose between wealth and relative military power, states would choose the second.<sup>76</sup>

Stephen Brooks argues that a distinctive feature of offensive realism is its claim that states are conditioned by the mere possibility of conflict (as opposed to its probability). “Neorealism holds that the possibility of conflict shapes the actions of states, who are seen as always adopting a worst-case perspective.”<sup>77</sup> Kenneth Waltz argued that in the international arena “any state may at any time use force [and] all states must constantly be ready either to counter force with force or to pay the cost of weakness.”<sup>78</sup> As Mearsheimer contends, the possibility is always there that “a state’s intentions can be benign one day and malign the next.”<sup>79</sup> Emphasis on the possibility of conflict also means that offensive realists heavily discount the future. If conflict is always possible, then a state needs to be militarily prepared all the time. The primary motivation of states is survival, and their primary responsibility is military security. Military capability depends on a state’s productive base. However, states have different productive bases, and as a result, different military capabilities. Their military capabilities define the states’ place in the international structure. Offensive realist theory admits that there are other (than military) material capabilities, like economic (but does not consider non-material factors, like ideas, norms at all) which determine a country’s productive base. However, if the two - military preparedness and economic capacity - come into conflict the former always trumps the latter. In this theory, a state would never give up its short-term military preparedness for potential net increases in its economic capacity because of the possibility of conflict.

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<sup>76</sup> Adam Smith, *The Wealth of Nations* quoted in Mearsheimer, “Power and Fear in Great Power Politics,” 192.

<sup>77</sup> Brooks, “Dueling Realisms,” 446. Brooks uses the term ‘neorealism’ for ‘offensive realism’ and ‘postclassical realism’ for ‘defensive realism.’

<sup>78</sup> Kenneth N. Waltz, *Man, the State, and War* (NY: Columbia University Press, 1959), 160.

<sup>79</sup> Mearsheimer, “The False Promise of International Institutions,” 11.

Thus, the theory favors short-term over long-term military preparedness. Additionally, short-term military preparedness subsumes other long-term priorities as well. In other words, a state will always seek to maximize its short-term military security even if it has negative consequences for other state priorities in the long run. When security pressures cease, a rational state focuses more on other long-term priorities, among them economic capacity. The greater the security pressures of today, the less that long-term priorities matter. As Mearsheimer argued, “states operate in both an international political environment and an international economic environment, and the former dominates the latter in cases where the two come into conflict. The reason is straightforward: the international political system is anarchic.”<sup>80</sup>

#### *Offensive Realist Theory in Russian/Soviet Foreign Policy Studies*

Mearsheimer argues that Russia and the Soviet Union pursued an expansionist foreign policy continuously: “Russia had a rich history of expansionist behavior before the Bolsheviks came to power in October 1917.”<sup>81</sup> The expansion was driven by a fear of Russian leaders from invasion. “Not surprisingly, Russian thinking about foreign policy before and after the Bolshevik Revolution was motivated largely by realist logic.”<sup>82</sup> The United States attempted to prevent Soviet expansion wherever it could during the Cold War. “Nevertheless, the Soviets had some chances to expand, and they almost always took advantage of them.”<sup>83</sup>

The realist logic characterizes post-Soviet Russian foreign policy as well.

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<sup>80</sup> John Mearsheimer, “Disorder Restored,” in *Rethinking America’s Security: Beyond Cold War to New World Order*, ed. Graham Allison and Gregory F. Treverton (NY: W.W. Norton, 1992), 222.

<sup>81</sup> Mearsheimer, *The Tragedy*, 190.

<sup>82</sup> Ibid.

<sup>83</sup> Ibid.

The evolution of Russian foreign policy during the 1990s provides further evidence that realism still has a lot to say about inter-state relations in Europe ... NATO's actions in the Balkans and its expansion eastward have angered and scared the Russians, who now view the world clearly through realist lenses and do not even pay lip service to the idea of working with the West to build what Gorbachev called "a common European home."<sup>84</sup>

Moreover, Mearsheimer calls Russia and China two great powers with power-projection capabilities, which makes the current international system a non-unipolar one. Mearsheimer believes that great powers are always on the offensive: "great powers will continue looking for opportunities to increase their share of world power, and if a favorable situation arises, they will move to undermine that stable order."<sup>85</sup>

#### *Offensive Realist Explanation for Russian Energy Companies' Presence in CEE*

Related to the topic of this dissertation, offensive realists would have predicted that Russia would try to expand to CEE as soon as its means permit, independently of whether it faces tangible challenges or threats. For the means of this expansion, offensive realism allows for the substitution of military means with economic ones as long as they are not in conflict. This is exactly what happened. By 1992, ex-Soviet Russia left CEE militarily, creating a power vacuum that had not been filled until NATO admitted Poland, Czech Republic and Hungary in 1999 (the decision was made in 1997). During this hiatus there was no credible challenge to Russian security from CEE. Still, Russian energy companies started their expansion into the region as early as 1994 – exactly as offensive realism would predict.

However, offensive realism suggests that economic imperialism is desirable only as long as it furthers military preparedness even in the short term. However, by the early 2000s, when this

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<sup>84</sup> Ibid., 378.

<sup>85</sup> Ibid., 50.

economic expansion reached its peak, its costs have amounted to several billion dollars annually. It would be difficult to argue that these funds could not have been spent on increasing the otherwise sharply declining military preparedness of Russia. For whatever reasons, the Russian leadership decided not to spend this amount on increasing military readiness but rather on financing economic imperialism. This is in sharp contrast to what offensive realism would predict, especially in light of the fact that most of the economic expansion took place in the immediate vicinity of the region's NATO entry (2004 in case of Slovakia, 1999 for the other three countries), which was tangible military challenge.

#### ***II.2.4. Defensive Realism***

Defensive realists assume that security in the international system is plentiful and thus argue that great powers are more secure when they aim to maintain the status quo instead of maximizing their power.<sup>86</sup> In defensive realist theory, rational states can afford only to react to rare external threats. However, even in these cases it is enough to balance against threats, with the exception when offensive military technologies prevail and thus states fear each other. However, rogue states often misunderstand the security-related incentives of the environment and interfere in rational states' proper reaction to systemic incentives.<sup>87</sup>

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<sup>86</sup> Representatives of defensive realist literature are: Robert Jervis, "Cooperation under the Security Dilemma," *World Politics* 30, no. 2 (January 1978): 167-214., Stephen M. Walt, *The Origins of Alliances* (Ithaca: Cornell University Press, 1987), Stephen M. Walt, *Revolution and War* (Ithaca: Cornell University Press, 1996), Snyder, *Myths of Empire*, Stephen Van Evera, "Offense, Defense, and the Causes of War," *International Security* 22, no. 4 (Spring 1998): 5-43., Barry Posen and Charles L. Glaser, "Realists as Optimists: Cooperation as Self-Help," *International Security* 19, no. 3 (Winter 1994/95): 50-90., Barry R. Posen, "The Security Dilemma and Ethnic Conflict," *Survival* 35, no. 1 (Spring 1993): 27-47., Thomas J. Christensen and Jack Snyder, "Chain Gangs and Passed Bucks: Predicting Alliance Patterns in Multipolarity," *International Organization* 44, no. 3 (Spring 1990): 137-168.

<sup>87</sup> Rose, 149-150.



For Brooks, while offensive realists emphasize the possibility of conflict, defensive realists focus on the probability of conflicts.<sup>88</sup> Following from this, defensive realists do not think that it is the worst-case scenario which determines a state's behavior. Also they do not think that short-term security considerations always supercede long-term considerations. According to defensive realists, states make intertemporal trade-offs based on a careful weighing of the probability of conflict. Also military preparedness does not always trump economic capacity if the two conflict, for defensive realists rational policymakers may decide to give up some military preparedness in exchange for net gains in economic capacity in case the gains are "substantial relative to the probability of security losses."<sup>89</sup>

Defensive realists do not subscribe to the neorealist proposition that it is the balance of military capabilities only that affects the likelihood of conflict. They identify three more material factors besides military capabilities which affect the probability of conflict: technology, geography, and international economic pressures.<sup>90</sup> The probability of conflict varies over time based on these factors. If states make their decisions based on assessing the probability of conflict, it follows that security pressures in the international system are not as imminent for defensive realists as they are for offensive realists. Actors always make choices between short-term and long-term objectives.<sup>91</sup> It follows that for defensive realists states not only pursue security but they also pursue power as well. Moreover, for defensive realism the ultimate goal of states is power and not security. Defensive realists hold that a state's productive base is composed of military preparedness as well as economic capabilities, as a result the pursuit of both contributes to long-term power. Even though the pursuit of greater economic capabilities

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<sup>88</sup> Brooks, "Dueling Realisms," 446. Brooks uses the term postclassical realism when he refers to 'neoclassical realism.'

<sup>89</sup> Ibid., 446-447.

<sup>90</sup> Ibid., 456.

<sup>91</sup> Ibid., 458-459.

and military preparedness do not always overlap, and sometimes may even be in conflict with each other, defensive realists argue that there is no hierarchy among goals (as for offensive realists the ultimate goal is security) but rather that the different objectives can be traded with each other as needed.<sup>92</sup> Defensive realists pursue power not for its own sake but to further other interests of the state. In this school, states do not pursue power to dominate others but “states are seen as seeking to enhance their share of economic resources, and hence their power, because it provides the foundation for military capacity, and furthermore because economic resources can themselves be used to influence other international actors.”<sup>93</sup> Conquest is only one means to achieve power, and states have a wide variety of other means at their disposal to increase their power. The defensive realist “conception of international behavior asserts that in situations when the first strategy, conquest, is the most cost-effective means to increase power, states will be prone to use military force in order to enhance their power.”<sup>94</sup> Consequently, where the most cost-effective way to enhance power is not through military conquest but by other means, states will go into that direction.

### *Defensive Realist Theory in Russian/Soviet Foreign Policy Studies*

Jack Snyder called Soviet expansionism a moderate one. He does not believe that Russia was more aggressive in its foreign policy than any other great power.

The Soviets’ moderate expansionism reflects the two-sided character of their strategic beliefs. On the one hand, the Soviet Union was born believing that security required expansion ... On the other hand, the Soviet Union’s early leaders understood that if they exercised restraint in foreign policy, the capitalist

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<sup>92</sup> Gilpin, *War and Change*, 22.

<sup>93</sup> Brooks, “Dueling Realisms,” 462.

<sup>94</sup> *Ibid.*, 462-463.

powers would be more likely to focus their aggression on each other and leave the Soviet state alone.<sup>95</sup>

Snyder believes that periods of expansion were followed by periods of retrenchment by Russia. However, the explanation of what was behind expansion and retrenchment (external or internal factors) is still lacking. “No one ... has tried to test systematically whether variations over time in Soviet grand strategy correlate with variations in the international circumstances the Soviet Union has faced.”<sup>96</sup> Snyder applied realist theory to explaining Soviet foreign policy and especially periods of retrenchment during Khrushchev, Brezhnev and Gorbachev. He found that while moderate periods and the Soviet period after 1945 can be explained as responses to the changes in the international structure, Khrushchev’s and Brezhnev’s foreign policy cannot be so explained. But “cognitive explanations, such as the Bolshevik operational code and cognitive learning models, fare even worse, despite their current popularity.”<sup>97</sup>

Snyder finds that the most plausible explanation can be found when applying the model of economic historian Alexander Gerschenkron of the Soviet Union that its domestic political character as a late industrializer is periodically forced to catch up with countries more advanced economically in big leaps.<sup>98</sup> Although Snyder finds that

domestic structure offers the single best explanation for variations over time in Soviet expansionism, this does not mean that the international system was irrelevant to Soviet behavior. On the contrary, the international system shaped Soviet behavior in several ways. First, the international environment helped to create the structure of the late polity by smashing the old domestic order in World War I and by providing the competitive environment that spurred Stalin’s revolution from above. Second, during periods of relatively unitary politics,

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<sup>95</sup> Snyder, *Myths of Empire*, 212.

<sup>96</sup> Ibid., 215. “An exception is Herrmann, who does this only for the Brezhnev period.” Ibid., fn 9.

<sup>97</sup> Ibid., 252.

<sup>98</sup> Alexander Gerschenkron, *Economic Backwardness in Historical Perspective* (Cambridge, MA: Belknap Press, 1962)

Soviet policy was closely shaped by the incentives of the balance of power system. Finally, even during relatively cartelized periods, international conditions helped make or break strategic ideologies.<sup>99</sup>

Even though Snyder found that it is the domestic political character of the Soviet Union that offers the most plausible explanation for expansion and restraint during Soviet times, the changes in the international structure have had an impact on Soviet decisions because “their effects are filtered through the medium of Soviet coalition politics.”<sup>100</sup>

#### *Defensive Realist Explanation for Russian Energy Companies' Presence in CEE*

With regard to the case of Russian energy companies in Central and Eastern Europe, defensive realists would have a strong argument for the possible motivations behind these actions. As neorealists, they would clearly assume that these companies are tools of the state's designs. However, as opposed to offensive realists they would find it easier to explain the chosen method of expansion. They could argue that independently of whether Russia faces tangible security challenges on its Western borders, weighing the probabilities of these challenges, it may decide that spending on economic expansion therefore enhancing its productive base increases its overall power more than spending on its military preparedness. Acquiring assets in a strategic industry of neighboring countries would certainly advance Russia's relative power vis-à-vis these countries.

As for the timing of the Russian corporate expansion, defensive realism fails to provide a sufficiently strong rationale. For the first steps of this expansion started in 1994 and 1995, when EU and NATO expansions were not foregone conclusions but mere possibilities, in case of the EU quite distant ones. While there existed a clear power vacuum in CEE, there was no significant

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<sup>99</sup> Snyder, *Myths of Empire*, 252-253.

<sup>100</sup> *Ibid.*, 254.

power for Russia to balance against. Therefore, defensive realism cannot account for the first years of the expansion, and it implies that Russian expansion may be more offensive than defensive in its posture.

### ***II.2.5. Neoclassical Realist Theory***

Neoclassical realist theory synthesizes classical realism and neorealism.<sup>101</sup> While neorealism explains systemic outcomes, it does not explain the behavior of states. Neoclassical realist authors insert domestic variables between the systemic factors and the particular state's foreign policy decision. Like Kenneth Waltz, neoclassical realists take the distribution of power in the international system as an independent variable. "A good theory of foreign policy should first ask what effect the international system has on national behavior, because the most powerful *generalizable* characteristic of a state in international relations is its relative position in the international system."<sup>102</sup> Neoclassical realists distinguish between power and foreign policy interests. (As opposed to classical realists for whom power is an end in itself.) For neoclassical realists, power is "the capabilities or resources ... with which states can influence each other."<sup>103</sup> Foreign policy interests of a state are goals which drive a country's external behavior.

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<sup>101</sup> Representatives of neoclassical literature include: Randall L. Schweller, *Deadly Imbalances: Tripolarity and Hitler's Strategy of World Conquest* (NY: Columbia University Press, 1998), Fareed Zakaria, *From Wealth to Power: The Unusual Origins of America's World Role* (Princeton: Princeton University Press, 1998), Thomas J. Christensen, *Useful Adversaries: Grand Strategy, Domestic Mobilization, and Sino-American Conflict, 1947-1958* (Princeton: Princeton University Press, 1996), William C. Wohlforth, *The Elusive Balance: Power and Perceptions during the Cold War* (Ithaca, N.Y.: Cornell University Press, 1993), and to certain extent Aaron L. Friedberg, *The Weary Titan: Britain and the Experience of Relative Decline, 1895-1905* (Princeton: Princeton University Press, 1988)

<sup>102</sup> Fareed Zakaria, "Realism and Domestic Politics: A Review Essay," *International Security* 17, no. 1 (Summer 1992): 197.

<sup>103</sup> Wohlforth, *The Elusive Balance*, 4.

They add domestic perception of the system and domestic incentives as an intervening variable. Their dependent variable is foreign policy decision, which is based on the distribution of power in the international system together with domestic perceptions and incentives.

First, since it is individuals who are making concrete foreign policy choices, it is necessary to incorporate not only the relative power capabilities of states but the perception of leaders about relative power capabilities. "Even if one acknowledges that structures exist and are important, there is still the question of how statesmen grasp their contours from the inside."<sup>104</sup> This also means that states' foreign policy does not necessarily follow the changes in relative power in the short- and medium term since what matters is the statesmen's perception about their country's relative power and then their reaction to it. This factor, however, makes analysis difficult. The link between power and policy is not at all straightforward because "rapid shifts in behavior may be related to perceived shifts in the distribution of power which are not captured by typical measures of capabilities."<sup>105</sup> Fareed Zakaria and Thomas Christensen underscore the significance of perceptual "shocks" which means that a single event makes decision makers conscious of the "cumulative effects of gradual long-term power trends."<sup>106</sup> While neorealism may explain international political outcomes in the long-term, it is not able to do so in the short- or medium-term. Neoclassical realism is much better suited to do so as it incorporates decision makers' perceptions about international events and how they translate into concrete action.

Second, even though the leaders of states may have a clear understanding of the changes in relative power capabilities, they do not necessarily have freedom to direct their states' resources in the necessary direction. As a result, it is necessary to identify the strength and structure of

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<sup>104</sup> Aaron L. Friedberg, *The Weary Titan: Britain and the Experience of Relative Decline, 1895-1905* (Princeton: Princeton University Press, 1988), 8.

<sup>105</sup> Wohlforth, *The Elusive Balance*, 294.

<sup>106</sup> Rose, 160.

states as a domestic intervening variable. It follows directly that states with different domestic structures but similar relative power capability perceptions act differently. “Foreign policy is made not by the nation as a whole but by its government. Consequently, what matters is state power, not national power. State power is that portion of national power the government can extract for its purposes and reflects the ease with which central decision makers can achieve their ends.”<sup>107</sup> Thomas Christensen introduces a different phrase “national political power,” which he defines as “the ability of state leaders to mobilize their nation’s human and material resources behind security policy initiatives.”<sup>108</sup> Consequently, states with similar external shifts in relative power and statesmen who have similar perceptions about the above shifts may react very differently to the changes of the international system based on how much “state power” they can use in their strategies to meet external challenges. Decision makers who can rely on more “state power” are able to react much faster to changes than those who do not possess as much “state power.” For neoclassical realists to explain a state’s foreign policy, perceptions are far from enough because it is equally important to incorporate “state power” which decision makers are able to use for their own purposes.

Neoclassical realist theory argues “that the scope and ambition of a country’s foreign policy is driven first and foremost by its place in the international system and specifically by its relative material power capabilities.” “They argue further, however, that the impact of such power capabilities on foreign policy is indirect and complex, because systemic pressures must be translated through intervening variables at the unit level.”<sup>109</sup> For neoclassical realists the basic parameters of a state’s foreign policy are driven by the relative distribution of material power. However, they do not argue that relative material power automatically translates into foreign

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<sup>107</sup> Cited by Rose, fn. 16. Originally in Zakaria, *From Wealth to Power*, 9.

<sup>108</sup> Thomas J. Christensen, *Useful Adversaries*, 26.

<sup>109</sup> Rose, 146.

policy (as in case of neorealism). Neoclassical realists add two intervening domestic variables – leaders’ perceptions and state power - in their explanation of foreign policy outcomes.

Neoclassical realists differ from classical realists and neorealists in terms of the motivation of states as well. “Instead of assuming that states seek security, neoclassical realists assume that states respond to the uncertainties of international anarchy by seeking to control and shape their external environment.” Moreover, “this school argues, they are likely to want more rather than less external influence, and pursue such influence to the extent that they are able to do so.”<sup>110</sup> Further, Gideon Rose quotes Fareed Zakaria who writes that “states are not resource-maximizers but influence-maximizers.” For Zakaria, states do not expand to acquire more resources (classical realist school) but expand as a consequence of material resources. It means that increased resources, i.e. increased relative power, lead to greater ambitions to expand.<sup>111</sup> Robert Gilpin and William Wohlforth emphasize the significance of international economic pressures which affect the economic opportunity cost of an assertive foreign policy, as well as the question of whether the most cost-effective way to influence another state is through informal economic or military means.

### *Neoclassical Theory in Russian/Soviet Foreign Policy Studies*

For William Wohlforth, the underlying basic course of Russian/Soviet history is “a bias toward expansion. That is, both Imperial Russia and the Soviet Union were biased toward the acquisition and retention of territory, for which they were willing to pay high costs.”<sup>112</sup>

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<sup>110</sup> Ibid., 152. ‘Influence’ is a key concept in the Realist School in general. Influence is “the extent to which capabilities translate into the ability to shape the behavior of others to produce a desired outcome” quoted from Dougherty and Pfaltzgraff, 70. Kindleberger defines influence as “the capacity to affect the decisions of others.” Kindleberger, 56.

<sup>111</sup> Rose, fn. 16. Originally in Zakaria, *From Wealth to Power*

<sup>112</sup> William C. Wohlforth, “The Russian-Soviet Empire: A Test of Neorealism,” *Review of International Studies* 27 (2001): 213.



Wohlforth uses neoclassical realist theory to explain the above phenomenon. “The standard neorealist explanatory model – the imperative of survival in anarchy given the distribution of power – is either indeterminate or predicts a defensive non-expansionary stance on the part of the state. The conclusion follows that costly expansionism can only be explained by reference to domestic politics, ideas, or some combination thereof.”<sup>113</sup> Wohlforth writes that Russia faced substantial security problems (outside international structural factors) throughout its history, which explains its expansionist bias. These were its flat geography in a Hobbesian environment, its relative backwardness compared to its rivals, and its size that induced a twofold deterrence strategy inward and outward.<sup>114</sup>

Wohlforth finds that the adaptive and the expansion models explain Russian and Soviet behaviour over time. The three stages of the adaptive model - perception of a new challenge and forced adaptation; success of adaptation for a generation or more; adaptation loses its competitive edge but because of path dependency there is a substantial lag between recognizing and addressing the problem – explain Russian and Soviet behavior over time.<sup>115</sup> Wohlforth applies the expansion model to the Russian case: 1.) the state adopts an expansionist bias inspired by its leader, 2.) the new territory often turns out to be too costly to conquer, 3.) after the successful conquest, the territory pays off in terms of security and wealth, and 4.) in the long term changing circumstances highlight the costliness of the conquest again.<sup>116</sup>

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<sup>113</sup> Ibid., 214.

<sup>114</sup> Ibid., 216-220. About the role of Russian backwardness in the country's role in great power politics, see Valerie Bunce, “Domestic Reform and International Change: The Gorbachev Reforms in Historical Perspective,” *International Organization* 47, no. 1 (Winter 1993): 107-138. “Russia's pattern of adaptation to relative backwardness chronically exacerbated its relations with the more advanced states of Europe. This was not because Russia was an exceptionally aggressive state compared to the other Great Powers. It was because the distinctive nature of Russia's power, institutions, and ideologies, arising from the pattern of late development, created a situation in which Russia and the West seemed inherently threatening to each other.” Jack Snyder, “Russian Backwardness and the Future of Europe,” *Daedalus* 123 (Spring 1994): 180. For discussions on how to exploit “the advantages of backwardness,” see economic historian Gerschenkron

<sup>115</sup> Wohlforth, “The Russian-Soviet Empire: A Test of Neorealism,” 228.

<sup>116</sup> Ibid., 229.

### *Neoclassical Realist Explanation for Russian Energy Companies' Presence in CEE*

For the issue studied in this dissertation, neoclassical realists would predict that what really matters with regard to Russia's propensity to expand is not so much its objective status in the balance of power but rather the Russian foreign policy leadership's prevailing perceptions about this status and the resources available for the Russian state. More specifically, the balance of power in CEE had experienced one major shift after the Cold War: in 1999, most of the region's countries were admitted to NATO. However, the perceptions of the Russian foreign policy elite changed at a different pace. Moreover, the resources available for the Russian state fluctuated quite widely in this period between the total collapse of 1998 and the quick recovery of the post-2001 period with the steady decline of 1992-1998 being somewhere in between. The interaction of these two intervening variables combined with the change of Russia's objective position in the balance of power determine the timing and the intensity of Russian corporate expansion attempts.

As argued in this dissertation, this prediction is in accordance with what had happened. Russian energy companies' activity in CEE grew when the Russian state became more resourceful and more hostile towards Western institutions, yet was marginal when the state was weaker and/or more open vis-à-vis the West.

In terms of the means of expansion, neoclassical realists would argue that Russia seeks to enhance its power. Based on an assessment of the probability of conflict, Russia made a trade off between short-term military preparedness and long-term economic capabilities, and clearly preferring the latter. Instead of a short-term military build-up, it would enhance its economic power through acquisitions in Central and Eastern Europe. Another explanation could be that in the post-Cold War world the most cost-effective way of gaining influence over Central and Eastern Europe is not by formal military but by informal economic means. For Russia, the best

way to enhance its international influence is to increase its economic rather than its military strength at the moment.

### ***II.2.6. Neoliberal/Institutional Theory***

The major contender to realist theory and its derivatives is neoliberal/institutionalist theory. Its predecessors (functionalist integration theory (1940s and early 1950s), neofunctionalist regional integration theory (1950s and 60s) and interdependence theory (1970s)) argued that international institutions can assist states in cooperating. These theories rejected the realists' assumption that the key actors in the international sphere are states. For functionalists, the key actors in world politics are international agencies, labor unions, political parties, supranational bureaucracies, and for the interdependence theorists multinational corporations and transnational and transgovernmental coalitions. They also questioned whether states were unitary actors. Liberal institutionalists doubted that states are primarily concerned about power and security and that they looked at each other as potential enemies. Most importantly they were very optimistic about the role international institutions can play in promoting cooperation.<sup>117</sup>

The liberal institutionalism of the 1980s – neoliberalism - comes closer to realism in the sense that it accepts several of the propositions of the Realist School.<sup>118</sup> First, it accepts that states are the primary actors in the international arena and that they are unitary-rational agents. Second,

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<sup>117</sup> Joseph M. Grieco, "Anarchy and the Limits of Cooperation: A Realist Critique of the Newest Liberal Institutionalism," *International Organization* 42, no. 3, (Summer 1988): 488-492.

<sup>118</sup> Representatives of the neoliberal institutionalist literature are: Robert O. Keohane and Joseph Nye, *Power and Interdependence* (NY: Longman, 2001), Stephen D. Krasner, *International Regimes* (Ithaca: Cornell University Press, 1983), Robert Axelrod: *The Evolution of Cooperation* (NY: Basic Books, 1984), Charles Lipson, "International Cooperation in Economic and Security Affairs," *World Politics* 37, (October 1984): 1-23., Robert O. Keohane, "Achieving Cooperation Under Anarchy: Strategies and Institutions," *World Politics* 38 (October 1985): 226-254. , Robert O. Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (Princeton, N.J.: Princeton University Press, 1984), Robert O. Keohane and Lisa L. Martin, "The Promise of Institutional Theory," *International Security* 20, no. 1 (Summer 1995), Arthur A. Stein, "Coordination and Collaboration: Regimes in an Anarchic World," *International Organization* 36, no. 2, (Spring 1982): 299-324.

neoliberals adhere to the assumption that anarchy hinders to a great extent states' capacity to cooperate.<sup>119</sup> But it holds that realism overestimates the likelihood and size of conflicts and underestimates the importance international organizations can play. While accepting the propositions of realism, it reinforces the conclusions of the liberal institutionalists. According to neoliberals, states can cooperate with the assistance of international institutions.

Neoliberalism (or neoliberal institutionalism) focuses on the impact of interdependence, interaction, learning, and regimes. The neoliberal institutionalist model of complex interdependence has three other assumptions that are different from those of the realist paradigm. First, societies are connected not only by interstate relations but by transnational and transgovernmental relations as well. Neoliberals place other actors than the state and other relations than inter-state relations at the same level as the former in explaining world politics. Second, there are no hierarchies among issues in international politics. While realists assume that military security has the foremost priority, neoliberal institutionalists do not believe so. Third, in regions of the world where complex interdependence prevails, a military solution to disagreements will not be an option. Governments in this setting resort to other resources in solving their disputes among each other. These regions of the world are the European Union, North-America and Japan.

States make cost-benefit analyses when deciding whether to cooperate with an international regime or not. The basic difference between realists and neoliberals is that, while the former consider cooperation unlikely, the latter hold that cooperation is possible despite the security dilemma. Moreover, neoliberals claim that institutions change the outcome of the cost-benefit

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<sup>119</sup> It is important to note that even though neoliberalism accepts many propositions of realism in the surface, they differ substantially in the details. Realism identifies a wider range of systemic-level constraints for cooperation than neoliberalism does. Neoliberals understand anarchy as „no central agency is available to enforce promises.” As opposed to this realists claims that anarchy means that „no central agency is available to enforce promises or to provide protection.” Joseph M. Grieco, “Anarchy and the Limits of Cooperation,” 503.

analysis by lengthening ‘the shadow of future’. It means that institutionalized arrangements can promote cooperation.<sup>120</sup> It also follows that international regimes are a crucial variable in understanding international politics in the neoliberal institutionalist perspective.

Neoliberal institutionalists analyze the systemic level as well as the sub-system level. They add domestic levels of foreign policy as a variable and claim that the behavior of states cannot be understood by examining purely the system level. Additionally, they emphasize the interactions between the system and domestic levels.

However, neoliberals do not claim that cooperation is easy to achieve. They maintain that even in cases when cooperation would benefit all parties involved, it can be blocked if either of the parties suspects the other of cheating, if they cannot agree on the best cooperative solution, if any of them expects to benefit from the public good regardless of cooperation, or if they are not certain of the other’s preferences and rationality. Neoliberals assume that states are atomistic actors compared with realists who assume that states are positional.<sup>121</sup> As atomistic actors, they are motivated by absolute gains in the neoliberal school, as opposed to relative gains according to the Realists’ understanding, i.e. for Realists one’s gain is the other’s loss. In the former case, the greatest obstacle to cooperation is cheating, which can be overcome by international institutions. By contrast, realists argue that states worry that their partners might gain more from the cooperation than they do.

Neoliberal institutionalists also involve ideas in their analysis because interests and ideas are not phenomenologically distinct, i.e. all interests involve beliefs. They argue that analytically

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<sup>120</sup> Keohane, *After Hegemony*, 67.

<sup>121</sup> Joseph M. Grieco, “Anarchy and the Limits of Cooperation,” 487. Grieco even specifies state positionality further saying that „state positionality may constrain the willingness of states to cooperate.” (499.) As Realists concentrate more on the danger relative gains may advantage their partners, their positionalism is defensive in nature. (500.)

interests and ideas have to be dealt with separately, but they stop short of the constructivist position that interests cannot be evaluated separate from ideas and identities.

### *Neoliberal Explanation for Russian Energy Companies' Presence in CEE*

Thus neoliberals would tend to view Russian energy companies as independent actors or at least actors whose interests and actions are not coordinated with those of the Russian state. They would argue that these companies' specific profit interests have been the major factors behind their expansion into Central and Eastern Europe. As argued in this dissertation, there is every reason to hold that these companies coordinate their actions with the Russian state. Moreover, the Russian state views them as tools of its foreign policy. Neoliberals would also argue that Russia's growing integration into the world economy and the prospect of joining the WTO tames its non-cooperative habits and would motivate it to adhere to the liberal rules of the world economy. However, Russia's urge to acquire energy assets in CEE through Russian companies have been growing in the last five years – a period when its integration into the world economy has been accelerating.

### **II.3. Summary**

Based on a review of the relevant literature, the neoclassical realist paradigm is best suited to explain the object of my analysis, which is to understand Russian energy companies' expansion into Central Europe. Based on neoclassical realist theory, what really matters with regard to Russian energy companies' propensity to expand into Central Europe is the Russian foreign policy leadership's prevailing perceptions about the country's status in the balance of power and the resources available for the Russian state.

### ***II.3.1. Hypotheses***

Based on the review of the Russian foreign policy literature and IR theory, I draw the following hypotheses:

1. When the Russian leadership perceives that Russia's relative influence vis-à-vis the West is low *and* the state has enough power to mobilize the necessary resources, Russian energy companies will try to expand towards Central Europe.
2. When the Russian leadership perceives that Russia's relative influence vis-à-vis the West is consistent with its expectations, Russian energy companies will not manifest any expansionist moves into Central Europe - even if Russia possesses enough state power to mobilize the necessary resources to do so.
3. When Russia does not possess sufficient state power to mobilize the necessary resources, Russian energy companies will not manifest any expansionist moves into Central Europe even when the Russian leadership perceives that Russia's relative influence vis-à-vis the West is low.

### ***II.3.2. Methodology***

In testing the hypotheses, this dissertation applies neoclassical realist theory. As Kenneth Waltz phrased it, "the third image describes the framework of world politics, but without the first and second images there can be no knowledge of the forces that determine policy; the first and second images describe the forces in world politics, but without the third image it is impossible to

assess their importance or predict their results.”<sup>122</sup> Neoclassical realists aim exactly at doing so and explaining foreign political outcomes by combining all three images.

Neoclassical realism “carries with it a distinct methodological preference—for theoretically informed narratives, ideally supplemented by explicit counterfactual analysis, that trace the ways different factors combine to yield particular foreign policies.”<sup>123</sup> These different factors are the objective circumstances of the relative balance-of-power, the leaders’ perception about the former, and the state power which they can mobilize. In neoclassical realist theory, these three factors combined are translated into particular foreign policies. The main characteristics of neoclassical realist theory - shifts in the relative distribution of power in the international system through the perception of decision makers - make the theory’s application rather difficult. “It [neoclassical realist theory] does not simply state that domestic politics matter in foreign policy, but specifies the conditions under which they matter.”<sup>124</sup> This assumes considerable knowledge about the country whose foreign policy is under scrutiny. While neoclassical realists assert that their theory can be applied to any country and political system, they say that “the application of the approach to any given country requires a great deal of knowledge about the nation in question.”<sup>125</sup> This can be done with extensive research relying on primary and secondary sources. “Based on their general assumption that states seek influence, neoclassical realists then examine how decision-makers respond to international power and seek to mobilize resources and support for new policies at home.”<sup>126</sup>

When testing the ability of neoclassical realist theory to explain an important aspect of Russian foreign policy, namely Russian energy companies’ conduct, this research relies on

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<sup>122</sup> Waltz, *Man*, 238.

<sup>123</sup> Rose, 153.

<sup>124</sup> Christensen, *Useful Adversaries*, 167.

<sup>125</sup> *Ibid.*, 248.

<sup>126</sup> Sten Rynning and Stefano Guzzini, “Realism and Foreign Policy Analysis,” Copenhagen Peace Research Institute, December 2001. Accessed July 16, 2006. Available from Ciaonet.



Stephen van Evera's methodological guide and definitions.<sup>127</sup> Van Evera defines theory as "general statements that describe and explain the causes or effects of classes of phenomena. They are composed of causal laws or hypotheses, explanations, and antecedent conditions." (pp. 7-8.) He defines a hypothesis as "a conjectured relationship between two phenomena." (p. 9.). An independent variable (IV) is "a variable framing the causal phenomenon of a causal theory or hypothesis," (p. 10.) dependent variable (DV) is "a variable framing the caused phenomenon of a causal theory or hypothesis." (p. 11.) For van Evera, an intervening variable (IntV) is "a variable framing intervening phenomenon included in a causal theory's explanation. Intervening phenomena are caused by the IV and cause the DV." (p. 11.)

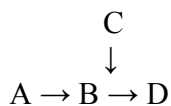
The neoclassical realist theory links independent, intervening, and dependent variables in a direct causal chain. In the neoclassical realist theory, the independent variable is the relative power distribution in the international system, while the dependent variable is the foreign political outcome of a given country. However, van Evera uses the term 'intervening variable' in different sense than neoclassical realist theory does. For van Evera, an intervening variable exists between independent and dependent variables. The independent variable does not directly cause the dependent one but causes the intervening variable which then directly causes the dependent one.

For neorealists the two intervening variables are leaders' perceptions and state power. They argue that the IV, that is the relative distribution of power in the system, translates into foreign policy through the two intervening variables of perceptions and state power. One could argue that the way neorealists use perceptions as an intervening variable corresponds with van Evera's definition. Changes in the relative distribution of power in the system cause changes in the perceptions of leaders, which in turn cause changes in the foreign policies of a given country. But

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<sup>127</sup> Stephen Van Evera, *Guide to Methods for Students of Political Science* (Ithaca: Cornell University Press, 1997)

the second neorealist intervening variable, i.e. state power, is not caused directly by changes in the power distribution in the system, but it behaves more like another independent variable. (Of course, it can be argued that in the long run, state power changes according to changes in the distribution of power in the international system, but this argument disregards other important drivers, i.e. domestic drivers, of state power.) The above relationships can be captured in an arrow diagram as follows: changes in the power distribution in the international system (A), leaders' perception (B), state power (C), Russian energy companies' expansion into Central Europe (D):



Changes in the relative power distribution in the international system cause leaders to change their perceptions. Then leaders' perception together with state power causes changes in the given country's foreign policy (which I examine through the lens of the energy companies' foreign conduct). The arrow diagram also shows that it is not changes in the international system that directly cause changes in a country's foreign policy, but changes in the system that affect the leaders' perceptions, which in turn cause (together with state power) changes in a country's foreign policy.

When testing the neoclassical realist theory, I will use observation as opposed to experimentation by using case-study analysis.<sup>128</sup> “The analyst explores a small number of cases (as few as one) in detail, to see whether events unfold in the manner predicted and (if the subject

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<sup>128</sup> Ibid., 50.

involves human behavior) whether actors speak and act as the theory predicts.”<sup>129</sup> I use the development of Russian energy companies’ expansion towards Central Europe between 1991 and 2004 as one case study. Within this period, I identify five sub-periods of Russian foreign policy, which reflect the current understanding about the landmarks of the development of post-Soviet Russian foreign policy in the literature. The sub-periods are as follows: 1992-1993: Early Atlanticism, 1993-1996: Facing NATO Enlargement, 1996-1998: Against a Unipolar World, 1998-2000: Instability and Uncertainty, and 2000-2004: The First Putin Presidency.

In each of the sub-periods, I first describe the Russian leadership’s perception about Russia’s relative influence vis-à-vis the West, offer an estimate for the size of Russian state power in that sub-period, explore Russian foreign policy towards Central Europe in general, analyze Russian energy companies’ expansion in Poland, Hungary, and Slovakia in depth, and finally evaluate whether these findings are consistent with the neoclassical realist paradigm.

Among the five main purposes Stephen van Evera asserts a case study can serve, this dissertation will serve the purpose of testing a theory, namely whether and to which extent neoclassical realist theory explains an important aspect of the post-Soviet Russian foreign policy vis-à-vis Central Europe.<sup>130</sup> Theory testing case studies can use three different methods: controlled comparison, congruence procedures, and process tracing. While I will use two out of the three, my primary method of testing is congruence procedure type 2: multiple within-case comparisons. When using this method, “the investigator makes a number of paired observations of values on the IV [independent variable] and DV [dependent variable] across a range of circumstances within a case. Then the investigator assesses whether these values co-vary in

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<sup>129</sup> Ibid., 29.

<sup>130</sup> The other four main purposes case studies can serve are: “creating theories, identifying antecedent conditions, testing the importance of these antecedent conditions, and explaining cases of intrinsic importance.” Evera, 55. Theory testing case studies are referred to also as ‘theory confirming’ or ‘theory infirming’ studies. See Arend Lijphart, “Comparative Politics and the Comparative Method,” *American Political Science Review* 65 (September 1971): 692.

accordance with the predictions of the test hypothesis.”<sup>131</sup> This method works best when there are many observations available on both the independent and dependent variables and their values vary greatly within the case. These two criteria – many observations of the variables and varying values - are met in my sub-cases. Relative distribution of power in the international system, perception of Russian leaders and Russian state power vary over time and so does the dependent variable that is the propensity of the Russian companies to expand. It means that to test the primary hypothesis that “when Russian leadership perceives that Russia’s relative influence vis-à-vis the West is low *and* the state has enough power to mobilize decision making of private concerns, Russian energy companies will try to expand towards Central Europe,” it is necessary to ask first whether periodic measures of Russian corporate expansion into CEE occurred at timed intervals between 1991 and 2004. My research shows that there are two intervals when Russian corporate expansion to CEE is measurably higher than in the other three intervals during this period. These two intervals when Russian energy companies pursued a corporate expansion in Central Europe are: 1994-96 and 2000-04. The next question is whether Russian energy companies expanded into CEE when Russia had sufficient state power to be mobilized and its perceived influence in the world vis-à-vis the West was low; and they did not expand when either Russian state power was relatively low or the Russian leadership perceived Russia’s actual influence in the world to be consistent with its expectations. In case congruence is observed between values of the independent and dependent variables on the one hand and values predicted by the hypothesis on the other, then the theory passes. It means that in case it turns out in these observations that Russian corporate expansion into CEE occurs when Russia has enough state power *and* perceives its influence vis-à-vis the West low, the first hypothesis passes the test. If there is no corporate expansion into Central Europe when Russia does not have enough state

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<sup>131</sup> Evera, 62.

power *or* it perceives that its influence vis-à-vis the West is in line with its expectations, then hypotheses 2 and 3 pass the test. A further advantage of the congruence procedure type 2 is that even though it is a within-case study, one can apply large-n analysis if the number of within-case observations reaches a critical point and the values of the variables are quantified.<sup>132</sup> I will assign numeric values to state power and categorize leaders' perceptions in the different sub-periods when analyzing their effect on the Russian state's propensity to expand.

This analysis of Russian corporate expansion also uses the method of process tracing. In this “the investigator explores the chain of events or the decision-making process by which initial case conditions are translated into case outcomes.”<sup>133</sup> As discussed earlier, it is hard to apply neoclassical realist theory because it demands incorporating different structural and domestic variables. It is difficult to prove how the changes in the structure translate into foreign political outcomes through the perception of leaders and state power. Process tracing is valuable for identifying the causal link between the independent and dependent variables. “Evidence that a given stimulus caused a given response can be sought in the sequence and structure of events and / or in the testimony of actors explaining why they acted as they did.”<sup>134</sup> Process tracing will be used to test these hypotheses.

When writing about my cases, I will rely heavily on description. Not only does process tracing assume a detailed analysis of cases, and as explained earlier, the application of neoclassical realist theory requires a thorough knowledge of the cases investigated, but also I am testing the theory in a field not tested before. “Description must often precede explanation or evaluation, however, since phenomena that have not been described cannot be explained or

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<sup>132</sup> Ibid., 63. Observation can be done in two different ways: large-n study and case study. Ibid., 50. In certain circumstances congruence procedure type 2 may be suitable to combine the two, as a result, to rely on the advantages of both.

<sup>133</sup> Ibid., 64.

<sup>134</sup> Ibid., 65.

evaluated. Hence students who seek to explain or evaluate phenomena that others have not fully described must first devote heavy attention to description.”<sup>135</sup> To test neoclassical realist theory, this research traces Russian thinking about CEE, Russian official foreign policy towards this region, as well as Russian energy companies’ activity in Central Europe. The detailed account then gives rise to theory testing, explanation, and evaluation.

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<sup>135</sup> Ibid., 95.

### **CHAPTER III: INTRODUCING THE INDEPENDENT VARIABLES**

Neoclassical realist theory emphasizes domestic variables to explain foreign political outcomes based on the domestic perception of the international system and the level of state power available for Russian leaders. Neoclassical realists say that the distribution of power in the international structure translates into foreign political outcomes through the state leaders' perception and through the amount of state power they are able to mobilize. This chapter introduces the two domestic variables as they are used throughout the case study.

First, this chapter offers a brief overview about how the perception of Russian leaders about the international system and Russia's influence in it changed between 1991 and 2004. This overview is strictly an abstract of a much longer description of Russian leaders' views on Russia's place in the world and changes in the international system which are examined in Chapters IV and V where I deal with the case study. Second, it introduces the other domestic variable, i.e. state power and describes the methodology used to estimate it. Third, it offers a summary to illustrate what neoclassical realist theory would predict regarding my hypotheses based on the two independent variables. The next two chapters, Chapter IV and V examine the case study of Russian companies' expansion towards Central Europe between 1991 and 2004 and examine whether their moves are consistent with predictions of the theory.

### **III.1. Russian Perceptions About Relative Power Distribution**

After the collapse of the Soviet Union, Moscow considered its relationship with the leading power of the West, i.e. the United States, as a partnership of equals. Russia was satisfied with its influence in world affairs (period between 1992-1993). However, the honeymoon with the West proved to be short-lived. Many of Moscow's expectations with regard to its influence were not met. For example, it tried in vain to marshal Western support for its desire to protect Russian minorities in the Baltic countries. More importantly, Russia felt betrayed and cheated because of NATO enlargement. Moscow believed that in exchange for its support of German unification, the West would not expand NATO to include the former satellite states of Central Europe. NATO's expansion into the former Soviet sphere of interest was viewed by Moscow as a zero-sum game: the West gained some influence in Central Europe and at the same time Russia lost influence. Throughout the early 1990s, Moscow aimed to keep Central Europe a demilitarized, neutral zone between Russia and the West. The years of 1994-96 made clear that Russia was not a partner on equal terms with the United States and the West. This was the time when the Russian leadership realized that NATO enlargement would indeed happen and most likely sooner than expected (period between 1994-96). In 1996, Foreign Minister Yevgeny Primakov placed Russia on a different course. Instead of issuing empty threats against NATO enlargement, he sought to balance against the unipolar world order led by the United States, and looked for means to counter the changing balance of power in Central Europe (period between 1996-98).

But Primakov's strategy did not bear much fruit, either, because between 1998 and 2000 Russian leaders viewed their country's influence vis-à-vis the West and especially the United States at the lowest since the end of the Cold War. In 1999, NATO formally admitted three former Soviet satellite countries into its ranks – a shock that provoked a burning realization of Russia's decline among its elite. The feeling of decline was exacerbated by Moscow's inability to



prevent the NATO bombings of Serbia, its long-time friend and ally. Between 1998 and 2000, Moscow felt not only betrayed but also demoralized and humiliated. That's why the next president, Vladimir Putin, built his presidential campaign around the theme of reviving the great power status of Russia. (period between 1998-2000)

Once elected president, Putin set out to fulfill this goal. Russian foreign policy became more assertive, willing to cooperate or clash with the West as its interests dictated. In 2003, an important foreign policy document declared that NATO, a symbolic organization of the West, was a potential enemy of Russia. Putin made no secret of his conviction of making Russia more influential than it was at the moment. He also believed that Russia is much stronger than during the 1990s largely due to the high world oil prices. Moreover, he has been not only open but vocal about the importance that Russian energy companies might play in rearranging the distribution of power in the international system. Putin was open about his intentions to use energy to change the international structure, and the Russian energy companies' intensive expansion into Central Europe after 2000 is a manifestation of Putin's foreign policy (period of 2000-04).

### **III.2. State Power**

State power is the state's ability to mobilize resources potentially available in a country. Weak states are not able to marshal much of their country's resources for the state's purposes, while the opposite is true for strong states. That is to say, a relatively poor country may be a strong state, as long as the state has the means to mobilize (North Korea comes to mind as an extreme example), while even rich countries may be weak states, as the latter may not be able to command much of the country's wealth and resources (Switzerland is a good example). Consequently, state power is not about wealth but the distribution of power within a country.

Financial ratios, i.e., ratios that measure the state's ability to collect revenues, are more applicable as proxies of state power than non-financial ones, because money is more fungible than any other good. That is to say, money's applicability for promoting power is better than that of other sources of state wealth. This is especially true in cases when state power is applied to foreign affairs because in foreign relations the state needs to be more reliant on its material power base than in domestic affairs, where it has many other, non-material sources of power, such as legitimacy.

In terms of financial ratios, the most comprehensive one to measure a state's ability to collect revenues is recurring revenues as percentage of GDP. The numerator of this ratio shows all proceeds that a state collects regularly, that is the amount of revenues it can count on collecting next year, as well. Obviously, there are other sources of revenues, for example privatization income or concession fees, but these are non-recurring items, which obviously cannot be considered bases of stable power. The denominator is the total domestic value added produced. Consequently, the proposed ratio approximates how much money a state is able to capture regularly from all the money made in the country.

As Russia does not use recurring revenues as a category in its national account nomenclature, I try to use an available and relatively reliable proxy instead, namely total tax revenues. Tax revenues are recurring to a large extent and cover most recurring items, i.e. personal income tax, corporate tax, VAT, customs, excise taxes, levies, etc. Moreover, tax revenues as percentage of GDP have been used widely in the post-Soviet Russian studies literature to measure the state's reach in the economy.

In the case of Russia, tax revenues as percentage of GDP have developed, as detailed in Table 1.

**Table 1.**

Year	Federal tax revenues as percentage of GDP, %
1992	20.3
1993	14.5
1994	14.4
1995	14.2
1996	14.6
1997	10.8*
1998	9.2*
1999	12.8*
2000	15.5*
2001	17.6
2002	17.1
2003	19.6
2004	20.4

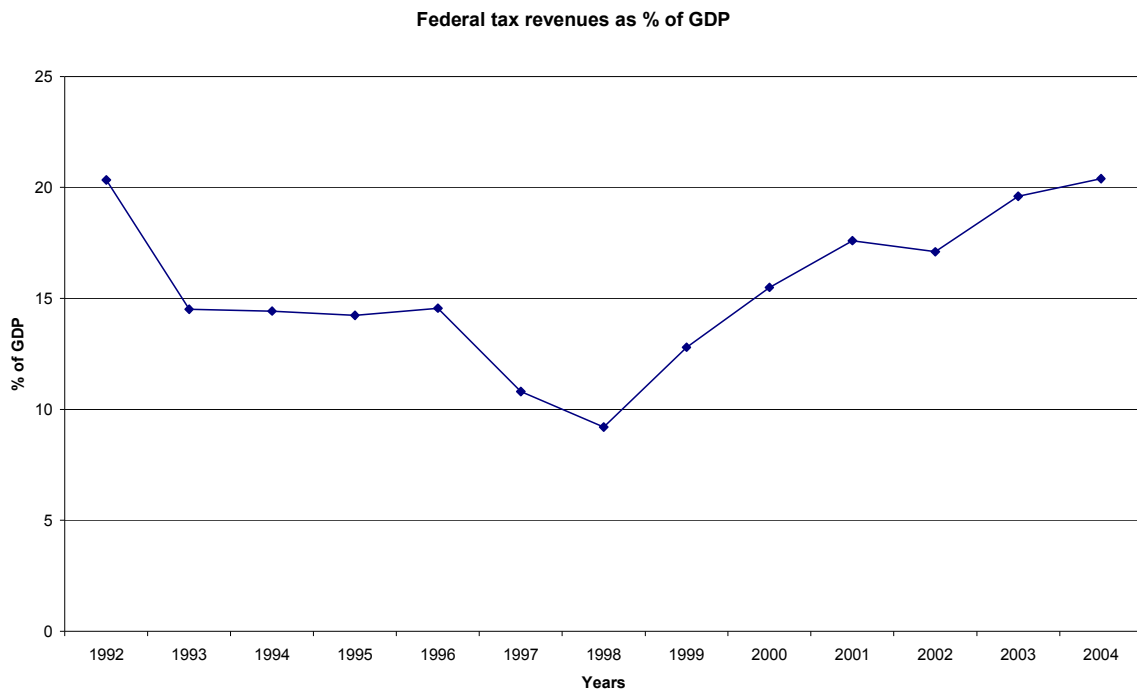
\* Ministry of Economic Development and Trade, Ministry of Finance, Economic Expert Group, Goskomstat

Source: Worldbank

An important note of methodology: data for 1992-1996 and 2001-2004 are from the World Bank. However, the World Bank database does not contain information on the years from 1997-2000. The missing data were collected from the OECD, which in turn used a data from the Ministry of Economic Development and Trade, Ministry of Finance, Economic Expert Group, and Goskomstat (these data are noted with asterisk in the table). While the OECD published no data points for the years before 1997, it does provide corresponding figures for 2001-2002. These data (17.8% and 17.2%, respectively) suggest that the OECD uses almost the same taxonomy as the World Bank, and therefore these data may be used to complement the original series.

As shown in Table 1 and Chart 1 (below), the Russian state's material base declined sharply from 1992 to 1993, had been steady from 1993 to 1996, dropped even lower between 1997 and 1998, started to climb back in 1999 and 2000, and recovered to 1992 levels in 2003-2004 only.

**Chart 1.**



An increasing number of scholars and analysts argue that Russia is in effect a petrostate. Moreover, “one of the prevailing theories behind the decline of the Soviet economy that ultimately led to the collapse of the USSR is that it was precipitated by an oil production decline, combined with both a dramatic drop in world oil prices after record highs in the wake of the 1970s OPEC oil embargo, and by the mismanagement and misuse of oil resources.”<sup>1</sup> According to this view, in good times, the petroleum industry accounts for a very large portion of the country’s GDP, and more importantly, for the bulk of the state’s discretionary income. That is to say, the proceeds from the petroleum industry, i.e. oil and natural gas upstream and downstream activities, determine the Russian state’s room for maneuver in both domestic and foreign policy.

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<sup>1</sup> Fiona Hill, *Energy Empire: Oil, Gas and Russia’s Revival* (London: The Foreign Policy Centre, September 2004), 51.

This would imply that the performance of the petroleum industry should be used as the best proxy for measuring state power in Russia.

There have been many studies conducted to determine the extent to which the recent upswing in oil prices and Russian oil output drove the recovery of the country. While the jury is still out on the precise magnitude of its impact, the only real issue is whether the petroleum industry was the sole or 'only' one of the most important drivers of this change.

There are no officially published statistics in the Russian Federation which would provide a figure for petroleum related state revenues. Most of these revenues are taxes that are proportional to the companies' actual revenues (and not with their profits), i.e. the higher the companies' revenues, the more taxes they pay. The most important taxes are export tariffs, extraction royalty, mineral replacement tax, and extraction tax.<sup>2</sup> Therefore to track the evolution, but not the actual amount, of petroleum related taxes, I have to track the revenue development of the industry. Although actual data is not available for the industry's total revenues, one can estimate how much the industry would have collected if it sold every drop of oil and natural gas at market prices (I will call this 'the theoretical revenue'). While these companies do not use market prices in all of their transactions, in fact, most domestic and some foreign sales take place at subsidized prices, this approach still makes it possible to outline the evolution - the ups and downs - of total revenue. Moreover, the difference between the industry's theoretical revenue and its revenue at actual prices also reflects a source of state power, for this is the amount the state decided to forego in order to promote an interest it holds important, e.g. domestic social stability or influence in a foreign country. In summary, the evolution of the Russian petroleum industry's

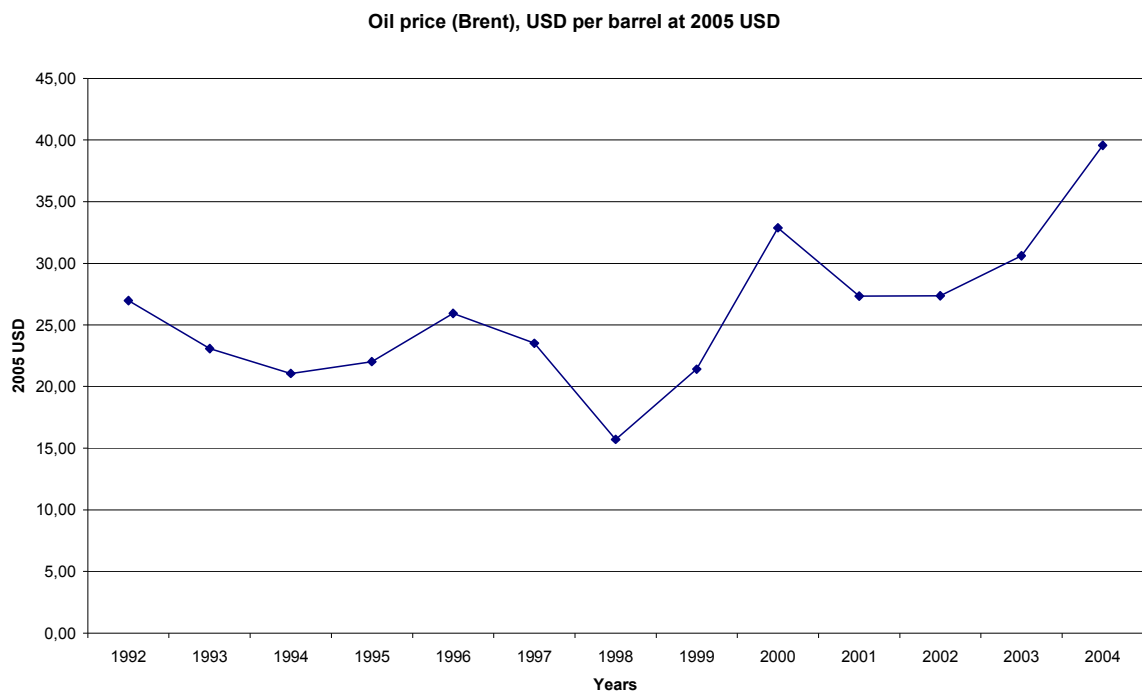
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<sup>2</sup> Gooheon Kwon, *The Budgetary Impact of Oil Prices in Russia*, 2003 (accessed September 30, 2006); Available from <http://www.imf.org/external/country/rus/rr/2003/pdf/080103.pdf>, 8.

theoretical revenue is a good proxy for the evolution, but not the absolute level, of the Russian state's revenues from this industry.

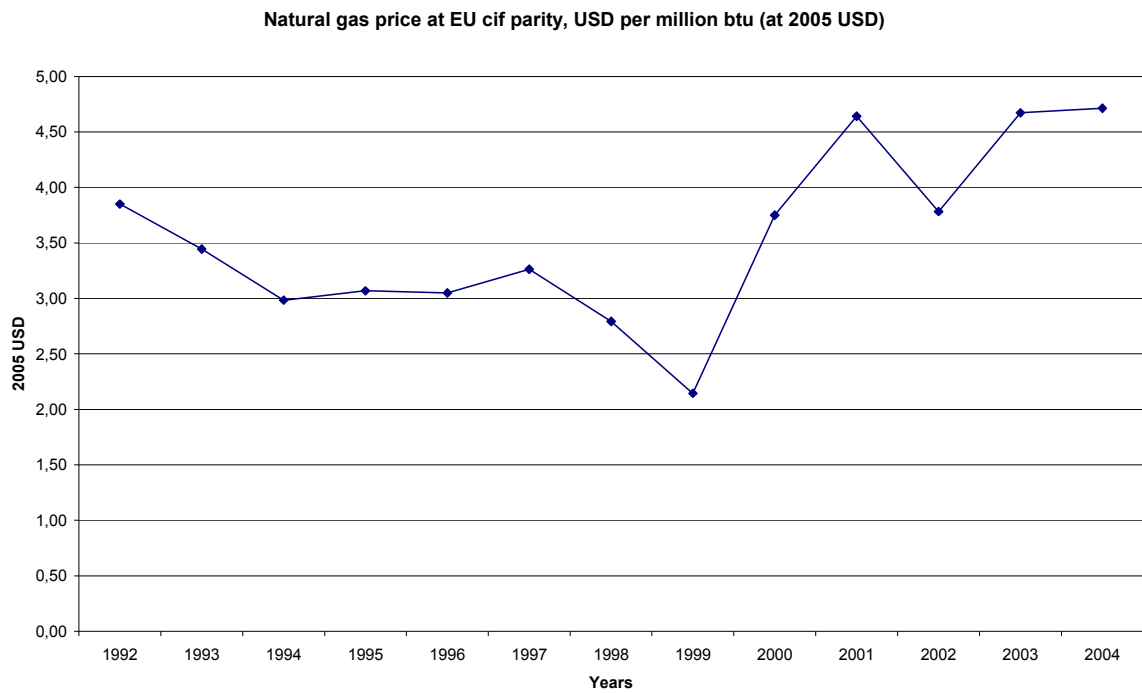
The following charts show the evolution of market prices for Brent crude oil and natural gas (at EU cif parity, as most of the Russian petroleum industry's sales take place in the EU).<sup>3</sup> All of these data and later calculations are converted to 2005 USD to filter out the impact of USD inflation.

**Chart 2.**



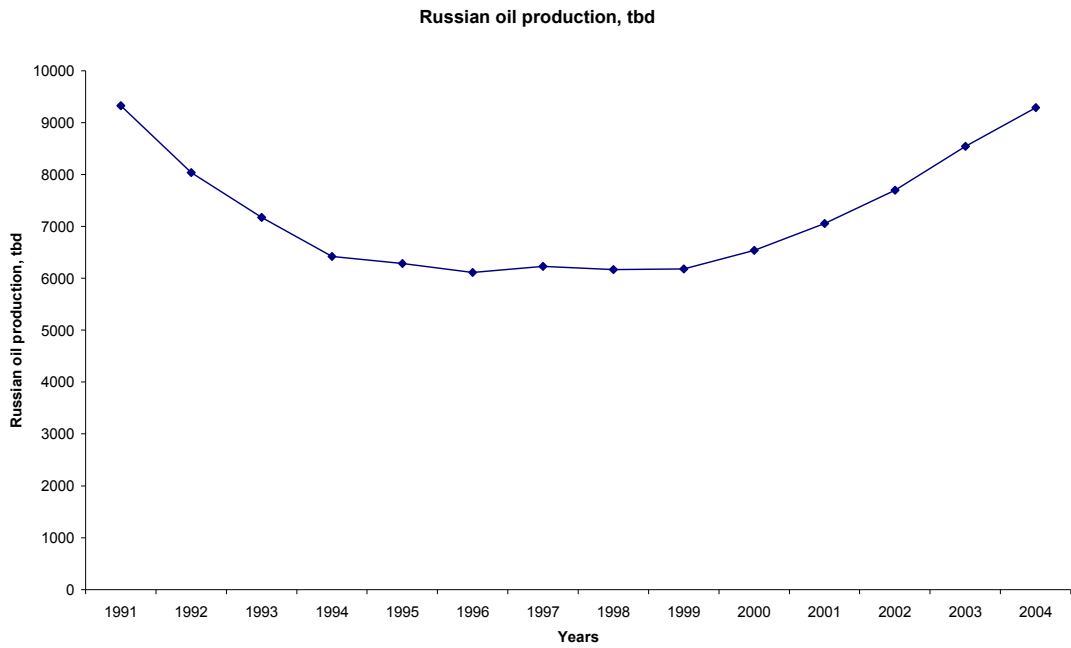
<sup>3</sup> All price and production data are taken from *BP Statistical Review of World Energy 2005* (accessed September 30, 2006); available from [http://www.bp.com/liveassets/bp\\_internet/globalbp/globalbp\\_uk\\_english/publications/energy\\_reviews\\_2005/STAGI/NG/local\\_assets/downloads/pdf/statistical\\_review\\_of\\_world\\_energy\\_full\\_report\\_2005.pdf](http://www.bp.com/liveassets/bp_internet/globalbp/globalbp_uk_english/publications/energy_reviews_2005/STAGI/NG/local_assets/downloads/pdf/statistical_review_of_world_energy_full_report_2005.pdf)

**Chart 3.**



As the above charts show, prices varied widely during the course of examined period, with an abyss in 1998 and 1999, and a spectacular peak in 2004. The other factor determining theoretical revenue is total production, and for its development see Charts 4 and 5.

**Chart 4.**



**Chart 5.**

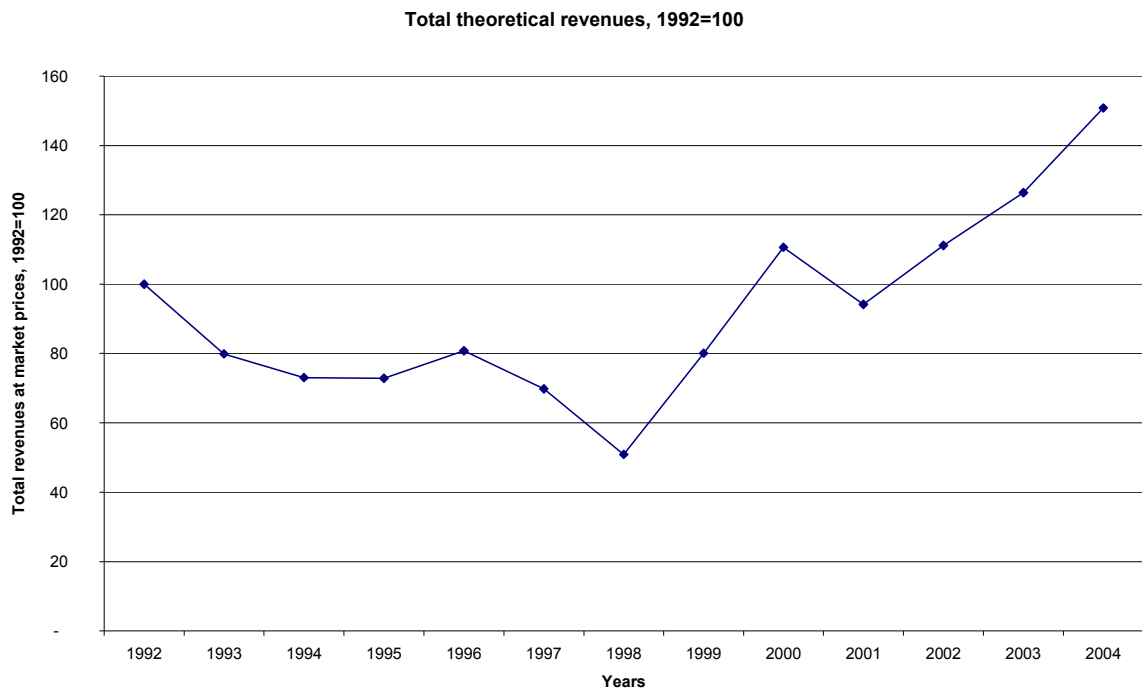




As shown in the above charts, the Russian oil industry experienced a major slump in output in the early to mid 1990s, from which it did not recover until after 2000. However, the same cannot be said of natural gas output, which remained very stable throughout the period.

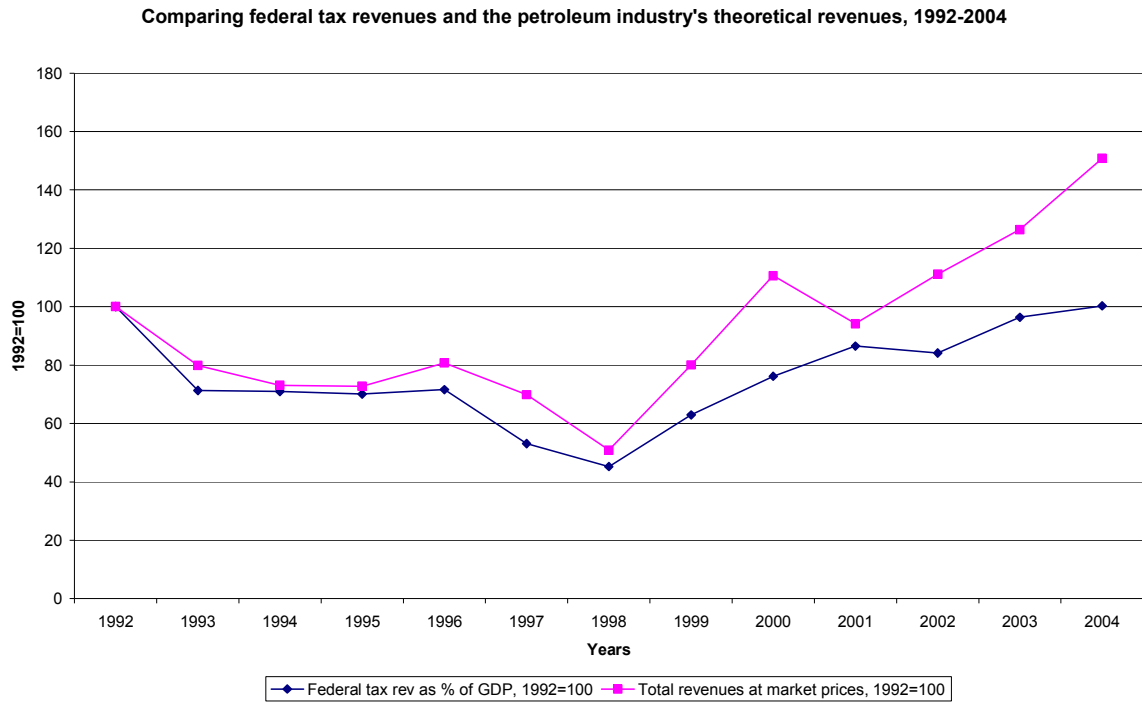
The combined effect of changes in price and production can be seen on Chart 6. This depicts the total development of the theoretical revenue of the Russian petroleum industry, i.e. both oil and natural gas. As discussed, it is not the absolute level of these proceeds, but their changes over time that are of interest. Thus, data is indexed to the 1992 level (1992=100).

**Chart 6.**



As Chart 7 shows below, from 1992, the development of the industry's theoretical revenue has had a strikingly similar pattern to that of the ratio of the Russian state's tax revenues and the country's GDP. In fact, the correlation between the two data series is 87 percent.

**Chart 7.**



Part of the explanation is that most of the revenues that the Russian state collects from the petroleum industry are tax revenues. Moreover, they account for a large part of the total amount of tax collected. The petroleum industry accounted for a quarter of total federal revenues in 1998, and “contributed to half of total revenue gains in the post-crisis period.”<sup>4</sup> This overlap is obviously one of the reasons for the strong co-movement of the two ratios, but hardly the only one. The finding itself is likely to support the notion that Russia has been a petrostate ever since 1992. However, determining the intricacies of the relationship between the two ratios is beyond the scope of this analysis.

While the two ratios depicted in Chart 7 move together very closely, there is a noticeable divergence between 1998 and 2000, and later between 2001 and 2004. In both cases, oil and

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<sup>4</sup> Kwon, 2.

natural gas prices shot up sharply, a growth that state tax revenues did not follow with the same intensity. The difference is especially remarkable between 2001 and 2004. During this period the petroleum industry's theoretical revenues grew by more than 60 percent, while tax revenues increased by only 15 percent. These phenomena point toward the limits of the petroleum industry vis-à-vis an entire economy on the magnitude of Russia's. Even the most spectacular of price growths will not be sufficient to lift the entire Russian economy and state out of its current level of development. Economic and institutional development, the primary movers of state power, take time and a proxy for measuring state power has to reflect this fact. While the theoretical revenues of the petroleum industry provide a good proxy for state power, they seem to exaggerate the ups and downs in it. Thus, this analysis uses the more comprehensive variable, i.e. tax revenue as percentage of GDP to measure state power.

### **III.3. Predictions Based on My Hypotheses**

These hypotheses relate Russian leaders' perceptions about Russian influence in the world and Russian state power (independent variables) to Russian energy companies' expansion in Central Europe (dependent variable). Based on the above described development of the independent variables, these hypotheses predict the following development of the dependent variable (see charts 8 and 9).

**Chart 8.**

Theory's predictions for the propensity of Russian energy companies to expand in Central Europe

		<b>State power</b>		
		<b>High</b>	<b>Medium</b>	<b>Low</b>
<b>Low</b>		Expand	Expand	Don't expand
<b>Russian leadership's perception about Russian influence in the world</b>	<b>Consistent</b>	Don't expand	Don't expand	Don't expand
<b>High</b>		Don't expand	Don't expand	Don't expand

**Chart 9.**

Application of the theory for the studied periods

	<b>Russian leadership's perception about Russian influence in the world</b>	<b>State power</b>	<b>Predictions of the hypotheses on the behavior of Russian energy companies towards Central Europe</b>
<b>1991-1993</b>	Consistent	High	<b>Do not expand</b>
<b>1993-1996</b>	Low	Medium	<b>Do expand</b>
<b>1996-1998</b>	Low	Low	<b>Do not expand</b>
<b>1998-2000</b>	Low	Low	<b>Do not expand</b>
<b>2000-2004</b>	Low	High	<b>Do expand</b>

## **CHAPTER IV: RUSSIAN ENERGY COMPANIES' EXPANSION INTO CENTRAL EUROPE, 1991-2000**

This chapter and the next one discuss Russian energy companies' expansion into Central Europe between 1991 and 2004 by using primarily the within-case congruence procedure type 2 method. The period under examination is split into five sub-periods based on the common understanding in the literature about the turning points in post-Soviet Russian foreign policy. Each sub-period first summarizes Russian views on the country's relative influence vis-à-vis the West, and then provides a numerical proxy for measuring state power. It also offers a summary of Russian views on Central Europe among foreign policy thinkers and the foreign policy-making establishment in the given period. Furthermore, it analyzes Russian diplomatic moves and the expansion of energy companies towards Central Europe. I describe my cases with great detail to make them available for other scholars who may want to apply other IR paradigm on them.

This chapter and the next one show that whenever the Russian leadership perceives that the country's relative influence vis-à-vis the West is low and the state has enough power to mobilize the necessary resources, Russian energy companies will try to expand towards Central Europe. At the same time, when the Russian leadership perceives that Russia's actual international influence is consistent with its expectations or it does not have enough state power to mobilize the necessary resources, Russian energy companies will not manifest any expansionist moves into Central Europe.

### **Pre-Phase: Gorbachev Era and the Collapse of the Soviet Bloc: 1985-1990**

Many characteristics of post-Soviet Russian foreign policy are rooted in the Gorbachev era, which is why it is important to review this period, even though it is not included in the analysis. Starting in 1985, two parallel processes accelerated. One was the rapprochement between the West and the Soviet Union, while the other was the internal ideological and political developments within the Soviet Union. In these years very little time and energy of the Gorbachev-era foreign policy makers was devoted to Central Europe. There were only two specific issues where Moscow kept direct control over its satellites. One affected these countries' relationship with the West, and the other concerned the assignments to key positions in the political establishments of the individual countries. However, these two tools did not prove sufficient to keep full control over the countries of the Eastern Bloc. By 1990-91, the Soviet Bloc collapsed.

When Gorbachev came to power, the so called Brezhnev doctrine had guided the Soviet Union's relationship with its satellites. Leonid Brezhnev had formulated what later became known as the Brezhnev Doctrine at the Fifth Congress of the Polish United Workers' Party in November 1968, after the invasion of Czechoslovakia. As the General Secretary of the communist party of the Soviet Union said, "the sovereignty of each socialist country cannot be opposed to the interests of the world of socialism, of the world revolutionary movement" and "it has got to be emphasized that when a socialist country seems to adopt a "non-affiliated" stand, it retains its national independence, in effect, precisely because of the might of the socialist community, and above all the Soviet Union as a central force, which also includes the might of its armed forces. The weakening of any of the links in the world system of socialism directly affects all the socialist countries, which cannot look indifferently upon this." Basically, in the

Brezhnev Doctrine, the Soviet Union reiterated its intention to suppress, with force if necessary, any attempt that would risk either the communist establishment in their satellites or those countries' loyalty to the Soviet Union. Moscow hardened its grip on Central Eastern Europe after 1968, as reflected in the Brezhnev Doctrine.

A milestone in the Russian attitude towards Central Europe occurred at the XIXth Congress of the Communist Party of the Soviet Union held in June of 1988. Mikhail Gorbachev called "the dangerous practice of our near past" to force a social system, life style, and politics on a country by another one. He particularly objected if this were to happen by military force. Gorbachev's statement marked the end of the Brezhnev Doctrine. Thus, the Soviet Union gave up the last major doctrine which determined its relationship to its satellites. In December 1988, Gorbachev went one step further. He announced "freedom of choice" for the Central and Eastern European countries in their domestic affairs, but he kept insisting on the coordination of questions related to foreign and security policy.<sup>1</sup> However, the internal changes in the Central European countries started a process which could not be stopped.

Before the dissolution of the Warsaw Treaty, the Soviet Union expected to keep a loose allied relationship with its former satellites especially in the military field, and to a lesser extent in economic areas as well. However, after the disintegration of the Warsaw Treaty it became obvious that this goal was untenable. At a minimum, Moscow afterwards aimed to keep Central Europe as a neutral and de-militarized zone between Russia and the West.

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<sup>1</sup> Alexander Duleba, *From Domination to Partnership: The Perspectives of Russian-Central-East European Relations* (Final Report to the NATO Research Fellowship Program, 1996-1998), 25.

At the operative level, the bilateral relations between the Soviet Union and the countries in the region were dominated by the collapse of the Eastern Bloc and thus by the disintegration of its military and economic organizations.

The first to request the withdrawal of Soviet troops was Czechoslovakia. It did so in November 1989, right after the fall of the communist regime. Already in February 1990, the two presidents, Mikhail Gorbachev and Vaclav Havel, signed an agreement about the withdrawal of the majority of the troops from the territory of Czechoslovakia by May 31, 1990. The withdrawal was to be completed by July 1, 1991. Hungary followed with a treaty signed on March 10, 1990, with the same deadline for the complete troop withdrawal as Czechoslovakia. Poland and Russia concluded the same kind of agreement in October 1991. Because of the complications of the withdrawals from East Germany, the deadline set was November 1992 for the majority of the troops, and December 1993 for complete withdrawal.

The two major organizations of the Eastern Bloc, the Warsaw Pact and COMECON, still existed. In the late summer of 1990, Poland, Hungary and Czechoslovakia agreed to coordinate their steps vis-à-vis these organizations. In September of that year, the defense ministers of the above countries met in a Polish town, the first time since 1945 without any Soviet representative present, to discuss how to coordinate their steps. The gathering was followed by a meeting of the foreign ministers of the three countries in Budapest, where they agreed that together they would demand the dissolution of the Warsaw Pact. The intensity of the coordination among these countries is reflected in the fact that their prime ministers met in February 1991 and started to call their forum the Visegrad Group. The Visegrad countries' joint pressure forced the Soviet Union to agree to the dissolution of the military organization in April 1991. The dissolution of the Warsaw Treaty started in July 1991, and in June 1991, the COMECON countries also agreed to dissolve the organization as of September 1991.



## **IV.1. Early Atlanticism: 1991-1993**

### ***IV.1.1. Perceptions and State Power***

This period in Russian foreign policy ran from the end of 1991 until the end of 1993. The chief objective of Russian foreign policy was to build a strong strategic relationship with the leading power of the Western world, the United States. In the minds of key Russian foreign policy decision makers of the period, even though the Soviet Union lost the Cold War, it retreated voluntarily and kept most of its military might intact. This, the argument went, kept them on an equal footing with the United States. The many declarations about the strategic partnership between the two countries and the openly Atlanticist Russian foreign policy manifest this thinking. The emblematic figure of this policy was Foreign Minister Andrei Kozyrev. Until the illusion of equal partnership was maintained, Russian foreign policy viewed Russia's influence in the world in line with its expectations.

As with state power, in the beginning of this period, the Russian economy was very much reminiscent of the Soviet economy of the late 1980s. It was no longer fully controlled centrally, but the state kept much of its leverage over most of the economy. In 1992, the government of Yegor Gaidar introduced mass privatization through a voucher scheme and with it the state's direct control over the economy took a sharp dive. Yet, tax-type federal revenues still accounted for more than 20 percent of the GDP, a level the Russian state was unable to reach again until 2004. By 1993, tax revenues collapsed to 14.5 percent of the GDP. In summary, between 1991 and 1993, state power was arguably the highest of the entire post-Soviet history of Russia.

Predictions based on my hypothesis:

	<b>Russian leadership's perception about Russian influence in the world</b>	<b>State power</b>	<b>Predictions of the hypotheses on the behavior of Russian energy companies towards Central Europe</b>
<b>1991-1993</b>	<b>Consistent</b>	<b>High</b>	<b>Do not expand</b>
<b>1993-1996</b>	Low	Medium	<b>Do expand</b>
<b>1996-1998</b>	Low	Low	<b>Do not expand</b>
<b>1998-2000</b>	Low	Low	<b>Do not expand</b>
<b>2000-2004</b>	Low	High	<b>Do expand</b>

My hypothesis would suggest that when the Russian leadership perceives that Russia's relative influence vis-à-vis the West is consistent with its expectations. Thus, Russian energy companies will not manifest any expansionist moves into Central Europe even if Russia possesses enough state power to mobilize the necessary resources to do so.

#### ***IV.1.2. Classical Foreign Policy towards Central Europe***

##### *Foreign Policy Thinking*

The Kozyrev foreign policy was vehemently attacked from different parts of the legislative as well as executive branches. It was criticized by Russian liberals for its “infantile pro-Americanism” and mostly for not taking Russian national interest into account. During 1992 several attempts were made to revise the Kozyrevian Atlanticist course. Arguably the most

significant attempt was made by the Council on Foreign and Defense Policy in August 1992.<sup>2</sup>

The document written by the Council analyzed Russia's interest in different parts of the world. It mentioned Central Europe but only in the context of this region eventually joining NATO and the European Union. According to the report, this could result in the isolation of Russia, which was not desirable at all. The new element in the document is that it talks about Central Europe in the context of Russia's potential isolation. It does not specify the type of isolation it most fears, but only projects that it could happen in the near future.

At the same time, the report downplayed the consequences of the Central European countries' membership in Western organizations:

Moscow is not at all interested in Central European countries becoming part of larger security political systems, which do not allow an entry for Russia. It is important to recognize at the same time that these countries do not have a significant role in Russian foreign policy. They are aiming towards the West, distancing themselves from Russia in geographic terms, and do not possess resources and technologies that could fully facilitate Russian rebirth. As a result, attempts to place these countries in the first row of the priorities of Russian politics are not realistic.<sup>3</sup>

This statement reinforces the view about Central Europe, which was prevalent during the first period, that the region is not important for Russia, either as a potential source of opportunities or as a source of threat. Even though the document argues that the Central European region should not occupy a key place in Russian foreign political priorities, it still differentiates among the several countries: "As a consequence of their geopolitical situation the most important countries

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<sup>2</sup> The Council was established that summer and this document is its first ever. The Council contains about three dozen influential politicians, experts, and businessmen. The reports of the Council have played an important role in Russian foreign policy thinking and making since its establishment. The studies use a pretty moderate and sober language and their policy recommendations have had their impact on the Russian political elite and foreign policy decision makers. The Council's importance is highlighted by the fact that when NATO's Secretary General paid a visit to Moscow in the Spring of 1996, it met with representatives of the Council and discussed with them NATO-Russia relations.

<sup>3</sup> „Strategiia dlia Rossii,” *Nezavisimaia Gazeta*, August 19, 1992

for Russia from the region are Poland and maybe Bulgaria (and Slovakia may be added).”<sup>4</sup> In summary, the Council viewed Central Europe as a marginal region in terms of Russian interests. In this regard, the document did not differ from the official Russian foreign policy doctrines vis-à-vis Central Europe.

### *Official Doctrine and Strategy*

The Russian foreign policy doctrines of this era hardly mention Central Europe. The major reason is that Russia did not see how its relations with Central Europe could have assisted or hindered its major goal which was the strategic relationship with the United States. Between March 1988, when Gorbachev signaled that the Brezhnev doctrine was over, and the end of 1993, Central Europe pretty much disappeared from Russian foreign policy. Moscow did not have any concise message to deliver to its former satellites. The period of 1991-1993 is characterized by Russia’s gradual withdrawal from Central Europe. The new Russian foreign policy thinking was illustrated at a conference entitled “The Transformed Russia in the New World” organized in Moscow in February 1992. Foreign Minister Andrei Kozyrev highlighted the basic pillars of the new Russian foreign policy and listed Russia’s interests in the different regions of the world, but he did not mention Central Europe in his talk.<sup>5</sup> The neglect of Central Europe by Kozyrev remains characteristic throughout the first era.

The foreign policy doctrine that was formulated in the Spring of 1992 was accepted by the Russian government in December of that year. It did not have anything substantial to say about Russian priorities towards these countries. It assigned to Russian diplomacy only one goal regarding the region, namely “our strategic task in the current situation is – to prevent Eastern

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<sup>4</sup> Ibid.

<sup>5</sup> Zoltan Sz. Biro, “Oroszország és a kelet-közép-európai térség,” in *Kelet-Közép-Európa az ezredfordulón* (Budapest: Hungarian Atlantic Council, 1999), 89-139.

Europe from transforming into a buffer zone which would isolate us from the West.”<sup>6</sup> This general statement was not supported with any action plan. These two years of Russian foreign policy thinking were characterized by optimism towards the future and the Russian-US strategic relationship.

There are several further reasons behind Russia’s neglect. First, the Central European countries were relatively poor compared to Western Europe, were outside of the existing Western structures, and thus they could not help Russia in its strategic objectives to integrate it into the world economy and the political organizations which would have guaranteed Russia the great power status it sought. Second, Moscow did not push for a more active presence in Central Europe because it could have been misinterpreted by the countries in the region and most importantly by the Western powers, whose favor it wanted to gain. Such a push could have been viewed as an attempt to revise the previous decision to give up the Brezhnev doctrine.<sup>7</sup> Third, there was certainly a lack of expert resources in Russia. Most of the energy and time of the government was committed to developing relations with the West, especially the United States, and only scarce resources remained to build relations with the former satellites.

The criticism directed at Kozyrev’s foreign policy and its obvious failures was gradually taken into account. Toward the second half of this period Russian foreign policy experienced a shift from unconditional Atlanticism. The first signs of this shift became visible in 1992, but it was only the Foreign Policy Concept of April 1993, later referred to as the Kozyrev doctrine, that officially incorporated the criticism and dealt with its consequences. The document, which was approved by President Yeltsin, was the first official statement in the post-Soviet period that talked about Russian interests and said that Russian and Western interests could potentially differ

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<sup>6</sup> “Principi vnesnei politiki Rossiiskoi Federatsii,” in *Vneshniaia politika i bezopasnost sovremennoi Rossii* (Moscow, 1999), 33.

<sup>7</sup> Biro, 107.

in general and in Central and Eastern Europe in particular. The document implied a policy focused on the relationship with the post-Soviet CIS countries. The Foreign Policy Concept of April 1993 marked the end of the first post-Soviet era in Russian foreign policy thinking and projected the basic characteristics of the second era.<sup>8</sup> The message of the Kozyrev doctrine towards Central Europe was that Russia must avoid international isolation, which it can do only by approaching the Western security structures and the Central European countries at the same time. Any preference for these countries should be avoided. Russia's interest was in creating an all-European security system, to which NATO would be subordinated, and to becoming an integral part of any security system in Europe.<sup>9</sup>

#### *Bilateral Diplomatic Relations*

The bilateral diplomatic relations between Russia and the Central European countries in the first two post-Soviet years reflected foreign policy thinking and official doctrines. The mutual relationship was kept on the back burner since the region did not play any major role in Russian foreign policy. For the reasons discussed above, the bilateral relations were restricted to technical matters, which can be divided into two categories. The first included the type of treaties that intended to close the Soviet past. Among them were the agreements on the withdrawal of Soviet troops and the repayment of the Soviet-era debt. Poland, Hungary and Czechoslovakia signed their agreements on the Soviet troop withdrawals between 1989 and 1991. The operation was completed by 1993 in all of the Central European countries. The withdrawal of the troops went smoothly, peacefully, and relatively fast, especially if one takes into consideration the fact that many Russian troops are still stationing in CIS countries. Agreements on the repayment of the

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<sup>8</sup> Duleba, 15-16.

<sup>9</sup> Yutaka Akino and Adam Smith Albion, *Russia-Ukraine-Visegrad Four: The Kozyrev Doctrine in Action* (New York: Institute for East-West Studies New York/European Studies Center Prague, 1993)

Soviet-era debt were concluded smoothly, as well. However, the same can not be said about the implementation of these agreements, which has dragged on ever since.

Russia also intended to place its relationship with the Central European countries on a new basis. It signed bilateral treaties with the Visegrad Four (Poland, Hungary, Slovakia and the Czech Republic) that intended to create a new framework for the bilateral relations with these countries. The parties dissociated themselves from the Soviet past and expressed their interest in developing mutually advantageous relations. All the treaties followed almost the same pattern. First, Russia did not want anything specific from any of the signatories; its only goal was to demonstrate towards the West that it is a normal country that aspires to build normal relations with its formal satellites. Second, as it had been discussed before, the Visegrad countries agreed to coordinate their policies towards the Soviet Union. Gorbachev was heavily criticized in the Soviet Union for agreeing to the dissolution of the Warsaw Treaty. Because negotiations on the bilateral treaties were going on at the time of the dissolution of the Warsaw Treaty Organization, Moscow changed tactics. It started to apply the Kvitsinsky doctrine, and aimed at limiting the Central European countries' room of maneuver in the security field bilaterally.<sup>10</sup> Moscow aimed at placing a so-called "security clause" in each of the new bilateral treaties with the Central European countries. This clause would have prohibited either of the signatories from joining any security organization that the other considers to be against its interests.

However, due to coordination among the Visegrad countries, Russian diplomats failed to include this "security clause" in the bilateral treaties. Finally, the Hungarian-Russian basic treaty was signed in December 1991, the Polish-Russian treaty in January 1992, the one with the Czechoslovak Federation in April 1992.

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<sup>10</sup> Yuliy Kvitsinsky was the Deputy Foreign Minister for Foreign Affairs of the Soviet Union between 1990 and 1991. He headed the delegations in charge of negotiating the bilateral treaties with the former satellites. Regarding security issues, the main goal of the Soviet Union was to include the "security clause" in the bilateral treaties.

It is worthwhile to take a closer look at the Hungarian-Russian relations during this period. In the midst of the coup attempt in August 1991, Hungarian Prime Minister Joseph Antall was the second foreigner to call President Yeltsin to offer the Russian president his support. Yeltsin was most grateful for Antall's call and afterwards placed a special emphasis on the development of Hungarian-Russian relations.<sup>11</sup> A major step was taken in the bilateral relationship by President Yeltsin's visit to Budapest in November 1992. He arrived with two Hungarian paintings which had been taken away by the Soviet troops in 1945 and these two artifacts were not the most valuable ones taken from Hungary. Still, the Russian president's gesture was symbolic and it was a good basis for a renewed bilateral relationship. There were altogether seven agreements signed during this visit, ranging from cooperation on the issue of minorities to cultural cooperation. Owing to Yeltsin's desire to place a special emphasis on Russian-Hungarian relations, the two sides managed to agree in "the zero solution" regarding the financial dispute around the Soviet troop withdrawal. Originally, Moscow had wanted compensation for the buildings it left behind in Hungary, which the Soviet Union claimed were Soviet investments. However, according to Hungarian opinion, it would cost Hungary at least as much to repair the ecological and other damages incurred by the Soviet forces. The dispute became so intense that General Burlakov, who was commanding the Soviet troop withdrawal from Hungary, even threatened to slow down or even stop the pull-out.<sup>12</sup> It was Yeltsin who came up with the zero solution in November 1992, according to which neither of the two sides would owe anything to the other. A further achievement of Yeltsin's trip was his consent to set up a Committee for Restitution to examine the fate of the art treasures which were taken from Hungary during WWII. Another important result of the November 1992 meeting was the speech President Yeltsin gave in the Hungarian

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<sup>11</sup> "A jovo fontosabb vagy a mult?" *Nepszabadsag*, December 6, 2001

<sup>12</sup> Laszlo Poti, *From Subordination to Partnership: Hungarian-Russian Relations, 1990-1997* Foreign Policy Papers no. 7 (Budapest: Hungarian Institute of International Affairs, 1997)



parliament, in which he condemned the Soviet invasion of 1956. He said that “ten years after the liberation of Hungary by the Soviet army from fascism one dictatorship was followed by another...we bow to the memory of the victims of 1956.”<sup>13</sup>

The Hungarian-Russian basic treaty, which was signed in December 1991, was first submitted for ratification to the Russian Duma in January 1993; however, the process stalled due to procedural reasons. When the basic treaty was signed, Prime Minister Antall wanted to place a paragraph in the preamble of the treaty renouncing the Soviet invasion of Hungary in 1956. While Mikhail Gorbachev did not like the idea, Yeltsin approved it. They agreed that the two foreign ministers would exchange letters in this regard and the correspondence would be attached to the bilateral treaty. Apparently in January 1993, the letters of the foreign ministers were not enclosed in the material submitted to the Duma.<sup>14</sup> However, according to Hungarian-Russian relations expert Laszlo Poti, the real reason for the prolonged process and less than full text was not related to the specifics of the issue but was an indirect expression of discontent with Kozyrev. Considerations that Russia should not be held accountable for deeds of the Soviet Union prevailed. Russia was afraid that such an apology would be a precedent for others as well, but finally, Russia ratified the Hungarian-Russian basic treaty in early 1995.

A new situation arose when Czechoslovakia broke up on January 1, 1993. Russia signed new bilateral treaties with the two successor states in August 1993. However, the official Russian foreign policy differed in August 1993 from that of more than a year before, when the original bilateral treaty had been signed with then Czechoslovakia; it was more concerned with Russia's perceived interests. Slovakia did not coordinate its steps with the Czech Republic, and the two countries signed two different treaties with Russia. The Russian-Slovak treaty says that the

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<sup>13</sup> *Nepszabadsag*, November 12, 1992

<sup>14</sup> Poti

“signatories to this treaty hereby confirm that the security of Europe...is connected with CSCE [Conference on Security and Cooperation in Europe]” and they shall “assist in the creation of an unified all-European space in all of its dimensions.” According to several commentaries, the treaty could be interpreted as excluding for Slovakia the option to join NATO and placing its security under the umbrella of CSCE instead. The Czechs managed to avoid any text that could have eventually forced them into ambiguous interpretations of the treaty. The Slovak-Russian treaty was the first diplomatic success of the new Russian foreign policy in Central Europe. From a Central European perspective, Slovakia became known as the weak link among the Visegrad Four. Even though the treaty did not prevent Slovakia from joining NATO, Slovakia remained the weakest country in the region when it came to standing up to Russian pressure.<sup>15</sup>

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<sup>15</sup> Duleba, 47.

#### ***IV.1.3. Russian Energy Companies' Conduct in the Region***

For this period of less than two years, I was not able to trace any expansionary moves from any Russian energy company in Central Europe whatsoever. In all the other sub-periods there are reports, testimonials, or company records about some attempts or actual steps, but not in this one. Between 1991 and 1993, no Russian energy company attempted to invest or laid the groundwork for any such moves in Central Europe, even though Russian state power to mobilize the necessary resources was arguably among the highest in the history of post-Soviet Russia between 1991 and 2004.

#### ***IV.1.4. Summary***

Between 1991 and 1993, the perception of Russian foreign policy decision makers was dominated by the vision of equal partnership between Russia and the United States, which they viewed such a partnership as consistent with their expectations. At the same time, state power in Russia remained relatively high, mainly as a remnant of the old command economy. Under such circumstances, my hypothesis is that Russian energy companies would not expand into Central Europe.

As discussed in this chapter, Central Europe almost disappeared from the map from the perspective of Russian foreign policy decision makers, which dealt with Central Europe through the lenses of Russia's relations with the United States. They wanted to close their Soviet past in these countries to demonstrate for Washington the emergence of a new Russia.

The region received more serious consideration only from thinkers and politicians critical of the mainstream foreign policy, i.e. people who questioned that Russia's actual influence through the so-called strategic partnership with the United States was in fact consistent with what Russia should expect. These people argued that the interests of Russia and those of the Western powers

are very likely to collide with regard to Central Europe. These people were to have their turn in Russian foreign policy making in the next period under study.

The mainstream foreign policy of 1991-1993 was satisfied with Russia's influence in world affairs. While Russian federal tax revenues were the highest of the first decade of post-Soviet Russian history during these two years to enable the Russian leaders to mobilize the necessary resources, no traces were found of Russian energy companies manifesting any meaningful effort to expand into Central Europe in this period. As a result, my findings coincide with the predictions of the hypothesis, namely while Russia has enough state power to mobilize the necessary resources, the Russian leadership perceives its relative influence in the world to be consistent with its expectations, and thus Russian energy companies did not move into Central Europe.

## **IV.2. Facing NATO Enlargement: 1993-1996**

### ***IV.2.1. Perceptions and State Power***

The second period of post-Soviet Russian foreign policy making lasted from the second half of 1993 to 1996. Because Russian expectations about maintaining the country's influence through a strategic partnership with the United States, the so-called Atlanticist course, were not fulfilled, a new approach was introduced. As Russia viewed that its relative influence in the world vis-à-vis the United States is low, Moscow started a more assertive foreign policy which was increasingly suspicious of Western intentions and institutions. The West's growing openness to the idea of enlarging NATO to include former Soviet satellites was a key thorn in Russia's eyes. As discussed earlier, from the very beginning of the post-Soviet period, Russian foreign policy strategists had been afraid to be isolated from the West by a new 'cordon sanitaire' of Central and Eastern European countries allied to the West. Russian foreign policy first aimed at outmaneuvering NATO by effectively trying to replace it with CSCE, and later on with OSCE as the institution providing the basic structures of the European security framework. Russian diplomacy invested much energy and effort into promoting CSCE/OSCE, but the initiative failed to deliver the expected results as the specter of NATO enlargement became more tangible.

In 1994, the First Chechen War broke out and started to highlight the limitations of Russian influence in and vis-à-vis the West. Despite Russia's insistence that the war was an internal matter, the conflict became a central topic of Russian-Western relations, and Russia could not end up looking good or even defensible in this situation.

As these two issues, the slow but steady increase of the likelihood of NATO enlargement and Russia's inability to convince practically anybody in the West to put a good face on its handling

of the Chechen War, served as external shocks shaping Russian perceptions about their country's low influence in world affairs.

State power measured as tax-type revenues as percentage of GDP stagnated at levels considerably lower than in the previous period, but are still relatively high compared to what was in the following 3-5 years. Tax-type federal revenues accounted to just above 14 percent of the GDP between 1994-1996 (See Table 1 in Chapter III), which is lower than during 1991-1993 but higher than in the next three and half years (from the re-election of Yeltsin in mid-1996 until the end of his presidency in December 1999). As a result, state power during this period is at the medium level.

Predictions based on my hypothesis:

	<b>Russian leadership's perception about Russian influence in the world</b>	<b>State power</b>	<b>Predictions of the hypotheses on the behavior of Russian energy companies towards Central Europe</b>
<b>1991-1993</b>	Consistent	High	<b>Do not expand</b>
<b>1993-1996</b>	<b>Low</b>	<b>Medium</b>	<b>Do expand</b>
<b>1996-1998</b>	Low	Low	<b>Do not expand</b>
<b>1998-2000</b>	Low	Low	<b>Do not expand</b>
<b>2000-2004</b>	Low	High	<b>Do expand</b>

According to this hypothesis, when the Russian leadership perceives that Russia's relative influence vis-à-vis the West is low and the state has enough power to mobilize the necessary resources, Russian energy companies will try to expand toward Central Europe.

#### ***IV.2.2. Classical Foreign Policy towards Central Europe***

##### *Foreign Policy Thinking*

In 1993, Central Europe jumped from nearly complete neglect to the forefront of Russian foreign policy thinking. According to Russian Central Europe expert, Irina Kobrinskaia, the change in Russian attitude towards the region occurred in the second half of 1993 when President Yeltsin sent a letter to Western countries about Russia opposing NATO enlargement. Russia did not start dealing with the Central European countries because it thought they were worth its attention but because it wanted to prevent them from joining NATO.<sup>16</sup> Even though on the surface the debate over NATO enlargement was about Central Europe, in reality it was much more about Russian-Western relations, Russia's place in the world, and its perceived influence in world affairs. Even during this period, Central Europe did not become a subject of Russian foreign policy, but only an object of it. Throughout the process of the first round of post-Cold War NATO enlargement, Moscow negotiated only with Western capitals. Russian foreign policy thinkers realized that Central Europe is not inclined to ally itself with Russia, and that Russia is not strong enough to coerce them to do so. Therefore, Russia's stated objective was to keep these countries neutral and free of "excessive" Western influence. In the Russian mind, NATO

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<sup>16</sup> Irina Kobrinskaia, "Rossiia – Tsentralnaia Evropa – NATO," in *Rossiia: novye parametry bezopastnosti* (Moscow: Carnegie Moscow Center, 1995), 8-40.

enlargement was not so much about Central Europe, but more about a visible change of power relations between the West and Russia in favor of the former.

Even before NATO enlargement became a major issue, a few scholars already had pointed out the significance Central Europe might play in Russian foreign policy. Alexander Zagorski pointed to the fact that Russia's major infrastructure and economic potential is in the European region. He argued that the Russian economy cannot ignore this reality and should develop its ties with Europe much more intensively. The geographical road to Europe goes through Central Europe, which is essential as a transit area from the Russian point of view.<sup>17</sup> Zagorski's thesis implicitly includes the fear of isolation from Western Europe, but he goes one step further to emphasize the positive potential of the region.

Irina Kobrinskaia took this analysis a step further. Besides emphasizing the region's role as a transit area, she also recommended that Russia cultivate more intense economic ties with Central Europe. She wrote that since these countries made bigger progress in implementing Western standards in their economies, stronger Russian-Central European ties would be useful for Russia in reaching similar objectives.<sup>18</sup> These "Europe-oriented" Russian Westernizers were the first ones to point out the importance of Central Europe for Russia.<sup>19</sup>

Central Europe as an important transit zone was a dominant theme in the discussions of the Russian realists. Alexander Bykov emphasized that the existing economic structures (e.g., transit lines, trade relations with Russia) made Central Europe's early attempts to turn its back on Russia untenable. Additionally, Western Europe was not prepared to fully open its markets to these countries. Bykov said that the double-corridor of countries on the Western border of Russia (one being the Visegrad four plus the Baltic countries, and the other the Western CIS countries of

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<sup>17</sup> Alexander Zagorski, "Rossiia i Evropa," *Mezhdunarodnaia zhizn'*, no. 1, 1993, 47-56.

<sup>18</sup> Irina Kobrinskaia, "Russia's Home and Foreign Policies," *International Affairs* (Moscow), October 1993, 46.

<sup>19</sup> Duleba, 18-20.



Belarus, Ukraine and Moldova) have the potential to become a bridge or a buffer zone between Russia and the West. In Bykov's opinion, they have to become the former.<sup>20</sup> Vladimir Razuvaiev went even further to talk about the necessity to gain control over the transit infrastructure between Russia and its European markets.<sup>21</sup> This was the first time that the idea of control over the transit infrastructure west of Russia appeared in Russian foreign political discussions. The realists grasped fully the importance of Central Europe as a transit area in the economic sense, and they thought that Russia must prevent the region from becoming a buffer zone and seek to exploit its transit potentials.

Regarding NATO enlargement, the prevalent view among realist thinkers was that from the Russian point of view the most attractive solution would be for Central Europe to stay neutral. "It is desirable, of course, that East and Central Europe remains, in the military-political sense, a "gray zone", a kind of geopolitical amortizer just in case of an unforeseeable development of situation in the space between Russia and Western Europe," said a study prepared by the Russian Institute of National Security and Strategic Studies.<sup>22</sup> To translate this usual Russian geopolitical jargon: Central Europe should be prevented from joining NATO.

It was the influential Council on Foreign and Defense Policy which went further than simply rejecting NATO membership for the Central Europeans. In its report "Strategy for Russia 2" issued in May 1994, the Council agreed with previous assessments that NATO's eastern expansion is not at all in Russia's interest. It recommended that the West should offer the Central European countries the option of joining the European Union instead of NATO. (Again, the report did not recommend approaching the Central European countries directly, but bargaining

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<sup>20</sup> Alexander Bykov, "Na prekriostke mirovogo razvitiia," *Mezhdunarodnaia zhizn'*, no. 2, 1993, 96-104. Cited by Duleba, 8.

<sup>21</sup> Vladimir Razuvaiev, "Russia and the Post-Soviet Geopolitical Area," *International Affairs* (Moscow), August 1993, 109-116.

<sup>22</sup> *Evolutsiia struktur voennoi bezopasnosti: rol i mesto Rossii*, Institute of National Security and Strategic Studies, (Moscow, 1997)

about their fate with the West.) It argued that EU-membership would satisfy the Central European desire to be integrated into the Western structures.<sup>23</sup> The Council's report was in line with other foreign political discussions regarding Russia's military isolation. It categorically rejected NATO enlargement, but its alternative recommendation was unrealistic. It is not within Russia's competency to decide about the admission of the above countries into the EU, therefore it cannot offer EU-membership. The most Moscow can do is not to object to such expansion. The document did not consider the possibility that Central Europe might be important for Russia from an economic point of view. The authors of the report must have been aware that accession to the EU was only a long-term prospect for the region. The idea of promoting European Union enlargement instead of NATO enlargement was endorsed by official Russian foreign policy as well.

The Council issued another report on the particular topic of Russia and NATO in May 1995. The document acknowledged the reality and unavoidability of enlargement, but emphasized the difficulties the North Atlantic Treaty Organization would encounter while executing it. The document also highlighted the arguments for an enlargement, and concluded by recommending that Moscow reinforce the counter-arguments and emphasize the negative consequences of the process.<sup>24</sup>

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<sup>23</sup> "Strategiia dlia Rossii 2," *Nezavisimaia Gazeta*, May 27, 1994

<sup>24</sup> "Rossiia i NATO" in *Strategiia dlia Rossii: 10 let SVOP* (Moscow: SVOP, 2002), 125-135.

### *Official Doctrine and Strategy*

On the one hand, official foreign policy making was ahead of foreign policy thinking and on the other it was behind. During this period, official Russian foreign policy was mainly preoccupied with the question of NATO enlargement. Moreover, it was not only preoccupied with but obsessed by the question of NATO. This obsession prevailed in every discussion about Central Europe from the second half of 1993 to 1996/1997.

The question of NATO came to the forefront in August 1993 when during his visit to Warsaw, President Yeltsin said that he understood Polish motivations to join NATO. The statement was not a slip of the tongue on Yeltsin's part. The Russian president meant it so strongly that it made its way into the official Polish-Russian joint declaration at the end of the summit. However, three weeks later Russia sent a letter to Washington and some Western capitals in which it retracted the Warsaw statement. In the letter, Yeltsin expressed his disagreement with NATO's enlargement, for two reasons. First, it would be extremely difficult for the Kremlin to communicate such a decision to the Russian public. It would generate negative reactions among the Russians and would eventually alienate the public from the current foreign political course. Second, Yeltsin emphasized that Moscow would be interested in good relations between the military organization and Russia; moreover, it would like to see closer relations between Moscow and Brussels than between Central Europe and the latter. However, it is not interested in the Central European countries becoming members of NATO, because it would mean that Moscow cannot consider the countries of the region either Russia's security area or a zone in which Russia could enforce its special rights and interests.

The letter is characteristic of Russian foreign policy in the era from several points of view. First, the contradiction between Yeltsin's statement and the content of the follow-up letter illustrates how much Russia was caught by surprise by the speed of NATO enlargement. Second,

Russia continued looking at the region as part of its sphere of influence. Third, as in questions affecting the fate of Central Europe, Moscow viewed the West as its negotiating partner. During NATO enlargement the primary concern for Russia was not the future fate of Central Europe but the West's increasingly greater influence compared to that of Russia. Russia viewed NATO enlargement as the embodiment of the changing relative power distribution in the international arena. While Yeltsin's letter was about the future of the security of Central Europe, the Kremlin did not send it to any of the Central European capitals. It even forgot to notify its Polish partners about taking back statements that were written in the joint Polish-Russian declaration.

Additionally, Russia did not offer any constructive alternative security guarantees for Central Europe. 1993 was the first time since the collapse of the Soviet Union that the region enjoyed increased attention from Moscow. However, this renewed interest was not meant for the Central European countries per se, but for the potential NATO member former satellites between Russia and the West. Moscow still considered the Central European countries as objects of its foreign policy rather than subjects of it. NATO enlargement embodied the declining influence of Russia in world affairs and it manifested itself in Central Europe. Throughout the following three years when the question of NATO enlargement dominated Russian and Western bilateral discussions, Moscow never bothered to discuss the issue with the Visegrad countries. Nor did it think it important to offer a viable alternative instead of NATO. For Russia the question of NATO enlargement materialized at the United States-Russia level, in terms of the changing influence of the two states in world affairs.

Despite the retraction from the joint Polish-Russian communiqué, Russia's first reaction about NATO enlargement was muted. Moscow seemed not to believe that enlargement could happen in the near future. Moreover, it overvalued its own importance and did not believe that its

partner, the West, would risk its relations with Russia by making a decision so obviously detrimental to Russia's perceived interests.

After the October 1993 Moscow events (the siege of the Moscow White House), Russia started to view the issue of NATO enlargement from a different perspective. While its opposition to the process did not change, Russia's strategy can be divided into three different periods. During the first, throughout 1994, Moscow believed that it could prevent NATO enlargement. By the summer of 1994, Moscow accepted the argumentation of the Council for Foreign and Defense Policy. The official line of the Kremlin was as follows: Russia cannot accept the Central European countries joining the North Atlantic Alliance, but it would welcome their EU-accession. It is in Russia's interest to see a stable and economically prosperous region in the middle of Europe.

During 1994, Moscow introduced another concept for preventing NATO enlargement by promoting CSCE. The goal of Russian diplomacy was to elevate CSCE and make it the all-European security organization that takes over NATO's role. It was Foreign Minister Andrei Kozyrev who started to float the idea in February 1994. In a speech, he recommended reforming CSCE and making NATO its military supplemental organization.<sup>25</sup> However, Moscow's behavior at CSCE summits and its disregard of the organization when dealing with matters in Russia's perceived sphere of interest undermined the credibility of the endeavor. The CSCE idea did not make progress for about three years.

By the end of 1994, the Kremlin realized that NATO enlargement would take place. At this time, it launched the second wave of actions, the goal of which was to bargain the most attractive concessions for its acquiescence to NATO enlargement. At the end of 1994, the Kremlin started secret negotiations with Washington in order to gain specific security compensations in

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<sup>25</sup> *Diplomaticheski Vestnik*, March 1994, 18-20.

exchange. However, while Moscow wanted to keep the negotiations in the greatest secrecy, they were leaked in Washington which caused political turbulence in Moscow. The Kremlin decided to end the discussions and later even denied their existence.

In spring 1995, the third phase in Moscow's approach to NATO enlargement started. In this phase, Moscow's goal was to slow down the enlargement process and possibly narrow its future scope. Moscow dramatically changed its rhetoric and along the lines of the recommendations phrased in the Council on Foreign and Defense Policy's report on "Russia and NATO," started to emphasize the downside of the enlargement. Even though it considered the accession of the three Visegrad countries as an *a fait accompli*, it hoped to make the issue divisive and controversial and eventually slow down further rounds of enlargement.

During the late 1993-1996 phase of Russian foreign policy, Moscow was very much preoccupied with postponing and/or changing the conditions of NATO enlargement in favor of Russia. The issue of NATO enlargement dominated foreign policy debates and Russian bilateral dialogues with the West. NATO enlargement was about the future of the Central European countries, but from Moscow's perspective it was Moscow's and a few other capitals' job to make a decision. "The special role Russia played in the crisis in South Eastern Europe, which the Western powers acknowledged as well, made Moscow to try to use its regained and accepted great power status to attempt to bargain about the future of the integration of the East Central European region."<sup>26</sup> By capitalizing on its role in the Balkans, Russia was desperately trying to influence NATO enlargement on terms favorable to Russia. While Moscow did not give up thinking about Central Europe as its area of influence, it did not manage to prevent or slow down NATO's enlargement. It made the Visegrad countries scapegoats for Russia's failures. The

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<sup>26</sup> Biro, 129.

bilateral relations between Poland, Hungary, and Slovakia on the one hand and Russia on the other practically ceased to exist.

### *Bilateral Diplomatic Relations*

The official diplomatic contacts between Moscow and the Central European capitals had very low intensity during this period. The technical issues were taken care of, but Moscow still did not consider these countries to be equal negotiating partners. There was only one exception to this rule. In 1995, Hungary took over the rotating presidency of OSCE, the successor organization of CSCE, which happened during the reign of the first reformed communist government in Hungary. The then Hungarian Prime Minister, Gyula Horn, used to be member of the Politburo of the communist Hungarian Socialist Workers' Party and was the foreign minister of the last communist government. Besides Horn, there were several other members in the cabinet who used to hold high-ranking positions in the Hungarian communist party. Contacts between Moscow and Budapest intensified in 1995. In March 1995, during Prime Minister Gyula Horn's visit to Moscow, President Yeltsin emphasized that Russia had exceptionally good relations with Hungary among the East Central European countries. At this visit, the two sides exchanged the ratification documents of the Basic Treaty – more than three years after they were signed. In the same month, on his way back from Geneva, Foreign Minister Andrei Kozyrev stopped to brief the Hungarian leadership about his negotiations with US Secretary of State Warren Christopher. The rather unusual stop-over was widely attributed to Hungary's status as chair of OSCE. In 1995, Russia still hoped for and was working on elevating the role of OSCE above that of NATO.

In the years following 1995, the intensity of the high-level bilateral meetings fell back to the earlier very low level. Consequently, Russia's renewed interest before was not meant for Hungary per se, but for the country holding the OSCE presidency.

#### ***IV.2.3. Russian Energy Companies' Conduct in the Region***

Russian energy companies' activity in Central Europe was substantial between 1993 and 1996. While diplomatic relations were at a minimum, the Russian gas monopoly, Gazprom made inroads into all the three countries. Moreover, Gazprom managed to conclude agreements in all three countries on favorable terms, and its moves were intensively supported by the Russian state.

#### **Poland**

##### *Gas Contract*

After the collapse of the Soviet Union, Poland and Russia placed the supply and transport of Russian gas to Poland and through Poland on a new basis. Two key documents were signed in this regard. The first one was an inter-governmental agreement concluded at the state level between the Russian and Polish governments in 1993, which was known in Polish public discourse as the 'gas contract'.

In August 1993, Moscow and Warsaw concluded an intergovernmental agreement, in which they agreed upon three major issues: 1.) on shipments of Russian natural gas to Poland as a target country, and also through Poland as a transit country to Germany, 2.) on the establishment of a joint company (Polish-Russian), and 3.) on the construction of a system of transit pipelines, called Yamal pipelines.



The 1993 agreement was signed in the last week of the Polish Hanna Suchocka government. In 1993, the general fear in Poland was that Russia would stop delivering gas. It was not only Poland that was afraid of such a development but other countries as well, including for example, France. Because of this fear, the Suchocka government aimed to conclude a long-term deal on Russian gas deliveries to Poland, in order to secure stable gas supplies to the country. There was nothing unusual about concluding a long-term contract for gas deliveries because this is a well-established practice in the natural gas industry to minimize the risks of the suppliers and recipients. Additionally, after the collapse of the Soviet Union, in the early 1990s there was a general trend in Europe to sign long-term agreements for the delivery of Russian gas. The Polish government agreed with Russia on the supply of 250 bn cubic meters of gas above existing quantities.

The first change to the 1993 intergovernmental agreement was made in September 1995 when the two parties signed the so-called protocol, in which they slightly lowered the quantity of Russian gas to be delivered according to the terms of the original treaty. This change was necessary because already in 1995 it became clear for the Polish side that the original prognosis for the expected growth of Polish gas consumption was too optimistic. Poland overestimated how much natural gas the Polish economy would need, for two reasons. First, the Polish economy had not developed as fast as expected during the 1990s. Second, at the beginning of the 1990s the expectation was that the proportion of natural gas consumption would increase significantly in the Polish economy, but gas had not replaced other energy sources as much as projected.<sup>27</sup> Consequently, the quantities of gas imported in the Russian-Polish agreement far exceeded real Polish demand. Even though the 1993 agreement was signed out of fear of natural gas shortages,

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<sup>27</sup> Interview with a senior official of the Supreme Chamber of Control, Department of Economy, Treasury and Privatisation (NIK) by the author, March 2003, Warsaw

the overestimation of the Polish gas needs put the future Polish governments into a disadvantageous negotiating position with Russia. In the protocol signed in 1995, the Polish and Russian governments agreed that the 250 billion cubic meters of gas will be delivered not above the existing quantities but altogether.<sup>28</sup> This was not a major concession from Russia, and Poland continued to have a highly disadvantageous gas supply contract with Russia.

The governmental intent about the long-term gas deliveries was delegated to the level of companies to work out the details. The second key agreement was concluded at the operational level between the Polish gas company PGNiG and the Russian gas company Gazprom in 1996. In 1996, the Polish gas company PGNiG and Gazprom concluded an agreement to supply 250 billion cubic meters of Russian natural gas to Poland over the next 25 years from 1997 to 2020.<sup>29</sup> According to the agreement, Gazprom would deliver the first 6 billion cubic meters in 1997. This quantity would gradually increase to 14 billion cubic meters by 2010.<sup>30</sup> According to the agreement, Russian gas would arrive through the Yamal pipeline system. The first Yamal pipe would deliver 2.88 bn cubic meters. The second Yamal would deliver the rest, which at the end of the 25-year period may be as much as 11 bn cubic meters. The contract prohibits Poland from reselling the gas to a third partner and it also includes a take-or-pay clause, which means that even if Poland does not consume the whole quantity of gas agreed upon in the contract, it has to pay for it.<sup>31</sup> Neither the intergovernmental agreement nor the contract of PGNiG and Gazprom was made public. As a result, the pricing arrangements were also not made public. Only the negotiators knew the real terms of the deal.

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<sup>28</sup> Interview with Chief Advisor to Deputy Prime Minister and Infrastructure Minister Marek Pol Professor Tomasz Bartoszewicz, March 2003, Warsaw

<sup>29</sup> The text of the agreement was never made public. I collected information about the gas contract from newswires, newspaper articles, interviews and governmental press releases.

<sup>30</sup> "Companies and Industries," *IntelliNews – Poland This Week*, January 27, 2003. Accessed July 10, 2003. Available from ISI Emerging Markets.

<sup>31</sup> "Poland Wants Russia to Free 40% of Yamal Gas Contract from 'take-or-pay' Rule," *IntelliNews – Poland Today*, July 3, 2002. Accessed July 10, 2003. Available from ISI Emerging Markets.

The 1993 inter-governmental treaty and the 1996 contract of PGNiG and Gazprom determined the quantity of Russian gas supply for the following 25 years. The two documents became the cornerstone of Polish-Russian relations in terms of natural gas supplies. The terms of the documents later turned out to be very unfavorable for Poland (to be discussed in Chapter IV.5.). Gazprom and the Kremlin did not hesitate to exploit the situation. The fact that the quantities of Russian gas imports in the gas contract were far above Polish demand put Poland in the disadvantageous position of bargaining vis-à-vis Russia by making Warsaw continuously ask Moscow to renegotiate the contract throughout the second half of 1990s. Finally the Buzek government managed to reopen negotiations about the gas contract in 2000.

#### *Polish-Russian Joint Venture*

A joint venture mentioned in the 1993 intergovernmental contract was established in September 1993. According to the agreement, its task would be to import Russian gas to Poland and through Poland to Germany. Additionally, this company would build, own and operate the Yamal pipeline system which was agreed upon in the same intergovernmental contract. The joint venture called Europol Gas originally had three owners: Polish Oil and Gas Company (PGNiG) (48%), Gazprom (48%), and Gaz Trading (4%), a private Polish company belonging indirectly to one of the Polish oligarchs, Alexander Gudzowaty.

Establishing joint ventures for either importing gas or transporting gas was a common strategy of Gazprom used throughout the region. These joint ventures were usually partly owned by Gazprom, and one of the local natural gas companies. Sometimes, they had other owners as well, usually companies involved in the gas trading. In the majority of the cases, the joint ventures were owned 50-50 percent by Russian and local partners. However, there were

exceptions to this rule, for example in case of Europol Gas or the Hungarian version of the joint venture, Panrusgas. During the early to mid-90s Gazprom established 18 joint ventures, out of those 8 in Central and Eastern Europe. See Table 1 below.

**Table 1: Gazprom's Joint Ventures in Central and Eastern Europe<sup>32</sup>**

<b>Company</b>	<b>Gazprom's Share (%)</b>	<b>Partners/country</b>	<b>Year of est.</b>	<b>Project</b>
Europol Gas	48*	PGNiG (Poland)	1993	<ul style="list-style-type: none"> <li>• Construction of the Yamal pipeline through Poland</li> </ul>
Gaz Trading	35*	PGNiG (Poland)	1993	<ul style="list-style-type: none"> <li>• Distribution and marketing within Poland</li> </ul>
Panrusgas	50*	Mol (Hungary)	1994	<ul style="list-style-type: none"> <li>• Construction of the Hungarian part of the transit pipeline to Italy</li> </ul>
Progresgas	50	Petrol (Serbia)	1992	<ul style="list-style-type: none"> <li>• Distribution and marketing within Serbia</li> </ul>
Topenergy	50	Bulgargaz (Bulgaria)	1995	<ul style="list-style-type: none"> <li>• Construction of a pipeline through Bulgaria to supply Serbia</li> </ul>
Slovrusgas	50	SPP (Slovakia)	1998	<ul style="list-style-type: none"> <li>• Distribution and marketing within</li> </ul>

<sup>32</sup> Duleba, 81. supplemented and modified by the author

				Slovakia
Wirom	25**	Romgaz (Romania)	1994	<ul style="list-style-type: none"> <li>• Distribution and marketing within Romania</li> </ul>
Yugorosgas	50*	Petrol (Serbia)	1994	<ul style="list-style-type: none"> <li>• Distribution and marketing within former Yugoslavia</li> </ul>

\* Higher than indicated because it owns a stake in one of the other minority shareholders

\*\* Wirom is a 50:50 joint venture between Romgaz and Gazprom’s subsidiary, WIEH, in which Wintershall is the other equal shareholder

In the early 1990s, the general fear in Central Eastern Europe was that Russia might stop exporting gas. As a result, countries in the region welcomed the idea of joint ventures as a way of guaranteeing the uninterrupted flow of gas, but the idea backfired. While before the establishment of the joint ventures, Gazprom was in a monopoly position with regard to the supply of natural gas, the joint ventures created a transit monopoly for Russian gas and in many cases an import monopoly as well. “Then it [Gazprom] gradually exploits formal measures (certain provisions in company articles, terms of gas contracts, etc.) and non-formal means (personal connections, pro-Gazprom lobbies) to gain the deciding vote.”<sup>33</sup> The Polish case illustrates this point.

On the surface, the Polish partner seemed to control Europol Gas. PGNiG, the state-owned gas wholesale monopoly had 48 percent of the shares and another Polish company, Gaz Trading, owned 4 percent, which adds up to 52 percent. However, in reality Gaz Trading’s ownership

<sup>33</sup> Ewa Paszyc, “Chapter 2: The Russian Energy Policy,” in *The Resource Wealth Burden – Oil and Gas Sectors in the Former USSR* (Warsaw: Centre for Eastern Studies, December 2003), 22.

structure was the following: Gazexport, the exporting subsidiary of Gazprom (35%), Wintershall, a German company, which was 50 percent owned by Gazprom (5%), a Polish company called Bartimpex (25%), PGNiG (30%), and Weglokoks, a Polish coal company (5%). As a result, Gazprom companies controlled 40 percent of the shares of Gaz Trading as opposed to 30 percent of PGNiG, which means that while the Russian state (through Gazprom) controlled 40 percent of the shares, the Polish state (through PGNiG) only 30 percent. The Polish company Bartimpex had the opportunity to cast the swing vote. With whomever Bartimpex voted, that side had the majority. Bartimpex was a company privately owned by a Polish oligarch, Alexander Gudzowaty, who acquired the initial part of his wealth through his Russian connections and his involvement in delivering Russian natural gas to Poland. With his involvement, a private company with strong Russian ties acquired the decisive vote in the Polish-Russian joint venture. Consequently, Europol Gas, the future owner of the Yamal transit pipelines, at the moment of its establishment, had a non-transparent ownership structure where the interests of Gaz Trading (with 4 percent of ownership) were not clear.

Based on the agreement which established the joint venture, Europol Gas was to construct and operate the Yamal pipelines. Europol Gas' only source of revenue was the transit fee paid by Gazprom for the transit of Russian gas through Polish territory. However, the transit fee on the Polish part of the pipeline was almost 50 percent lower than the transit fee Gazprom paid for gas transit in Germany.<sup>34</sup> According to the gas contract, through the first Yamal line Poland was to receive 3bn cubic meters of gas for its own consumption and the rest (29bn cubic meters) was to

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<sup>34</sup> Originally reported by *Rzeczpospolita*, April 9, 2002. Cited in "Agreement Close on Eve of Gazprom Chairman's Visit," by *PNB*, April 9, 2002. Accessed October 22, 2002. Available from ISI Emerging Markets. At the time, the average transit fee for natural gas transfer in Western Europe was \$2.5 for 1000 cubic meters and 100 km. Gazprom paid \$1.35 as transit fee to Europol Gas. "State's Budget Might Lose USD 1.4 bln by 2019 Due to EuRoPol Gaz's Gas Transit Fees," *Internet Securities Businesswire*, March 19, 2003 and "Russia Agrees to Cut Gas Deliveries to Poland by 35%," *Internet Securities Businesswire*, January 24, 2003. Accessed October 24, 2002. Available from ISI Emerging Markets.

be delivered to Germany. It means that the transport of the 29bn cubic meters was Gazprom's private business. The transit fee to be paid for the delivery through Polish territory was part of the regular business operation. However, with establishing the joint venture (48% owned by Gazprom), the Russian giant managed to pay this transit fee partly to itself. Additionally, the transit fee was not high enough for Europol Gas to generate enough revenues to finance the construction of the Yamal pipelines. The missing amount had to be obtained from loans. Therefore, Gazprom had strong leverage over Europol Gas, as the transit fee was the latter's sole source of revenue. The size of the transit fee was established through negotiations between Gazprom, the supplier of gas, and Europol Gas, which was the operator of the transit Yamal pipelines. Since Europol Gas was a joint venture of Gazprom and other companies, Gazprom was sitting on both sides of the table while the size of the transit fee was being negotiated. Among all the parties involved, it was Gazprom which had the biggest leverage over the transit fee. This structure placed Gazprom in a very advantageous negotiating position for the terms of gas deliveries through Poland.

The intergovernmental treaty of 1993 determined the future of the Polish-Russian joint venture. First, the ownership structure of the company, Europol Gas, which was established to import and transfer Russian gas, as well as to construct and operate the Yamal pipelines, was non-transparent from the very beginning. Additionally, it was not at all certain that Poland would have an equal say in the operation of the joint venture. Second, the size of the transit fee agreed in the initial agreement determined that Europol Gas would not be able to pay for the construction of the Yamal pipeline system on its own, thus making the company vulnerable to Gazprom right at the time of its establishment.

## *Yamal*

The 1993 agreement outlined generally the idea of a system of transit pipelines transporting gas from the Western Siberian gas field of Yamal to Poland and Germany. The details of the pipeline system were set forth in an intergovernmental agreement signed in August 1994.<sup>35</sup> In February 1995, Polish Industry Minister Marek Pol concluded another intergovernmental treaty with Russia on the schedule for the construction of the Yamal pipelines. It was planned that the Yamal system will include two pipelines. The first was supposed to start operating in 1997 with a capacity of 32 billion cubic meters per year.<sup>36</sup> The construction of the second line was to be finished in 2001 with a projected capacity of 35.4 billion cubic meters. With the above deal, Gazprom met several objectives. First, the Russian company acquired direct access to the Western European gas market, most importantly to Germany, Gazprom's biggest European customer.<sup>37</sup> Additionally, gas delivered through the Yamal pipeline is very price competitive in Germany.<sup>38</sup> As a result, construction of the Yamal pipeline would lead to strengthening Gazprom's position in the Western European market. Second, the vast majority of Russian gas to Western Europe (over 90%) had been delivered through the pipeline called Brotherhood, which goes through Ukraine.<sup>39</sup> As it has been pointed out by several scholars, at the beginning of the 1990s Ukraine pursued a pro-Western foreign policy that was intended to achieve energy

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<sup>35</sup> *STAT-USA – Country Commercial Guides*, January 1, 1998

<sup>36</sup> The first Yamal pipe was officially opened in September 1999 and started operating in December 1999; however, only with 20 bn cubic meters of capacity instead of 32 bn m3 planned.

<sup>37</sup> The idea of a pipeline delivering Russian gas through Belarus and Poland was already floated since the 1980s. The Reagan administration tried to convince Western Europeans not to build the pipeline as it would make Europe more dependent on Russian gas. The author's e-mail correspondence with Professor Richard Pipes in 2003/2004.

<sup>38</sup> Delivering one cubic meter of Norwegian gas to the German market costs \$2.75, one cubic meter Russian gas through the Blue Stream pipeline \$3.62 compared to \$2.23 when the gas is delivered through Yamal. The cost of Middle Eastern gas varies from \$2.72 to \$3.31. Data from the Hungarian Energy Office.

<sup>39</sup> In 1999, 127.6 billion cubic meters of gas, about 30% of Europe's gas supply, was exported to Western Europe through the Ukrainian system. "Ukraine: Poland Snubs Alternate Russian Pipeline Scheme," *EIGOMI*, July 27, 2000. Accessed October 27, 2002. Available from ISI Emerging Markets.



independence from Russia.<sup>40</sup> Since the Yamal pipeline circumvents Ukraine, Russia's dependence on the gas transport through Ukrainian territory decreased. Third, when the Yamal contract was signed, Poland's natural gas consumption in proportion to that of other energy sources was among the smallest in the post-Soviet area. However, Yamal made gas so competitive on the Polish market that it was reasonable to expect an increase in gas consumption relative to that of other energy resources in Poland.

Discussed earlier, the terms of the gas contract were never made public. In estimating the price of Russian gas in the Polish market this analysis relies on the data of the Hungarian Energy Office. According to that, Russian gas in Germany costs \$2.23. Since the gas travels through Poland and the costs of natural gas increase substantially with the distance it travels, it is reasonable to expect that gas costs no more than this amount in Poland. At the same time, Norwegian gas costs \$2.75. When Poland concluded the deal about the Yamal pipelines, it was reasonable to assume that Russian gas would be competitive in the Polish market. However, by the end of the 1990s Poland imported about 30 percent more than its real demand, and thus paid 30 percent more for each unit of gas, i.e. \$2.9. If Poland did not manage to renegotiate the gas contract and needed to pay for all the gas agreed upon, Russian gas would lose its competitiveness even to Norwegian gas at \$2.75.

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<sup>40</sup> See Rawi Abdelal, "Interpreting Interdependence: National Security and the Energy Trade of Russia, Ukraine, and Belarus," in *Swords and Sustenance: The Economics of Security in Belarus and Ukraine*, ed. Robert Legvold and Celeste Wallander (Cambridge, Mass.: MIT Press, 2004), 101-127.

## Slovakia

### *Slovak-Russian Joint Venture*

Slovakia meets most of its gas demand by imports. While it produced only 0.2 bcm natural gas in 2002, it imported 7.9 bcm from Russia. The Slovak imports represent 1.35% of the total gas production of Gazprom.<sup>41</sup> To further illustrate the relative size of the two parties: Gazprom's annual turnover is more than Slovakia's GDP.<sup>42</sup> The estimated value of SPP, the Slovak gas monopoly was between \$6-7 billion, which is hardly more than one third of the annual turnover of the Russian giant.<sup>43</sup>

Slovakia occupies a key place in the transit of Russian gas to Western Europe. Before Yamal 1 became operational, an average 80 percent of Gazprom's natural gas exports to Central and Western Europe went across the territory of Slovakia.<sup>44</sup> Supplying gas to Central and Western Europe through Slovakia was not Gazprom's choice, but was a consequence of the existing infrastructure. There was no alternative transport route to the one through Slovakia. During this period, Slovakia and Russia were mutually dependent on each other regarding gas transfer. It was as important for Slovakia to receive the transit fees and the gas it consumed as it was for Russia to be able to offer a steady natural gas supply to its customers further to the West.

From the Russian point of view, the political climate in Slovakia has been very favorable during the Meciar era. Between 1993 and 1998 Bratislava's relations with the EU and the US substantially weakened, but it strengthened its ties with Russia. Slovakia was referred to in the journalistic language as the 'Central European island of Russia.' The Kremlin did not even

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<sup>41</sup> *IEA World Energy Outlook 2002*

<sup>42</sup> Both is around \$20 billion. "Gazprom Gas Company," *MosNews.Com*. Accessed August 2, 2005. Available from <http://www.mosnews.com/mn-files/gazprom.shtml>.

<sup>43</sup> SPP's value was calculated based on the price the Slovak government received for a 49% stake offered for privatization in early 2002 and the estimated price the government intended to receive.

<sup>44</sup> *Slavia Capital*, January 10, 1999. Accessed October 27, 2002. Available from ISI Emerging Markets.

refrain from interfering in the Slovakian elections. President Yeltsin noted to Vladimir Meciar on his visit to Moscow in September 1998, just before the elections in Slovakia that “we in Russia are happy that you strongly stand by your security and friendly relationship with Russia in Europe... We very much want you to win the next election.”<sup>45</sup>

The idea of establishing a joint venture between Gazprom and SPP, the Slovak gas monopoly, was first discussed in February 1995. The Russian partner offered a ‘gas for food’ model for the new company. According to this model, Gazprom would use part of the money received from the sale of natural gas to buy Slovak goods, which it would sell on the Russian market. In the mid-1990s, right after having lost a great portion of its Eastern markets, the model seemed to be attractive for Slovakia. However, the two partners did not reach a common understanding about the establishment of the joint venture until two years later in April 1997, while the company itself was established only in March 1998, still under Meciar’s reign, in the next phase of Russian foreign policy according to this taxonomy.

## **Hungary**

### *Hungarian-Russian Joint Venture*

After the Netherlands and the United Kingdom, Hungary is the most natural gas dependent country in Europe. In 1999, gas accounted for 39.4% of the total Hungarian energy consumption compared to the European average of 22.2%.<sup>46</sup> Additionally, gas penetration is continuously increasing in the country. Hungary is very much dependent on outside sources of gas. The ratio

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<sup>45</sup> Karel Hirman, *Faktor ropy a plynu v suskej domacej a zahranicnej politike* (Bratislava: Research Center of the Slovak Foreign Policy Association, 1998)

<sup>46</sup> “Mol: The TVK Acquisition,” INSEAD Case Study, Draft Version (Fontainebleau: Insead, 2004), 4.

of own production to imports is about 1:3, and own production is declining continually. In 2000, Hungary imported 9047 million cubic meters of gas.

All the imported gas arrives from Russia through the Brotherhood pipeline system. In practice, gas can flow through two alternative routes: one through Ukraine to Hungary, and the other through Ukraine and Slovakia to Austria and from there to Hungary on the Baumgartner pipeline. If one takes a look at the map of the European gas pipelines system, the first impression is that Hungary is connected to the Western system; however, a closer look makes it clear that even though the gas enters Hungary on the country's Western border and flows in a West-East direction, it is exactly the same Russian gas as that which arrives through the Ukrainian-Hungarian border.

Gazprom managed to set up a joint venture in Hungary just as in Poland, and later Slovakia. The model was similar to the ones established in the former. In May 1994, parliamentary elections were held in Hungary, which resulted in the victory of the Socialist Party, the successor to the communist party. Already in October 1994, a Russian-Hungarian joint venture called Panrusgas was established. Before that time, the supply chain of Russian gas to Hungary was as follows: Gazexport, the exporting arm of Gazprom, sold gas to a Hungarian intermediary company called Mineralimpex, which then resold the gas to Mol, the Hungarian gas monopoly. Additionally, a Hungarian law required Mol to take over Mineralimpex by December 31, 1994. The law did not detail how the supply chain would change afterwards, but presumably Gazexport would have sold gas directly to Mol. With the establishment of Panrusgas, a new player was introduced in the supply chain. Gazexport sold gas to Panrusgas; Panrusgas resold the gas to Mineralimpex, which resold it to Mol. After December 1994, the chain simplified with Mol's takeover of Mineralimpex. From then on, Gazexport sold gas to Panrusgas, which then resold it

to Mol. In practical terms, Panrusgas replaced Mineralimpex in the natural gas supply chain as an intermediary between the Russian gas producer and the Hungarian gas monopoly.

However, there was a significant difference between Mineralimpex and Panrusgas. While the former was 100 percent owned by Mol, the Hungarian company, Panrusgas had several owners: 50 percent was owned by Interprokom, a daughter company of Gazprom, 30 percent by Mol, 15 percent by a Hungarian company called Dunantuli Kolajipari Gepgyar (DKG, Transdanubian Crude Oil Machinery Factory), and 5 percent by Mineralimpex. Nominally, Panrusgas was 50 percent owned by Gazprom and 50 percent by Hungarian companies. However, Interprokom, Gazprom's daughter company, owned 100 percent of DKG, and as a result owned 65 percent of Panrusgas, while Mol controlled only 35 percent. Among all the gas joint ventures established in the middle of the 1990s, the Hungarian was the most disadvantageous for the host country.

The short-term business objective of the company was to be an intermediary between Gazprom and Mol and thus profit from the mediation. It was named the official Hungarian counterpart to which Gazprom was supposed to transfer gas covered by the long-term supply treaty between Russia and Hungary. Obviously, the extra company inserted between Mol and Gazprom had no economic value-added whatsoever. It was Gazprom's insistence that led to its establishment. As we will see, Gazprom was able to achieve concessions for Panrusgas that it could not have achieved for itself.

Panrusgas did not own any property, pipeline or equipment; its core operation was based on two contracts, one with Gazexport and the other with Mol. These two contracts have been valid from 1996 through 2015, and authorized the delivery of 230 billion cubic meters of natural gas in the value of \$22-23 billion.<sup>47</sup> Neither of the two contracts was ever made public. As a result, the price on which Gazprom supplied the natural gas to Panrusgas is not public information.

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<sup>47</sup> *Vilaggazdasag*, April 9, 1999. Accessed October 28, 2002. Available from ISI Emerging Markets.

However, a senior official of the joint venture said that the price of natural gas corresponds with prices in the market. Hungary does not pay the most, and neither does it pay the least for Russian gas in the region.<sup>48</sup> In theory, Panrusgas could have sold this gas to whomever it wanted if Mol did not have its gas wholesale monopoly guaranteed by law and did not own all large capacity pipelines in the country. In this case, its gas wholesale monopoly would have been terminated and other players entered the market, and as a result Panrusgas could have sold the gas to any Hungarian customer.

The long-term business objective of Panrusgas was to build a transit pipeline through the Hungarian region of Transdanubia as a part of a large pipeline stretching from Russia to Southern Italy. Based on the contract which established Panrusgas, the pipeline would have been owned by the Russian-Hungarian joint venture and operated by Mol, i.e. it would have broken the gas transit monopoly of Mol. Additionally, EU laws require that as soon as Hungary enters the European Union, any wholesale gas monopoly should be terminated. If the pipeline was built, and the gas wholesale monopoly of Mol terminated, Panrusgas would have been in the position to enter the gas wholesale market by using its own pipeline. The original contract that established Panrusgas gave not only the control over gas intermediation into the hands of Gazprom, but gave it the option of potentially entering the Hungarian gas transit and wholesale business from a very strong position. Panrusgas was conducting negotiations about delivering gas to Italy with Edison, an Italian company. However, by the summer of 1998, negotiations between Gazprom and Edison broke down. The Russian company signed a contract with another Italian company, Snam, instead, but this agreement did not cover the planned pipeline. Because the negotiations failed, the plan of building a pipeline was also taken off the table.

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<sup>48</sup> Interview with a former senior official of Panrusgas, who did not allow to uncover his name, Budapest, September 2005

The Hungarian and Russian visions for Panrusgas differed sharply. Russians wanted to use it as a vehicle for getting a foothold in the Hungarian gas wholesale business. Hungarians, on the other hand, wanted to have the joint venture for export promotion purposes. For Gazprom agreed to buy Hungarian products in exchange for the supply of natural gas in excess of the quantity set forth in the long-term inter-governmental contract. Among the preferred products were food and medicine. The Hungarian partner was hoping to use Panrusgas as a vehicle to gain back some of the lost Eastern markets. However, during its first year of operation, in 1995, Panrusgas bought Hungarian products worth only 10 percent of its total revenue.

In the same year, Laszlo Pal was sacked as Minister for Trade and Industry and was named CEO of Mol. Few months later, Mol increased its share in Panrusgas to 50 percent. This was a most interesting turn of events, because in the position of Minister for Trade and Industry, Laszlo Pal agreed to a disadvantageous ownership structure for Panrusgas. As CEO of Mol, however, he reinstated the 50-50 percent ownership, which was the common solution in the region. The change in the ownership structure might have been motivated by the public uproar and the highly increased media attention on Panrusgas that the Russian majority in the company generated.

In 1996, Panrusgas received the right to import 2 billion cubic meters of gas from Russia in exchange for Hungarian participation in the Jamburg gas field's exploration. The right originally was supposed to go to Mol. In the same year, Panrusgas started to negotiate with Hungarian local gas distributors about supplying them directly, i.e. circumventing Mol. Even though Panrusgas did not manage to do this, its efforts illustrated that it was out of the control of Mol. Panrusgas' activity resembled that of EuropoIGas in Poland, where the joint venture laid fibre optic cable and thus circumvented the Polish state's interests and control.

#### ***IV.2.4. Summary***

Between the second half of 1993 and 1996, Russian foreign policy thinking and action was dominated by the specter of NATO enlargement. Moscow believed that the expansion of the Western military alliance into the former Soviet sphere of influence, i.e. the Western powers' disregard for Russia's concerns in the matter, reflects Russia's low relative influence in world affairs vis-à-vis the United States. As a result, Russian foreign policy was set to counter this trend. Russia's open intention was to change the international structure again in favor of Russia, namely to increase Russian influence in the world. Central Europe appeared on the mental map of Russian decision makers as the terrain of Western expansion, i.e. an area where the balance-of-power between Russia and the West would change in favor of the latter. Central Europe became the first region of the world where Russia's relative influence vis-à-vis the West was quite low. In the same period, state power has declined significantly compared to the first few years of the 1990s, but was markedly higher than in the years to follow. As a result, Russia still possessed enough state power to mobilize the necessary resources. The hypothesis is that under such circumstances Russian energy companies would expand into Central Europe.

As discussed in this chapter, Russian energy companies, more precisely, Gazprom was very active in the region during this period. It had two major goals in all three examined countries. First, it aimed at getting involved in exporting and importing its own gas to Central Europe. Historically, Gazprom sold natural gas to the local gas wholesale monopoly. Between 1993 and 1996, it initiated negotiations with these monopolies and their governments about creating joint ventures in charge of importing Russian gas. The initiative was successful in all cases. Gazprom ended up with substantial ownership in the companies which were endowed with monopoly rights to purchase natural gas from Gazprom itself on behalf of the three Central European countries (in case of Slovakia the formation of the joint venture did not take place until the next



phase). Moreover, in case of Poland and Hungary, the Russian side tried to create a joint venture ownership structure which on the surface seemed to provide control for domestic companies, but in fact gave control to Gazprom through personal loyalties (Poland) or actual ownership (Hungary). In Poland, where this control was more covert, the Russian side managed to keep the structure intact. In Hungary, where Gazprom's effective control was traced through corporate registries, the issue created such a public uproar that the Russian company's share was limited to 50 percent.

The second aspiration that Gazprom manifested in the region was to get the rights to build gas pipelines through all three countries. In the case of Poland, it managed to reach an agreement as the resulting Yamal pipeline became the major tool of Gazprom's expansion in Poland and a serious headache for the Polish government later.

### **IV.3. Against a Unipolar World: 1996-1998**

#### ***IV.3.1. Perceptions and State Power***

The third phase of post-Soviet Russian foreign policy started with Yeltsin's reelection in 1996 and ended with the financial crisis in the summer of 1998. A major change occurred in Russian official foreign policy after Yeltsin's reelection. A new foreign minister, Yevgeny Primakov, replaced Andrei Kozyrev. They shared similar goals for Russian foreign policy but had different strategies of how to reach them. Both aimed at reestablishing the influence of Russia in world affairs to a degree that could be comparable to the position of the Soviet Union. Kozyrev wanted to do this by establishing a strategic partnership with the United States. On the other hand, "policy, Primakov said, would be designed to "defend Russia's national interests" and prevent the evolution of international relations into "a unipolar world under U.S. command.""<sup>49</sup> Primakov placed great emphasis in his deeds and rhetoric as well to trying to prevent a unipolar system and finding other great powers (like China and India) to balance against the United States.<sup>50</sup> Clearly, he believed that Russia's relative influence in the world, especially vis-à-vis the United States, was alarmingly low.

An important manifestation of this low influence was NATO enlargement, which made the Western military alliance capable of deploying troops closer and faster to the Russian border than before. Primakov stated that Moscow would continue to oppose vigorously any NATO enlargement to the East unless Moscow has a voice in the transformation of that alliance. "Only after that," the Russian foreign minister said, could anyone "tackle the question of whether or not to expand."<sup>51</sup>

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<sup>49</sup> Paul Goble, "Russia: Analysis from Washington - Primakov's New/Old Line," *RFE/RL*, August 12, 1996

<sup>50</sup> See Samuel P. Huntington, "The Lonely Superpower," *Foreign Affairs*, March/April 1999

<sup>51</sup> Goble

In this period, state power had been declining sharply. Federal tax revenues as percentage of GDP were at 14.6% in 1996, they declined to 11.1% in 1997 and to an abysmal 9.4% in 1998. That is to say, within two years, federal tax revenues fell by one-third. The waning of state power manifested in many other respects, including the unprecedented power that a small clique of oligarchs, who financed President Yeltsin's reelection, accumulated. The nadir came with the financial crisis of August 1998, in which the Russian Central Bank sacrificed several billion dollars of reserves to defend the indefensible Ruble. The crisis also marked the end of the so-called liberal economic policies that characterized the management of the Russian economy from 1992 to 1998.

Predictions based on my hypothesis:

	<b>Russian leadership's perception about Russian influence in the world</b>	<b>State power</b>	<b>Predictions of the hypotheses on the behavior of Russian energy companies towards Central Europe</b>
<b>1991-1993</b>	Consistent	High	<b>Do not expand</b>
<b>1993-1996</b>	Low	Medium	<b>Do expand</b>
<b>1996-1998</b>	<b>Low</b>	<b>Low</b>	<b>Do not expand</b>
<b>1998-2000</b>	Low	Low	<b>Do not expand</b>
<b>2000-2004</b>	Low	High	<b>Do expand</b>

According to this hypothesis, when Russia does not possess enough state power to mobilize the necessary resources, Russian energy companies will not manifest any expansionary moves

into Central Europe even when the Russian leadership perceives that Russia's relative influence vis-à-vis the West is low.

### ***IV.3.2. Classical Foreign Policy towards Central Europe***

#### *Foreign Policy Thinking*

In May 1997, Russia and NATO signed an agreement on the creation of the NATO-Russia Permanent Joint Council. The Russian elite welcomed the agreement because it gave the opportunity to Moscow to accept NATO enlargement without losing face. Its proponents also emphasized that the Joint Council will be a mechanism through which Moscow will have regular access to NATO member countries for consultation. Of course, the NATO-Russia agreement was not welcomed by everybody. The debates among the Russian foreign policy thinkers on the process of NATO enlargement continued. Even though the issue of NATO enlargement prevailed in foreign policy discussions, it did not dominate the debate nearly as much as it had two years before. At the same time, in mainstream foreign policy thinking entirely new voices emerged that changed the foundations of post-Soviet Russian thinking about the Central European region.

This was the first time in post-Soviet Russian foreign policy thinking that Central Europe was put on the radar screen of leading Russian strategic thinkers. Dmitrii Trenin called for an increased attention towards Central Europe, arguing that "Russia has not yet learned to find the right tone in its relations with minor neighbors, specifically with the former Warsaw Treaty allies and the former USSR republics. Geopolitics and geostrategy still prevail in Russian foreign-policy thinking at the expense of geoeconomics. In consequence of this, many situations are

analyzed from the viewpoint of potential threats, and not from the viewpoint of possibilities being on offer.”<sup>52</sup>

Similar arguments can be found in the first significant foreign policy document which was dedicated to Central Europe, published in February 1997 by the Council on Foreign and Defense Policy. Entitled “East Central Europe and the Interests of Russia,” the document examined thoroughly Russia’s interest in Central Europe.<sup>53</sup> The report acknowledged that the military, political and economic integration of the region into Western institutions was not preventable and would happen in the foreseeable future. Pragmatically, it admitted that Russia would not be able to stop this process, and that it had to adjust to the new situation as effectively as possible. The report acknowledged that Russia was driven out politically and militarily from Central Europe and warned that if Russia did not want to be driven out entirely economically as well, it needed to adapt to the new circumstances. It pointed out that while Russia is not an alternative to the European Union for the countries of the region, it still provided over 90 percent of the natural gas for Central Europe, as well as a substantial part of the region’s crude oil demand. However, the level of bilateral trade fell back sharply after the breakup of the Soviet bloc; only 14 percent of Russia’s overall trade was conducted with the region, while 40 percent of total Russian trade was with the European Union. The report argued that Russia should strengthen its economic presence in Central Europe, projected that the Visegrad countries would be accepted into the European Union in 2005, and recommended that to counter the military and political integration of the region into NATO, Russia should build up important economic positions in Central Europe before these countries become members of the Union. The document evaluated that, with the

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<sup>52</sup> Dmitrii Trenin, “Baltiiskaia kontseptsia Rossii,” *Nezavisimaya Gazeta*, March 11, 1997

<sup>53</sup> “Tsentralnaia i vostochnaia Evropa i interesi Rossii,” in *Strategiia dlia Rossii: 10 let SVOP* (Moscow: SVOP, 2002), 154-171.

exception of Slovakia, the political atmosphere was not necessarily positive toward any larger Russian presence in the region.

Interestingly, the report on “East Central Europe and the Interests of Russia” differentiated between two types of countries in the broadly defined East Central European region. The first were those countries that were less developed, such as Bulgaria and Romania, and as a result, leaned more towards cooperating with Russia and would enter the EU later. In the second group were the more developed countries, such as Poland and Hungary, which were less eager to work with Russia and would become members of the European Union sooner. The dilemma for Russia was to decide where to strengthen its position. The document unambiguously supported an increase in Russian influence in the second group of countries, reasoning that a strong economic presence there would become much more valuable than uncertain political influence in the Balkans.

In summary, the authors of the 1997 report saw a changing balance of actual influence between Russia and the West in Central Europe. They concluded that Western organizations managed to expand militarily and politically into the region, and called upon Russia to expand economically into Central Europe to counter the unfavorably changing balance of power in the region. It identifies natural gas as a key lever in the relationship with the region. The 1997 February analysis is the first influential report to openly switch from a security perspective to an economic one with regard to the region, and to talk about Russian economic presence in Central Europe as an influence comparable to military and political one. Even though some thinkers had pointed out the economic importance of the region a few years earlier, the analysis of the Council on Foreign and Defense Policy was the first significant document which systematically analyzed Russian economic interest in Central Europe as one comparable with its military and political interests.

The Russian administration welcomed the analysis and the recommendations of the report. According to Dmitrii Riurikov, Counselor to President Yeltsin, “the report lies on the desk of every state official in whose job description are relations with that region.”<sup>54</sup> Comments from Rem Vyakhirev, then head of Gazprom, held at a press conference in Warsaw on 19 January, 1998, echoed this approach. He said that “there is no reason to fear Russia or Gazprom, we are honest, friendly and interested in good relations with all our partners, although we can strike a blow should the need arise.”<sup>55</sup>

The basic argument of the February 1997 report resurfaced in one of the documents written by the Council just before the Helsinki Summit between Presidents Boris Yeltsin and Bill Clinton, which was entitled “For the Positive Agenda in Russian-American Relations.”<sup>56</sup> As a recommendation for Yeltsin, the document stated about Central Europe that “it is absolutely obvious that it is unacceptable to leave the Central and Eastern European countries in feeling the historic injustice that had been committed against them. Their demands to be fully integrated in the most important European economic and political structures, have to be met.” The authors of the document understood that the process of integration of Central Europe into the Western political and economic structures could not be stopped. However, the ease with which the document approached the issue was a new development.

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<sup>54</sup> Duleba, 50.

<sup>55</sup> “Gazprom Will not Halt Gas Supplies,” *Polish News Bulletin*, January 20, 1998. Accessed October 22, 2002. Available from ISI Emerging Markets.

<sup>56</sup> “K pozitivnoi povestke dnia v rossiisko-amerikanskich otnoseniach,” in *Strategiia dlia Rossii: 10 let SVOP* (Moscow: SVOP, 2002), 190-194.

### *Official Doctrine and Strategy*

Primakov stated that Russia would become an international actor in world affairs just as it did towards the end of the Soviet era. In the years of 1996-97, or more or less until the Paris agreement between NATO and Russia and the Madrid summit, the official Russian foreign policy regarding Central Europe as a region was still very much dominated by the question of NATO enlargement. The new Russian foreign minister aimed at disconnecting the political and military aspects of membership in the North Atlantic Treaty Organization. "We are talking about the unacceptability for us of expanding NATO's military infrastructure up to the territory of Russia. If the new NATO members are fully incorporated into the alliance's military systems -- management, communications, reconnaissance, rear logistics, etc. -- then NATO troops can be deployed there in a matter of hours. This possibility, though small today, will become a factor of uncertainty for us... A broad consensus has taken shape in Russia on the problem of NATO expansion... political forces of the most different orientations treat this idea equally negatively."<sup>57</sup>

The situation changed only in mid-1997 when Poland, Hungary, and the Czech Republic were invited to start accession talks with the organization. Having no other option, Russia did accept the incorporation of the three countries to NATO. However, the main aim of Russian foreign policy was to prevent any further enlargement eastward because it would have changed the relative balance of power even more unfavorably for Russia.

At the same time, the official Russian foreign policy increasingly turned towards greater economization of the relations between Russia and Central Europe. As discussed, the official Russian foreign policy seems to have taken the February 1997 report written by the Council on Foreign and Security Relations as a guideline for its future policies towards Central Europe. Moscow developed the concept of asymmetric response, according to which, Russia should

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<sup>57</sup> Cited by Thomas L. Friedman, "Foreign Affairs; Russia's NATO Fax," *The New York Times*, July 24, 1996



respond to military expansion of NATO by economic expansion into Central Eastern Europe.<sup>58</sup> In its bilateral relations with countries of CEE, Russia focused increasingly on economic issues.

### *Bilateral Diplomatic Relations*

During this time, bilateral diplomatic relations with the Central European countries were kept at a minimum with the exception of Slovakia, where Russia saw an opportunity to provide an alternative security option to NATO.

Russia approached the Baltic States and Slovakia with an offer to provide security guarantees. While the Baltic states did not even consider the offer, Slovakia seemed open to the idea. One of the parties in the Meciar government, the Slovak National Party, propagated the idea of neutrality for Slovakia. Negotiations started between the two sides. In April 1997, during his visit to Bratislava, Viktor Chernomyrdin favored the idea of neutrality for Slovakia. Russia concentrated its efforts on persuading Slovakia to declare neutrality or even accept security guarantees from Russia. Officially, Slovakia did not express which option it preferred, but the situation changed dramatically when Slovak Prime Minister Vladimir Meciar lost power in 1998 and the strongly pro-Western government of Mikulas Dzurinda took over. Thereafter, Slovakia started to pursue a clear pro-NATO membership policy.

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<sup>58</sup> Duleba, 50.

### ***IV.3.3. Russian Energy Companies' Conduct in the Region***

Russian energy companies did not have any new initiatives in the region, as their activities were limited to fulfilling their contractual obligations negotiated in the previous phases. Gazprom used the joint ventures set up earlier for importing the gas it exported from Russia, but showed no effort to acquire new rights or assets. The construction of the Yamal pipeline went on as scheduled according to the Russian-Polish intergovernmental agreement, but no new development emerged in this regard.

The only exception to this rule was the Russian government's and Gazprom's joint effort to establish a natural gas importing joint venture in Slovakia in the mold of Europol Gas (Poland) and Panrusgaz (Hungary). The negotiations started in 1995 but accelerated only after Russian Prime Minister Viktor Chernomyrdin's visit to Bratislava in 1997. The Slovak and Russian prime ministers signed three agreements related to the import and transfer of natural gas. In the first agreement, Slovakia and Russia agreed that Russia will provide Slovakia with natural gas between 1998 and 2008. The second agreement concerned gas transit through the territory of Slovakia, while the third was an agreement about establishing a joint venture between SPP and Gazprom.<sup>59</sup> The joint venture agreement was finalized and concluded in October 1997. The new company, called Slovrusgas, was founded in March 1998, in the last year of the Meciar government. Slovrusgas was a joint venture of SPP and Gazprom with a registered capital of USD 1 million, with both sides owning 50 percent. The final agreement was never made public; the partners referred to confidentiality as their reason. However, the Russian party received a lock-in deal on Slovak gas supply until 2008 and some other concessions not public at the time of the signing.

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<sup>59</sup> *Trend*, April 22, 1998. Accessed October 25, 2002. Available from ISI Emerging Markets.

Slovrusgas' core activities included importing natural gas above the quantity agreed upon in the long-term contracts, some gas trading and mediation, and consulting and investment services. Importantly, it aimed to improve bilateral trade relations by increasing the export of primarily Slovak goods and services to Russia and the reverse. Gazprom agreed to spend up to 40% of its revenues from gas sales on buying Slovak goods and services and selling them on the Russian market.

Slovakia's natural gas needs were met in the long-term (1998-2008) contract signed between the two countries. However, as demand varies based on weather conditions as well as development of the Slovak gas industry, Slovrusgas received the right to import gas above the volume agreed upon in the long-term contract. The long-term contract, plus the establishment of the joint venture, guaranteed that until 2008 Gazprom remains the sole supplier of natural gas to Slovakia. According to Slovak-Russian relations expert Alexander Duleba, "as a result, Slovakia remains the only Visegrad country to be completely dependent on natural gas deliveries from Russia, at least until 2008."<sup>60</sup>

Soon after the signature of the joint venture contract, some information on its content became known publicly. First, in May 1998, Roman Vaclavik, Director of the Economic, Commercial and Asset Management Division in Slovrusgas, said that if the Southern branch of the Yamal-Europe pipeline was built [i.e. the inter-system connect pipeline which would have transited through Slovakia], the transit of gas through that pipeline would be carried out by Slovrusgas.<sup>61</sup> This simply meant that the Meciar government traded away SPP's – the Slovak state-owned gas monopoly's - biggest asset, namely its transit monopoly. Jurij Komarov, senior official of Gazprom in an interview given to the Slovak weekly *Trend* in mid-summer 1998 underscored

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<sup>60</sup> Duleba, 86.

<sup>61</sup> *Trend*, May 5, 1998. Accessed October 25, 2002. Available from ISI Emerging Markets.

again that Slovrusgas would be involved in gas transit going through Slovakia.<sup>62</sup> Second, on August 12, 1998, it became public that Slovrusgas pays more for the gas it receives from Russia than the Western European customers who are hundreds of miles further from the source than Slovakia. It seems that in their negotiations with the Slovak partner Gazprom and the Russian Prime Minister negotiated a very good deal financially.

#### ***IV.3.4. Summary***

Between 1996 and 1998, Russian foreign policy became increasingly concerned with the unipolar world order led by the United States as it set about to counter what it saw as excessive American influence in the world. In so doing, it aspired to restore Russia's influence. To phrase it differently, Russia perceived its relative influence in world affairs to be unacceptably low. The issue of NATO enlargement, or more precisely, Russia's inability to halt it with diplomacy, was the most tangible manifestation of this phenomenon. At the same time, state power reached its abyss in the entire post-Soviet Russian era, with federal tax revenues accounting for less than 10 percent of the GDP in 1998, a third less than it was two years before or after.

Russia's most influential foreign policy thinkers started to discuss what Russia should do about Central Europe. A widely used report by the Council on Foreign and Defense Policy, titled "East Central Europe and the Interests of Russia", proposed that Moscow counter Western political and military expansion into the region with Russian economic expansion there, specifically mentioning natural gas as an important tool in this effort. Despite this clearly articulated strategy, this thinking did not manifest itself in bilateral diplomatic relations. The only country with which Russia had strong diplomatic activity in this period was Slovakia, and the

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<sup>62</sup> *Trend*, July 22, 1998. Accessed October 25, 2002. Available from ISI Emerging Markets.

reason behind this was a good old-fashioned security initiative rather than the economic strategy suggested by the report.

The hypotheses in this case would suggest that when Russia does not possess enough state power to mobilize the necessary resources, Russian energy companies would show little to no expansion in Central Europe even when the Russian leadership perceives that Russia's relative influence vis-à-vis the West is low. The case supports this prediction. Russian energy companies had no meaningful new initiatives in Poland and Hungary. The only country where one of them, Gazprom did expand was Slovakia, but this choice for expansion shows the weakness of Russia at the time. Slovakia was the easiest possible target for a Russian company in Central Europe during this period. This country has been not only by far the smallest and economically the weakest among Central European countries, but unlike the other countries of the region, was very open toward Russia and Russian investment. It even flirted with the idea of remaining neutral as opposed to joining NATO. Despite this open and welcoming atmosphere, in the joint venture deal Gazprom was unable to secure anything more than what it already secured vis-à-vis Poland and Hungary years before.

#### **IV.4. Instability and Uncertainty: 1998-2000**

##### ***IV.4.1. Perceptions and State Power***

This period started with the 1998 financial crisis and ended with the election of Vladimir Putin to president in March 2000. The financial crisis dealt a major blow to Russia and President Yeltsin personally. The run on the Ruble and the ensuing huge fall in real incomes undermined the popular legitimacy of the system Yeltsin and his supporters built over half a decade. His foreign policy was no exception to this. The Russian public became very anti-Western, especially anti-American. According to a poll conducted by the Russian Center of Public Opinion in April 1999, only 39 percent of the respondents maintained a positive attitude toward the United States in comparison with 67 percent in December 1998. Moreover, 33 percent of Russians claimed to hold a hostile attitude toward the United States.<sup>63</sup> As many American consultants were involved in the privatization of the Russian economy, they became one of the main scapegoats for the Russian economic collapse. Russian foreign policy decision making became anarchic, which made the outcome of foreign political decisions even more inconsistent.

Moreover, within a year after the crisis two serious foreign policy developments made the public acutely aware of the limitations of their countries' influence in the world. The first of these was the formal entry of Poland, Hungary and the Czech Republic into NATO. Even though the decision was made two years before, it materialized in April 1999. The second, arguably more painful lesson came during the 1999 Kosovo crisis. Even though Russia drew a red line on NATO military intervention against the Serbian President Slobodan Milosevic, the military alliance went ahead when the intervention ignored Russian warnings. The Kosovo crisis was the lowest point in Russian-Western, especially Russian-American, relations in the first post-Soviet

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<sup>63</sup> Vladimir Shlapentokh: "Monica Highlights Russian Culture" (accessed August 5, 2005); available from <http://www.msu.edu/~shlapent/monica.htm>

decade. Most importantly, the invasion of Kosovo was widely resisted by the Russian public and interpreted as a betrayal of their country by America.

The Russian foreign policy elite saw the lowest influence of Russia vis-à-vis that of the United States in world affairs. Fear of losing further control of the countries of the former Soviet Union and its visible marginalization in world affairs led to a feeling of defeat, confusion and loss of self-confidence. This feeling is clearly manifested in the period's only major official foreign policy paper, the Russian military doctrine of 1999. First of all, it is remarkable that Moscow felt the need to revise its 1993 military doctrine only six year later in 1999. While Russian decision makers believed the military failures of the first Chechen war did not justify rewriting the doctrine, the experiences of the Kosovo war made them rethink their military strategy. The new military doctrine symbolizes a return to the dominance of security and military issues in the foreign policy thinking in Moscow. The language of the military doctrine was harsh, and reflected the defeatist attitude prevailing in Russian foreign policy thinking at the time. It did not have any important consequences, but was an expression of frustration with world affairs.

In terms of state power, federal tax income as percentage of GDP was at its lowest of the entire observed period in 1998 (9.2%). In 1999, proceeds were only marginally higher (12.8%). State power measured as federal tax revenues as percentage of GDP were substantially lower in 1998 and 1999 than any time before 1997. Moreover, during these two years, state power was at its lowest in the entire examined period between 1991 and 2004.

Predictions based on my hypothesis:

	<b>Russian leadership's perception about Russian influence in the world</b>	<b>State power</b>	<b>Predictions of the hypotheses on the behavior of Russian energy companies towards Central Europe</b>
<b>1991-1993</b>	Consistent	High	<b>Do not expand</b>
<b>1993-1996</b>	Low	Medium	<b>Do expand</b>
<b>1996-1998</b>	Low	Low	<b>Do not expand</b>
<b>1998-2000</b>	<b>Low</b>	<b>Low</b>	<b>Do not expand</b>
<b>2000-2004</b>	Low	High	<b>Do expand</b>

According to the hypothesis, when Russia does not possess enough state power to mobilize the necessary resources, Russian energy companies will not manifest any expansionist moves into Central Europe even when the Russian leadership perceives Russia's relative influence vis-à-vis the West to be low.

#### ***IV.4.2. Classical Foreign Policy towards Central Europe***

##### *Foreign Policy Thinking, Official Doctrine, and Strategy*

At a time when there was no clear official Russian foreign policy even toward countries of primary importance for Russia, it is not surprising that we cannot speak of a clear policy vis-à-vis Central Europe. The region was again marginalized in Russian foreign policy thinking as well as in its doctrinal and strategic thinking. As Russia expert Andras Deak put it, during this period



“there was no thinking official or private about Central Eastern Europe in Russian foreign policy at all.”<sup>64</sup>

### *Bilateral Diplomatic Relations*

The bilateral diplomatic relations between Russia and the Central European countries reflected internal Russian uncertainties and the unpredictability of foreign policy during the late Yeltsin years. Because there was no coherent Russian policy towards Central Europe, Moscow became especially sensitive and reactive to the steps taken by the individual Central European countries. Polish-Russian and Hungarian-Russian relations were characterized by tensions and confrontation, and several scandals strained the relationship. While very little or no constructive steps were taken to build up bilateral ties, the destructive steps - distrust and misunderstanding - made these two years the worst period in the bilateral relations of the post-Soviet era. Some commentators called it “the little ice age” of Polish-Russian and Hungarian-Russian relations. Even though the Russian-Slovak relations of the period were not as bad, the bilateral Russian-Slovak ties between 1998 and 2000 were the worst since the collapse of the Soviet system.

### Poland

There were two major incidents which made Polish-Russian relations tense. First, in January 2000, Poland expelled nine Russian diplomats for spying. The move took Moscow by surprise, which the Russian Foreign Ministry described as unprecedented and accused Poland of complicating Polish-Russian relations. On January 21, the next day, Moscow expelled nine Polish diplomats in retaliation. According to the statement of the first secretary of the Polish embassy in Moscow, the diplomats were involved only in legitimate activities. The Polish side

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<sup>64</sup> Interview with Russia expert Andras Deak, Budapest, September 2005

considered the move by Russia unjustified and one which unnecessarily aggravated bilateral relations. Kacek Niedzielski, the Polish embassy's first secretary also added that Russian spying activity in Poland had increased since the country's accession to NATO.<sup>65</sup> The Russian side suspected Poland of not acting on its own will. The day after the expulsion of the Russian diplomats Foreign Minister Igor Ivanov noted that "neither can I say whether the decision had been taken in Warsaw or had been prompted by anybody else."<sup>66</sup> A few days later the Moscow press speculated that a third country's intelligence forces assisted the Poles in uncovering the Russian intelligence network.<sup>67</sup> On January 30, *Warsaw Voice* reported that Russian politicians believed that the Polish move was strongly linked to NATO Secretary General Lord Robertson's recent visit to Warsaw. Robertson acknowledged that Poland notified NATO about its move in advance, but he denied any involvement of his organization in the Polish decision. In April 2000, an allegedly secret report of the Polish security services was leaked to the press. The report claimed increased Russian espionage activity in Poland since the country's accession to NATO, and Polish secret service minister Janusz Palubicki accused Russia of continuing spying since the expulsion of the nine diplomats.<sup>68</sup>

At the same time, another incident made bilateral relations even worse, leading to the cancellation Foreign Minister Igor Ivanov's visit to Warsaw and to the recall of Russian Ambassador Sergei Razov. On February 23, 2000, several demonstrations were staged in Poland against the Russian war in Chechnya. Polish protesters stormed the grounds of the Russian consulate in Poznan, put anti-Russian graffiti on the walls, burned the Russian flag, and replaced

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<sup>65</sup> Originally reported by Russian *NTV* on January 22, 2000. Cited in "Polish Embassy in Russia, Russian in Poland on Diplomatic Expulsions," *BBC Monitoring*, January 22, 2000

<sup>66</sup> Originally reported by *ITAR-Tass News Agency* on January 21, 2000. Cited in "Russians Have Proof Expelled Polish Diplomats Were Spies," *BBC Monitoring*, January 21, 2000

<sup>67</sup> "Tinker, Tailor, Diplomat, Spy," *Warsaw Voice*, January 30, 2000. Accessed November 2, 2002. Available from ISI Emerging Markets.

<sup>68</sup> "Russian Spy Remarks Raise Storm," *Warsaw Voice*, April 9, 2000. Accessed November 2, 2002. Available from ISI Emerging Markets.

it with the Chechen banner. A Russian Foreign Ministry statement called the incident “an act of vandalism during which Russian national symbols have been desecrated.”<sup>69</sup> Foreign Minister Igor Ivanov called it “an act of hooliganism” and made his planned visit to Warsaw, due on March 3, dependent on the Polish side’s explanation of the incident. On February 26, members of the Russian Bolshevik Party threw eggs and paint on the buildings of the Polish embassy in Moscow and the consulate in St. Petersburg. According to Polish eyewitnesses in the building, Russian security personnel did not do anything to prevent the protesters.<sup>70</sup> The Russian Duma passed a resolution in which it accused the Polish authorities of harboring pro-Chechen separatists. At the end of February, Moscow recalled its ambassador to Warsaw, while sources in the ministry indicated that his date of return was uncertain.<sup>71</sup> Igor Ivanov’s planned visit to Warsaw was cancelled. On March 4, the day after the cancelled visit was supposed to take place, the Russian Foreign Ministry issued a statement saying it was satisfied with the Polish official reaction to the Poznan incident. In early March, several other Russian protests were held in front of the Polish embassy in Moscow. When Sergei Razov returned to Warsaw on March 17, he said: “I would like to hope that the cancelled visit of the Russian Foreign Minister to Poland and the ambassador’s recall for consultations have made them, at least, think about prospects for the relations with Russia.” In the opinion of a Russian diplomat, “the fact that the ambassador has returned by no means signifies that we are pleased with the present state of Polish-Russian relations. We expect the Polish side to investigate the matter to its end and punish the guilty

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<sup>69</sup> Originally reported by *PAP News Agency*, February 24, 2000. Cited in “Polish Ambassador Summoed over Russian Consulate Incident,” *BBC Monitoring*, February 24, 2000. Accessed November 2, 2002. Available from ISI Emerging Markets.

<sup>70</sup> Originally reported by *PAP News Agency*, February 28, 2000. Cited in “Poland Concerned over Incidents at Polish Embassy in Moscow,” *BBC Monitoring*, February 29, 2000. Accessed November 2, 2002. Available from ISI Emerging Markets.

<sup>71</sup> Originally reported by *PAP News Agency*, February 25, 2000. Cited in “Russian Foreign Minister Cancels Polish Visit,” *BBC Monitoring*, February 25, 2000. Accessed November 2, 2002. Available from ISI Emerging Markets.

parties.”<sup>72</sup> An article published in the Polish weekly *Wprost* suspected that the Poznan incident might have been staged by Russians. The article alleged that one of the pro-Chechen organizations was established by the Russian intelligence services. It also said that Polish counter-intelligence service has long suspected that some of the people involved in pro-Chechen activities in Poland were in fact Russian agents.<sup>73</sup> The same article claimed that Russian official organs instructed regional authorities to freeze contacts with their Polish counterparts.

The cancelled visit and the recall of the ambassador demonstrated the seriousness of the incident. Former deputy foreign minister of Russia Andrei Fyodorov said that “relations between Russia and Poland today are worse than in all previous years, much worse than at the time when there was a debate in our country on NATO’s eastward expansion. Both sides are to blame for that.” In his opinion, Russia still refused to treat Poland as equal partner; not surprisingly, Poland did not trust Russia.<sup>74</sup>

### Hungary

Hungarian-Russian bilateral relations practically froze as the consequence of the so-called convoy incident in April 1999. Two weeks after the start of NATO’s bombing of Yugoslavia, the Russian and Belarussian governments sent a convoy of several trucks allegedly carrying humanitarian aid to Serbia. Moscow asked Budapest in advance for permission to let the convoy pass, which it duly received. However, the Hungarian border guards at the city of Zahony denied the convoy transit as it contained eight trucks carrying several thousand liters of fuel. The

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<sup>72</sup> Originally reported by *PAP News Agency*, March 17, 2000. Cited in “Poland: Recalled Russian Ambassador Returns to Warsaw,” *BBC Monitoring*, March 17, 2000. Accessed November 2, 2002. Available from ISI Emerging Markets.

<sup>73</sup> Originally reported by *Wprost*, March 19, 2000. Cited in “Polish-Russian Relations: Is Poland Doomed to a Cold War with Russia?” *PNB-Weekend Supplement*, March 30, 2000. Accessed November 2, 2002. Available from ISI Emerging Markets.

<sup>74</sup> “Opinion on Polish-Russian Relations,” *PNB-Weekend Supplement*, April 13, 2000. Accessed November 2, 2002. Available from ISI Emerging Markets.

quantity was far beyond the level necessary for the convoy and as such was in violation of the UN fuel embargo against Serbia. Additionally, there were five Kamaz trucks with armoured cabs in the convoy. The Hungarian authorities were of the opinion that the five Kamaz trucks had a “double-use,” in violation of the embargo. The Russian side considered the Hungarian objections unjustified and threatened not to pass without the five Kamaz trucks.

Sergei Shoigu, Russian Minister for Emergency Situations, said in an interview to the Russian state television channel ORT that they had notified the Hungarians about the content of the convoy well in advance and Hungary did not object to it.<sup>75</sup> The Hungarian side emphasized that the original bill of lading did not correspond with the real contents in the convoy. Moscow accused Hungary of breaching a 1977 Soviet-Hungarian treaty about simplified customs procedures in case humanitarian convoys want to pass to a third country, which in this case would have meant not checking the contents of the convoy.<sup>76</sup>

The Russian handling of the affair illustrates the confrontational style of Moscow’s foreign policy in the late Yeltsin years. A day after the incident, the Russian Ministry of Foreign Affairs issued a press release, in which it reinforced “its lack of comprehension regarding the steps taken by the Hungarian leadership, which places obstacles in front of the passing through of the Russian-Belarusian convoy.”<sup>77</sup> In an interview given to the Russian television channel *ORT*, Russian Minister for Emergency Sergei Shoigu said that it was strange for the Hungarian side to object to passing through the five armored trucks. These trucks were refurbished exactly in accordance of the prescriptions of the UN High Commissioner for Refugees in order to defend

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<sup>75</sup> “Orosz-feherorosz segelyszallitmany: embargos anyagok, katonai jarmuvek,” *Nepszava*, April 12, 1999. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>76</sup> “Sojgu vadjai,” *Magyar Hirlap*, April 12, 1999. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>77</sup> “Zahonynal elakadt az orosz segely,” *Nepszabadsag*, April 12, 1999. Accessed October 27, 2002. Available from ISI Emerging Markets.

those in the driver's cab.<sup>78</sup> The Press Department of the Russian Ministry of Foreign Affairs warned that the incident at Zahony might affect bilateral relations. According to it, the conduct of the Hungarian authorities questioned the NATO member Hungary's declared intention to continue building partnership relations with Russia in the future. Russian Foreign Minister Igor Ivanov called the Hungarian conduct a "violation of every existing international basic principle and legal norm" and threatened Hungary with the gravest consequences possible. Chairman of the Foreign Affairs Committee of the Duma, Vladimir Lukin, said that it "generates hate," while Parliamentary leader of Our Home Russia, Vladimir Rizhkov, envisioned a "cooling down in the Russian-Hungarian relations."<sup>79</sup>

The conflict was finally resolved at a meeting between the Hungarian Minister of Internal Affairs and Sergei Shoigu, Russian Minister for Emergency, who flew to Budapest to discuss the matter. After waiting for two days, the convoy was allowed to pass. However, the five armored trucks had to stay in Ukraine. Additionally, four out of the eight carrying fuel were denied passage. The other four were allowed to accompany the convoy to Roszke, which is the Hungarian border town on the Yugoslavian-Hungarian frontier. They had to wait there for the return of the convoy. Hungarian authorities insisted that two Hungarian officers would accompany the convoy to its destination. According to their opinion, this was needed because military experts claimed that 31 out of the 75 trucks could be classified as dual-use. Hungarian officers were supposed to certify that all the trucks returned to Russia after they had unloaded the humanitarian aid on board. However, Yugoslavian authorities denied entry for the Hungarian officers. The convoy passed safely to Yugoslavia and returned to Russia. Even though at the end

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<sup>78</sup> "Orosz-feherorosz segelyszallitmany"

<sup>79</sup> "Zahonyi viharocska," *Vilaggazdasag*, April 13, 1999. Accessed October 27, 2002. Available from ISI Emerging Markets.

the incident was resolved smoothly, it put a stain on bilateral relations between Hungary and Russia.

On April 20, Russia asked Hungarian Minister of Foreign Affairs, Janos Martonyi to postpone its trip to Moscow, originally scheduled for the end of May. Additionally, Moscow recalled its ambassador to Budapest for consultations, which meant that the meeting between the heads of government, Viktor Orban and Yevgeny Primakov, originally planned for the summer, had to be cancelled as well.<sup>80</sup> The Russian ambassador returned to Budapest only on May 4. The cancellation of the trip and the recalling of the ambassador were most likely due not only to the convoy affair. Just after that incident had been resolved, the Hungarian Minister for Defense, Janos Szabo announced that Hungary would not negotiate any further with its unreliable Russian partner about the reconstruction of 26 MI-24 helicopters.

Two more incidents substantially worsened Russian-Hungarian relations at the end of the Yeltsin era. In July 1999, Moscow intended to send Russian KFOR troops to the Pristina airport. To do that, it needed Hungary to permit the use of the latter's air space. However, after consultations with the KFOR Headquarters and countries playing a crucial role in KFOR, Hungary denied passage until the successful conclusion of the NATO-Russia negotiations. Even though Hungary's conduct was considered justified and Moscow never objected officially, Russia again threatened grave consequences for the bilateral relations.<sup>81</sup> The final incident was an interview given by the Hungarian Prime Minister to the Canadian *Globe and Mail*. The interview went as follows: "Canadian Minister for Foreign Affairs Lloyd Axworthy questioned whether there is still any need for nuclear weapons in NATO's arsenal. Orban said that there should not

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<sup>80</sup> "Hazarendeltek az orosz kovetet," *Nepszabadsag*, April 21, 1999. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>81</sup> "Egyezseg az orosz atrepulesrol," *Nepszabadsag*, July 6, 1999. Accessed October 27, 2002. Available from ISI Emerging Markets.

be any doubt that the alliance still needs these weapons since Russia's future is uncertain. Hungarians may not be happy about it, but this government would consider allowing the United States to deploy nuclear weapons in the territory of the country during a crisis situation – Orban added.”<sup>82</sup> The Russian Ministry of Foreign Affairs evaluated Orban's statement as a “direct violation of the basic treaty signed by Russia and NATO in 1997.” Moreover, the Russian spokesperson considered connecting the possible deployment of nuclear weapons in Central Europe with an incorrect analysis of the Russian domestic political situation very dangerous.<sup>83</sup> The Hungarian Ministry of Foreign Affairs issued a statement in which it repeated that there was no talk about deploying nuclear weapons in the territory of Hungary, nor was Hungary's membership in NATO directed against Russia.<sup>84</sup> As a result, the affair was over, but it came at a sensitive time. First, Hungary along with two other Central European countries, became members of NATO the previous April. As much as it was emphasized that their membership in the military alliance was not directed against Russia, their primary motivation to join the alliance was in fact their fear of Russia. Orban's statement reinforced the worst fears in Moscow about NATO's first round of enlargement. Second, the Canadian interview was the fourth substantial incident in the bilateral Hungarian-Russian relations within a narrow time frame.

Hungarian Foreign Minister Janos Martonyi's visit, which was cancelled in the Spring, was planned to take place at the end of November 1999. Even though there was speculation in the press about a Russian request for postponing the visit again, it finally did take place.

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<sup>82</sup> *Globe and Mail*, October 29, 1999

<sup>83</sup> “Moszkva komolyan aggódik-Orbán kijelentésének újabb visszhangja,” *Magyar Hirlap*, November 3, 1999. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>84</sup> Statement of the Hungarian Ministry of Foreign Affairs regarding worries of the Russian Ministry of Foreign Affairs about an eventual deployment of nuclear weapons in Hungary, November 4, 1999 (accessed July 23, 2004); available from [www.kulugyminiszterium.hu](http://www.kulugyminiszterium.hu)



## Slovakia

The last phase of the Yeltsin government coincided with a change of government in Slovakia. In the parliamentary elections in 1998, the pro-Russian Meciar government lost the elections. The new government of Mikulas Dzurinda promised to redirect the course of Slovak foreign policy toward integration into the European Union and NATO. Even though the new government named Russia an important strategic partner especially in the sphere of energy, it called for a more balanced relationship with Moscow. In this sense, the new government program declared that “foreign policy towards Russia should be entirely coordinated with the EU approach, while in the security sphere Slovak-Russian mutual cooperation must continue to be determined by the nature of ties between the Russian Federation and NATO.”<sup>85</sup>

Three decisions by the Slovak government between 1998 and 2000 strained the Russian-Slovak relationship. First, in March 1999, the Dzurinda government decided to withdraw from the contract signed during the Meciar regime about delivering the S-300 rocket system under the settlement of the Soviet-era debt from Russia. The government explained its decision with conflicting interests between aspirations for NATO membership and using the Russian S-300 system.<sup>86</sup> The second decision was made in the Summer of 1999. As in the case of Hungary, Russia approached Slovakia to open its air space for the transfer of Russian troops to Kosovo. Bratislava, like Budapest, denied the request. However, while Hungary was already a member of NATO at the time, Slovakia was not. With its decision, the Dzurinda government placed Slovakia entirely on the side of NATO as opposed to Russia. Third, Slovakia adopted EU’s official policy and decided to introduce visa requirements for Russian citizens traveling to and

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<sup>85</sup> Originally in *The Foreign Policy Priorities of the Slovak Republic from 2000 to 2003. A Medium-Term Concept* (Bratislava: Program Declaration of the Government of the Slovak Republic, 1998). Cited by Alexander Duleba, “Slovakia’s Policy towards Russia, the Ukraine and Belarus,” in *Eastern Policy of the Enlarged European Union: A Visegrad Perspective*, eds. Katarzyna Pelczynska-Nalecz, Alexander Duleba, Laszlo Poti and Vladimir Votapek (Bratislava: Slovak Foreign Policy Association, 2003), 154.

<sup>86</sup> Michael Shafir, “Yugoslavia: The Kosovo Crisis and the NATO Hopefuls,” *RFE/RL*, March 30, 1999

through Slovakia beginning in March 2000. Again, although Slovakia was four years from EU-membership, it demonstrated its determination to comply with the Union's standards vis-à-vis third countries. As Slovak-Russian relations expert Alexander Duleba put it, "from 1998 to 2000, the Dzurinda government managed to standardize Slovak-Russian ties and was successful in eliminating Meciar's political heritage. Naturally, Russia responded with restraint, if not coolness, to this change in attitude."<sup>87</sup>

Even though Moscow never reacted to the Slovak steps with the sensitivity and emotion it expressed vis-à-vis similar Polish and Hungarian steps, the flourishing period of bilateral Slovak-Russian relations was over.

#### ***IV.4.3. Russian Energy Companies' Conduct in the Region***

Just as in the case of the previous phase, Russian energy companies' activities were restrained between August 1998 and March 2000. In 1998 and 1999, they were focused on continuing the initiatives already launched, in particular maintaining the privileged position of their joint ventures. However, the will was not enough to substitute for the lack of resources.

In case of Slovrusgas, the original agreement contained Russian commitments to buy a substantial amount of Slovakian products in exchange for gas. This part of the deal, however, turned out to be problematic. Already in July 1997, Rem Vyakhirev noted that the goods Slovakia offered in the 'gas for goods' model were those "which nobody else had wanted."<sup>88</sup> In March 1999, Pavol Kinces, CEO of SPP and head of the board of directors of Slovrusgas acknowledged that "until now it has been a problem that the Russian partner was interested mainly in food" and not the medicine and industrial products, which we had offered from the

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<sup>87</sup> Duleba, "Slovakia's Policy towards Russia, the Ukraine and Belarus," 155.

<sup>88</sup> *Sme*, July 7, 1997, Accessed October 20, 2002. Available from ISI Emerging Markets.

very beginning.<sup>89</sup> It was in the Slovak government's interest to sell goods with higher value added in the Russian market. Gazprom was also interested in receiving goods which it can utilize easier in the Russian market. However, the changes made to the agreement were of marginal importance.

Similar issues arose vis-à-vis Hungary as well. By 1998, it became obvious that Panrusgas had failed as a vehicle for promoting Hungarian exports to the Russian market. The quantity of Hungarian products sold in exchange for Russian gas was far below expectations. As a result, Mol and Gazprom signed another agreement in December 1998, according to which Gazprom would buy Hungarian products for all gas delivered above 90 percent of the contracted volume, and not only in exchange for gas delivered above the quantity agreed upon in the long-term contract. By the end of 1999, Gazprom should have bought Hungarian food and medicine for \$65 million.<sup>90</sup> However, the export of Hungarian products was not going as smoothly as expected. As of February 1999, only very low value added products like canned food and chicken left the country. Hungarian medicine could not find its way to the Russian market through this route, even though Hungarian pharmaceutical companies were major players in the Russian market on their own.<sup>91</sup> The December 1998 agreement between Mol and Gazprom was superceded by another one signed by Hungarian Economy Minister Attila Chikan and Vice-President of Gazprom Vyacheslav Sheremety in March 1999. According to the new agreement, Mol may import a maximum of 1 billion cubic meters of natural gas per year (out of its total imports of 8-9 billion cubic meters of gas) in exchange for Hungarian products. Hungarian exports to Russia were expected to increase by \$60 million per year as a result of the deal, i.e., to \$125 million in total.

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<sup>89</sup> *Trend*, March 17, 1999. Accessed October 20, 2002. Available from ISI Emerging Markets.

<sup>90</sup> *Nepszava*, December 22, 1998. Accessed November 11, 2002. Available from ISI Emerging Markets.

<sup>91</sup> *Magyar Hirlap*, February 19, 1999. Accessed November 11, 2002. Available from ISI Emerging Markets.

However, as of April 1999, the total value of Hungarian products delivered to Russia in exchange for gas was only \$10 million. Bilateral contracts for the delivery of Hungarian products in exchange for natural gas later that year were signed in the amount of \$34 million in April 1999.<sup>92</sup> The Hungarian government's commitment to the barter deal was essential to make it work. According to Megdet Rahimkulov, the CEO of Panrusgas, the Hungarian government pressed Mol to take over the excess gas in the mild winter of 1998/99. Mol had to decrease its own production to be able to take the excess quantity of imports of gas. Despite all the intentions, the export of Hungarian products in exchange of the excess quantity of natural gas remained far below the desired quantity. As a former senior official of Panrusgas phrased it, the barter trade was so miniscule that it was not worth mentioning.<sup>93</sup>

There was only one case in this period when Russia had a major energy related initiative, but even in this case, it did not go beyond threatening words. This initiative was to float the possibility of withdrawing from building the Yamal 2 pipeline. According to the 1994 agreement, the Yamal system should consist two pipes. The construction of the first was finished in 1999, even though a new debate started about the financing of the two compressor stations that would increase the pipe's capacity from 20bn cubic meters to 32bn cubic meters. Still, from the contract's point of view the construction of the second pipeline should have started as soon as the first was fully operational in 2001.<sup>94</sup> In February 1999, Gazprom management board member Yuri Komarov first hinted that Gazprom would withdraw from the idea of constructing the second Yamal pipeline. His explanation was that demand for gas in Western Europe was not

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<sup>92</sup> *Vilaggazdasag*, April 9, 1999. Accessed November 11, 2002. Available from ISI Emerging Markets.

<sup>93</sup> Interview with a former senior official of Panrusgas, who did not allow to uncover his name, Budapest, September 2005

<sup>94</sup> Originally reported in *Gazeta Wyborcza*, May 29, 2001. Cited in "In the Steely Embrace of the Pipeline," *PNB*, May 31, 2001. Accessed October 22, 2002. Available from ISI Emerging Markets.

growing as fast as expected, which meant that the construction of the second pipe was not feasible in economic terms.<sup>95</sup>

However, there is reason to believe that Gazprom's explanation was rather an excuse than the real justification for the withdrawal from the construction of the second pipe. At the time of this announcement, it became also known that Gazprom was considering building a gas pipeline under the Baltic sea from Russia to Germany in order to avoid Poland as a transit country.<sup>96</sup> If Gazprom entertained the idea of the Baltic pipeline, then the low Western European gas demand could not be the real reason for the cancellation of the second Yamal pipe. Additionally, the Baltic pipe would cost much more than the second Yamal. The Baltic pipe's projected costs of construction were \$2.5-3 billion as opposed to the second Yamal pipe's projected costs of \$1-1.5 billion.<sup>97</sup> There are two plausible explanations for the "Baltic instead of Yamal" idea. First, to rely much less on Poland as a transit country thus avoiding mutual dependency.<sup>98</sup> As Polish Industry Minister Marek Pol's chief advisor Tomasz Bartoszewicz said: "The Baltic pipeline was designed to put political pressure on Belarus and Poland."<sup>99</sup> Second, to prevent the building of a gas pipeline would connect Norway with Poland and thus deprive Poland of an alternative source of natural gas. According to international law, pipelines are not allowed to cross each other underwater to minimize the risk of an underwater accident. "The President and the government of the Russian Federation support the monopoly's [Gazprom's] campaign to build a trans-Baltic gas pipeline to transport Russian gas directly to Germany, Great Britain, the Netherlands and Scandinavia. The construction of such a major gas pipeline would put an end to all other projects

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<sup>95</sup> *PNB*, February 2, 1999. Accessed October 21, 2002. Available from ISI Emerging Markets.

<sup>96</sup> *Ibid.*

<sup>97</sup> "Gazprom Looking for Alternative Pipeline Routes to Europe," *Poland AM*, January 26, 2001. Accessed October 20, 2002. Available from ISI Emerging Markets. Also at [http://www.europolgaz.com.pl/english/finanse\\_naklady.htm](http://www.europolgaz.com.pl/english/finanse_naklady.htm)

<sup>98</sup> In case both pipes of Yamal were built, they would deliver 67.4 bn cubic meters gas annually.

<sup>99</sup> Interview with Chief Advisor to Deputy Prime Minister and Infrastructure Minister Marek Pol Professor Tomasz Bartoszewicz, February 2003, Warsaw

to build gas pipelines across the Baltic Sea.”<sup>100</sup> The Baltic pipeline which would connect Russia with Germany would run East-West direction, and as a result, its construction would rule out the option of building any North-South pipeline under the Baltic Sea connecting either Norway or Denmark with Poland. Additionally, if the Baltic pipeline is built, then most likely Yamal 2 would not be constructed. Western European gas demand forecasts do not justify building two East-West pipelines in the Northern part of Europe. As a result, if the Baltic pipe is built, Yamal 2’s construction will most likely be postponed for the indefinite future.

Gazprom’s February 1999 announcement, about its potential withdrawal from building Yamal 2 and at the same time entertaining constructing the Baltic pipeline, started a chain of talks about whether the second pipeline of Yamal would be built and its alternatives. Gazprom used Yamal 2 as a stick and/or carrot in its negotiations with Poland and made the construction of the second pipeline also a political question. In October 1999, Rem Vyakhirev, then head of Gazprom said that his company will build the second line. The question is only when it will do so. He did not give any specific date for starting the construction of Yamal 2.<sup>101</sup> At the same time, the Russian giant announced that it will decide within a year about the construction of the Baltic pipeline.<sup>102</sup> Vyakhirev answered Polish anxieties about Yamal 2 by saying that “if Poles don’t like Russian gas, they can always go back to burning wood in stoves.”<sup>103</sup> Furthermore, two months later Gazprom started to float the idea of yet another pipeline running from Belarus to Poland and through Southern Poland to Slovakia where it would connect into the old

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<sup>100</sup> Paszyc, 21.

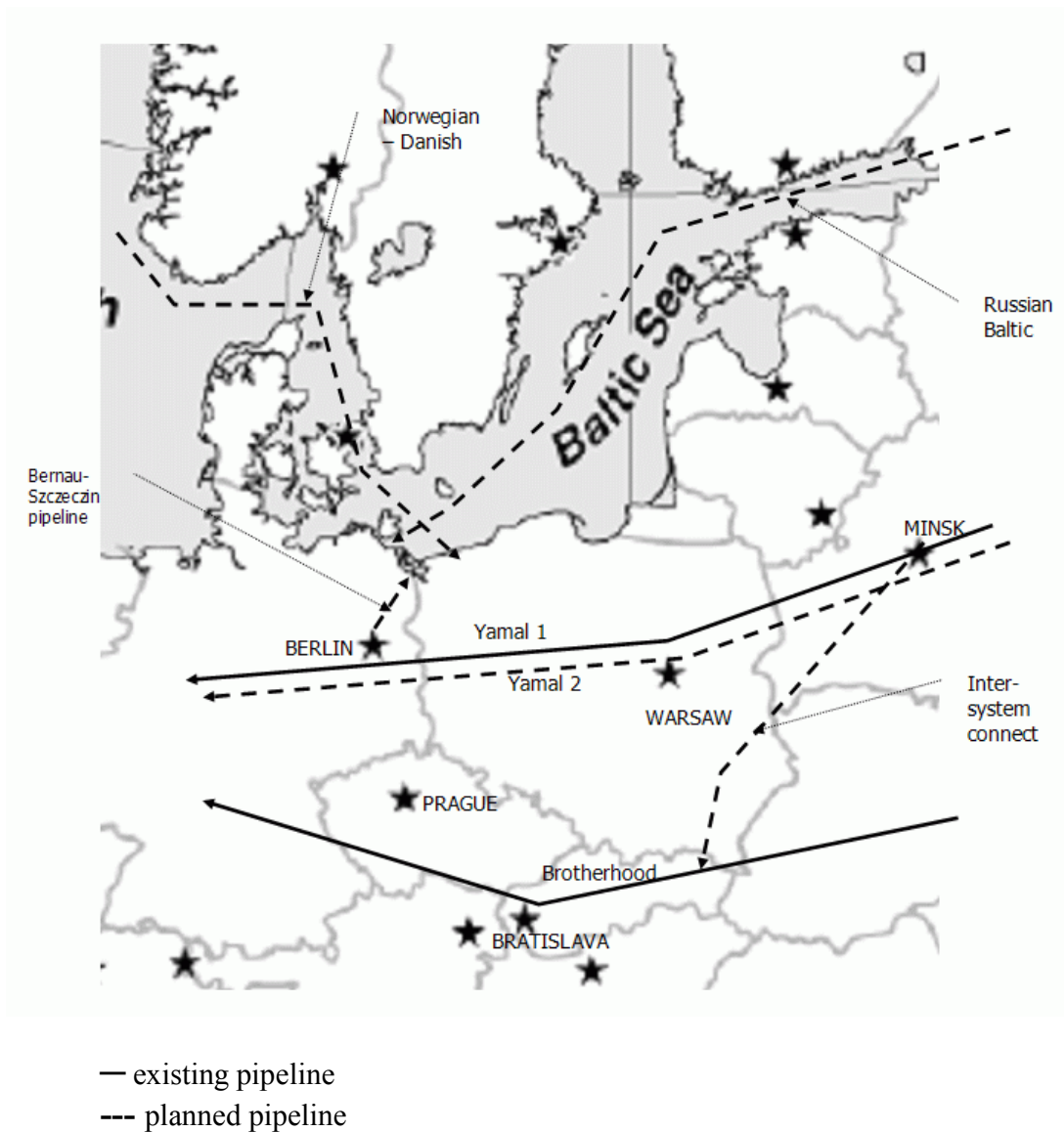
<sup>101</sup> “Polish Stretch Is Ready: Yamal-Europe Gas Pipeline,” *Warsaw Voice*, October 3, 1999. Accessed October 28, 2002. Available from ISI Emerging Markets.

<sup>102</sup> “What’s New,” *Prawo i Gospodarka*, October 12, 1999. Accessed October 29, 2002. Available from ISI Emerging Markets.

<sup>103</sup> “Heard in Passing,” *Warsaw Voice*, October 24, 1999. Accessed October 29, 2002. Available from ISI Emerging Markets.

Brotherhood pipeline.<sup>104</sup> This pipeline would connect the Yamal pipes with the Brotherhood system, and as a result, they started to refer to it as the inter-system connecting pipeline.

**Map 1: Existing and Planned Natural Gas Pipelines to, through and around Poland\***



\* Map is prepared by the author.

<sup>104</sup> “Gazprom Points the Finger at Ukraine,” *EIG – Energy Compass*, December 10, 1999. Accessed October 29, 2002. Available from ISI Emerging Markets.

When the inter-system pipeline was first suggested, Gazprom did not make it clear whether it would replace Yamal 2 altogether or would only supplement the Yamal system. There is reason to believe that in the beginning Gazprom was deliberately vague about the two pipes and its intentions. In reality, Gazprom considered the idea of building the inter-system connection pipeline from the very beginning as nothing else than an overt threat to Ukraine. Gazprom initiated the idea at the time when its dispute about Ukraine's gas debt was peaking. The Russian gas company has been very dependent on Ukraine as about 90 percent of the Russian gas export to Western Europe went through Ukrainian territory. In addition to not paying its gas bills, Ukraine was siphoning off additional gas from the pipeline. However, as long as the Brotherhood pipe remained Gazprom's main transit route to Western Europe, it had only limited tools at its disposal to prevent the stealing of gas or enforce payments. In 1999, Gazprom launched a strategy to take control of the Ukrainian part of the Brotherhood pipeline. The idea of the inter-system connect pipeline, which would circumvent Ukraine and as a result deprive Kiev of an important source of revenue from transit fees, was part of this bigger strategy. As Tomasz Bartoszewicz, Chief Advisor to Marek Pol, Infrastructure Minister in the Miller government, phrased it "it was a kind of a virtual project to pressure Ukraine."<sup>105</sup>

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<sup>105</sup> Bartoszewicz interview



#### ***IV.4.4. Summary***

The 1998 financial meltdown, the three former satellite countries' official entry to NATO, and Russia's inability to do anything for its long-term friend and ally, Serbia, shook the Russian foreign policy establishment. Foreign policy lost its strategic vision and became chaotic. Russian leaders have not seen since the collapse of the Soviet Union their country's relative influence in world affairs to be so alarmingly low. Feelings of injustice and betrayal became commonplace and hostility to the West came back to fashion. The ensuing reactionary visions were manifested in the Russian military doctrine of 1999, which read like the vision from a fortress under siege.

As there were more fundamental issues to tackle, Central Europe again fell off of the radar screen of foreign policy thinkers. The visible confusion with regard to strategy and doctrine meant that the official Russian foreign policy had no clear vision of what it wanted from or in Central Europe. This situation was exacerbated by the Central European countries' newly-found assertiveness vis-à-vis Russia. Having joined NATO (Poland and Hungary) and having the opportunity shown to do so (Slovakia), all three countries resisted Russian pressures with vehemence and steadfastness not experienced from them before which, combined with Russian reluctance to give in, led to serious diplomatic conflicts in case of two countries.

At the same time, state power was at its second lowest level in the entire post-Soviet period, which limited the Russian government's ability to act even if it had a clear strategy. The hypothesis is that under such circumstances, Russian energy companies would not expand any further in Central Europe, and this case supports that hypothesis.

With one exception, Russian energy companies, more precisely Gazprom, had very limited initiatives in Central Europe. Gazprom aimed merely at maintaining the special position its joint ventures had in Slovakia and Hungary. However, lacking the means to buy and sell enough Central European products in Russia, Gazprom was unable to carry out even this goal. The only

major issue raised - abandoning the construction of Yamal 2 - was limited to verbal threats, even if harsh ones. These developments support the logic of this hypothesis, which is that Russia had the will (result of the perceived very low influence in world affairs) but not the skill (state power) to expand in Central Europe in this period.

## **CHAPTER V: RUSSIAN ENERGY COMPANIES' EXPANSION INTO CENTRAL EUROPE DURING THE FIRST PUTIN PRESIDENCY, 2000- 2004**

### ***V.1. Perceptions and State Power***

After coming to power, President Vladimir Putin consolidated his power relatively quickly. The Putin era brought to Russia long-sought stability in the political, as well as the economic, sphere. One key factor in this stabilization was the dramatic increase in oil prices: while in 1999 the world prices of crude oil were around \$10 per barrel, in 2004 they reached about \$30 per barrel.<sup>1</sup> As oil prices directly influence the price of natural gas, the Russian petroleum industry became a key driver of economic recovery. According to World Bank estimates, about 25% of Russian GDP came from the crude oil and natural gas sectors in 2003.<sup>2</sup> The Russian economy produced an average annual growth rate of 6.5% from the 1998 financial crisis until 2004.<sup>3</sup> This growth gave much needed extra money and confidence to Russia.

With regard to foreign policy, the first Putin presidency was characterized by confidence and pragmatism. While its attitude toward the West had its fluctuations, the entire period was characterized by a commitment to increasing Russia's influence in the world substantially, and its willingness to make compromises as long as they seemed to serve this long-term interest. That is to say, even though the Putin administration was clearly much more pragmatic than his

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<sup>1</sup> Crude oil price statistics (accessed August 12, 2005); available from [http://www.eia.doe.gov/emeu/aer/pdf/pages/sec11\\_15.pdf](http://www.eia.doe.gov/emeu/aer/pdf/pages/sec11_15.pdf)

<sup>2</sup> The Russian Federation (accessed September 3, 2005); available from [http://www.worldbank.org/ru/ECA/Russia.nsf/ECADocByUnid/0CF40EF2E501A275C3256CD1002B7D90/\\$FILE/RER7\\_eng.pdf](http://www.worldbank.org/ru/ECA/Russia.nsf/ECADocByUnid/0CF40EF2E501A275C3256CD1002B7D90/$FILE/RER7_eng.pdf)

<sup>3</sup> *The CIA World Factbook: Russia* (accessed October 1, 2005); available from <http://www.cia.gov/cia/publications/factbook/geos/rs.html>

predecessors in its relationship with the West, its dissatisfaction with Russia's current influence was profound.

At the beginning of his presidency, Putin recognized that short-term Russian foreign policy aspirations were not in line with the country's realities. His biggest foreign policy achievement was to harmonize the former with the latter.<sup>4</sup> He realized that Russia lacked the necessary resources to be a stand-alone player in world affairs, and therefore, it needed to join forces with other powers. Moscow tried to make a stronger relationship with the European Union and started an active policy of rapprochement with Europe with the eventual goal of joining the Union. By the end of 2001, foreign policy thinkers started to discuss openly if Russia should aim at joining the Union in 15-20 years. The Putin administration seemed to internalize this goal.

The Russian opening toward the West became even more tangible after September 11, 2001. However, it is important to note that this opening did not happen abruptly but was preceded by one and a half years of preparation. Russian foreign policy did not change with September 11; it changed when Putin came to power.<sup>5</sup> He wanted to make Russia a great power again but believed that these aspirations cannot be met against the West but only in a partnership with it. He was pragmatic in choosing his means towards his end. He viewed Russia's economic capabilities as its major handicap in achieving its desired influence in the international arena. He believed that economic capabilities would have increasing importance in determining a country's place in the world in the future. Putin aimed at using a Russian alignment with the West to revive Russian economic power. Russian economic strength would be simply a tool for him to increase Russia's relative power in the international system.

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<sup>4</sup> Interview with Associate Professor Zoltan Sz. Biro, Budapest, June 2002

<sup>5</sup> Zoltan Sz. Biro, "Moszkvai dilemmak," *Nepszabadsag*, November 3, 2001. Accessed July 30, 2004. Available from <http://www.nol.hu/cikk/35425/>.

President Putin's 2002 State of the Nation address concentrated on domestic issues. Its main emphasis was on the development of the Russian economy. With regard to foreign policy alignment, it gave preference to Russian relations with the West over those with the East. Putin added special importance to foreign affairs in July 2002, when for the first time in 16 years he as president of Russia summoned all the Russian ambassadors and gave them a briefing on the priorities of Russian foreign policy. The emphasis on strengthening the Russian economy, as well as Russian companies abroad, was bigger than ever. "The country's foreign policy must be subordinated to domestic economic interests." Regarding the European Union, "Putin said that economic ties with the European Union – especially in the energy sphere – are the top priority."<sup>6</sup> This time the Russian president went beyond the goal of strengthening the Russian domestic economy. He outlined the subordination of state means to the interests of the Russian economy and companies. Putin demanded that Russian diplomats assist the Russian business elite and businessmen in developing the markets of the countries where these diplomats are assigned. At the same time, he announced the plan that Russian trade missions, which at the time were supervised by the Ministry for the Economic Development and Trade, would be transferred to the Foreign Ministry, and that economic departments would be established at the embassies to assist Russian businessmen in developing foreign markets.<sup>7</sup> There were analysts who shared the views of the Russian president. "Unfortunately, until now Russian diplomacy has remained on the sidelines of pushing the real interests of Russian corporations abroad," Andrei Ryabov, a political

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<sup>6</sup> *RFE/RL*, July 12, 2002. Accessed July 10, 2004. Available from [www.rferl.org](http://www.rferl.org).

<sup>7</sup> "Putin Outlines Main Planks of Russian Foreign Policy – TV Reports," originally in *Russia TV*, July 12, 2002. Cited by *BBC Monitoring*, Johnson's Russia List #6353, July 13, 2002. Accessed September 15, 2003. Available from <http://www.cdi.org/russia/johnson/6353.htm>.

analyst at the Carnegie Moscow Center said. “Meanwhile, as some Russian companies expand to the West, they would like to get the support of the diplomatic corps.”<sup>8</sup>

Leading Russian politicians made several comments indicating that they were thinking along the lines promoted by President Putin. Russian foreign minister Igor Ivanov noted at the foreign policy institute MGIMO in May 2001 that “energy diplomacy” was becoming a promising new direction for Russia’s international relations.<sup>9</sup> In February 2003, at Gazprom’s 10<sup>th</sup> birthday, President Putin called the company an essential tool of Russia’s economic and political influence in the world.<sup>10</sup>

Putin’s increased emphasis on promoting Russian economic – and especially important energy interests abroad - supplements the sharp increase of state control in the Russian energy sector. The CEO of the Hungarian oil monopoly, Zsolt Hernadi, called the year 2002 a watershed in this regard.<sup>11</sup> Putin started to appreciate the potential of the Russian energy sector and aimed at a systematic re-concentration of power in the hands of the state. In May 2001, he replaced Rem Vyakhirev as head of Gazprom with Alexei Miller. Putin emphasized that the principal task of the new CEO is to support the interests of the Russian state in the company. He also noted that Miller should “collect everything which by right belongs to the state and make the company’s operations, first of all its financial activity, absolutely transparent to all shareholders.”<sup>12</sup> As a step in this direction, Miller started to recollect all the assets which were stolen from Gazprom by its former managers. In January 2002, Russian authorities detained Yakov Goldovsky, ex-president

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<sup>8</sup> Oksana Yablokova, “Putin Tells Diplomats to Do PR for Russia,” *Moscow Times*, July 13, 2004

<sup>9</sup> Dr. Mark A. Smith, *Russian Business and Foreign Policy* (Conflict Studies Research Centre, May 2003), 2.

<sup>10</sup> Speech at Gazprom’s 10<sup>th</sup> Anniversary, February 17, 2003 (accessed February 27, 2003); available from <http://www.gazprom.ru/text/article/article6182.shtml>

<sup>11</sup> Interview with Zsolt Hernadi, President-CEO of Mol, the Hungarian Oil and Gas company, August 2005, Budapest

<sup>12</sup> “President Putin: Gazprom’s New CEO’s task is to Uphold State Interests at that Company,” *Pravda*, June 20, 2001. Accessed November 13, 2002. Available from ISI Emerging Markets.

of Sibur, the leading Russian petrochemical holding company that played a major role in buying one of the Hungarian petrochemical companies a year and a half earlier.

The most visible example of Putin's move is the case against Yukos, which started in the summer of 2003. Several plausible scenarios exist to explain the Kremlin's move against Yukos, but two of them seem to be most likely. First, Yukos together with four other Russian oil producers announced at the end of 2002 a plan to build an oil pipeline from Western Siberia to the port of Murmansk. The project would have been financed by private sources and operated by private companies. In Russia, all the crude oil pipelines are in the hands of Transneft, a state-owned company. Transneft's monopoly means that even though the extraction is privatized, the state maintained its control over the delivery and export routes, as well as the exit points of crude oil from Russia. According to estimates, Russia was able to produce 300-350 million tons of oil per year economically. If the new pipeline were built, Russia could have increased its production to 450 million tons per year, a 25-50% increase in production. With regard to transport capacity, the new private pipeline would have controlled 25-30% of Russian crude oil transport, a significant share of the total.<sup>13</sup> If the head of Yukos Mikhail Khodorkovsky had managed to execute his plans, he would have broken the monopoly of the Russian state in the transport of crude oil and thus Moscow would have lost its sole control in the oil business, which is one of its primary sources of revenue. In early November, a month after Khodorkovsky's arrest, Simon Kukes, the new head of Yukos, expressed preference for the new oil pipeline infrastructure to be built by the Russian government as opposed to private companies.<sup>14</sup>

Second, Khodorkovsky conducted negotiations with ExxonMobil about selling 40% of Yukos to the American company. If this transaction took place, the Russian state would have lost much

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<sup>13</sup> Murmansk pipeline (accessed September 30, 2005); available from <http://www.yukos.com/RM/Murmansk.asp>

<sup>14</sup> "New Yukos Head: Western Ally Not Necessary," *The Russia Journal*, November 10, 2003

of its leverage over Yukos. First, ExxonMobil does not have the dependency on the Russian state that all local energy companies have. Therefore, it would have enabled Yukos to be more inclined to resist pressures from the Kremlin. Second, although heavy-handed administrative measures would have still been at the Kremlin's disposal to coerce Russian-registered Yukos, their costs would have become prohibitive. For such measures can inflict billion-dollar damages on shareholders, in this case a very influential American company, almost certainly hurting seriously the Kremlin's relationship with the United States, a pivotal country for Putin's foreign and economic policy. Simon Kukes withdrew Yukos from the negotiation immediately, stating that foreign companies do not offer any strategic advantage for Yukos.<sup>15</sup> To drive the point home, a few days later Defense Minister Sergei Ivanov, one of President Putin's closest allies, said in an interview for the Russian business daily *Kommersant* that the Kremlin should control its oil resources more closely in the future.<sup>16</sup> Khodorkovsky's moves were completely opposed to the interests of the Russian state, at least as they were formulated by Vladimir Putin.

The Putin administration implemented renewed state control in the Russian energy sector and with it a re-concentration of political and economic power. Moscow reassured its leverage over natural resources, their export routes, and their exit points from Russia. The Russian president's desire to rely on Russian economic power appeared at the rhetorical level as well, and again the energy sector provided the example. Putin said to German Chancellor Gerhard Schroeder on October 9, 2003: "We are not going to break up Gazprom. The European Commission should have no illusion: they are going to be dealing with the state in the natural gas industry." He also added that "the gas pipeline system is a child of the Soviet Union, and only we are in a position

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<sup>15</sup> Ibid.

<sup>16</sup> *Kommersant*, November 17, 2003



to maintain it in working condition, even if you are talking about the sections that lie outside Russia.”<sup>17</sup>

By late 2003, there were signs of growing assertiveness of Russia. In October 2003, Sergey Ivanov presented its white paper it claimed the right of preventive attack on neighboring countries and implied that Russia considered NATO a potential enemy. At the end of 2003, Putin even announced that Russia did not aim at joining the European Union. Still, the emphasis on the necessity of Russian economic recovery, as well as the great weight lent to economic considerations in foreign policy, continued to exist.

In summary, Russian foreign policy in President Putin’s first term became more pragmatic than its immediate predecessors’. However, the period, just like all the others after 1993, was characterized by strong dissatisfaction over the perceived low level of Russian influence vis-à-vis the West. As tools of foreign policy changed, the energy industry received a bigger and more important role in pursuing the country’s interests.

State power underwent a dramatic change in this period. Federal tax revenues as a percentage of GDP recovered from the abysmal level of 1998 (9.2%), in 2000 reached the highest level since 1993 (15.5%), and continued to grow steadily afterwards (17.6%, 17.1%, 19.6%) in 2001, 2002, and 2003, respectively), reaching 20.4 percent in 2004, higher than in the last year of the Soviet Union. The substantial growth in oil and natural gas prices was one of the most important factors in the recovery, yet not the only one.

As shown in the table below, under these circumstances – relative influence low and state power high – my hypothesis is that Russian energy companies were very active in their expansion to Central Europe.

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<sup>17</sup> Originally reported by *ITAR-TASS*, quoted by Edward C. Chow, “Russian Pipelines. Back to the Future?” *Georgetown Journal of International Affairs*, Winter/Spring 2004, 32. Accessed August 10, 2005. Available from <http://www.carnegieendowment.org/pdf/files/chowarticle-jan04.pdf>.

Predictions based on my hypothesis:

	<b>Russian leadership's perception about Russian influence in the world</b>	<b>State power</b>	<b>Predictions of the hypotheses on the behavior of Russian energy companies towards Central Europe</b>
<b>1991-1993</b>	Consistent	High	<b>Do not expand</b>
<b>1993-1996</b>	Low	Medium	<b>Do expand</b>
<b>1996-1998</b>	Low	Low	<b>Do not expand</b>
<b>1998-2000</b>	Low	Low	<b>Do not expand</b>
<b>2000-2004</b>	<b>Low</b>	<b>High</b>	<b>Do expand</b>

According to the hypothesis, when the Russian leadership perceives that Russia's relative influence vis-à-vis the West is low and the state has enough power to mobilize the necessary resources, Russian energy companies will try to expand toward Central Europe.

## ***V.2. Classical Foreign Policy towards Central Europe***

Central Europe continued to have a marginal role in Russian foreign policy thinking. The region came into the forefront during discussions about the effects of EU enlargement on Russia.<sup>18</sup> During the first two and half years of the Putin presidency these discussions were mainly about technical matters, such as visa issues or the access of Russian citizens to the Kaliningrad region. Later, the discussion shifted to the issue of power distribution between the

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<sup>18</sup> See Anders Aslund and Andrew Warner, *The Enlargement of the European Union: Consequences for the CIS Countries*, Working papers, Political and Economic Reform Project, Russian and Eurasian Program (Carnegie Endowment for International Peace, April 2003); Russia and the European Union, panel discussion, organized by the Carnegie Endowment for International Peace on May 5, 2004

enlarged EU and Russia. In these debates, Central Europe or relations with it did not occupy any significant place. In summary, the region did not reach the threshold to be given notable attention in Russian foreign policy discussions or thinking.

### *Official Doctrine and Strategy*

In January 2000, the Russian National Security Concept was signed. President Yeltsin handed over the presidency to Acting President Vladimir Putin a couple of days earlier. The Concept increased the number of scenarios in which Russia would be inclined to use nuclear weapons. Even though the Concept was accepted at the very beginning of Putin's presidency, it reflected the renewed assertiveness of the military typical in the late Yeltsin years. At the beginning of his presidency, from 2000 to about Summer/Fall of 2003, Putin chose a new direction for Russian foreign policy. The tone of the National Security Concept of 2000 reappeared again only 3 years later in the so-called Ivanov paper (or Ivanov doctrine), presented by Russian Defense Minister Sergey Ivanov on October 2, 2003.

Putin outlined the major directions his foreign policy would take in the Russian Foreign Policy Concept of 2000, which was approved on June 28, 2000.<sup>19</sup> There were two important points in the concept which had indirect relevance for Russia's relations vis-à-vis Central Europe. First, Putin realized that the key to Russian revival was to make the country economically strong. It was a recognition that only an economically strong Russia could be a world player again. As a result, he subordinated other foreign policy objectives to the development of the Russian economy. The Concept said that "the main priority in the foreign policy of the Russian Federation in international economic relations is to promote the development of the national

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<sup>19</sup> *The Foreign Policy Concept of the Russian Federation*, June 28, 2000 (accessed on October 5, 2005); available from <http://www.fas.org/nuke/guide/russia/doctrine/econcept.htm>

economy, which, in conditions of globalization, is unthinkable without broad integration of Russia in the system of world economic ties.” In order to achieve this objective, among others, “Russia must be prepared to utilize all its available economic levers and resources for upholding its national interests.”

Second, Putin shifted Russian foreign policy from America-centrism toward a greater emphasis on Europe. The priority given to Europe may be partially explained by economic realities as well. While more than 25 percent of Russian imports and 35 percent of Russian exports were conducted with the European Union, the corresponding figure for the US was 5-6 percent in both directions.<sup>20</sup> The Concept noted that “relations with European states is Russia's traditional foreign policy priority.” Central and Eastern Europe was mentioned in a single sentence in the Concept, which indicated that the region could have some significance in helping Russia reach its objective of making the country economically strong.

In October 2003, Sergey Ivanov presented a white paper which claimed the right of preventive attack on neighboring countries and implied that Russia considered NATO a potential enemy. At the end of 2003, Putin even announced that Russia did not aim at joining the European Union. With these alterations, the tactics of Russian foreign policy had changed. However, the basic drivers remained the same, actually they became more transparent. Russia continued to be unsatisfied with its relative influence vis-à-vis the West, and was deeply disturbed by the continuing expansion of NATO into Central Europe.

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<sup>20</sup> *The EU's Relations with Russia: EU-Russia Trade*. Updated in November 2004 (accessed on October 7, 2005); available from [http://www.europa.eu.int/comm/external\\_relations/russia/intro/trade.htm](http://www.europa.eu.int/comm/external_relations/russia/intro/trade.htm)

### *Bilateral Diplomatic Relations*

The Putin presidency brought a new approach in the bilateral relations with the Central European countries as well. In 2000, bilateral relations with both Poland and Hungary reached their lowest point since the collapse of the Soviet bloc. The mutual expulsion of the diplomats in January 2000, the storm against the Russian consulate in Poznan in March 2000, and the fibre optic cable scandal at the end of the year (to be discussed later) made 2000 the worst year in the post-Soviet Polish-Russian relations. Vis-à-vis Hungary, the so-called Borsodchem scandal in August 2000 (to be discussed later) symbolized the mutual distrust between the two sides. Even though Slovak-Russian relations were never as bad as Polish-Russian or Hungarian-Russian ones in 2000, during the late Yeltsin years Slovakia and Russia did not enjoy the intensity of the bilateral contacts as before. However, the goals of Russian foreign policy, to strengthen Russia's economic relations and economic presence especially through the energy sector, in the countries of Central Europe, came into the forefront. The new Russian approach was felt in Moscow's relations with all the three aforementioned countries.

#### Poland

In January 2002, President Putin paid a two-day visit to Poland. Poland became the first former satellite country Putin visited. The Russian President's visit to the Polish capital was interpreted as a breakthrough in the Russian-Central European relations. Putin could have visited Bratislava, a capital, with which Moscow enjoyed a continuous fruitful relationship. The choice of Poland, which had the most troublesome relations with Russia in the preceding years, signaled a brand new tactic in Russian thinking about the region. Additionally, the circumstances of the trip were symbolic, as well. This was the time when Putin was a well received guest in the

European capitals and in Washington. He had a direct and easy access to Gerhard Schroeder, Tony Blair and Jacques Chirac. Putin stopped in Warsaw on his way home from Paris. However, while the Russian president would have flown over Poland just three years before, this time he considered it important to visit in person.

Since the end of 2000, tensions between Poland and Russia started to ease. Polish politicians made several trips to Moscow, and their visits were reciprocated. However, it is important to emphasize that the real opening came from the Russian side.<sup>21</sup> In November 2000, Foreign Minister Igor Ivanov made up for his cancelled visit of March 2000 (cancelled because of the Poznan consulate incident). In May 2001, Prime Minister Mikhail Kasyanov arrived in the Polish capital. Vladimir Putin's visit was the first of a Russian president to Poland since Boris Yeltsin's in 1993.

Putin's visit to Poland had symbolic value. The Russian president offered gestures to his Polish counterpart which were unthinkable only a few years earlier. He laid a wreath on the monument of the Warsaw Uprising, a symbol of the difficult historical relationships between the two countries. The Russian President also commemorated the victims of the 1956 uprising in Poznan. Putin also emphasized that the gloomy wartime events and Stalinist crimes belonged to the past and could not interfere with current relations between Poland and Russia. To further stress his message, he said that he did not think there was any obstacle to prevent the compensation of the Polish victims of the Stalinist terrors. Putin's step was remarkable in light of Russian public opinion. According to Ekho Moskvi polls, Russians were divided over the idea of

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<sup>21</sup> Interview with Russia analyst Marek Menkiszak, OSW (Centre for Eastern Studies), February 2003, Warsaw

compensation.<sup>22</sup> However, the Russian president “earned scores in the eyes of most of the Poles” with these two gestures.<sup>23</sup>

In accordance with the prevailing Russian emphasis on economic issues in relations with Central Europe, most of the negotiations between the Russian and Polish partners concentrated on economic questions. However, they could not reach agreement on most of the topics, including the volume of the future natural gas deliveries to Poland. On the other hand, Russian businessmen accompanied Putin and they concluded several agreements.

At the political level, President Putin and Polish Prime Minister Leszek Miller agreed that Polish and Russian premiers should meet at least twice a year.<sup>24</sup> At their press conference, the two stated that they are seeking a renewed cooperation with each other.<sup>25</sup> President Putin also noted that the good Polish-Russian relations demonstrated that it is possible to have good relations with Russia and he expressed his hope that Polish-Russian relations would serve as an example for other Central European countries. (He must have had primarily Hungary, and to a lesser extent the Czech Republic, in mind.) The nice words did not yield much tangible results. Although the tone of the relationship normalized, no real breakthroughs followed.

### Hungary

The improvement in the Russian-Hungarian relations came with a certain delay compared to the development of Polish-Russian or Slovak-Russian relations. It is hard to explain what caused this delay. It could have been the result of the aftermath of the cold relationship of the later

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<sup>22</sup> “Varso orozzbarat szerepben,” *Nepszabadsag*, January 18, 2002. Accessed September 7, 2002. Available from <http://www.nol.hu/cikk/43098/>.

<sup>23</sup> Kai-Olaf Lang, *Ein neues polnisch-russisches Verhältnis? Putins Polenbesuch im Januar 2002*, SWP-Aktuell 1, Stiftung Wissenschaft und Politik (Berlin: Deutsches Institut fuer Internationale Politik und Sicherheit, January 2002), 6.

<sup>24</sup> “The Bison and the Bear: Bilateral Relations,” *Warsaw Voice*, January 27, 2002. Accessed October 28, 2002. Available from ISI Emerging Markets.

<sup>25</sup> Ibid.

Yeltsin years. It is also possible that the Russian partner was waiting to see the outcome of the Hungarian parliamentary elections in April 2002. The slogan of “gaining back the Russian markets” and improving relations with Russia became one of the campaign themes of the Hungarian Socialist Party (the post-communist party). In case of their victory, Moscow could have reasonably expected a sharp turn in Hungarian foreign policy towards Russia. The Orban government’s last major ministerial visit to Moscow was paid by Foreign Minister Janos Martonyi in February 2002. However, the planned visit of the Hungarian Prime Minister Orban never took place. Interestingly enough, the Hungarian Socialist Party’s prime minister designate Peter Medgyessy paid a visit to Moscow in February 2002, as well, where he met Yevgeny Primakov and Duma President Gennadiy Seleznyov. Medgyessy’s visit to Russia two months before the Hungarian parliamentary elections highlighted the priorities of a future Hungarian socialist government’s foreign policy.

The election victory of the Socialist Party resulted in many high-level meetings between the two countries. On one of his first trips abroad, the new Hungarian Foreign Minister Laszlo Kovacs went to Moscow in September 2002 to prepare a prime ministerial visit to the Russian capital. The visit took place in December 2002. The last time a Hungarian Prime Minister paid an official visit to Moscow was in 1995. The meeting was rather symbolic and remarkable because of its existence and not because of its substance. Basically the two partners agreed about the settlement of the remaining part of the Soviet-era debt. At this time, Moscow aimed at closing this chapter of Soviet history vis-à-vis all its former satellite countries. Even though on the surface bilateral relations reached a new level, very little substance was achieved. First, while during the September meeting of the two foreign ministers it was vaguely discussed that the Hungarian military cemetery in the Russian Rudkino would be opened in 2002; the opening did not take place. No further steps were taken regarding the return of the Sarospatak library taken



from Hungary by Soviet troops during World War II. Moreover, between the September and the December meetings, the return of the library became even more difficult. A Russian committee set up to investigate the options for returning the more than one-hundred books to Hungary, concluded on September 30, 2002 that the books could not be given back unless the Hungarian parliament passed a law about the return of all Russian art pieces in Hungary. However, this condition seemed to be unfulfillable. The Hungarian partner had asked Russia several times for an official list of all the Russian art pieces allegedly in Hungary but never received such a list. On the other hand, an investigation by Hungarian authorities did not find any art pieces taken from the Soviet Union in any of the Hungarian public collections.<sup>26</sup> Finally, during Peter Medgyessy's December visit a general agreement was made about the return of the Sarospatak books. However, decisions to implement the agreement did not conform to high-level intentions and the books were not returned until early 2006.

Also while it was already built by the beginning of 2002, the Hungarian military cemetery in the Russian town of Rudkino was officially opened only in May 2003. Allegedly the newly created cemetery was in sharp contrast with the surrounding Soviet cemeteries, making the Russians living in Rudkino angry. To receive the permit to open the cemetery, the Hungarian government paid 40 thousand euros to the local municipal government.<sup>27</sup> Additionally, further conditions on the establishment of the Hungarian military cemetery in Russia were unfavorable to Hungary. First, Budapest paid not only for establishing the Hungarian memorial in Russia but also for the renovation of the Soviet memorial in Hungary. This went against the common diplomatic practice. Second, the Hungarian partner had planned to hold the opening ceremony at

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<sup>26</sup> "Kolcsonos gesztusokra varva," *Nepszabadsag*, November 27, 2002. Accessed September 7, 2002. Available from <http://www.nol.hu/cikk/88600/>.

<sup>27</sup> "Orosz ketsegek a rudkinói temető ügyében," *Nepszabadsag*, May 28, 2003. Accessed August 17, 2004. Available from <http://www.nol.hu/cikk/112263/>.

the political level. However, the Russian partner deliberately downgraded the opening to the level of military institutes. The highest ranking official on the Hungarian side who participated at the opening ceremony was the chief director of the Hungarian Military History Museum and Institute.<sup>28</sup>

Despite the few tangible results, on the surface the bilateral relations were flourishing compared to the preceding period. The intensity of the high-level contacts continued. Russian Prime Minister Mikhail Kasyanov visited Budapest in September 2003. He was the first Russian Prime Minister to come to Hungary since 1994. In December of the same year, Hungarian Prime Minister Peter Medgyessy again met President Putin in St. Petersburg. This was the fourth bilateral meeting of the two since the Medgyessy government came to office in May 2002 and the second Hungarian prime ministerial visit to Russia since then. The key issue of the last high-level bilateral Hungarian-Russian meeting of the first Putin presidency was the participation of Russian companies in the upcoming Hungarian privatization tenders. President Putin said that Russian investments in Hungary amounted only to \$1 billion but Russian companies intended to become more active players in the Hungarian economy. Prime Minister Medgyessy assured his Russian partner that there were no prejudices against Russian investments in Hungary.<sup>29</sup>

Certainly Hungarian-Russian relations after 2002 improved substantially compared to the previous period, as was also the case in Polish-Russian relations. In the case of Hungary, the presumed Russian opening and pragmatism toward Central Europe coincided with a change of government. The new Hungarian government was very open toward Russia and intended to place the bilateral relations at a new level. Between 2002 and 2004, two long-pending issues were finally resolved: the settlement of the remaining part of the Soviet-era debt and the opening of the

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<sup>28</sup> Interview with former Hungarian Ambassador to Moscow Erno Keskeny, May 2003, Budapest

<sup>29</sup> "Mit igert Medgyessy Putyinnak?" *Magyar Nemzet*, December 1, 2003, 9.

Hungarian military cemetery. The high-level meetings were dominated by bilateral economic and trade issues, as well as by discussions about the participation of Russian companies in the Hungarian privatizations.

### Slovakia

The relatively cold atmosphere of 1998 and 2000 was put behind in Slovak-Russian relations, as Putin started to approach Slovakia with a pragmatic foreign policy in terms of diplomacy.

In January 2001, Russian Foreign Minister Igor Ivanov visited Slovakia. The visit was remarkable for at least two reasons. First, it was the first high-level visit of a Russian politician since the Dzurinda government took office in 1998. Second, Ivanov said that Russia respects Slovakia's decision to aspire for membership in the European Union and NATO. After 1998, when the openly pro-Russian government of Vladimir Meciar was ousted out of office, this was the first time Moscow acknowledged Slovak foreign policy aspirations. In November 2001, Slovak President Rudolf Schuster visited Moscow. Prior to this visit the last time a Slovak president paid a visit to Moscow was in 1993. During the meeting, the Russian side emphasized its intention to place Slovak-Russian relations on a new basis, respecting the Slovak government's aspirations. Putin said that Slovak-Russian bilateral relations were not only free of any problems, but were developing energetically in political, economic, and cultural spheres. Additionally, he expressed confidence that Schuster's visit would help to intensify relations between the two countries in all areas.<sup>30</sup>

In March 2004, Slovakia joined NATO and in May of that year the European Union. With these moves Slovakia declared a visible commitment to the West. However, Russian-Slovak

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<sup>30</sup> "President Schuster Continues his Visit to Russia," *SITA*, November 13, 2001. Accessed November 7, 2002. Available from ISI Emerging Markets.

relations were kept at a rather good level. This was largely due to a new Russian foreign policy under President Putin. On the other hand, also then Slovak Foreign Minister Eduard Kukan had a lot to do with it. As a 1964 graduate of the Soviet school of MGIMO of diplomacy, he paid special attention to maintaining good relations with Russia throughout the period.

In sum, diplomatic relations between the two countries were normal during 2000 and 2004. No major breakthrough or incident happened.

### ***V.3. Russian Energy Companies' Conduct in the Region***

#### **Poland**

##### *(i) Europol Gas*

As discussed earlier, revenues from the transit fee of Russian natural gas through Polish territory were not enough for the Polish-Russian joint venture, Europol Gas, to fulfill the other purpose of its establishment, i.e. the construction of the Yamal pipeline system. To be able to carry out the construction, Europol Gas had to borrow funds. It was Gazprombank, the bank of the Russian monopoly Gazprom, that offered to give credit to Europol. In 1999, the company borrowed \$257m from Gazprombank. Later that year, Gazprombank extended its credit for Europol Gas to \$1bn with a repayment date of June 2002.<sup>31</sup> Dependency on Gazprombank hit in March 2001 when Rem Vyakhirev threatened that if Europol did not meet its financial repayment obligations, he would seek the company's bankruptcy. As explained earlier, the paradox of the situation is that Europol Gas's revenues depend on agreements about transit fees between its two

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<sup>31</sup> Originally in *Rzeczpospolita*, July 6, 2001, cited in "Gas: Defending Gudzowaty, the SLD Is Protecting Russian Monopolist Gazprom's Interests," *PNB – Economic Review*, July 10, 2001. Accessed October 27, 2002. Available from ISI Emerging Markets.

owners, one of them being Gazprom. The initial agreement that created Europol Gas in 1993 and framed the conditions of its operation already determined its fate. At the moment of its establishment, Europol Gas became vulnerable to Gazprom. The threat of bankruptcy re-emerged in May 2001.<sup>32</sup>

The fate of Europol Gas was one of the issues during the renegotiation of the gas contract in 2002/03 when it became clear that the quantities of Poland's natural gas needs projected in the original agreement were way above the country's actual demand. PGNiG and Gazprom decided to restructure the repayment schedule of Europol's debt, which amounted to \$850 million at the time. Europol was supposed to pay back the above amount by 2018.

In 2002, the transit fees Europol received were almost 50 percent lower than those charged in Germany.<sup>33</sup> In the renegotiated contract the transit fees were re-set at a level that enabled Europol Gaz to finance the construction of Yamal 1 and to repay its loan from Gazprombank. First Gazprom would pay \$2.74 for the transfer of 1000 cubic meters of natural gas per 100 km, this amount would start falling and reach \$1 per 1000 m<sup>3</sup> for 100 km by 2014.<sup>34</sup>

However, with the new agreement, Poland is in an even more disadvantageous position regarding gas prices than before. "Signing the Russian deal the government gives up potential revenues from an increased transfer of Russian gas through Poland. From 2014, Poland will be charging for the transit of Russian gas far lower fees than those currently charged in Western Europe. The fee will be roughly three times lower than today."<sup>35</sup> The transit fees that Gazprom pay are enough only to finance the building of the pipeline, i.e. Poles do not receive anything for

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<sup>32</sup> "Gazprom Might Seize Europol Gaz," *PNB – Economic Review*, May 4, 2001. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>33</sup> "Agreement Close on Eve of Gazprom Chairman's Visit," *Rzeczpospolita*, April 9, 2002, cited by *PNB*, April 9, 2002. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>34</sup> Interview with a senior official of the Supreme Chamber of Control, Department of Economy, Treasury and Privatisation (NIK) (At the time of the agreement, Gazprom used to pay \$1.35 for 1000 cubic meters for 100km.)

<sup>35</sup> Rafal Kaspro, originally in *Rzeczpospolita*, cited by *PNB-Economic Review*, April 29, 2003. Accessed July 8, 2003. Available from ISI Emerging Markets.

the usage of their territory until 2018, but afterwards they receive only one third of the fees paid for the transit in Western Europe. While the Russian partner, as owner *and* creditor, has more leverage over the pipeline until 2018, it is not clear who would have the upper hand afterwards. The Polish company Gaz Trading may become the one with the decisive word. In the new agreement Poland gave up its potential to get revenue from the transit fee and to have full legal control over the part of the gas pipeline running through its territory.

Besides being the operator of the Yamal pipelines, Europol Gas's other responsibility was to coordinate the construction works of the pipelines. According to the original agreement, the Polish gas company PGNiG and Gazprom share the costs of the construction work in proportion to how much of the pipeline's capacity each party will use. The two pipes' joint capacity is targeted at 64bn cubic meters altogether, 32bn cubic meters each. PGNiG buys part of the 64bn for Polish domestic consumption, Gazprom transfers the rest to Germany. According to the 1996 agreement, Poland will take a maximum of 14bn cubic meters of gas annually. Based on the projections, Polish gas consumption will reach this level only in 2010. Before then, Poland's Russian gas import will be substantially lower, reaching the 14bn cubic meters only gradually. It means that when Poland's consumption of Russian gas will reach its peak, PGNiG will use no more than 20 percent of the Yamal pipelines' capacity. As a result, PGNiG shall cover no more than 20 percent of the construction works of Yamal.

However, the 1996 agreement states that only 2.88bn cubic meters will be imported for Polish domestic consumption through Yamal 1, while the rest will arrive through Yamal 2. As a result, PGNiG will use 2.88bn cubic meters of Yamal 1's 32bn cubic meters capacity, which is about 10%, while Gazprom will use the rest for transporting gas to Germany. According to the 1996

agreement between PGNiG and Gazprom, the Polish partner is then supposed to cover 10% of the construction works of Yamal 1.

Yamal 1 started operating in December 1999 but only with 20 bn cubic meters capacity. To reach its target capacity of 32bn cubic meters, three compressor stations had to be built on the Polish section of the pipe. When Yamal 1 started to operate in December 1999, the construction of the second Yamal line had not even started. Moreover, Gazprom had floated the idea of not building Yamal 2 at all.<sup>36</sup> The issue of who is financing the construction of the three compressor stations became the subject of an ongoing dispute between PGNiG and Gazprom from 2000 to 2003, and only the renegotiated gas contract of 2003 resolved the issue.

The two parties' basic disagreement was on the interpretation of the 1996 agreement. Gazprom expected PGNiG to pay 20% of the construction works as would be PGNiG's share in the two Yamal pipes' capacity. On the other hand, PGNiG argued that since it is not at all certain that Yamal 2 will be built, it ought to cover only 10% of the costs of building Yamal 1, as the Polish gas company will use only 10% of the first pipe's capacity. PGNiG argued that the amount it had contributed to the construction of Yamal 1 before December 1999 already equals 10% of the total costs of building the first pipe, and thus the two compressor stations should be financed by Gazprom. The Buzek government held that the Polish partner shall not finance the finishing of Yamal 1 until Gazprom does not commit itself to building Yamal 2.<sup>37</sup>

In December 2001, Undersecretary of State at the Polish Economy Ministry Marek Kossowski announced that Gazprom expressed a desire to hold 70 percent in Europol Gaz. According to Kossowski, the Russian company argued that since Poland had not provided financial guarantees to finish the construction of the first trench of Yamal, it is entitled to change

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<sup>36</sup> A subchapter below discusses the issue of the Yamal 2 pipeline.

<sup>37</sup> *IntelliNews – Poland This Week*, January 14, 2002. Accessed October 28, 2002. Available from ISI Emerging Markets.

the shareholder structure of Europol Gaz to 70%/30% in favor of Gazprom. The Russian giant was demanding \$280 m guarantee for construction of three gas pumping stations that would allow an increase in the pipe's capacity to 32 bn cubic meters. Even though Marek Kossowski was of the position that Poland had met its obligations, interestingly enough, in January 2002, the Polish state agreed to grant guarantees for about \$180 m investments into the first two gas-compressor stations that would increase the capacity of the first Yamal pipeline to 28 bn cubic meters.<sup>38</sup> (Then the third compressor station would increase the capacity of Yamal 1 to 32 bn cubic meters.) I could not find sufficient information to explain what factors made the Poles change their position on the financing of the compressor stations. This is the time, however, when Gazprombank threatened several times to ask for Europol's bankruptcy. I do not have any tangible evidence to connect the two cases, but can only speculate that the threat of bankruptcy could have been a factor in making the Poles change their attitude.

Finally, the two sides agreed in the renegotiated gas contract to set the level of the transit fees and to restructure Europol's debt to Gazprom to enable the joint company to finance the construction works of the three compressor stations. The works were about to start in April 2003. Later the starting date was moved to December 2003.

Even though the short-term disputes were resolved, Poland lost most of the potential revenue it expected to gain from the pipelines. Moreover, it lost much of the control over the Yamal 1 pipeline at least until 2018 for two reasons: 1.) the ownership structure of Europol Gas continued to follow Russian interests, as Bartimpex continued to hold the swing vote, and 2.) the fact that Gazprombank financed the construction of the pipeline made Europol Gaz vulnerable to its creditor.

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<sup>38</sup> "Poland to Guarantee for USD 180mn Investments in Yamal Gas Pipeline," *IntelliNews-Poland Today*, January 14, 2002. Accessed October 27, 2002. Available from ISI Emerging Markets.



(ii) *Gas contract*

As discussed earlier, the gas contract of 1993 between Poland and Russia overestimated the quantity of gas the Polish economy would absorb. However, the take-or-pay clause of the contract prohibited reselling the gas. Additionally, even if Poland did not take the gas, it had to pay for it. New calculations were made for future estimates on Polish gas demand. In 2000, Warsaw intended to renegotiate the 1996 contract based on the new estimates. However, during this time the right-wing Buzek government was in office, and Gazprom rebuked every attempt of the Polish side to start renegotiating the agreement.<sup>39</sup> It was the left-wing Leszek Miller government which managed to reopen talks on the Russian gas supply.

In January 2002, the talks started between Poland and Gazprom about the Russian gas supply. Poland expected to add a 10-year extension to the contract without changing the total amount of gas delivered. In this case Poland would receive the same amount of gas over an extended period, thus decreasing the quantity imported each year by almost 30 percent.<sup>40</sup> At the beginning, in his rhetoric Gazprom chief Alexei Miller opposed renegotiating the contract. In an interview with the Polish newspaper *Rzeczpospolita*, he said that Gazprom intends to resolve the issue of gas supplies to Poland based on the Polish-Russian intergovernmental agreement of 1993. Furthermore, he insisted on the 1996 contract and its “take-or-pay” rule and was not willing to take into consideration the pleas of Polish politicians.<sup>41</sup>

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<sup>39</sup> Interview with Piotr Naimski, former advisor to Polish Prime Minister Jerzy Buzek, Nowy Sacz, Poland, May 2003

<sup>40</sup> Interview with former Deputy President of PGNiG Piotr Wozniak, March 2003, Warsaw

<sup>41</sup> Originally in *Rzeczpospolita*, January 23, 2002, cited in “We Stick to Contracts,” Gazprom Head Comments on Polish Hopes,” *PNB*, January 23, 2002. Accessed October 27, 2002. Available from ISI Emerging Markets.

In July 2002, the Polish government came up with another proposal. Deputy Economy Minister Marek Kossowski said that Poland hoped that Russia would agree to PGNiG's proposal to free about 40% of the contracted gas (about 100bn cubic meters out of the total 250bn) from the "take-or-pay" rule. "We take the view that since the investment [the construction of Yamal] has been realized in 55%, we should apply the „take-or-pay" rule to some 60% of the contracted gas."<sup>42</sup> According to the agreement, Gazprom obligated itself to build two trenches of Yamal and the construction of the second one, which was supposed to transfer the bigger chunk of the Russian gas to Poland. However, the construction of the second pipe had not even started as of summer 2002. Negotiations stalled for a couple of months when in October 2002, Poland threatened with international arbitrations, if it was unable to renegotiate the gas contract till the end of 2002.<sup>43</sup> In December, Gazprom proposed a swap deal for Poland. Gazprom would fill in Norway's obligation towards Poland with Russian gas and the Norwegian Statoil would service Gazprom's contract in the UK.<sup>44</sup> However, this suggestion went against the idea behind the Norwegian-Polish negotiations to diversify natural gas deliveries to Poland (more about this below). Warsaw pursued the Norwegian contract to diversify gas supplies to Poland, i.e., to decrease the country's dependence on Russian gas. Gazprom's suggestion would mean that the Norwegian contract could be fulfilled without building the planned pipeline between Norway and Poland under the Baltic Sea. Poland would not have any alternative gas supply route to the one coming from the East.

Finally in February 2003, Warsaw and Moscow managed to renegotiate the 1993 gas contract at the governmental level. At the company level, the annex about Russian gas supplies was

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<sup>42</sup> "Poland Wants Russia to Freelance 40% of Yamal Contract from Rule 'take-or-pay'," *Internet Securities Businesswire*, July 2, 2002. Accessed November 2, 2002. Available from ISI Emerging Markets.

<sup>43</sup> "Poland Likely to File for International Arbitrage Concerning Russian Gas Supplies," *Internet Securities Businesswire*, October 28, 2002. Accessed November 2, 2002. Available from ISI Emerging Markets.

<sup>44</sup> "Companies and Industries," *IntelliNews – Poland This Week*, December 9, 2002. Accessed July 11, 2003. Available from ISI Emerging Markets.

signed in March 2003. According to Polish Infrastructure Minister Marek Pol, based on the renegotiated contract Russian gas supplies to Poland will be lowered by 74.6 billion cubic meters. It means that Russia will actually deliver 34.5% less gas during the period of 2003-2020 than agreed upon in the original contract.<sup>45</sup> According to Marek Pol's Chief Advisor Tomasz Bartoszewicz, the reduction consists of three different parts. First, there is a decrease in the absolute quantity Russia will supply, which was lowered from 250 billion cubic meters to 212 billion in the new contract. Second, Russia is supposed to supply the remaining quantity over an extended period until 2022, as opposed to 2020 as agreed originally. Third, because of the ongoing disagreements and negotiations, some quantity, which originally was supposed to be delivered to Poland before 2003, was actually not transferred. The amount of gas which was never supplied further decreases the total amount. These three parts add up to a 34.5% reduction in Russian gas deliveries.<sup>46</sup>

Piotr Wozniak, former Supervisory board member and former Vice-president of PGNiG, holds a different opinion. He claims that the original agreement between PGNiG and Gazprom divided the quantity of gas delivered by Gazprom into two parts: a 'fixed quota' and a 'flexible quota.' The 'fixed quota' was not subject to further negotiation and was under the 'take-or-pay' rule. However, the 'flexible quota' was exempted from the 'take-or-pay' rule and gave room for PGNiG to take the quantity each year, which it actually needed. According to Wozniak, the absolute gain, which has been presented by Marek Pol, is actually virtual. The two parties eliminated the 'flexible quota' from the agreement and left the 'fixed quota' only. As a result, Poland is obliged to take almost as much gas as before. Additionally, Wozniak is suspicious about the added value of the extra two years. In his opinion, gas deliveries had not started in 1997

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<sup>45</sup> Originally reported by *PAP News Agency*, February 12, 2003. Cited in „Poland, Russia Sign Agreement on Gas Supplies,” *BBC Monitoring*, February 12, 2003. Accessed July 11, 2003. Available from ISI Emerging Markets.

<sup>46</sup> Bartoszewicz interview

as planned, only two years later, and thus the extension in reality is nothing else than postponement of the realization of gas deliveries.<sup>47</sup>

Another former Supervisory Board Member of PGNiG Rafal Kasprow also harshly criticized the agreement. „The terms of Poland’s recent gas contract with Russia mean strengthening Gazprom’s monopoly for almost another two decades...Poland has agreed to sign an agreement that will reduce revenues from the transit of Russian gas, boost its price, hinder market liberalization, and hurt the chemicals industry.” According to Kasprow, for the first time the contract endorsed the ‘take-or-pay’ rule, which means that Poland must pay for the gas even if it is not delivered.<sup>48</sup>

According to the original contract, 2.88 bn cubic meters gas was to be delivered through Yamal 1, while the rest was supposed to arrive through Yamal 2. As Yamal 2 had not been built as of that time, it was agreed that quantities above the 2.88 bn cubic meters will be delivered through three older pipelines coming from Ukraine and Belarus into Poland.<sup>49</sup>

Originally it was agreed that the old pipes will be used for delivering Russian gas only if the construction of the Yamal pipes is finished. Additionally, while the old pipes were not mentioned in the text of the 1996 contract, the text of the renegotiated contract explicitly says that gas above the 2.88 bn cubic meters will be delivered through them.

From the Polish point of view, this part of the contract is disadvantageous. In theory, Poland has always had the opportunity to import 1 to 1.5 bn cubic meters of gas from other sources than Russia through these old pipelines. Moreover, Ukrainian or Kazakh gas may even cost less than Russian. However, if Russian gas arrives through the old pipelines, it will consume the whole

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<sup>47</sup> Wozniak interview

<sup>48</sup> Rafal Kasprow, originally in *Rzeczpospolita*, cited by *PNB-Economic Review*, April 29, 2003. Accessed July 8, 2003. Available from ISI Emerging Markets.

<sup>49</sup> “Pol: Gas Issues No Longer Burden Polish-Russian Relations,” *PNB – Economic Review*, February 14, 2003. Accessed July 12, 2003. Available from ISI Emerging Markets.

capacity of the old pipes, leaving no room for Ukrainian or Kazakh gas. Consequently, the alternative of importing gas from CIS countries other than Russia through the existing pipes got lost with the renegotiated contract. To change this provision of the contract, which is not advantageous for Poland, both companies (PGNiG and Gazprom) have to agree. As a result, this provision is unlikely to change unless Poland is ready to make some concessions to Russia. The Polish Supreme Chamber of Control, which is in charge of auditing all treaties signed by the Polish government, is of the opinion that the new gas contract is unfavorable to Poland.<sup>50</sup> Tomasz Bartoszewicz implicitly accepted the objections of the opposition on this point. However, he claimed in mid-March 2003 that the issue of gas entry points is a delicate problem and the Polish government does not want to raise the topic publicly as long as Gazprom does not sign the annex to the agreement.<sup>51</sup> (As mentioned earlier, the renegotiated contract was signed at the state level in February 2003, and Gazprom finally signed the annex to the 1996 company level agreement at the end of March.)

In early March 2003, Marek Pol met Russian Deputy Prime Minister Viktor Khristenko who was under strong criticism by Gazprom. The Russian company believed that the inter-governmental agreement was concluded on terms unfavorable to Gazprom. At the time, it seemed that Alexei Miller was reluctant to accept the agreement. According to Tomasz Bartoszewicz, Khristenko promised its Polish partner to put pressure upon Gazprom and said that since his signature is on the inter-governmental agreement of February 2003, if he does not succeed, he may have to resign. (If the companies had not signed the annex, the intergovernmental agreement

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<sup>50</sup> Interview with a senior official of the Supreme Chamber of Control, Department of Economy, Treasury and Privatisation (NIK)

<sup>51</sup> Bartoszewicz interview

would not have been valid.)<sup>52</sup> Later, the contract was duly signed, raising the possibility that Khristenko and Miller were involved in a classic negotiation.

It is difficult to judge whether the renegotiated gas contract is advantageous for Poland. As discussed earlier, even the government side acknowledged that in terms of the inclusion of the old pipes, the new contract is certainly not favorable for Poland. However, opinions on the rest of the contract differ sharply. Since the inter-governmental and company level agreements were never made public, it is impossible to judge which side is right. However, what is certain is that until 2022 Russia will be the sole supplier of natural gas to the Polish economy.

*(iii) Second Yamal Pipeline*

According to the 1994 agreement, the Yamal system consists two pipes. The construction of the first was planned to be finished in 1997, while the construction of the second was planned to start immediately afterwards and was expected to be operational by 2001.<sup>53</sup> Reality turned out to be quite different. For a summary of the rather complex chain of events related to Yamal 2, see Table 2 below.

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<sup>52</sup> Ibid.

<sup>53</sup> Originally reported in *Gazeta Wyborcza*, May 29, 2001. Cited in “In the Steely Embrace of the Pipeline,” *PNB*, May 31, 2001. Accessed November 7, 2002. Available from ISI Emerging Markets.

**Table 2: Natural Gas Pipeline Ideas and Plans to, through and around Poland**

Pipelines	93	96	Jan 99	Febr 99	Dec 99	May 00	July 00	Oct 00
Yamal 1					Yamal 1 started operating with 20 bcm capacity, the issue of who is financing the two compressor stations came up			
Yamal 2				Gazprom first hinted that it would withdraw from constructing Yamal 2		Gazprom announced to withdraw from the construction of Yamal 2 and build the inter-system connection pipe instead		
Norwegian -Danish		PGNiG and Norwegian Statoil started talks about delivering 3-4bcm of gas to Poland	Statoil froze negotiations about constructing a pipe between Norway and Poland					
Inter-system connect					The idea of the inter-system connect pipeline first entertained			Gazprom signed a deal with Gaz the France, Snam, Wintershall and Ruhrgas about the construction of the inter-system connect pipeline
Bernau-Szczecin							Idea of a pipeline from Germany's Bernau to the Polish Szczecin first occurs	
Russian Baltic				Gazprom hinted to consider a pipeline under the Baltic Sea connecting Russia with Germany				

Pipelines	Nov 00	Jan 01	March 01	June 01	Aug 01	Febr 02	Febr 03	X 03
Yamal 1	Fibre optic cable scandal broke out							The renegotiated 1993 gas contract resolved the issue of the financing of the compressor stations at Yamal 1
Yamal 2								
Norwegian -Danish			PGNiG, the Danish DONG, and Statoil entered a consortium to build a natural gas pipeline from Denmark and Norway to Poland	PGNiG signed an agreement with DONG to supply 2bcm gas per year	Poland signed an agreement with Norway about constructing a pipeline for supplying 5bcm gas per year			
Inter-system connect						Idea of the inter-system connect dropped		
Bernau-Szczecin								
Russian Baltic		Gazprom, the Finnish Fortum Oy and two German companies announced to sign a letter of intent for the construction of the Baltic pipe						

As discussed in great detail in the previous chapter, Gazprom first hinted the idea of withdrawal from constructing Yamal 2 in 1999. Almost parallel with this, it also floated the idea of building an alternative pipeline below the Baltic Sea, establishing a direct link with Germany without crossing Poland, and preventing the construction of a pipeline from Norway to Poland. Later that year, Russia raised the idea of building the so-called inter-system connect pipeline, which was designed to put pressure on Ukraine. For a summary of the existing and planned pipelines discussed in this chapter, see Table 3.

**Table 3: Major Characteristics of the Pipeline Plans to, through and around Poland**

	Initiator	Direction	First time idea occurred	Key features
Yamal 1	Polish and Russian states	East-to-West (from the Western Siberian Yamal to Germany)	1993	•Supplements the Brotherhood pipeline as a major supply route for Russian gas to Western Europe
Yamal 2	Polish and Russian states	East-to-West (from the Western Siberian Yamal to Germany)	1993	•Supposed to deliver about 80% of the gas supply to Poland from Russia under the 1993 agreement •Its construction never started
Norwegian-Danish	Polish state	North-to-South (Norway to Poland under the Baltic Sea)	1996	•Poland promoted it to diversify its gas import
Inter-system connect	Gazprom	East-to-West (Russia-Belarus-Poland-Slovakia)	Dec 1999	•Would bypass Ukraine •Used as an implicit threat for Ukraine
Bernau-Szczecin	Bartimpex + Ruhrgas	West-to-East (from Germany's Bernau to Poland's Szczecin)	July 2000	•Would deliver Russian gas
Russian Baltic	Gazprom	East-to-West (from Russia to Germany under the Baltic Sea)	Febr 1999	•Presented as an alternative to Yamal 2 •Used as a threat for Poland

It was only in May 2000 that Gazprom made it clear that it would like to withdraw from the construction of Yamal 2 and build the inter-system connection pipeline instead. From the Polish point of view, this new track would be disadvantageous for several reasons. First, the inter-system connect pipeline's Polish part would be shorter than that of Yamal 2. As a result, the



transit fee would be lower. Second, the new track would go through a part of Poland which is much less industrialized. Thus, Poland could not be able to take advantage of the new track as much as of the original one. Third, the new track might touch or come close to a national reserve area, which Poland wants to avoid.

Slovakia preferred the new track as it meant more gas transiting the country. The increased gas transit would result in increased revenues from transit fees. It would also make Slovakia a more important partner of Russia as a significant portion of gas transit to Western Europe would go through Slovakian territory. In case the new track was built, the biggest loser would be Ukraine. The new track would circumvent Ukraine and connect into the old Brotherhood pipeline. The part of the Brotherhood line running through Ukrainian territory would be operated at the minimum capacity possible. It would make Ukraine much more vulnerable to Russia and it would also lower transit fees paid to Kiev. In the most extreme case, Gazprom would even be able to turn off the gas on Ukraine, which it is unable to do as long as 90% of the Western European gas transit goes through Ukrainian territory. However, as soon as Yamal 1 and the inter-system connect are in place with more capacity than Western European demand at the moment, Gazprom has more tools at its disposal to convince Ukraine to pay its gas bills. For Gazprom the new track would give more leverage over Ukraine, but make Gazprom's Western European transit more dependent on Slovakia. It would also not ease Gazprom's dependency on Poland, as the new track would cross Polish territory as Yamal 2 would have done. Second, Russia would have to renegotiate its 1993 intergovernmental treaty with Poland as Gazprom committed itself to the building of Yamal 2. By the Winter of 2005/2006 Gazprom managed to lower its dependence on Ukraine and thus turned off the gas on Ukraine for a couple of days.

The decision whether to agree to the building of the inter-system connect pipeline became a political issue in Warsaw. On May 20 2000, Polish Economy Minister Janusz Steinhoff said that

when deciding on the new track, beyond Poland's economic interests, Poland's foreign policy interests and Ukrainian interests will be taken into account as well.<sup>54</sup> Steinhoff's statement was reinforced by President Alexander Kwasniewski, who told in an interview that the political task of the Polish government was "to avoid acting counter to Ukraine's interests."<sup>55</sup> At the same time, Kiev started to recruit Western companies to enter a joint venture with Gazprom to operate Ukraine's pipeline system.<sup>56</sup> A few days later Rem Vyakhirev announced that Gazprom would speed up the construction of the inter-system connection pipeline that would bypass Ukraine.<sup>57</sup>

The Russian state also put its weight behind Gazprom's plan. During Kwasniewski's visit to Moscow in July 2000, President Putin renewed Gazprom's proposal about the inter-system connect pipeline.<sup>58</sup> A few weeks later, Russia's Deputy Prime Minister Viktor Khristenko sent a letter to Polish Prime Minister Jerzy Buzek to ask Poland to cooperate in the construction of the inter-system connect pipeline.<sup>59</sup>

In July 2000, Polish Prime Minister Jerzy Buzek signed a declaration for the construction of a natural gas pipeline with an expected capacity of 5 billion cubic meters with his Norwegian

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<sup>54</sup> Interestingly enough, just before this announcement press reports were speculating about the recent resignation of Deputy Economy Minister Jan Szluzak. According to press speculations, Szluzak's resignation had to do with his letter from February, in which he says that Poland "supports in principle" Gazprom's proposal about the new track. Even though it is unclear why he had to resign, on May 20th, 2000, Economy Minister Janusz Steinhoff called Szluzak's letter a mistake. Originally in *PAP News Agency*, May 21, 2000, cited in "Poland to Table Yamal Gas Pipeline Stance in Talks with Gazprom – Minister," *BBC Monitoring*, May 21, 2000. Accessed October 28, 2002. Available from ISI Emerging Markets.

<sup>55</sup> Originally in *Gazeta Wyborcza*, July 8, 2000, cited in "Ukraine's Failure to React to Polish Goodwill Gestures on Gas Transit Analyzed," *BBC Monitoring*, July 22, 2000. Accessed October 26, 2002. Available from ISI Emerging Markets.

<sup>56</sup> "Ukraine: Kiev Woos Western Partner for Pipeline Venture," *EIGOMI*, June 15, 2000. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>57</sup> "Ukraine: High-Stakes Game," *EIGOMI*, June 16, 2000. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>58</sup> "Poland Opposes Russian Gas Pipeline That Bypasses Ukraine: Minister," *Agence France Presse*, July 21, 2000. Accessed January 5, 2003. Available from LexisNexis.

<sup>59</sup> Originally in *PAP News Agency*, August 9, 2000, cited in "Russia Sends Letter to Polish Premier on Gas Pipeline Issue," *BBC Monitoring*, August 9, 2000. Accessed October 22, 2002. Available from ISI Emerging Markets.

counterpart Jens Stoltenberg.<sup>60</sup> After consultation with Ukraine, at the end of July 2000, Janusz Steinhoff stated that Poland will likely say no to the inter-system connect pipeline.<sup>61</sup>

After Steinhoff's announcement, Gazprom presented a letter of intent signed by Western gas companies, the French Gaz de France, the Italian Snam and the German Wintershall and Ruhrgas, to construct the inter-system connect pipeline. At the same time, two companies, Alexander Gudzowaty's Bartimpex (the swing shareholder in Europol) and the German Ruhrgas, presented an alternative to the Norwegian-Polish pipe. According to their suggestion, Poland should diversify its gas supplies by connecting to the German gas system with a short pipe from Germany's Bernau to the Polish city of Szczecin.<sup>62</sup> There were no doubts among the players that even though Gazprom was not part of the recommended structure, it was the one who inspired the Bernau-Szczecin pipeline. Both the timing and the actors reinforced this notion. The idea came at the time of heated discussions about Central and Eastern European countries' dependency on Russian gas supplies. The actors who came out with the proposal were Bartimpex, a company making its business on Russian gas deals and Ruhrgas. At the time, Ruhrgas was in the process of developing a strong alliance with Gazprom. The German company acquired a 2.5% share in Gazprom in December 1998. The two companies also agreed that Gazprom would supply one third of Ruhrgas' total needs until 2030. In May 1999, Ruhrgas acquired a further 1.5% of Gazprom, thus owning a total of 4% of the Russian company.<sup>63</sup> Additionally, in early 2003, Bruckhard Bergmann, Chairman of the Executive Board of Ruhrgas became a member of the

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<sup>60</sup> "Escaping Russia's Shadow," *Warsaw Business Journal*, July 17, 2000. Accessed October 22, 2002. Available from ISI Emerging Markets.

<sup>61</sup> "Political Overview," *ISI BOSS Business News Poland*, July 31, 2000. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>62</sup> Originally reported in *Gazeta Wyborcza*, August 5-6, 2000. Cited in "Gas Imports: Government Chooses More Costly Solution," *PNB*, August 7, 2000. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>63</sup> "Gazprom and Ruhrgas – Partnership with a Promising Future," Moscow International Petroleum Club (accessed July 31, 2004); available from <http://www.mmnk.org/ruhrgaz-gazprom.htm>

Board of Directors of Gazprom.<sup>64</sup> Independently of who proposed it, the idea had no merit beyond helping Gazprom's position. For the German pipeline was presented as an alternative to the Norwegian one in the sense that it would also contribute to the diversification of Polish gas imports. However, as gas market analysts have pointed out, the German pipeline would deliver Russian gas. Additionally, it would cost more than Russian gas arriving through the Yamal pipeline since it has to take a longer route across the whole territory of Poland to Germany, turning around in the German pipe system and coming back to Poland from the West.

In October 2000, Gazprom announced that it signed a deal with Gaz de France, Snam, Wintershall and Ruhrgas about the construction of the inter-system connect pipeline bypassing Ukraine.<sup>65</sup> Only a few days after the deal was concluded, Russian President Putin asked Warsaw to agree to the construction of the inter-system connect pipeline for which he promised a revenue of \$1 bn in transit fees for Poland.<sup>66</sup>

The Polish rhetoric changed in November 2000. Both a representative of the Foreign Ministry and Economics Minister Janusz Steinhoff softened their criticism and said that in theory Poland could agree to building the inter-system connect pipe if Ukraine's interests are not hurt.<sup>67</sup> On November 22, Russian Foreign Minister Igor Ivanov visited Poland. He was dissatisfied with Warsaw making its decision about the pipeline based not only on economic but also on political considerations. Ivanov said that there is too much "political noise" around the inter-system connect pipeline. He encouraged the Poles that the whole issue "should not arouse such a great

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<sup>64</sup> "Bergmann Burckhard: Chairman of the Executive Board of E.ON Ruhrgas AG, Member of the Executive Board of E.ON AG" (accessed August 7, 2005); available from <http://www.gazprom.com/eng/articles/article8831.shtml>

<sup>65</sup> "Pipeline a Political Issue for Poland," *The Industry Newsletters*, October 30, 2000. Accessed October 30, 2002. Available from ISI Emerging Markets.

<sup>66</sup> Originally in *Gazeta Wyborcza*, November 6, 2000 cited in "Yamal Natural Gas Project May Threaten Poland's Energy Diversification Plans," *PNB*, November 10, 2000. Accessed October 29, 2002. Available from ISI Emerging Markets.

<sup>67</sup> "Pipe Schemes," *Warsaw Voice*, November 12, 2000. Accessed October 27, 2002. Available from ISI Emerging Markets.

deal of emotion, should not be dramatized,” rather “only the economic side should play a main role.”<sup>68</sup> “If, however, political considerations prevent the decision, “Russian gas will bypass Poland.””<sup>69</sup> The Russian foreign minister delivered in effect a threat in the name of Gazprom.

To back Ivanov’s threat, in January 2001, Gazprom announced that it was about to sign a letter of intent with the Finnish Fortum Oy and two German companies for the construction of a gas pipeline under the Baltic Sea. The Baltic pipeline would be an alternative to the existing stretch of Yamal running through Poland.<sup>70</sup> In other words, Gazprom demonstrated that it was ready to make good on Ivanov’s threat.

In November 2000, the issue of the inter-system connect pipeline got mixed with the issue of the fibre optic cable. According to the original contract, Gazprom was allowed to lay a fibre optic cable along the pipeline. An accompanying cable is an established practice in the gas industry for monitoring the gas flow and checking any problems which may occur. However, in November 2000, Warsaw recognized that the cable, which was laid by Gazprom along the Yamal pipeline, had far too much bandwidth to be used solely for the purposes of monitoring the pipeline’s activity. According to Communications Minister Tomasz Szyszko, the high-capacity data transfer cable might even pose a threat to Poland’s national security.<sup>71</sup> According to the most extreme opinions, the cable’s bandwidth is enough to transfer data equivalent to eavesdropping on all the phone conversations conducted in Poland; moreover, it may be enough to transfer data from all

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<sup>68</sup> Originally reported by *PAP News Agency*, November 22, 2000. Cited in “Poland: Russian Foreign Minister Says Pipeline Proposals Economically Justified,” *BBC Monitoring*, November 22, 2000. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>69</sup> Originally reported by *ITAR-TASS News Agency*, November 30, 2000. Cited in “Russian Gas to Bypass Poland if Politics Interfere – Foreign Minister,” *BBC Monitoring*, November 30, 2000. Accessed October 25, 2002. Available from ISI Emerging Markets.

<sup>70</sup> “Gazprom Looking for Alternative Pipeline Routes to Europe,” *Poland AM*, January 26, 2001. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>71</sup> “Companies and Privatisation,” *ISI BOSS Business News Poland*, December 4, 2000. Accessed October 28, 2002. Available from ISI Emerging Markets.

European phone conversations.<sup>72</sup> Polish Communications Minister Tomasz Szyszko said that „the lack of a decisive reaction from state authorities in the face of Gazprom’s activities in question may in consequence lead to the loss by Poland of a part of its sovereignty over its territory in the high-tech sector.”<sup>73</sup> On the other end of the spectrum are those who claim that the technical parameters of the cable would not make it capable for transferring so much data. As a result, they claim, the argument that the cable is a national security threat for Poland is a serious exaggeration. This opinion was expressed by Tomasz Kulisiewicz, a Polish expert on computer technology who said that technologically the cable did not pose any security threat to Poland and fears in this regard were not justified.<sup>74</sup>

Even though I am not in a position to decide whether the planned fibre optic cable has posed a national security threat to Poland, the outbreak of the scandal illustrated at least three things. First, it revealed one aspect of Gazprom’s way of conducting business. Gazprom has never apologized or given an explanation for its conduct. Moreover, it did not prove to be cooperative in trying to correct it. Second, the scandal brought to surface the fact that Europol Gas had lost its control over the fibre optic cable and over the Yamal pipeline. Third, the investigation of the scandal inspired other investigations about Poland’s energy security. These investigations showed that Poland’s dependency on Russian gas was even greater than previously thought.

The investigation into the fibre optic cable issue found that the language of the contract of 1996 signed by PGNiG and Gazprom was not specific enough. Even though Gazprom did not breach the contract, it violated its spirit. Even if its language was not specific enough, it allowed for a cable only for technical/monitoring purposes and not commercial ones. The issue of the

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<sup>72</sup> Originally in *Gazeta Wyborcza*, August 27, 2001, cited in “New Law Gives Government Control over Yamal Fibre Optic Cable,” *PNB*, August 27, 2001. Accessed October 28, 2002. Available from ISI Emerging Markets.

<sup>73</sup> “Yamal Data Cable Controversy: Who Gets the Profits?” *PNB – Weekend Supplement*, December 7, 2000. Accessed October 28, 2002. Available from ISI Emerging Markets.

<sup>74</sup> Interview with computer technology expert Tomasz Kulisiewicz, Warsaw, March 2003

fibre optic cable made huge waves in the Polish press but became much less of a thorn in the bilateral relations than the gas contract or the construction of the second thread of Yamal. The cable scandal was solved in August 2001 with the Sejm passing an amendment to the Telecoms Law that restored the Polish government's control over the fibre optic cable. In the future, foreign operators of networks on Polish territory have to apply for approval from the state specifying that their activity does not harm Polish national interests.<sup>75</sup>

The fibre optic cable issue made Polish Justice Minister Lech Kaczyński launch an investigation into Poland's dependency on Russian gas. The investigation „concluded that Poland's dependence on one single supplier grows deeper, since the Polish side did not seek other sources of acquiring natural gas, and did not construct an underground gas storage base, so no reserves can be saved in case of emergency.”<sup>76</sup> As a result, the Buzek government speeded up negotiations with Norway and Denmark. In March 2001, Norway proposed building a pipeline to Poland to supply 5bn cubic meters of Norwegian gas per year. The pipe would be able to start operating in 2007. At the same time, the Danish state gas company DONG proposed a shorter pipeline that would be capable of delivering 2 bn cubic meters of gas annually starting in October 2003. The Danish pipeline would eventually link up with the Norwegian pipeline.<sup>77</sup> At the end of March, PGNiG finally entered a consortium with the Danish DONG and the Norwegian Statoil to build a natural gas pipeline linking Denmark with Poland. The pipeline would also provide access to Norwegian gas.<sup>78</sup> The real goal of building a gas pipeline from Norway or Denmark to

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<sup>75</sup> Originally in *Gazeta Wyborcza*, August 27, 2001, cited in “New Law Gives Government Control over Yamal Fibre Optic Cable,” *PNB*, August 27, 2001. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>76</sup> Originally reported by *Rzeczpospolita*, December 21, 2000. Cited in “When Nobody Knows What's Going on, Then It's About Money and Power,” *PNB – Weekend Supplement*, December 28, 2000. Accessed October 28, 2002. Available from ISI Emerging Markets.

<sup>77</sup> “Poland Industry: Petroleum and Gas Updates,” *EIU – Country Economic News*, March 6, 2001. Accessed October 28, 2002. Available from ISI Emerging Markets.

<sup>78</sup> “PGNiG Signs Deal with Denmark's DONG and Norway's Statoil,” *ISI BOSS Business News Poland*, March 31, 2001. Accessed October 28, 2002. Available from ISI Emerging Markets.

Poland would have been to create an alternative route and thus make Poland less dependent on Russian gas. Still, Poland would have received the vast majority of its gas imports from Russia but with the North-South pipeline the alternative of receiving gas from other sources would have placed Poland in a better negotiating position vis-à-vis Russia. As a result, it was not the quantity to be delivered through that pipeline which was important, but the fact that an alternative route would have been established.

Meanwhile, negotiations between Poland and Gazprom about the route of the second thread of the Yamal pipeline were still going on. Since Poland kept objecting to the inter-system connecting pipeline, on March 20, 2001, Gazprom chief Rem Vyakhirev “threatened the Polish side that if it did not consent to the construction of a new thread of the Yamal pipeline, the visit to Warsaw by the Russian Prime Minister would be deferred.”<sup>79</sup> The Secretary of the Russian Security Council, Sergey Ivanov, arrived in Poland for a two-day visit the following day and was asked to comment on Vyakhirev’s statement. Ivanov said that if it was said indeed, he considered it „a completely curious example of the influence of economic circles on the world of politics.” “I am not prepared to treat this seriously, and all the more since, according to my knowledge, contacts concerning the course of the pipeline are very effective and a lot has already been said, and certain deadlines have even been written down. So, if Vyakhirev said something like this, this only witnesses to the fact that he is quite simply breaking away from a particular language, from a particular philosophy of talks.”<sup>80</sup> However, as another example will show later, Vyakhirev might not have exaggerated, for the Kremlin did not refrain from making political visits dependent on a country’s attitude towards Russian energy companies.

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<sup>79</sup> Originally in *PAP News Agency*, March 21, 2001, cited in “Poland: Russian Security Council Secretary Arrives for Visit,” *BBC Monitoring*, March 22, 2001. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>80</sup> *Ibid.*



The Buzek government's main motivation to conclude the Norwegian and Danish gas contracts was to improve Poland's energy security. In June 2001, Poland signed an agreement with Danish DONG to supply gas. According to the agreement, Poland would buy 16bn cubic meters of gas over a period of 8 years starting in 2003 and ending in 2011. A pipe would be built from the Danish town of Rodvig to Poland's Niechorz. The pipeline's capacity would be 8 bn cubic meters of gas per year. Eventually, it could also be used for transporting natural gas from Norway.<sup>81</sup> The deal was immediately attacked by the Polish Socialist Party (SLD). The party chief Leszek Miller said that in case SLD had won the parliamentary elections in the Fall of 2001, it would have revisited the Danish-Polish gas deal. According to the SLD, there were cheaper solutions for gas diversification, the Bernau-Szczecin pipeline for instance. However, according to Economy Minister Janusz Steinhoff, the price of Danish gas was lower than that coming through Bernau would have been. Additionally, it would not have been solely Poland that had to bear the costs of the pipeline construction. By then, Hungary and Slovakia already expressed their interest in participating in a North-South pipeline project for exactly the same reason as Poland, i.e. to diversify their gas imports.<sup>82</sup>

In August 2001, Poland concluded a similar deal with Norway. This was the last major act of the Buzek government in the field of energy before it was ousted. According to the Polish-Norwegian agreement, the two sides would construct a natural gas pipeline which would supply Poland with 74bn cubic meters of Norwegian gas between 2008 and 2024. The first 2.5bn would be delivered in 2008, which amount would increase to 5bn cubic meters in 2011.<sup>83</sup> According to

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<sup>81</sup> Originally reported by *Rzeczpospolita*, July 6, 2001. Cited in "Gas: Defending Gudzowaty, the SLD Is Protecting Russian Monopolist Gazprom's Interests," by *PNB – Economic Review*, July 10, 2001. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>82</sup> "Privatisation and Companies," *BOSS Business News Poland*, July 6, 2001. Accessed October 28, 2002. Available from ISI Emerging Markets.

<sup>83</sup> Originally reported by *PAP News Agency*, January 28, 2003. Cited in "Polish-Norwegian Gas Contract Deadline Extended," by *BBC Monitoring*, January 28, 2003. Accessed July 11, 2003. Available from ISI Emerging Markets.

the agreement, the pipeline would be financed by the Norwegian partner and its capacity would reach 8bn cubic meters per year. Poland would buy 5bn cubic meters and it would be Warsaw's responsibility to find a buyer for the remaining 3bn cubic meters.<sup>84</sup>

While the Buzek government made significant steps to diversify Polish gas imports, the SLD government started to revisit the Danish and Norwegian deals immediately after taking office. Already in December 2001, Economy Minister Jacek Piechota hinted that Poland could not afford to buy Norwegian gas.<sup>85</sup> In January 2002, the decision to start constructing the gas pipeline from Denmark was put on hold for a year.<sup>86</sup> The agreement with Norway had to be ratified by December 1, 2002. Since it did not happen, the ratification deadline was postponed one more time to December 31, 2003.<sup>87</sup> The agreement was not ratified then, either, and PGNiG and Statoil officially withdrew from their contract to build a pipeline.<sup>88</sup>

Meanwhile, Gazprom dropped the idea of the inter-system connect pipeline. A member of Gazprom board of directors, Boris Fyodorov, said that the Russian giant would concentrate on two other projects: the pipe under the Black Sea and the Yamal pipe. „My impression is that the project [inter-system connect] is basically cancelled, it was not discussed [at the previous board meeting]... This project from an economic point of view in any case was not the best solution.”<sup>89</sup> Fyodorov's admission that the inter-system connect pipeline economically was not the best solution confirms the belief that the whole idea mainly served political purposes. Eastern expert

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<sup>84</sup> Interview with a senior official of the Supreme Chamber of Control, Department of Economy, Treasury and Privatisation (NIK)

<sup>85</sup> Originally in *Rzeczpospolita*, December 12, 2001. Cited in “PGNiG Dismissal Weakens Government Position before Moscow Visit,” *PNB*, December 12, 2001. Accessed October 28, 2002. Available from ISI Emerging Markets.

<sup>86</sup> Originally reported by *Gazeta Wyborcza*, February 21, 2002. Cited in “Economy Minister: Gazprom Taking Its Time over Calculations,” *PNB*, February 22, 2002. Accessed October 27, 2002. Available from ISI Emerging Markets.

<sup>87</sup> Bartoszewicz interview

<sup>88</sup> “PGNiG, DONG Discuss Reduced Gas Deliveries,” *PNB*, December 4, 2003. Accessed July 31, 2004. Available from LexisNexis.

<sup>89</sup> “Gazprom to Rule on Gas Pipeline Bypassing Ukraine after Study,” *Agence France Presse*, February 6, 2002. Accessed January 6, 2003. Available from LexisNexis.

Bartolomiej Sienkiewicz was of the same opinion. “The inter-system connect pipeline was a political maneuver on Russia’s part. Neither Gazprom, nor the Russian state ever considered it seriously. Russians never prepared any serious study about it. It served to blackmail Ukraine and to break the Polish-Ukrainian alliance.”<sup>90</sup>

It is not a coincidence either that the idea was dropped by February 2002. At that time, Gazprom managed to get control over the Ukrainian stretch of the Brotherhood gas pipeline. As a result, from Gazprom’s perspective, the inter-system connect pipeline has served its purpose as a credible stick for Kiev to make the Russian company enter in the Ukrainian transit pipeline system. The idea of the inter-system connect pipeline going southward into Slovakia got off the table.

#### *(iv) Rafineria Gdanska*

Before getting into the details of the Rafineria Gdanska story, it is important to provide a longer introduction to the logic of the oil industry, as it is markedly different from that of the natural gas industry.

Besides the gas industry, the oil industry is the other industry of paramount strategic importance in industrialized countries. However, the oil market is significantly different from the natural gas market. Moreover, unlike the case of natural gas, Central Europeans have many alternative opportunities for import other than Russia. Additionally, Russia is a less significant player in the international oil market than in the gas market. As a result, Russian oil companies have had a weaker hand vis-à-vis Central European countries than Gazprom had: while the latter has been a monopoly provider, the former have always had to think about the alternative

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<sup>90</sup> Interview with former head of the Polish Centre for Eastern Studies and one of the best known Eastern experts of Poland, Bartolomiej Sienkiewicz, Warsaw, March 2003

suppliers. In the oil industry, the only way a supplier can become a true monopoly provider is for it to gain control of all major oil pipelines, port terminals or refineries, that is, to get control over the distribution channels of alternative sources of supply.

The major difference between the oil market and the gas market is that it is much easier and cheaper to transport oil than gas.<sup>91</sup> This fact has many consequences. First, natural gas prices are a function of the distance between the consumer and the site of extractions. The larger that distance is, the more expensive the natural gas will be. It is unjustified on economic grounds to transport natural gas beyond a certain distance. As for the European market, Russian natural gas loses its competitiveness (compared to Norwegian, Algerian and British gas) somewhere in the geographic middle of Germany and Italy. Distance is much less of a determining factor in the price of oil. As a result, it is much easier to substitute one seller for another. In the hypothetical case of Russia ceasing to sell crude oil, there would always be alternatives to buy oil elsewhere.

Second, the main transport vehicle for gas is pipeline. The LNG market is developing but it does not yet account for a significant portion of the natural gas market.<sup>92</sup> On the other hand, crude oil is easily transportable not only by pipelines but also by sea. As a result, a country that has a seaport with an oil refinery can almost certainly be able to provide its oil industry with continuous supply of refined oil. If the pipeline route leading to a refinery is cut, it can always buy crude from tankers.

Third, because of the above characteristics, gas delivery contracts are usually long-term, while oil contracts are short-term. As a result, countries commit to a gas provider for decades to

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<sup>91</sup> Interview with Mr. Bruce Everett, former Downstream Government Relations Manager, ExxonMobil Corporation, Adjunct Associate Professor of International Business, Fletcher School of Law and Diplomacy, Medford, MA, July 2003

<sup>92</sup> LNG stands for Liquefied Natural Gas. It is natural gas not in gaseous form but having been liquefied through cooling. LNG is carried in tankers. Daniel Yergin and Michael Stoppard, "The Next Prize," *Foreign Affairs*, November/December 2003

secure a stable supply of natural gas. On the other hand, they don't have to tie themselves to one crude oil supplier for long.

The multitude of alternatives both in terms of sources and distribution channels means that the buyer of oil is in a more advantageous position than the buyer of natural gas. If a provider wants to strengthen its hand it needs to limit the number of alternatives a buyer may have. The only realistic way to do so is to get control of the points where alternative sources may enter the given market. In the case of crude oil, these are the pipelines, the ports, and the refineries.

Pipelines are the number one vehicle for transporting crude oil in Central Europe. Whomever owns the pipeline decides access to its transit capacity. If a Russian company owns a pipeline going through a Central European country, it would be able to deny access to the transit capacity of the pipe for any third party without any explanation.<sup>93</sup> Let's assume that Lukoil owns the only oil pipeline crossing Hungary. If Mol, the Hungarian oil monopoly buys crude from Azerbaijan to be transported via Ukraine, Lukoil would be able to deny the Hungarian part of the pipeline for the transport of the Azeri oil, without violating any laws.

An alternative supply route for crude oil is by sea. Countries with access to the sea usually have at least one port which is able to receive large ocean-going tankers. Even though these countries may receive the majority or all of their crude import through pipelines, the capability to receive crude from other sources, makes them less vulnerable to the pipeline supplier. Consequently, if an oil company that supplies a certain country with crude oil through a pipeline wants to gain leverage over the country's oil industry, one of its options is to gain control over the country's oil terminal. Such a move would deprive the country of alternative sources of

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<sup>93</sup> Even though Hungary, Slovakia and Poland are members of the European Union, the oil industry is not liberalized yet. It means that pipeline owners are allowed to deny access to the lines for third parties.

supply. Additionally, if the given oil company controls the part of the pipeline going through the country's territory, it has a full control over the country's oil industry and market.

In the form crude oil is imported, it cannot be utilized for its most useful purposes. Before any kind of utilization, it needs to be refined, which is why there are refineries at the end of each import pipeline and oil terminal. As a result, refineries are the other Achilles heel of a country's oil industry. If Lukoil were to own Hungary's sole refinery, the Russian oil company would have the means to pressure Hungary to buy only Russian oil through the pipeline leading to the refinery. Otherwise, it could deny processing oil coming from other sources without violating any laws.

All in all, the industry logic suggests that crude oil suppliers have less leverage over their buyers than in case of natural gas. If a crude provider were to improve its bargaining position it has to limit the buyers' access to alternative sources of supply. If a Russian company wanted to control the oil industry of a Central European country, it would need to aim at acquiring the country's pipelines, oil terminals, and refineries.

Despite the theory about alternative sources detailed above, the Central European countries had more than 80% of their crude oil consumption bought from Russia thirteen years after the collapse of the Soviet Union.

Poland' own crude oil production is tiny compared to its total consumption. While in 2000, it produced about 10.000 barrels per day (bpd), it consumed 420.000 bpd. 98% of Polish crude oil consumption is covered by imports.<sup>94</sup> About 82% of Polish crude oil consumption comes from Russia, the rest is supplied by the United Kingdom, Norway and Iran.<sup>95</sup> Hungary produced about

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<sup>94</sup> An Energy Overview of the Republic of Poland (accessed August 7, 2004); available from <http://www.fe.doe.gov/international/CentralEastern%20Europe/plndover.html>

<sup>95</sup> "What We Should Fear is Our Own Weakness, not Russian Capital," *PNB – Economic Review*, September 13, 2002. Accessed October 29, 2002. Available from ISI Emerging Markets.

27,000 bpd crude oil in 2000, while it consumed 145,000 bpd. Over 80% of Hungarian crude oil consumption is met from outside sources. The ratio of domestic production to imports is expected to worsen. According to estimates, Hungarian production would be down to 15,000 bpd by 2010.<sup>96</sup> Most of Hungary's needs are covered by Russia. Mol, the Hungarian oil wholesale monopoly company, signed a production sharing agreement with Yukos for the joint development of the Zapadno-Maloblyk field in Siberia in December 2002. According to the agreement, the two companies established a joint company with 50-50% shares for the joint exploration of the field.<sup>97</sup> This agreement practically guarantees that Hungary will continue to use Russian oil to cover more than 80% of its consumption in the foreseeable future.

Slovakia has negligible oil resources of its own. It produced only app. 3,500 bpd of crude in 2000. It relies heavily on oil imports from the Russian Federation, which make up about 97% of its oil consumption.

Moreover, it is important to note that until mid-2003, there have been only two Russian oil companies that have made significant inroads into the wider Central and Eastern European region (from the Baltics in the North to the Balkans in the South). They were Lukoil and Yukos. The Central European perception was that Yukos had been coming from the north while Lukoil had been approaching the region from the south and the two Russian oil companies had divided the region between each other.<sup>98</sup> One of the two companies entered into oil transport contracts with every country in Central Eastern Europe, but never in competition. For example, it was Yukos that supplied the Hungarian market with crude oil, but Lukoil has never tried to get even the

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<sup>96</sup> An Energy Overview of the Republic of Hungary (accessed August 7, 2004); available from <http://www.fe.doe.gov/international/CentralEastern%20Europe/hungover.html>

<sup>97</sup> "A Mol es a Jukosz a Zapadno-Malobalik olajmezore vonatkozó szerződést írt alá," December 20, 2002 (accessed August 10, 2004); available from [www.mol.hu](http://www.mol.hu)

<sup>98</sup> Interview with Zoltan Kovacs, an investment banking executive with extensive experience in oil and gas deals in the region (for example he was in charge of TVK's stock market defence strategy during the Borsodchem takeover battle), Budapest, June 2002

smallest slice of this cake. Russian oil companies have never competed against each other for a supply contract in the Central European countries (this was not the case in bidding for assets).

The example of the Hungarian case shows how this situation came about. In November 1994, the Hungarian Ministry for Industry and Trade and the Russian Ministry of Energy signed an agreement to establish an intermediary company for Russian oil similar to Panrusgas in the gas supply chain. The Russian ministry nominated Yukos to coordinate with the Hungarian side in the establishment of the intermediary company. At the same time, Yukos also received the right from the Ministry of Energy to coordinate Russian crude oil deliveries going to Hungary. This gave the company an opportunity to push other Russian oil suppliers out of the Hungarian market. In April 1995, during negotiations between Mol and Yukos, the Russian company announced that it was not interested in any barter deal (in practice this meant the exclusion of any intermediary), but wanted to trade with Mol only in hard currency. Yukos also announced its desire to establish or buy a retail network in Hungary and to participate in the privatization of the Hungarian energy companies. By the end of 1995, the Russian company became the monopoly provider of the Hungarian market, and continued to cover about 60-70% of Hungary's crude oil consumption up until 2004.<sup>99</sup>

The Russian Ministry of Energy's most important lever to influence the foreign conduct of private oil companies was its control over Transneft. Even though the Russian oil industry was privatized in the beginning of the 1990s, the Russian state did not privatize Transneft, the owner of all the crude oil pipelines in the Russian Federation. The bottleneck of Russian crude exports was access to the outside markets. It was state-owned Transneft that controlled all the pipelines and through them the oil companies' opportunity to deliver to outside markets. By nominating

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<sup>99</sup> "Rovidesen indul a Mol-Jukosz ceg," *Nepszava*, February 12, 2002. Accessed November 7, 2002. Available from ISI Emerging Markets.



Yukos to be in charge of oil deliveries to Hungary, Moscow was able to appoint Yukos as the only Russian supplier for Hungary.

It can be observed in the Central and Eastern European region during the entire examined period that only one Russian oil company supplied a particular country with Russian crude oil. Russian oil companies did not compete against each other, but split the market. While certain organs of the Russian state, especially the Ministry of Energy and Transneft, have clearly played a part in coordinating the two major oil companies' (Lukoil and Yukos) supply activities in this region, most experts believe that the purpose of this interference was to maximize Russian proceeds from oil export.

However, the efforts to create an import dependency comparable to natural gas import dependency – if such an aspiration existed – was clearly in vain. For no matter what share of a country's consumption is supplied from one source, the real question is whether alternatives exist. As long as credible alternatives are available, the dominant supplier has to play by the usual rules, e.g., in pricing or general conduct, otherwise the buyer can simply switch to another provider. Although switching is never costless, in the oil market it is relatively cheap, especially compared to the value of the assets at stake. Central Eastern European countries have always had alternatives to Russian crude, and therefore supply contracts have never threatened to create dependency.

As detailed in the previous section, a crude oil provider, which aspires to a monopoly position, can overcome this problem only through acquiring the assets that control the entry of alternative suppliers. In this sense, Central European countries have one characteristic that in theory can make them vulnerable to Russian influence in their oil industries. As in the gas industry, they usually have only one major pipeline going through their territory, which is owned by one pipeline operator. They also have only one or two refineries and have only one wholesale

monopoly company. This situation is partly the heritage of communism. In the communist economy, strategic industries were centralized and owned by the state. After the collapse of communism, these industries were kept in one piece and in state control. In addition to the communist heritage, the other reason that explains the above situation is the size of the countries in the region. The general tendency in the oil industry is consolidation, meaning that larger companies have better chances to survive. As a result, small countries like the ones under discussion here justify no more than one player. This centralization, however, makes the oil industries of Central Europe especially vulnerable. In case of privatization, it is enough for a Russian company to buy either the pipeline operator or the refinery to gain effective leverage over the entire oil industry of the country.

Now let us take a quick look at the oil industry of the region, especially the situation of the aforementioned key assets: oil terminals, pipelines, and refineries. Among the three countries examined, only Poland has direct access to the sea and has one major sea terminal, Naftoport. It has several oil refineries, but only two have substantial capacity, Rafineria Gdanska's and PKN Orlen's. Slovakia does not have access to the sea. Toward the South, it would need to cross at least two countries to get to a sea port; toward the North, it would need to go via Poland. For using the latter route, it would need to drive a pipeline through the Carpathian mountains, which is a formidable natural barrier. There is, however, a domestic transport monopoly, Transpetrol, a pipeline company. The country has one major oil refinery, controlled by Slovnaft. Hungary does not have direct access to the sea either. However, until recently Hungary received its crude oil from two sources, from Russia on the East and to a lesser extent through the Adriatic port of Omisalj via a pipeline going through Croatia into Hungary. In 2002, Yukos successfully lobbied for the elimination of the latter route with the caveat that this capacity might be restored. MOL,

the domestic oil and gas company has monopoly over oil wholesale, and owns the country's only significant refinery in Százhalombatta.

After this detour, let us take a look at the Rafineria Gdanska story. In Poland, at the beginning of the privatization of the Polish oil sector, there were two big oil refineries which covered about 80 percent of the oil market. The bigger one is called PKN Orlen. Orlen controls 60 percent of the Polish wholesale oil market.<sup>100</sup> Its refinery is located in the city of Plock. The other refinery is Rafineria Gdanska (RG), located in the Polish port of Gdansk. RG controls 20 percent of the Polish oil market.<sup>101</sup> The Friendship oil pipeline is the only one going through Poland. It delivers crude oil to Germany and also to the port of Gdansk. The Polish section of the pipe is owned and operated by a Polish company, PERN, which is fully owned by the state treasury. The country's only sea terminal, Naftoport, is located in Gdansk.

The Polish government has been undecided for years about the strategy it should pursue in its oil industry. The basic questions were whether to consolidate the oil sector and if so, what kind of privatization to allow. Consolidation of the oil sector would have meant a merger between PKN Orlen and Rafineria Gdanska. Some who supported this idea argued that the merger would substantially strengthen PKN Orlen's position by creating a strong Central European oil concern. As a result, the Polish oil company would be able to resist any potential takeover by a hostile buyer. Moreover, Orlen would be in a much stronger position vis-à-vis the Austrian OMV or the Hungarian Mol in the competition to Central European industry leadership.<sup>102</sup> However, those who opposed the idea argued that the merger would result in exactly the opposite effect. One oil

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<sup>100</sup> Orlen in Poland (accessed August 11, 2004); available from [www.petrochemia.pl](http://www.petrochemia.pl)

<sup>101</sup> Rafineria Gdanska – company profile (accessed August 11, 2004); available from <http://www.polishproducts.pl/org.asp?on=657&c=276> Besides the two big refineries there were three more in Southern Poland. However, their capacity and role on the Polish oil market is insignificant.

<sup>102</sup> See more about this issue below.

company in Poland would be an easy target for any Russian oil company. If Lukoil or Yukos takes over the merged company, the whole oil industry would immediately be in Russian hands. A merger would make Poland a more lucrative target for Russian companies, because a successful takeover of the new company would put the owner into a monopoly situation in the Polish market.

The other option was to avoid consolidation of the Polish oil sector. The disadvantage of this option is the lost opportunity of strengthening PKN Orlen's position in the competition for the Central European market. However, with this solution the drawbacks of consolidation can be avoided. Proponents of this solution argue that it is unavoidable that sooner or later Russian oil companies will take over the Polish oil sector. As a result, the best that Poland could do is to make Russian companies compete in the Polish market. Proponents suggest that the Polish government should support the creation of two big Polish oil companies and then privatize them. One of those companies would be PKN Orlen, and the other could be RG. However, the market share between Orlen and RG is very uneven (60% vs. 20%). Such a strategy would necessitate strengthening RG.

With regard to privatization, there have been at least three major issues to decide. The first is the percentage of the refineries' shares that should go on sale. The second is whether to sell the refineries to a strategic investor or to a financial one. The third is whether to prefer domestic buyers or foreigners, and how to attract Western companies.

Initially, the Polish government's strategy was to privatize Rafineria Gdanska first and PKN Orlen later. The government's original industry strategy did not allow a merger between the two Polish oil companies. In 1996, the Polish government created Nafta Polska (NP), a state agency to execute the privatization of the Polish oil industry. The state share in RG and Orlen was transferred into the ownership of Nafta Polska. NP was authorized to prepare and announce the

tender for the privatization of RG, then evaluate the offers and pick the winner. NP first attempted to sell RG in 1998; however, it did not announce a winner, because it allegedly did not receive good offers. The second tender for the privatization of RG was launched in early 2001. This time 75% of the shares of Rafineria Gdanska were put on sale. By May 2001, the privatization tender was down to two finalists: the Hungarian oil company Mol and a company called Rotch Energy. At the time of the tender all that was known about Rotch was that it was based in the UK and was allegedly owned by two Arab sheiks. It was mysterious why a UK-based company, which did not have a single investment in the oil industry, or a single investment in Central Europe, and was undercapitalized would be interested in buying Rafineria Gdanska. The rumor in the market was that Rotch was partly (or fully) owned by a Russian company, possibly Lukoil or Yukos. In this case, selling RG to Rotch would have meant selling it to a Russian oil giant. Even though this allegation was never proven, it did not seem far-fetched. It has been a common Russian strategy to enter a privatization tender in the region under the disguise of a Western company. As it will be discussed later, this happened in the case of the Hungarian petrochemical company, Borsodchem.

Out of the two finalists for RG, Rotch was chosen to start the due diligence, but soon it turned out that it did not have the necessary financial means to back its offer for the refinery. Meanwhile Yukos, whose offer had been rejected for procedural reasons, announced that it would still be interested in buying Rafineria Gdanska, should Rotch fail to buy the refinery. However, a Yukos interest in RG could not have gone unnoticed in Poland. Polish Treasury Minister Wieslaw Kaczmarek said that selling the stake in RG to a Russian investor (referring to Yukos) would “create a huge political storm.” “Yukos is not being taken into account at this stage of RG privatization, but one has to realize that after 10 years of absence, Russian investors will someday

return to Poland.”<sup>103</sup> A few days after Yukos’ announcement, Rotch announced that because of its lack of sufficient financial means to buy RG, it had teamed up with a Russian company to carry out the deal.<sup>104</sup> Rotch managed to agree with Lukoil to issue a joint offer for Rafineria Gdanska. According to their agreement 49% of the 75% shares of RG would be owned by Lukoil and 51% by Rotch. According to the preliminary agreement between the potential buyers and the Polish state, Rotch would not be allowed to sell its share in RG to Lukoil for the next 10 years.<sup>105</sup>

In several earlier Central and Eastern European privatization tenders, Russian companies entered the process with a Western company. Even though the Russian companies would have been interested in the target companies on their own, they experienced local resistance against their taking over pieces of the strategic industries of countries in the region. Most governments would have preferred Western investors in the oil, gas and petrochemical sectors. However, Western companies stayed away from privatization tenders in this region, for several reasons. First, the general tendency in both the gas and oil industries is vertical integration, that is, acquisition of the vertical chain from exploration through pipelines and refineries to wholesale. In this part of Europe Russian companies are the major suppliers of raw materials, owners, co-owners, or operators of pipelines. As a result, this region is their natural area of expansion. Second, as far as refining is concerned, it has long been a business with low profit margins. Refineries can be operated profitably if they are running at almost full capacity. There are too many refineries in Europe currently, and the tendency will be consolidation in the industry. As a result, buying a refinery in a Central Eastern European country makes business sense for the

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<sup>103</sup> “Final Decisions on Orlen, RG Sale Expected in February,” *PNB*, January 30, 2002. Accessed October 29, 2002. Available from ISI Emerging Markets.

<sup>104</sup> Originally in *Puls Biznesu*, February 6, 2002, cited in “Rotch to Team Up With Russian Partner to Vie for Gdansk Refinery,” *PNB*, February 6, 2002. Accessed October 29, 2002. Available from ISI Emerging Markets.

<sup>105</sup> Rotch Energy and Lukoil Most Likely to Take Over Gdansk Refinery,” *PNB*, May 10, 2002. Accessed October 28, 2002. Available from ISI Emerging Markets.

company that supplies it with crude and thus is able to operate at full capacity. Lukoil and Yukos were such companies.

However, local governments and public opinion were against Russian companies' takeover of strategic industries. A poll conducted in the Fall of 2002 found that over 51 percent of Poles believed that Russian investment was not favorable for Poland.<sup>106</sup> This fact also explains Treasury Minister Kaczmarek's aforementioned statement. As a solution, Russian companies started to team up with Western companies and entered into privatization deals in consortia to legitimize the Russian partner. Western-Russian consortiums were more welcome in the Central Eastern European privatizations than were purely Russian ones. However, it happened several times that shortly after the consortium had won the tender, the Western partner sold its share to the Russian one. It created a situation, which went against the very intent of the selling governments. That is the reason why the Polish government decided to include a clause in the Rafineria Gdanska deal to prohibit Rotch from selling its shares to Lukoil for the next 10 years.

After the Polish government had evaluated the Rotch-Lukoil offer, in July 2002, Treasury Minister Kaczmarek said that "if I were to assess Lukoil's project relating merely to the content and disregarding political background, I would evaluate it very high. However, this project involves political risk."<sup>107</sup> Controlling the second largest refinery in Poland, with a market share of only 20%, is not such a big political risk in itself. What makes the RG sale to Lukoil a bigger cause for concern is that the refinery owns 26.54% of Naftoport, the only Polish oil terminal. Naftoport gives access for Poland to alternative sources of crude oil. If Lukoil acquired a controlling share of Naftoport, it could use it as a tool for significant leverage. Former PGNiG

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<sup>106</sup> Originally reported in *Rzeczpospolita*, September 26, 2002. Cited in "(Another) Up and Down Week in Refinery Saga," *PNB-Weekend Supplement*, October 3, 2002. Accessed October 28, 2002. Available from ISI Emerging Markets.

<sup>107</sup> "Poland to Consider Political Risk of Lukoil Investment in Refinery," *Agence France Presse*, July 26, 2002. Accessed January 6, 2003. Available from LexisNexis.

(Polish gas company) boss Piotr Wozniak commented “the Russians will make use of any business weakness on the part of their negotiating partners. The Russians are tough and uncompromising partners, we are too weak for them. If we sign the sale agreement for RG we will be making a mistake that they will exploit to the full.”<sup>108</sup>

The above opinion was shared not only by Poles but others dealing with political risk assessment. Managing director of Fitch Ratings, Richard Hunter, said that his firm would consider a takeover of RG by Lukoil as a negative factor in Poland’s evaluation as an investment target. He believed that the deal would make Poland permanently dependent on Russia.<sup>109</sup> Lukoil CEO, Vagit Alekperov, was of a different opinion. “Our offer gives what’s most important – stability and security. The refinery is given a chance to purchase oil straight from the producer, with no third parties involved. All buyers will benefit from it.”<sup>110</sup>

In late 2002, Lukoil threatened PKN Orlen, the state-owned company providing more than three-fourths of refined oil in Poland that it might discontinue crude oil sales to the company unless Lukoil got its way with RG.<sup>111</sup> This was hard ball at its peak. The Russian company was trying to blackmail the Polish government at the beginning of the heating season. In February 2003, visiting Russian Prime Minister Mikhail Kasyanov openly supported Lukoil’s bid for the Gdansk refinery. Mikhail Kasyanov said that “the Russia’s government supports endeavors of

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<sup>108</sup> “Refineria On My Mind – Russians Set to Dominate Polish Fuel Sector?” *PNB – Weekend Supplement*, August 8, 2002. Accessed October 28, 2002. Available from ISI Emerging Markets. In the interview I conducted with Mr. Wozniak, he said that he had negotiated with the Russians dozens of times. According to him, after the Dutch, the Russians are the toughest negotiators in Europe. Nobody comes even close to them. Wozniak interview

<sup>109</sup> “Refineria On My Mind – Russians Set to Dominate Polish Fuel Sector?”

<sup>110</sup> Originally in *Gazeta Wyborcza*, September 5, 2002. Cited in “Neither Polish Nor Russian Oil Holdings Give Up Fight for Gdansk Refinery,” *PNB*, September 10, 2002. Accessed October 28, 2002. Available from ISI Emerging Markets.

<sup>111</sup> “Russia vs. Orlen,” *Wprost*, April 20, 2004. Accessed September 8, 2005. Available from ISI Emerging Markets.



Russian companies to invest in Poland. Proposals, such as Lukoil's and Siewierstal's, are still valid."<sup>112</sup>

Finally in April 2003, Nafta Polska presented a proposal to the Polish government to call off the tender for Rafineria Gdanska. Instead of selling RG to any strategic investor, Poland revised its oil industry strategy. The new strategy called for strengthening RG by merging it with three small southern refineries. It does not prohibit explicitly a future merger between PKN Orlen and RG. However, the privatization of the two companies was postponed until each is strong enough. In the summer of 2003, Rafineria Gdanska was merged with the three southern refineries, and created a group called Lotos.

*(v) PKN Orlen – Mol Merger*

The idea of closer cooperation or eventual merger between the Polish and the Hungarian oil monopolies first arose in the Fall of 2000. At that time, there were right-wing governments in office in both countries: the Buzek government in Poland and the Orban government in Hungary. The major motivation behind the idea of merging the two companies was to defend them against a hostile takeover. It was well understood back then that business logic dictated a vertical build-up in the oil industry. Companies that were involved in exploration all over the world entered the vertical chain from exploration through transit and refining to wholesale and retail. This way, they managed to acquire the profits not only from the exploration but also from the entire vertical chain. By 2000, it was apparent that the Russian companies engaged in exploration were aiming at entering every stage of the vertical chain of the oil industry. Their motivation was

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<sup>112</sup> "Lukoil and Seversteel Still Want to Invest in Poland, Russia's PM Says," *Internet Securities Businesswire*, February 21, 2003. Accessed July 8, 2003. Available from ISI Emerging Markets.

understandable, as the least profitable link in the chain (back then) was exploration. It was also a tendency in the industry that companies without their own exploration capacity were sooner or later taken over. Both PKN Orlen and Mol were wholesalers and retailers but they lacked significant exploration activity. Market analysts predicted that they would soon be taken over by a third company. Additionally, based on the experiences of the Central and Eastern European privatization tenders, it was also clear that western companies were much less interested in investing in the region's oil sector than were Russian companies. This region was a natural area for expansion by the Russian oil companies. The Polish and the Hungarian governments feared that their oil company would be taken over by a Russian one. In this case, the oil industry of the country would become completely dependent on Russia. As both companies were at least partly state-owned, the governments as well as the companies started to pursue negotiations about a potential merger between them.<sup>113</sup> There were several scenarios discussed when finally in August 2001, Mol proposed a merger of equals with PKN Orlen. The deal would have been worth \$1.5 billion.<sup>114</sup> Simultaneously with the negotiations between PKN Orlen and Mol, the tender for the Polish oil refinery, Rafineria Gdanska (RG) was going on. Mol was among the contenders for RG. However, rumors in the market arose that on the coattails of Mol, Yukos would enter RG. Mol did not manage to persuade the Poles that this was not the case.

The Mol-PKN Orlen negotiations broke down in January 2002. Then the Polish government decided to invite OMV parallel with Mol to hand in offers for 17.6 percent stake of the Polish oil company. However, in April 2002, the government finally decided not to sell the above stake in PKN Orlen. At the same time, the Buzek government withdrew from privatizing Rafineria

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<sup>113</sup> There is a third player in the Central and Eastern European oil industry. It is OMV, the Austrian company. OMV does not have its own exploration either. There were talks about a potential merger of the three companies, as well; however, from the dissertation's point of view I skip discussing that scenario and concentrate only on the one strictly motivated by the fear of a Russian take-over.

<sup>114</sup> Originally reported by *ViewsWire Eastern Europe*. Cited in "Eastern Europe Industry: Oil Abroad?" *EIU-Regional Economic News*, August 24, 2001. Accessed October 27, 2002. Available from ISI Emerging Markets.

Gdanska. In both cases, the Polish government was afraid of losing control over one or both of the two key companies in the Polish oil industry. There were two major considerations behind the discussions about the merger of Mol and Orlen. First, the question was whether under the umbrella of Mol a Russian company would enter PKN Orlen. Second, whether the new entity would be an easy target for take over by a Russian company. Regarding the first issue, it was a widely held belief in Poland that Yukos had a substantial share in Mol and with a merger it would acquire a good part of the Polish oil company. The fear of a Russian takeover became the decisive factor in the Polish decision not to sell PKN Orlen to Mol. 30 percent of the shares of Mol are traded on the Hungarian stock exchange and owned by several small shareholders whose identity is not necessarily known. Market analysts even estimated that Gazprom had a certain amount of shares in Mol at the time of the Borsodchem takeover (to be discussed later) in September 2000. After the latter deal, Mol's corporate stature was changed to prevent anything similar happening to the Hungarian oil company. Still, as Piotr Naimski acknowledged, among others, it was he who recommended to Polish Prime Minister Jerzy Buzek not to sell PKN Orlen to Mol before the Hungarians can show the identity of the owners of the aforementioned 30 percent share.<sup>115</sup> Mol CEO Zsolt Hernadi said that Hungarians were never able to explain to the Poles that Mol was strong enough to defend itself and Russians could not take it over. Additionally, the so-called dual-listed or dual-headed model Mol recommended for the merged entity would have made it even less likely that somebody acquired substantial shares in the new company. "We could say anything, the fear from the Russians was deeply set in the heads of the Poles."<sup>116</sup> The final "no" was issued on the Poles' behalf in April 2002. The decision was made

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<sup>115</sup> Naimski interview

<sup>116</sup> Hernadi interview

to work out a strategy for the Polish oil industry first and then continue with privatization in that sector.

In November 2003, Mol received one more time the exclusive rights to negotiate a merger deal with PKN Orlen. Again the major issue behind the negotiations was whether the new entity would become an easy prey for the Russians. As Rafal Jankowski of Pekao Bank phrased, “it is a misunderstanding to believe that the merged entity will be able to buy oil more cheaply. Mol's negotiating capabilities are very limited, especially as far as the Russians are concerned. Mol has an exploration joint venture with Yukos. This is not usual that the Russians allow someone to explore their oil deposits. And if they did, they are going to be dictating the terms.” The Polish government ordered a study about the possible impacts of a PKN Orlen-Mol merger. The report was written by the Polish Foreign Ministry's European department, the Ministry for Economics, and the Centre for Eastern Studies (CES), a Warsaw-based think tank. The fact that both the foreign ministry and CES were involved in writing the report illustrates that there were not only economic considerations behind the decision.<sup>117</sup> The report claims that the merger of Poland's largest oil company PKN Orlen with its Hungarian peer Mol would create an entity that could easily fall prey to one of the Russian oil groups and become an instrument of political pressure. “Merging Orlen with the Hungarian company could result not only in the state losing control over Orlen, but also in the merged entity being taken over by Yukos.” Oil and gas exports are increasingly important in Russia's foreign policy and in the instruments it uses to fulfil its strategic interests, says the report. Recent years have seen Russia's growing expansion in the Central European states' energy sectors, a significant process given that the interests of the

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<sup>117</sup> CES is a think tank set up by former Polish intelligence service personnel in the beginning of the 1990s and is specializing on research of countries East from Poland. The think tank has the best knowledge base about Russia and CIS affairs in Central Europe. The confidential report about the impact of a potential merger of Mol and PKN Orlen written in the Spring of 2004, was not made public as of October 2005. All the references and quotations from the report are taken from the Polish paper *Gazeta Wyborcza*.

Russian state and the leading companies operating in the sector (Gazprom, Yukos, and Lukoil) are concurrent. The report strongly advised against the merger for exactly the same considerations as two years before, namely the fear that the merged entity would be an easy prey for a Russian company.<sup>118</sup>

At the time of the negotiations with Mol, the Polish state owned 33% of PKN Orlen. Originally, it wanted to sell 10% of its stake. However, Mol had one condition for buying that stake. Mol's management wanted to receive guarantees that the Polish state would sell a remaining 13%, thereby pushing the state's stake below 10%. According to Zsolt Hernadi, Mol wanted to avoid a situation where after the deal is done, the Polish state dictates the terms of the merged entity.<sup>119</sup> However, the Poles were afraid of doing so exactly because of fears of a Russian takeover. "Post-merger, both companies will be too small to defend themselves effectively. Moreover, taking over a single company is easier than taking over two. Both companies' relatively dispersed ownership makes them easy takeover targets," said Sebastian Slomka, an analyst at the PKO BP brokerage as quoted in *Gazeta Wyborcza*.

The deal was not concluded by April 30, 2004, when the deadline for the negotiations expired. In an interview for the Polish daily *Parkiet*, Maciej Gierej, the former president of Nafta Polska, commented on the behind-the-scenes aspects of the planned merger. He said that there is a game that has been, and still is, going on aimed at a cheap takeover of the company to be formed through the merger. He suspected that Russian fuel giants may be behind this.<sup>120</sup> Whether true or not, and whether Polish fears were justified, it was clear that the Russian factor overrode even economic considerations for the merger and became the decisive one in the final decision.

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<sup>118</sup> Originally reported by *Gazeta Wyborcza*, April 17, 2004. Cited in "Gov't Report Warns of Russian Factor as Preparations for Orlen/Mol Merger Gather Pace" *PNB*, April 20, 2004. Accessed August 30, 2005. Available from LexisNexis.

<sup>119</sup> Hernadi interview

<sup>120</sup> Originally reported by *Parkiet*, May 13, 2004. Cited in "Former Nafta Polska President on Orlen-Mol Merger," *PNB*, May 13, 2004. Accessed September 5, 2005. Available from LexisNexis.

*(vi) Conclusion*

During the first Putin presidency, Russian energy companies' expansion in the Polish petroleum sector reached a level not seen any time since the collapse of the Soviet Union. Russian energy companies tried to exploit every opportunity to strengthen their position in Poland. In their activities they were supported by Russian diplomacy, which placed their facilitation at the forefront of its strategy in Central Europe. In fact, Russia viewed these forays as so important that it explicitly linked ministerial visits to certain milestones in this regard, and raised these issues even at the prime ministerial and presidential level. However, Russian energy companies relied not only on these overt helps but on covert means as well.

In the gas sector, Gazprom managed not only to keep its advantageous position in Europol Gaz, but also to lower the transit fee it needed to pay in Poland. Moreover, it managed to neutralize the biggest challenge to its monopoly supplier position, the planned Norwegian gas pipeline. The only concession it had to make was with regard to quantities covered in the gas contract between Russia and Poland. Even in this case, it is not obvious that Gazprom gave in more than its counterpart (in fact, the opposite might be closer to the truth).

Between 2000 and 2004 Russian oil companies made systematic attempts to enter the Polish oil industry. They entered both privatization tenders for the second largest Polish refinery Rafineria Gdanska. Several times they expressed interest in buying into PKN Orlen, the biggest refinery of Poland. However, Russian companies were well aware that they have little or no chance of winning at any of the Polish privatization tenders on their own. It would have gone against the very intent of the Polish governments to sell one of the two biggest refineries to a

Russian company. To circumvent this problem, they used covert means to achieve their aspirations, but to no avail.

It is clear that Russian oil companies' room for maneuver has been much smaller than Gazprom's. Although Russian oil accounts for 80% of Polish crude import, Poland has every means to switch suppliers – an oil terminal with a refinery, pipelines it controls – Russian oil companies have had no way to strong arm the Polish government into any deals the latter would not have wanted to enter otherwise. They also tried to achieve their aspirations through covert tools. However, these had very little chance for success. As the history of the PKN-Mol merger attempt shows, the Polish government, as well as the Polish media and public, has been suspicious of any likely Russian ownership in these sectors. The Russian state seems to have concentrated most of its efforts to help the more promising gas industry, and according to this research, wasted much less energy supporting the very challenging task of helping Russian companies acquire any major Polish oil assets.

## Slovakia

### (i) *The Privatization of SPP*

Slovensky Plynarensky Priemysel (SPP) is the natural gas importer, transmitter, distributor and merchant monopoly in the Slovak Republic. SPP has the exclusive rights to import gas from abroad and distribute it in the wholesale market. Additionally, it is the owner of the pipeline system that transports natural gas through the territory of Slovakia in an East-West direction. In the 1990s, about 50% of SPP's revenues came from transmitting gas through the five lines and stretches which run all the way through Slovakia.<sup>121</sup> The transit revenues totalled about 600 million USD per year.<sup>122</sup> The pipeline system has a capacity of 90 bcm per year, which is almost three times as much as that of Yamal 1 (32 bcm) and 30% more than the capacity of the two Yamal lines together (64 bcm). During the 1990s, the transport capacity of the pipeline system was utilized almost entirely. In 1998, SPP transported 84 bcm, while in 1999, 88 bcm.<sup>123</sup> Before its privatization, SPP was one-hundred percent state-owned.

The difference between the Polish PGNiG and the Slovakian SPP was that the latter owned the transit pipelines crossing Slovakian territory, while in Poland Europol Gas had control over the transit system. Therefore, control over SPP means control over the import, wholesale distribution, and transport of all the natural gas arriving in Slovakia. If one ever intended to acquire leverage over the Slovakian gas industry, one had only to aim at taking over SPP. SPP's strategic position was very well understood by the Slovaks. In May 1999, Economy Minister

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<sup>121</sup> "Company Operations," *Slavia Capital – Company Highlights*, February 7, 2001. Accessed November 9, 2002. Available from ISI Emerging Markets.

<sup>122</sup> "Economic News Summary, June 14. Yamal II will Increase SPP's Transit Revenues by Ten Percent," *SITA – Economy and Business*, June 14, 2001. Accessed November 9, 2002. Available from ISI Emerging Markets.

<sup>123</sup> "Company Operations," *Slavia Capital – Company Highlights*, February 7, 2001. Accessed November 9, 2002. Available from ISI Emerging Markets.



Ludovit Cernak said that even though Slovakia was eager to attract foreign investors, it was crucial to keep state control over strategic companies like SPP.<sup>124</sup>

The Slovak government first started to float the idea of privatizing SPP at the beginning of 2000. Interestingly enough, this happened only a few months after Gazprom announced in October 1999 that it would consider building a pipeline under the Baltic Sea within a year. In early March 2000, Gazprom gave an ultimatum to Slovakia and Poland: either consent to building the inter-system connect pipeline bypassing Ukraine or Gazprom would construct the northern under-water pipe.<sup>125</sup> If the inter-system connect was built, the volume of gas transported through Slovakia would have increased significantly (this would have required significant additional investment in the Slovakian pipeline infrastructure), thus making Slovakia the paramount transit country of Russian natural gas. In this case, the value to the owner of the pipeline system, i.e. SPP's, would increase substantially. However, if the idea of the inter-system was dropped and the Baltic line were built instead, the value of SPP would potentially decrease as the volume of transit would drop. The Slovakian pipelines had been used almost exclusively for delivering Gazprom gas. As a result, the ultimatum had a massive direct impact on the evaluation of SPP. Gazprom's threats and promises were able to influence the value of the Slovakian gas monopoly tremendously. The pressure of Gazprom on Slovakia was not in vain. On March 14, 2000, Slovakia officially agreed to the proposal of the Russian company to build a gas pipeline through Belarus and Poland to Slovakia.<sup>126</sup> Economy Minister Lubomir Harach claimed that the new pipeline is in the interest of Slovakia as it diversifies resources since it delivers gas from the

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<sup>124</sup> "Investors Losing Patience with Cabinet over Nafta Gbely Sale," *The Slovak Spectator*, May 17, 1999. Accessed November 9, 2002. Available from ISI Emerging Markets.

<sup>125</sup> *SITA*, March 4, 2000. Accessed November 9, 2002. Available from ISI Emerging Markets.

<sup>126</sup> *Trend*, March 14, 2000, Accessed November 9, 2002. Available from ISI Emerging Markets.

Yamal gas fields. Second, it is in the interest of SPP, as well, whose value will rise before its planned privatization if the new pipeline is built.<sup>127</sup>

In May 2000, the Slovak government decided to sell 49% of SPP shares. A few days after announcing the intent to privatize, Economy Minister Lubomir Harach said that Gazprom expressed interest in participating in the privatization through the Russian ambassador to Bratislava.<sup>128</sup> Even though the minister did not endorse Gazprom's interest openly, the context of his talk then and later suggested an implicit endorsement. The Slovakian approach to energy privatization was different from the Polish one. While avoiding a Russian investor and attracting a Western one was the main consideration in Poland, Slovakia seemed to have no concern over Gazprom and probably actively supported its participation in SPP's privatization. The latter proposition is based on an article published in the reliable Russian business paper *Kommersant* few days after Harach's comments. According to the article, Slovakia did not object to the construction of the inter-system pipeline through its territory on the condition that the Russian giant would participate in the privatization of SPP.<sup>129</sup> Gazprom did not want to comment on *Kommersant's* information and the Slovak Economy Ministry denied any link between the pipeline and SPP's privatization. But Slovak Economy Minister noted that it cannot be stated categorically that the dependence of Slovakia on Russian energy will increase if a Russian company buys into SPP. According to him, it depends on the size of the stake the Russian investor would buy.<sup>130</sup> However, a few days after the article was published, a Gazprom official responsible for the company's export policy, Jurij Komarov, noted that „the decision of Gazprom

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<sup>127</sup> “Harach: New Pipeline Will Raise SPP's Value,” *TASR Export Service*, March 9, 2000, Accessed November 9, 2002. Available from ISI Emerging Markets.

<sup>128</sup> “Slovakia: Sell-Off Beckons for Oil and Gas Companies,” EIGOMI, May 11, 2000, Accessed November 9, 2002. Available from ISI Emerging Markets.

<sup>129</sup> Originally in *Kommersant*, June 15, 2000 cited by *SITA – General News*, June 16, 2000, Accessed November 9, 2002. Available from ISI Emerging Markets.

<sup>130</sup> “Minister Harach Does Not Rule Out Gazprom's Entry into SPP,” *SITA – Economy and Business*, June 16, 2000, Accessed November 9, 2002. Available from ISI Emerging Markets.

on its involvement in the privatization of SPP affects also its participation in building the aforementioned [inter-system connect] pipeline.”

However, during the spring of 2000 negotiations with the Poles about the alternative pipeline going from Norway to the South intensified. In May, the Slovak government expressed its interest in the construction of the Norway-Poland gas pipeline. It also said that Bratislava is considering an alternative gas pipeline via the Czech Republic. Moreover, the month after, Slovak Economy Minister Lubomir Harach said that „we are interested in good cooperation not only with Gazprom and Russia, but also with other countries of the former Soviet Union because a certain diversification in eastern natural sources for the supplies of Slovakia is needed.”<sup>131</sup> Harach reinforced the government’s decision to consider an alternative route via the Czech Republic. In June 2000, Gazprom’s senior official responsible for the company’s export policy, Jurij Komarov, threatened Bratislava with the option either „constructively cooperate in implementing the planned project with Russian gas officials or to lose the transit.”

However, as the likelihood of the Norway-Poland pipeline waned, Slovakia returned to its original strong support of the inter-system connect pipeline. During his January 31, 2001 visit to Bratislava, Russian Foreign Minister Igor Ivanov said that he welcomed Slovakia’s interest in participating in the construction of the pipeline. However, an entire year passed without any official steps taken in the matter of SPP privatization. Finally, the tender was announced in August 2001.

Gazprom confirmed officially its interest in participating in the privatization of SPP on June 18, 2001, two months before the tender was officially released. In mid-November, Gazprom’s chief executive, Alexei Miller, said that „Gazprom’s participation in SPP’s privatization is strategically important for both countries and will guarantee stable gas supplies to Slovakia as

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<sup>131</sup> Ibid.

well as to other European countries in the future.”<sup>132</sup> His statement coincided with the Slovak president’s visit to Moscow. It is hard not to see the thinly veiled threat in Miller’s words, which link a stable gas supply to the issue of privatization. This implicit threat was a frequently used tool of Gazprom’s, and the company made good on it at least once in the period under discussion, vis-à-vis Belarus and thus indirectly Poland in February 2004.

Discussions between Gazprom and the Slovak state started in mid-November 2001 right after the Slovak president Rudolf Schuster paid an official visit to Moscow where he met President Putin. According to the company’s press release, the issue of Gazprom’s participation in the privatization of SPP, received special attention at the high-level bilateral meeting.<sup>133</sup> Gazprom CEO Miller’s words during the same days as well as the final outcome of the privatization suggest that the Slovak government had experienced at least a partial change of heart with regard to sole Russian ownership of 49% of SPP.

Throughout the privatization process of SPP, the Slovak state continually emphasized that it intends to sell the 49% share to one strategic investor or a consortium of such investors. From Gazprom’s point of view, the most attractive option was to win the 49% stake alone. Even if Gazprom had a chance to do so, it was soon gone. For in early December, the Slovak Privatization Agency sold 49% of Transpetrol, the owner and operator of the Slovak oil pipeline, to Yukos. The decision was severely attacked by experts and the Slovak press (more about the issue later). The outcry made it obvious that even in this former bastion of pro-Russian sentiment, another sale like Transpetrol’s would not be tolerated. Even though in mid-October, Gazprom

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<sup>132</sup> “Russian Gazprom Ready to Make a Final Bid for Slovak Gas Monopoly SPP,” *IntelliNews – Slovakia Today*, November 14, 2001, Accessed November 9, 2002. Available from ISI Emerging Markets.

<sup>133</sup> “Corrected: Summary of Last Week’s Major Economic Happenings,” *SITA – Economy and Business*, November 18, 2001, Accessed November 9, 2002. Available from ISI Emerging Markets.

submitted an offer on its own, for the second round of SPP privatization, it was no longer a viable option.

When the final deadline for submitting bids for 49% stake in SPP arrived in February 2002, the government received only one offer. It came from a consortium of Ruhrgas, Gaz de France and Gazprom. According to *The Financial Times*, Gazprom would own one third of the stake.<sup>134</sup>

Although the Slovak state would keep 51% stake in SPP, the transaction agreement prescribed 52% shareholder approval for any decision and two thirds approval for major decisions.<sup>135</sup> The Slovak state practically lost control over the gas company because for any decision that requires shareholders' consent, it needs the approval of the minority stakeholders as well. Moreover, in case the Slovak government wants to sell further shares, the current minority shareholders have pre-purchase option for further 3%. That is to say they can reach 52%, which according to the current transaction agreement, equals to a majority stake in SPP. From a Slovak point of view, the sale of SPP brought mixed results. First, the consortium paid Sk 130bn (\$2.7bn) for the 49% stake, while the government price target was Sk 150-200bn. Second, the Slovak state gave up the control of SPP by giving veto rights to the minority shareholders in every decision. Third, a potential upside for Slovakia is that it cemented its role as a major transit route for Russian gas to Western Europe.

From Gazprom's point of view the terms of the sale are rather attractive. The company received a say in all the decisions related to SPP and became partial owner of the gas monopoly importer, transmitter and distributor in Slovakia and with it the pipeline system going through the country. A negative aspect of the deal from Gazprom's point of view is that it had bought the

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<sup>134</sup> "Slovakia Set to Back 49% Sale of Gas Monopoly," *Financial Times*, March 11, 2002. Accessed July 31, 2003. Available from LexisNexis.

<sup>135</sup> "State Will Have to Agree Decisions with SPP Investor," *TASR Export Service*, March 12, 2002. Accessed November 9, 2002. Available from ISI Emerging Markets.

49% stake in a consortium and not by itself. However, as it has been discussed before, Ruhrgas and Gazprom work in close cooperation with each other through their cross-ownership and cross-management. Gas de France is also a long-time partner of Gazprom. The terms of the consortium are not known, but Gazprom seems to be the indispensable member, because it is the one that supplies gas for SPP.

Out of the three countries studied, Slovakia was the most important transit country for Russia. At the same time, the Slovakian governments were the most open towards Russia and Gazprom. The positive attitude of the Slovak government towards Russia explains why Russian companies came to Slovakia much less covertly than they did to Poland or Hungary. However, even in Slovakia, some provisions attractive for the Russian side had to be included in confidential provisions of the bilateral contracts to avoid public discussion and scrutiny.

*(ii) The Privatization of Transpetrol*

Transpetrol owns and operates the Slovak part of the Druzhba crude oil pipeline, a 515-km long track with an annual transport capacity of 21m tons. Transpetrol was established in 1991, and had only one shareholder, the Slovak Economy Ministry. The Druzhba pipeline delivered Russian oil to Slovnaft, which owns the single Slovak refinery located in Bratislava and also to Mol, the Hungarian oil monopoly. However, its transport capacity was heavily underutilized. In 2000, it transported only 9.279 million tons of crude oil, which is about 44% of its total capacity.

The Economy Ministry decided to sell its 49% stake of Transpetrol to one or a consortium of strategic investors in 2000. In the final phase of the tender in September 2001, the number of possible investors was six: Slovnaft, Ceska Rafinerska (the single Czech refinery), Rosneft,

Texaco, Surgutneftegaz and Yukos.<sup>136</sup> The privatization process came across an unexpected obstacle a month after. Humenne District Court stopped any sale of Transpetrol shares because a private company sought to acquire 34% of the pipeline operator's shares as compensation for losses, which were apparently caused by faulty tax declarations in 1995.<sup>137</sup> Despite the preliminary injunction issued by the court, the Privatization Ministry decided to continue with the privatization. However, as a result of uncertainty, a few potential investors shied away from submitting a final offer. Ceska Rafinerska decided to leave the tender in November, and Rosneft also backed out, voicing concerns about the pending 34% share.<sup>138</sup> Slovakia received only two offers for Transpetrol. One from Yukos and the other from Slovnaft. Transpetrol's 49% shares and the management right of effective control over the company's operation was sold to Yukos for USD 74 m. According to Privatization Minister Maria Machova, the price offered for Transpetrol weighed 60% in the selection criteria. Other criteria included the capital base of the bidders, the development perspective for the oil transit pipeline and the ability to increase the value of the state's stake in the company.<sup>139</sup>

Slovnaft heavily criticized the decision. It submitted a bid in the value of USD 65.4 m plus a free transfer of its storage tanks worth USD 20 m. Slovnaft also claimed it had not been notified that the latter assets would not be considered as part of the bid.

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<sup>136</sup> "Slovakia Industry: Petroleum and Gas Updates," *EIU-Country Economic News*, October 10, 2001. Accessed November 9, 2002. Available from ISI Emerging Markets.

<sup>137</sup> "District Court Precaution May Endanger Transpetrol Privatisation," *TASR Export Service*, October 29, 2001. Accessed November 11, 2002. Available from ISI Emerging Markets.

<sup>138</sup> "Russian Giant Takes Transpetrol," *The Slovak Spectator*, December 17, 2001. Accessed November 11, 2002. Available from ISI Emerging Markets.

<sup>139</sup> "Russian Yukos Won the Tender for Transpetrol," *Slavia Capital – Corporate Update*, January 7, 2002. Accessed November 11, 2002. Available from ISI Emerging Markets.

The transaction invited many negative reactions. The Slovak daily *Novy Cas* wrote that the sale “will only deepen the inadmissible dependence of Slovakia on one course.”<sup>140</sup> Another daily, *Narodna Obroda*, criticized the uncertainty surrounding the conditions of the tender. “ If bidders and the seller start to argue about the clarity of conditions after a tender worth billions of crowns was completed, there must be something wrong with it.”<sup>141</sup>

While Transpetrol is the owner and operator of the sole crude oil pipeline crossing Slovakia, it is only a tiny portion of Yukos’ investments. In 2000, Yukos had a turnover of \$9.8 billion, which was the equivalent of almost half of Slovakia’s GDP. It spent \$1 billion per year to increase its production. Furthermore, it intended to spend \$4 billion for expansion into the European market.<sup>142</sup> The \$74 million sale price of Transpetrol is a minor item in the Russian oil company’s budget.

Increasing the volume of crude transmitted through the Druzhba pipeline was one of the conditions Slovakia stipulated for its bidders. Yukos constantly emphasized its intention to use the transit capacity to the fullest extent. The Druzhba pipeline had a capacity larger than the demand of the Slovakian market. As a result, Yukos had to find customers abroad. In theory, the Russian company had two options: to sell oil to the Czech Republic and to Germany or turn southwards and eventually transfer oil to the Adriatic coast. Yukos started to develop both options. It initiated dialogue with Czech customers who had bought one-third of the crude oil transported by Transpetrol. At the same time, Yukos pursued the option of selling crude oil southwards. Already in 2000, an agreement between pipeline operators in Russia, Belarus, Ukraine, Hungary, Slovakia and Croatia was concluded to connect the Druzhba and Adria

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<sup>140</sup> “From the Slovak Press,” *CTK – Daily News*, December 14, 2001. Accessed November 11, 2002. Available from ISI Emerging Markets.

<sup>141</sup> *Ibid.*

<sup>142</sup> “Russian Giant Takes Transpetrol”



pipelines to facilitate the flow of oil from Russia to the Omisajl terminal on the Adriatic coast. To this end, the flow of a 176 km part of the pipeline in Croatia had to be reversed from a South-North to a North-South direction. The construction was completed in 2003.

Slovak plans to diversify crude oil supplies practically came to an end. Even though during the privatization process, Yukos emphasized its willingness to diversify oil sources going to Slovakia, it changed its mind after the tender was closed. In December 2001, Prime Minister Mikulas Dzurinda said that the country was interested in a new crude oil pipeline project (Brody-Odessa) which would transport Caspian Sea oil through Slovakia to Western Europe. However, Yukos Vice President Yuri Beilin acknowledged that the Russian company viewed such a project as a competitor.<sup>143</sup>

### *(iii) Conclusion*

During the first Putin presidency, Russian energy companies were more active than ever in Slovakia. As in the case of Poland, Russian companies could count on the support of Russian diplomacy, as well as the prime minister and even the president. With such background, they took part in both of the major privatizations in the energy sector and won both tenders. In contrast with their forays into Poland and as we will see later, Hungary, the Russian companies were able to do so overtly, without any disguise or cover.

Gazprom had three major objectives with regard to Slovakia in this period. First, it wanted to use the country as a supporter in its dispute with Poland over the inter-system connect pipeline. This aspiration was fulfilled relatively easily. Second, it wanted to prevent Slovakia from becoming a major supporter of the Polish initiated North-South pipeline. While Bratislava voiced its desire to decrease its dependency on Russia, in effect it did not provide any meaningful

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<sup>143</sup> "Russia to Be Only Slovak Crude Source?" *The Slovak Spectator*, December 21, 2001. Accessed November 11, 2002. Available from ISI Emerging Markets.

support for the Polish side. Third, it wanted to get at least blocking control of SPP, the Slovakian pipeline monopoly. Gazprom had to compromise in this field and achieving its blocking position in consortium with two other Western gas companies. All in all, Slovakia proved to be friendly turf for the Russian giant, which managed to further strengthen its position in Slovakia in the examined period.

Similarly, Russian companies were more than welcome to bid in the privatization of Transpetrol, the most important oil company of Slovakia, the owner of the Slovak part of the Druzhba oil pipeline. In a sharp contrast to Poland, the Russian companies entered the privatization tender on their own, as they did not need a consortium with a Western partner. It applies not only for Yukos, but also Rosneft, a state-owned Russian oil company and Surgutneftegas, which was also known for its close ties to the Kremlin. By choosing the Russian company and supporting the strategy it promoted, Bratislava had foregone the opportunity to diversify its supplies.

## **Hungary**

### *(i) Borsodchem Takeover*

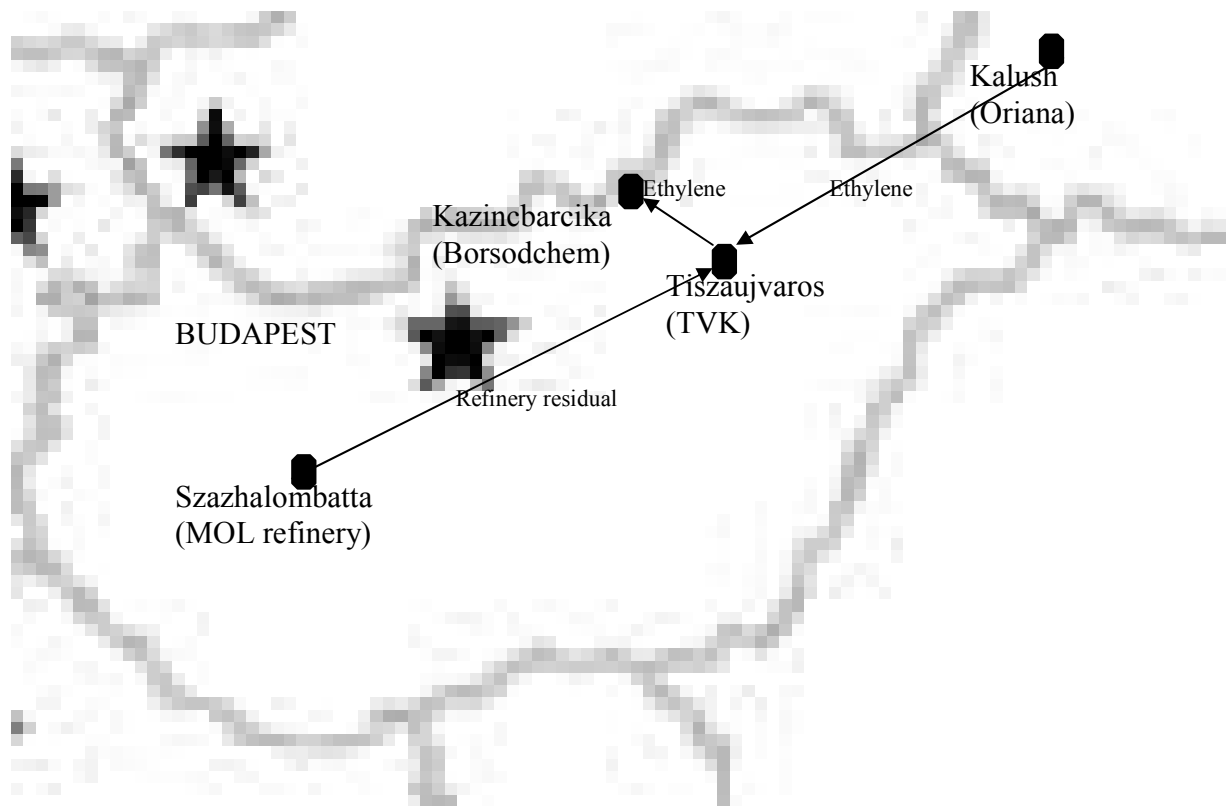
At the beginning of the 1990s, the structure of Hungary's domestic natural gas industry was similar to those of other Central European countries. There was one state-owned company, Mol, that had a monopoly position on the gas market. Mol owned the Hungarian part of the Brotherhood gas pipeline, and had exclusive wholesale rights for gas. Moreover, Mol owned the country's only oil refinery an important by-product of which, naphta, is the key raw material of the local petrochemical giant, TVK. TVK sells its most important and very dangerous by-product, ethylene, to the region's second largest petrochemical company, Borsodchem. These three companies are connected to each other through pipelines.

The two major companies in the Hungarian petrochemical sector, TVK in Tiszaújváros and Borsodchem (BC), are giants by regional standards. In 2000, both stocks were among the top five best performers in the Hungarian stock exchange. BC was among the most successful PVC producers in the world; it was the only company in the industry that did not have any losses since 1990. Its customers were all Western companies, and it had professional management. Additionally, BC managed to grow internationally, bought a Czech petrochemical company, and acquired shares in a Croatian and a Serbian company. TVK produces raw materials for petrochemical companies. It is the biggest petrochemical raw material supplier in the Central European region. Among others, it supplies Borsodchem with one of its byproducts, ethylene. Moreover, the two companies live in a symbiotic relationship. Ethylene is a very sensitive material and explodes easily. According to European standards, ethylene is allowed to be delivered only through pipelines. As a result, a pipeline connects TVK with BC, through which the former supplies the latter with raw material. At the same time, TVK must refrain from

building large stocks of ethylene to avoid unnecessary hazards. Consequently, the two companies depend on each other. If TVK would not supply Borsodchem with ethylene, BC's operation would be endangered as it has no pipeline connection to any other ethylene supplier. Even if it found a partner who would be ready to deliver ethylene, BC could receive it only through the pipeline system going through TVK, i.e., BC would still need the goodwill of TVK to let its essential raw material through. On the other hand, if BC refused to take over TVK's ethylene, the Tiszaujvaros company would be in serious trouble as it would have to find a secure way to store ethylene and eventually find a partner ready to take it over. BC's management decided to buy 30 percent of TVK in the summer of 2000. Through this ownership, it aimed to secure the stable supply of ethylene.

Additionally, there is a symbiosis between oil companies and petrochemical companies as well. During the refining process, many different residuals are created. While these products are residuals for the oil companies, they are essential raw materials for petrochemical companies. It is extremely hard to store these materials; additionally, refining is a very low profit margin business. Therefore, the refineries need the revenue from the sale of residuals. Mol's Szazhalombatta refinery's residuals go to TVK. Therefore, Mol's profit is highly dependent on TVK purchases, while TVK's operations are dependent on BC's purchases. If BC stopped buying from TVK, TVK would need to stop its operation. Were TVK to cease operations, Mol would have difficulties in selling its residues; therefore TVK and indirectly BC could inflict substantial harm on Mol. (See Map 2 below)

**Map 2: Symbiosis among Mol, TVK and Borsodchem**



In the spring of 1998, two investment funds, Croesus and Templeton, bought some shares in TVK. According to estimates, Croesus bought about 15-25 percent of TVK, while Templeton owned about 10 percent.<sup>144</sup> Templeton Funds is a company based in Singapore, and Croesus is a group of Hungarian investors. The two investment funds continued to buy TVK shares in 1999. However, Mol stepped in and started to acquire TVK shares because it was afraid that TVK would end up in the hands of a non-strategic investor. Mol managed to neutralize the investments of Croesus and Templeton. Additionally, the Hungarian oil and gas monopoly also asked BC to acquire some Templeton and Croesus shares in TVK. BC did a so called “handcuffs” deal: it gave cash to TVK for shares in TVK. As a result of the deal, Templeton and Croesus were not allowed

<sup>144</sup> “Tulajdonosi harc a TVK-ért,” *HVG*, November 26, 1999. Accessed November 14, 2002. Available from ISI Emerging Markets.

to sell their TVK shares without the approval of the BC board. However, they still sold their shares without the approval of the BC board to an offshore company, Milford. They claimed that it was not shares but GDRs (GDRs are certificates about share ownership).

In 1999, Gazprom bought a 51 percent share in Sibur, a Russian petrochemical complex. This was the first time that Gazprom diversified its activities into the petrochemical sector. On the 5th of September 2000, an Ireland-based offshore company, Milford Holdings, bought 24.58 percent of Borsodchem. Nothing was known about Milford except that according to Irish authorities' information, it is owned by Cypriot citizens. Additionally, Milford's name first appeared in Hungary a few years earlier in connection with Gazprom. Immediately after Milford's acquisition, speculation appeared in the market that the Irish company indeed represents Gazprom. However, at the beginning the Russian giant denied being behind Milford, but Milford Holdings issued a statement admitting that it was owned by Gazprom only on the 19th of September.<sup>145</sup> Besides Milford, several other companies made similar purchases of BC shares on Gazprom's request. The Russian MDM Bank bought 8.15 percent of Borsodchem on Gazprom's request, while the Vienna-based Central European Oil and Gas bought 17 percent.<sup>146</sup> Gazprom's action is called a hostile takeover because it tried to take over the company without its management's consent. BC corporate chapter required the owner of 40 percent shares of the company to make a public offer for the rest of the shares. While in practice Gazprom owned over 40 percent of Borsodchem already at the beginning of September 2000, the companies it entrusted with buy-ups admitted only at the end of November that they acted on behalf of

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<sup>145</sup> *MTI*, September 20, 2000. Accessed November 14, 2002. Available from ISI Emerging Markets.

<sup>146</sup> "Saber Rattling over Borsodchem," *Business Hungary*, February 2001. Accessed November 14, 2002. Available from ISI Emerging Markets.

Gazprom.<sup>147</sup> That is to say, Gazprom concealed the fact that it owned 40 percent of BC and therefore avoided the mandatory offer for the rest of the shares.

As mentioned earlier, BC bought 30 percent of TVK the summer before. As a result, the owner of Borsodchem is the owner of TVK, as well, i.e., out of the three companies that live in a symbiotic relationship Gazprom would have substantial ownership in two. The Hungarian oil and gas monopoly, Mol, is highly dependent not only for its profit but for its uninterrupted operation on TVK. The Tiszaujvaros-based company is in the position to do substantial harm to Mol. In order to calm TVK's shareholders, Milford issued a statement, signed by Milford's representative in Hungary, Megdet Rahimkulov, who was at the same time the President-CEO of Gazprom's bank in Hungary, as well as, President-CEO of Panrusgas. The statement said that companies in the Gazprom group and the cooperating company called Oriana in Ukraine would be able to offer a continuous supply of benzol, vinylchlorid, and propylene to the Hungarian companies of TVK and Borsodchem. Moreover, after the planned extension of Oriana, it would be able to cover the whole need of ethylene, propylene, benzol and vinylchlorid of the Hungarian companies.<sup>148</sup>

Megdet Rahimkulov announced that eventually Gazprom would be able to replace Mol as the major supplier of TVK. As it is essential for Mol to continue to supply TVK with the residual of its refinery, this statement implicitly reinforced the notion that Gazprom's intentions vis-à-vis Mol in this transaction were not necessarily benign. Their fears were further aggravated by statements from Gazprom representatives then and in the past. At the end of September, in an interview Megdet Rahimkulov denied that Gazprom is in the process of buying up Mol shares,

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<sup>147</sup> "BC-tulajdonosok a kapcsolataikrol – Tovabb folytatodik a harc a menedzsment es a nagy reszvenyesek kozott," *Magyar Hirlap*, November 29, 2000. Accessed November 14, 2002. Available from ISI Emerging Markets.

<sup>148</sup> "Harc a TVK iranyitasaert," *Vilaggazdasag*, September 20, 2000. Accessed November 14, 2002. Available from ISI Emerging Markets.

but it did not exclude doing that in the future.<sup>149</sup> It can be also noted that Gazprom denied any connection to Milford for two weeks, which made the credibility of the Russian company's assurances at least questionable. The Hungarian oil and gas monopoly was concerned that Gazprom could create a situation through its ownership of TVK and BC that would force Mol into major losses. Some industry analysts speculated that Gazprom might want to force Mol to sell its natural gas wholesale business.<sup>150</sup>

On the day when Milford admitted its connection to Gazprom, September 19, the trading of Borsodchem, TVK, and Mol stock was suspended at the companies' request. Mol's management called for an extraordinary meeting between the oil company and Borsodchem. During this meeting, with the cooperation of BC's management, Borsodchem sold a 7 percent share in TVK to Mol. Mol's old and new acquisitions together added up to 29.8 percent share of TVK. At the same time, Mol received the right to buy an additional 25 percent of TVK through option deals with BC and Hungarian financial institutions. As a result, a few days after Milford's announcement, Mol acquired the option to become the majority owner of TVK. With this move it prevented Gazprom from becoming the owner of the Tiszaujvaros-based company.

Even before the deal took place, market analysts predicted that the sale of BC's TVK shares might have been the reason for the suspension in the trading of the companies' stock. On September 21, Megdet Rahimkulov warned in a television interview that if Gazprom's interests were not taken into account in the transactions, the Russian company would reconsider its policies regarding the purchase of Hungarian meat, vegetables, fruit, and medicine in exchange for natural gas. He added that the supply of natural gas would continue to be regular and reliable. Rahimkulov also said that Milford's 24.7 percent share in Borsodchem would not enable it to

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<sup>149</sup> "A Mol lehet a nyertes," *Vilaggazdasag*, September 21, 2000. Accessed November 14, 2002. Available from ISI Emerging Markets.

<sup>150</sup> Kovacs interview



prevent the sale of TVK to Mol, but were that to happen, Milford would use all legal means possible in Hungary as well as in foreign and European courts to stop it.<sup>151</sup> Milford immediately sued the management of BC, and dropped the case only after Gazprom acquired the majority of the shares of the company in November 2000. Additionally, BC and TVK signed an agreement to extend their existing ethylene contract from 2003 to 2013. They also increased the quantity under the agreement. The motivation behind this was that although the Hungarian side was able to prevent Gazprom from controlling TVK, it could not prevent Gazprom's penetration into BC. The contract aimed at securing continuous operations for TVK. In early October, Gazprom said that through Milford Holdings it planned to replace the management of Borsodchem at the November 24 general assembly of the petrochemical company, and rewrite BC's agreement with Mol, according to which BC would sell its 15% share in TVK to Mol within two years.<sup>152</sup>

The sale of BC's TVK package considerably decreased the value of Gazprom's investment in Borsodchem. When it bought shares of BC, it expected to gain some leverage over TVK as well. Moreover, because of the cross-ownership, Gazprom would have acquired some shares in Mol. With the sale of BC's TVK package, Gazprom was left alone with BC and some unknown volume of shares in Mol. Market players even speculated that Gazprom might not be interested in keeping Borsodchem alone.

The takeover of BC was the first venture of Gazprom in the petrochemical industry outside the former Soviet Union. Since then the company has entered many privatization tenders to invest in other petrochemical companies in the region. There are several plausible scenarios behind Gazprom's motivation to buy Borsodchem.

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<sup>151</sup> "A Gazprom felulvizsgálja magyarországi vásárlásait – Meg bizonytalan a Mol-Borsodchem üzlet," *Magyar Hírlap*, September 22, 2000. Accessed November 14, 2002. Available from ISI Emerging Markets.

<sup>152</sup> "Az irek vizsgálják a Milfordot," *Nepszabadság*, October 14, 2000. Accessed November 14, 2002. Available from ISI Emerging Markets.

First, the Russian giant simply aimed to control the petrochemical industry of Hungary. It is a strategic industry for any country and a smart business as well. Both Borsodchem and TVK are profitable companies, among the best stocks in the Hungarian Stock Exchange and a boom was expected in the petrochemical industry. Hungary as a transition economy is expected to have a continuous increase in the demand for PVC and other plastics products in the future.

A second scenario is that Gazprom wanted to gain control of TVK's and BC's ethylene pipelines. There is a pipeline connecting TVK and BC (50 kilometers long) owned by BC. There is another pipeline connecting Oriana of Ukraine and TVK (120 kilometers long), in which the piece between the Hungarian border and Tiszaujvaros is owned by TVK. Sibur, Gazprom's petrochemical company, entertained the idea of building an ethylene pipeline snake from Russia to Western Europe. The original idea of connecting the former COMECON countries' petrochemical factories with pipelines came from TVK's management in the summer of 1997. This would enable raw materials to be delivered the safest and cheapest way in compliance with EU regulations. According to the original idea, a 910 kilometer system would have been built between Tiszaujvaros and Szazhalombatta in Hungary, the Slovakian capital Bratislava, Schwechat in Austria, and Litvinov in the Czech Republic. This would have been connected to the existing German system on one end, and to the Ukrainian Kalus, the headquarters of Oriana on the other.<sup>153</sup>

Sibur internalized the idea and Sibur head Yakov Goldovskiy presented it to the Hungarian government in 2001. According to the Russian version, the pipeline system would have started at the Yamal gas fields, and it would have delivered ethane gas from there to Borsodchem. The Brotherhood pipeline consists two pipes parallel to each other and Sibur would have used one of

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<sup>153</sup> "Tobbseget szerezhet a TVK-ban a Mol," *Nepszabadsag*, September 25, 2000. Accessed November 15, 2002. Available from ISI Emerging Markets.

them for delivering ethane. On the basis of Borsodchem, Sibur would have built a cracking factory that produces ethylene out of ethane gas. From their base at BC, they would have built the ethylene pipeline system and supplied TVK, Bratislava, the Czechs and the Poles at Plock. The investment would have cost about \$4 billion.<sup>154</sup> Gazprom's Hungarian representative said to the Hungarian daily *Nepszabadsag* at the end of September 2000 that they were considering a similar solution.<sup>155</sup> According to Zsolt Hernadi, President-CEO of Mol, the business logic behind such an investment is that the petrochemical raw materials produced from ethane are much cheaper than those produced through the traditional procedure of oil refining. Additionally, as already mentioned, the petrochemical industry is booming, so it made business sense to invest there.

The third plausible explanation for Gazprom's investment in Borsodchem was to get control of Mol. If the deal was executed the way Gazprom planned originally, the Russian company would have controlled BC, and effectively had veto power in TVK. This would have meant strong leverage over Mol. Mol feared that Gazprom's ultimate objective was to control the Hungarian oil company. This fear initiated several specific steps on Mol's behalf to prevent Gazprom from controlling the Hungarian company. First, as it was mentioned before, Mol bought BC's shares in TVK. Second, after the Borsodchem takeover Mol rewrote the company's statute. The management of the Hungarian company built in a few tools in the statute that defend the company against hostile takeovers. Third, after this deal Mol and the Polish oil company PKN Orlen agreed to cooperate against Russian attempts to buy up petrochemical companies in Hungary and Poland.<sup>156</sup>

The Russians never denied their interest in Mol. For example, after Alexei Miller's meeting with the Hungarian Prime Minister Ferenc Gyurcsany in April 2005, journalists asked him

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<sup>154</sup> Hernadi interview

<sup>155</sup> *Nepszabadsag*, September 23, 2000. Accessed November 15, 2002. Available from ISI Emerging Markets.

<sup>156</sup> See more about this below in the Mol-PKN Orlen merger chapter.

whether Gazprom was interested in 12 percent of Mol, which was offered for sale. Miller answered positively.<sup>157</sup> Additionally, throughout the whole period, it had been continually rumored in the market that Gazprom was interested in Mol.<sup>158</sup> CEO of Mol Zsolt Hernadi claimed to have never seen any sign of Gazprom trying to take over Mol. On the other hand, Mol is a listed company with a very diverse ownership structure. 30 percent of its shares are owned by small shareholders. It is not known whether Gazprom or its proxies are among these investors. However, market analysts continually estimated that Gazprom had a substantial share in Mol. John Lauer, who used to be an EBRD-delegated board member of Borsodchem until Gazprom had him ousted, put Gazprom's share in Mol at 17-20 percent.<sup>159</sup> Former Chairman of the Board of Directors of Mol, Janos Csak, estimated the size of Russian investments in Mol somewhere between single and double digits. Even though he admitted that because Mol was a listed company, it was nearly impossible to tell the size of Russian investments in the company, he never denied that the Russians might have had significant shares in Mol. Moreover, he was of the opinion that indeed it was the case.<sup>160</sup> Based on the Russian company's statements, its behavior in other Central European countries, business logic and insider opinions, it is reasonable to assume that Gazprom was interested in gaining leverage over Mol. It entered the tender for Mol's

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<sup>157</sup> Hernadi interview

<sup>158</sup> The Hungarian daily business paper *Vilaggazdasag* wrote on September 30, 1998 that "the statute of Mol prevents anybody to own more than 25% of its shares directly or indirectly. It means that Gazprom does not have the opportunity to acquire the majority of the shares. However, according to market rumors, Gazprom would like to acquire a majority share in the Hungarian oil company." "There was never direct Gazprom-share in any of the Hungarian gas companies", said Mihail Rahimkulov, the CEO of Panrusgas and AEB Bank, to the Hungarian weekly called *Figyelo*, "the bank trades with Mol and TVK shares, but only for speculative purposes." However, it is important to note that AEB Bank is hundred percent owned by Gazprombank, the daughter company of Gazprom, and AEB was also among the companies which bought BC shares on behalf of Gazprom in 2000. The Hungarian daily *Magyar Hirlap* wrote on December 14, 1999 that "it is an open secret that Gazprom owns a significant amount of Mol's shares. It was the former CEO of Mol, Laszlo Pal, who admitted the presence of the Russian gas giant. He added that according to his information, Gazprom does not aim at managing Mol. Answering a question of *Magyar Hirlap*, Gazprom's representatives reinforced the above information. When asked whether they have increased their package of about 10% lately, they answered only with a mysterious "mozhet bity", i.e. it is possible."

<sup>159</sup> Interview with former board member on the board of Borsodchem, delegated by EBRD, and ousted out after Gazprom's takeover, John Lauer, Budapest, June 2002

<sup>160</sup> Interview with former Chairman of the Board of Directors of Mol Janos Csak, Budapest, September 2005

Slovakian equivalent, SPP, and several times expressed its interest in investing in PGNiG, the Polish gas company, as well.

The three scenarios are plausible explanations for Gazprom's step. Additionally, the three do not exclude each other. Most likely, the motivation behind the takeover was a mixture of the three.

Even though BC's takeover was Gazprom's first venture in the petrochemical industry outside the former Soviet Union, at the same time it also entered a tender for the Ukrainian Kalus-based petrochemical company, Oriana. Oriana sold raw materials to TVK through the pipeline which connects the Ukrainian company and TVK. However, it also had enough ethylene to supply BC if TVK was to be circumvented as BC's key supplier. While TVK and Oriana are connected with an ethylene pipeline, there was no direct ethylene pipeline connection between Oriana and BC. Oriana, however, was a very unreliable company. It usually operated for two-to-three months and then interrupted operations.

The Ukrainian government announced the privatization tender of the petrochemical company Oriana in 2000. Both Sibur and Lukoil participated in the tender. At the time when Gazprom launched its bid for BC, it was assumed that Gazprom would soon have control over Oriana. The understanding at the BC board meeting in September 2000 was that Gazprom would win the tender for Oriana.<sup>161</sup> At the height of the BC takeover, in the second half of September, Gazprom even offered Oriana's raw materials to supply the Hungarian petrochemical companies. Moreover, it also projected that after winning the tender for Oriana and the planned restructuring of the company, it would be able to supply BC with ethylene, as well.<sup>162</sup> In theory, this way Gazprom could have circumvented TVK in supplying BC with its essential raw materials. This

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<sup>161</sup> Lauer interview

<sup>162</sup> "Harc a TVK iranyitasaert," *Vilaggazdasag*, September 20, 2000. Accessed November 15, 2002. Available from ISI Emerging Markets.

would have weakened TVK dramatically, which in turn would have affected Mol very negatively. Gazprom would have needed Oriana for the ethylene pipeline snake as well, which according to the original plans, would have connected to Oriana. However, in October 2000, the Ukrainian government named Lukoil the winner of the tender. Gazprom's loss at the Oriana tender made the Russian gas giant's implicit threat to replace TVK as the key supplier of BC less feasible in the short term.

Negotiations between Mol and BC were supported by the Hungarian government with British and American intelligence agencies in the background. The Hungarian business community was afraid that Gazprom was not a strategic investor, which did not have modern technology or know-how to transfer to the acquired companies. Therefore, it did not add value. Additionally, investors were afraid that Gazprom will implement the methods used in Russia: cash down the company, strip its assets, then make it bankrupt. The same thinking was behind EBRD's announcement in mid-November that the European Bank wouldn't raise the number of its shares in Borsodchem because ownership of the Hungarian company was non-transparent.<sup>163</sup> It was perceived as part of the Russian way of doing business that the CEO of Borsodchem and his family received many death threats during the battle for ownership from individuals who wanted him to cooperate with Gazprom.

Besides the business community, the Hungarian state and American and British intelligence agencies, as well as a security specialist firm, Kroll Investigating Services, got involved. During the final negotiations between Mol and BC, there was a hot line between the American embassy

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<sup>163</sup> "Egyelőre nem jegyeznek BorsodChem-et – Kivár az EBRD," *Világgazdaság*, November 17, 2000. Accessed November 14, 2002. Available from ISI Emerging Markets. Before the Russian takeover, one of the major shareholders of BC and TVK was EBRD. At the peak, EBRD had 12.5% share in BC. The European Bank's investment in the Hungarian petrochemical company was its first in the region. After the Russian takeover, EBRD gradually withdrew from the company and sold all of its shares. The reason is that they lost control of their investment, its value went down after the takeover. Interview with former board member on the board of Borsodchem, delegated by EBRD, and ousted out after Gazprom's takeover, John Lauer

in Budapest and the Hungarian Prime Minister's office.<sup>164</sup> At that time, the Western parties were mostly interested in the money laundering aspect of the takeover. Throughout the transaction, Gazprom used cover companies to disguise its identity. One of them called Milford was established in October 1999 with \$300 million capital. The company had connections to Cyprus (based on the Irish authorities' findings, it had two board members: an English lawyer and a Cypriot lawyer), and a third connection to the Caribbean. Therefore, there was good reason to assume that it was involved in widespread money laundering activities. In terms of the money which was used to buy BC shares, the investigating agencies traced back 30 money transfers. Beyond Milford, Gazprom used two Austrian companies, CE Oil and Gas, and Vienna Capital Partners. These companies continued to deny any relation to Gazprom until the end of November 2000. However, their denial was less than credible, because all of their actions were in concert with those of Milford and Sibur and they voted together at each of the general assembly meetings. Moreover, Georg Stahl, a representative of CE Oil and Gas became a board member of Sibur in July 2001.

Legally, the Hungarian government had the option to force Gazprom to tender openly for BC. Hungarian law said that if a company acquires more than 25% of another company, it has to make an offer for all the shares. This way, even if the takeover could not have been prevented, at least the price of BC would have gone up for Gazprom. Such a move would have protected small shareholders from losing their shares' value. However, the Hungarian government's position was that the evidence about Gazprom acquiring more than 25% of Borsodchem was only circumstantial. They did not find specific evidence that companies suspected to be Gazprom's cronies were indeed interconnected. The Hungarian government decided not to force Gazprom for tender. In a way, it let Gazprom take over BC on the cheap. However, in the summer of 2001,

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<sup>164</sup> Lauer interview

the Hungarian government changed the law in order to prevent such deals from happening again. According to the new law, circumstantial evidence should be enough to force a tender. The Hungarian government could have intervened in the takeover by inquiring about the source of the money as well. However, according to Hungarian law before the BC takeover, stopping the transaction would have required specific evidence of money laundering. The specific evidence was missing. However, the law was changed after the Borsodchem affair. “In the US all the Russians who did this hostile takeover would be in jail. They gambled that the Hungarian government would not step in, and they won. The Hungarian government refused to do a forced tender for the company, but allowed it to be taken over in the capital market... The takeover was a very sophisticated, well-organized, shrewd, smart move by the Russians.”<sup>165</sup> After the transaction was concluded, insiders estimated that Gazprom controlled about 80-90% of BC, and probably 40-45% of TVK.<sup>166</sup>

*(ii) Connecting the Druzhba and Adria Pipelines*

The Hungarian crude oil industry has been the most monopolistic of all the countries examined here. Mol has had the right to import crude oil, it has owned the single oil refinery in the country, in Szazhalombatta, it has been the owner and operator of the domestic large capacity crude oil pipelines, and it has had wholesale monopoly rights. Anyone who wanted to do business in the Hungarian crude oil industry has had to deal with Mol.

Although Russia has accounted for more than 80% of Hungarian crude oil consumption, the country was not entirely dependent on Russia. In theory, Hungary had an alternative route for crude oil supply.

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<sup>165</sup> Ibid.

<sup>166</sup> Ibid.



Crude oil supplied by Yukos arrived through the Friendship (Druzhba) pipeline coming from Ukraine. The alternative route was from the South. There is a pipeline called Adria that originates in the Croatian port of Omisalj and goes all the way North to the Hungarian refinery in Szazhalombatta. Because the long-term treaty signed between Mol and Yukos in 1994 covered Hungary's total crude oil demand, there was no need to use the Adria pipeline. However, as CEO of Mol Zsolt Hernadi phrased it the biggest advantage of the Adria pipeline is that it exists. Even though it does not operate, the fact that Mol has an alternative supply route for eleven months a year from which the Hungarian company would be able to receive crude oil shipments from all over the world, gives a feeling of security with regard to crude oil supplies. The existence of the Adria pipeline makes Hungary less dependent on Russian crude oil supplies.<sup>167</sup>

After the September 11, 2001 attacks, the United States decided to diversify its crude oil supplies and increase Russian crude shipments substantially. There were several talks about the best transport route for Russian crude. It was decided that the best route for a significant portion of the Russian export would be through the Friendship and Adria pipelines to the Croatian port of Omisalj. However, there were two problems with this suggestion. First, Friendship and Adria were not connected to each other. Second, Adria's original flow of direction from South to North had to be reversed into a North-South direction. The two pipelines cross the territory of Croatia, Hungary, Slovakia, Ukraine, Belarus and Russia. Agreements by all the above countries, as well as of the pipeline operating companies, were needed to execute the plan. Both Friendship and Adria ended in the refinery at Szazhalombatta, in Hungary. As a result, it was Mol, the owner of the refinery and the owner of the Hungarian branch of the two pipelines, who had to decide about connecting the two. The costs of connecting them were miniscule, and Mol would have been able

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<sup>167</sup> Hernadi interview

to cover the investment from the transit revenues of the first two years of increased flow.<sup>168</sup> The most important factor in Mol's decision to agree to the Friendship-Adria line was the future energy security of Hungary. Even though Mol hardly used the Adria pipe for crude oil delivery, the option was always there, which gave leverage over the Russian monopoly exporter as well. Before agreeing to connecting the two pipes, Mol instructed the Hungarian government to sign a letter that there was a supply security issue, and Hungary needed to ask its Russian partner for guarantees of stable supply of crude. The Hungarian government signed the letter. It was to be delivered through the Hungarian mission in Russia, and handed over by the Hungarian ambassador personally. While the official letter was en route, Mol agreed with Yukos and signed the contract. Soon after, there was a change of government in Hungary and the new leadership overlooked the agreement between Mol and Yukos. Three months later, the original letter written by the Hungarian government was delivered to Transneft. On the same day, Mol received a fax saying that on a certain section of the Druzhba pipeline, Transneft was carrying out extraordinary repairs and the flow of oil had to be stopped. This was the only time when the Russians turned off the tap on crude oil deliveries to Hungary after 1990. The case was never publicized. Mol immediately found out that the Hungarian government's letter caused the problem. According to the CEO of Mol, Zsolt Hernadi, the Russians understood that there was an agreement at the level of the companies and the letter of the government superceded that. He believed that the action was not blackmailing by the Russians, but rather was a reaction to the gap between the company's and the government's words. The misunderstanding was clarified the same day, and oil deliveries restarted the day after.<sup>169</sup> Still, it is instructive to note how easily a supplier can use its position to increase its bargaining power and how strong this power would be if the buyer has

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<sup>168</sup> "Magyarországon keresztül megy az orosz olaj Amerikába," *Magyar Hírlap*, June 11, 2002. Accessed November 15, 2002. Available from ISI Emerging Markets.

<sup>169</sup> Hernadi interview

no alternatives. Moreover, it is hard not to see the Russian side's readiness to land some heavy punches in strategic debates.

Even though the flow of the Adria was reversed, the option to reinstate the original direction of a South-North flow was left open. Mol asked for and received guarantees from its Croatian partner that should the need arise, Mol would be guaranteed a South-North direction of flow of crude.<sup>170</sup> Such a reversal of flow would certainly require some extra time and resources. This solution provided Mol substantial extra revenues and maintained all of its medium- and long-term options to diversify supplies. What it cost, however, was the ability to switch to an alternative provider within a very short time frame.

The last issue with regard to the Hungarian oil industry, which has not been covered yet, is the possibility of a Russian takeover of Mol. Ever since Mol was made public, the market has been full of rumors about different Russian companies holding sizable stakes in the Hungarian company. All that can be said for certain is that a significant percentage of the shares are held through custody banks and institutions that administer them for the benefit of their clients. Only the custodian may know who the actual owners are. These are the shares that the Polish government suspected to be in Russian hands and which made Warsaw withdraw from the planned PKN-Mol merger. Even though the Hungarian government and Mol's management did not believe the Polish assumption, they have had no way to disprove it, for they lack the most important piece of information. They have argued that no Russian companies tried to appoint any directors to Mol's Board and that the latter institution is controlled by financial investors. The Polish side contended that such an argument did not refute the possibility that a Russian company only held the shares and intended to use them after the merger.

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<sup>170</sup> "Horvat garanciara var a Mol," *Magyar Hirlap*, June 14, 2002. Accessed November 15, 2002. Available from ISI Emerging Markets.

The Hungarian and Polish authorities have had more information about the matter, and still they could not prove their assumptions either way. Therefore I do not want to take sides in this debate. All that can be said for certain is the following. Mol is in a pivotal position in the Central European oil sector, as it controls all the key oil assets in Hungary, and some in Slovakia and Croatia. It is publicly listed, and therefore is in theory open for takeover by whoever is willing to pay the price. Yukos and Lukoil are on the record as having declared their interest in Mol. Also, several current and former Hungarian senior government officials who did not want to be identified even by their title told me that in all foreign or prime ministerial level negotiations, the Russian side has raised the issue of Russian investment in Mol (the Hungarian state still holds a minority stake in the company). At the same time, Mol's corporate charter has clauses that make it prohibitively expensive to buy more than 25 percent of the company. This fact may work as a deterrent but may also encourage covert takeover methods.

*(iii) Conclusion*

Russian energy companies' activities reached a new level during the first Putin presidency. They were able to rely on some Russian diplomatic support, especially after the change of government in Hungary in 2002.

Gazprom tried to acquire the two largest petrochemical companies in Hungary, probably as a part of a larger strategy targeting MOL, the Hungarian oil and gas monopoly. Because the Hungarian business community and public opinion did not welcome Russian investments in strategic sectors of Hungary, Gazprom used primarily "covert" means to reach its goal. Gazprom went very far down this road and acquired the majority shares of BC through illegal means not free from mafia methods. It was due only to Mol's determined action that Gazprom did not

manage to acquire the majority shares in the other major Hungarian petrochemical company, TVK, and a substantial stake in MOL.

Russian oil companies intended to gain leverage over the Hungarian oil industry. Yukos managed to have the flow at the Adria pipeline reversed, even though it has clearly limited the Hungarian oil company's short term alternatives to Russian oil. In so doing, Yukos was not reluctant to use covert means to get its way: it turned off the oil tap, referring to alleged extraordinary reconstruction works. I did not find any proof of Yukos relying on extra Russian state support in this case; however, the most senior Russian government officials have repeatedly pointed out the desirability of Russian ownership of MOL to their Hungarian counterparts.

#### ***V.4. Summary***

During the first Putin presidency, the Russian leadership's goal was to make Russia great again. The Russian president's campaign and legitimacy was built on the promise of making Russians proud of their country, which was translated into making Russia a great power again. At the same time, surging oil prices and the economic consolidation undertaken by President Putin raised state power to levels not seen since the collapse of the Soviet Union. Based on Russia's perceived low influence and high state power, the hypothesis is that Russian energy companies should expand in Central Europe, and as the sub-cases in this chapter suggest, this is exactly what happened.

Bilateral diplomatic and economic contacts became far the most intensive since the collapse of the Soviet Union. Russian energy companies made several attempts (some successful ones, as well) to increase their presence in Central Europe. They not only applied for the privatization tenders of companies in the strategic industries in these countries but pushed for the sale of others and recommended new pipeline roads. Russian companies were assisted by Russian official

diplomacy (ambassadors, prime minister, president) and sometimes implied to act on behalf of the state. They used the most overt means in their expansion in Slovakia where they were the most welcome, but they came mostly covertly in Poland and Hungary where public opinion was rather against Russian presence in strategic industries. During the first Putin presidency Russian companies gained a significant foothold in all the three countries: Yamal 1 (\$1bn investment) became operational in Poland, Gazprom won the privatization tender for the Slovak gas monopoly (SPP), Yukos won the privatization tender for the operator of the Slovak part of the oil pipeline (Transpetrol), and Gazprom acquired the majority ownership of one of the largest petrochemical companies in Hungary (Borsodchem). Moscow not only attempted to do so but indeed managed a successful economic expansion into Central Europe between 2000 and 2004.

## CHAPTER VI: CONCLUSION

This study seeks to answer: why Russian energy companies move into Central Europe in certain time periods and not in others. What explains the changing periods of expansion vs. non-expansion? Given the widely held conviction in and outside Russia that Russian energy companies are tools of Russian foreign policy, the investigation started by examining whether derivatives of realist theory might explain the phenomenon in question.

To answer the questions based on the review of the Russian foreign policy literature and International Relations theory, the study tested the following hypotheses:

1. When the Russian leadership perceives that Russia's relative influence vis-à-vis the West is low *and* the state has enough power to mobilize the necessary resources, Russian energy companies will try to expand towards Central Europe.
2. When the Russian leadership perceives that Russia's relative influence vis-à-vis the West is consistent with its expectations, Russian energy companies will not manifest any expansionist moves into Central Europe - even if Russia possesses enough state power to mobilize the necessary resources to do so.
3. When Russia does not possess sufficient state power to mobilize the necessary resources, Russian energy companies will not manifest any expansionist moves into Central Europe even when the Russian leadership perceives that Russia's relative influence vis-à-vis the West is low.

These hypotheses were drawn from neoclassical realist theory, which argues that the relative distribution of power in the international system (independent variable), through the perception of state leaders (intervening variable) together with state power, is defined as the power to mobilize the necessary resources, (independent variable) explain foreign political outcomes (dependent variable). Through these case studies, I tested the usefulness of neoclassical realist theory in explaining an important aspect of post-Soviet Russian foreign policy toward Central Europe.

This analysis of Russian perceptions of relative power distribution in the international system focused on the period of 1991 and 2004. The size of state power was also examined during this time. The study used federal tax revenues as percentage of GDP to estimate the level of state power in Russia. It found that in the first two years of post-Soviet Russian foreign policy in the so called Kozyrev-era Russian leaders perceived their country's influence in the world to be satisfactory. However, this perception changed soon as Russian leaders' views on their country's place in world affairs became negative. They thought that Russia's influence in the world was low especially in comparison with that of the United States. They considered Russian influence to be the lowest between the 1998 economic crisis and President Putin's ascent to power. After 1993, it became a stated goal of Russian foreign policy to revise the prevailing world order in favor of Russia. However, Moscow has not always had enough state power to mobilize the necessary resources to do so throughout the period. Federal tax revenues as a percentage of GDP were high between 1991 and 1993, but they started to decline gradually, which continued until 1998 when federal tax revenues were only 9.8 percent of the Russian GDP compared to 20.3 percent in 1992. Starting in 1999, tax revenues began to climb, sometimes accelerating exponentially. In 2004, federal tax revenues reached 20.4 percent of the Russian GDP. As a result, state power went through substantial changes throughout the period. While it started at a



high level, it stagnated at between 1994 and 1996 to be followed by a period of very low state power between 1997 and 1999 and again a high one between 2000 and 2004. Based on these estimates for the independent variables (perception and state power), this analysis suggests the outcomes detailed in the following table.

Application of the hypotheses for the studied periods

	<b>Russian leadership's perception about Russian influence in the world</b>	<b>State power</b>	<b>Predictions of the hypotheses on the behavior of Russian energy companies towards Central Europe</b>
<b>1991-1993</b>	Consistent	High	<b>Do not expand</b>
<b>1994-1996</b>	Low	Medium	<b>Do expand</b>
<b>1996-1998</b>	Low	Low	<b>Do not expand</b>
<b>1998-2000</b>	Low	Low	<b>Do not expand</b>
<b>2000-2004</b>	Low	High	<b>Do expand</b>

These hypotheses predict that when Russia perceives its influence in the world to be low and has enough state power to mobilize the necessary resources, Russian energy companies expand into Central Europe. However, whenever one of these two criteria is missing, there is no expansion. Russia may perceive its influence to be low, but if it does not have enough state power Russian energy companies do not expand. Also when Russia perceives its influence to be consistent with its expectations, even though it may possess enough state power to mobilize the necessary resources, Russian energy companies do not expand.

To test the hypotheses the dissertation used a case study on the foreign policy of Russia between 1991 and 2004 towards Central Europe. This period was split into five sub-periods which correspond with the widely accepted milestones of post-Soviet Russian foreign policy: 1991-1993 Early Atlanticism, 1993-1996 Facing NATO Enlargement, 1996-1998 Against a Unipolar World, 1998-2000 Instability and Uncertainty, and 2000-2004 The First Putin Presidency. The study found that Russian energy companies were very active in two sub-periods: between late 1993 and 1996 and between 2000 and 2004, however, they showed little to no interest for expansion whatsoever in the other three sub-periods: 1991-1993, 1996-1998 and 1998-2000. In each chapter, I examined in detail the Russian perceptions about Russia's place in the world and changes in state power, and found that in both periods when Russian energy companies showed considerable interest towards Central Europe (between late 1993 and 1996 as well as between 2000 and 2004) Russian leadership assessed the relative power distribution in the international system to be disadvantageous for Russia and at the same time had considerable state power to mobilize. These two variables were not present together in the three sub-periods in which there was little to no Russian energy expansion in Central Europe. That is to say, the energy companies' Central European activities were consistent with what my hypotheses predicted. The following section offers a brief overview of the findings for each sub-period.

## **VI.1. Findings of the Case Study**

### ***1991-1993: Early Atlanticism***

The chief objective of Russian foreign policy in this period was to build a strong strategic relationship with the leading power of the Western world, the United States. Key Russian foreign policy decision makers believed that even though the Soviet Union lost the Cold War, it retreated voluntarily and kept most of its military might intact. Based on this view, Russia is entitled to be

treated on an equal footing with the United States. Russia pursued an openly Atlanticist foreign policy during this period. Moscow viewed its relations with its former satellites through the lenses of Russian-American relations. In the diplomatic sphere it sought to close down the Soviet past by concluding treaties about the withdrawal of Soviet troops and settling the Soviet-era debt. On the other hand, it paid practically no attention to its former satellites, concentrating its energy and focus on the strategic relationship with the United States. Its overarching goal vis-à-vis Central Europe was to keep it a demilitarized, neutral zone between the West and Russia. In the first two post-Soviet years, the Russian leadership believed and made Russia more or less believe that Russian-American relations are those of equals.

In terms of state power, it was very high by post-Soviet Russian standards. Despite the collapse of the Soviet economy, tax-type federal revenues still accounted for more than 20 percent of the GDP in 1992, which was a level that the Russian state was not able to reach again until 2004.

Russia perceived that its relative influence in the world is consistent with its expectations. At the same time, it had high state power to mobilize the necessary resources. The hypothesis would predict that when Russia perceives its influence to be consistent with its expectations, even though it has enough state power, Russian energy companies do not expand into Central Europe.

This is exactly what was found in this research for the period of 1991-1993. No single move by a Russian energy company into Central Europe was found at this time. The findings are consistent with the predictions of the hypothesis.

### ***1993-1996: Facing NATO Enlargement***

This period may be characterized as a sobering one after the illusion of equal partnership with the United States. The most important issue which made Russian leaders rethink their perceptions about their country's actual influence in the world was the West's growing openness to the idea of enlarging NATO to include former Soviet satellites. Russia's inability to prevent the enlargement and additionally Moscow's perceptions that as a consequence Russia would be isolated, made it painfully clear for Russian decision makers that their country's relative influence vis-à-vis the United States is far from a partnership of equals. Another issue which became a costly reminder of Russian weakness and low relative influence in the world was the Chechen war. These two issues - the increased likelihood of NATO enlargement and Russia's inability to get his message with regard to the Chechen War through in the West - served as external shocks that shaped Russian perceptions about their country's low influence in world affairs. Central Europe appeared on the radar screen of Russian decision makers as an area where the hostile organization, NATO, plans to move in. Russia viewed Central Europe as a territory where the balance-of-power between the United States and Russia was about to change in America's favor. While it planned to keep the area as a demilitarized zone between Russia and the West, now it became painfully clear for Moscow that it is about to lose Central Europe to NATO. It is no wonder that Russia perceived its relative influence in world affairs to be declining and the visible terrain of the decline was in Central Europe.

State power measured as tax-type revenues as percentage of GDP was lower in this period than in the first two post-Soviet years but much higher than in the years after. Tax-type federal revenues were just little bit above 14% of the GDP between 1994-1996. Compared to similar figures of the preceding and following periods, it can be said that state power during this period was at a medium level.

Between 1994 and 1996, the Russian leadership thought that Russia's relative influence vis-à-vis the United States was low even though Russia possessed enough state revenues to mobilize the necessary resources. The hypothesis is that when the Russian leadership perceives that Russia's relative influence vis-à-vis the West is low and at the same time the state has enough power to mobilize the necessary resources, Russian energy companies would try to expand in Central Europe.

My findings are in line with the predictions of the hypothesis. The first wave of Russian energy companies' - more precisely Gazprom's in this period - expansion into Central Europe happened exactly during this time. Gazprom had two important goals in all the three examined countries (Poland, Hungary and Slovakia). First, it aimed at getting involved in not only exporting but also importing Russian gas to Central Europe. To achieve that, Gazprom launched three-party negotiations in the period between 1994 and 1996 among national companies with monopoly rights to import natural gas from Russia, the national governments of the Central European countries, and itself about creating joint ventures in charge of importing Russian gas. Gazprom managed to set up joint ventures endowed with monopoly rights to import Russian gas in all the three countries (officially the one in Slovakia was set up only in 1997). Gazprom ended up with substantial ownership in all the three companies. Moreover, in Poland and Hungary, Gazprom attempted to create a joint venture ownership structure which, even though on the surface seemed to provide majority for domestic companies, in fact gave control to Gazprom through personal loyalties (Poland) or actual ownership (Hungary). In Poland, this Russian control was more covert and the Russian side managed to keep this structure until a public scandal, which involved Gazprom, uncovered it for the Polish public. In Hungary, Gazprom's effective control above the Hungarian-Russian joint venture created significant public uproar and the Russian company's share was limited to 50 percent.

The second aspiration that Gazprom managed to achieve in the region was to get the rights to build gas pipelines through all the three countries. In case of Poland, it even managed to reach an agreement during this period, as the resulting Yamal pipeline became the major tool of Gazprom's expansion in Poland in the years to come.

Gazprom made substantial inroads into Central Europe between 1994 and 1996. It is important to call attention to the fact that the Russian company's expansionist moves were initiated from Russia, meaning that it did not react to tenders or appear in Central Europe at the invitation of the Central European countries. It came because it wanted to pursue its goals of getting involved in natural gas imports and acquiring rights to build new pipelines. The decision to go to Central Europe was a Russian decision.

### ***1996-1998: Against a Unipolar World***

The third phase of post-Soviet Russian foreign policy was characterized by Yevgeny Primakov's strategy to defend Russia's national interests by preventing the evolution of the international system into a unipolar world. Primakov's foreign policy was characterized by looking for potential partners with whom Russia would be able to balance against the United States. Behind this strategy was the recognition that Russia's relative influence in the world, especially vis-à-vis the United States, was alarmingly low. The accelerating NATO enlargement continued to be the most visible sign of Russian weakness. The terrain where Russia most noticeably lost influence vis-à-vis the United States was still Central Europe. It became clear for Russia that it lost its military influence in Central Europe by NATO entering the region. A document written by an influential think tank in Russia concluded that Central Europe is still important for Russia, however, it still lost the region militarily and politically. At the same time, the document recommended countering NATO's move into Central Europe by an economic

expansion of Russian companies, and these recommendations were endorsed by decision makers. The Russian leadership understood that their country's influence is declining. At the same time, they sought to change the trend and prevent Russian influence from eroding, and to do so through Russian energy companies, as the report recommended.

In this period, state power was also in the decline. Federal tax revenues as percentage of GDP were at 14.6 percent in 1996, and fell sharply in 1997 to 11.1 percent, and to 9.4 percent in 1998. This was the lowest throughout the history of post-Soviet Russia. Within two years federal tax revenues fell by one-third, which means that between 1996 and 1998 state power in Russia was low.

Between 1996 and 1998 Russian leaders were dissatisfied with their country's place in the international system, however, they did not possess enough state power to mobilize the necessary resources. The hypothesis would suggest that when the Russian leadership perceives that Russia's relative influence vis-à-vis the West is low but does not have enough power to mobilize the necessary resources, Russian energy companies would not expand towards Central Europe.

These findings are in accordance with the hypotheses. Russian energy companies did not have any new initiatives in Central Europe between 1996 and 1998, but they merely fulfilled their contractual obligations which they negotiated in the previous phase. Joint ventures continued to be the vehicle for importing gas from Russia. The construction of the Yamal pipeline went on according to schedule. Gazprom, however, did not show any efforts to acquire new rights or assets in any of the three countries regarding the joint ventures, pipelines, new industries, or companies. The only major development during this period was that Gazprom managed to establish a Slovakian-Russian joint venture in Slovakia. However, this move does not contradict the predictions of the hypothesis. First, the initial negotiations about setting up the joint venture were conducted during the previous phase. Second, Slovakia was at the time far the most open

toward Russia, and from a strategic point of view it is less important for Moscow than either Poland or Hungary. The fact that the only new move Gazprom was able to make happened in Slovakia illustrates the very weakness of the Russian state between 1996 and 1998. Even though Russia understood its declining influence in the world and declared its intention to counter this trend, it did not have the means to do so. Even when an influential document already stated that the military expansion of NATO should be countered by an economic expansion of Russia, Moscow did not possess enough state power to mobilize the necessary resources to implement this recommendation.

#### ***1998-2000: Instability and Uncertainty***

Russian leaders perceived that their influence in world affairs was by far the lowest during these years in the history of post-Soviet Russia. NATO was enlarged formally in April 1999 when it admitted Poland, Hungary, and the Czech Republic into its ranks. At the same time, NATO launched a war against Serbia, a long-time Russian friend and ally. Moscow was unable to prevent or influence the decision to go to war. The Kosovo crisis became the lowest point in Russian-American relations in the first post-Soviet decade. Russians feared that America's influence would reach the countries of the former Soviet Union and they were afraid of further marginalization in world affairs. The prevailing feelings were that of defeat, confusion and loss of self-confidence. Central Europe appeared as a manifestation of all those bad things happening to Russia. Russian bilateral relations with countries of Central Europe were at their lowest in the entire post-Soviet Russian history during these two years, and were characterized by incidents, expulsions of diplomats and cancelled high level visits. All these issues highlighted the prevailing Russian feeling of betrayal and defeat.



Federal tax revenues as percentage of GDP were at their lowest of the entire observed period in 1998 at 9.2 percent. In 1999, tax income was 12.8 percent, and state power was substantially lower in 1998 and 1999 than any time before 1997 or any time after.

Between 1998 and 2000 Russian leaders were very much unhappy with their country's place in the international system, however, they did not possess enough state power to mobilize the necessary resources to counter this trend. The hypothesis is that when the Russian leadership perceives that Russia's relative influence vis-à-vis the West is low but does not have enough power, Russian energy companies would not expand toward Central Europe.

These findings support the hypothesis. Russian energy companies' activity in Central Europe was quite limited between 1998 and early 2000. Gazprom was focused on maintaining its privileged position in the joint ventures, and the Russian company had only one major new initiative during this time. In February 1999, Gazprom first started to float the idea of withdrawing from the construction of the Yamal 2 pipeline by recommending two alternative pipelines instead: one below the Baltic Sea and another one through Belarus and Southern-Poland to Slovakia. During this time, however, no decision was made or contract signed, and thus the issue stayed at the rhetorical level with verbal threats. The oil companies, which will have become so active after 2000, did not show any signs of expansion in this period. Indeed, Russian energy companies' very limited activity in Central Europe between 1998 and 2000 supports the predictions of the hypothesis. Russia was very much dissatisfied with its influence in the international system and wanted desperately to change the structure, but it did not have the capabilities to do so, and as a result, Russian energy companies did not show any significant move in Central Europe during this time.

### ***2000-2004: The First Putin Presidency***

Vladimir Putin assumed the presidency after the chaotic last two years of Yeltsin's presidency. He consolidated his power relatively quickly and started to make good on the paramount message of his campaign, namely making Russia great again. Putin thought that Russia's relative influence in the world is alarmingly low and was determined to change the balance of power in favor of Russia. This one major goal was in front of his eyes throughout his first term, and he was willing to make compromises only as long as they seemed to serve this long-term interest.

Putin placed special emphasis on strengthening Russian economic capabilities. In several speeches, he pointed out that without a strong economy, Russia will not be able to become a great power again. He put many state resources into this direction. At the same time, Putin started a strong centralization of power not only in the political but in the economic realm. The case against Yukos was one example of that. Moreover, the Putin government was the first post-Soviet Russian administration to explicitly refer to energy companies as tools of Russian foreign policy.

This aspiration was assisted by Russia's swift economic recovery. Federal tax revenues as percentage of GDP were at 15.5 percent already in 2000, the second highest in nine years. State power continued to grow steadily reaching 19.6 percent in 2003 and 20.4 percent in 2004. This huge increase in state power gave a big room of maneuver for the Russian leadership.

Between 2000 and 2004 the Russian leadership held that Russia's relative influence vis-à-vis the United States was way too low for comfort. At the same time, the Russian state collected more revenues than ever and was more powerful than any time since the collapse of the Soviet Union. This hypothesis would suggest that when the Russian leadership perceives that Russia's relative influence vis-à-vis the West is low, and at the same time the state has enough power to

mobilize the necessary resources, Russian energy companies would try to expand towards Central Europe.

These findings are very much in line with the hypothesis. During this period Russian energy companies' activity in Central Europe reached an intensity not seen before, as they tried to exploit opportunities to strengthen their position in Poland. In their endeavors they were very much supported by the Russian state and its representatives. In the gas sector, Gazprom kept its advantageous position in the Polish-Russian joint venture, and at the same time managed to lower the transit fee it has to pay for delivering its gas through Poland to Germany. One of Gazprom's greatest successes during this period was to prevent the building of the planned Norwegian gas pipeline, which would have posed the greatest challenge to its monopoly position.

During this time Russian oil companies also made systematic attempts to enter the Polish oil industry. They participated at both privatization tenders for the second largest Polish refinery Rafineria Gdanska, and regularly expressed their interest in buying into PKN Orlen, the biggest refinery of Poland.

Russian energy companies were very active in Slovakia during this period. As in Poland they enjoyed the highest level of support from Russian state officials in their moves in Slovakia. Gazprom had three initiatives in Slovakia: first, it used the country as a bargaining chip against Poland in the inter-system connect pipeline dispute. Second, Gazprom managed to get Bratislava on its side in the attempts to block the Norwegian-Polish pipeline. Third, it managed to buy a blocking share in SPP, the Slovak gas monopoly, as part of a consortium. At the same time, Yukos managed to buy a controlling share in Transpetrol, the Slovak oil monopoly, which also owns the Slovak part of the Druzhba pipeline. Both Slovak energy monopolies ended up partly in Russian hands between 2000 and 2004.

Russian energy companies' activity also grew in Hungary during this period. Gazprom tried to enter a new industry, the petrochemical one, by acquiring the majority shares of Borsodchem, which is one of the two largest petrochemical companies of the region. Gazprom also made an attempt to acquire the other regional leader in the industry, TVK. There is reason to believe that during this time Gazprom made several attempts at trying to get leverage over Mol, the Hungarian gas and oil monopoly (the Hungarian equivalent of PGNiG and PKN Orlen together or SPP and Transpetrol together). Yukos managed to get the flow of the Adria pipeline reversed and connect it with the Druzhba pipeline, thus making the Druzhba-Adria a transport pipeline for its crude oil to the Adriatic coast.

The findings underscored the predictions of the hypothesis. The Russian leadership was dissatisfied with Russia's place in the world and determined to change the structure. President Putin placed great emphasis on economic capabilities as a tool to make Russia great again, and the high intensity of Russian energy companies' activity in Central Europe illustrates this point.

## **VI.2. Implications for theory**

In this study neoclassical realist theory was useful in explaining Russian energy companies' expansion in Central Europe. Neoclassical realist theory is often criticized for having relatively poor applicability in predicting foreign political outcomes and the timing of their occurrence, but in this case neoclassical realist theory does have predictive power. The hypothesis is that in case Russia finds that the relative balance of power in Europe is changing unfavorably and possesses enough state power, Russian energy companies would continue expanding into Central Europe. Russian energy companies' expansion directly affects the Central European countries. If a Central European decision maker sees that the Russian leadership perceives that its country's relative influence vis-à-vis the West is low and the Kremlin possesses enough state power, he

could expect a surge in Russian energy companies' initiatives in Central Europe. In this sense neoclassical realist theory does have predictive power.

However, neoclassical realist and realist theory is vague on the usefulness of economic capability and economic expansion in general. The realist school focuses primarily on military power and capability and military expansion. However, these findings suggest that the Russian leadership, especially starting in 2000, placed special emphasis on the role that Russian energy companies can play in Russian foreign policy. At the same time, it executed a heavy centralization of power in the energy sector. This research illustrated that Moscow decided to expand into Central Europe by economic and not by military means, and that Moscow may very well follow a similar pattern vis-à-vis other countries and regions. For realist theory to keep its explanatory power it needs thorough discussions on the issues of economic capabilities and economic expansion. It needs to answer the question of the extent to which economic capabilities contribute to national power, what is the relationship between military and economic capabilities, and how effective is economic expansion compared to military one.

### **VI.3. Implications for Russian Foreign Policy Studies**

There is an understanding in the field that Moscow uses Russian energy companies as a tool of its foreign policy vis-à-vis countries of the former Soviet Union. It is accepted in the literature that Russian companies' conduct is part of Russian foreign policy vis-à-vis countries in Central Asia, the Caucasus, Ukraine and Belarus. Interestingly enough, scholars also agree that there is a similar Russian conduct vis-à-vis the Baltic states, which are not part of CIS and are members of NATO and the European Union. However, as this study suggested Russian energy companies' activity in Central Europe relates to Russian perceptions about their country's influence in the world as well as the level of state power. These findings generate the following general research

questions: does Russian energy companies' expansion in any part of the world is driven all the time by the Russian leaders' perceptions and state power? Do Russian energy companies behave differently in their relations with Western European countries or with the United States than they do with countries of Central Europe? What are the similarities and the differences of Russian energy companies' conduct in different parts of the world? Is there always a correlation between Russian energy companies' appearance in certain parts of the world on the one hand and Russian perceptions and state power on the other? The activity of Russian energy companies in the world is visible. Scholars increasingly accept the idea that on some occasions these companies are used by the Kremlin for foreign political purposes. Understanding their moves may become one of the keys to understand today's Russia. As a result, these cases should become the subject for further research.

Furthermore, this study illustrated that a systematic application of IR theory is able to shed light on Russian studies. It would not be surprising to find that Russian companies' expansion outside of Russia is a new phenomenon in Russian history. Testing several IR theory's explanatory power on this phenomenon contributes to the understanding of one very important aspect of current Russia.

Russian foreign policy towards Central Europe is an unexplored area in research. Even though Central Europe is clearly not Moscow's primary focus area, the Kremlin's conduct toward the region many times reflects Russian thinking on its relations with Western countries. Understanding Russian-Central European relations would have implications for the field as a whole, as well.

#### **VI.4. Further research**

In these cases there are four instances in which Russian leaders perceive their country's influence to be low. As a result, the hypotheses were tested on four instances when one of the independent variables' value was 'low'. Of the four, in two Russia had enough state power while in the other two it did not. As a result, the hypotheses were tested on two-two instances when one of the independent variables (relative power in the system) was constant, i.e., low, and the other independent variable (state power) was on two occasions "enough state power" and on two others "not enough state power". In all the four sub-cases, Russian energy companies behaved as the hypothesis would have predicted. However, there was only one sub-case where Russia perceived its influence to be in line with its expectations. In this case, Russia did possess enough state power to mobilize the necessary resources, and behaved as the hypothesis would have predicted, i.e., Russian companies did not expand. However, there was no example among my sub-cases for a combination of perception being consistent with expectations and at the same time Russia not possessing enough state power. As a result, the hypothesis, ("when the Russian leadership perceives that Russia's relative influence vis-à-vis the West is consistent with its expectations, Russian energy companies will not manifest any expansionary moves into Central Europe - even in case Russia possesses enough state power to mobilize the necessary resources to do so") was tested, only in one case in the dissertation on the time period between 1991 and 1993. To make a legitimate conclusion that the hypothesis passes the test regarding Russian companies' expansion into Central Europe, further research is needed.

A natural area to test these hypotheses is to examine its validity during the second Putin presidency. Russian perceptions about Russian influence in the world and available state power should be examined, and the activity of Russian energy companies in Central Europe should be scrutinized. Afterward, the hypothesis testing could follow.

In this dissertation the dependent variable was the Russian companies' expansion into Central Europe. However, the study did not examine the intensity of the expansion. Russian companies' activity in the region is much more intense during 2000-2004 than during 1994-1996. In both instances Russian leaders perceive their country's influence to be low vis-à-vis the West. However, there are certainly differences between the perceptions of the two time periods. The nuances and differences should be quantified or measured in order to examine whether perception has any explanatory value for the difference in the intensity of Russian companies' expansion. There is also considerable difference between the size of state power at the two periods. During 1994-1996 federal tax revenues were about 14.4 percent of the GDP. In 2000-2004 the state was able to collect as federal tax revenue around 18 percent of the GDP on average, a 25 percent increase. It should be subject to further research to examine whether the substantial increase in federal tax revenues explains the increased Russian energy company activity in Central Europe.

The study outlined Russian official diplomacy towards Central Europe as well as the Russian energy companies' expansion into the area, but it did not examine in depth whether there is any relationship between the two. A preliminary comparison of the two suggests that they do not relate, which raises the question of why these two aspects of Russian foreign policy are divergent from each other. Most Central European policy makers and energy company executives would argue, and clearly tend to believe, that this is an intentional separation. In this case, diplomacy is the overt aspect of Russian foreign policy, while energy companies are the covert ones. This issue could be the topic of further research.

The study discussed Poland's and Hungary's less recipient environment towards Russian investments compared to Slovakia's welcoming attitude. Further research could focus on whether Russian energy companies are more active in countries where they are well received or there is no relationship between the intensity of their activity and the recipient country's attitude.



However, based on this research it is a legitimate assumption that the intensity of the Russian companies' activity is not dependent on the recipient country's attitude. The intensity of Russian investments changed during the period of 1991 and 2004 several times year by year. It changed according to Russian perceptions and available state power. However, a second research question could ask whether the means Russian companies apply depend on the recipient country's disposition towards Russia. The answer is most likely "yes". This study touched upon the question and a preliminary hypothesis can be phrased: when a country has a positive attitude towards Russian investment, Russian companies use overt means (e.g., apply for a privatization tender openly). Conversely, when a country has a negative attitude towards Russian investment, Russian companies use covert means (apply for a privatization tender in consortium with Western companies to acquire a company through hostile takeover, and so on). This research raises several difficulties. First of all, how do we measure attitudes: positive vs. negative. Second, what matters is not really the attitude in the given country but Russian perceptions about the target country's attitude towards Russian investment. In any case, this research would have strong direct policy implications.

### **VI.5. Final Thoughts**

The study evaluated whether Russian energy companies' moves in Central Europe and Russian foreign policy demonstrate that there are traces of similar behavior in the past in Russian-Central European relations. The basic difference between Russian behavior toward Ukraine and Central Europe is in the level of publicity the two received. In case of Ukraine, Moscow succeeded in 1.) creating a Russian-Ukrainian joint venture, 2.) elevating a Gazprom subsidiary, RosUkrEnergo, as an equal co-signer of an interstate contract, and 3.) eliminating the alternative option of Turkmen gas for Ukraine. Moscow managed to do the same vis-à-vis

countries in Central Europe before. However, in those cases these moves happened more covertly with less publicity and in a gradual way. First, Gazprom managed to establish a joint venture on similar terms to that in Ukraine in each of the three examined countries between 1993 and 1998. Second, the negotiations between Russia and the Central European countries regarding gas deliveries and major privatizations always involved both the Russian state and Gazprom, the officials of whom many times behaved interchangeably, which made the negotiation processes opaque throughout the period. Third, Gazprom successfully eliminated the alternative option of Norwegian gas deliveries, which is the only source of natural gas potentially competitive to Russian gas, in Poland in 2002/2003. Yukos managed to change the direction of the flow of the Adria pipeline, as a result, reducing Hungary's options for alternative crude oil supply in 2003. Gazprom and Yukos managed to buy into the Slovak gas and oil monopolies respectively, and as a result, these companies will not even try to look for alternative supplies. Even though these phenomena were known for years, very few asked the question of what were the influences on Russian behavior. There is a common understanding in the literature that Russia used Gazprom to gain back some of the influence it lost because of Victor Yushchenko's, who is a Western-oriented politician, victory in the Ukrainian elections. Now policy makers and scholars have to clarify whether Russian intentions have been rather similar in the Russian-Central European relations.

What happened in Ukraine in January 2006 already happened in terms of Central European countries' relations with Russia. Russian energy capabilities and Russian intention are not new. The goal of the Russian leadership is to reestablish Russia as a great power again. It seems clear that the Russian leadership views Central Europe as an area where some of its past influence should be gained back as soon as Russian state power allows it, which should give an early warning for all policy makers who are concerned with the energy security of the European Union.

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Deak, Andras, Russia expert, Budapest, September 2005.

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Everett, Bruce, former Downstream Government Relations Manager, ExxonMobil Corporation, Adjunct Associate Professor of International Business, Fletcher School of Law and Diplomacy, Medford, MA, July 2003.

Fine, Daniel, Economist Professor, MIT, Washington, DC, July 2003.

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Senior official of the Supreme Chamber of Control, Department of Economy, Treasury and Privatisation (NIK), Warsaw, March 2003.

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