



Energy, Russian Influence, and Democratic Backsliding in Central and Eastern Europe

A comparative assessment and case studies
from Belarus, Ukraine, Moldova, Hungary,
Romania

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Energy and Politics: How the Kremlin is using the Energy Policy to Regain Influence in Eastern Europe. And What Should Be Done to Fight Back

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In Eastern Europe, two governance models collide. One is the liberal, Western model, which combines democracy with the rule of law, promotes an open society with liberal and inclusive institutions, encourages transparent governance and sets limits for administrative discretion and political corruption. In economic terms, this model fosters free competition, level playing field, effective commercialization (including hard budget constraints) and the limitation of monopoly abuse. The other is the illiberal alternative, grounded in nationalism and economic populism, with a strong anti-globalization (i.e. anti-Western) discourse. It favours opaque decision-making, clientelistic, preferential rules for certain well-connected players, it makes room for corruption, including through soft budget constraints, and it goes against the principles of a free competitive market. In its softer version, it is a pro-status quo regime informally protecting incumbent economic agents against natural change; harsher versions of illiberalism drift towards “revenge” nationalizations and active protectionist measures.

This clash of values has become ever more visible in the past decade, after the economic crisis and challenges to national identity that many countries in the region faced after having joined – or started negotiations to join – the EU. In the accession process, these countries had had to embrace Western values, sometimes at odds with the interests of local players. The economic crisis of 2008 however provided unprecedented opportunities for local post-communist elites to challenge the validity of the liberal model (as it happened in the West itself, one would say). The moment coincided with Russia’s recovery from the weakness of the ‘90s, helped by a decade-long surge in the price of natural resources. Despite the drop of resource prices, Putin’s regime accumulated enough wealth to become increasingly assertive in regaining its lost influence in the region. Kremlin’s efforts range from soft-touch interventions by favouring some politicians and offering lucrative deals to local oligarchs, to hard shows of power such as the occupation of Crimea - the choice of means depends on local opportunities.

It doesn’t matter if Russia really has a consistent plan to regain influence in Eastern Europe, as suggested by some authors, or if it uses the existing weaknesses in these countries opportunistically: the new illiberal fashion plays into the hand of Kremlin as much as into that of local vested interest groups¹. Whichever is true, Kremlin’s influence in the region takes two, mutually-reinforcing forms. First, it seeks to influence policy decisions in a country by exerting control over a strategic sector in the economy. It has a penchant for energy, the obvious choice considering how dependent these countries are on Soviet-built infrastructure (pipelines, technology). The technological path dependence in the energy sector has been recently reinforced by Kremlin’s grand initiatives to build nuclear power plants like Belene or Paks-2, or major pipelines such as South/Turkish Stream.

Second, and partly coupled with Kremlin’s “energy weapon”, comes the support given to politicians, parties and movements in order to influence directly the domestic policies of these countries or their position in the EU on issues that affect Russia’s interests in the region – a good deal of this influence work is also made through energy transfers, directly and indirectly. Moscow did not invent these politicians and their movements out of the blue. Indeed, it can be

¹ *The Kremlin Playbook. Understanding Russian Influence in Central and Eastern Europe*, ed. Heather A. Conley, Center for Strategic and International Studies, 2016

argued that East European populist and anti-globalization leaders are inspired in good measure by the new, nativist trend in Western politics (which elsewhere we called the Elite 2.0²). But it perfectly serves its purpose to nourish and encourage them, openly or more discreetly, depending on what local history and public opinion permits. When it comes to policy areas, nevertheless, the energy leverage is, particularly after 2014, by far Kremlin's main economic instrument used to undermine European rules in the region and to weaken recently-born institutions, fashioned on Western liberal models, such as the impartial and technocratic market regulators. This mirrors perfectly the rhetorical war against "technocrats and experts" being waged by some in the West.

Critically, we observe a shift in Kremlin's influence in the region through energy in recent years. Before the late 2000's Kremlin used the energy leverage openly as a main instrument for foreign policy in all of the countries and with the EU. But following EU's strong answer through its competition and energy / security of supply policy (the Third Energy Package with the requirements for unbundling, EU's energy security strategy, the acceleration of gas market liberalization, the construction of interconnectors to diversify supply routes and sources, DG Comp's investigation on Gazprom's abuse of dominant position in countries in CEE, all of which reduced gas prices, monopoly positions and risks of interruptions of supply etc.), combined with the reduction of gas consumption across all the countries, this channel of influence has indeed been weakened. Since 2014, following this path became also quite expensive for Russia's dwindling budget, seriously diminished lately by the declining oil prices and the reduction of revenues from gas. Instead, Kremlin may have found a more insidious way to regain influence through the energy sector, through what we may call kleptocratic methods (a more proper way of designating the informal war). This consists of fostering organized crime, corruption, financial offshorization in the sector, in networks of local and Russian oligarchs; as well as controlling countries through "no-man's-land" territories or breakaway regions which are financed through energy or retain control over critical energy routes and sources. The latter are more difficult to understand from a Westerner's perspective not used to such practices and, thus, they require more ingenious ways to fight. However, fighting corruption and organized crime at the borders of the EU is critical for the EU itself. They could become safe havens for criminals from the EU; undermine EU's sanctions policy on Russia; allow money laundering benefiting criminal groups or extremist parties in the EU etc. Very importantly, EU and US investors in the countries are very much affected by this particularly devious behavior, being discriminated against local oligarchs, seeing their investments seized by Russian-backed guerillas or just endangered by displays of military in disputed territories. But new EU member states are also not free of corruption, though here we see "softer", more familiar forms for it – in the energy sector, corruption discriminates against newcomers, tweaking the rules of the game in favour of the incumbents and is a serious hindrance for investments.

The present report is based on in-depth research on Russian influence in Hungary, Romania, Belarus, Moldova and Ukraine. It also builds on the research on Hungary, Bulgaria, Latvia, Slovakia and Serbia launched last year by CSIS/CSD³. The report focuses on Kremlin's influence through the energy sector, reflected in the change of policies, laws, institutions and the member states' positions in the EU decision-making bodies in regard to Russia's interests, as well as in tweaking of rules to favour certain players, Russian and local. Benchmarking the countries in the report with countries analyzed in the *Kremlin Book*, we observe common patterns, as well as diverging paths.

Thus, Kremlin's influence through the energy sector embraces various forms, which depend on local conditions, level of dependence on Russian energy supplies, but also cultural affinities

² *Populism 2.0 and Rebirth of Alternatives to Liberal Democracy*, EFOR annual report, 2017, (<http://expertforum.ro/raport-anual-2017/>).

³ The Kremlin Playbook, *ibid*.

and strength of economic ties. It must be noted from the start, however, that such influence would be of little consequence had the countries in question not have their own pre-existing internal governance weaknesses. We also thought it would be interesting to compare EU member countries (Hungary and Romania, plus some references to Bulgaria and the Baltic states) with non-members (Belarus, Moldova, Ukraine) in order to see if the Union's border makes any difference as far as the channels or magnitude of Kremlin's influence are concerned.

What we could identify are seven channels of Kremlin's influence in the region through the energy sector:

1. Attempts to gain control over national gas transportation networks, through joint ventures / co-ownership between national transmission system operators (pipeline networks) and Gazprom, the Russian state owned gas monopoly.

In all former Soviet countries surveyed, Gazprom sought to maintain the monopoly of its USSR-era transit routes of gas to Eastern Europe and dominate the local gas markets, preferably in a vertically integrated structure combining supply and networks. This is exactly the kind of structure the EU considers anti-competitive and proactively tries to dismantle. The Russian strategy was implemented more or less successfully, depending on the stance of national governments. In Moldova, gaining control over the assets was relatively easy in the late '90s, when the Moldovan government was weak and could not consider the possibility of diversifying the sources of gas; true, at that time the gas market liberalization was in its initial phases in Western Europe as well. Belarus, in contrast, negotiated very toughly the possible joint venture with Gazprom, seeking to extract as much rent as possible from the deal, in terms of money and energy supply. Ukraine's position on the matter fluctuated over time, depending on who was in power: pro-Russian governments favoured a partial take-over, whereas pro-Western politicians preferred to focus on the integration with the EU market, maintaining control over critical energy assets and diversifying supplies.

A similar pattern could be observed in the electricity sector, though the structure of the system is in this case less monolithic. Ukraine, Moldova, Belarus are connected to the Russian system, in synchronous mode, which makes it costly and difficult to interconnect with and be supplied from the European market. Romania and Hungary, on the contrary, switched to the European system, joining UCTE (Union for the Coordination of the Transmission of Electricity) and later ENTSOE (European Network of Transmission System Operators for Electricity) in the late '90s or early 2000s. The position of Ukraine and Moldova on the synchronization with the European system has been ambivalent, depending on the stance of the governments and political will to diversify supplies by importing energy from direction West and decoupling from the Russian system, but also the dependence on cross-system balancing flows.

The official policy of the European Union is to create competitive markets in energy, with effective competition between producers and suppliers, and clear separation of the interests of producers / suppliers from the network operators, in order to avoid foreclosure of the market. This strategy is embodied into the so-called *Third Energy Package of the EU (3EP)*: a set of directives and regulations completed in 2009 which are aimed at ownership unbundling on the gas and electricity markets and the creation of a network of politically independent national regulators, plus a EU-level agency to coordinate them all according to common rules and principles. The philosophy behind 3EP is that competitive energy markets work to the benefit of the consumers, as they ensure choice and security of supply instead of abuse of monopoly or dominant position. This is a clear example where the tabloid press, ventilating clichés about "European overregulation" in front of the uninformed public, is wrong, while the "EU bureaucracy" is right. Overcoming the historic fragmentation of national markets and promoting security of supply through a larger, integrated and more fluid network of suppliers and consumers is the best form of insurance against both price of supply fluctuations or manipulation attempts.

By contrast, continuing with the old monopolies goes against the interests of consumers, generally in favour of the incumbent industries (existing energy suppliers which can avoid competition, but also certain local consumers, which benefit preferential deals with these incumbent suppliers). In other words, enforcing EU's rules breaks these old boys' clubs and creates opportunities for investments by non-incumbent players; with proper competition enforcement, it may even lead to price reductions (or, at least, contain their growth).

The worst case scenario is to have not just a monopoly, but a politically-controlled one like Gazprom, which sometimes is able to sacrifice its own profit for various *raisons d'état*. In our region this dark art comes by the name of "energy diplomacy", a term which instantly brings to mind old Soviet James Bonds in ill-fitted suits but with a steely determination to impose the Party's will (or, later, of the oligarchs or siloviki), in the rusty décor of the '80s. Politicians like to present "energy diplomacy" like a superior form of policy-making, accessible to the initiated few, in contrast to the vulgar "commercial approach" where all the cards are on the table, the game is played by the rules and the private agents are allowed to seek greater profits and efficiency. In reality, what we see behind the smokescreen is just another piece of propaganda blurring realities in the attempt to defend opaque, clientelistic and wasteful quid-pro-quos against the advance of the liberal model of governance.

Like in the past, the clientelistic model deploys price policy as a tool to influence the governments' decisions. For instance, through the so-called Kharkiv Accords, Russia concluded a lucrative deal with Ukraine to extend its lease on the Black Sea Navy facilities in Crimea until 2042. The Accords were signed by president Yanukovich in 2010 in exchange for promised (but largely misleading, as it turned out afterwards) discounts for the gas prices. While Ukraine passed in 2007-2009 a law banning privatization of the gas transmission system, this is also reinforced today by EU's 3EP, finally transposed in Ukraine's legislation, which forbids Gazprom from taking over Naftogaz, the operator of Ukraine's gas transmission system. This holds even if Ukraine doesn't import or transit gas from Russia: Naftogaz owns transit pipelines which could be used in reverse (e.g. Romania-Moldova-Ukraine), but it also owns the rest of the grid, on which not applying non-discriminatory third party access could block Western gas from access to the market. Ukraine is virtually independent today of direct gas imports from Russia, by interconnecting with the EU. In other words, "the Western model" protects Ukraine's energy independence and guards against potential abuses of dominant position.

2. "Soft budget constraints" vs full commercialization of business undertakings

Non-commercial practices are fairly common in the energy sector mostly in the post-Soviet space, and slightly less so in new EU member states. These practices include subsidization; debt write-offs; arrears; below-market energy pricing; or outright barter. Belarus is an exception in this respect, as much of its economy survives on rents extracted from Russia. Write-offs, "tolling schemes" or "processing"-type contracts (i.e. supplying raw materials in exchange for processed goods, from machinery to refined oil), or energy cheap/free-of-charge are the norm not only in the energy sector, but in the whole Belarussian economy. Belarus has simply not undergone a transition to market economy, as the other countries more or less have, no matter how incomplete the transition might be in the latter.

Even in these other countries, Gazprom in particular has allowed its partners to default on debts, which reinforces Russia's grip on the country's resources and politics. A case in point is Moldova, where Russian-controlled businesses in Transnistria are offered convenient gas prices (1/10 of the usual price to Moldova) and the possibility to default on gas payments for decades. As a result, Moldova's total debt to Gazprom has climbed to over 80% of the country's GDP. To add insult to injury, Moldovan citizens on the right bank of river Dniester pay the full cost of gas and electricity (at prices 15-20% higher than in Romania in the case of electricity), but part of their payments finance the separatist regime in Tiraspol (on the left bank), as Moldova's total energy debts to Russia increase.

Even if disputed, such debts which are allowed to accumulate for years could be used at some point to threaten with interruptions of supply or with the execution of debts to gain control over critical assets, such as gas pipelines or other energy infrastructure. In Ukraine and Belarus, the Kremlin already used the leverage of the huge arrears of payments in the attempt to gain control over the gas transmission system. Moldova negotiated a derogation from EU's 3EP by 2020 on the unbundling principle for the gas sector, because the unbundling would have directly undermined Gazprom's interest: Gazprom is both a shareholder with 50% in Moldova's gas transmission (indirectly controlling another 13% through Transnistria's regime) and the sole gas supplier to the country; by EU's rules, it should choose one or the other. The "debt trap" also represents a means by which Russia finances and supports separatist regimes like Moldova's Transnistria and Ukraine's Donetsk and Lugansk "republics".

The "soft budget constraints" create fuzzy accountability and pose energy security and macroeconomic risks. While arrears originated in the energy-intensive structure of the economy (another communist legacy) and in the high energy prices in PPP terms, the buildup of arrears clashes with the "Western model" of liberal market economy. In Brussels' and Washington's terms, non-payments and non-collection involving state owned companies like gas transport networks represent illegal state aid, hidden public sector deficits and are thus incompatible with the normal contractual, commercial and competition practices. In fact, joining EU requires the adoption of a "fully functional market economy", while IMF programs always insist on "hard budget constraints" – and this is why.

3. Preference for opaque contracts, bilateral energy deals, beneficial owners and links to politicians

The failed or incomplete transition to a well-functioning market economy is connected in all countries discussed here with dubious privatizations or business deals which benefited the local and/or Russian elites. Some of them even reversed privatizations when the purchasers turned out to be unable or unwilling to play the old local game. Russian interests benefited either directly or indirectly. Belarus' refineries operate closely interlinked vertically with Russian companies. Ukraine privatized directly energy distribution assets with Russian or Russian-connected oligarchs. Moldova sold its gas network to Gazprom while its energy regulator ANRE authorizes the operation of dubious offshore energy suppliers such as Energokapital, a company linked to Russian interests in Transnistria, despite it being de facto bankrupt and thus not eligible for the supply license.

Hungary entered joint ventures with Russian companies and, at the same time, nationalized previously privatized energy operators, all covered by a barrage of anti-Western discourse. Romania privatized industries in the late '90s with local oligarchs on a similar non-transparent, non-competitive, preferential model, though here the beneficiaries were not directly linked to Russian interests: the Romanian public is by reflex hostile to visible Russian connections. However, such privatizations indirectly benefited Gazprom, as they ensured particularly good prices to Gazprom for the Russian gas through a defective regulatory regime and blocked Romania's gas exports, which would have competed with Gazprom in the region.

All these deals are today incompatible with the Western norms. Privatizations imposed by the EU or IFIs had to be competitive and to ensure that market distortions are eliminated. The best example is Romania's competitive, good practice privatization of Petrom, the national oil company, in 2004, which was a de facto condition for EU accession. Energy regulators must be independent and strong, as per EU's directives, and should not be subject to pressure from politicians on prices, tariffs or licensing. Corporate governance of companies, both state owned and private, are a key concern for both the US and the EU. Full implementation of corporate governance at Western (e.g. OECD) standards would not allow the siphoning-off of money from energy deals of state owned companies in the countries analyzed to local or Russian oligarchs.

4. Attempts to create no-man's-land zones (breakaway territories), outside the control of the national governments, to provide leverage for Kremlin in influencing the policies and politics of the countries concerned.

These are the obvious and similar cases of Transnistria (older and almost forgotten in the West) and Crimea and Eastern Ukraine (fresher and more visible), with a further identical case in Georgia and a similar one - in Azerbaijan. In such cases, energy plays a key role. A large share of Ukraine's coal reserves, supplying half of the country's fossil-fired power capacity, is located in the pro-Russian, separatist territories. This affects the availability of electricity both in Ukraine and Moldova, which starting this year will import Ukrainian energy. Moldova's supply of energy (gas and electricity) is controlled by Russia through separatist Transnistria. Major gas pipelines from Russia cross Transnistria, which allows Gazprom to maintain strategic uncertainty about the split of the debts for gas supplies between Transnistria and the right bank (Moldova proper). Russian-controlled Cuciurgan power plant ensured before April 2017, when the new contract with the Ukrainians was concluded, about 80% of Moldova's electricity production; it may function in the future as a backup if Ukrainian suppliers (DTEK), which mainly operates coal-fired TPPs, cannot meet their contractual obligation.

The occupation of Crimea also affects Ukraine's extraction of offshore gas from the Black Sea and, possibly, Romania's as well. In the case of Ukraine, the consortium of Western investors in the Black Sea Skifska field fell apart after the invasion of Crimea. The armed conflict in the country's East prevented shale gas production to start and made Shell and Chevron to leave Ukraine. In Romania, while investors are not very concerned for the moment of a potential Russian intervention, the gas deposits are in the exclusive economic zone, but not in the territorial waters of Romania. Their exploitation could become problematic if the Russian navy starts to perform maneuvers in the area.

5. Attempts to further extend monopolies, perpetuating the path dependencies of existing infrastructure

In Ukraine and Hungary, the strategy of Rosatom (and its subsidiaries), the Russian nuclear company, was to lure national governments into becoming fully dependent on its own nuclear fuel or on Russian technology for the nuclear units. The pro-Russian governments in Kyiv considered entering a joint venture between Energoatom and Rosatom for nuclear fuel and a merger of the nuclear assets of the two companies. In both Ukraine and Hungary, the governments planned for the implementation of mega-projects for nuclear units, under non-transparent contracts, with Russian loans financing the operations and Russian state guarantees for the projects.

In both cases, the procurement for the project was non-competitive. The US Westinghouse would have been a better alternative, as it provides the same fuel and has a similar technology, but it was non-transparently sidelined in both Ukrainian and Hungarian tenders. In what concerns the allegedly favourable financing conditions to build nuclear units, the Ukrainian project (expanding the Khmelnytsky nuclear power plant), discussed in 2010, was abandoned when Russia raised the interest rate and following the aggression; in Hungary, the loan is also not cheap compared to market alternatives.

Apart from the huge costs of such nuclear units (Paks-2 costs 7-10% of Hungary's yearly GDP), the main risks would be the cost escalation during project construction, which happens frequently in similar projects, and the enhanced dependence on nuclear fuel from Russia. As in the case of Gazprom, Rosatom and its subsidiaries favour long-term contracts, foreclosing the market. We see here the same pattern as in Bulgaria's non-transparent, non-competitive contract with Rosatom for the construction of Belene nuclear power plant: similar financing arrangements, at similarly high values and similar cost escalation risks. Bulgaria had to pay over 600 million EUR in compensations following an international settlement, after it pulled the plug on the unfeasible Belene project in 2012.

It must be noted that all three nuclear projects mentioned violate the European public procurement principles, the transparency rules and raised potential state aid issues. Hungary and Bulgaria, EU member states, even had to amend their own legislation (previously in line with EU's) to allow exceptions for these large projects.

6. Divide et impera, Russian (old) style

In their efforts to maintain a monopoly position in the gas markets, gas transit or nuclear energy, Russian companies have used their connections with local politicians to influence key decisions in the countries analyzed. In politics, Hungary has explicitly adopted the Russian strongman model and the "illiberal democracy", while actively fighting inside the EU bodies against the sanctions imposed to Russia. While the deterioration of rule of law and democratic standards come from within, Russia indirectly benefited. In exchange for its support on sanctions and policies, the Hungarian government was rewarded with potentially lucrative deals in energy, such as more favourable prices for gas and Russian investments in the mega-project in the nuclear units of Paks-2, though these deals in fact reinforce the country's dependence on Russia's energy supplies in the future.

Other countries in the region (Moldova, Ukraine, and Belarus) have played double games between the EU and Russia, trying to appease both and gain something from cooperation with each of them. Belarus is an interesting case, as it wanted, and partially succeeded in both diversifying its economy to the West and obtaining Russia's free energy. It has carefully negotiated with EU limited improvements on political liberty and human rights. When confronted with "disobedient" governments, and if foresees weak to no consequences, as in the case of Ukraine, Kremlin responded with a mix of punitive measures (threats with interruptions of supply, prohibitive price increases, diversion of gas routes by providing incentives for other countries to join pipeline projects like North Stream and South / Turkish Stream) and outright attacks of the country's territorial integrity. The latter also has a very strong energy security component, for both Ukraine and Moldova, disrupting electricity supplies.

The West could help. Gazprom has been under investigation by the EU Commission (DG Competition) for abuse of monopoly and dominant positions in countries in the region, for its practices of market foreclosure through interdiction to re-export gas and long-term, rigid price contracts; for market segmentation, including through intergovernmental agreements; and for non-competitive pricing. While the deal reached by the EU recently with Gazprom sounds reasonable enough, the main challenge for the Commission is to ensure effective implementation and prompt penalization for breaches of trust. Intelligent political and economic conditionality, combining rewards and sanctions, are essential to cleaning up the corruption and poor governance in the region. However, these conditionalities must be credible and properly enforced, which is not easy: Gazprom may relent when confronted by a determined EU Commission, but it is expert at attrition games and playing for time, knowing that in a large, democratic and pluralist body like the European Union focus and determination are hard to sustain when crises and political emergencies move the public attention elsewhere. Consistency and real commitment are essential and EU risks of undermining its own policy, leverage and influence if it doesn't act coherently. Thus, EU's soft approach to projects like Nord Stream 2 and OPAL, which de facto allows Gazprom's preferential access to EU's energy market, weakens the credibility of the deal with Gazprom following DG Comp's investigation. It is also self-defeating if, on one hand, the West (EU, IMF) provide budgetary support and conditioned financing to Ukraine's budget; while authorizing at the same time Nord Stream 2 and OPAL, which translates into a loss of 2.5 bn USD in transit revenues for Ukraine (3% of the country's GDP or some 10% of the total budget). This simply dwarfs the foreign aid, not to mention undermining mutual trust and cooperation between Kyiv and Brussels, contrary to the terms of Association Agreement. Last, but not least, the fact that EU allows serious breaches of rule of

law, democracy and separation of powers, as in the case of Hungary, without finding credible sanctions, it will have very little credibility in its conditionality to non-member states.

In fact, all countries and governments in the East are skilled at paying lip service to EU and IFI conditions, while maintaining the status quo. If “the West” is perceived as a weak actor easy to fool, the double-game will proliferate: from Belarus’ very limited compliance with requests to liberalize the regime; to Moldova’s “pro-European” government which continues the same old deals and skillfully works around EC’s conditionality for energy market reforms; from Romania’s soft non-compliance for years on gas market opening; to Hungary’s outright bully position in its dealings with EC; and, last but not least, the vacillating Ukrainian governments, now promoting energy diversification, but delaying the judicial reforms that would allow, for example, investigations into blatant cases of corruption in the energy sector under both previous governments and current senior officials.

7. Opportunistic behavior

It would be wrong to assume that all the problems in the region are caused by Russia’s direct interference. However, the more corrupt a country becomes and adverse to Western values, the more the Kremlin can benefit indirectly. The Romanian story indicates that a country can mismanage its energy resources without any foreign intervention, with the Russian interests free riding on the local corruption networks and poor policies. The preferential deals for local gas consumers led to Romania not opening the gas market for exports, which would have meant competition in the region for Gazprom. Local networks can skim a country together with Russian oligarchs, as noticed in the Ukrainian energy assets privatized with Russians and in the special deals with large energy consumers, e.g., fertilizer plants.

The energy deals in Transnistria – such as, but not limited to, the electricity contract through the intermediary offshore Energokapital – benefited in the end the Russian, Moldovan and Transnistrian networks working jointly to siphon off public resources (it is possible that before 2014 some Ukrainians were also involved, if we judge from the non-transparent and non-competitive sharing of Moldova’s energy imports between Transnistria and Ukraine). Energy privatizations in Ukraine with Russian-connected oligarchs required the active participation of decision-makers in Kyiv. The corruption accusations surrounding the renationalization of critical energy companies in Hungary and offshoring of Hungarian energy undertakings are closely linked to both Hungarian politicians and Russian interests.

Finally, a few words about the broader political and social context of the energy policy reforms needed to address points 1-7 above. It is not something new or specific to Central-Eastern Europe that poor governance is concealed behind public displays of nationalist, “we-are-no-colony” or “unique way” discourse: against the implementation of reforms, such as the commercialization of the sector; against price liberalization, market opening, privatization for investments and the import of know-how, implied by the convergence to EU standards. As much is clear from the country chapters included in this report, but this is not unique to the region.

What is really curious in our parts, however, is that this new wave of anti-colonialism and rediscovered national pride is strikingly uni-directional: anti-Western, and almost never anti-Eastern, so to speak, even though the recent history of the region would testify otherwise⁴. In a way, this is another proof of rapid Westernization in terms of politics, ideas and cultural influences, which is beyond doubt. Together with the institutions and the *acquis communautaire*, the elites in Eastern Europe have also imported wholesale from the West the anti-globalization – and even the openly anti-Western discourse – with its prestigious intellectual and academic halo, and they have begun to practice it with great gusto. After all, this rhetoric, with its appealing clichés, dovetails nicely with the lingering strands of populism and

⁴ Maybe Ukraine would be an exception, for obvious reasons, but even here the situation is complex and deserves a longer discussion for which there is no space in this report.

national romanticism on which the young states of Eastern Europe were created not so long ago. It offers emotionally pleasant conspiratorial explanations for why local elites and businesses find it hard to compete on the wider, European liberal market, with products or ideas⁵. Here the meeting of minds with Russian opinion leaders is fast and natural, because they too think and speak in the same terms.

Cleaning up of corruption the energy sector in the region also requires effective judicial prosecution and the full implementation of the rule of law, apart from preventive measures such as transparency, competitive procurement, free competition. Again, countries in the region are often not institutionally strong enough, in terms of well-functioning prosecutors' offices and courts, regulators, anticorruption bodies, public sector auditors, to perform such tasks effectively. It is essential that EU and US help with the implementation of critical reforms in the judiciary in these countries, particularly if we look at the "kleptocracy" element of Kremlin's influence in the region. Moreover, direct application of the respective "cross-border" anti-money-laundering and anti-corruption legislation, like the United States' Foreign Corrupt Practices Act, towards Ukrainian and Russian corrupt officials or executives may be possible as exemplified by the recent action against Ukrainian energy oligarch Dmytro Firtash, arrested in Vienna. As much as American national legislation is invoked in this case, such assistance is well in line with the US national interests and possibly national security issues.

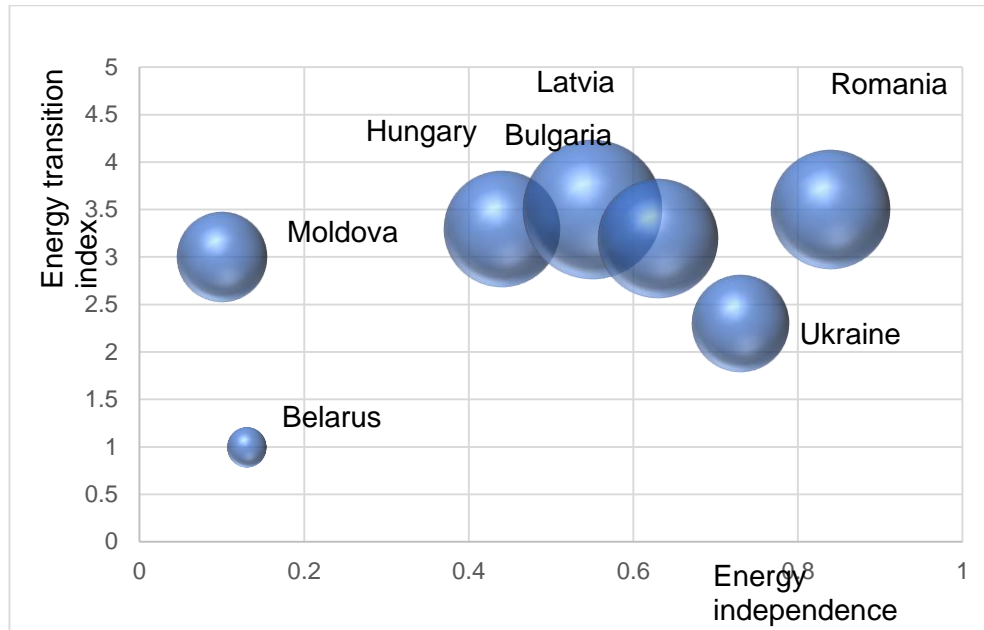
At the same time, international community should be aware that the more reforms advance and the more effective the anti-corruption becomes, the louder the populist voices will be with twisted versions of the big story of national persecution: the judiciary is the instrument of foreigners (so part of the hated, unelected and undemocratic "elite") set of finishing off "us" (local businesspeople) in order to deliver the country and its resources to "them" (multinationals, the EU bureaucracy, etc.). Needless to say, Kremlin can only be pleased when such developments occur.

This is why it is important that in the region "Western values" be internalized by the public at large, better and more transparent policies be promoted, so that the causes and effects of measures are clearly related and explained, as a basis for true accountability for government actions. Policy reforms, whether in energy, judiciary or other sectors, must be reinforced with a serious support for the few remaining public platforms where such issues of common interest can be debated rationally. Without this, they will continue to have weak local ownership and be perceived as a pet project of "the elite".

To paraphrase a fundamental principle from another profession, energy reforms must not only be made to work, but must also be seen by the citizens that they work.

⁵ *Populism 2.0, EFOR, ibid.*

Figure: Democratic governance (bubble size), energy independence and energy transition index



Note: Democratic governance is based on the composite index of governance in Freedom House's Nations in Transit 2017 and is measured as difference between 7 (minimum score, scale 1-7 where 7 is the worst) and the score of the country. Energy transition index is from EBRD's Transition report 2016-2017, average for natural resources and electricity. Energy independence is based on share of domestic production and total energy balance from the International Energy Agency, latest data (for 2014). This includes not only gas, but total energy balance, taking into account electricity, primary fuels e.g. for nuclear etc. It must be noted that energy independence scores will have probably improved since 2014 – mostly because of EU's energy security strategy, which already accelerated gas interconnections in the region.

BELARUS. *Anesthesia a la Russe*. How Belarus Became a Rentier-State and What Are the Paths

Alexei Pikulik

Introduction

Within a very diverse group of post-Soviet states, Belarus has been a truly unique case of political and economic transformation. This chapter shows how Belarus leadership's ability to establish asymmetrical contractual relations with Russia and by this to continuously turn economic dependency into windfall profits, affected the country's pathway after gaining independence in 1991. I go as far as to argue that Belarus should be treated as 'rentier-state' that has been extracting rents externally (from Moscow) and redistributed them internally to support a certain form of inclusive social contract. In other words, the rents served as anesthesia covering the insolvency of Belarus' unreformed economic sectors and were used to maintain strong state capacities, buy loyalty of large social groups and maintain strong repressive state apparatus. Yet, the ambitions of this chapter are rather modest: I put the main stress on the issue of asymmetrical relations with Russia in the energy sector, focusing on oil, gas and electricity where significant rents were extracted. Thus, I purportedly devote less attention to other instances of Belarus' external rent-seeking: e.g. administratively stimulated demand for Belarusian goods on the Russian market, smuggling of goods and re-exports and at large, Belarusian engagement into various integration processes with Russia (Union State) and other partners (Customs Union, Eurasian Economic Union).

Unlike the countries of Central and Eastern Europe that engaged in the establishment of the democratic polities and market-making, using the gravitational force of the EU as a boost and *acquis communautaire* as a concrete roadmap, Belarus like other post-Soviet republics (with the exception of the Baltic trio) was outside of EU's strong leverage and linkage perimeter. Like other post-communist states, after the collapse of the USSR, Belarus started with a hybrid political regime - best characterized as pluralism by default (Way and Levitsky, 2001) but unlike many others, soon established an autocratic political regime that got consolidated in 1996, after the second National Referendum. Yet, the market-reforms that started across all the cases as the response to Gaidar's decision to liberalize the prices on January 2, 1992, were aborted in 1995 by Lukashenka, and the country experienced a unique dual co-decomposition of both political and economic domains. Thus, unlike Russia, Ukraine, Georgia, Moldova, Armenia, Kazakhstan, and Kyrgyzstan that arrived at a combination of hybrid or autocratic political regimes with the distorted market-economies⁶, Belarus stabilized in a combination of consolidated political autocracy with the socialist-mixed economy. Whereas by the former I imply a political regime in which the catalogue of political and civic rights is neither extended, nor effective, and the liberal state with the rule of law is missing⁷. The latter-socialist mixed economy – refers to a stable hybrid of economic institutions and is not a transitional stage on the road to capitalism (Szelenyi and Kostello, 1996). The empirical siblings of these economic regime-types were often labelled 'market socialism' and were widely discussed in the literature of the mid 80s (Sik, 1985; Sik and Sling, 1975). The main characteristic of such a regime type is the partial extension of economic rights and the existence of some private sector while the state retains an upper hand in the allocation of resources and the steering of economic activity. In

⁶ I use 'distorted market economy' to characterize the economic regime, in which the property rights are extended de jure, but are not fully honoured de facto, either by a state, or by other economic groups using and abusing their access to power, size and market-power to shape the rules of the game for themselves, e.g. oligarchy, cronyism, state predation.

⁷ This definition is a combination of Dahl's (1968) and O'Donnell's (1991) definitions of democracy/polyarchy.

other words, economic rights are only partially extended de jure, while de facto, they are not fully effective since the state safeguards the public sector and encroaches upon the rights of the private actors, forcing the latter out of certain areas of economic activity. Its main characteristic is the asymmetrical/selective supply of property rights, yet in this particular form of interaction, property rights are distributed unevenly towards the public sector, at the cost of the private sector.

In practical terms, it means that in Belarus the state sector produces around 70% of the GDP, and employs more than 50% of the labor force, while keeping unemployment rate under 1.8%. Furthermore, the state heavily subsidized certain services for the population: up to 60% of utility and communal bills, and provided with free education and healthcare borrowing the social protection system from the USSR. Whereas in the mid-2000s the economy of Belarus was growing around 9% per year on average, high average salaries (e.g. 500 USD in 2010) were provided by the state, the ratings of Lukashenka remained stably high. That allowed some researchers (e.g. BISS, 2009) to speak about the 'social contract' which explains the foundations of the Belarusian regime through rational choice and not coercion: the society tolerates repressed political and civil-rights in exchange for the economic and social benefits that are generously provided by the state. Between 1992 and 2014, the distribution of the abundant rents were the glue that kept the equilibrium stable, after rents started to diminish in the aftermath of Russia's economic crisis, the government had to lower down the side-payments to the society, but replaced them with the discourse of independence, sovereignty and stability. Especially in the light of the conflict in Ukraine, this substitution for rents was appreciated by the society.

Having briefly described the outcomes of Belarusian transformation, it is time to approach the core question: what allowed Belarus to stay afloat during all those years and support its insolvent and outdated economic structure. For that, let us remember a quote from Leszek Balcerowicz: 'socialism is a great thing, as long as there is someone to pay for it'.

The following chapter is structured in the following way. I start with a) brief outline of the rentier-state theory that I am heavily using here, I continue with b) explaining Belarus' economic legacies that and pay specific attention to the economic structure it inherited from the USSR, c) I explain Lukashenka's policies of balancing and earning external rents with both internal and external political strategies and then I move on and explore d) how the rents were created in the energy sector. Having done this, I provide with some policy-recommendations for both Brussels and Washington DC.

Rentier-state theory

The theory of rents was built on several layers. First of all, there was the influential piece by Mahdavi (1970) in which he set forth a new concept of a rentier state - a state that receives substantial rents from foreign individuals, concerns or governments, thus allowing it to live from the externally generated rents rather than from the surplus production of the population (Karl, 2005). Following Adam Smith (1937), rents are the profits —reaped by those who did not sow.

The second was the popular petrostate variation of the theory which brought the Dutch Disease economic effect, present in the oil-exporting countries, into politics, leading to the —oil hinders democracy (Ross, 2001) assumption. A group of scholars (Beblawi and Luciani, 1987; Karl, 2005, 2007; Luong, 2006; Luong and Weinthal, 2001; Morrison, 2005, 2009; Ross, 2001; Ross, 1999, 2004; Stiglitz, 2007; Wantchekon, 2004) suggested that the commodity-structure of the economy has a determining impact on both political and economic developments. Autocratic regimes and distorted economies with an uneven distribution of property rights are the usual outcomes in those resource-abundant economies which generate rents from raw-commodity exports (usually oil). Rents are believed to hinder democracy through the following

mechanisms: (i) uneven concentration of power, i.e. those controlling rent extraction and distribution can afford costly coercive and co-optive tools (Fish, 2005); (ii) economic statism (Luong and Weinthal, 2001), (Karl, 2007), weak institutionalization and corruption and (iii) the missing accountability, i.e. since the economic development is not provided by the surplus of the society, the state can spend without taxing and in turn the citizens do not demand from the representation when they are not taxed (Beblawi and Luciani, 1987).

The third was the assumption that the effects of the oil revenues may not be unique but similar to other externally generated revenues, e.g. foreign aid, since the chief mechanism linking unearned revenues with the regime-types is the 'no representation without taxation' argument of fiscal sociology (Bräutigam, 2000; Moore, 1998; Smith, 2008).

Finally, there were those (Acemoglu and Robinson, 2006; Boix, 2001; Morrison, 2009) who held that the non-taxed revenues to the government (including foreign aid, borrowing from abroad, profits of the state-owned companies, etc.) have properties of regime-stabilization: since the state is capable of spending without taxing its citizens, it can pursue whatever interests unconstrained, and secure the regime survival by means of redistribution of those rents in a polity. Since the most common non-taxed profits come from oil, this argument also encompasses the issue of rents through revenue mechanisms.

The theory of rents, as I argue here, is relevant to the post-Soviet space. Since the economic disintegration the CMEA zone economies was lagging behind political disintegration and Russia continuously served as a donor for various post-Soviet Republics, e.g. emitting the currency for the non-reformed economies of the neighboring countries and thus bearing the inflationary burden for them, supplying them with credits at negative interest rates, fueling them with subsidies and, most importantly, providing them with energy resources at prices set significantly below the market-prices. Certain post-Soviet countries (both state and non-state actors) could establish beneficial linkages to Russia to their own advantage and at the expense of Russia. Consequently, the interstate rent-seeking opened up the ability of various state and non-state actors in the post-Soviet Republics to convert the external public losses into internal private benefits. Herein, Russian leverage and linkage could mutate the donor-receiver relations. The origins of those rents were multiple: arbitrage opportunities contained in the interstate trade and customs agreements; administratively stimulated demand for exports; foreign aid; negative-interest credits; price imbalances; smuggling; barter agreements; and most importantly, discounts on energy imports.

The following units of this chapter show how Belarus became a rentier-state using its energy dependency. I build upon the seminal work of Balmaceda (2006) who used the term 'rents of energy dependency' referring to Belarus and Ukraine and an earlier piece (Pikulik, 2010) explaining the divergent pathways of Russia, Ukraine and Belarus through the work of the external rent-flows.

Soviet legacies in Belarus

To understand the post-Soviet dynamics of Belarus we need to start with analyzing its Soviet inheritance, as these were the structures that largely shaped the leadership's behavior, by providing them a set of constraints and opportunities.

Many scholars have emphasized the importance of the economic structure in determining the success of the market reforms (Norgaard (2000), Trantidis (2006), Shevtsov (2004), Ioffe (2003), Koktish (2000). Belarus was seen as one of the mostly distorted Soviet republic's economy and here scholars linked the sky-high level of the inherited economic distortions in Belarus (the presence of the very large Soviet enterprises) with the subsequent reversal of political and economic reforms. The nature of the Belarusian economy, one of the most industrialized economies in the world in the beginning of the '90s (IMF, 1993), embedded its critical dependency on Russia for energy imports and the final product exports (mainly

machinery) which would have made the termination of the intra-enterprise and trade ties overwhelmingly expensive, thus foreclosing the neo-liberal reform scenarios. Also, the economic distortions were reflected in the political representation, resulting in a mighty lobby of the red-directors in the Supreme Soviet in the beginning of the 90s.

Belarus underwent extensive modernization, industrialization and urbanization during the second-half of the 20th century (the urban population increased from 6% in 1920 to 66,5% in 1989 (Marples, 1998). A predominantly rural country until the Second World War, Soviet Belarus thereafter evolved into a Republic with a diversified economy and a developed industrial base. The general role of BSSR in the Soviet economic structure was one of an 'assembly plant', while the Soviet and generally the Russian heartland played the role of a raw material base. Home for 3.5% of all-Union population, BSSR produced 4.2 % of its GDP, the largest per capita rate among all of the Soviet Republics. Such a system presumed high economic distortions that favoured the production of finished goods over the extraction of raw materials, yet the resources needed to be continually supplied from Russia. BSSR had a positive balance in the all-Republic trade system, and could easily be called a net winner of the Soviet economic systems. On the other hand, due to its profile as a massive military-industrial complex, over 70% of BSSR enterprises were controlled directly from Moscow central-based ministries and bodies. BSSR was largely dependent on the import of the raw-materials from the other republics, namely Russia. Highly integrated into the economy of the Soviet Union, Belarus typically exported 50% of its GDP (notably agricultural machinery and products, military equipment, spare parts, heavy transportation, and chemicals) to other Soviet republics while it imported more than 40% of its GDP from them. The composition of these imports was evidence of its dependence. In particular, Belarus relied, for over 90% of its raw materials and production input requirements, on supplies from other parts of the Soviet Union.

In summary, as a shop-window of socialism, the BSSR could boast the highest GDP per capita and one of the highest levels of socio-economic development in the USSR (the highest HDI among FSU before 1986). The profile of the Belarusian economy led to the immigration of a highly skilled labor force into Belarus. One more aspect should be noted here in relation to the quality of the sectoral economic distortions on the Belarusian economy. 'If there is a rifle on the wall during the first act of the play, during the second it will surely fire' is a famous dramaturgical quote from Stanislavsky. The rifle that would fire, 20 years later, was mounted on the wall of Belarus in the form of modern-oil refineries built in BSSR in the late 70s as a part of the Soviet defense doctrine (supplying Soviet tanks with fuel at its Western borders).

Thus, Belarus was equipped with modern oil refineries with the capacity to refine up to 25 mln tons of oil per year. The first, the Mazyr Refinery was made into a share-holding company in 1993 by the Kebich government, and Russian oil companies had important interests there. In 1994, the Slavneft Joint Company was established as a Russian-Belarusian joint venture. The major stakes were held by the Slavneft Oil Company (based in Russia), with 42 percent of ownership; the Belarusian government, with 42 percent; workers and managers with 8 percent, and private investors with 8 percent.

The second is the Naftan refinery in Navapolatsk which has become one of the most attractive assets in the economy of Belarus. First, because of its location (closer to Western markets than Russian refineries); second, two pipelines, the Surgut-Polatsk and Samara-Ventspils, meet there and third, the Samara-Polatsk oil products pipeline also passes there. It produced booming profits especially during the Chechen War in 1997, its output helping to compensate for the loss of the Grozny oil refinery.

To summarize, Belarus is an energy dependent country with one of the most energy-intensive industries and scoring highest of all the post-Soviet countries in terms of economic distortions (Norgaard, 2001). Their overall refining capacity is around 25 million tons per year, whereas the internal need of Belarus for petrochemical products is around 5 mln tons. This would later allow Belarus to export the remaining 20 mln tons of oil mainly to the EU, making

a huge margin between the incoming internal prices for Russian crudes and the market price given by the major traders in the EU.

Gas has been the second important market: getting gas for internal prices, with the high intensity of energy in the production of Belarusian goods, it allowed the national industry to be highly competitive in terms of prices. Gas totaled around 80% in Belarus' energy balance. The Belarusian economy scored second in 1991 in terms of energy dependency, and only slightly diminished its dependency on gas in electricity, production and in the mineral business.

Rents as anesthesia for the insolvent economic sectors. Lukashenka's survival strategy

Lukashenka, elected in 1994 as president in Belarus, significantly built upon both his predecessor's Kebich strategy of negotiating loans, writing-off of the country's debts for gas with Russia and extracting rents from Russia. In the '80s, Moscow was paying for loyalty several of its satellites by providing them with free supplies of oil, gas and petrochemicals in order to keep them stable. Thus, around 60% of the total USSR's exports oil to Europe was done in the form of energy grants, and only 40% was sold on the market-prices.

The first and foremost source of free rents was the agreement on a Monetary Union with Russia. In 1991, the country signed the Economic Union treaty with Russia, and made no step to introduce its national currency, a step that would have led to the cutting off of supplies of cheap energy from Russia. The Central Bank of Russia had the monopoly of printing money but allowed the central (national banks) of the Republics to issue credits to the state-owned enterprises or to cover budget deficits (via 'wire rubles') (Silitski, 2000). In this way, in fact it was Russia that paid for the budget-deficits in the CIS countries, by printing money for them. As a result, Belarus received 12% of its GDP in 1992 and 15% of its GDP in 1993 in this form. It should be noted that the wire-ruble issued in Belarus had the same value as in the other Republics, and that governments could issue unlimited quantities of money due to the effects of varied inflation rates in different countries. Paradoxically, these subsidies were paid to Belarus from the IMF stabilization debt that Russia received in 1992.

The second source of rents came from written-off debts: in 1991, 1992 and 1993, Kebich borrowed a total of 3.6 billion USD from Russia (according to the EIU report, 1995) which were used to cover the inefficient bill of the Belarusian economy (20% of the budget). This debt would be completely written-off by Yeltsin as a sign of further political integration between the two countries.

The third source of rents between 1991 and 1993 were the barter agreements: exchanging overpriced non-oil/gas commodities with the underpriced oil/gas. Some of the oil was refined and sold to Poland and in exchange the commodities produced by the Belarusian enterprises were bought in Russia⁸.

Lukashenka reversed the economic reforms already in 1995 fearing the potential chaos and the 'valley of tears' period. He successfully managed to replace them by the windfall profits that

⁸The fourth source of rents emerged from the decision of the authorities of Belarus to declare its nuclear-free status and to return the nuclear warheads, stationed in the territory of Belarus, back to Russia. This decision was literally sold to the West — in 1992 Belarus received technical credits from Austria (500 million dollars) and the USA (50 million dollars) which were used to bail out the insolvent SOEs. Soviet Belarus was home to one of the largest concentrations of conventional forces on the continent of Europe. Both tactical nuclear weapons and 72 long-range SS-25 strategic missiles were deployed there. The Belarusian declaration of sovereignty in July 1990 registered the republic's intention to get rid of nuclear weapons. In the wake of the formation of the CIS, all tactical nuclear weapons were withdrawn to Russia. In February 1993, the Belarus parliament voted to sign the Strategic Arms Reduction Treaty (START-1) and the Nuclear Non-Proliferation Treaty (NPT). In the latter part of 1993, Belarus proceeded to dismantle and hand back to Russia a large part of its military arsenal as provided for by the Conventional Forces in Europe (CFE) Treaty. In March 1996, Belarus destroyed the last combat aircraft under CFE provisions. The last nuclear missile was removed to Russia in November 1996.

the country extracted externally through three major rent flows: (i) multilateral and bilateral integration projects (e.g. common Customs Union with Russia; Monetary Union; etc.); (ii) discounts on energy resources imported from Russia (including the tariffs on the transition of Russia's gas to Europe and the export of oil to the EU); and (iii) administratively secured demand for finished Belarusian goods on Russia's market (including trade preferences, barter deals and simply smuggling).

The ever-closer relationship between Russia and Belarus was cemented on April 2nd 1996 with the signing of the Union Treaty which created the Community of Sovereign Republics (CSR). The treaty called for the co-ordination of foreign and military policy including border policing, the unification of tax and investment legislation and of transport and energy systems, common tariffs, pensions and other benefits, a joint credit, fiscal and monetary system and a common currency. On May 23rd 1997 the two countries signed a Union Charter which included commitments to coordinate economic and foreign affairs and defense. So far, the greatest progress has been achieved in relation to administrative matters and the least on economic unification.

In March 1996, Lukashenka managed to negotiate a write-off on Belarus' 1.3 billion USD debt to Russia (9% of the country's GDP) officially in return for allowing Russian military installation to remain in the country. In March 1997, the Union of Russia and Belarus (a rather amorphous association of two separately governed countries) was created. Belarus gained unlimited access to Russian markets and the ability to purchase gas at the price offered to domestic consumers. Yet, in Belarus the government was re-selling gas and oil with 25% interest.

The difference was accumulated in the President's Fund (it should not even be called the 'black budget' since it was perfectly legal according to the new constitution). During 1996-1998, as the local-based think-tank (IPM) economists claimed, the size of the Presidential fund exceeded the state budget. This money was to be used for the financing of various social projects.

The customs union agreement was signed on January 6th 1995, with much optimism. The document called for a two-stage process of implementation. During the first phase, internal customs were to be eliminated and the trade regimes of the two countries unified. In the second, the common customs and border guard authorities were to be established and the customs legislation of both countries unified. After the symbolic removal of the border post by Lukashenka and the Russian Prime-Minister Chernomyrdin, little progress followed. Until 2004, Belarus and Russia maintained different tariff levels on 139 out of 288 items of exported goods.

Custom tariffs were not harmonized between Russia and Belarus. Thus, while Belarusian goods pay no duties in Russia, Russian goods in Belarus transiting through Belarus on their way to the West pay full duties. Moreover, from 1996 until 2001, Belarus was collecting an overwhelming share of import duties on all goods moving from the West to Russia, crossing Belarusian territory (in 1998 alone, customs duties paid at the Belarusian border on foreign automobiles shipped to Russia totaled 600 million USD).

Belarus used the customs union to generate rents at Russia's expense. From 1995 up to 2007, Belarus did not pay Russia obligatory export duties on oil products made at Belarusian refineries from Russian oil. Belarus sold goods to Russia by way of barter at inflated prices that were even higher than world market prices. In 1996, for example, Russia purchased Belarusian sugar at a price of 513 USD per ton while, at the same time, buying sugar from other countries for just over 300 USD per ton (Zlotnikau, 2009).

Car re-export was the final deal. According to the Customs Union established in 1996, Russia insisted on the protection of its domestic car manufacturers from the large number of second-hand cars brought into Russia from Western Europe, particularly through Belarus. Yet, the legislature of Belarus allowed Russian dealers to import cars to Russia via Belarus, avoiding the payment of Russian tariffs. These contributed to the rentier state model greatly. According to

one 1997 calculation, for example, these inflows amounted to between 1.5 billion USD and 2 billion USD, or the equivalent of 9-12 percent of Belarus' GDP, 37 percent of the budget's revenue (Zlotnikau 2009).

Oil-based rents

From 2003 until 2007, Belarus could have been easily labelled a 'petrostate'. The oil refining capacity of Belarus is 11 million tons per year compared to Ukraine's 12 million tons per year. According to the EIU data (2004), between 1998 and 2001 the profits from oil export in Belarus rose 307-fold.

Of all the sources of income related to Russian energy, none proved more profitable to Belarus than the export of refined oil products to Western markets, especially between 2002 and 2006 (Balmaceda, 2009). Belarus imported crude oil from Russia at low prices and free or nearly free of any Russian export duties, refined it, and subsequently sold it to Europe. As a result, Belarus profited from the difference between the special low price it paid to import it. Also, barter was employed: the crude and the much higher market price it charged for refined products, and it received related export duties as well. Profits only increased even more with the rise in the price of oil products in Western European markets during this period (Balmaceda, 2009). Thus, in the mid-2000s, export duties on oil products provided about 10 percent of the total revenue for the Belarusian budget (Manenok, 2008).

Table 1. Oil-rents in Belarus

	Import (mln. tons)	Price per ton (for Belarus)	Price per ton (for Germany)	Price difference USD	Belarus GDP, bln.USD	Oil rent, % GDP
2001	11,91	115,80	174,80	59,00	12,35	5,68 %
2002	14,02	107,30	178,02	70,72	14,59	6,79 %
2003	14,89	133,20	203,97	70,77	17,82	5,90 %
2004	17,80	181,40	256,19	74,79	23,30	5,71 %
2005	19,35	218,00	373,85	155,85	32,40	9,30 %
2006	20,57	268,24	455,38	187,14	36,90	10,43 %
2007	20,04	361,06	516,71	155,65	45,20	6,90 %
2008	21,28	446,42	718,22	271,80	59,70	9,68 %
2009	21,48	328,00	455,08	139,45	46,40	6,44 %
2010	12,28	460,00	585,60	125,60	55,22	2,79 %
2011	18,14	459,00	822,27	363,27	55,13	11,95 %
2012	20,20	398,00	826,91	428,91	63,01	13,74 %

As we see from the table above, the average rents between 2001 and 2012 were around 7.95 of Belarus' GDP.

The two refineries produced an annual volume of 25 mln tons of petrochemicals out of which 4-5 were used for the internal purposes. Russian oil companies clearly had their interest in working in Belarus: firstly, during the Chechen war of 1997, Belarusian oil refineries substituted for those that were destroyed in Chechnya. Second, Russian oil companies (Lukoil,

Bashneft, Tatneft) used Belarus as a transit intermediary, as the export tariff for oil from Belarus was systemically lower than those from Russia.

In the late 2000s, during the period of the Customs Union's creation, the two countries agreed that Belarus would import Russian oil on a duty-free basis, but also undertook to transfer to the Russian budget the whole amount of export duties on "*crude oil and certain categories of products produced from oil ("oil products")*" exported from its territory to third-party countries. Export duties from the extraction of its own oil (estimated 1.7m tons a year) go to the Belarusian budget (Firsava, 2012). Yet, instead of exporting of the crudes and oil products, Belarus started to use the 'solvent scheme' (a slight alteration of oil products to evade the obligation of transferring export duties to Russia, limited to crude and specific oil products). Solvents were among most widely exported Belarusian products for a long time, in 2012 the growth rate of their export increased. The exports of solvents during January – April 2012 compared to January – April of last year made Belarus \$1.472m.

Table 2. Solvents

2012	Size of fee per ton	Exports of solvents, thousand tons	Underpaid export duties to Russia
January	262,3	386,1	101,274
February	259,8	487,2	126,574
March	271,4	518,8	140,802
April	304,4	499,3	151,986
May	296,6	519,5	154,083
June	277	459,4	127,253
July	243,7	372,3	90,729
Total			892,701

The solvent scheme ceased to exist in 2014 and sparked a conflict with Russia.

Gas rents

There were three ways in which Belarus was able to extract rents from Russia from the gas business. Firstly, it happened via acquiring generous discounts on gas from Russia, and thus diminishing the prices of the finished goods produced. Secondly, the government sold gas to the internal producers and the households with 20-25% interest added to the price. This free money flowed, according to some observers, into the Presidential budget. Thirdly, Belarus made extra rents on the fees that Russia had to pay for transiting the gas (25% of the total supply to Europe) and oil (36% of the total supply to Europe) through Belarusian territory. In consideration of just these factors, Belarus was making around 1 billion USD per year.

Let us try though to calculate the rents based on the imports of gas from Russia (and let us exclude the transit fees, which would clearly topple the final sum).

Table 3. Gas-based rents

Year	Gas imports, bln. m3	Price for thousand m3, for Belarus	Price for Germany per thousand m3	Price difference, USD bln3	Gas rent, USD	Belarus GDP, bln. USD	Gas rent, % GDP
1996	14,549	50,39	102,48	52,09	757,857,140	14,75	5,14 %
1997	16,446	30,00	96,13	66,13	1,087,573,980	14,12	7,08 %
1998	16,252	30,00	80,82	50,82	852,926,640	15,22	7,02 %
1999	16,856	30,00	65,05	35,05	592,802,800	12,13	4,00 %
2000	17,357	30,00	124,34	94,34	1,637,459,380	12,73	12,83 %
2001	17,333	30,00	139,43	109,43	1,896,750,190	12,35	15,36 %
2002	17,772	30,60	126,42	95,82	1,702,913,040	14,59	11,66 %
2003	18,11	36,90	125,50	88,60	1,604,546,000	17,82	9,00 %
2004	19,64	46,68	135,18	88,50	1,738,140,000	23,30	7,45 %
2005	20	46,68	212,94	166,26	3,325,200,000	32,40	10,26 %
2006	20,8	46,70	295,65	248,95	5,178,160,000	36,90	14,03 %
2007	20,6	100,00	293,13	193,13	3,978,478,000	45,20	8,80 %
2008	21,1	119,00	472,95	353,95	7,468,345,000	59,70	12,50 %
2009	17,8	150,00	341,03	191,03	3,400,334,000	46,40	7,32 %
2010	21,6	185,00	296,01	111,01	2,397,816,000	55,22	4,32 %
2011	20,6	280,00	381,48	101,48	2,090,448,000	55,13	3,79 %
2012	22,5	165,60	435,23	269,63	6,066,675,000	63,01	9,62 %

As we see from the **Table 3**, within 17 years between 1996 and 2012, gas-based rents totaled 8.83% of the GDP on average. Cheap gas was used both for reexports and for the making of Belarus' industry competitive pricewise, which together with the administratively stimulated demand for Belarusian goods on the Russian market gave Belarus a strong economic advantage.

Yet, the discussion of gas rents would have not been complete without the discussion of the ownership of Belarusian transit system. It was associated with various 'gas wars'.

The first gas dispute between Belarus and Russia happened in 1995-1996. For almost two years (1994 and 1995), the Belarusian government was unable to pay for the deliveries of gas to Gazprom, which resulted in the accumulation of a 1 billion USD debt. During that time, Russia did not force payment: Gazprom periodically demanded money and Minsk offered various programs which were intended to restructure the debt. First, Minsk offered to use Belarusian construction companies to build (with discount) residential houses in the Kaliningrad region (as well as the other regions in Russia) and create an infrastructure for those industry workers who worked in the Far North for over 10 years. Moreover, in 1994 the government of Kebich proposed that Russia buy Beltransgaz (and thus, restructure the debt). Both of the initiatives were interrupted, given that in 1994 Kebich lost his office.

In 1995, Lukashenko again voiced the offer to sell Beltransgaz to the Russians but made sure that the Parliamentary committee (which he controlled) postponed the decision on whether to allow foreign capital to enter the national pipeline system. Finally, in 1996 the debt was restructured via a 'zero sum option': Belarus cancelled its claims against Russia for the unpaid costs of the removal and maintenance of nuclear warheads, and approved the lease for military bases in Belarus. At the same time, Belarus and Russia agreed that the payments for gas would be in noncash form, i.e. via the goods produced in Belarus and intended for the Russian market.

During Putin's first presidency, Russia started to press Belarus for the gas payments and raised its concerns about the barter being conducted between the countries. The main source of tension was, however, not the energy debt as such, but the issue of Beltransgaz. According to the 1998 agreements (on the Union State), Belarusian pipelines had to be integrated into Russia's pipeline system. However, as was mentioned earlier, Lukashenka used all tools to avoid the selling of Beltransgaz.

In order to avoid further pressure, Lukashenka reduced the debt to Gazprom from 200 million in 2000 to 77 million USD in 2001 (given that 2001 was the election year) and the remaining 77 million USD debt was restructured to include various cash and non-cash payments over the following three years.

The growing tension between Russia and Ukraine in that period pushed Putin not to escalate the conflict with Lukashenka (Russia obviously could not afford to lose both of the gas transit countries at the same time).

The third gas war actually began in 2002. It was based on the struggle for Beltransgaz. Belarus, in 2002, received gas at domestic Russian prices, promising Russia the privatisation of Beltransgaz to Gazprom. However, it slowed down the process significantly. In April 2002, during the process of integration, Russia and Belarus signed two intergovernmental agreements, which laid down the basic principles of Russian-Belarusian cooperation in the gas sphere. Gazprom would deliver gas to Belarus at domestic wholesale prices (30.1 dollars per thousand cubic meters), and the Belarusian side was obliged to create a joint gas transportation enterprise based on Beltransgaz no later than July 1, 2003.

In 2003, the Belarusian side used all possible tools to delay the negotiations on the establishment of a joint gas transportation company. Belarus declared as excessive the price of 5 billion USD for Beltransgaz and suggested that Russia could only buy 49% of shares instead of the promised 50%+1 share.

In early 2004, negotiations on the acquisition of Gazprom shares in the Belarusian company reached an impasse, and Gazprom declared itself free from the obligations to supply Minsk with gas at the domestic prices and suggested that Lukashenka pay 50 USD for 1000 m³ instead.

After the latter refused, Gazprom suspended the supply of gas to Belarus for a few hours in February 2004. In early June 2004 in Minsk, the Gazprom's CEO Alexei Miller and Beltransgaz CEO Peter Petuh signed a commercial agreement on the conditions of the Russian group (46,68 dollars per thousand cubic meters). Pressing Belarus to sell Beltransgaz, Russian officials started to insist that Belarus buy gas from Gazprom at the price of 200 USD per thousand cubic meters. The company also hinted that the price could be reduced by half if Belarus were to agree to create a joint venture with Gazprom on the basis of that asset. Gazprom offered to pay 1.5 billion USD, however Lukashenka declared that the company was worth 17 billion USD. In response to this ridiculous offer, Gazprom threatened to turn off the supply to the Republic from January 1, 2007.

Finally, on December 31, 2006 Gazprom and Beltransgaz signed a contract for gas supply and transit for 2007-2011. The document established the price for Russian gas in 2007: 100 USD per 1000 m³ and the price formula to January 1, 2008 (corresponding to the formula price for Russian gas supply to Europe which depends primarily on the market conditions and market prices of a basket of petroleum products).

The same day, Gazprom and the Government of the Republic of Belarus signed a protocol under which Gazprom was to acquire a 49% stake in Beltransgaz for 2.5 billion dollars in equal installments over a period of four years.

In a way, Lukashenka successfully maneuvered with Russia in regards to gas-rents. For over 12 years, he managed to receive underpriced gas, promising to sell Beltransgaz to Russia in return. Furthermore, seeing that the termination of gas-supply to Belarus would affect Russia's credibility as the EU's supplier, he felt rather confident in his bargaining powers. When Beltransgaz was finally sold, some observers started to speculate that the total value that Russia paid for it (with all the tranches, credits and discounts) exceeded 12 bln USD, which was way higher than the market price of the venture.

What's next? Rentier state losing rents

In this article we started with the assumption that Belarus has been a rentier-state, and as latter chapters demonstrated between 1996 and 2012, just the gas rent and the oil rent in Belarus were close to 16% of the GDP. This figure does not calculate other forms of the external rent-seeking, such as smuggling, barter, writing off loans, etc.

After 2013, the situation has significantly worsened. The devaluation of Russia's currency, the conflict in Ukraine, and the Western sanctions affected the stability in the region to a great extent. Being unable to cover the inefficiency of the economy by Russian rents, Lukashenka started to employ different survival-techniques: redistribution policy was soon replaced by the discourse of the last stable country in the region that controls its borders and that is trying to play Switzerland when it comes to neutrality.

When it comes to the policy-recommendations to the West, both the EU and the DC should further revise its standing on Belarus.

Table 4: Western approach to Belarus

	Prevailing Western policy and the EU sanctions on Belarus	Prevailing strategy of providers of democracy assistance
1998- 1999	Isolation: sanctions against 131 top-officials)	Political approach
1999-2002	Engagement: no sanctions	
2002	Isolation: sanctions between against 8 top officials (visa ban) between Nov 2002 and April 2013	
2003-2004	Engagement: no sanctions	
2004-2008	Engagement: although sanctions are imposed against officials (between 6 and 41)	
2008-2011	Engagement: number of people under sanctions (visa bans) reduced from 41 to 5	Mixed: efforts to roundtables prevailed (yet, there the application of political strategy during 2010 elections)
2011-2015	Isolation with engagement towards the end of the period: sanctions against 243 persons (visa bans) and 29 companies as of 2011, reduced to 199 persons and 19 companies accordingly, freezing of the banking accounts and embargo on specific military-industrial products	Developmental approach
2015- 2016	Engagement: sanctions are frozen against 171 persons and 10 companies	
2016- now	Engagement: sanctions lifted against everybody but 4 persons excluding Lukashenka and his family. Embargo on arms remains.	

The West (especially the EU) used the two classical *modus operandi* in dealing with the official Minsk - a) a mode of engagement: positive conditionality (*a la* ‘more for more’) and building as much linkage and leverage as possible and b) mode of isolation: applying sanctions against the regime. The table above identifies three periods when isolation was prevailing as a strategy and six when engagement was rather on the agenda. When it comes to the difference between the EU and the USA in dealing with Belarus, the latter was much more constant: the Act on Democracy passed in 2004 paved the way to introducing sanctions against some Belarusian companies and some top-officials. The Western strategy towards the pro-democratic opposition was less constant given the uncertain movements of high politics and because of the multitude of actors involved in democratic assistance: various funds and

implementers organizations focused on different sectors and supported sometimes totally opposite things. Only since 2002, a Belarus International Implementers Meeting has been held every year in interested EU countries. Alongside Political Implementers and Media Implementers Meetings, this has given actors a venue to discuss how to further their goals, and, if some desire, to coordinate their work (Bouchet 2015).

Western strategies towards Belarus evolved in the past decade. It would be wrong to assume that the pendulum between isolation and engagement was swinging only as the result of the internal Belarus' political dynamics and on the level of official Minsk's compliance with the EU and the US expectations on the quality of liberal democracy and human rights. A level of intensity of political repressions against the opponents and an actual number of political leaders kept in jail (who were considered as 'political prisoners') mattered only to a degree. Much more important was the Western Realpolitik concerning country's position towards the emerging conflicts in the region. Thus, the two major latter shifts from isolation to engagement in Western policy towards Belarus were largely driven by Belarus' position of not recognizing Abkhazia and South Ossetia in 2008, and Belarus' position towards Crimea (in 2014) and its effort to take a role of the peacekeeper in the region in the light of the conflict between Russia and Ukraine in 2015. In other words, the official Minsk managed to skillfully sell its position to the West and together with certain in-degree changes within the regime (minor shifts a more liberal autocracy) it paved the way to the opening up for the new pages in the West-Belarus relations. For the latter, it played greater importance since Belarus needed to diversify its economic dependency from Russia and considered the West as the alternative source of money and aid. The fact that the EU has shifted its policy towards Belarus (at least twice) without forcing Minsk to fully comply with its requirements had two major effects. One, the official Minsk started to consider the EU a weak actor, which could be manipulated, which is capable of abandoning its principled position on human rights and democratic freedoms when regional security is at stake. Second, it changed the risk perception within the Belarusian opposition: totally depended on the West for survival, it had no further security that Western aid needed for the survival would continue.

Recommendations for Brussels and Washington

Overall, what could be the best strategy dealing with Belarus? Firstly, in the light of Ukraine's crisis, Belarus ability to maneuver between the West and Russia gains extra importance for the overall regional security. Here the West has to face a serious dilemma: Realpolitik or a normative approach. The first refers to accepting Lukashenka's new attempted role of a regional peacekeeper and paying less attention to manifestations of Belarus' autocratic tendencies in the light of the potential military and security threats. The second refers to the policy that prioritizes human rights issues over some rational calculations.

The main policy-recommendation that fits both Brussels and Washington DC is thus as follows: given the structure of Belarusian trade, regional security threats, a positive change in Belarus is likely to come about through country's internationalization, further linkage to the West and the creation of a form of a positive agenda. Belarus should be rather helped to overcome its resource dependency by developing an up-to-date economic structure and this is the key to long-term positive changes that will last.

UKRAINE. The Price of Independence: From Bribery to War

Denys Nazarenko
Roman Nitsovych
Anton Antonenko

The Winner Takes It All. How Russia silently took over Ukrainian energy assets

Gaining utmost benefit from the critically weak Ukrainian political leadership before 2014, Russia managed to acquire many of its most crucial energy assets. Officially, the sharing of ownership over such property between Ukraine and the Russian Federation remained a highly controversial issue during the first years after Soviet Union breakup. At the same time, the Ukrainian government often showed little concern that Russian capital constantly increased its level of concentration of control over the energy assets, directly or via Ukrainian oligarchs known for extensive business relations with Russia. Historically, most of the technological value chains, especially those in heavy industries and in the energy sector, have been, and until recently largely continued to cross the borders of the two (or more CIS) countries, thus prompting Russian business to seek to retain or obtain control over the Ukrainian infrastructure. This has guided Russian foreign economic policy directions for the upcoming years.

But more importantly, Ukraine's geographical position significantly shaped the design and character of the energy assets installed on its territory during Soviet times, which, in turn, shaped the main points of interest of the Kremlin leaders. Not surprisingly, this interest has principally crystallized around the gas transmission system (including extensive storage facilities critical for the uninterrupted supply to Europe) retained by Ukrainian Naftogaz, an asset vital for Gazprom and thus for Russia itself in numerous respects.

In the Soviet Union, oil and gas industries, as well as the energy sector overall, have always been a top priority. They have also been vertically centralized and subordinated to the respective ministries, while diversified across the Union's huge territories in an attempt to tie different regions into the process and value chains for deeper economic integration among the republics⁹. This is one of the most important factors for the continued dependence of CIS republics from the Russian Federation. But this is also why the Russian capital was additionally incentivized to build cross-border business groups, and the energy sector is probably the most illustrative example.

A significant part of Ukraine's assets, including energy-related ones, started to be privatized from the mid-1990s. Unsystematic in the beginning, with rising centralization of state power in Russia and suppression of political and business elites opposed to Vladimir Putin followed by mass extraction of financial resources, the economic expansion of Russia in Ukraine started to gain potential, strategy and focus.

Apart from the natural gas industry, oil refining and retail business became the first victims of Russian influence – between 1994 and 2001, four of the largest refineries were acquired. Although two of them were re-sold in 2006, the impact was strong enough to shape the oil import direction strongly in favour of Russian producers until today. Before 2007, when domestic oligarch Ihor Kolomoyskyi completed a powerful integrated petroleum undertaking

⁹ Breaking the Unbreakable Union: Nationalism, Trade Disintegration and the Soviet Economic Collapse, Marvin Suesse Humboldt-Universitaet zu Berlin, EHES WORKING PAPERS IN ECONOMIC HISTORY NO. 57, p. 3 (https://www.wiwi.hu-berlin.de/de/professuren/vwl/wg/economic-history-research/publications/ehes_no57.pdf).

and forced Tatarstan partners out of business in Ukraine, the petroleum retail market had been dominated by the Russians, as well¹⁰. As of now, because of arguably deliberately ineffective management of the oil refining industry, not only does it completely depend upon crude supplies from the Russians, but it has also decreased materially in output¹¹, thus surrendering the market to imported petroleum and diesel suppliers. Not surprisingly, the two largest suppliers of processed petroleum in Ukraine are Russia and Belarus¹², with the former operating materially on Russian crude oil, too.

As of today, the largest share of direct Russian capital in Ukraine's energy sector is in energy distribution and supply. One of the least wealthy¹³ members of the Russian Parliament, Alexander Babakov (United Russia faction), together with his business partners, has, in a series of transactions in 2001 and in 2013, privatized the controlling stakes in 7 *oblenergos*¹⁴ and minority stakes in 3 more *oblenergos*. The Russian businessmen Konstantin Grigorishyn, who recently received Ukrainian citizenship, is in control of 12 more *oblenergos* with decisive shares in two of them. Except for those mentioned *oblenergos* and 7 more remaining in operational control of the State Property Fund of Ukraine, all others are privatized in full or in part to domestic oligarch groups, which are more or less tied with Russia – the ex-Minister of Energy Yuriy Boyko, Igor Surkis, Rinat Akhmetov and, less so, Ihor Kolomoyskyi¹⁵. In addition, mass-media has frequently tracked decisions of the Ukrainian electricity TSO Ukrenergo in favour of Mr. Grigorishyn, which to a degree substantiate claims that he is casting certain control over the company¹⁶.

While privatization as such has been (and, unfortunately, remains) what Ukraine's economy urgently needs, the acquisition of energy assets by the Russians may not be considered as ordinary investment activities. Notably, in 2013 operations, VS Energy of Mr. Babakov purchased shares from the US-based AES Corporation. While the official statement of the company's CEO mentioned "simplifying structure" in line with "strategic vision", many local and foreign analysts explained the decision by Americans' inability to get equal treatment from regulatory bodies with the Russian VS Energy since 2001¹⁷. It appears that, at that time, the Minister of Energy Yuriy Boyko (having his own interest as shown above) and Eduard Stavitsky (currently under international search for theft of substantial state property), and who both were the members of pro-Russian Party of Regions, facilitated effective expelling of American investments from energy sector of Ukraine in favour of promoted Russian capital.

VS Energy showcased how decisions on the part of Ukrainian government have often been taken in a non-transparent, highly discretionary manner. But what is more important and obvious, Russian "investors" have never appeared to be willing to bear any major expenses

¹⁰Russian capital in the economy of Ukraine/Михайлюк О. Л. Російський капітал в економіці України / О. Л. Михайлюк, Л. В. Сухіна // Науковий вісник. Одеський державний економічний університет. Всеукраїнська асоціація молодих науковців. – Науки: економіка, політологія, історія. – 2006. - №8 (28). – С. 11-22., p. 4, at <http://dspace.oneu.edu.ua/jspui/handle/123456789/1091>.

¹¹ Energy sector of Ukraine: results of 2015, Razumkov Center, 2016, pp. 16-17 at http://old.razumkov.org.ua/upload/2016_ENERGY.pdf.

¹² From 2013 to 2017, shares of Belarus and Russia in oil products imports fluctuated between 35% to 54% and from 16% to 29%, respectively, together representing up to two thirds of all imports and well more than a half of all consumption. Data by the State Fiscal Service of Ukraine at <http://sfs.gov.ua/ms>.

¹³ According to the official information of State Duma of the Russian Federation, Mr. Babakov and his wife have annual income of roughly USD 70 thousand and own no car and no estates except the tiny apartment. // <http://www.duma.gov.ru/structure/deputies/131439/>.

¹⁴ Oblenergo is a combined regional power supplier and distributor in Ukraine. There are total of 27 *oblenergos* operating in Ukraine, including those 3 in occupied Crimea and parts of two Eastern regions.

¹⁵ According to INSIDER, Ukrainian investigation media <http://www.theinsider.ua/business/52d550ee60af5/>

¹⁶ <http://www.theinsider.ua/business/55a3cd716e645/>, <http://www.unian.info/politics/1242179-yatsenyuk-accuses-grigorishin-of-anti-ukrainian-work-on-russias-fsb.html>

¹⁷ <http://blogs.ft.com/beyond-brics/2013/02/28/why-americas-aes-sold-its-ukraine-utilities-to-russians/>

related to modernization or even amortization of the assets they acquired. For example, the Ukrainian gas distribution networks operated by the DSOs that are, to a significant degree, under partial Russian control (through Mr. Firtash whose company RosUkrEnergo for a long time had been functioning as an intermediary between Ukraine and Gazprom) are largely worn-out¹⁸. Extracting value with less spending on maintaining operability of the assets had side effects on multiple directions. In addition to evident substantial margins earned, gas storage, distribution and supply to end consumers has been conducted in a ridiculously non-effective manner accounting for 2.74 bcm and 2.51 bcm of technical losses in 2014 and 2015, respectively¹⁹. Beyond any doubts, this issue has been among the barriers for Ukraine in becoming energy independent and introducing a truly market-based gas trade.

Why did Ukraine appear reluctant to prevent Russian capital from acquiring most of the national energy assets, with a poorly disguised purpose of degrading the national energy industries and infrastructure? With a critically low capacity of the state institutions, disorganized civil society, corrupt law enforcement system, the Russian capital, well-organized and rich in resources, faced little resistance. And vice versa, by empowering political and executive leadership, bringing best practices of governance, enforcing comprehensive energy strategy, forecasting and countering energy dependence threats, and by supporting independent and competent civic movements, the situation may be significantly turned around.

Chasing the Grail. Russia's restless attempts to control international gas transit through Ukraine

The Russian state has been constantly trying to take control over the Ukrainian gas transmission system. This was due both to the expansionist nature of the Russian foreign policy²⁰ and to the subsequent strategy of Gazprom as a monopolistic tool for such a policy, aimed at establishing its presence on the European energy markets. The ultimate goal would be, therefore, a total control of the whole chain from the gas production wells in Siberia to the gas stove in a household anywhere in the single European market.

The gas transmission system (GTS) of Ukraine, given its enormous annual entry capacity above 288 bcm and the exit capacity of over 151 bcm (in the European direction), is among the top valued assets in the country²¹. Clearly, its value reflects the importance of the asset as a principal connection of bulk Russian gas deposits with the demand of EU Member States²². It is also the key to control of Ukraine's internal market, with major industries being also the largest gas consumers. Consequently, these are two main stakeholders, after Ukraine itself, interested

¹⁸ According to the most recent activity report of the National Energy and Public Utilities Regulatory Commission of Ukraine, significant share of all such pipelines have expired their projected lifetime and require urgent modernization that have never taken place in the past. See:

http://www.nerc.gov.ua/data/filearch/Catalog3/Richnyi_zvit_NKREKP_2015.pdf, p. 76-77.

¹⁹ Ibid.

²⁰ In 2003, the Russian Federation passed the Energy Strategy of Russia until 2020, then replaced in 2009 by the Energy Strategy of Russia until 2030. Both documents featured undisclosed guidelines of centralizing of the national energy system and potential creation of a Euro-Asian energy area dominated by Russia through becoming a key gas infrastructure player in it. See further: Ukraine and Russia: current summary and long-term cooperation issues, a Policy Brief by Razumkov Center, National Defence and Security, is.6, 2010, p. 3. Available at: http://old.razumkov.org.ua/ukr/files/category_journal/NSD117_ukr_1.pdf

²¹ In 2014, Naftogaz CEO Andriy Kobolyev provided one of the most recent assessment of the system net worth at the level of USD 25-35 bn. A more precise evaluation is hard to perform due to complicated structure of property and significant turbulence anticipated at implementing of Naftogas unbundling plan // <https://www.rbc.ua/ukr/news/ukrainskaya-gts-otsenivaetsya-v-25-35-mlrd-dollar-kobolev-23072014184200>

²² From 2009 to 2015, the role of Ukrainian GTS for Russian gas transit declined from almost 80% in 2009 to slightly more than 42% (or 67.0 bcm of overall amount of 158.6 bcm supplied by Gazprom Export to European consumers) in 2015. See: <http://www.gazpromexport.ru/en/statistics/> and <http://utg.ua/live/>.

in how well it is performing. Each of them endeavored to influence this operation: while the EU never appeared to be willing to control the system and has constantly encouraged Ukraine to improve its trustworthiness as a transit country by implementing structural market-based reforms, Russia preferred a different way.

By exploiting old debts arising out of Soviet Union heritage distribution, as well as new debts resulting out of large scale non-payment for gas supplies for Ukraine's extensive internal use and by claiming that Ukraine performed unauthorized withdrawal of transit gas, throughout 1990s and 2000s Russia has constantly attempted to push Ukrainian governments to capitulate its control over the GTS²³. In 2002-2004 and again in 2011²⁴, under the Yanukovych rule, takeover attempts were connected with the creation of the gas transmission consortium – an idea initiated by the presidents Leonid Kuchma and Vladimir Putin, as well as the German Chancellor Gerhard Schroeder. However, the trilateral project first transformed into a bilateral one and later terminated due to different positions. Ukraine aimed at constructing two new pipelines "Bogorodchany-Uzhgorod" and "Novopskovsk-AlexandrovGai", while Gazprom initially aimed at managing the entire GTS. Later on, under the Tymoshenko government, any operations with the GTS privatization, rental, concession etc. were prohibited by law²⁵, blocking those attempts. However, Russia gave up the idea of creating a consortium only in 2013²⁶, after Ukraine has amended legislation for the implementation of its commitments in the Energy Community.

Russia has used different arguments to have the Belarussian scenario of GTS takeover be replicated in Ukraine. Mainly, the promises were connected with the increase of transit volumes from 110 billion to 130-140 bcm a year. In the context of negotiations on gas supplies price or discounts on it, which took place almost every year – at least, until 2014, when the contacts transformed in actual trilateral format with full participation of the European Commission – this issue has been raised as well.

Another way to seize Ukrainian assets was by pressuring the EU, by different means, by portraying Ukraine as an unreliable and unpredictable partner in the gas transit. The gas disputes of 2006, 2008 and 2009 were provoked by the Russian party, for the aim of either Ukraine's GTS takeover or better deals on gas supply (in terms of prices and conditions). This can be treated as an early application of hybrid warfare tools, enforcing the disputes escalation, which "has been mainly applied to armed conflicts"²⁷. Typical means of such pressure are delaying signature of annual annexes to the supply contract, manipulating with pressure on Ukraine's GTS entry points, and accusing Kyiv of "unauthorized gas withdrawal" from the pipelines, accompanied by massive information campaigns²⁸. Such induced disruptions in supply affect not only Ukraine, but also European countries, in Eastern Europe and the Western Balkans – which are most dependent on Russian gas supplies and thus most vulnerable.

According to Ukrainian legislation²⁹, since 1992, the main gas pipeline system constitutes a strategically important part of state property and under no conditions may become subject to

²³ See: <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2010/11/NG27-TheRussoUkrainianGasDisputeofJanuary2009AComprehensiveAssessment-JonathanSternSimonPiraniKatjaYafimava-2009.pdf>, p. 5,

²⁴ http://dif.org.ua/uploads/pdf/1369919873_2544.pdf

²⁵ <http://zakon4.rada.gov.ua/laws/show/605-16>

²⁶ <http://ua.krymr.com/a/25342711.html>

²⁷ <https://ecpr.eu/filestore/paperproposal/3d7d0dcd-1e93-48fb-9a97-001d91dab1bb.pdf>

²⁸ <https://www.theguardian.com/world/2009/jan/03/russia-ukraine-gas-supplies-gazprom>

²⁹ Art. 7 of the Law of Ukraine "On the Pipeline Transport" (<http://zakon3.rada.gov.ua/laws/main/192/96-%D0%B2%D1%80>), Art. 40 of the Law of Ukraine "On Oil and Gas"

(<http://zakon2.rada.gov.ua/laws/show/2665-14>), Art. 5 of the Law of Ukraine "On Privatization of the State Property" (<http://zakon3.rada.gov.ua/laws/show/2163-12>), Art. 21 of the Law of Ukraine "On the Natural Gas Market" (<http://zakon3.rada.gov.ua/laws/show/329-19>).

privatization or any other form of alienation. Unlike Belarus in 2007-2011, Ukraine managed to protect, both in terms of legally defining such specific status and practically implementing these provisions, its GTS from direct acquisition by Gazprom. This situation prompted Russia to look for indirect instruments to enforce its aims for operation of the pipeline and storage system.

Having no viable success in the direct legal acquisition of the assets, the Russian leadership facilitated the establishment of totally opaque layered commercial structures authorized to become parties to gas supply to Ukraine. Starting with the Basic Treaty between the governments in 1998 and up to the supply contract of 2009, Russian and Ukrainian government officials and representatives of corrupt business groups arranged and re-arranged various sets of obligations providing multiple intermediaries, always featuring companies close to Gazprom³⁰. Such non-transparent environment allowed Ukrainian oligarchs' proceeds and assets to boom, flourishing on price differences and respective budgetary offsetting, barter and tolling schemes. In turn, Russia always managed to partially have indirect control over the gas sector of Ukraine and retain tools of influence over the GTS.

This pressure was strong because, following the 2009 gas purchase and transit contracts, Ukraine lost access to Central Asian gas supply (though this was provided by shadow Gazprom intermediaries like RosUkrEnergo) and Gazprom became the only supplier. Diversification efforts under Yanukovich, started in 2012, had marginal effect on the gas market balance and were used only as political argument in negotiations.

Following wide criticism of such intermediary-based relations from both its own population and European consumers, and amid deep political crisis in Ukraine that would eventually help V. Yanukovich to win the presidential race, in 2009 Gazprom and Naftogaz³¹ signed the transit agreement until 2019. Although a short document, the deal included some provisions and omitted other critical aspects, with clear leaning towards the Russian side³². Signing of a questionable contract, which ensured achievement of some tactical purposes, only left Russia wanting more. Though imperative norms of the Ukrainian legislation made it difficult to acquire the GTS directly, the favourable political environment encouraged the Kremlin to take more ambitious steps. On April 30 2010, Vladimir Putin in his capacity as Prime Minister of the Russian Federation officially suggested to merge NJSC "Naftogaz of Ukraine" and OJSC "Gazprom"³³. Given the incomparable capitalization magnitudes of the two companies, such a move would by all means result in complete acquisition and surrender of Naftogaz, including the operation rights of the transmission system to Gazprom. As stunning as it was, the proposal in fact appears just one step further along the long time pursued intention of Russia to reinstate its control over the transmission capacity of Ukraine. What is more important, at that time Ukrainian authorities endorsed the plan as feasible and worth elaborating³⁴.

At the time of proposal, the two countries, as well as the third parties in the EU, had already

³⁰<https://www.oxfordenergy.org/wpcms/wp-content/uploads/2010/11/NG21-UkrainesGasSector-SimonPirani-2007.pdf>, chapters 3 'Gas in Ukraine' and 4 'Gas supply 2006-2007'.

³¹ Under current legislation and state property structure in Ukraine, GTS as state property rests with the State Property Fund of Ukraine. Its operation, however, is conducted on behalf of the ultimate holder – the Government of Ukraine – by public joint-stock company "Ukrtransgaz", which in turn is a subsidiary of Naftogaz, also 100% state owned company.

³² For example, the contract requires Naftogaz to keep supply on the western borders uninterrupted even if intake on the Russian border falls. Other issues concern tariff fees, which are arguably not set on a fair basis. See further: <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2016/11/Has-Ukraine-scored-an-own-goal-with-its-transit-fee-proposal.pdf>, p. 4. Provisions of this deal are currently claimed to become subject to change by Naftogaz in Stockholm arbitration process.

³³<http://www.reuters.com/article/us-gazprom-naftogaz-idUSTRE63T4DH20100430>

³⁴ Ukraine's PM under President Yanukovich and one of top leaders of governing Party of Regions Mykola Azarov commented Putin's words as "not a joke" and "ordinary business practice"// <http://www.pravda.com.ua/news/2010/07/23/5243748/>.

experienced gas disputes in 2006 and 2009. The latter case persuaded all stakeholders that the current system of relations between Russia as gas supplier, Ukraine as transit country and EU Member States as consumers may not be regarded sustainable and stable. This led to discussions of various models of Ukraine's GTS operation, including the merger suggested by Russia. Another one, put forward by Ukraine, represented an idea of a trilateral consortium and provided that the EU should participate to ensure stable flows of natural gas. With such options on the table, the Ukrainian government of President Yanukovich and PM Azarov cunningly maneuvered seeking for a higher bid for investments promised all the way until being ousted as the result of the Revolution of Dignity in 2014³⁵.

In addition, the Russian party used its influence on Ukrainian political elites and internal struggles between different political forces. In 2009, the conflict between the President V. Yushchenko and the Prime Minister Y. Tymoshenko led to long-term gas contracts with unfavourable conditions for Ukraine – with strong take-or-pay clause, ban on re-exports, high basic price of 450 USD/tcm, fixed transit tariff etc. In 2010, using ties with then-President V. Yanukovich, Russia negotiated a lucrative deal to extend its lease on the Black Sea Navy facilities in Crimea until 2042 (fixed as international agreement), in exchange for a price discount on the Russian gas (a yearly decision of the Russian government). Known as the Kharkiv Accords³⁶, the controversial deal became an example of corrupt Ukrainian elites' political fiasco, as the gas prices in 2010-2013 only increased despite the discounts provided. In 2014, following the annexation of Crimea, Russia unilaterally denounced all the related international agreements³⁷.

The economy of the Russian Federation is roughly ten times stronger than Ukraine's³⁸. High level of interconnection between Russian business and Russian government suggests the fact that considerable financial resources were always available to serve political goals of the Kremlin³⁹. However, as of today, Russia has lost its momentum. After waging an aggressive war against Ukraine, acquiring of the GTS in any legitimate way by Gazprom is unthinkable. Beside the fact that it would be a political impossibility, this is also fixed legally. According to the 2015 Natural Gas Market Law aimed at implementing the Third Energy Package, the ownership unbundling, an essential part of market based reform in Ukraine's gas sector, can be only followed by specific form of joint control over the system by the state of Ukraine (51% stake) and the entity controlled by either the United States or one or more Energy Community Contracting Parties⁴⁰.

The Ukrainian GTS now loses its importance to Russia, as alternative routes are moving

³⁵ "We can only repeat what we have said many times. The EU wishes, if Ukraine and Russia wish so, to enter into tripartite consultations on the gas transit at any time. The commission also stated many times that it is ready to assist in the formation of a possible trilateral consortium," follows the comment by the European Commission spokesperson to the statement by PM Azarov on March 2013. // <https://www.kyivpost.com/article/content/eu-ukraine-relations/eu-reiterates-its-readiness-to-work-on-eu-ukraine-russia-tripartite-gas-consortium-321936.html>

³⁶ <http://www.pravda.com.ua/articles/2010/04/29/4990510/>

³⁷ <http://www.kremlin.ru/events/president/news/20673>

³⁸ According to CIA World Factbook, GDP by purchasing power parity of Russia during the years of 2013-2015 decreased from USD 3,834 bln to USD 3,718 bln, while that of Ukraine decreased from USD 403 bln to USD 340 bln, thus approximately remaining one tenth of Russia's GDP during this time. // <https://www.cia.gov/library/publications/the-world-factbook/>

³⁹ Numerous instances of non-economic decisions of funds allocation by Gazprom are described by Russian opposition experts. For example, Boris Nemtsov and Vladimir Milov claim Gazprom invested much more in acquiring non-core assets then it spent on oil and gas exploration during the years of Putting leadership // B.Nemtsov, V.Milov. Independent expert report "Putin and Gazprom, 2008, <http://www.milov.org/wp-content/uploads/2016/01/putin-i-gazprom.pdf>

⁴⁰ It. 1.1, 3.1 of Art. 21, It. 1 of Art. 45 of the Law of Ukraine "On the Natural Gas Market" No. 329-VIII dated April 04, 2015.

closer to implementation. Adding to that Russia's liquidity crisis and the extremely adverse political context, nowadays it is hard to see any viable prospects or attempts for Gazprom to establish its control over the Ukrainian pipelines and storage facilities directly. A change of the political leadership in Ukraine therefore remains the only chance Kremlin may count on to finally get the prize it desires. Since Russia mainly failed in this direction before 2005 and even during the more favourable political environment in Ukraine during 2010-2013, undermining the democratic and sovereign course of Ukrainian policy is of utmost importance as this remains the only viable way to control, at least indirectly, Ukraine's GTS.

Together in the Wobbling Boat. Russia's pipeline politics threatening Ukraine and the EU alike

Another pivot of the Russian approach is the so-called pipeline politics – i.e. pursuing rather political than commercial projects for the construction of pipelines bypassing major transit countries. With this means, Kremlin not only gains support among Gazprom's key partners, but also mobilizes political elites across Europe, using disunity on specific issues of gas transportation as a tool⁴¹.

A classic example became the European Commission decision, announced on October 28th 2016, setting out the rules for increased utilization by Gazprom (and possibly other companies) of the OPAL pipeline, which is the onshore leg of the Nord Stream pipeline. Naftogaz' calculations suggest that if Gazprom gains access to additional 30% of OPAL's capacity, the gas transit via Ukraine will drop by 10-11 bcm a year and lead to 290-320 million USD loss in revenue. Should this number increase 40%, transit will decrease by 13.5-14.5 bcm and revenues drop by 395-425 million USD⁴².

This step was perceived as not friendly: "The approval of such decisions without prior consultations with Ukraine is the breach of Article 274 of the Association Agreement between Ukraine and the EU, which provides for mutual consideration by the parties of the capacity of energy infrastructure of both sides, as well as holding consultations and coordination of actions in the field of security of energy resources supply", declared the Deputy Foreign Minister of Ukraine, Olena Zerkal⁴³.

Not only Ukraine, but also Slovakia and Poland would suffer, as this could compromise the security of gas supplies to Central Europe and complicate the interconnection from Germany to this region⁴⁴. Given the still unfinished antitrust investigation, with potential settlement between the EC and Gazprom being close⁴⁵, this would mean at least high level of tolerance towards the Russian abusive strategy in gas supply markets in the CEE and Baltic states. To be mentioned, the accusations include territorial restrictions in supply contracts, unfair pricing policy and leveraging dominant market position⁴⁶.

The OPAL case has also provided the Russians with more political leverage to move ahead with the bypassing pipelines. Combined, the Nord Stream 2 capacity of 55 bcm and the Turkish Stream capacity of 63 bcm would almost offset the Ukraine's gas system role for transit. The political nature of the project is confirmed by independent studies, which indicate that complete reduction of Russian gas transit via Ukraine by 2020 might not be possible and even not "commercially optimal should acceptable transit terms be agreed with Ukraine post-

⁴¹ N. Bouchet, Russia and the Democracy Rollback in Europe. Europe Program, Vol. 2, No. 2, p. 9. Available at: <http://www.gmfus.org/file/5776>

⁴² <https://www.osw.waw.pl/en/publikacje/osw-commentary/2016-11-09/european-commission-enables-increased-use-opal-pipeline-gazprom>

⁴³ <http://en.interfax.com.ua/news/general/382891.html>

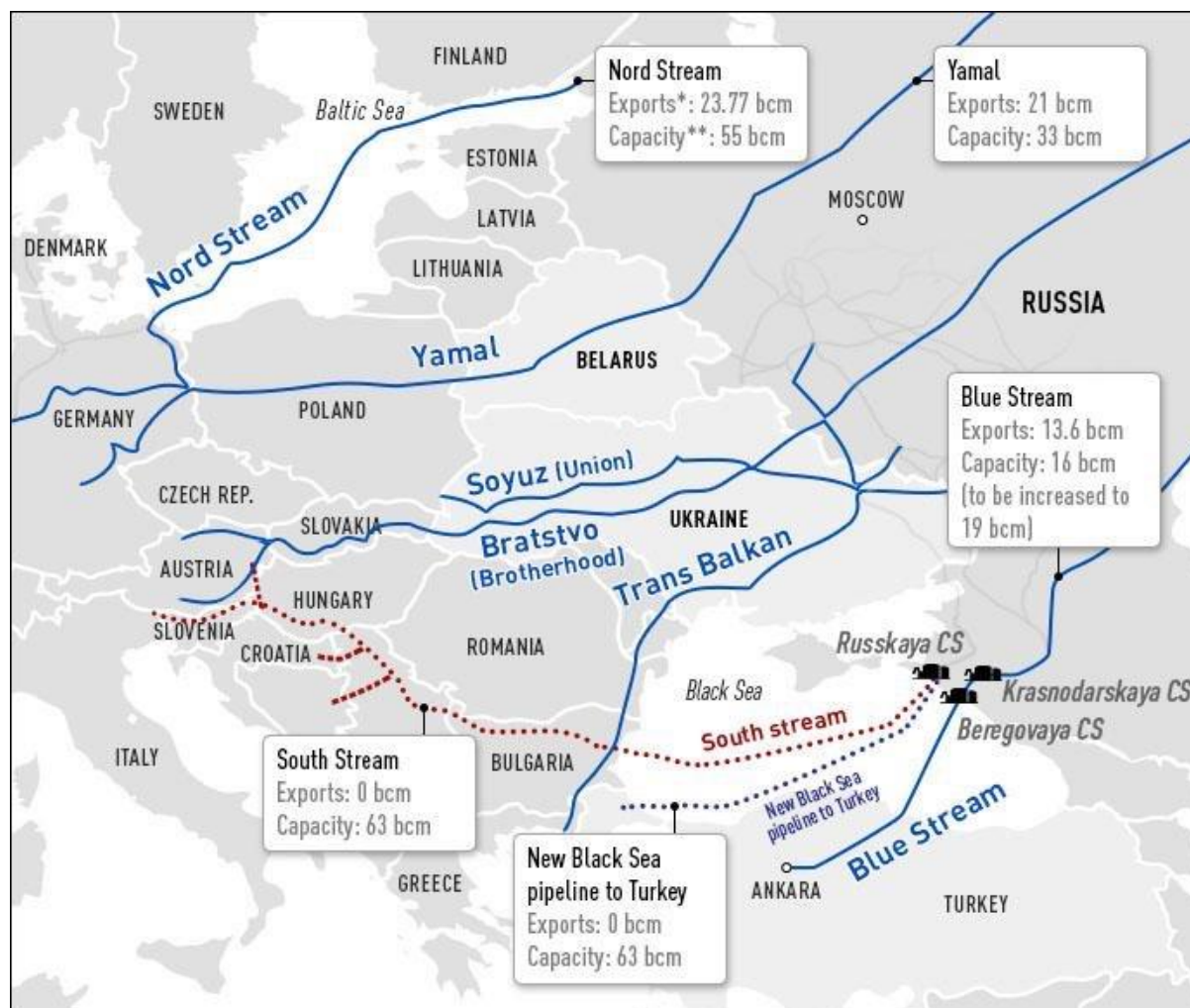
⁴⁴ See <http://energypost.eu/case-nord-stream-2/>

⁴⁵ <http://www.wsj.com/articles/gazprom-eu-near-antitrust-case-settlement-1477502386>

⁴⁶ http://europa.eu/rapid/press-release_IP-15-4828_en.htm

2019"⁴⁷. Moreover, even current gas flows show that the Ukrainian route is more flexible and can offer better response to seasonal spikes in gas demand⁴⁸.

Hence it is still questionable whether the European authorities would be capable to act in strict compliance with the EU acquis. Although there are solid legal grounds for opposing these projects, at least concerning the Nord Stream 2⁴⁹, there was no official or legal action taken except of assurances that Ukraine would retain its major transit role⁵⁰ and the security of supply in CEE countries would be guaranteed.



Source: *The New Cold War: Ukraine and beyond*

After 2014, following dramatic events of the Revolution of Dignity⁵¹ and the Russian aggression, the situation became less tense given quite successful strategies of the EU and Ukraine for ensuring security of supply. On the one hand, the EU has started to develop an

⁴⁷ <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2016/02/Russian-Gas-Transit-Across-Ukraine-Post-2019-NG-105.pdf>

⁴⁸ <http://m-korchemkin.livejournal.com/789949.html>

⁴⁹ <https://www.ceps.eu/publications/nord-stream-2-legal-and-policy-analysis>

⁵⁰ <https://www.kyivpost.com/ukraine-politics/eus-sefcovic-ukraine-play-decisive-role-transit-country-russian-gas-2019.html>

⁵¹ The other name of popular uprising that took place mainly in November 2013 – February 2014 and resulting in expelling of much of Ukrainian public government, including President V. Yanukovich, PM M. Azarov and numerous ministers and other officials, followed by extraordinary president and parliament elections. This moment of weakening of the state was also availed by Russia in order to occupy the Autonomous Republic of Crimea, an integral part of Ukraine.

external energy policy based on diversification and interconnectivity – which, however, still needs strengthening in the framework of the Energy Union. Another factor was changes in the global energy markets, with prices for hydrocarbons being on the low and supplies (namely, U.S. gas arrival in Europe) significantly increased. On the other hand, Ukraine has – with support from its Western allies – first negotiated several “packages” (separate agreements on Russian gas supply) and later diversified its gas supply to the extent that the Russian factor is not as threatening as before⁵². However, the manipulations with gas pressure and the rhetoric of “unauthorized gas withdrawal” are still present as methods of Russian hostile policy.

The new management team of Naftogaz here showcases an example of success strategy to take after. A guidance by the national interest only, rather wide autonomy from the government due to a swiftly implemented corporate reform in line with the best OECD practices and a strong competence of a younger than ever before top and middle management – all together contributed to implementing solutions allowing for not buying gas directly from Russia since late 2015⁵³. Furthermore, Ukraine’s strategy for countering persistent Russian impact includes the legal action in the Stockholm arbitration, demanding change of both supply and transit contract with Gazprom. A comprehensive case on discrimination and market abuse against Gazprom appears to have serious odds of winning.

According to the Naftogaz position, this would change gas trade rules in the region. First, Gazprom would no longer act as a virtually present operator between Ukrtransgaz and TSOs of neighboring countries, allowing free bi-directional gas flows between Ukraine and Slovakia, Hungary, Poland, and Romania. Second, gas transfer points would be changed from the western to the eastern border of Ukraine (which are located far away from the conflict zone), thus contractually bringing Ukraine on the side of the EU and allowing Ukraine’s TSO to take full contractual responsibility for gas transit and also reducing the associated risks to European companies⁵⁴.

In addition, in early 2016, Naftogaz – with the Energy Community Secretariat as intermediary – has officially transferred the complaint against the Nord Stream 2 project to the European Commission⁵⁵. It deals with issues of non-compliance with the EU *acquis communautaire* in the energy sector. Also, in November 2016, the Verkhovna Rada (Parliament) of Ukraine has called on the European Parliament, European Commission, national parliaments and the EU member states to prevent implementation of the construction of bypassing gas pipelines⁵⁶. Finally, Ukraine takes active part in the Central and South-Eastern European Gas Connectivity (CESEC) initiative, which allows it to negotiate higher volumes of gas transit and develop interconnectivity⁵⁷. The first significant project is the planned Ukraine-Poland interconnector.

These efforts shall be further supported. As Ukraine’s gas transmission system becomes more independent, transparent and secure, Western policymakers shall execute all possible influence to review new infrastructure projects like Nord Stream 2 which aim to offset Ukraine as the shortest and most reliable way of gas delivery to the EU.

Fighting abusive practices of Gazprom’s total domination at Ukrainian gas industries takes ground beyond Naftogaz as well. In January 2016, the Antimonopoly Committee of Ukraine (AMCU) fined Gazprom 85 bn UAH (app 3.4 bn USD) for abuse of dominance in the gas transit

⁵² http://dixigroup.org/storage/files/2016-08-19/polpaper_ua_energy_transition_factors.pdf

⁵³ <http://utg.ua/still-alive/>

⁵⁴ <http://www.naftogaz.com/www/3/nakweb.nsf/0/21D6495FCDCE4BDBC2257F2C0037AA5D?OpenDocument&year=2015&month=12&nt=%D0%9D%D0%BE%D0%B2%D0%B8%D0%BD%D0%B8&>

⁵⁵ <http://www.naftogaz.com/www/3/nakweb.nsf/0/3F88F08C5630C625C2257F32004B5043?OpenDocument&year=2016&month=01&nt=News&>

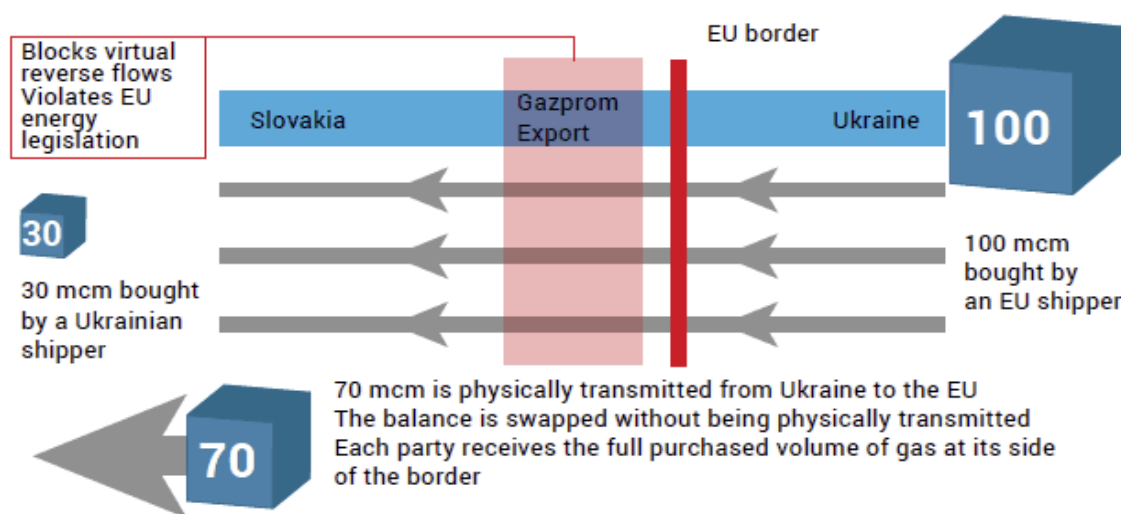
⁵⁶ <http://ukranews.com/en/news/460397-rada-calls-on-parliaments-of-eu-states-to-disallow-implementation-of-projects-for-construction-of-gas-pipelines-bypassing-ukraine>

⁵⁷ https://ec.europa.eu/energy/sites/ener/files/documents/CESEC%20MoU_signed.pdf

market. The investigation concluded that from 2009 to 2015 Gazprom was constantly breaching the conditions of the contract with Naftogaz⁵⁸. Gazprom's monopolistic position does not only prevent higher gas-to-gas competition in Ukraine (at least, for blocked supplies from Central Asia), but also prevents from widening the capacity of reverse gas supplies.

Currently, any operation with gas supplies is possible, including swaps and backhaul, allowed by the acting Ukrainian legislation (compliant with the Third Energy Package) and interconnection agreements with TSOs of neighboring countries. However, it is Gazprom's intermediary position which blocks full interconnectivity on the Slovak direction – the largest one with 100 mcm of daily capacity. As much as the outcome of this countering Gazprom directly influences the state of energy security within the European continent, a coordinated and well-weighted position of all potentially affected stakeholders is seen more than vital.

UNBLOCKING THE INTERCONNECTOR ENABLES VIRTUAL GAS FLOWS



Source: Naftogaz⁵⁹

Another important element are the reforms of gas sector⁶⁰, which need to be incentivized and completed. It is the liberalization of Ukraine's gas market, which would allow better security of supply in the region. Directions of key interest are unbundling of Naftogaz and involvement of Western investors in the new TSO management, market opening for households and municipal heating companies, establishing spot market through creation of a gas hub⁶¹, and improving conditions for investment in oil&gas production.

Along with gas hub project, cross-border infrastructure projects between Ukraine and EU shall be facilitated. Combined with the spirit of solidarity in the emergency cases, those can turn Ukraine's gas market into a place for liquid business and transform Ukraine from recipient to net contributor of the energy security.

In a shorter and more practical dimension, Russian policy, and especially the ways it is effected, towards EU energy markets have to be duly investigated and assessed. The most speaking example of such policies is the Nord Stream 2. This project, if completed as currently projected, beyond all reasonable doubts both poses significant threat to commercial load of Ukrainian GTS and would lower impact energy security in the EU by deepening dependence upon Russian gas supplies. The European Commission and the national governments therefore should show more willingness to defend strict and unambiguous rules of the Third energy package aimed at protecting the Member State's interests in energy supplies.

⁵⁸<http://www.uawire.org/news/kyiv-fines-gazprom-3-4-billion>

⁵⁹ <http://www.naftogaz.com/www/3/nakweben.nsf/0/29BCD2249EBF8851C2257F9B0025483E?OpenDocument&Expand=1.2&>

⁶⁰ For details, see http://dixigroup.org/storage/files/2016-05-10/polbrief_dixi_gas_market_reform.pdf

⁶¹ http://dixigroup.org/storage/files/2016-12-19/web_en_ukrainian_gas_hub_2016_en.pdf

On a Tight Leash. Technological dependence of Ukrainian energy sector upon Russia - showcase of nuclear energy and grid synchronization

On February 10, 2010, three days after publication of the results of presidential elections that eventually brought Viktor Yanukovych to the full control of the country⁶², the Russian Foreign Minister Sergey Lavrov reportedly put his signature on the conceptual document “Program of effective and systematic use of foreign policy factors for long-term development of the Russian Federation”⁶³. Although its text leaked and the paper itself has never been proven to be signed into power, it reveals very closely the dominant points of foreign policy of Russia in relations with other nations and the CIS states in the first place. According to the Program, Ukraine should be extensively engaged in the economic co-operation, avoiding however to lead to technological dependence of the Russian companies on Ukrainian counterparts. Instead, in oil trade, the Odesa-Brody pipeline should be made operating in reverse regime to prevent Ukraine’s access to supplies of Caspian oil; in gas transit, Russia was to determine the Ukrainian government to implement the idea of a consortium for control over its GTS; and in nuclear industry, fuel supplies by Rosatom should remain uncontested for as long as possible⁶⁴.

Whether or not the Program is true and effective, the Russian Government and energy enterprises followed and continue to follow its provisions carefully, using all tools available to prevent Ukraine from diversifying its energy sector from the “big brother”, both in terms of resources supplies and in technologies. In doing so they were mostly active and successful under President V. Yanukovych and Prime Minister M. Azarov – arguably the least democratic leadership in modern history of Ukraine⁶⁵.

Nuclear power generation is getting progressively more vital for Ukraine. It is only due to stable operation of all 15 power blocks at the technological maximum of load that the government managed to avoid massive blackouts during the plunges of demand. In 2014 and 2015, NPPs produced 50% and 57% of all electricity of Ukraine respectively, and made unnecessary the import of electricity from the aggressor state⁶⁶. This increased share was due to keen deficit of anthracite coal necessary for operating half of major TPPs as all Ukrainian anthracite mines are located within the pro-Russian terrorist-controlled territories. Bearing in mind that these 15 power units together constitute just 27% of total installed power generating capacity, it is hard to overestimate the role of NPPs in power generation in Ukraine. With dramatic events at the beginning of 2017 that finally caused the coal trade within the occupied

⁶² By means of working around the Constitution of Ukraine to its version of 1996, President Yanukovych has enlarged its own authority to the extent described in 2015 as “usurpation” by the Prosecutor General of Ukraine. The move was specifically questionable given the harsh way it was undertaken – the Constitutional Court in an arguable excess of its powers ruled the respective law passed by the Parliament as non-constitutional and effectively changed national legal regime on its own. See further:

<http://www.pravda.com.ua/news/2015/02/6/7057684/> and Dissenting opinion of the Judge V. Shyshkin <http://zakon5.rada.gov.ua/laws/show/na20d710-10>.

⁶³ See the leaked text in Russian: <http://blogs.pravda.com.ua/authors/kuzyo/4bec22fe3e992/>

⁶⁴ Y. Lenchuk. Foreign Economic Dimension of New Russian Industrialization, 2015. Sect. 10.

⁶⁵ According to sociological polls, starting from 2010 the protest moods increased steadily in Ukraine. As of 2012, 10,400 cases were under review by the ECHR, at rapid increase from previous periods, and the rule of law in Ukraine was recognized only by 3% of population. See further: http://cpr.oa.edu.ua/wp-content/uploads/2015/11/Protestnyi_potencial_ta_pol_mobilizaciya_chynnyky_vzayemodiyi_Matsiyevsky_Kovalko.pdf

⁶⁶ As Ukraine currently remains synchronized with IPS/UPS rather than with ENTSO-E, in case of imminent need of power load it may only be imported from the Russian grid or from its close and partially controlled ally Belarus.

territories of eastern Ukraine to cease⁶⁷, and subsequent emergency regime of power system, nuclear generation is being relied upon more than ever before. That is why continually decreasing, but still critically significant, dependence on the Russian technology, supplies and services seems so astonishing.

In many respects, the nuclear cooperation between Ukraine and the Russian Federation went on after the collapse of the Soviet Union as a single industry. Out of the full cycle of nuclear fuel production, Ukraine owns only the uranium ore production (covering approximately one third of its own total consumption of fuel) and primary processing undertakings, as well as four power plants, thus lacking enrichment and fabrication plants and enough spent fuel storage facilities. This predetermined the format of Energoatom (Ukraine's only NPPs operator and a fully state-owned corporation) relations with Rosatom (as well in complete ownership of the Russian state) – currently Ukraine purchases nuclear fuel under a 10-years long contract signed with Rosatom's subsidiary TVEL, and dispatches spent fuel from 3 of its 4 NPPs to Russian storage facilities⁶⁸. The markets for such fresh fuel supplies and spent fuel disposal are estimated at USD 600 mln and USD 200 mln per annum, respectively⁶⁹.

Although the current dependence on Russia in nuclear power generation seems high, it could have been even higher. Already during his first official visit to Kyiv under the newly-elected President Yanukovich, the Russian PM Vladimir Putin presented a draft inter-governmental deal providing immediate (within half-year timeframe) merger of all two countries' nuclear assets, including uranium and zirconium production sites in Ukraine. At that time, opposition MP and member of the Energy Committee of Verkhovna Rada S. Pashynskyi described the proposal as exploiting Ukrainian extractive industry with all processing, and especially uranium enrichment procedures, to be carried out in Russia⁷⁰. Instead of striking such a radical deal, the governments stuck to the idea of establishing of a JV on fabrication of fuel in Ukraine.

It is quite illustrative that Westinghouse, the only non-Russian nuclear company interested in and capable of becoming party to a joint venture with Ukraine, has filed respective applications in 2009 and 2010. Disregarding that it scored higher than TVEL in almost all respects, and, most importantly, that it did not ask for total control in the project, Westinghouse still has not been chosen during the tender for undisclosed reasons⁷¹.

The terms and conditions of the proposed JV with the Russians provided for all business decisions to be approved by TVEL and, more importantly, that the technology used by the entity to be leased from TVEL rather than purchased, which would lead to neither actual diversification of supplies, nor approaching self-sustained full nuclear fuel cycle⁷². Following the start of the aggression, however, the JV has been frozen and then cancelled by the Ukrainian authorities, even though its implementation proceeded successfully before 2014.

Another instance of cooperation is the projected construction of two new blocks of the Khmelnytskyi NPP as agreed by the governments of Ukraine and Russia in 2010. In addition to contracting Rosatom's Atomstroiekспорт for the construction of nuclear facilities and thus opting to continue its reliance on only Soviet and Russian VVER technology - meaning deeper

⁶⁷<https://www.ft.com/content/276f3fd8-098c-11e7-ac5a-903b21361b43>

⁶⁸Zaporizhzhia NPP is equipped with its own limited capacity dry storage facility for spent nuclear fuel, constructed in 2001.

⁶⁹ O. Kosharna. The Ukrainian Nuclear Energy Partnership with Russia: The End of an Era of Cooperation. RUSSIAN ANALYTICAL DIGEST No. 193, 30.10.2016, p. 7. Available at: <http://www.css.ethz.ch/en/services/digital-library/articles/article.html/745235cd-5e7d-4589-9b62-b740e8eedbb0>

⁷⁰http://www.ukrrudprom.com/digest/Rossiia_predlogila_Ukraine_obedinit_aktivi_v_atomnoy_energetike.html

⁷¹Diversification of nuclear fuel in the context of national energy independence. Analytical note by the National Institute for Strategic Studies. <http://www.niss.gov.ua/articles/1735/>

⁷²O. Koscharnaja, Die unersetzliche Atomenergie, UKRAINE-ANALYSEN NR. 168, 11.05.2016, p. 11 See: <http://www.laender-analysen.de/ukraine/pdf/UkraineAnalysen168.pdf>

dependence on Russian suppliers and service providers -, for these two new blocks the Russian government committed to grant a sovereign-guaranteed loan for 4/5 of total CAPEX⁷³. The agreement failed to be implemented as well, this time because of the fact that Russia unreasonably raised the loan interest and refused to accept local content provisions suggested by Ukraine.

But could the cooperation in nuclear power generation be considered as bearing no political emphasis? Aside of clear contradiction to the stated intention to diversify supplies of nuclear fuel with the ultimate aim to ensure energy security of Ukraine⁷⁴, the high dependence on Russian technologies and supplies rendered a powerful leverage for Kremlin to reach its own purposes in Ukraine. Identically to gas sector, this tool was used to create an opaque environment in setting prices for electricity, providing a significant gap between those for households and business, with the former paying much less than market level and the latter cross-subsidizing the population. With output by the NPPs historically making not less than 40% in power balance of Ukraine, keeping electoral-oriented regulated low prices for households was only possible given the non-market based relations with fuel and maintenance suppliers from Russia.

In the same way, but probably with lesser magnitude than in gas sector, the lack of transparency in the electricity wholesale market, distribution and supply, prompted high scale political corruption benefiting from manual management of billions worth industry. This complicated and extremely corrupt environment, enriching pro-Russian political elites, by all means prevented Ukraine from undergoing market reforms and fighting vested interests in politics within all the previous years. Just recent high-profile investigations by the newly created National Anti-corruption Bureau of Ukraine lead to a number of suspects escaping the country. The loudest case in gas sector involves MP O. Onyshchenko that not only caused Mr. Onyshchenko himself to flee Ukraine, but also resulted in detaining acting Head of Fiscal Service of Ukraine with the charge of taking part in extremely high level embezzlement. In power industry, an evolving case regards Mr. M. Martynenko, a former MP who also chaired the Committee on Energy and Nuclear Defense Issues, who also has been detained for a while, but then released for other politicians' and ministers' bail. Both cases are currently underway, though slow and low-efficient court system of Ukraine makes their results vague.

Following the armed aggression, Ukraine has been consistently, though not too rapidly, amputating ties with Russia in nuclear cooperation. In line with respective provisions of the new National Security Strategy⁷⁵, real steps towards diversification of supplies have started to be implemented: cooperation with the US-based Westinghouse – the only company capable of producing fuel for Ukrainian reactors other than TVEL – moved towards strategic cooperation with loading more blocks with its fuel arrays, though still in trial mode, according to a supplementary agreement signed in 2014. Ukraine is also well on the way to have its own extensive Integrated Storage Facility for Spent Nuclear Fuel with planned commissioning already in 2018⁷⁶.

⁷³<http://www.newsru.ua/finance/20nov2009/aes.html>

⁷⁴ Respective aims have been clearly set forth by the Concept of State Economic Program Nuclear Fuel of Ukraine approved by the Resolution of the Cabinet of Ministers No.216-r dated February 25, 2009 (<http://zakon5.rada.gov.ua/laws/show/216-2009-%D1%80>), as well as sufficient scientific and economic potential of Ukraine for launching its own full cycle nuclear industry was recognized and emphasized in the Energy Strategy of Ukraine by 2030 approved by the Resolution of Cabinet of Ministers No.1071-p dated July 24, 2013 (<http://zakon4.rada.gov.ua/laws/show/n0002120-13>). See also: http://www.razumkov.org.ua/ukr/files/category_journal/NSD110_ukr_4.pdf

⁷⁵ Approved by the President Poroshenko on May, 26, 2015 (<http://zakon3.rada.gov.ua/laws/show/287/2015>)

⁷⁶ The Ukrainian Nuclear Energy Partnership with Russia: The End of an Era of Cooperation 6 Olga Kosharnaya, Kyiv (<http://www.css.ethz.ch/content/dam/ethz/special-interest/gess/cis/center-for-securities-studies/pdfs/RAD193.pdf>) p. 7



Westinghouse President and CEO Danny Roderick and Energoatom President Yuriy Nedashkovskiy sign contract to enhance Ukraine nuclear safety with Westinghouse BEACON™ Core Monitoring System (Photo source: Business Wire)

Nevertheless, in political perspective, the speedy implementation of market-based reforms in electricity sector of Ukraine, introducing the best practices in state owned enterprises management, as it is currently underway in gas sector and in Naftogaz, respectively, might yield even more sensible results by making power generation transparent and market-based, effectively de-oligarchizing the whole industry. Direct participation of the US capital, in part of Westinghouse, as well as potential cooperation with French AREVA, might both cover the gap after TVEL is set aside, bring solid contracts to the companies, and open another viable market closed until very recently.

The power system and grid operation offers yet another significant instance of Russia's successful prevention of Ukraine from technological development and diversification. Currently, Ukrainian electricity grid with the exception of its westernmost region is synchronized with IPS/UPS grid, the integrated area of the CIS countries⁷⁷. In closer detail, however, it is clear that Ukraine is much more synched with Russian power grid as capacity of electricity transmission lines connecting two countries amount to 26.3 TWh per annum. For comparison, yearly connectivity with Belarus is estimated at 6.1 TWh, with Moldova – 1.5 TWh⁷⁸. At the same time, Ukraine features a comparatively small autonomous grid synchronized with ENTSO-E – so-called Burshtyn island. Through this separated grid Ukraine is capable of exporting electricity westwards – mainly to Hungary and Poland. Total current actual export capacity is estimated at the level of approximately 650 MW, while installed transmission capacity to the neighboring EU Member States equals roughly 5 TWh per annum. Technically such situation means that under ordinary circumstances the United Energy System of Ukraine, which currently has significant excess of installed generation capacity, is only capable of exporting its surplus to Russia, Belarus and Moldova with almost no viable

⁷⁷ "UPS" stands for Unified power system [of Russia] whereas "IPS" stands for Integrated power system and relates to those grids integrated to the Russian one, namely Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Mongolia, Tajikistan and Ukraine.

⁷⁸ <http://mpe.kmu.gov.ua/minugol/doccatalog/document?id=222032>

connectivity with the EU. In fact, under any serious emergency threatening imminent blackouts, Ukraine remains effectively dependent on imports from Russia.

Historically, there have been two major reasons for the Ukrainian political leadership to disregard the potential danger of such dependence on Russia. Firstly, unlike other countries of the Energy Community, the Ukrainian potential in power generation makes it more than self-sustainable, and thus no critical emergencies were seen as a real danger. Secondly, and more importantly, given the high involvement of Russian business in power distribution, power generation (indirectly through close business relations with DTEK owner R. Akhmetov, as well as leverage towards state-owned monopolists Energoatom and Ukrhydroenergo through rather loyal ministers of energy and government as a whole) and power transmission (reported influence of Russian businessman K. Grigorishyn onto the Ukrainian TSO Ukrenergo⁷⁹) Russia appears to have been carefully controlling that no attempts to synchronize with European grid are fruitful.

The first and only successful effort of connectivity on the western border was the Burshtyn power-island that has been brought to existence during 1995-2002 as a trial dedicated to prove overall feasibility⁸⁰. Following this accomplishment, Ukrainian TSO's management team was optimistic regarding extending the island to cover the whole United Energy System. However, the intentions have drowned in the lack of political will to continue the experiment. In 2006, on the wave of euro-optimism following the Orange revolution that led to the Presidency of V. Yushchenko, UTCE-Ukraine-Moldova trilateral talks completed with UTCE Secretariat accepting of the applications of the two countries to join the grid simultaneously. The work continued in 2008, when terms of reference for a respective feasibility study was approved by the Ukrainian government, and further in 2011, following Ukraine's joining the Energy Community, the European Commission provided appropriate financing for implementing such a study.

While there were always some economic reasons for Russia to prevent Ukraine from breaking synchronization with UPS/IPS, in order to retain the possibility to sell some electricity to the Ukrainian grid, they do not seem to have a decisive role, since such cross-border flows have been neither significant, nor systematic. And yet Russia continues its unsubstantiated pressures for the *status quo*, despite Ukraine's clearly defined intentions to join European grid. This strategy, so far successful, suggests that Russia has remained a key veto player.

In addition to the technical requirements needed from stakeholders that would lead to significant investments, joining the single European electricity market would be preconditioned by the creation of a competitive and free domestic market of electricity in Ukraine. The transparent rules of the Third Energy Package would make it much harder for the assets held by the Russian business to stay dominant in their respective market segments. On a deeper level, the introduction of a more transparent and competitive business environment in the energy sector would eliminate complicated budgetary schemes allowing for the part of Ukrainian political elite to earn corrupt windfall incomes and likely to re-invest those into rigging further elections to keep the wicked system running on⁸¹. It is, therefore, no surprise that Ukraine became interested in the joint European grid during the political leaderships that assumed office as the result of invoking direct democracy.

Most recently, the new management team of Ukrenergo reported that the feasibility study of synchronization of power grids of Ukraine and Moldova is complete and, most importantly, it

⁷⁹<http://politolog.net/hot/grazhdanin-rossii-grigorishin-cherez-stavlennikov-kontroliruet-ukrenergo-zhurnalistk-infografika/>

⁸⁰http://mpe.kmu.gov.ua/minugol/control/uk/publish/printable_article?art_id=93953

⁸¹ According to the court decision following civil upheaval during aftermath of 2004 Presidential elections in Ukraine, voting and vote counting process have been violated on numerous levels rendering the results of the elections void. See further: <http://www.scourt.gov.ua/clients/vs.nsf/0/2A1C4C7D8C6241CBC3256F9D00228DA5>

demonstrated there is such a technical possibility. Moreover, TSO's management stated that given the current pace of organizational and technical process it might take not more than three years to reach complete synchronization with ENTSO-E⁸². At the same time, reaching this ultimate goal, given continued support of the TSO itself, will most crucially depend on Ukraine continuing its pro-European course. This is understood as not merely claiming its aspiration, but first of all as adoption and implementation of market-based reforms in Ukraine. In this process, reasonable technical support and cooperation on the part of the EU partners should be regarded as a high priority (given the insufficient capacity of the state-owned TSO), along with overall political support of the reforms in electricity sector steadily taking place in Ukraine.

Last Resort. Russia's exploiting vulnerable groups of coal miners to disguise igniting the conflict. Burden of hybrid warfare

Hybrid warfare was started by Russia a long time before its special forces appeared at the building of the Supreme Council of Crimea on February 27, 2014, and even before the first shots were fired on Maidan in Kyiv against peaceful protesters. It first became visible in the presidential race of 2004, when Ukrainians were divided into "3 sorts" in the political ad⁸³. In this play, electoral basis of the most pro-Russian national political force in Ukraine, the Party of Regions (which now ceased to exist under this name) and political gravity center of, as falsely declared, less respected "sort" of Ukrainians primarily laid in the highly industrialized (in Soviet times), resource-rich regions of the Eastern Ukraine.

Among the numerous factors that preconditioned turning local population of Donbas into easy victims of the Russian propaganda, these are the most influential: high concentration of population, powerful informational influence given bordering Russian part of the same geological region, and specific of economic outputs - coal-mining industry represents core labor engagement of the locals. The latter fact was systematically utilized by the Russian informational campaigns in Ukraine in order to create and exaggerate so-called regional identity of Donbass residents, mainly emphasizing the glorious profession of a coal miner. The ideas centering on this largely artificial image most likely resulted from the work of the political advisors of both Russian state and its political proxies and allies inside of Ukraine planting the seeds that were then carefully nurtured by the campaign itself. In most instances of such campaigns the promoted messages were set in simple head-lines persuading that the hard-working miners of the Eastern regions ("Donbass is the bread-winner of all Ukraine") are disregarded on the national scale ("You should listen to the voice of Donbass").

As residents of the eastern part of the country had a limited range of opinion leaders and sources of information, it was always easy to manipulate their thoughts. That was also multiplied by the strong role that Russian media played in the region, echoing the messages by the Russian-backed politicians. The stories that arose in various times were laughed at in Kyiv because of their lack of ties with reality, but at the same time were seriously taken in the eastern regions. V. Yanukovych who attempted to become the President twice, based his second try on massive populism⁸⁴. As media noticed, he pulled to Kyiv a big portion of regional elites, making him "their guy" in Donetsk and Lugansk. Such local identity has always been positioned as strongly anti-Ukrainian and significantly pro-Russian, in fact representing nostalgia for Soviet

⁸²<http://www.ukrenergo.energy.gov.ua/Pages/ua/DetailsNew.aspx?nID=3266>

⁸³ The idea behind this type of populist messages was to exploit historic affiliation of different parts of currently united Ukraine with different composed states, mainly - the Russian and Austrian empires. While there are indeed considerable differences in many respects, it was never a state policy or program of any nation-wide parties to discriminate any regional peoples against other parts of the population. Among other things, such discrimination is directly prohibited by the Constitution.

⁸⁴<http://ua.korrespondent.net/ukraine/politics/1349159-bilshist-ukrayinciv-vvazhayut-sociniativ-yanukovicha-populizmom-opituvannya>

times and reinventing Soviet culture based on strong, but often non competent leadership, oppressing social freedoms in exchange for stability and dominance of heavy industries in economy. Needless to note how the corresponding environment is far from democratic process and close to the regimes established by Putin and Lukashenko.

It is hard to identify the degree of circumstances being created by the Russians or facilitating factors being put together and just benefitting from the right moment, but severe dependence of Ukrainian power generation upon steam coal mined locally in Donbass (and incomparably less from some deposits in the Western region) lasted throughout all recent history. In turn, the Eastern regions gained significant political weight that only increased the following efforts for homogenizing political landscape on the ground by escalating cultural differences of the local people of East and South of Ukraine against the rest of the country⁸⁵. The messages also went along to describe the economically powerful Donbass as a donor for less industrialized and thus less “performing” regions. Coal industry played a major role in this propaganda, especially within the periods of political leadership of Yanukovych, originated himself from a miner city of Yenakiyev, under which numerous state aid measures were introduced specifically towards coal enterprises of Donetsk and Lugansk regions, as well as several editions of the Law “On Increasing the Prestige of Miner Job”⁸⁶ were passed allowing for significant budgetary spending in a materially loss-making industry. Indirectly, in order to sustain this specific bias towards the interests of energy business groups (mainly Rinat Akhmetov controlling DTEK holding company and the richest Ukrainian) and to secure jobs and thus loyalty of its core electoral group, the Ukrainian government has never endeavored viably to implement its numerous promises to lower the dependence on coal within national power generation mix.



⁸⁵<http://www.istpravda.com.ua/artefacts/2013/05/24/124685/#18>

⁸⁶<http://zakon2.rada.gov.ua/laws/show/345-17>

That way or another, currently Ukraine remains critically vulnerable due to remaining mining of coal, especially that rare high-efficient anthracite coal that is only produced in Donbas (both Ukrainian and Russian parts). With occupation of territories, Ukraine lost 85 coal mines of all forms of ownership that amounted to 57% of their total number of Ukraine. Among the anthracite coal mines that produce fuel for the majority of TPPs in Ukraine, almost all were left on the terrorist-controlled territory⁸⁷. With the beginning of military actions, 69 out of 150 Ukrainian mines had to stop extraction and 7 were destroyed⁸⁸. Ukraine faced the need to either bring coal from the occupied territories or to import it from few locations, including Russia. Transportation of coal from the occupied territories was subject to the availability of railway connection across the front line⁸⁹, possibility to bring enough railway carriages to pick up coal as there were risks related to storage, safety etc. Ukraine had to import anthracite coal from abroad, e.g. South Africa⁹⁰. All in all, this had put Ukraine under coal dependency, possibly designed to balance the decreasing ties to gas and nuclear dependency that existed before. In December 2016, the Ministry of Energy mentioned that Ukraine can manage to survive without supplies from the occupied territories of Donbas⁹¹. Since March 2017, following mass civic protests led by several opposition MPs and claiming the trade with the occupying forces is opaque, illegal and amoral and thus should be ceased, any cargo traffic has been banned on all access points along the contact line by the decision of the National Security and Defense Council enacted by the President of Ukraine⁹².

Another illustrative example of the magnitude of Russian influence challenging the steps towards Ukraine's energy independence is how prospective production of unconventional gas has been effectively cancelled through active campaigns among local agents in the region. In 2012 Shell applied and received the right to sign the product sharing agreement to develop the Yuzivska field in Kharkiv and Donetsk regions for shale petroleum though fracking. The ex-Minister of Energy E. Stavytskyi said that in 10 years Ukraine would get 8-10 bcm annual production of gas from this field alone⁹³, which would more than halve the volumes of Russian gas supplies.

The aggressive social campaign against the project gained surprisingly powerful momentum, given that the region was never before famous of any similar grassroot protest movements whatsoever⁹⁴. First before of that, and lately due to first military actions evolved in the region, Shell postponed the start of works several times⁹⁵. In 2015 Shell pulled out completely of the agreement⁹⁶. One of the reasons for this cited by observers was the failure to find substantial gas reserves for extraction⁹⁷. However, no wells were drilled under the Yuzivska production sharing agreement, and the company representatives pointed at the climate around the project⁹⁸. In other words, unusual and suspicious civil activity followed by the armed

⁸⁷<http://hromadske.ua/posts/reforma-chy-vyzhyvut-ukrainski-shakhty>

⁸⁸<http://www.niss.gov.ua/articles/2188/>

⁸⁹<http://www.epravda.com.ua/news/2016/06/30/597506/>

⁹⁰http://biz.censor.net.ua/resonance/3008843/kervnik_34tsentrenerg34_34mojna uklasti sotn kontraktv pit annya hto tob postachatime vuglyya34

⁹¹<http://www.5.ua/ekonomika/ukraina-mozhe-obiitysia-bez-vuhillia-iz-donbasu-minenerho-126049.html>

⁹²<http://www.reuters.com/article/us-ukraine-crisis-blockade-cargo-idUSKBN16M14T>

⁹³<https://uk.wikipedia.org/wiki/%D0%AE%D0%B7%D1%96%D0%B2%D1%81%D1%8C%D0%BA%D0%B0%D0%BF%D0%BB%D0%BE%D1%89%D0%B0>

⁹⁴ See further: <https://www.euractiv.com/section/europe-s-east/opinion/russia-s-silent-shale-gas-victory-in-ukraine/>

⁹⁵<http://ua.112.ua/ekonomika/shell-znovu-vidklala-burinnya-pershoyi-rozvidualnoyi-sverdlolini-na-yuzivskomu-rodovyschi-104706.html>

⁹⁶<http://ua.interfax.com.ua/news/general/299606.html>

⁹⁷<http://www.epravda.com.ua/news/2015/11/23/568629/>

⁹⁸<http://www.qclub.org.ua/news/hjolova-shell-konstatuvav-znyzhennya-tempiv-rozvidky-yuzivskoho-rodovyscha-cherez-ato/>

aggression locked the possibility of producing additional volumes of gas, which together with diversification and energy efficiency processes could lead to significant drop of dependence on imported gas supplies.

Not just unconventional gas, but the offshore gas too became captive in the course of the Russian occupation of Ukrainian territories. In 2013, Ukraine and a consortium of companies that included Exxon Mobil, Royal Dutch Shell, and OMV Petrom signed an agreement that opened the way to negotiations on the production sharing agreement on the Skifska field in the Black sea offshore⁹⁹. The operations were planned to begin in 2014, which had not happened because of the military aggression. The expected amounts of production were 8-10 bcm of gas annually¹⁰⁰. The Black Sea offshore was a promising place for possible gas production, as Chornomornaftogaz, the subsidiary of Naftogaz, planned to explore 7 fields by 2015 and bring its annual production to 3 bcm¹⁰¹. Even the infamous corruption scandal “Boyko rigs”, with investigated procurement of drilling rigs at inflated prices in 2011¹⁰², was also a part of the plan to increase gas production and to make it more effective. It is interesting to know that Turkey reportedly addressed Ukraine with an offer to rent rigs when they were bought¹⁰³, and Russia relocated them¹⁰⁴ after the occupation, with Ukraine having no chance to take them back.

There were also plans by the private company Vanco Prykerchenska to start exploration in the Black Sea offshore in early 2011¹⁰⁵, subsequently envisaging drilling of the first well in 2015¹⁰⁶. The company reported about plans for investing USD 1 bn over 8 years of exploration and production¹⁰⁷. The situation which took place in the gas sector looks as if Ukraine was locked out of the potential to engage additional amounts of fuel, including both unconventional and offshore gas. While it could be one of the sub-events of the occupation, it might be as well one of the reasons for such actions on the part of Russia that otherwise could not block these efforts.

Resulting from that, there are several implications for the energy policy dimension in Ukraine. First, it provided Russia with another energy leverage on Ukraine in addition to gas dependence that was weakening. As the region was previously known for its coal production, the war brought a lot of changes to the energy infrastructure, cutting Ukraine's confidence in coal supplies for its heating infrastructure. Another point of influence is the need to compensate for the loss and make changes to socially sensitive tariffs. In the energy sector, the direct losses from the Russian-led war is the loss of control over coal supply (especially the anthracite coal), closure of the unconventional gas exploration on the Yuzivska field, inability of companies and consortiums to fully engage into exploration of offshore gas fields. That was done with hands of both the Russian military and proxies who were manipulated by years from the side of Russian media propaganda and pro-Russian politicians on various levels, both in the region and in Kyiv. Beyond any doubts, efforts to secure and increase Ukraine's already high dependence upon Russian energy supplies should be regarded as one of the factors which prompted Vladimir Putin to completely disregard international laws and start occupation in 2014.

⁹⁹<http://www.epravda.com.ua/news/2013/09/25/396248/>

¹⁰⁰<http://dt.ua/ECONOMICS/ugodu-pro-rozpodil-produkciyi-na-skifskiy-dilyanci-shelfu-chornogo-morya-bude-pidpisano-protiyagom-misyacya-129043.html>

¹⁰¹http://www.bbc.com/ukrainian/politics/2016/09/160914_ukraine_russia_court_rl

¹⁰²<https://www.pravda.com.ua/news/2016/01/6/7094582/>

¹⁰³<http://gazeta.ua/articles/economics/turechchina-hoche-orenduvati-vishki-bojka-zmi/434960?mobile=true>

¹⁰⁴<https://www.ukrinform.ua/rubric-economics/1931041-rosiya-evakuyuvata-vishki-boyka-schob-ne-vidsudiv-naftogaz-zmi.html>

¹⁰⁵<http://economics.unian.net/energetics/466956-vanco-prykerchenska-planiruet-nachat-razvedku-na-shelfe-chernogo-morya-v-pervoy-pолоvine-2011-g.html>

¹⁰⁶http://www.oilnews.com.ua/a/news/Vanco_nachnet_burenie_na_chernomorskom_shelfe_v_2015_g/207577

¹⁰⁷<https://inventure.com.ua/news/ukraine/kompaniya-vanco-planiruet-v-techenie-vosmi-let-investirovat-1-mlrd>

Recommendations for the EU:

- In relations with Russia, a principal decision has to be made of zero tolerance of any exemptions from the generally applicable EU regulations, as it can lead to fragmentation of the markets and decreased competition, making the countries affected dependent and vulnerable to further demands and influences from the Russian side.
- Specifically, the EU policymakers shall execute all possible influence to review new infrastructure projects like Nord Stream 2, which aim to offset Ukraine as the shortest and most reliable way of gas delivery to the EU. So far, both issuing permits for construction of the Nord Stream 2 pipeline and resolution of the Commission on functioning of OPAL system set Ukraine aside with no communication whatsoever. Such approach needs comprehensive revision on the side of the Commission in line with the considerations related to the Energy Union.
- Given a favourable horizon, the EU should focus on making decisions on taking Russia to the level playing field in terms of antitrust investigations. What is more important, a system should be elaborated aimed at preventing such violations on the Russian (or any other, if any) side in the first place in the future.
- The new regulation on security of supply, providing the European Commission with the right to get into intergovernmental energy agreements with non-EU countries before they are concluded, shall become effective as soon as possible. Whether within the Energy Community and the CESEC framework or otherwise, inclusion of Ukraine on the side of the EU would significantly increase magnitude of such measures.
- While there is some level of institutional assistance rendered by the EU with regard to raising institutional capacity of Ukrainian governmental and law enforcement bodies, the efforts must be significantly boosted in the light of low capacity of Ukraine's responsible ministries and agencies.
- The EU's external energy policy in the framework of the Energy Union still needs strengthening to extend its scope to neighboring nations. The support to Energy Community expansion is required, as well as raising of its institutional capacity to ensure oversight over legislation and practices in the Contracting Parties being progressively compliant with the EU rules.
- The EU Member States in Central and Eastern Europe could also benefit from including the Ukrainian gas system in the North-South corridor and by effective commercial utilization of Ukrainian storage facilities by European customers.

Recommendations for the US government, Congress and Senate:

- The United States' Foreign Corrupt Practices Act, as well as other systems for anti-fraud and anti-money-laundering legislation when applied towards Ukrainian and Russian corrupt officials or executives may become a game changer, as exemplified by the recent action against Mr. Firtash. Fueling this instrument and wider collaboration with new Ukrainian law enforcement authorities would earn further success.
- Further and deeper cooperation of the newly-created anti-corruption bodies of Ukraine as National Anti-corruption Bureau and Specialized Anti-corruption Prosecutor Office with the FBI and other US prosecution agencies, including knowledge transfer and trainings, may help building capacity required to fight structural corruption within the energy sector of Ukraine. It is important to raise effectiveness of the court system appropriately.
- Finding economically reasonable means of expanding of the United States' LNG supplies to the joint gas market of Europe has a great potential of mitigating persistent efforts of Russia to use gas supplies and related infrastructural projects as geopolitical tools to break the unity.

Recommendations for both Brussels and Washington:

- Both the US government, through various instruments like USAID and leading role in IMF, and the EU, through numerous bilateral and multilateral aid programs, are capable of incentivizing the Ukrainian government to enhance the pace of market reforms.
- Issues of significant increasing of institutional capacity of Ukrainian public bodies, including governmental agencies and courts, as well as those related to reasonable privatization of energy assets, should be more viably incorporated into memoranda signed regularly between Ukraine and the IMF with regard to support of the government's economic program
- Training and educational programs aimed at increasing the professional expertise and capacities of decision-making authorities in Ukraine, for example EU-funded Twinning, bring exceptional use. Such programs would yield even more results given wider spreading across Ukrainian agencies.
- Supporting grass root movements and lifting the barriers for emerging political forces not financed by the oligarchs tied with the Russian capital would contribute to improving political competition, giving the voters a much wider choice and freeing the country from the oligarch consensus system, which perfectly fits Russia's interests.
- Holding a strict position on corporate reform issues like introduction of the OECD best practices of corporate management in state-owned enterprises should become even more vigorous policy of the Western donors to Ukraine as a large share of economy is still not privatized and state-owned enterprises are well-known to be the greatest sources of the high-profile embezzlement schemes.
- A wider transfer of modern technologies in terms of nuclear industry and other energy related infrastructure and a freer export of hardware from the Western countries would ease and enhance the process of breaking the technology dependence upon Russia. In the same time, this would compensate to a degree losses due to anti-Russian sanctions and trade restrictions for the US and EU suppliers.
- Much deeper direct participation of the European and American capital in Ukrainian energy assets is seen to bring a better balance of interests on the playing field. In the view of the technology gap and business practices, Ukrainian energy sector is only preparing to run up such investments, which appears to bear significant margin.
- Dialogue at highest possible level, namely in the framework of the Minsk process and the Normandy format, with effective coordination with other parties (US, UK, Poland, Canada etc.), would be required to keep the issues of energy relations with the occupied territories under control and not allow the Russian party of the conflict to manipulate. Specific attention should be paid to the distorted, misinterpreted and sometimes clearly made-up information coming from the Russian sources regarding Ukraine and its territories occupied by the terrorists that are supported by Russia itself.
- Helping raising public awareness and building the capacity of independent and competent NGOs on the part of development agencies of the EU and the US might trigger lowering the populism perception by Ukrainian electorate and subsequently improve the perception of the market reforms that are underway in Ukraine.

MOLDOVA. Pulling the Strings: Russia's Control over Moldova's Energy Sector

Denis Cenuşa

General overview

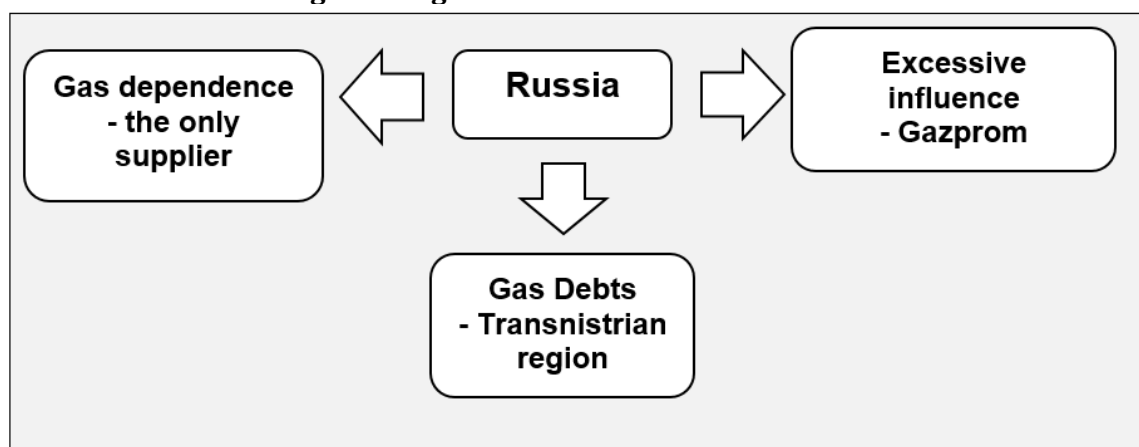
The energy sector of Moldova is exposed heavily to structural reforms driven by the transposition of EU's energy acquis. The acquis is an obligation stemming from Moldova's membership in the Energy Community since 2010 and the implementation of Association Agreement with EU, signed in 2016. Nevertheless, Russia still succeeds to secure its interests in the energy sector, both by using the political pressure and exploiting the local corrupt energy stakeholders. Russia currently controls almost 100% of the gas supply to Moldova; 50% of the gas transmission network (plus 13% indirectly through the Transnistrian administration); and up to 80% of the production of electricity consumed in Moldova, through the Russian-owned power plant Kuchurgan in Transnistrian region. Accepting non-payments from gas consumers in Transnistria (including from the power plant), it has accumulated debts of over 80% of Moldova's GDP; with this leverage, it can influence political decisions in Chisinau, e.g. by threatening to discontinue energy supplies or by suggesting it could execute at any time strategic assets (e.g., electricity network, gas distribution, or even the EU-financed interconnector with Romania), whenever Kremlin is dissatisfied with Moldova's policies. The continued dependency on Russia has been reinforced by local vested interests, which benefited from the non-transparent deals for electricity and gas, as will be explained.

By these indirect means, Russia obtained the delay of the unbundling provisions in gas sector by 2020, which would have seriously affected its interests by requiring the separation of the control of the gas network from the supply business. It also retains the possibility to deliver electricity, produced by the Russian-controlled power plant in Moldova's breakaway region, even after this year a tender replaced Kuchurgan with Ukrainian suppliers for imported electricity.

Russia's monopoly in the gas sector

The risks of Russia's leverage in the gas sector stems from a myriad of sources such as: 1) overall significant dependence of Moldova on gas supplies from Russia; 2) emerging debts on gas to Gazprom; and 3) excessive influence of a giant Russian stakeholder (Gazprom).

Table 1 Russia's leverage in the gas sector



Dependence on Russian gas

Moldova's gas sector depends by almost 100% on gas deliveries from Russia, almost 3 bcm in 2011-2015 of yearly imports.¹⁰⁸ Only around 1 bcm goes to the part of the country under Chisinau's authority (right bank). The rest (about 2 bcm) is directed to the Transnistrian separatist region, which does not pay for the gas to MoldovaGaz, the Moldovan transport system operator. Accumulated arrears over two decades soared Moldova's (right plus left bank) official debts to Gazprom to incredibly high amounts, over 80% of its yearly GDP. Besides, Moldova is also a transit country for Russian gas channeled to Balkans and Turkey (16.7 bcm in 2015)¹⁰⁹. The transit would be disrupted in the future if Ukraine-Russia transit contract is not extended beyond 2019.

The dependence on gas imports from Russia is a serious risk for the security of supply. Partially, this insecurity is caused by the unpredictable behavior of Russian authorities, which exert political pressure by exploiting Moldova's energy dependence. For instance, Gazprom rejected the idea of negotiating a new contract to replace the former one for the period 2007-2011, signed in 2006. A new gas contract, for a 3 years period¹¹⁰, came out from the "road map" on restoring bilateral trade relations, agreed in November 2016.¹¹¹ Gazprom announced the extension of the existing contract (2016) for three more years until 2019.¹¹² This timespan coincides with the deadline for the exemption that Moldova received from the Energy Community on implementing the Third Energy Package on unbundling in gas sector.

But diversification of imports and routes of deliveries could reduce the dependence on Russian gas and facilitate the negotiation of a new and more convenient contract as Gazprom enters competition with EU (Romanian) suppliers. This opportunity reflects the legal commitments on diversification of supplies enshrined in the EU-Moldova Association Agreement¹¹³, and the transposition measures from the Third Energy Package. These commitments have incentivized the construction of Iasi-Ungheni interconnection between Romania and Moldova, opened in August 2014, with only 1 million m³/year delivered during 2015, or less than 0.1% of Moldova's consumption.¹¹⁴ The potential of this interconnection remains yet untapped because it is not yet linked with Chisinau, the region with the highest share of internal consumption (approx. 60%). Once finished, the interconnector from Iasi to Chisinau would not only diversify supply, but would also influence the gas prices. During the decrease of the oil global prices in 2016, which normally shape the final price on gas sold by Gazprom, Moldova benefited from low prices for Russian gas (approx. 200 USD/1000 m³ in 2016).¹¹⁵ Therefore, the Russian gas became cheaper than the gas proposed by Romania during

¹⁰⁸ Gazprom's data on gas deliveries to ex-Soviet republics, <http://www.gazprom.com/about/marketing/cis-baltia/>

¹⁰⁹ <http://www.moldovagaz.md/menu/ro/about-company/transportation>

¹¹⁰ <http://newsmaker.md/rus/novosti/kishinev-i-moskva-udarili-po-gazam-storony-gotovy-podpisat-trehletniy-kontrakt-na-28951>

¹¹¹ Cenușă D., "Association Agreement with EU and maintaining of Moldova in CIS", November 2016, IPN News Agency,

https://www.academia.edu/30341811/Association_Agreement_with_EU_and_maintaining_of_Moldovaev_in_CIS

¹¹² <http://gov.md/ro/content/intrevederea-premierului-pavel-filip-cu-vicepresedintele-consiliului-de-administratie-sad>

¹¹³ http://expert-grup.org/ro/biblioteca/item/download/1511_d3527cd3fb892d86a39ec496490692c0

¹¹⁴ The supply from Romania by OMV Petrom constituted 1,1 million m³ during 2015 in comparison with approx. 1 billion m³ shipped by Gazprom, <http://anre.md/files/raport/Raport%20anual%20de%20activitate%202015.pdf>

¹¹⁵ For 2015, ANRE calculated an average price for the imported gas of 260 USD/1000 m³, <http://expert-grup.org/en/biblioteca/item/1209-extindere-gazoduct-iasi-ungheni-spre-chisinau-studiu/1209-extindere-gazoduct-iasi-ungheni-spre-chisinau-studiu>

its short-term supply in 2015 (220 USD/1000 m³)¹¹⁶. But as the oil prices are highly volatile, the Romanian gas looks more predictable in terms of price formation; diversification would also facilitate gas-to-gas competition and thus may reduce prices or avoid price increases in the future.

Following the transposition of the Third Energy Package (Directive 73/2009) in May 2016 and the preparation of the feasibility study, EBRD, EIB and EU offered a financial package of 92 million EUR to Vestmoldtransgaz (an independent transport operator managing the interconnector with Romania) for the Ungheni - Chisinau pipeline extension.¹¹⁷ However, even if the pipeline is built, the real supply diversification will depend on the effective access of Romanian suppliers to the Moldovan market. The Ungheni-Chisinau pipeline would be connected to Moldovagaz' pipelines and it must be ensured that no real or imaginary technical problems would limit the access for the Romanian gas in a network controlled indirectly by Gazprom. This requires a strong and independent regulator, and well-designed primary and secondary legislation. This will also require the unbundling principle implemented thereby challenging the monopolist position of MoldovaGaz, where Gazprom de facto rules.

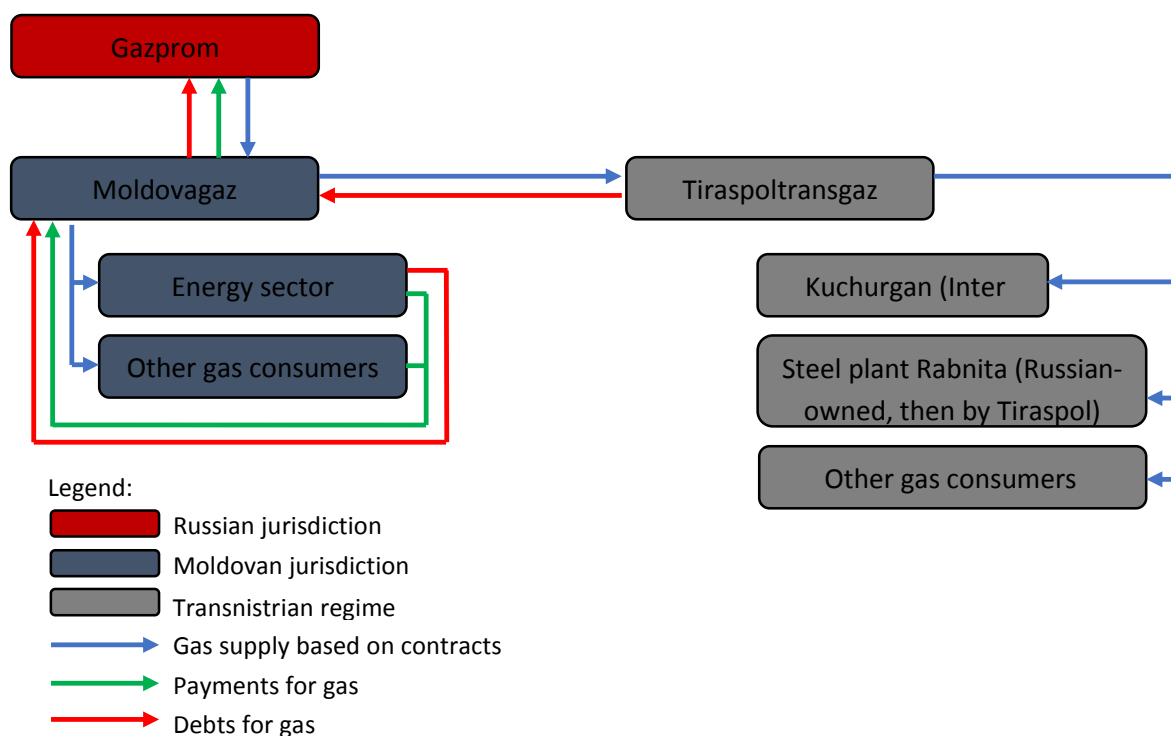
Debts in energy sector

The historical level of gas debts towards Russia is one of the most pressing issues for the energy and social-economic security and political stability of the country. Technically, Moldovagaz purchases gas for both the right and the left banks (see figure). Legal inconsistencies related to the contracts between MoldovaGaz and Gazprom, poor corporate governance of Moldovagaz and non-commercial operation of all the companies involved create uncertainties about who should be directly accountable for paying the debts on gas consumed by the Transnistrian region (90% of Moldova's total debts). However, the Russia-Moldova protocol signed in November 2016 confirmed that the overall debt of MoldovaGaz to Gazprom is 5.25 billion USD, which implicitly includes the Transnistrian region.¹¹⁸

¹¹⁶ http://www.economica.net/moldovenii-nu-ne-mai-vor-gazele-ce-nu-a-dorit-sa-spuna-guvernul-de-la-chisinau-contraoferata-rusilor-este-de-nerefuzat_110127.html

¹¹⁷ The EIB and EBRD are each lending 41 million EUR, while the EU ensures a 10 million EUR grant, December 2016, <http://www.ebrd.com/news/2016/eu-bank-and-ebrd-support-gas-interconnection-between-moldova-and-romania-.html>

¹¹⁸ Moldova-Russia protocol, November 2016, http://www.mec.gov.md/sites/default/files/protokol_rm-rf_29.11.16.pdf



Source: Parlicov, Soitu, Tofilat, (<http://www.viitorul.org/en/content/energy-sector-moldova-hostage-impunity-and-renter-arrangements-conclusions-and>)

Partially, the lack of clarity on who should repay the debts contributed to their continuous accumulation, accounting for 5.4 billion USD¹¹⁹ by October 2016. By January 2017 these debts surpassed the amount of 6 billion USD, which represents approximately 80% of Moldova's GDP. The lack of legal clarity over the separation of these debts, within the bilateral Moldova-Russia contract, encourages a moral hazard behavior with regard to gas consumption from the separatist administration. As a result, it destabilizes the security and the sustainability of the energy sector of Moldova.

While the gas debts are a permanent source of insecurity for Moldova's energy sector, the separatist region benefits from it. On the one hand, it ensures significant fiscal revenues, and on the other hand, it produces economic advantages for local exporting industries, both of them being fundamental for the survival of the breakaway region, and for various populist measures involving gas free of charge.¹²⁰

Thus, first, the gas sector and connected industries are the major sources of income for the region (approx. 30%)¹²¹. They boost the public budget of the separatist region, which experienced dramatic decreases in Russian financial support (in 2012 - 150 mil. USD, versus 15 mil. USD in 2015)¹²². According to the region's revenue collecting system, the resources yielded from gas sector feed into a special account of the region's central bank, used to reduce region's budget deficit. According to some estimates, the indirect subsidies assured by the consumption

¹¹⁹ <http://www.moldovagaz.md/press/ru/2016/september/article771>

¹²⁰ <http://www.moldova.org/en/pensioners-war-veterans-receive-free-natural-gas-transnistria/>

¹²¹ According to the separatist region's budget for 2015, the biggest share of taxes were paid by companies from the gas sector or linked to it (about 30% or 50.9 mil. USD out of 163.9 mil. USD): Enegokapital, Kuchurgan Power Plant (Moldavskaya GRES), gas operator TiraspolTransgaz-Transnistria, Moldovan Metallurgical Factory etc., http://www.minfin-pmr.org/stories/files/otcheti_ministerstva/2016/182%D1%80.pdf

¹²² Data on Russian humanitarian assistance offered to the Transnistrian separatist region in 2015, <http://www.minfin-pmr.org/otchety-ministerstva/1075-informatsiya-o-raskhodovanii-gumanitarnoj-pomoshchi-rossijskoj-federatsii-v-2015-godu>

of unpaid Russian gas reached 1.3 billion USD obtained along the last 9 years (2007-2016). In this way, the region could cover about 35% of its budget during the same period.¹²³

Second, due to low gas costs, the production costs in the region are lower, which makes goods exported from the region more competitive on external markets. Based on cheap gas, the power plant from the region produces electricity subsequently acquired by the Moldovan state-owned electricity supplier (Energocom) from the right bank of Dniester's river. The last contract on energy supplies from the region ended in March 2017. Moreover, underpriced gas allows unrealistic low prices for consumers - 0.03 cents in Transnistrian region (0.34 cents per m³ in Moldova, right bank)¹²⁴, and for businesses alike. Before the looming economic crisis in the region, more visible since 2014, low prices for commodities, based on cheap gas, made the separatist region more attractive for citizens from the right bank.

Although the region's administration collects taxes for consumed gas from households and businesses, it has constantly refrained to pay for it to MoldovaGaz. Consequently, this has allowed the region to function based on an unsustainable economic and social model, "free riding" the Moldovan state. Gazprom does not put any pressure on the region to pay, although the latter is under full control of Russian authorities. Gazprom's benevolent attitude on gas debts arising from Transnistrian region contrasts with its reaction in case of alleged debts of Ukraine. Overall, the emerging gas debt has been weakening the position of the Moldovan government, which increases Gazprom chances to obtain bigger concessions in very likely future legal disputes on gas.

According to the available information on the agreement – undisclosed under commercial secret grounds -, the Moldovan system operator must pay the debts, even if they are calculated separately. This practice raises the question of what can be used to compensate these debts. One of the solutions underlined by some pro-Russian politicians is to hand over to Gazprom the remaining gas infrastructure and assets (networks of transmission, transit pipeline, distribution capacities), including the Moldovan state's 30% shares in MoldovaGaz. However, the existing assets might be enough to obtain 3.2 billion USD¹²⁵ and therefore to repay half of the debts. It is also questionable whether such a solution would include the Moldovan segment of the gas interconnector with Romania, and Vestmoldtransgaz, a Moldovan fully state-owned company, which manages it. Nevertheless, the recent Russia-Moldova protocol simply avoids the issue of debts accumulated from unpaid gas consumed in Transnistrian region. Despite that, Russian authorities focus on the debts of Moldova (4.7 million USD) determined by deficient "state tariff regulation"¹²⁶. This issue is even included the Russia-Moldova Action Plan for restoring the trade and economic relations in 2016-2017¹²⁷. The action plan is part of the above-mentioned bilateral protocol, negotiated without any kind of public consultation. Thus, the Moldovan side undertook a range of debts-related commitments towards Russia such as: i) avoiding the accumulation of new debts by Moldovan authorities (right bank of Dniester river); ii) compensation of the operational losses of MoldovaGaz caused by ineffective tariff policy; iii) exploring new sources for debts reimbursement including through loans contracted by MoldovaGaz. These commitments pose huge risks for the system operator MoldovaGaz, facing huge debts deriving from Transnistria and poor internal management.

¹²³ Parlicov V., Șoitu T., Tofilat S., Impunity and Rent-based Agreements in the Energy Sector of the Country, April 2017, <http://www.viitorul.org/ro/content/sectorul-energetic-%C3%AEn-republica-moldova-este-ostaticul-impunit%C4%83%C8%9Bii-%C8%99i-%C3%AEn%C8%9Belegerilor-rentiere>

¹²⁴ <http://novostipmr.com/ru/content/kak-segodnya-razvivaetsya-gazovaya-otrasl>

¹²⁵ <http://www.viitorul.org/ro/content/sectorul-energetic-%C3%AEn-republica-moldova-este-ostaticul-impunit%C4%83%C8%9Bii-%C8%99i-%C3%AEn%C8%9Belegerilor-rentiere>

¹²⁶ http://www.mec.gov.md/sites/default/files/protokol_rm-rf_29.11.16.pdf

¹²⁷ Moldova-Russia Action Plan for restoring bilateral trade and economic relations for 2016-2017, November 2016, http://www.mec.gov.md/sites/default/files/plan_rm-rf_2016-2017_29.11.16.pdf

All the above-mentioned practices are in serious opposition with the lack of any commitments on the Russian side to exercise its leverages on Transnistrian region forcing it to pay its outstanding debts. Concomitantly, although Russia constantly overlooks the debts of Transnistrian region refusing to demand from the region to pay,¹²⁸ it proposed to restructure the debts of Moldovan power generator (Termoelectrica) toward MoldovaGaz. This disproportional approach proves that Russia pursues a double standard principle on debts, and shows the clear interest of Gazprom to encourage the growth of debts deriving mainly from the separatist region.

Russian monopoly on gas sector

The monopoly over gas deliveries is complemented by Russia's strategic positioning (via Gazprom), as a shareholder of 50% of MoldovaGaz (joint stock company).¹²⁹ Moreover, Gazprom relies on additional 13.44% of shares, transferred for administration purposes, by the Transnistrian Property Administration Committee of the separatist region of Moldova. This arrangement resulted from the unilateral illegal decision of the separatist region to establish region's own system operator Tiraspoltransgaz-Transnistria, founded to undertake the assets that belong to the homonym entity subject to MoldovaGaz.¹³⁰ Since 2005, the separatist region has been looking for possibilities to sign a direct contract with Gazprom, avoiding the intermediary MoldovaGaz and expecting preferential price or even free-of-charge gas.¹³¹ Instead, Gazprom decided to sign a long-term contract with MoldovaGaz in 2006, without foreseeing separate contractual responsibilities for the Transnistrian region. Correspondingly, Gazprom contributed consciously to the debt increase from the Transnistrian region accounted as belonging to MoldovaGaz, and implicitly to the Moldovan state.

The monopolist position of Russia originates from the Moldovan governmental decision of 1998, when Moldova-Russia joint stock company MoldovaGaz was established as a merger of Moldovan enterprise Moldova-Gaz (set up in 1995¹³² amid post-Soviet privatizations) with a mixed Moldova-Russian enterprise Aprogaztranzit. In the newly created company MoldovaGaz, the Moldovan state accepted Gazprom as a majority shareholder. The authorities justified the decision as a necessary action to pay the debts for Russian gas¹³³ and secure gas supplies. In other words, the Moldovan authorities bear the responsibility for contributing to the establishment of the Russian monopoly in the Moldovan gas sector, which took place under the pressure of unpaid debts.

Therefore, Gazprom gained control over gas supply, transmission and the distribution capacities of the Moldovan gas sector. The internal composition¹³⁴ of MoldovaGaz allows Gazprom to adopt the decisions taken within the company, while the Moldovan authorities (Ministry of Economy) have limited executive competences. Given the limited attributions, the Moldovan side was unable to remove the former president of the MoldovaGaz Administration Council, Alexandr Gusev. In November 2015, Gusev has been prosecuted for embezzlement and

¹²⁸ <http://newsmaker.md/rus/novosti/kommersantj-gazprom-otkazalsya-ot-predlozhennoy-moldovoy-shemy-restrukturizatsii-m-29744>

¹²⁹ Structure of the shareholders at MoldovaGAZ,
http://www.moldovagaz.md/userfiles/file/darea_de_seama_2014.pdf

¹³⁰ <https://ava.md/2005/03/31/odnostoronniy-vygod-pridnestrov-ya-iz/>

¹³¹ <https://point.md/ru/novosti/ekonomika/moldova-gaz-pridnestrovje-budet-zaklyuchatj-kontrakt-na-postavki-prirodnogo-gaza-napryamuyu-s-oao-gazprom>

¹³² Governmental Decision nr. 605 of 10.08. 1994,
<http://lex.justice.md/viewdoc.php?action=view&view=doc&id=303361&lang=2>

¹³³ Governmental Decision nr. 1068 of 21.10.1998,
<http://lex.justice.md/index.php?action=view&view=doc&lang=1&id=297405>

¹³⁴ Author analyzed the publicly available items concerning Moldovagaz's regulation, which is not available in full.

mismanagement at MoldovaGaz¹³⁵, but he escaped the legal consequences of the Court decision by fleeing to Russia. However, with the approval of the Russian side (Gazprom), the government appointed on February 2017¹³⁶ its exponent Vasile Botnari then acting Minister of Information Technology and Communications as a new director of MoldovaGaz. This fueled suspicion that between Gazprom, the governing coalition under Democratic party leader and oligarch Vladimir Plahotniuc, and the acting Moldovan President Igor Dodon might exist certain agreements covering the energy sector.

MoldovaGaz is the founder of Moldovatrangaz, the sole transmission system operator.¹³⁷ The new Gas Law passed in May 2016, transposing EU's gas directive (73/2009), requires free non-discriminatory access to the national transmission system. Supposedly, MoldovaGaz can use its leverages to influence the decisions of Moldovatrangaz concerning the capacities for gas volume, shipped via transmission system, allotted to third parties. This unfair practice results from the inconsistent secondary legislation (Regulation on access to gas transmission networks and congestion management¹³⁸, adopted in December 2016). The Regulation contains certain deficient provisions that can favour MoldovaGaz.¹³⁹ Such a situation can affect the newcomers on Moldovan gas market, which cannot operate if the transmission operator allocates all the available capacities to Moldovagaz.

Finally, MoldovaGaz owns approximately 70% of the distribution infrastructure (12 subsidiaries).¹⁴⁰ This completes the strong vertical control over the entire Moldovan gas system. It starts from supplies agreed between the gas producer and exporter Russian state-owned Gazprom and the Government of Moldova (Ministry of Economy). Then it involves the supplier MoldovaGaz, half-owned by Gazprom, and the transmission operator founded by MoldovaGaz that also owns the big bulk of distribution entities.

Indirect electricity dependence on Russia

The electricity sector's liberalization is more complete than in the case of the gas sector. It is a result of the existence of various stakeholders on the market, which are clearly separated. At the same time, this sector engages more state-owned enterprises (Energocom – system operator and supplier at unregulated prices, Moldelectrica – transmission operator, North Electricity Supplier¹⁴¹ - supplier, Red Nord and Red Nord-Vest - distributors). There are also fully private operational entities, established by Spanish company Gas Union Fenosa.¹⁴²

The unbundling principle has been implemented more fully on the electricity market. It started with the old Law on electricity of 2009 transposing the Second Energy Package available at that time. Therefore, both state and private companies abided by the principle of unbundling. The fundamental aspect is that the electricity suppliers are separated from the networks. This is different from the gas sector, in which Gazprom, the Russian gas producer and exporter, controls the supplier company (MoldovaGaz) and its subsidiary transport system operator

¹³⁵ <http://www.zdg.md/stiri/stiri-sociale/cine-sunt-sefii-de-la-moldovagaz>

¹³⁶ <http://www.ziarulnational.md/mocanu-a-avut-dreptate-vasile-botnari-noul-director-al-sa-moldovagaz/>

¹³⁷ <http://idno.md/companii?q=Moldovagaz>

¹³⁸ <http://anre.md/ro/content/consult%C4%83ri-publice-0>

¹³⁹ The regulation lacks clear procedure based on which the transmission system operator will appoint the suppliers that get the access to pipeline's capacities.

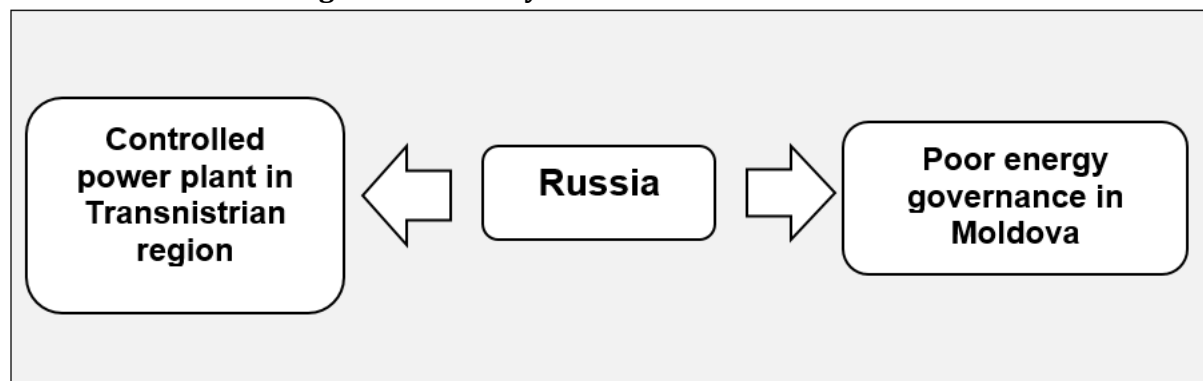
¹⁴⁰ Nuțu O., Cenușă D., Expert-Forum, Expert-Grup, Expanding Iasi-Ungheni pipeline to Chisinau: challenges and opportunities, <http://expert-grup.org/en/biblioteca/item/1209-extindere-gazoduct-iasi-ungheni-spre-chisinau-studiu/1209-extindere-gazoduct-iasi-ungheni-spre-chisinau-studiu>

¹⁴¹ <http://www.anre.md/ro/content/anre-eliberat-o-licen%C8%9B%C4%83-pentru-furnizarea-energiei-electrice-la-tarife-reglementate-noii>

¹⁴² Gas Natural Fenosa is a joint stakeholder, owned Union Fenosa International, and established in 2008 as a result of privatization and merging of three state-owned distributor entities. Since 2015, in the light of unbundling, Gas Natural Fenosa has split in two enterprises – Red Union Fenosa (energy distributor), and Gas Natural Fenosa Supplier (the second national supplier at regulated prices). <http://www.gasnaturalfenosa.md/>

Moldovatransgaz. Nevertheless, Russia is active in electricity as well through its acquisition in 2005 of the energy producer from the breakaway region of Moldova (Transnistrian region). Moreover, the Moldovan poor energy governance additionally favours the Russia-controlled energy stakeholder, which had for years preferential access on the market, as will be explained below.

Table 3. Russia's leverages in electricity sector



Russia's indirect influence on electricity production and supply

Moldova covers 80% of its electricity needs from Kuchurgan power plant (Moldavskaya Gres) in Transnistrian region privatized in 2005 with the Russian Inter RAO UES¹⁴³ that invested at early stages approx. 200 mil. USD¹⁴⁴. Later, the Moldovan system operator Energocom and Inter RAO UES signed an agreement to import electricity from Kuchurgan (2008) for January 2009 - March 2010.¹⁴⁵

Figure 1. Sources of electricity in Moldova

		mil kWh	%, total
Domestic production		792.8	21.3
	Termoelectrica	670.5	
	CET North	53.2	
	Costești Hydro Power Station	49.8	
	Other local producers	19.3	
Import		2924.4	78.7
TOTAL		3717.2	100

Source: ANRE

¹⁴³ Moldavskaya Gres (Kuchurgan power plant) represents the main power generator plant (2250 MW) owned by Inter RAO ESS outside Russia, followed by Ekibastuzskaya Gress in Kazakhstan (1000 MW), Trakya (Turkey), Grami 1 and 2 (Georgia), and Vydmantai Wind Park UAB (Lithuania).

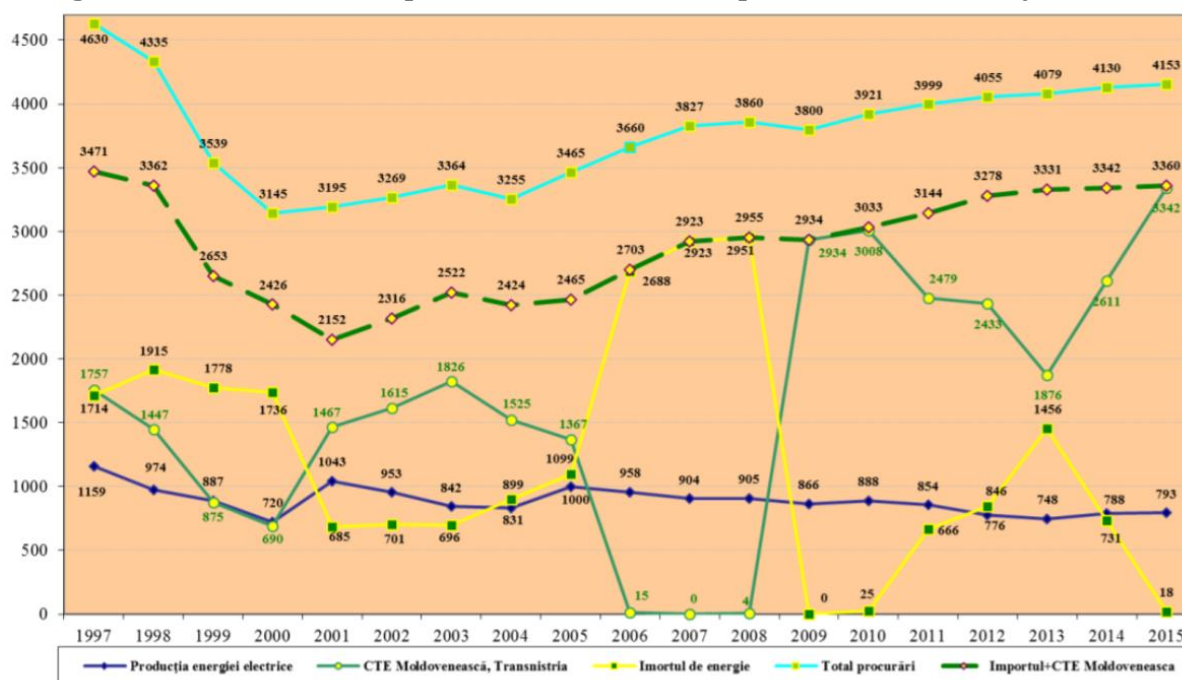
¹⁴⁴ <http://moldgres.com/>

¹⁴⁵ http://www.interrao.ru/press-center/news/detail.php?ID=621&phrase_id=248156.

Central authorities have been buying electricity from Kuchurgan plant before it was privatized with Inter RAO UES, but the quantities dropped dramatically in 2005, when the Ukrainian suppliers entered the Moldovan market. Between 2010 and late 2014, the imports from Ukraine (DTEK – supplier) took place in parallel with deliveries from Kuchurgan (See below Figure 2).

The militarized Russian-supported separatism in Donbass region in late 2014 created shortages of electricity production and determined Ukrainian to stop the export of electricity to Moldova. This suspension coincided with the establishment of a new company in the Transnistrian region, called Energokapital, founded by a group of offshore companies¹⁴⁶ and operating under a license issued by Moldovan energy regulator (ANRE) in late 2014. Energokapital has undertaken the supply operations, previously performed by Kuchurgan power plant. Therefore, Energokapital receives the necessary volumes of gas from Tiraspoltransgaz-Transnistria, Transnistria region's system operator, at very low prices. Afterwards it pays Kuchurgan power plant to convert the gas into electricity, sells it to Moldovan system operator Energocom, which sells it to the suppliers from the right bank (Gas Natural Fenosa Supplier, North Electricity Supplier, distributors).

Figure 2. Production, procurement and imports of electricity, mil. kWh



Source: Annual report of ANRE 2015

The Kuchurgan Power Plant can also export electricity to Romania¹⁴⁷. Special generating capacities were agreed in 2008. The electricity was delivered directly to Romanian grid via

¹⁴⁶ Energokapital was founded by „Bas Market” registered in Transnistrian region and „Ornamental Art Limited” with juridical address in Hong Kong (which is owned by Energy Assets Development, registered in Ediburgh). The former was established by „Intercom Management LTD registered on Belize, and Iurie Dzețul, considered to be a proxy of the former so-called president of the separatist region Evgheni Șervciuk, replaced after December 2016 elections by Vadim Krasnoselki., <http://crimemoldova.com/news/social/energokapital-vs-energocom-o-nou-edin-am-nat/>

¹⁴⁷ An agreement between Moldovan trasmission operator Moldelectrica and Inter RAO UES was signed during the visit of the Russian president Vladimir Putin to Moldova for the participation in the CIS summit held in Chisinau in November 2008.

network Kuchurgan – Vulcănești and Vulcănești- Isaccea (400 kV)¹⁴⁸. Even if the energy can be supplied, there is little interest from the Romanian side, which is rather interested to export the energy surplus to the Moldovan market in the nearest future.

According to Moldova-Russia protocol of November 2016, Russian authorities aim to take actions in order to “contribute to the signature of contracts on electricity supplies (including on extending the existing ones) from the Kuchurgan power plant”.¹⁴⁹ On the one hand, Russia promotes the interest of its electricity giant Inter RAO UES. On the other hand, it seems that it has a parallel interest in keeping Energokapital in the game. Otherwise, the protocol would not foresee that Russia has also contributed to the extension of the existing contract between Energocom and Energokapital until the end of March 2017. Nevertheless, the Moldovan authorities made an error by accepting such a statement in the protocol. It contradicts the principle of transparency and non-discrimination in contracting, which should be based on open and competitive public tenders and not on political trade-offs specifically with Russia.

The interconnection with Romania on electricity is crucial to decrease the dominant position of Kuchurgan power plant. Once this interconnection is operational, estimated in 2021, Moldova will be capable to contract electricity from Romania as well. The most feasible scenario is to make the interconnection in the South, extending the existing Isaccea- Vulcănești line, building a back-to-back station, and an extension to Chisinau, which might be realistically operational after 2021.

Inter RAO UES expressed its interest for this interconnection aiming to export electricity to the Romanian market as it did in 2009-2010. However, this interconnection is of vital importance for the energy security of Moldova in terms of electricity delivery. In parallel, another interconnection in the North of Romania (Suceava-Bălți) should be a back-up for the one in the South, which is already under Russia’s close eye. The idea of combining the interconnection in South with the one in the North got support from international financial institutions, such as the World Bank. Not all of the international institutions back this approach. For instance, EBRD is keen to offer investments only in the Southern interconnection. Nevertheless, the existence of at least one interconnection on electricity with Romania frees Moldova from the dependence of Russia’s Kuchurgan power plant in the Transnistrian region.

Poor governance of the electricity market

The poor energy governance in Moldova increases Russia’s influence in the electricity sector. However, this is a collateral effect rather than something generated by Russia itself. This refers to contracts on electricity supply from Kuchurgan power plant, owned by Inter RAO UES.

The first issue of poor energy governance lies in the lack of open tenders on the electricity market. Thus, the Moldovan authorities have not applied any open competition procedures for contracting electricity produced at Kuchurgan power plant since it started to buy electricity from Kuchurgan power plant or import electricity from Ukraine until last year. In 2005, Kuchurgan power plant has become part of Inter RAO UES, and signed a delivery contract with the Moldovan supplier Energocom only after three years in 2008 for the period 2009-2010. Later on, until 2015, the Moldovan government (Ministry of Economy) purchased electricity from both Kuchurgan power plant and Ukrainian suppliers without organizing open tenders. In consequence, Moldovan consumers paid very high prices, e.g. twice as high as prices in Romania.

¹⁴⁸ A contract of delivery existed in 2009-2010, but it involved an insignificant volume of electricity directed to Galati and Northern part of Romania’s Moldova region, <http://www.mediafax.ro/economic/inter-rao-ar-putea-relua-exportul-de-energie-in-romania-in-2010-5021866>

¹⁴⁹ http://www.mec.gov.md/sites/default/files/protokol_rm-rf_29.11.16.pdf

In late 2014, following the Crimean crisis, Moldova imported electricity only from Transnistria. An intermediary was set up, Energokapital, which entered the market between Kuchurgan power plant and Energocom. Given the absence of Ukrainian suppliers, the Moldovan supplier Energocom and Energokapital maintained a high price on electricity (6,795 USD cent/kWh)¹⁵⁰.

In February 2016, Moldovan government and Energocom were forced to organize a public procurement tender, after the Spanish Gas Union Fenosa organized for the first time in the history of Moldova's electricity market an open tender in February. Gas Union Fenosa invited four companies – Kuchurgan power plant and Energokapital – both from Transnistrian region, Ukrainian DTEK and the Moldovan supplier Energocom. But only Energocom and Kuchurgan power plant had sent their bids.

The Moldovan system operator Energocom received the proposals from Energokapital and Ukrainian DTEK, but opted for Energokapital that proposed prices a bit higher than DTEK (DTEK offered energy at 4,7 cent/kWh versus Energokapital at 4,8995). The Ukrainian supplier accused the Moldovan side of abusively excluding it from the tender. According to Moldovan authorities, prices were not the only consideration, but also the security of supply. In their views, Ukraine was not a reliable supplier given the situation in Donbass. This estimation contradicted the official position of Kiev that had reported a surplus of production and expressed its readiness to resume exports to Moldova. The small discrepancy between the two price proposals (approx. 0.2 cent), and the weak argumentation of Moldovan side about Ukraine's inability to ensure safe deliveries, raised the suspicion about a rigged bid.

In consequence, Moldovan authorities renewed the contract with Energokapital for an additional year (1 April 2016- 31 March 2017). At the same time, Energokapital refused to sell electricity to Gas Union Fenosa that actually advertised the bid in the first place, clearly favouring the Moldovan state owned supplier Energocom. Lastly, the Spanish company and other stakeholders agreed to buy from the only supplier on unregulated prices Energocom. This case shows two serious shortcomings: i) unclear and non-transparent tender procedures organized by the state-owned supplier (Energocom); and, ii) unfair competition on contracting electricity deliveries, which affects private companies (Gas Union Fenosa).

New rules on procurement of energy supplies entered into force in January 2017, resulting from the recommendations of the Energy Community. They introduced much clearer and more transparent procedures for selecting the best possible offer of electricity supply, under the monitoring of a Group of Observers constituted from national stakeholders (Ministry of Economy, energy regulatory body), the EU Delegation to Chisinau and the representative of the Energy Community.¹⁵¹ However, this did not help to exclude the suspicions of rigged bids. Therefore, sidestepping the technical criteria obliging to ensuring the production capacity, the state-owned supplier Energocom participated and won the bid as a seller to Moldovan suppliers to end-users, outrunning both the Transnistrian producer (Kuchurgan Power Plant) and some other Ukrainian suppliers.

It is not clear when Energocom succeeded to sign the purchase contract with Ukrainian DTEK Trading, from which it will buy electricity for 50.2 USD/MWh¹⁵² and will sell it further,

¹⁵⁰ Expert-Grup, CRJM, ADEPT, Monitoring report on the implementation of the Priority Reform Action Roadmap, September 2016, http://expert-grup.org/media/k2/attachments/Monitoring_report_on_the_implementation_of_the_PRAR.pdf

¹⁵¹ https://www.energy-community.org/portal/page/portal/ENC_HOME/NEWS/News_Details?p_new_id=14304

¹⁵² <http://mec.gov.md/ro/content/republica-moldova-semnat-cu-ucraina-noul-contract-de-furnizare-energiei-electrice>

for the same price, to the Moldovan market operators¹⁵³. Interestingly, though Energocom is a state-owned supplier, which in turn needed to purchase electricity from imports, and though it is under full control of the Ministry of Economy, it was not required to procure competitively the imported electricity it now resells – a matter that has been completely missed by the EC observers during the tender. It is also unclear why Energocom operates the supplies without making any profit. Besides that, the Ukrainian authorities claimed that they are capable to deliver approx. 810 mil. MWh, which represents 30% out of approx. 3 billion MWh of annual consumption¹⁵⁴. Not having enough electricity from Ukraine will mean to sign a contract with Kuchurgan Power Plant at some point. The same need might appear in case Ukrainian energy system will collapse because of destabilization in Donbass region, therefore repeating the scenario of November 2015.

A second shortcoming related to energy governance stems from the activity of offshore-related companies. There is no regulation that would restrict such companies to operate in strategic sectors of the economy, in particular energy. It must be also noted that the national energy regulator (ANRE), under full control of Chisinau, issued the license for Energokapital, which has among its direct and secondary beneficial owners offshore companies registered in Hong Kong, the UK, and Belize. Some of these companies have the same juridical addresses as the companies involved in the Moldovan banking sector embezzlement, as it was revealed in late 2014.

Thus, the national regulator ANRE fails to clean up the electricity market of companies that are accused of illegal financial operations, even if they occur in the separatist region. The law enforcement representatives from the separatist region initiated investigations against Energokapital for taking off their region 19 million USD via Moldovan bank Victoriabank¹⁵⁵. The investigations started in July 2016, and Gazprom was informed about it as well. On the Moldovan side, the regulator overlooked this case, and Energokapital continued to operate without being sanctioned by 31 March 2017. However, according to some sources, the Prosecutor's office started an investigation on this case too.

In addition, Energokapital brought in 2016 an action against the Moldovan supplier Energocom for presumably unpaid debts, accounting for 350 million MDL ¹⁵⁶ (approx. 16 million USD). The Transnistrian region company threatened to cut off the electricity supply in case Energocom refuses to fulfill its financial obligations.¹⁵⁷

Despite the deficient profile of the supplier from the Transnistrian region (shell companies in offshores, involvement in illicit activities etc.), the regulator ANRE still fails to react, e.g. by withdrawing the license. The poor enforcement shows the complicated matter of improving Moldova's energy governance, despite commitments of Moldovan authorities (under EU conditionality and the supervision of the Energy Community) to improve the energy legislation, in particular concerning the independence of the energy regulator.¹⁵⁸

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http://www.gasnaturalfenosa.md/sites/default/files/ro/Achizitii_de_energie/Comunicat_de_presa_01042017.pdf.

¹⁵⁴ Cenunșă D., Electricity Procurement: 3 Post-tender Scenarios, Expert-Grup, March 2017, http://expert-grup.org/media/k2/attachments/Achiziția_de_energie_electrică_3_scenarii_post-licitație_EN.pdf

¹⁵⁵ <http://anticoruptie.md/ro/stiri/cum-pleaca-banii-pentru-energie-in-off-shore-prin-conturi-la-victoriabank>

¹⁵⁶ <http://jurnal.md/en/economic/2016/5/10/energocapital-versus-energocom-the-controversial-intermediary-from-tiraspol-asks-for-a-debt-of-350-million-lei-but-cannot-justify-the-claims/#update-637724>

¹⁵⁷ http://expert-grup.org/media/k2/attachments/Monitoring_report_on_the_implementation_of_the_PRAR.pdf

¹⁵⁸ Energy Community, Action Plan for strengthening the independence of ANRE, December 2016, <http://anre.md/files/Action%20Plan.pdf>

Third Energy Package in Moldova

The Moldovan membership in the Energy Community (2010) introduced commitments related to gradual liberalization of the energy market, that were later in 2014 endorsed by the EU-Moldova Association Agreement¹⁵⁹. The two frameworks create strong binding effects for Moldova, which almost pass through double scrutiny on Third Energy Package implementation.

The liberalization of the energy sector means that Moldova undertook the obligation to effectively separate (unbundle) the transport grids from the suppliers. Additionally, it must ensure non-discriminatory third party access to the transport infrastructure. However, because of increased pressures from Russia on Moldovan authorities, the Energy Community accepted (2012) a derogation, delaying the implementation of the unbundling in the gas sector by January 2020¹⁶⁰.

In this regard, the Third Energy Package and full liberalization of the market along with efficient diversification of the imports through interconnections with Romania are crucial to redress the situation on gas market. Finally, the efforts on Third Energy Package include the improvement of the legislation concerning the Moldovan regulator ANRE¹⁶¹.

Scenarios of Russia's future actions

Gas:

- Mainly, Russia's scenarios in gas sector refer to historical debts, which appear in MoldovaGaz' books. Even if the Moldovan state owns 30% of shares, vs Gazprom that owns 50%, there is no clarity whether the Moldovan state has ensured state guarantees for debts payment. The bilateral agreements between the Moldovan side and Gazprom are not available to the public. However, pro-Russian politicians such as the elected president Igor Dodon, during the presidential electoral campaign in 2016, suggested the idea to repay the debts using the assets and the infrastructure that remains out of the indirect control of Gazprom through MoldovaGaz. Once implemented, there is no guarantee that the principle could not be extended even to the now independent company Vestmoldtransgaz which owns the infrastructure built together with Romania (gas interconnection). Or, possibly, to other assets, such as electricity networks and interconnectors. This would be indeed the ultimate irony, since the interconnecting infrastructure is built on European grants and, possibly, co-financed by private investments.

- Russia can also use its influence over the transmission network through Moldovatrangaz, a subsidiary of MoldovaGaz. Hence, the risks depend on how well the transmission operator ensures the non-discriminatory access to networks, including for suppliers from Romania. Legally, it is required to do so; in practice, all sorts of "technical issues" might be used as a pretext to create artificial bottlenecks for outside suppliers. To avoid this, it is critical that the energy regulator be really independent, powerful and competent.

- Moreover, the supplier/producer separation is necessary, but Gazprom may reuse the contract on gas deliveries to Moldova, extended in December 2016 until 2019, aiming to delay

¹⁵⁹ Emerson M., Cenușa D. (ed.), Deepening EU-Moldova relations: What, why and how?, CEPS, Expert-Grup, Rowman & Littlefield International, <https://www.ceps.eu/system/files/Moldova%20e-version%20with%20covers.pdf>

¹⁶⁰ Cenușa D., EU-Moldova energy relations: Similarities and distinctions between Energy Community Treaty and the Association Agreement, https://www.academia.edu/20921535/EU-Moldova_energy_relations_Similarities_and_distinctions_between_the_Energy_Community_Treaty_and_the_Association_Agreement

¹⁶¹ Cenușa D., Position note on transparency and independence of the National Energy Regulatory Agency, November 2016, <http://expert-grup.org/en/biblioteca/item/1342-nota-de-pozitie-privind-transparenta-%C8%99i-independenta-anre/1342-nota-de-pozitie-privind-transparenta-%C8%99i-independenta-anre>

even further the requirements on unbundling assumed by Moldova within the Energy Community for up to January 2020.

- Diversification of the supplies through Romania can be endangered as well, but this is rather linked to internal Moldovan politics after legislative elections in 2018, and to the sustainability of gas transit via Ukraine.

- From a regional perspective, if Russia builds Turkish Stream to bypass Ukraine for the gas transit to Europe, this would also mean a loss of transit tariffs for Moldova. The current transit is about 16-18 bcm per year. At the current tariff of 3 USD/1000 m³, split 50%-50% with Transnistria, this would mean a loss of some 25 million USD per year for Moldovatransgaz (and the same amount for Tiraspoltransgaz).

Electricity:

- Russia is interested in protecting its business and influence in the region. Therefore, it wants to preserve its lucrative contracts between Kuchurgan power plant (Inter Rao UES) and Moldova. To this end, Russia discussed with Moldovan authorities the possibility to guarantee the continuation of contracts with Kuchurgan power plant. They touched this issue during negotiations for the bilateral Action Plan to restore bilateral economic relations, signed in November 2016. This issue remains on the top of Russia's agenda even though the Moldovan authorities opted temporarily for electricity delivered by Ukrainian operators. In addition, Russia's investments in Kuchurgan power plant have already reached at least 200 million USD, and the plant can supply energy to Moldova and the Romanian market, especially when the Moldova-Romania interconnection in the South is ready (estimated for 2021).

- Non-transparent tenders represented a constant advantage for Russia to keep selling on the Moldovan market and exclude other suppliers, such as those coming from Ukraine. Therefore, clear, transparent and functional procedures for public procurement should be further insured, by introducing them into the primary legislation and extending them exhaustively within the entire system, to prevent Russia and any other actor with vested interests (either from the Transnistrian region or from Ukraine), from exploiting poor and corrupt energy governance. In this regard, an important role lies on the energy regulator that should maintain the order on the market and eliminate the companies that violate legislation and/or pose risks to energy security.

- Moldovan authorities announced the plan of privatization of state-owned regulated suppliers Red-Nord and Red Nord-Vest in 2017.¹⁶² Bearing in mind the existing position of Russia in energy sector, the privatization of these two assets can be of interest to Russian investors. Therefore, rigorous procedures for privatization on energy market should be followed in order to ensure fair participation of foreign investors, avoiding rigged bids on the energy deliveries from the Transnistrian region and including from Ukraine.

Conclusions

The energy sector in Moldova is weak because of excessive dependence on Russia's sources of energy – gas supply and electricity supply from Kuchurgan power plant. The dependence on gas gives Russia a strong hand over certain political decisions, as it was the case of the delay of Third Energy Package implementation. Partially, this explains Russia's decision (Gazprom) to extend up to 2019 the old contract on gas deliveries to Moldova, aiming to perpetuate the uncertainty related to security of supply, and to exert further pressure on Moldovan authorities.

A new contract on gas supply would also raise the issue of gas debts accumulated by Transnistrian region that acts as a classic free rider by refusing to pay for consumed gas. Therefore, even in the Protocol of November 2016 for restoring Moldova-Russia bilateral

¹⁶² <http://newsmaker.md/rus/novosti/bolshaya-rasprodazha-gosimushchestva-na-privatizatsiyu-vystavyat-moldtelecom-air-m-28975>.

relations, the latter focused on Moldovan side of debts, rather than committing to use its leverage to persuade Transnistrian region to pay the outstanding debts (more than 6 billion USD, the equivalent for approx. 90% of the total debts of MoldovaGaz to Gazprom).

The diversification of gas suppliers through completing the interconnection with Romania, but also a non-discriminatory access to the transmission networks, are indispensable measures to unchain the gas market from the dependence on Gazprom.

The electricity sector seems to be more advanced in terms of liberalization, and currently more stakeholders operate on the market. However, the problems stem from the existence of one big producer and supplier – Kuchurgan power plant, which is a significant acquisition of Inter RAO UES in the separatist region of Moldova. This power plant delivers approx. 80% of the electricity consumed on the right bank of Dniester River. Russia insists on strengthening the position of its asset on the electricity market, including through demanding political promises from the Moldovan authorities. Such a position contradicts with the principles of open and fair public procurement rules. The lack of such principles reflects the poor governance in the energy sector that allowed the shady offshore entities to maintain higher prices for consumers. A vivid example is the contract with Energokapital, from the Transnistrian region, which operated between December 2015- March 2017 on the Moldovan market regardless of its connection with offshore-based shell entities or with illicit activities. Regardless the new rules for procurement of electricity, inspired from European recommendations, the bid organized in February-March 2017 was far from perfect; it is surprising that the very supplier of the Ministry of Economy, Energocom, was not required to purchase electricity in a competitive procurement procedure, being allowed instead to participate as a bidder and offering electricity to other suppliers imported in a non-transparent manner. Consequently, the sustainability of the electricity supplies for 2017-2018 cannot be fully ensured, though the Ukrainian operator delivers the supplies. This creates the ground for new contracts signed ad-hoc and on dubious conditions with Transnistrian power producer.

The interconnection on electricity with Romania is of great importance for Moldova. According to existing estimations, the supply of electricity from Romania will be available only after 2021. Consequently, a special attention should be focused on the electricity tenders, by creating maximum competition and excluding the entities with questionable profiles. The energy regulator should start to properly regulate and ensure compliance on the electricity market, not only guaranteeing fair prices, but also fair competition rules for all domestic and foreign stakeholders. The transposition process of the EU energy legislation includes these goals, but they will be superficial and unsustainable without political will, which can be achieved in Moldova by effective conditionality from EU and other external partners, including the US.

Recommendations for the EU:

- Combine the efforts with the Energy Community to scrutinize the reform of the energy regulator aiming to increase its independence, transparency and performance;
- Monitor the adoption of the secondary legislation in order to depict and exclude the future obstacle against the effective access to the transmission networks;
- Streamline the dialogue and joint actions with Romania and financial institutions (EBRD, EBI, World Bank) in order to increase the financial and technical assistance to speed up the construction of the interconnections on electricity and natural gas. This is crucial in order to avoid future energy crises stemming from the gas debts or the unsustainable¹⁶³ development of the energy system in the Transnistrian region will remain an important energy producer for Moldova's right bank.

¹⁶³ http://www.expert-grup.org/media/k2/attachments/RER_Transnistria_July_2016_EN.pdf

- Ensure political supervision and technical monitoring to facilitate the gas interconnection with Romania, which should occur along with full implementation of the Third Energy Package and before the contract on gas with Russia ends (in 2019);
- Political support to Moldovan Government in negotiating a new contract on gas supplies with Gazprom, based on principles of transparency, predictability, and legal clarity. This depends on the functionality of the future achievement of the interconnection with Romania.
- Ensure the possibility to assess the future Moldova-Russia gas contract through the EU's mechanism of ex-ante assessing the Intergovernmental Agreement between member states and third parties on gas acquisitions, defined in 2016.¹⁶⁴
- Assist Moldovan side on qualitative revision of the potential contract with Gazprom, by excluding the take-or-pay principle, and including the Stockholm dispute settlement Court¹⁶⁵, known as the most reliable neutral body for international dispute resolution, instead of Moscow dispute court (that is apparently included in the existing contract with Gazprom).
- Introduce the issue of gas debts payment to Gazprom on the agenda of the bilateral economic relations as this sensitive issue can provoke a serious triple crisis (energy, fiscal and economic), with uncertain political consequences.
- Use conditionality tools to promote the establishment of open, fair and competitive public procurement procedures for the energy sector. Learning from the shortcomings of the procurement of electricity supplies, undertaken in February-March 2017, clear rules should be applied exhaustively within the entire electricity system, including upon the state-owned enterprises (e.g. Energocom).
- Restrict the operations of companies with offshore beneficial owners in the energy sector, using the transparency principles proposed for the banking sector in the aftermath of the banking fraud.

Recommendations for the US:

- Impose strong conditionality principle on reforms in energy sector by US development programs active in Moldova (ex: USAID).
- Team up with EU on promoting the reforms linked to Third Energy Package, with focus on improving the energy regulator.
- Explore the possibilities to channel financial assistance to hasten the construction of interconnections with Romania on both gas and electricity.

¹⁶⁴ <http://www.consilium.europa.eu/en/press/press-releases/2017/03/21-stronger-energy-security/>

¹⁶⁵ Arbitration Institute of the Stockholm Chamber of Commerce (SCC), <http://www.sccinstitute.com/statistics/>

HUNGARY: Exploring new frontiers for Russian energy policy capture – the Hungarian case

András Deák
Sándor Léderer
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“We have large-scale plans with Hungary”

The quotation above is from Vladimir Putin, who made this statement at the 3rd Valdai meeting in 2006.¹⁶⁶ Even if he referred only to gas projects, the quote has become a widely known, emblematic statement in the Hungarian-Russian bilateral relations. For many policy experts it signaled Russia’s growing interest not only in Hungary itself, but also in regional affairs. No doubt, Putin sent this message as an act of goodwill and a clear sign of friendship. Nonetheless, for many Hungarians it sounded much more as an evil omen or at least as a potential threat.

Looking back after ten years, it would be difficult to dismiss the importance of Putin’s statement. It can be considered as a virtual starting point of the transformation of the bilateral relations. Since then, Hungary has become an active supporter of Gazprom’s regional pipeline plans, signed a giga-contract with Rosatom on the construction of two new nuclear plants. Its main opposition party, the right-wing radical Jobbik allegedly accepts or accepted large-scale Russian funding¹⁶⁷, while the Hungarian government openly advocates the lifting of EU sanctions vis-à-vis Russia. Hungary was the first Visegrad country, where the traditional dichotomy of Russia-friendly left-Russia-skeptic right parties dissolved: Viktor Orbán, a staunch conservative critic of Russia for two decades, has turned into one of Moscow’s most vocal defenders after 2010. Practically all major political parties have been affected by Moscow’s temptation, leaving no credible alternative in foreign policy. What is more, the once skeptical population seems to be changing its attitudes either. Even Orbán’s supporters have followed him through this bizarre transformation: today, Fidesz is a Central European conservative party whose voters are the most pro-Russian on the Hungarian political landscape.¹⁶⁸ Not surprisingly, for many Western analysts Hungary seems to be a Central European state, which is notoriously and hopelessly Russia-friendly.

All these developments beg the question about their origins. The recently published study, “The Kremlin Playbook”¹⁶⁹ puts the erosion of democratic institutions and the competitive state at the heart of Moscow’s regional influence. It describes Russia’s activities as a practice, which both exploits and incentivizes this process by creating an “opaque network of patronage across the region”. At first sight Hungary seems to be a show case of this interaction, where the deterioration of democratic standards went hand in hand with growing Russian influence. At the same time, not questioning the plausibility of this interpretation, Russian influence has many variations through the CEE region. Unlike in Bulgaria or Serbia, Moscow does not have a strong economic or institutional foothold in Hungary. With the exception of the right-wing radical party Jobbik, Russia neither has major grass-root projects of influence, nor visible

¹⁶⁶ *Transcript of Meeting with Participants in the Third Meeting of the Valdai Discussion Club (09/09/2006)*. Internet: <http://kremlin.ru/events/president/transcripts/23789> (accessed 06/11/2016)

¹⁶⁷ *A nagy Oroszország kovácsolta frigy [Unbreakable Union that Great Russia has welded to stand]* Internet: http://index.hu/belfold/2014/09/23/a_nagy_oroszorszag_kovacsolta_frigy/ (accessed 22/01/2016)

¹⁶⁸ *A magyarok többsége Amerikát választaná és nem Oroszországot [The majority of Hungarians choose America, not Russia]*. Internet: <http://444.hu/2015/01/07/a-magyarok-tobbsege-amerikat-valasztana-es-nem-oroszorszagot/>. (accessed May 18, 2015).

¹⁶⁹ Conley et al. (2016): *The Kremlin Playbook – Understanding Russian Influence in Central and Eastern Europe*. CSIS, Washington.

ownership in the local economy. In the coming paragraphs we will demonstrate that its significance in terms of gas and oil imports has been declining fast since 2008, trade has suffered a serious setback after 2014. Russian presence shows little characteristics of having a bottom-up design with traditional “state capture” by Russia’s local business partners and influential middle-men deeply entrenched in the local elites. The government and the country is firmly in Viktor Orbán’s grip, there is little chance to bypass him or create a *fait accompli* in any major issues.

In reality, Russia’s influence in Hungary primarily rests on elite relations. Perhaps because of the relation’s newborn nature, Moscow approached directly the top decision makers in the country and pinpointed a selected set of major policy targets. It aimed to drive some policy processes in a direction, which puts its influence on a long-term fundament and prevents the realization of other policy outcomes. Its strategy was rather “policy”, than “state” capture. Energy was the showcase of this process. Russia successfully maintained and even reinforced Hungary’s path dependence in a situation when global and European energy developments offered an opportunity for a new path setting. The South Stream project led to a major policy rivalry with the Nabucco-pipeline after 2007. Gazprom’s price concessions formed a major platform of Orbán’s campaign and utility rate cut pledge in 2013, cementing his reelection in spring 2014. Nonetheless, the crown jewel of Russian energy influence in Hungary is the Paks nuclear deal signed in January 2014, which determines the national sectoral and partially even the financial landscape for the next decade.

The following Report presents the assembly line of Russian “policy capture” in Hungary. Chapter 2 describes the bilateral trade and investment patterns with a particular focus on Russia’s slowly diminishing role in hydrocarbon sectors. Chapter 3 analyses the know-how of Russian influence-building and gives an extensive and multi-faceted assessment of its major pillars. Chapter 4 landscapes the political and party positions on Russian energy in particular, while Chapter 5 tries to evaluate potential liaisons between energy and foreign policy issues. In Chapter 6 we attempt to strike a balance in the debate about causality and assess the magnitude of Moscow’s influence in general.

The shaky fundamentals of dependence: energy trade and Russian inward sectoral FDI

As all the Visegrad countries, Hungary is deeply integrated into the European economy. Right after the fall of communism in 1989, the government launched its privatization process and opened the economy before Western investors. The commanding posts of national economy had been occupied by representatives of multinational companies, the activities of foreign corporate actors constitute the fundament of Hungarian welfare. In 2015 the stock of foreign direct investments in percentages of GDP was 77.7%¹⁷⁰, while the share of EU in total foreign trade turnover also composed roughly 80%. These are relatively high proportions even in a CEE comparison, demonstrating the magnitude of Western penetration in the country’s economy. Russian state and corporate actors did not have a distinguished role in this process. By the time of Russia’s consolidation in the early 2000s, the process of privatization and inflow of FDI had already been finished, making it difficult for Moscow to regain some of its former significance. Unlike in some South Eastern European or Baltic states, there was not too much room left for Russian capital and trade.

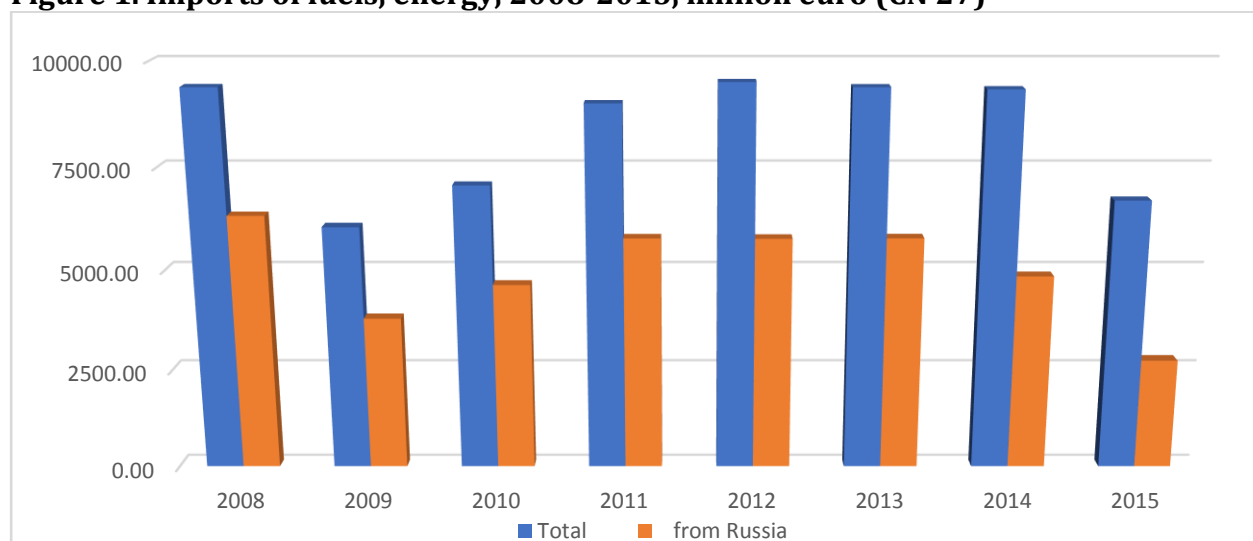
The composition of bilateral trade bears the main characteristics, typical for all Visegrad countries. Russia comprised the biggest export market outside EU28. Its share peaked in 2013 at 3.11% of total exports. Understandably, much of this turnover came from local branches of multinational companies and consisted of manufactured and semi-manufactured goods, with

¹⁷⁰ UNCTAD

little or no influence from political relations. Since then, exports have fallen dramatically due to the worsening dynamics of Russian demand and sanctions. Similar trends can be observed on the import side. Imports from Russia took 8.55% share of the total in 2013 and are almost exclusively dominated by energy and fuels. Unlike Poland, the Czech Republic or Romania, Hungary is a resource poor country with high energy import ratio. Thus, it has a diverse energy import portfolio, with relatively high proportions of nuclear fuel (17.9% of TPES in 2014) and primarily natural gas (30.6%).

Nonetheless, this exposure has been decreasing since the late 2000s. As Figure 1 shows, imports of energy in value terms has dropped after 2014 primarily due to the falling oil prices. Nevertheless, the share of Russia in energy imports has been steadily decreasing for the last couple of years. Even if this is partly due to the changing residence of some Russian exporters, the bulk of these shifts originate from some fundamental changes on the market. Availability of large scale gas imports from Western Europe and the swap from Russian natural gas to Western electricity imports in the generation sector have the biggest input in this regard.

Figure 1. Imports of fuels, energy, 2008-2015, million euro (CN 27)

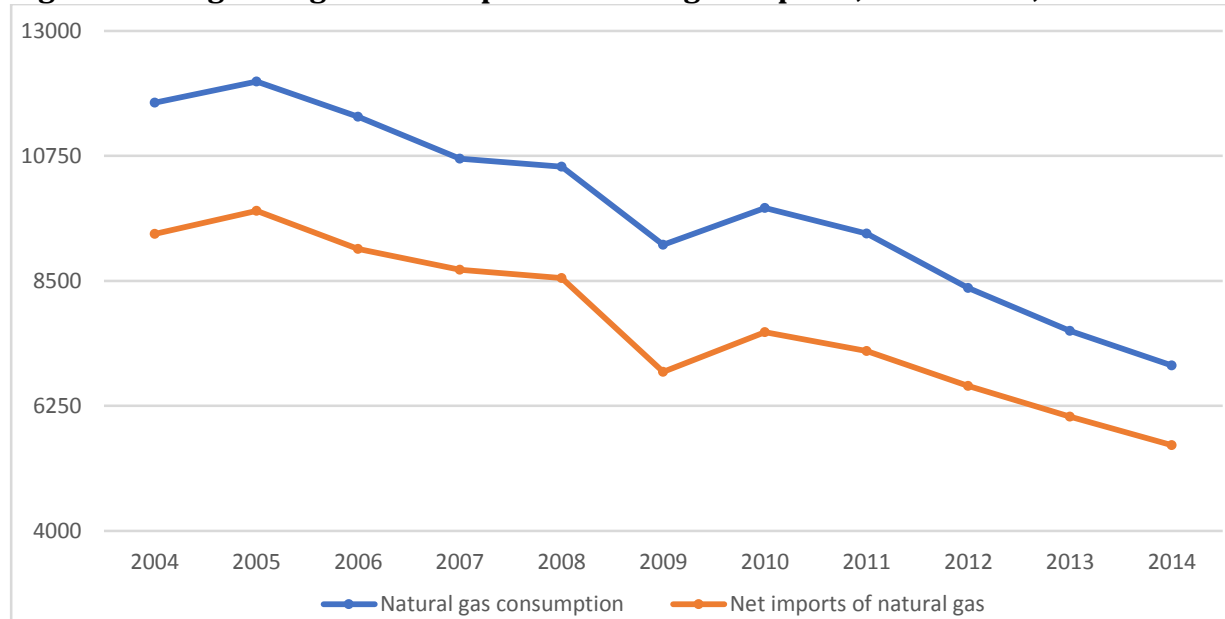


Source: Hungarian Central Statistical Office

Another major factor of declining Russian imports was the declining domestic consumption of natural gas. As Figure 2 demonstrates, gas demand has practically halved in the last ten years, falling from above 12 Mtoe to around 7 Mtoe. All major segments of consumption have been shrinking including industrial, households' and the power plants' use. Oil and oil product demand followed a similar trend, even if at a much more moderate pace. All these dynamics suggest a swift and flexible adaptation to the high price environment putting Russian energy export levels under pressure.

Altogether, Hungarian energy patterns had been on the way of loosening the Russian dependence after 2008-2009. Given its declining consumption trends, the emerging European single electricity and gas markets, the improving interconnectivity situation and the expanding gas hubs thorough the European continent, the traditional concerns around Russia's energy threat seemed to be passing away by the early 2010's.

Figure 2. Hungarian gas consumption and net gas imports, 2004-2014, ktOE



Source: IEA

As far as FDI concerned, Russian and Russia-related investments (including investments that are registered from other countries, like Austria, Cyprus, but the ultimate owners are Russian entities) are almost invisible in Hungary. This is ultimately true if we look at Hungarian statistical data collected by the National Bank. Russian Central Bank data also registers Hungary as a minor destination for Russian capital even among the CEE and SEE countries. At the same time, Table 1 also reflects some major hostile, but unsuccessful takeover attempts during the 2000s. In 2001 an opaque group of Russian investors, reportedly mainly members of the outgoing Gazprom management tried to purchase chemical plants controlled by the Hungarian MOL-group (controlling the oil and partly the gas sectors). Due to the harsh reaction on the governmental and corporate level, this threat was mostly averted. The relatively high data for 2009 signals Surgutneftegaz's acquisition of 21.2% MOL shares from Austrian ÖMV. Due to legal and corporate limitations, the Russian company could not delegate its candidates to the management and into the Board and had no influence on the decision making. The Hungarian state bought this stake in 2011, setting back Hungary on the list of Russian FDI destinations in CEE drastically.

Table 1. Russian FDI stock in the CEE countries^a, according to data provided by the Central Bank of Russia, end of year, 2009–2013 (millions of dollars and per cent)

	2009			2011			2013		
Rank ^b	Country	Value	Share ^c	Country	Value	Share ^c	Country	Value	Share ^c
1	Hungary	2,266	0.75	Bulgaria	2,439	0.67	Latvia	3,046	0.64
2	Bulgaria	1,586	0.52	Serbia	1,488	0.41	Bulgaria	2,863	0.60
3	Lithuania	1,38	0.46	Lithuania	1,444	0.40	Czech Rep.	1,844	0.38
4	Montenegro	1,339	0.44	Czech Rep.	1,309	0.36	Serbia	1,786	0.37
5	Czech Rep.	1,336	0.44	Montenegro	935	0.26	Lithuania	1,406	0.29
6	Poland	596	0.20	Latvia	704	0.19	Montenegro	1,226	0.26
7	Estonia	589	0.19	Bosnia & H.	561	0.16	Bosnia & H.	875	0.18
8	Bosnia & H.	541	0.18	Poland	545	0.15	Poland	627	0.13
9	Latvia	535	0.18	Croatia	250	0.07	Estonia	400	0.08
10	Serbia	394	0.13	Hungary	228	0.06	Croatia	398	0.08
11	Croatia	206	0.07	Estonia	220	0.06	Hungary	237	0.05
12	Romania	63	0.02	Romania	147	0.04	Slovakia	97	0.02
13	Slovakia	48	0.02	Slovenia	64	0.02	Slovenia	72	0.01
14	Slovenia	14	0.00	Slovakia	59	0.02	Romania	36	0.01
15	Albania	–	–	Albania	–	–	Albania	2	0.00
16	Macedonia	–	–	Macedonia	–	–	Macedonia	1	0.00

^a Excluding the CIS and Georgia. ^b In descending order. ^c As a percentage of total Russian outward FDI stock.

Source: Csaba Weiner's compilation based on data from the Central Bank of Russia (http://cbr.ru/Eng/statistics/credit_statistics/direct_investment/dir-inv_out_country_1_e.xlsx).

If we add other major Russian-controlled companies with non-Russian residence, we get a better estimate for total FDI. If turnover data of Panrusgáz Gas Trading Zrt, Kafijat Investment and Asset Management Zrt. and ISD Dunafer Zrt. are also taken into account, the share of Russian and Russia-related affiliates in total turnover of all foreign affiliates and all enterprises in Hungary in 2014 increases to 2.56% and 1.36%, respectively. Table 2 shows the major entities with Russian investments and their ownership structure. On the basis of this data, it is reasonable to suggest, that Russian investments do not have a relevance neither on the macroeconomic, nor on the energy sectoral level.

Table 2. The ownership structure of the main Russian investments in Hungary in 2014

Hungarian investment	Activity	Share (%)	Immediate investing company	Immediate investing country
<i>1. Immediately owned by Russians (i.e. captured by the Hungarian FDI statistics as Russian FDI)</i>				
Panrusgáz Gas Trading Zrt.	Gas intermediation	40	Gazprom Export	Russia
		10	Centrex Hungary Zrt., owned by Austria's Centrex Europe Energy & Gas AG, controlled by Russia's Gazprombank	Hungary
Ganz Engineering and Energetics Machinery Kft.	Manufacture and installation of hydromachines, nuclear power station machinery and oil drilling equipment etc.	51	Rosatom's TsKBM	Russia
<i>2. Immediately owned by individuals with Russian nationality, but Hungarian residency</i>				
Kafijat Investment and Asset Management Zrt.	Investment and asset management	100	Ruslan and Timur Rakhimkulov (Russian nationals, but Hungarian residents)	Hungary
<i>3. Portfolio investment, ultimately owned by Russian nationals, but Hungarian residents via a Hungarian-registered company</i>				
OTP Bank Nyrt.	Banking	8.9	Rakhimkulov family via the Hungarian-registered Kafijat Zrt. (see above) ^a	Hungary
<i>4. Ultimately owned by Russians, but the immediate investor is a third-country company</i>				
Sberbank Hungary Zrt.	Banking	99	Sberbank Europe AG	Austria
ISD Dunafer Zrt.	Production of flat-rolled products	98.29	Steelhold Ltd. (belonging to Ukraine's ISD, 50 per cent controlled by Russian investors)	Cyprus
Vogel & Noot Mezőgépgyár Kft.	Production of agricultural machinery	100	Vogel & Noot Landmaschinen GmbH & Co KG; Vogel & Noot Landmaschinen GmbH ^b	Austria
Vogel & Noot Talajtechnika Kft.	Production of agricultural machinery	100	Vogel & Noot Landmaschinen GmbH & Co KG ^{b, c}	Austria
Centrex Hungary Zrt.	Gas trading	100	Centrex Europe Energy & Gas AG, controlled by Russia's Gazprombank	Austria
MET Hungary Zrt.	Gas trading	12.7	Switzerland's MET Holding AG (Ilya Trubnikov, a Russian-Canadian businessman is a 12.7 per cent owner of the MET Group)	Switzerland
WIEE Hungary Kft.	Gas trading	100	Wintershall Erdgas Handelshaus Zug AG (WIEE)	Switzerland
RAG Kiha Kft.	Oil and gas exploration and production	50	Serbia's NIS, 56.15 per cent owned by Gazprom's Gazprom Neft	Serbia
Pannon Naftagas Kft.	Oil and gas exploration and production	100	Serbia's NIS, 56.15 per cent owned by Gazprom's Gazprom Neft	Serbia
Mechel Service Hungary Kft. ^d	Selling Mechel's steel products	100	Mechel Service Global B.V.	Netherlands

5. Potentially Russian-influenced or supposedly partially owned				
Normbenz Hungary Kft. (Lukoil's former filling stations in Hungary)	Retail and wholesale of oil products	100	Hungary's Norm Benzinkút Kft., owned by Hungary's IMFA Petroleum Kft. (created by a former Hungarian representative of Yukos and the Belize-based Normeston Trading Ltd.)	Hungary

^a Kafijat also has a 3.3 per cent stake in Mol. ^b Concern Tractor Plants/Agromash Holding B.V., Netherlands (Machinery & Industrial Group N.V., or M&IG, Netherlands). Vnesheconombank acquired 100 per cent of M&IG shares but did not obtain control over the company. Most of the shares had been held by Mikhail Bolotin. ^c UniCredit Bank Austria AG, Austria, took a mortgage over the shares. ^d Under voluntary liquidation.

Source: Csaba Weiner's compilation

Given these trade and FDI statistics, there are no hints on a growing Russian economic leverage in Hungary. Sectoral and fundamental policy trends point towards a more relaxed and diverse energy landscape, where Russia remains a major source of fuels, but with a limited market power. Its imports have become replaceable from other sources and on other routes, significantly decreasing its monopoly. Hungary could benefit from the European policy and market shifts after 2009 very early, practically collecting all its major dividends by the mid-2010s.

Energy policy capture – the Hungarian case

In spite of its limited investment fundamentals and declining trade trajectory, if we look at the Hungarian-Russian relations since 2013, we witness the opposite trend. Bilateral meetings have intensified, Russia's importance as a partner has grown tremendously. The turn is visible in all major respects of the ties. The government announced its "Eastern opening" in foreign policy relatively early, and Hungarian senior officials publicly argue in favour of increasing exports to Russia and finding investment opportunities there. Viktor Orbán criticized the sanctions against Russia, qualifying them as harmful, characterizing Europe as one, who 'shot itself in foot'¹⁷¹. Budapest was the first capital hosting Vladimir Putin for a bilateral meeting in February 2015, just seven months after the downing of the Malaysian MH17 airplane. Prime Minister, Viktor Orbán also listed Russia among those "illiberal democracies", whose achievements are worth for further study by political leaders.

These statements and actions were in sharp contrast with Viktor Orbán's Russia-skeptic policy record. Just as late as 2008 he characterized Hungary as the "happiest barrack of Gazprom" and led a feverish campaign against the Social-liberal government's Russia policy. Thus, the most important question, what were the major motivations behind his U-turn in foreign policy and what the role of energy was. Even if it is difficult to grasp the economic component in this strange transformation, it is certainly a major factor. Given the cabinet's almost exclusive affinity to economic considerations in foreign policy¹⁷², Orbán's turn to Russia must have a strong economic justification. The bilateral relations are based much less on the notion of political similarities and illiberal parallels, and reflect the characteristics of a strong *quid pro quo* logic.

¹⁷¹ Europe 'shot itself in foot' with Russia sanctions: Hungary PM, Internet: <http://www.reuters.com/article/us-ukraine-crisis-sanctions-hungary-idUSKBN0GF0ES20140815> (accessed 25/11/2016)

¹⁷² After his landslide electoral victory in 2014, Orbán delivered this new directive at the annual ambassadors' meeting with the rather blunt observation that "ideology-oriented foreign policy has been invented by smart countries for foolish ones". Hungary's foreign missions were instructed to place greater emphasis on increasing Hungarian exports and investments, since "we live in an economic world". In: Orbán: *Sunnyogással nem jutunk semmire* [We will get nowhere acting in a sneaky way], Available at: <http://index.hu/belfold/2014/08/25/kulkepviselet-vezetoi-ertekezlet/> (accessed May 18, 2015).

All this suggest, that Moscow could offer benefits at high local value for the cabinet, implying a high level of Hungarian interest in strengthening the bilateral relations. Perhaps it was even the Hungarian government, who initiated some actions and hoped for a favourable arrangement. By 2014 Viktor Orbán had only few domestic and external constraints in forming his Russia policy left. At the home front, the opposition was both weak and more Russia-friendly than Fidesz itself. Paradoxically, pro-European and pro-Atlanticist foreign policy sentiments would have born more risk for the government on this domestic policy arena, than any alternative orientation. Opting for Russia or for any other non-Western diplomatic relations was relatively risk-free on the party politics level. As the opinion polls quoted above, the public sentiment was also moderately neutral and did not limit the cabinet in its actions.

As far as the external environment concerned, Prime Minister Viktor Orbán consciously built up his image as the *enfant terrible* of the European politics. He aimed to outline an “anti-liberal” alternative to the European mainstream discourses and differentiate his behaviour and policies from it. In this regard, conflicts and even moderate, but rhetorically harsh confrontation with the “West”, the EU or any of its representatives in symbolic or even bigger issues constituted a vital element of Orbán’s foreign policy. During his first term, he conditioned his broad electorate to a more patriotic and militant Western-skeptic attitude. In this regard, even good relations with Russia, despite its historical role and security challenges became an acceptable foreign policy option as a symbol of a truly “independent” Hungarian diplomacy. At the same time, the Hungarian cabinet also remained within the “red line”, and in major strategic issues it has not challenged neither the US, nor the bigger Western powers. Despite its noisy opposition and feverish rhetoric, PM Viktor Orbán has never voted against important strategic initiatives concerning Russia on the EU or NATO forums.

In this regard by the end of its first term the Hungarian cabinet had a relatively free-hand in managing and improving its relations with non-Western powers. The transition in the MFA from the moderate Atlanticist János Martonyi to the Orbán-clientele Péter Szijjártó in 2014 apparently symbolized this policy turn. PM Viktor Orbán could choose its policy objectives and instruments freely and shape the country’s relationship according to his wishes. Nonetheless, the major difference between the two actors is, that Russia had a more systematic approach, with objectives for much longer term and potentially with more strategic content. Unlike the Hungarian mercantilist attitude, which was case by case combined with considerations of short-term domestic policy necessities, Russia could take short-term financial sacrifices in order to get permanent political and economic benefits in the future.

Energy admittedly was one of the drivers of the bilateral rapprochement. Four major and presumably interrelated topics emerged on the sectoral field with real or potential Russian involvement between 2012 and 2014:

1. The issue of the South Stream pipeline. Being a radical critic in the opposition, Fidesz has started to advocate the Russian pipeline after the failure of Nabucco-West in 2012.

2. The emergence of gas trader MET. The gas trader MET, which has won some opaque privileges on the Hungarian market, has both some Russian connections and István Garancsi, an alleged dummy of Viktor Orbán among its owners. This puts the company’s activities into another light, raising suspicion regarding corrupt practices with the involvement of Russian actors.

3. Major price and contractual concessions of Gazprom in the long-term gas supply contract (LTSC). Even if these concessions are in line with the continental trend, in the Hungarian case their magnitude goes beyond CEE average and their timing had political significance. It enhanced Orbán’s utility rate cut efforts, his “silver bullet” in the 2014 parliamentary electoral campaign.

4. The Paks nuclear extension contracts. In 2014 Hungary contracted two new nuclear plants from Rosatom for an approximately 12 billion EUR value. The Russian government provides a credit-line up to 80% of the construction costs.

In this paper we will argue, that these events were stepping stones in the establishment of a new kind of sectoral influence of Russia. Through a chain of different engagements Moscow consciously or as a matter of events succeeded in setting up an asymmetric sectoral relationship and keep Hungary on the Russian energy path. This enhances both its influence and its potential to extrapolate its “persuasive” capabilities to other policy fields. We will refer to this asymmetric situation as “energy policy capture”¹⁷³: when an external actor, in this case Moscow, could establish a highly favourable for itself bilateral framework that can systematically provide it an upper hand in the sectoral and political negotiations for a relatively long time.

It is important to underline, that the bilateral set of deals is not limited to energy. Even if energy represents by far the biggest issue both in terms of value and relevance, the above mentioned list can be extended by a number of smaller arrangements. Russia was a successful candidate for many projects where its technological legacy remained applicable, outcompeting sometimes companies with more favourable offers. Russian firms under suspicious circumstances won a tender for refurbishing metro vehicles (289 million EUR), could overhaul Mi-17 helicopters (12.7 m. EUR). Issues related to Russian metallurgic and nuclear machine industry companies are heavily discussed on the bilateral agenda, as well as potential Hungarian construction and export tenders in Russia, sometimes with the involvement of dummies of PM Viktor Orbán (Lőrinc Mészáros). This also justifies the assumptions, that the bilateral agenda is heavily dominated by economic issues. There is some sort of reciprocity between the partners, exchange of political favours and economic deals.

The traditional concept of state or regulatory capture ¹⁷⁴ assumes that institutions, established to safeguard common goods, are taken hostage by private interests of some particular groups from within the given political-economic polity. The capture is mutually beneficial for both the decision makers in the policy/state agency themselves and the representatives of the private entity, understandably at the expense of public interests. In the case of Hungarian-Russian energy policy capture an external actor, Moscow, without the inclusion of middle-men succeeded to setup a context for Hungarian decision making, where the government was ready to approach them in a more closely manner. It offered short-term political/economic benefits and potentially created a parallel network of private interests in order to establish a longer-term and less reversible engagement. The Russian gains are rather institutional, comprise a system of enhanced and potentially asymmetric cooperation, with an open-ended nature.

¹⁷³ Or alternatively it is called as „energy state capture”. See Attila Antal (2016): *A korrupciótól az állam foglyul ejtéséig* [From corruption to the state capture], Available at: <https://www.energiaklub.hu/publikacio/a-korrupciotol-az-allam-foglyul-ejteseig-state-capture-az-energetikaban> (accessed November 17, 2016).

¹⁷⁴ George J. Stigler (1971): *The theory of economic regulation*, in: Bell Journal of Economics, 1971, vol. 2, issue 1, pp. 3-21. Available at: <http://www.ppge.ufrgs.br/giacomo/arquivos/regulacao2/stigler-1971.pdf> (accessed 2 January 2017).

We identified four real or potential elements of this policy setup with the following characteristics:

1. *The sectoral relationship is based on a growing number of large-scale and long-term arrangements with high corruption and management risks*¹⁷⁵. Some of these risks are natural: energy usually comprises oligopolistic market designs¹⁷⁶; delivered products are sometimes very complex (like nuclear)¹⁷⁷; in some cases these relations are bilateral monopolies, reducing the applicability of market-based solutions and resulting in distributive games¹⁷⁸; informational asymmetry in these cases favours the supplier's side¹⁷⁹. In the last couple of years three arrangements (South Stream, the LTSC and the Paks nuclear extension) of this kind dominated the Hungarian-Russian energy relations. Obviously the Hungarian side was open to increase the number of these engagements with a single supplier, namely Russia (Paks nuclear extension) and/or maintain existing ones (LTSC) despite of changing market fundamentals. This trend raises major questions regarding the true intentions of Moscow and the reasons of Hungarian receptivity.

2. *The Hungarian energy landscape went through a major renationalization campaign, changing the bargaining power and the nature of negotiations substantially*. The former role of foreign multinational companies is taken over by state-owned enterprises (SOE). Most importantly the state-owned MVM (Hungarian Electricity Works) purchased the gas wholesaler from E.ON, holding the LTSC in 2013. South Stream Hungary has been permanently held by various state-owned entities since its founding in 2008, bypassing the privately-owned gas transmission operator (FGSZ). State ownership can be advantageous in energy sectors in some particular cases like by improving the international bargaining position, at the process of capital and resource allocation for complex projects with industrial policy overflows or with sensitive technology content¹⁸⁰. At the same time in SOEs' operations considerations related to social welfare take a more formidable role¹⁸¹, managerial capabilities are often vulnerable in politicized environments, economic efficiency and political power relations have to be taken into account simultaneously¹⁸². It often may offer inroads for political patronage and rent-seeking behaviour, principal-agent corruption schemes can be set up much easier. Furthermore in the Hungarian case the renationalization of the gas sector increased the informational

¹⁷⁵ Susan Rose-Ackerman (1999): *Corruption and Government: Causes, Consequences, and Reform*, Cambridge University Press. Marcel Hertogh et al. (2008): *Managing large infrastructure projects*. Available at: <http://netlipse.eu/media/18750/netlipse%20book.pdf> (accessed December 21, 2016). McKinsey (2013): *A risk-management approach to a successful infrastructure project. Initiation, financing, and execution*, McKinsey Working Papers on Risk, Number 52 Available at:

http://www.mckinsey.com/~media/mckinsey/dotcom/client_service/Risk/Working%20papers/52_A_risk-management_approach_to_a_successful_infrastructure_project.ashx (accessed December 21, 2016)

¹⁷⁶ Alberto F. Ades; Roberto Di Tella (1995): *Competition and Corruption*, Draft Paper, Oxford University.

¹⁷⁷ Flavio Menezes (2000): *The Microeconomics of Corruption: The Classical Approach*, EPGE - Ensaios Econômicos 2000/11.

¹⁷⁸ Carol Dahl (2015): *International Energy Markets: Understanding Pricing, Policies, and Profits*, Penwell Corporation.

¹⁷⁹ David Easley; Maureen O'Hara (1988): *Contracts and asymmetric information in the theory of the firm*, In: *Journal of Economic Behavior & Organization*, Vol. 9, No. 3, pp. 229-246.

¹⁸⁰ Raymond Vernon (1979): *The International Aspects of State-owned Enterprises*, in: *Journal of International Business Studies*, Vol. 10, No. 3, pp. 7-15.

¹⁸¹ Yair Aharoni (2000): *The Performance of State-owned Enterprises*. In: Pierangelo Maria Toninelli (ed.): *The Rise and Fall of State-Owned Enterprise in the Western World*, Cambridge University Press, pp. 49-73. Dieter Bös (1981): *Economic Theory of Public Enterprise*, Springer.

¹⁸² Spiros Lioukas; Dimitris Buorantas; Vassilis Papadakis (1993): *Managerial Autonomy of State-owned Enterprises: Determining Factors*, in: *Organization Science* Vol. 4, No. 4, pp. 645-666. David Stark; Balázs Vedres (2012): *Political Holes in the Economy: The Business Network of Partisan Firms in Hungary*, in: *American Sociological Review* 77:5, pp. 700-722.

asymmetry with Russia, since there had been no gas companies and sectoral know-how in state ownership until 2010 (see later). Given the concept of “political governance” of Fidesz, the nationalization process also implied a more direct subordination of technocratic and purely economic considerations to political aspects. The negotiations in these matters were coordinated and often conducted by the Prime Minister’s Office in total secrecy, ignoring the public administrative or the traditional business process. Since traditional business-minded agents have lost much of their representation in the decision making, it opened up a broader terrain for the government’s activities.

3. *The Russian-related segments have taken the dominant role in energy investments, handicapping alternative energy market outcomes.* This was the result of different factors: it was partly due to the launch of some investments, in particular the Paks extension and partly due to the shrinking activities of other investors and companies. Nonetheless their combined effects point towards a growing role of Russia in the energy field. Populist measures on price regulation has minimized utility tariffs, leading sectorial companies into the red. Investments into electricity and gas sectors has crumbled, falling from 0.9% to 0.44% of the GDP between 2010 and 2014¹⁸³. Further development of the pipeline network or investments into efficiency measures, house insulation have becoming financially challenging in such a regulatory environment. Moreover, the former Green Financing System (KÁT) was abolished and the government failed to introduce a new system of mandatory feed-in tariffs for renewable energy. Thus solar, wind or even cogeneration investments can be made only on a purely self-financing basis or on case-by-case decisions made by the Ministry/Regulator. All this led to a situation, when practically no investments can be made on a private basis and almost all activities are concentrated in the SOEs. Parallel, the Paks nuclear extension more than doubles the domestic nuclear electricity generation capacity (from approximately 2000 MW to 4400MW) by 2026, creating a heavy oversupply at the lower end of the electricity load curve, especially in night-times. With such a prospect, it is understandable, that the cabinet is counter-interested in any additional upcoming electricity-generation investment, potentially competing with future nuclear capacities. Thus the utility rate cut and the Paks extension practically squeeze the gas and electricity markets, leaving no room for credible alternatives for the upcoming decade.

4. *The government’s conviction, that the current “quid pro quo” basis of the bilateral relations is beneficial for Hungary.* This belief roots in the government’s foreign policy concept that sets economic and business considerations as the primary focus for diplomacy. In 2014 PM Viktor Orbán announced his goal to increase the share of non-EU countries to one-third in total exports by 2018. Political, security and “Western civilizational” aspects are downsized in the new mindset.¹⁸⁴ As the extradition of the Azeri killer to Baku showed¹⁸⁵, political measures can be easily exchanged for economic benefits in Budapest. Moscow is perceived to be a “strong buyer” of these concessions, an actor who is ready to monetize political friendship and non-conformity in EU and NATO matters. The idea of “package deals” were increasingly popular

¹⁸³ Source: Eurostat, *Investments into electricity, gas, steam and air conditioning supply*. The same indicators for 2014 were 1.59% in the Czech Republic, 2.35% in Slovakia and 1.44% in Ukraine.

¹⁸⁴ *Józan ésszel és bátorsággal kell képviselni az országot*, Available at: <http://www.kormany.hu/hu/a-miniszterelnok/hirek/a-leggyorsabban-novekvo-eu-s-orszagok-koze-fogunk-tartozni> (accessed December 25, 2016).

¹⁸⁵ Ramil Safarov is an Azeri officer, who committed a murder motivated by ethnic hatred against his Armenian colleague on a NATO language course in Budapest in 2004. He was sentenced to life imprisonment by a Hungarian court in 2006, while in Azerbaijan he became a national hero. Despite the strong indications, that he would be pardoned by the Azeri government, the Fidesz government extradited him to Baku in 2012. Viktor Orbán defended this decision by referring to the long-term interests of Hungary.

among foreign policy decision makers close to Russian-negotiations.¹⁸⁶ Thus it is reasonable to think, that the Hungarian government would like to increase its “Russian portfolio” and open new dossiers if it seems to be advantageous for it.

In the rest of this chapter we will shortly analyze these four projects and policy elements and show their interrelations. Each policy entity functioned in its own way, resulting in different implications and policy objectives. Nevertheless, in their current form they constitute an interrelated set of engagements, complementing each other on the sectoral landscape.

The issue of South Stream pipeline – the first contact...

The South Stream project rested a broad regional platform with a complex set of Russian policy objectives. It tried to bias the construction of pipeline connections between the Caspian region/Middle East and the EU (Nabucco, later TAP). It also solved as a potential by-pass for the Gazprom’s Ukrainian route. It could have provided a better access to some tiny markets on the Western Balkans and strengthen the competitive edge of Russian gas on some existing, Southern European marketplaces.

Hungary had an enhanced dialogue with Russia on South Stream (formerly Blue Stream 2) from its public appearance in 2006 until its suspension in 2014. Excluding a short interruption between 2009 and 2012, Budapest showed increased enthusiasm about the project and actively supported its realization. Practically all major political formations welcomed its construction, even if in different periods and not regardless from the government-opposition relations.

The context of South Stream was very similar in all the transit countries. The main policy arguments were the better access to Russian gas, increased supply security by reducing transit risks, strengthening the countries’ bargaining position in LTSC negotiations, practically resulting in lower prices and the transit fees, as a source of governmental income. At the same time, the project brought a number of risks. The regulatory clash with the EC was the most visible one. Gazprom refused to launch the usual regulatory approval procedure, while its contractual regimes with the transit countries, even the IGAs (Intergovernmental Agreements), comprised several controversial points. In this case Gazprom has not engaged into lengthy policy clarifications, leaving the transit countries alone vis-à-vis the EC regulatory authorities. This was most visible on the Bulgarian example, leading to the suspension of the project in the end. Gazprom was also relatively safe from project preparation risks: the unilateral cancellation of the project did not result in financial compensation for the transit states. Moreover, Gazprom could freely change the specifics during the preparatory phase, including the route and destination of pipeline especially in the Hungarian case, without any financial or policy consequences.

In the Hungarian-Russian dialogue South Stream played the role of “relational catalyst”. South Stream was the flagship project on the bilateral level between 2006 and 2009 with the Socialist-liberal cabinet and in 2012-13 with the Fidesz-government. The project and its political preparations attracted the attention of local political elites and established a permanent system of high-level meetings and contacts. Vladimir Putin’s intensified regional visits and meetings were organized around South Stream with a myriad of other consecutive senior contacts and accompanied initiatives. Unlike in Bulgaria and Serbia, in the Hungarian case Russia did not have the local net of middle-men and the already existing set of interests, capable to organize a broad and strong bilateral agenda. Especially in the case of Fidesz in 2012,

¹⁸⁶ The idea had already come up during the first meeting between Orbán and Putin in November 2010 to combine the issues of the Paks expansion, natural gas supply, Budapest subway enlargement, and MOL share package into a single deal. *Vengrija menyjajet szvoju nyeft na rosszijszkij gaz* [Hungary changes its oil to Russian gas], *Kommerszant*, 30 November 2010, Available at: <http://www.ugmk.info/digest/vengrija-menjaet-svoju-neft-na-rossijskij-gaz.html> (accessed June 13, 2012).

relations had to be constructed from scratch, due to Viktor Orbán's former anti-Russian attitude.

South Stream biased not only EU harmonization (and regulation) in the field of natural gas, but also and even to a larger extent the Visegrad cooperation. In the case with Slovakia it led to the emergence of competitive with Hungary gas transit positions, while in the case of the Czech Republic and Poland it raised doubts regarding the true intentions and commitment of Budapest in Eastern matters. Hungary strengthened its relations with Russia when Western-Russian relations were on general decline, to some extent spoiling the mood of Visegrad summits. Retrospectively Hungary was only the first mover in this regard. By 2014-15 the potential Russian fears about transforming the Visegrad cooperation into an anti-Russian *cordon sanitaire* have faded away, with Hungary and Slovakia skirmishing the retreat.

The pipeline issue also catalysed negotiations on a broader set of natural gas matters. As in many other countries South Stream had never stood alone, its matters strongly interrelated with existing LTSCs and other, gas-related issues. This was even more important in the Hungarian case, where the gas industry was predominantly privatized and the LTSC was not in the hand of a state company, but belonged to the portfolio of E.ON. Formally Gazprom and the government could not pursue negotiations on gas import prices without the inclusion of the E.ON management. Other potential issues, investments into gas sector were practically impossible, given the lack of domestic state corporations in the sector. Not surprisingly, under the Gyurcsány-government between 2006 and 2009, the South Stream project was not given to MOL, owning the high-pressure gas pipeline network, but to the Hungarian Development Bank (MFB). PM Viktor Orbán had started a major nationalization campaign and raised the Hungarian Electricity Works (MVM) as a state-owned sectoral national champion, creating its "gas leg" right after his landslide electoral victory in 2010. There was a clear wish from the Hungarian political side to engage Russia in a broader set of gas issues, but it lacked the mandates and credibility until the end of Orbán's first term. South Stream negotiations to some extent substituted this institutional deficit and accelerated the process of sectoral re-politicization.

MET-trader – leaving the public sphere behind...

The second set of developments that in all likelihood constituted a stepping stone in strengthening Russian influence in the Hungarian energy sector is centered around the MET Group - a group of privately held energy trading companies with a complicated and rather opaque ownership history that includes Russian stakeholders. As a result of a series of decisions made by various state actors, the group became the ultimate beneficiary of a set of legislative and regulatory amendments concerning gas trading between 2011 and 2015.

Despite the regional changes in the market design, the LTSC has retained considerable significance in the Hungarian-Russian gas trade. As in other cases through Europe, the LTSCs proved to be inflexible amid the rapid market changes forthcoming after 2008. Adaptation and intense contractual renegotiations had been under way since then and Gazprom was forced to offer major concessions to keep its competitive edge. It had to give price and pricing concessions, decrease the required take-or-pay (TOP) obligations and change many important details.¹⁸⁷ It is very telling about Gazprom's position and ambition, that from the 36 LTSCs in its European portfolio, none has been cancelled and in all the cases the sides were able to find a *modus vivendi* and implement a reasonable set of modifications. Nonetheless, this was a complex process and the magnitude of adaptation, the contractual outcome depended on the

¹⁸⁷ See in detail: Jonathan Stern; Howard Rogers (2011): *The Transition to Hub-Based Gas Pricing in Continental Europe*, OIES, Available at: <https://www.oxfordenergy.org/wpcms/wp-content/uploads/2011/03/NG49.pdf> (accessed September 19, 2012).

buyers' bargaining power, negotiation skills and determination. Not surprisingly in the CEE region, where Gazprom had a better position, its concessions lagged behind those in Western Europe.¹⁸⁸ Thus the strategy, corporate-state cooperation and the presence of a clear vision on the importers' side were of crucial significance.

Hungary was in a relatively good bargaining position, since its LTSC was due to expire in the second half of the 2010s, and its early interconnectivity programme provided a considerable access to alternative contractual sources in Austria and later in Slovakia (from 2015). Nonetheless the existence of the LTSC and primarily its TOP requirements have brought a major protectionist policy drive into the relations since 2009. Both Gazprom and its Hungarian counterpart (until 2013 the local E.ON subsidiary, then MVM) wanted to constraint alternative imports and secure their market position for LTSC supplies. Thus, they contracted the Austrian (HAG) import options for LTSC gas, despite the shorter route and the abundance of Ukrainian cross-border import capacities. This bottleneck decreases the pressure on the current LTSC at the expense of competition, reducing alternative access to cheaper gas, resulting in a loss of social welfare. The European Commission raised its objections to the Hungarian Regulator in this regard in 2015.¹⁸⁹

In such situation, the government's/regulator position was of major significance. Until 2010 the Hungarian Energy Office was relatively weak and failed to keep the cross-border auctioning transparent. Fidesz broadened the Regulator's scope of authority and empowered it to enforce the rules. Indeed, in January 2011 the Regulator stopped an attempt of major importer companies to prolong the existing system of capacity allocation until 2015.¹⁹⁰ This was a major signal that the government would like to reallocate the HAG cross-border capacities in the forthcoming period. The way, how this would be done was of large importance for the future of LTSC, Gazprom and E.ON. By liberalizing the HAG entry point and letting the competition free, Gazprom and E.ON should have reduced their contractual volumes with all the related loss of shrinking market share and financial consequences. Thus it was in Gazprom's and E.ON's eminent interest to keep the status quo intact.

In 2011, the Fidesz government restructured Hungary's mandatory electricity purchase scheme that subsidized power plants using renewable energy sources and CHP plants (combined heat and power plants) to no longer include the latter among the beneficiaries.¹⁹¹ As a result, these plants could no longer provide heat for district heating at a discount. In order to prevent a surge in district heating prices, the government in turn decided to secure cheap gas for affected neighborhoods and institutions by way of regulation. 585 million m³ of gas were released from the strategic reserve to be sold by MVM (Hungarian Electricity Works) at a fixed rate to those eligible¹⁹².

One of the associated decrees also stated that the reserves must be replenished. To this end, it granted almost exclusive use of the Hungarian-Austrian (HAG) Pipeline to state-owned MVM, its subsidiary, MVM Partner Ltd. and E.ON Gas Trading Ltd. (a privately held company at the

¹⁸⁸ REKK (2013): *Földgáz nagykereskedelmi modellalternatívák 2015 után Magyarországon* [Alternative models to gas wholesale trade for Hungary after 2015], March 2013, Available at: <http://2010-2014.kormany.hu/download/0/44/d0000/tanulm%C3%A1ny%202013%20m%C3%A1rcius.pdf> (accessed 23 April 2014).

¹⁸⁹ *Új eljárás indult Magyarország ellen!* [New process was launched against Hungary!], in: Portfolio, 27 February 2015, Available at: <http://www.portfolio.hu/gazdasag/energia/uj-eljaras-indult-magyarorszag-ellen.210784.html> (accessed 28 December, 2016).

¹⁹⁰ FGSZ (2013): *A 2011.01.28-i kapacitásaukcióról*, [On the Auction of Capacity on 28.11.2011], 27 January 2011, Available at: <https://fgsz.hu/hu-hu/media/hirek/20110128-i-kapacitasaukciorol> (accessed 28 December 2016).

¹⁹¹ Act No. XXIX/2011 on Changes to the Legislation on Energy, Magyar Közlöny 2011 Vol. 32. Available at: http://www.termostar.hu/uploads/rendeletek/2012/vet_2011.pdf (accessed 2 January 2017).

¹⁹² Governmental Decree No. 54/2011. (7 April 2011), Magyar Közlöny 2011 Vol. 37. pp. 10081-84. Available at: <http://www.kozlonyok.hu/nkonline/MKPDF/hiteles/mk11037.pdf> (accessed 2 January 2017).

time) without auction.¹⁹³ The government framed the decision as an extraordinary measure in order to ensure security of supply. This justification was weakened by the fact that the cross-border capacity reserved for MVM and E.ON far exceeded the amount released from the strategic reserve: a total of 2.9 billion m³ annual capacity was allocated to the two companies, most of which went to MVM. This put MVM in a unique position, as at this point, prices in the Western European gas market had been significantly lower than the rates set out in the LTSC for years. These privileges were then extended each year up until 2015 - also in contradiction with the government's original narrative. Partly due to these regulations, the EU initiated infringement proceedings against Hungary in 2015, and the decree was repealed shortly after.

So how did MET come into the picture? Wary of the risks of entering the gas market, MVM's management decided not to take advantage of the opportunity directly. Instead, they opted to enter into a set of agreements with MET Hungary Inc. and its Swiss subsidiary, MET International AG (METI). The mechanism set up can be summarized as follows: METI sold gas acquired at favourable rates in Western Europe to MVMP at the Austrian-Hungarian border (i); MVMP then carried it across to Hungary, taking advantage of their free access to the HAG pipeline (ii); to then sell the gas to MET Hungary for virtually the same price they bought it for (iii). MET Hungary was then free to sell the cheaply imported gas at a premium. Consequently, the vast majority of the vast profits made possible by the government's attempt to create a quasi-monopoly for a state-owned enterprise were ultimately realized by a private third-party entity for a period of four years.¹⁹⁴

MET's predecessor, MOL Energy Trader was founded by MOL in 2007 and was converted into a public limited company in 2009. In the following years, its ownership structure changed quite a lot. Two Russian-owned offshore companies controlled significant amounts of shares in the company. One owned by Megdet Rahimkulov, a former Gazprom executive with close ties to the Russian and Hungarian energy sector, the other by Ilya Trubnikov, a Russian-Canadian businessman of whom little is known. Trubnikov's company still holds a stake in MET, however, it sold most of its shares to two Hungarian businessmen with close ties to MOL senior officials in 2013. One of them, István Garancsi is also a longtime ally and alleged dummy of Viktor Orbán.

At the moment, there are ten companies between MET and its five ultimate owners, half of which are offshore.¹⁹⁵ MET evidently is not involved in the sort of illicit activities typical of companies with similar ownership structures. Why then do the owners - with the exception of MOL - choose to hide behind offshore companies? The initial involvement of Russian stakeholders in the venture, and the subsequent selling of their shares to the Hungarian businessmen in the midst of the company's meteoric rise are equally puzzling. The company's portfolio and trajectory offer little explanation for either.

A recently published in-depth case study of the MET-story from Corruption Research Center Budapest (CRCB) calls attention to the fact that many significant developments in the company's history happened to coincide with crucial deals and negotiations between Hungary and Russia concerning the energy sector.¹⁹⁶ Most notable among these were Hungary's

¹⁹³ *Decree of the Ministry of National Development No. 13/2011. (7 April 2011)*, Magyar Közlöny 2011 Vol. 37. pp. 10120-22. Available at: <http://www.kozlonyok.hu/nkonline/MKPDF/hiteles/mk11037.pdf> (accessed 2 January 2017).

¹⁹⁴ A legtöbb pénzt most így lehet csinálni Magyarországon [This how you can currently make the most money in Hungary]. Available at: <http://tldr.444.hu/2015/01/14/a-legtobb-penzt-most-igy-lehet-csinalni-magyarorszagon/> (accessed 14 December 2016).

¹⁹⁵ As published on the company's website. Available at: <https://hugas.met.com/hu/tulajdonosok> (accessed 16 December 2016).

¹⁹⁶ CRCB (2016): *Járadékvadászat és a haveri kapitalizmus modelljei a magyar energiapiacra, 2011-2015. A kormány – MVMP – MET történet elemzése* [Theoretical models of rent seeking and crony capitalism in the Hungarian energy market - The analysis of the Hungarian government – MVMP – MET story], CRCB, Budapest. Available at: https://www.energiaklub.hu/sites/default/files/met_energiaklub_korrupciokutato_20161026.pdf (accessed 2 January 2017).

repurchase of Surgutneftegas's stake in MOL in 2011 (i); the negotiations about South Stream and the extension of the LTSC between Viktor Orbán, Alexei Miller and Vladimir Putin in 2012, 2013 and 2015 (ii); Hungary buying the gas division of E.ON in 2013 and, returning the LTSC to the state (iii) and the announcement of the Paks 2 project in 2014 (iv). While MET denies all allegations of political influence, it cannot be ruled out that these developments had a role in how the company's shares changed hands and how it was able to operate.

The CRCB study's main focus is to determine to what extent do government failure and various theoretical models of rent seeking explain the dealings between the government, MVM and MET. While the currently available information does not allow for a definitive answer to these questions, so much is evident that many aspects of the chain of events simply do not follow market logic or economic rationale. To find explanations for the decisions made by the various parties, it must be presumed that other mechanisms were at play.

Shooting the silver bullet – the utility rate cut

By mid-2012 Fidesz has lost more than half of its voters and its popularity only barely exceeded the rating of the long-time rival Socialist Party.¹⁹⁷ PM Viktor Orbán utmost needed a strong campaign to broaden his electorate. He wanted to retain his two-third majority on the forthcoming spring 2014 elections, thus he desperately needed every single vote. He had to find solid messages for a catch-all campaign, addressing large masses beyond his party followers. In this situation, the government launched its utility rate reduction, cutting household prices for many items, primarily for electricity and natural gas by over 25% throughout 2013–14. This measure became Fidesz's electoral silver bullet, practically monopolizing the official communication by the end of the campaign. This message contributed decisively to Fidesz's popularity, which swelled from a low point of 1.3 million supporters in 2012 to a mass of 2.1 million by the time of the elections, bringing Viktor Orbán a new constitutional majority in the Parliament.

Fidesz had showed increased affinity towards social affordability considerations much before the 2013 campaign. It introduced a price moratorium on gas and electricity utility prices as early as 2010. This proved to be painful for corporate stakeholders especially in the gas segment, since import price levels have increased by more than 30% in the consecutive years. The regulator has kept the different cost items in line with the moratorium, putting the burden on the corporate actors of the value chain, primarily owned by foreign multinationals. Thus, there was little doubt, that the utility rate cut would lead these companies deeply into the red. This was not against the will of the government, Fidesz wanted to nationalize the whole vertical of the sector and buy out the foreign companies. By this regulatory squeeze, the cabinet could kill two birds with one stone: win popular support for the elections and take over the gas and electricity sectors.

Notwithstanding, Fidesz had to face the controversy, that after the nationalization the increased losses in the gas value chain would have to be tackled by state corporations. E.ON, holding the LTSC and controlling major segments of the domestic market, reportedly lobbied very efficiently against putting further burdens on its shoulders, forcing the government to a relatively expensive buyout in October 2013¹⁹⁸. Given the roughly 500–550 billion HUF (approximately 1.7 billion EUR) annual turnover on the Hungarian gas market by that time, the utility rate cut would have created a sizeable deficit in the new owners', MVM balances. In this

¹⁹⁷ Data are taken from Gábor Török: *Miért vezet a Fidesz? [Why Fidesz is in the lead?]* Available at: http://torokgaborelemez.blog.hu/2013/01/31/485_miért_vezet_a_fidesz (accessed 6 December 2016).

¹⁹⁸ The state-owned MVM paid 280 billion HUF (appr. 900 million EUR) for E.ON Gas Trade holding the LTSC and for E.ON Storage. The price have been debated by many policy experts, especially since the LTSC was about to expire by the mid-2010s.

situation, Gazprom provided a number of major concessions in the LTSC between autumn 2013 and spring 2014¹⁹⁹, parallel to the Paks nuclear extension contracting process. This help became vital in managing the gas value chain amid the sharp utility rate reduction campaign.

These concessions were not unprecedented in Western Europe but in the CEE region. During 2012, most of the Western European companies managed to renegotiate their LTSCs and bring it in line with market realities for the time being. Nevertheless, in the CEE region in the first half of 2012 prices varied between 30 and 43 €/MWh and in most of the cases their level exceeded Gazprom's German export price by 25-50%²⁰⁰. The TOP concessions were of even bigger significance. As it has been shown above, the Hungarian gas consumption practically collapsed, falling from 13 to 8 bcm in less than a decade. This step saved MVM from severe over contracting and could buy only as much gas as it really needed.

Gazprom offered these concessions in a period, when it had a high political relevance for Fidesz in the midst of its electoral campaign. The concessions came hand-in-hand with the Paks nuclear extension negotiations, starting by the signing of the Intergovernmental Agreement (IGA)²⁰¹ 14 January, 2014 and followed by the agreement on the Russian credit-line on the 28 March, 2014²⁰². It would be difficult to state that Gazprom's activity was fully unjustified, but its timing and relative early action in a CEE comparison suggest a good deal of preferential treatment. It is reasonable to assume, that gas pricing concessions were not fully independent from a bigger deal, namely the Paks nuclear extension agreement.

The Paks nuclear extension – the crown jewel of Russian influence

In 2012, the Paks power plant generated 45.9% of the gross electrical power produced in Hungary, and 37.3% of its total consumption²⁰³. This is a sizable proportion, and there is absolute professional consensus on the view that one of the country's biggest long-term issue regarding energy policy is the replacement of these power plants after their expected end of life in the 2030s. Three possible options exist as partial or total alternatives to nuclear: natural gas, renewable energy, and electricity imports. None of these can fully substitute the existing nuclear blocs and any combinations of these three fuels hide energy policy trade-offs with considerable shortcomings. Thus it is understandable, that there was a strong support for nuclear energy from industrial and the governmental circles, and that renouncing it completely was considered an utterly heretical idea.

At the same time, Hungarian energy policy discussions have been long dominated by the "Paks only" argument. Policy debates about the necessity, the timing, the scale and other details of these new blocs have been ruled out from the very beginning. A resolution passed by a large majority in parliament in 2009, which at that time was still under the government of Ferenc Gyurcsány²⁰⁴, also raised the issue in this form instead of mandating the state to consider alternative solutions and implementation. Oddly enough, it was the Fidesz government with its new version of the National Energy Strategy that has come the closest to thinking through this

¹⁹⁹ Reportedly Gazprom offered a price discount above 10% in October 2013 and further, major take-over concessions in February 2014. *Gazprom Eyes New Hungary Deal*, in: Argus FSU Report, June 2014, p. 6.

²⁰⁰ REKK (2013), p. 14.

²⁰¹ Law No. II/2014. Available at: <http://www.opten.hu/2014-evi-iitorveny-j247382.html> (accessed 18 December 2016).

²⁰² Law No. XXIV/2014. Available at: http://net.jogtar.hu/jr/gen/hjegy_doc.cgi?docid=A140002 (accessed 18 December 2016).

²⁰³ *A Magyar Villamosenergia-Rendszer (VER) 2012. Évi Statisztikai Adatai* [Statistical Data of the Hungarian Power System 2012], p. 42, 54, Available at:

http://www.mavir.hu/documents/10258/154394509/a_magyar_villamosenergia_rendszer_2012_evi_statistikai_adatai.pdf/b1fcb6e-ed81-42bc-bf05-569aec2cfaa3 (accessed 14 November 2014).

²⁰⁴ Parliamentary Resolution No. 25/2009 (IV.2.), Available at:

<http://mkogy.jogtar.hu/?page=show&docid=a09h0025.OGY> (accessed 28 December 2016).

issue. To this day, this analysis and its appendix by the Regional Centre of Energy Policy Research (Regionális Energiagazdasági Kutatóközpont [REKK]) is the only official impact study that outlines the problem in a complex manner²⁰⁵. The National Energy Strategy 2030 was not committed to enlarging Paks definitively, even if due to its eclectic nature, it did include references that later the government could cite to bolster its position. All in all, there is no doubt that from 2009, and especially from 2011, government policy displayed behaviour that hinted at such an investment. Nonetheless until the very end of 2013 it was not unambiguously stated that it would undertake this project on these terms in the near future.

Besides the existing nuclear technological ties and obvious political pressure from Moscow to get this contract as soon as possible, Rosatom had a major advantage compared to other potential contractors. The Russian budget provided a loan, that covers 80% of the projected costs, and although the negotiated, tiered interest rate between 4 and 5% does not appear to be cheap compared to current rates, it is fixed, however, meaning that it is immune to changes in the international supply of capital and Hungary's credit risk rating. The significance of this latter point is understandable if we consider that Hungary's borrowing costs have traditionally been higher than those of the other countries in the region. The similar credit lines in the cases of Areva or Westinghouse would have been much smaller, and favourable loan rates set by the cooperating banks would also reflect the levels of market risk. Lacking such a loan scheme, the total cost of the project, around €12.5 billion, would have to be procured from either internal resources or external credit markets, the bulk of which is being constructed, largely over a ten-year period that starts at the end of the 2010s. If the budget were to bear this entire amount²⁰⁶, then it would increase the deficit/debt as a share of GDP by an annual average of 1.3%. This means either a major budgetary adjustment or a significant rise in Hungary's foreign currency debt (approximately by some 40%), driving up its borrowing costs. The Russian loan for the project spreads out this burden over a period of nearly thirty years, with repayments occurring during the plant's operational life. If such an offer is combined with favourable interest rates, then it is preferable to a market-based solution for any client similar to Hungary.

Nonetheless, the decision and the contractual regime already ignored many sensitive points, implying major vulnerabilities for the project itself. First of all the launch of the new units is scheduled for 2025-26, assuming that six nuclear blocs will produce electricity simultaneously until 2032 (when the life-time of the first existing Paks bloc constructed in 1982 expires). This is an opaque decision causing further physical and financial uncertainties and complicating the profitable operation of the new units. Regulatory issues have been fully ignored especially as far as the EU conformity regarded. The EC had launched several investigations regarding public procurement (the lack of tendering), potential state aid aspects and transparency considerations (the past and future decisions related to the project were classified). Furthermore, the few documents made public reveal some deficiencies, like the lack of international dispute settlement for the credit-line.

Further problems may arise during the construction phase. As a Report on the corruption risks related Paks underlines, these risks mainly originate from the characteristics of the investment as such: the sheer size of the project (7-10% of the Hungarian GDP); the informational asymmetry stemming from the application of new nuclear technology; the bilateral monopoly situation, typical for such investments²⁰⁷. Nuclear plant constructions often

²⁰⁵ REKK (2011): *A Nemzeti Energiasztratégia 2030 – Gazdasági hatáselemzés* [The National Energy Strategy, 2030 – Economic Impact Study], in: *Nemzeti Energiasztratégia*, Magyar Közlöny Vol. 119, Available at: http://doc.hjegy.mhk.hu/20114130000077A7AF_1.PDF, (accessed 2 January 2017), pp. 30344-30359.

²⁰⁶ The more market-friendly solution with at least a part of the total sum incorporated into the electricity price was ruled out by the government.

²⁰⁷ Mihály Fazekas; Zsolt Főző; István János Tóth (2014): *Az atomerőmű-beruházások korrupciós kockázatai: mire számíthatunk Paks II esetében?* [The Corruption Risks of Nuclear Investments: What can we expect in the case of

result in cost and time overruns and their proper management.²⁰⁸ Russia has four domestic VVER-1200 construction projects: the two new Leningrad II blocs, the Novovoronezh II project and the Baltic I in Kaliningrad.²⁰⁹ The Leningrad blocs were planned to be on-line by 2013 and 2016 respectively, but due to a variety of reasons, including construction problems at the sites and capacity abundance on the market the official deadline has been shifted to 2018 for the first unit.²¹⁰ Because of similar reasons the Baltic I project has been suspended at a relatively early stage, and Novovoronezh II unit is expected to start commercial operation only after nine years of construction in 2019. Given the problems at Rosatom's own projects and the relatively weak Hungarian project management record, the complexity of the project in terms of permitting and its legal aspects, the management and sharing of project risks between the parties are of vital importance.

Hardly anything is known about these aspects. The three implementation agreements signed in December 2014 are fully classified with all the related past and future data for 30 years according to a specific law passed by the Parliament. The government commissioner responsible for Paks II argues, that the contracts oblige Rosatom to deliver turnkey blocs until the deadlines, thus the risks on the Hungarian side are minimized.²¹¹ Nonetheless, the successful completion would require goodwill and high-level of precision from both sides and the consequences of potential commercial conflicts are disproportionately large. The credit-line agreement, one of the few documents made public by the Russian side, revealed the very limited bargaining power of the Hungarian partner.

Prominent among the many concerns raised by various parties following the announcement of the expansion agreement were those relating to the possible violation of domestic and EU-level public procurement and competition laws. Following complaints filed by environmental NGOs and green party politicians, the European Commission opened two investigations in 2015: an infringement case on the government's decision to award the contract to Rosatom directly, without tendering, and a competition case looking into the possibility of illegal state aid.

Despite their evident initial skepticism, EU officials later proved to be much more reluctant to challenge the deal. The Commission closed the infringement case a year later in November 2016, concluding that the contract meets the criteria for a technical exclusivity exemption. Controversy over the decision was exacerbated by its timing and how it was made public. It was buried in a list of more than 75 other cases despite its high-profile nature, and was released amid revelations about former Energy Commissioner Günther Oettinger's flight to Budapest in May on a private jet owned by Klaus Mangold, a lobbyist and consultant on the Paks II project who has close ties to the Kremlin²¹². As of March 2016, the investigation into whether Hungary

Paks II?], Korruptiókutató Központ Budapest (CRCB), p. 3. Available at:

http://energiaklub.hu/sites/default/files/korruptcios_kockazatok_paks.pdf (accessed 28 December 2016).

²⁰⁸ See IAEA (2012): *Project Management in Nuclear Power Plant Construction: Guidelines and Experience*, IAEA Nuclear Energy Series No. NP-T-2.7. Available at: http://www-pub.iaea.org/MTCD/Publications/PDF/Pub1537_web.pdf (accessed 2 January 2017) and Craig A. Severance (2009): *Business Risks and Costs of New Nuclear Power*. Available at: <http://www.nirs.org/wp-content/uploads/neconomics/nuclearcosts2009.pdf> (accessed 2 January 2017).

²⁰⁹ World Nuclear Association: *Nuclear Power in Russia*. Available at: <http://www.world-nuclear.org/information-library/country-profiles/countries-o-s/russia-nuclear-power.aspx> (accessed 2 January 2017).

²¹⁰ Mycle Schneider; Antony Froggatt (2016): *The World Nuclear Industry - Status Report 2016*, p. 209. Available at: <http://www.worldnuclearreport.org/> (accessed 2 January 2017).

²¹¹ *Paks II.: A garancia az, hogy "mi sem vagyunk kispályások"* [Paks II: The guarantee is that "we are not amateurs either"], Available at: http://hvg.hu/gazdasag/20141209_Aszodi_Attila_interju (accessed 2 January 2017).

²¹² *German EU commissioner used Kremlin lobbyist's jet*. Available at: <https://euobserver.com/institutional/135915> . (accessed: 30 December 2016)

covering the costs of the project (as set out in the loan agreement) would qualify as illegal state aid was closed, giving a green light for the construction.

The lack of transparency around the expansion project has also been a major cause for concern. The cooperation agreement between the Russian and Hungarian governments was negotiated completely behind closed doors, with no public debate preceding it. The Hungarian Government published the agreement after it was released on the Russian Government's website. In the spring of 2014 several parties sued for the impact assessments and analyses establishing the necessity of the expansion after their freedom of information requests were rejected. A share of different documents connected to the investment were eventually made public over a year later, but even their existence was called into question for a while as the result of one of the court rulings.²¹³

The Fidesz government also resorted to extreme legislative measures to shield the Paks II project from public scrutiny. A bill adopted in March 2015 exempted the project from Hungary's already restrictive Freedom of Information Act, classifying all information relating to the design, construction and funding of the two nuclear reactors for 30 years, as well as all decision support documents. The law cited unspecified national security interests and the protection of intellectual property rights in general as grounds for the blanket restriction that left no discretion for data controllers and rendered the option of judicial review of any refusal to gain access meaningless.²¹⁴ The government was forced to partially dial back these restrictions a year later after an EU Pilot procedure launched following a complaint filed by MEP Benedek Jávor concluded that the amendment violated EU disclosure requirements.

The EU only examined the Paks II project within the framework of the above three questions, however, the corruption risks inherent in an investment of such nature and magnitude are much greater in scope. As detailed in an assessment by corruption experts commissioned by Energiaklub²¹⁵, a Budapest-based energy policy think tank, the risks common to all large infrastructure projects are in this instance compounded by shortcomings of the deal in question.

Only a handful of companies are capable of constructing nuclear power plants, while national governments are virtually the only buyers. Such bilateral monopolies are especially susceptible to corruption. International empirical studies on similar projects demonstrate that at least 5% of the value of such investments is exposed to corruption risks. Hungarian data suggests that the corresponding value may be as high as 13-16%, with higher priced investments being associated with higher corruption related losses²¹⁶. This means that in the case of Paks II, up to EUR 2 billion could be lost to corrupt transactions, assuming that current budget estimates are not exceeded and already contain the rent gained via corruption. However, delayed completion and budget overruns are the rule rather than the exception worldwide when it comes to large infrastructure projects. This is particularly true of nuclear power plant constructions, which regularly end up costing double or triple the amount originally estimated. Moreover, in the case of Paks II, the signed agreement may not include additional work clauses, only regulating penalties to be paid by the Hungarian state in case of delays in the repayment of the loan. This could create bad incentives on the seller side and further opportunities for abuse.

The authors of the study also emphasize the relation-specific nature of the deal and the information asymmetry between the two parties as sources of particular concern. The investment is dependent upon financing opportunities offered by the Russian party, while the

²¹³ *Paksi hatástanulmányok nem léteznek* [No impact assessments exist for Paks extension]. Internet: http://index.hu/gazdasag/2014/06/23/paksi_hatastanulmanyok_nem_leteznek/ (accessed: 30 December 2016)

²¹⁴ Hungarian Civil Liberties Union (TASZ): *Hungary Classifies All Information Regarding Paks Nuclear Plant*. Available at: <http://tasz.hu/en/freedom-information/hungary-classifies-all-information-regarding-paks-nuclear-plant>. (accessed: 30 December 2016)

²¹⁵ Mihály Fazekas; Zsolt Főző; István János Tóth (2014).

²¹⁶ Ibid p.3.

contractor is not only responsible for the physical construction, but for a range of other services as well (necessary technology, preparatory and follow-up works, operation, fuel supply, training, waste storage, safety measures, etc.). A high degree of information asymmetry arises from the heavy reliance on the expertise of the contractor regarding the complex technologies that only it has full knowledge of. This can be exploited by the Russian party through overpricing and a number of other means. Overpricing is also an issue when considering the high number of subcontracts such an investment project generates. While the agreement stipulates that the ratio of Hungarian suppliers involved in the project may be as high as 40%, Hungarian infrastructural construction companies cost their services 20-30% percent higher than those set out.²¹⁷ There is a very limited number of such companies operating in Hungary and the largest players are closely linked to the Fidesz party.

As in the case of the gas trading deals outlined in the previous section, the Hungarian government has thus far failed to clearly communicate, how several crucial decisions regarding the Paks extension project serve the public interest and dispel suspicions of other motivations, such as Russian influence and high-level political corruption benefiting business interests with close ties to the government. This is particularly worrisome in the case of one of the largest investment projects in the country's history that will have far-reaching implications for decades to come.

Domestic perspectives on Russian energy dependence

Russian energy dependence was in the forefront of Hungarian politics between 2006 and 2009 as Fidesz - then in opposition - kept the issue high on the domestic agenda. Leading Fidesz politicians often criticized the MSZP-led government for signing up for the South Stream project and being ready to increase the country's dependency on Russian gas. They characterized Russian gas deals as politically motivated ones, and portrayed them as a policy against democratic (Western) values. For the Gyurcsány-government the Russia-policy had also symbolic importance, proving a post-Socialist country's ability to overcome the past and establish new kind of relations.

After Fidesz had returned to power in 2010, the party has reversed its policy, and pledged support to South Stream until its final suspension in 2014. WikiLeaks reports revealed that opposition leader Viktor Orbán criticized the pipeline only to mobilize its voters, but in fact, he "has admitted to us (the representatives of the US Embassy – *authors' comment*) that he would pursue a similar (to the one of the government's – *authors' comment*) policy on South Stream"²¹⁸. Thus Fidesz supported the implementation from the first moment, after getting back to power.

The Fidesz-government, however, remained divided along the issue. While advisors of the Prime Minister, like Réka Szemerkényi and János Martonyi, Minister of Foreign Affairs tried to decrease the energy dependence of the country, the circles around Péter Szijjártó - who became Foreign Minister in 2014, but served in the Prime Minister's Office as State Secretary for Foreign Affairs and External Economic Relations since June 2012 - already suggested a more pragmatic approach. He conducted independently from the MFA negotiations with Russia and other potential suppliers and had his own communication towards the public²¹⁹.

²¹⁷ Ibid pp. 37-39.

²¹⁸ Wikileaks (2010): *GoH soon to enter South Stream joint venture with Gazprom*, 21 January, 2010, Section 9. Available at: https://wikileaks.org/plusd/cables/10BUDAPEST30_a.html (accessed 28 December 2016).

²¹⁹ For example in December 2012 he met Alexei Miller in Moscow and publicly praised South Stream as an investment improving Hungary's energy security. See: *A Gazprom vezetőjével tárgyalt Moszkvában Szijjártó*, [Szijjártó held negotiations with the head of Gazprom in Moscow], in: Portfolio, 20 December 2012, Available at: http://www.portfolio.hu/vallalatok/energia/a_gazprom_vezetojevel_targyalt_moszkvaban_szijjarto.177423.html (accessed 28 December 2016).

Many suggests, that Fidesz had actually tried to look for alternative sources - as indicated by the famous Safarov case, intended to improve relations with Azerbaijan in order to secure gas from other suppliers. The negotiations were led by Szijjártó, and although Minister Martonyi was strongly against the idea of extradition in exchange for a gas deal, Prime Minister Orbán supported Szijjártó. Safarov was released in August 2012, and as a result, Szijjártó's role in energy related deals had increased in the following years.

By the end of 2012, it became obvious that the Azeri link would not work out. During the year the Shah-Deniz consortium decided to support the Trans Adriatic Pipeline (TAP) against Nabucco-West as the major transit route for new Azeri gas. This killed all the remaining hope for swift and major source diversification for Hungary. Gas diversification became neither easy, nor cheap, leaving only the Russian South Stream as the single major project on the table. Understandably this failure accelerated the swift from a real diversification-based approach to a profit-based one.

The Paks nuclear extension project, announced in January 2014 provoked most of the criticism against the government's energy policy, mainly driven by the Politics Can be Different (Lehet Más a Politika (LMP), the self-proclaimed green party of Hungary. Although at the beginning LMP was focusing on criticizing environmental aspects of the deal, as details came to light (but in many cases remained secret, despite court decisions), party officials shifted the focus of the criticism to transparency problems. Nonetheless, LMP is an anti-nuclear party and it gave only highly conditional support even for the life-extension of the existing blocs. Thus, for the LMP and other, smaller green formations protest against the Paks extension is a matter of identity and there are no significant divisions about this issue inside the party.

Other leftist-liberal parties had a more complicated background to criticize the cooperation with Russia on the field of energy. The previous governing force, the Hungarian Socialist Party (Magyar Szocialista Párt-MSZP) was falling into two parts, as some members, led by former Prime Minister Ferenc Gyurcsány, founded the Democratic Coalition (Demokratikus Koalíció-DK). MSZP had limited moral ground to criticize the government for its gas business deals, or buying back the shares of MOL, as the MSZP-government led by Gyurcsány was primary responsible for creating closer links with Russia. Ferenc Gyurcsány, who had excellent private relations with President Putin, also needed several years to properly distance himself from his own previous policies.

These two parties only found their critical voice by the time of the Safarov-case²²⁰ and after the Paks-deal was announced²²¹. The approach of both parties included an environmental and transparency aspect, but also focused on the economic consequences and financial, budgetary implications for Hungary. MSZP has become very active recently in criticizing the Paks investment, and linked the issue with the discussion on renewing the long-term gas supply deal with Russia. According to their position, the construction of Paks 2 has neither financial nor energy policy ground, only serves private interests to bind the country's future to Russia. The Democratic Coalition is rhetorically the most combatant and it also condemns the Orbán-government by selling the country to Russia. It also initiated investigative measures through its MEPs at the European Commission.

The main opposition party, the right-wing radical Jobbik, was driving a pro-Russian policy openly until 2014-2015. In fact, the party itself was financed in its early stage by Russia, as was the case in other far-right anti-EU and anti-NATO parties throughout Europe. By 2014, Jobbik

²²⁰ *Várjuk a kormány magyarázatát Safarov-ügyben!* [We are waiting for the government's explanation of the Safarov-case!], MSZP, 12 November 2012, Available at:

<http://mszp.hu/hir/varjuk-a-kormany-magyarazatat-safarov-ugyben> (accessed 29 December 2016).

²²¹ *Titokban adnák el Magyarország függetlenségét* [They would sell the country's independence in secret], DK, 27 February 2015, Available at: <http://web.dkp.hu/kozlemenytitokban-adnak-el-magyarorszag-fuggetlenseget/> (accessed 29 December 2016).

moved towards a more centrist direction. It criticized several aspects of the Paks extension project, like the Russian credit-line and the law classifying all relevant data for 30 years.²²² Nonetheless this has meant neither distancing itself from Russia, nor opposing the Russia-related projects as such. Pro-Kremlin statements have become somewhat more silent and less visible on the public level.

When it comes to non-governmental organizations, the picture is much clearer. There is no visible, large scale support to major civil society organizations, advocating closer links with Russia. The interesting fact is, that is also true for most of the Hungarian GONGO's. Unlike in the case of many other Western states, there is no evidence, that Russia has financially supported policy initiatives or events (except Jobbik). There is a wide array of potential reasons for this: it might be the cultural, historic and linguistic differences, the lack of interests in the current situation or the wish to streamline support for the flagship projects, like Jobbik. Hungary being a small non-Slavic country in Central Europe makes the country strategically more irrelevant than some analysts suggests.

The unwilling ally – Hungarian foreign policy towards Russia in the time of sanctions

The annexation of the Crimea, the conflict in Eastern Ukraine and the sharp downturn in Western-Russian relations caught the Hungarian foreign policy in the midst of its opening towards Russia. Relations have been intensifying since 2012 and no later than by January 2014, when the Paks nuclear extension project was awarded to Russia, the disengagement from Moscow became relatively complicated. Thus, Budapest got involved into a loyalty dilemma and it had to choose from a number of complex options.

The motivations of PM Viktor Orbán in his Russia-policy U-turn are unclear. There is a high number of narratives and its international reception was also rather divided along these interpretive lines.

The “pragmatist” explanation of Orbán's pro-Russian attitude presents his policy as a reactive measure. According to this narrative, Fidesz was received by strong resistance and indeed hostility by EU member states, when he started deconstructing the system of checks and balances. He became quickly isolated, therefore he was looking for alternative directions in his foreign policy, which he has found in the East. Another interpretation is that it was rather this pragmatic approach and imprints of the Hungarian foreign policy which alienated some of its former allies.

In any case, the Hungarian government's foreign policy always had its own boundaries. First, due to the massive EU transfers, Fidesz has to be very tactful not to risk incomes from the cohesion fund. Therefore, from the very beginning the most crucial momentum in its Russia-policy in general and in the case of the Paks extension project in particular, was whether the Commission would approve the project or not. They tested their limits, but confrontation on the strategic level was not among the policy options. Russia was a residual relational asset, benefits from this nexus could not outcompete Western policy and financial sources. The fundamental goal was to preserve both and avoid situations, when Budapest had to choose between the two.

Second, the opportunity costs of the Russian “flirt” has multiplied in the new environment, questioning the validity of former motivations even in foreign policy circles with “pragmatist” mindsets. The US travel ban of six senior government-related people over corruption charges,

²²² *Paks II: elkerülhető a hitel* [Paks II: the credit can be avoided], Jobbik, 11 June 2014, Available at: <https://jobbik.hu/hireink/paks-ii-elkerulhető-hitel> and *Tiltakozunk a paksi beruházás nyakló nélküli titkosítása ellen* [We protest against the overconfidentiality of the Paks investment], Jobbik, 27 February 2015, Available at: <https://jobbik.hu/hireink/tiltakozunk-paksi-beruhazas-nyaklo-nelkuli-titkositasa-ellen> (both accessed 29 December 2016).

even if it had no direct connection to Russia, ignited a surprisingly serious crisis in the Fidesz. For many decision makers, the ban was interpreted as an early indication of more confrontation, the government was paralyzed and showed clear signs of panic²²³. Nonetheless, the highly visible pro-Russian attitude had trade-offs in other relations either. Polish, and in broader terms the Visegrad cooperation was at stake, especially in the new situation, when the PiS' rise to power opened up new frontiers to CEE cooperation. Despite all the controversies of German Russia policy, for Angela Merkel it was politically important to keep together the EU sanction policy, setting firm limits for Hungarian actions.

Not surprisingly, following the Russian aggression in Ukraine the Hungarian diplomacy entered a period of seesaw politics. It accepted the major EU and NATO decisions, but consciously tried not to put them into a Russian context and publicly expressed its unwillingness of action if its Russian interests were at stake. During the annexation of Crimea, the main diplomatic message was about the interests of Hungarian minority in Transcarpathia, an extremely unhelpful issue in that given situation, rather than territorial integrity and sovereignty of Ukraine. In July 2014, when the Malaysian MH17 plane was downed in Eastern Ukraine and the third round of sanctions were accepted, Orbán underlined the importance of separating the economic and political issues in regards of Russia.²²⁴

All these controversies culminated during President Vladimir Putin's brief visit to Budapest in February 2015. This was the first bilateral visit he had made to the European Union since June 2014. European Union leaders kept an informal rule not to meet President Putin on the territory of the EU for bilateral talks. By breaking this rule, PM Viktor Orbán found it important to minimize the reputational damage and launched a mini-offensive to meet Polish, Ukrainian, German and other European leaders. For Budapest, it was still important not to become isolated because of its Russia-policy. Meanwhile Hungary announced several times that it will respect EU sanction policy as long as there is a common position on this issue, it will not become a policy-breaker.

The situation has considerably changed since the start of the European migration crisis in mid-2015. The crisis was used by PM Viktor Orbán as a springboard for his comeback to European politics and an attempt to establish some sort of an alternative to continental liberal mainstream. He tried to keep the issue on the agenda, transformed his restrictive refugee policy into a political trademark and strived for reshaping the existing European power relations in his favour. This affected his Russia policy in two respects. First, he established more respect in Moscow raising the status of the Hungarian relations. Second and more importantly, in Budapest the Russia-nexus became a factor of confusion. Pro-Russian sentiments started to unduly trouble the Hungarian coalition building. Thus the Hungarian diplomacy tried to diminish the visibility of its Russian relations but preserve its fundamentals. Russian sentiments became more silent without any reconsiderations of its original goals.

Conclusions

It is widely held, that the unfolding since the late 2000s technological, policy and market changes open up new perspectives for CEE energy companies. Market integration and liberalization shall challenge Russian dominance on these markets and promote diversification efforts. The case of Hungary demonstrates, that these outcomes are far from being guaranteed. Russia still has a considerable leverage on local energy policies, it can influence and sometimes determine CEE energy decisions.

²²³ *Hogy áll az amerikai kitiltási botrány?* [How do things stand with the US travel ban?] Eco.hu, 28 October 2014. Available at: <http://www.eco.hu/hir/hogy-all-az-amerikai-kitiltasi-botran-y/> (accessed 2 January 2017).

²²⁴ Végh Zsuzsanna: *Magyar válaszok a Majdan után*, [Hungarian responses to the Maidan events], in: *Regio* 2016/1 Vol. 24. pp. 20-48. Available at: <http://dx.doi.org/10.17355/rkkpt.v24i1.94> (accessed 2 January 2017).

The reasons are manifold: political ambitions, bureaucratic inertia, variety of policy visions and rent-seeking attitudes have all their input into this trend. The different fields of relations with Russia including energy do not point into a single direction and it is difficult to see a masterplan/special concept behind them. The volume of trade and investment have decreased in the last years, despite emphasizing the importance of business opportunities and the public acknowledgement of Putin's politics and Russia's role in the region by the Hungarian Government. Patterns of authoritarian leadership and anti-western state propaganda became part of Hungarian domestic politics, while Hungarian foreign politics remained committed to the country's EU membership. Often it seems that the Russia-related deals and communication is driven by momentary or particular political interests rather than a well-founded concept.

Budapest seems to look at Russia as a potentially useful partner within given boundaries, but as an inconvenient relationship beyond these ramifications. Prime Minister Orbán kept relations with Russia on such a level that in case of a political need he can still make a U-turn. Russia is a major point of Orbán's vision of foreign policy checks and balances and because of policy inertia, this nexus has reached its most prominent engagement in the field of energy.

Nonetheless, it would be misleading to consider the "Russian policy capture" as a purely Russian act. For many CEE corporate strategies, the "Russian option" is a reasonable protectionist measure to secure respective market shares and maintain their policy leverage. Opting for Russia on the gas and nuclear markets is not a model-neutral choice any more. Since the late 2000s diversification on the gas market assumes a more fragmented corporate landscape, diminishing the share of domestic national energy champions. For the nuclear industry, the Russian option is almost the only way to secure survival. For political decision makers, the Russian dependence means some sort of control over import prices, even if through murky political negotiations. Thus, for these actors the existing set of bilateral monopolies is also an ultimate choice of a market model, where they can keep their status intact. It is not all about corruption, rent-seeking and state capture, but reasonable, even if particular interests, visions or expert convictions of relatively big sectors may lie behind these major trends.

These actions have clear implications, visible on the market structures. The Russian efforts to retard the rate of entry by other market participants on various energy segments are incontrovertible thorough the CEE region. Nonetheless, these practices are often pursued in susceptible local environments, with internal corporate actors actively soliciting domestic coercive state instruments for cooperative outcomes with Russia. In Hungary, the inclusion of political decision makers, promoting bilateral political relations with Russia proved to be highly beneficial for national champions in the gas and nuclear sectors. They provided significant pay-outs in a complex reward structure: economic concessions from the Russian partner, improving bargaining positions within the industry, benefits and improved leverage vis-à-vis the political decision makers. Thus the "Russian energy nexus" has deep justifications within the Hungarian sector and should not be handled as a purely external factor.

Recommendations for Brussels:

- Observe sectoral energy trends in their longer trends, in a more holistic way, differentiated by past achievements and current directions. The current system of policies leaves a major window for reversals of reforms, practically diminishing past EU and domestic efforts to improve the domestic market patterns.
- The existing system of security and competition indicators reflect the realities of the 2000s. Since then many challenges have been addressed, but also new problems have arisen. EC should overview its current indicators and instruments in order to be equipped to manage articulated and coordinated efforts to dismantle local competition on the energy markets.
- The issue of Russian path dependence is still valid. In some cases regional elites remain interested in maintaining the Russian connection, even at the expense of local market patterns

and violating common rules. The EC should rigorously qualify these cases and enforce common legislation, rules. Simultaneously it should continue its search for new, pro-active ways to address Eastern European countries, especially their energy affordability problems.

- demand full transparency on Paks related public contracts, especially ones related to Russian financial mechanisms in order to fully control that they are in line with the EU sanction policy
- request more information on the MET related contracts to review whether they comply with EU competition rules
- consider legislation on nuclear power plant as their construction have a high level national security factor
- enforce much stricter transparency requirements regarding SOE's, state / EU investments and EU funds (since Hungary is highly dependent on EU funds, and has to avoid the infringement of EU rules)
- Set up European Public Prosecutor General's Office will strengthen law enforcement. This would make the operation of criminal groups benefiting from favouritism and the misuse of EU money more difficult.
- Direct funds towards renewable energies, regional EU energy projects can contribute to diversifying the energy portfolios of MSs, strengthen ties / dependencies within EU countries stronger.
- Support civil society actors working on energy and anticorruption issues.

Recommendations for Washington:

- put a pressure on Central European states to finalise the interconnectors especially one between Romania and Hungary and Croatia and Hungary
- support the development of the KrK LNG terminal, and encourage /provide political support to US firms to sign framework agreements enabling this countries to buy US LNG
- demand more transparency on governmental deals especially ones related to MET and Paks (US based transparency organisations)
- Encourage investment into manufacturing of products / parts connected to renewable energies in Hungary (to create motivation for the government to support such industries through creating favourable market conditions, low taxes, positive legal framework and market demand).
- Invest in innovation, R&D connected to renewables.
- Support civil society actors and journalists working on energy and anticorruption issues.

Notes for Brussels and Washington

The case of Hungary very well demonstrates that early EU and NATO membership and a relative successful transition is not an ever lasting guarantee against Russian influence. Transition is a two-way street, local establishments may seek Russian support because of various reasons and Moscow can adapt its strategy to these new environments.

Hungary's relations with Russia are put into a strong national "freedom fight" context. In this logic it is Hungary's sovereign right to form its relations with foreign powers and Western countries, Brussels has no say in these matters. Thus, the "Eastern opening" is very resistant to criticism and rhetorical offenses coming from Washington or other European capitals. References to cost-benefit relations, national interests, requests on more transparency have been consciously interpreted as Western demarches driven by selfish foreign interests. Public criticism has to be used selectively and with caution. Core government electorate and major right-wing oppositional segments are resilient or hostile to external pressure, while for some

pro-Western public segments messages from the US or Europe constitute important positive signals of attention.

Improvements in gas security, interconnections and physical availability of regional hubs have weakened, but not broken the Russian influence over the local market. There has been no alternative direct producer-consumer relations set in the region, thus Gazprom has still a major competitive edge, used often according to the Kremlin's political preferences. Thus regional gas supply issues, like the Black-sea off-shore projects and the construction of the Croatian LNG have to remain flagship projects for local gas policies.

Local political and corporate actors, national energy champions resist market liberalization and the creation of the single market, driven by particular interest and protectionist considerations. These efforts are particularly strong in the national gas and nuclear sectors. Russia provides an interface for these domestic players and creates plausible energy policy narratives to influence decision making. Setting up alternative energy policy visions together with local actors, strengthening corporate and regulative integration of the Hungarian market would be highly desirable.

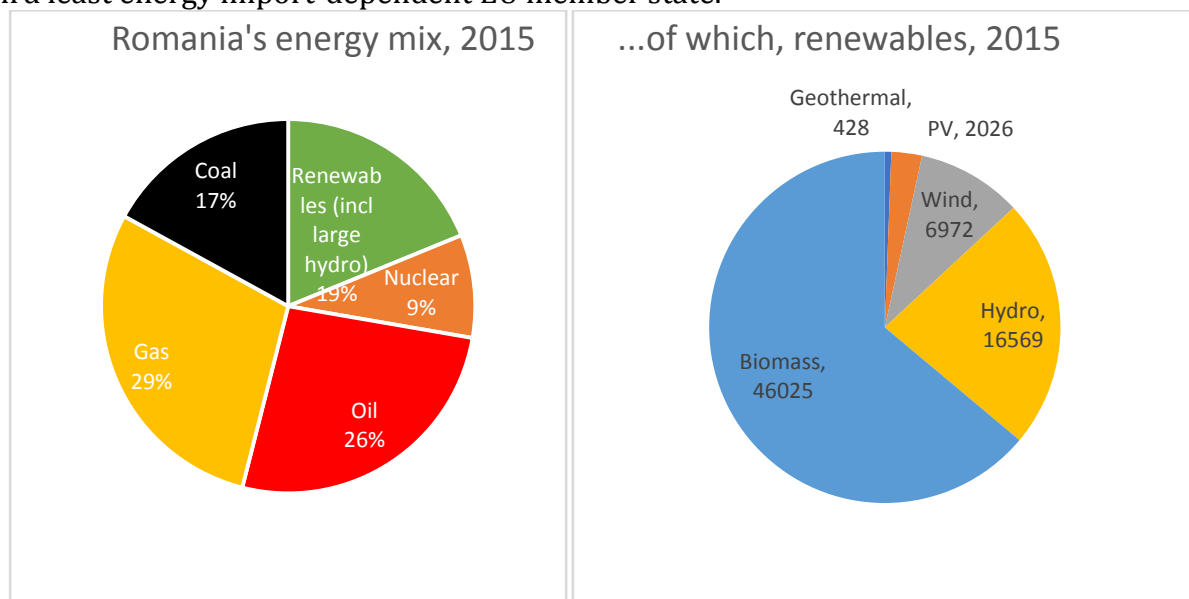
The Paks 2 nuclear deal has inherent contradictions within. It is a major link between Russia and Hungary, but also a considerable threat to good bilateral relations. Given its sheer size, complexity, the necessary trust to manage the construction and the relative lack of urgency of its fulfillment, the construction seems to be a long saga with many policy twists. It is desirable for the EU and US to form a long-term policy with high level of optionality in this matter. Understandably, the project has to fit into the given international and EU legal and policy framework. On the other hand, Budapest may need these policy instruments in order to normalize relations with Moscow or counter bilateral pressure. The Paks 2 project shall be considered as a pilot case of Russian nuclear investments in the EU and managed accordingly.

ROMANIA: No need for Russian pressures, Romanians misgovern themselves

Ana Otilia Nuțu
Sorin Ioniță

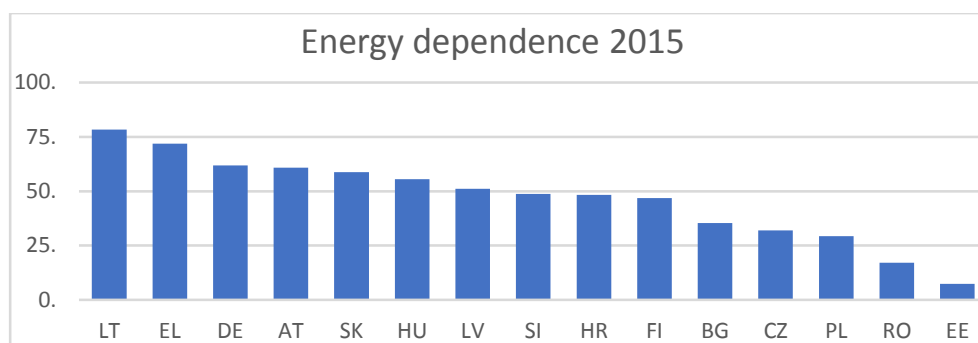
Among the countries in the region, Romania's situation concerning Russian influence in or through the energy sector is rather particular. First, the country is largely independent from imports of energy from Russia. Local production of coal, gas and oil, connection to the international oil market through the Port of Constanta, excess refining capacity built in the 1970s and 1980s, a liberalizing gas market, strong domestic electricity production based on local or renewable fuel (nuclear, hydro) and integration in UCTE since 2003 and ENTSOE since 2004 limit the extent to which Russian suppliers could abuse monopoly or dominant position in any of the energy subsectors.

Secondly, the public in Romania is rather strongly anti-Russian. The dislike of Russia, deeply entrenched in public opinion, has historic roots dating from the 18th century. The ruling class in the two Romanian principalities of the time had a hard time deciding which of the two occupiers was worse – the Ottomans of the old or the newly arrived Russians – so learned quickly to play double games by aiming at a careful balance between the superpowers. Even the Communist regime began a slow disentanglement from USSR in the early '60s, which culminated with Ceausescu's decision to disengage altogether from the Warsaw Pact during the invasion of Czechoslovakia in 1968. Ceausescu's regime gained a sort-of-legitimacy by its strongly nationalistic stance. It strove to achieve complete economic independence from USSR, including on energy, a critical sector in a heavily industrialized economy. Particularly after 1980, Romania's energy program called for a drastic reduction on oil and gas, where domestic production had peaked in the 1970s and the shortfall could only be compensated by imports. Instead, it relied on increasing the contribution of domestically-produced coal, hydroelectric power, nuclear power (on Romanian fuel and Canadian technology), and even, to a very limited extent, nonconventional sources²²⁵. As a consequence, Romanian overall energy infrastructure is today largely independent from Russian supplies and technology. Even today, Romania is the third least energy import-dependent EU member state.



Source: *Romanian energy strategy, 2016*

²²⁵ <http://countrystudies.us/romania/58.htm>.



Source: Eurostat

Russia's investment policy in Romania

Due to these two particularities, Russian influence, to the extent it exists, is rather indirect and discrete, compared to other countries in the region. No politician would openly admit Russian connections without incurring public disavowal²²⁶. Data from official statistics suggests that Russian capital in the form of stock of direct investment is quite limited in Romania²²⁷. A more relevant statistical figure concerns trade with Russia, which is relatively limited as share of Romania's total foreign trade. Thus, trade with Russia represents just 3-4% of imports and exports, compared to 70-75% with the EU, and is on a par with the shares of imports and exports from countries like Turkey and USA (and below imports from China, ranging between 4.1-4.7%). Trade with Russia probably decreased in 2015 also following international sanctions against Russia and Russia's embargo on EU products in response.

Table: Share of Russia (%) in total imports and exports in Romania

	2013	2014	2015
Share of imports	4.4	4.0	3.2
Share of exports	3.1	3.1	2.0

Source: National Bank of Romania, reports on balance of payments, 2013-2015

However, there are some significant Russian investments in certain sectors of the economy, following privatizations in the late '90s and early 2000s. Most investments concern local factories in iron/steel processing, other metals, chemicals, refineries, oil extraction equipment, gas stations, with main players such as Lukoil, TMK pipes, Vimetco aluminum, Russkii Aluminii. Total investments in Romania between 1998-2008 amount to about 2.1 billion USD²²⁸. Many of

²²⁶ The early attempts of 1989-1991 in Romania, under president Iliescu, to strengthen the relationship with Russia, culminating with a Treaty of Friendship, was met with rather strong opposition, including from Iliescu's rural and conservative electoral base. The Treaty was in the end not ratified by Parliament.

<http://journal.ispri.ro/wp-content/uploads/2012/03/11-Rudolf-112-129.pdf> Romania turned towards a radical pro-West policy in 1996, with the change in power, which initiated accession negotiations to EU and NATO.

²²⁷ Data on FDI can be quite elusive. The National Bank of Romania's statistics on FDI indicate that "Other countries", with below 100 million EUR in 2015, among which Russia is apparently included, have in total a 1.7% of total foreign direct investment. Russia's Central Bank indicates that FDI stock in Romania in 2013 was just 36 million EUR. However, it is very possible that Russian-owned companies are registered in offshores, primarily Cyprus, which is at 6.9% of total FDI stock. The joint ventures operating as intermediaries for gas imports in Romania could be registered in other countries, e.g. WIEE (50% Gazprom, 50% German Wintershall), registered in Switzerland etc.

²²⁸ http://romania.mid.ru/ro_RO/web/romania_ro/economia

these companies either closed or reduced significantly their activities, following the global economic crisis; substantial reduction of energy-intensive industries after 2008; and, at least in part, a reduction of preferential deals for cheap energy with Romanian state owned companies, as will be explained further.

The main such investments included²²⁹:

- **Mechel** took over in 2003 factories concentrating about 80% of the Romanian market for steel for reinforced concrete. In 2010, Mechel employed about 7000 people. In 2008, the owner of the company Igor Zyuzin had a conflict with Putin, which led to a drop of the company's share prices by 30% globally (from 15 to 10 billion USD total capitalization). In the end, by 2013, Mechel divested its assets in Romania, which were closed and reduced Romania's steel production by 15%.

- **Vimetco** (aluminum) owns 84% of Alro Slatina, which was privatized in 2002 with Vimetco's predecessor Marco Industries BV (Dutch company controlled by the Russian businessman Vitaly Mashitskyi). The company consolidated its quasi-monopoly on the steel market by acquiring another company, Alum Tulcea. It is one of the largest electricity and gas consumers in Romania (8% of total energy consumption). The company benefited from preferential electricity contracts with the state owned Hidroelectrica, a sweet deal which was not however a new favour, but the continuation of previous deals dating from communist times, when the company was fully state owned. Another aluminum company, Alor Oradea, purchased in 1998 by Russkii Alumini (controlled by Oleg Deripaska), closed in 2001. Most of the aluminum production goes to export.

- **TMK** (iron and pipes) purchased iron processing plant Resita and pipe producer Artrom Slatina in 2003 and 2004. It has substantially restructured the processing activity and the pipe production. TMK is controlled by the Russian Dmitri Pumpianski. About 80% of the production of pipes is exported.

- **Lukoil** (refining) purchased 51% in Petrotel refining plant in 1998. Currently, the refinery has a capacity of some 2 million oil tons (Romania processes about 10 million per year in recent years). Another refinery, RAFO Onești, one of the largest, was privatized in 2001 to two local oligarchs. They resold it to Balkan Petroleum in 2003; Balkan Petroleum was in the end purchased by the Russian Iakov Goldovskyi, who, in the end, in 2006, decided to scrap the refinery. The remaining oil refining capacity in Romania belongs to OMV Petrom (Petrobrazi and, under closure, Arpechim) and Rompetrol (taken over by Kazmunaigaz - Kazakhstan). In 2011, Lukoil was involved in a rather controversial contracting procedure with the regulatory agency for mineral resources ANRM, where the company was expected to finance a database with the mineral resources; however, the company was not supposed to have access to secret information from the database. Currently, Lukoil has two concessions in the Black Sea, where the expected reserves amount to some 32 bcm (about 3-4 years of Romania's yearly consumption of gas). It also has gas stations, but a rather small market share (below 5%).

- **Gazprom** owns several small oil concessions; about 1% of the total gas stations; and has a monopoly on Romania's gas imports, through intermediaries such as Conef or WIEE.

Thus, the main Russian involvement and investments in the energy sector concern oil, up- and downstream; gas supply; and, possibly in the future, gas production in the Black Sea. Russia has never expressed interest in investments in electricity generation or distribution in Romania. The electricity sector is not of much interest for Russian investors for several reasons. First, the environment for investments in electricity generation is relatively unattractive in general²³⁰. Second, the large projects announced by the Government (nuclear reactors 3&4,

²²⁹ This section summarizes and updates several media sources, mainly <http://www.hotnews.ro/stiri-esential-17030369-cata-influenta-are-rusia-economia-romaniei-companiile-cheie-oligarhii-situatia-lor.htm>

²³⁰ There were very few investments in electricity generation. The so-called "boom in renewables" was short-lived, in 2012-2013, when the state aid scheme through green certificates was very favourable, but this has

Tarnița reservoir & pump storage, refurbishment of coal units, partly with EU funds) were very slow in development. Third, the technology in Cernavodă nuclear power plant, for both the existing 1&2 and planned 3&4 units, is Canadian, following Ceausescu's original blueprint which emphasized reliance on non-Russian technology and local fuel, compatible only with CANDU reactors. As Romania joined the European system (UCTE, now ENTSOE) in 2003, it cannot even be easily connected to the Russian-compatible (Moldovan, Ukrainian) systems. In fact, Romania's electricity sector has been much more attractive to Chinese prospective investors than to Russians, though the *modus operandi* of these investors looks rather similar to that of Russia in Bulgaria or Hungary for nuclear plants²³¹.

For example, Chinese investors expressed interest in coal fired plants and in nuclear reactors 3&4, as well as the Tarnița pump storage. In all cases, there is no clear commitment from the Government so far. All projects are affected by problems of governance: transparency in the selection of the partner (no public procurement, but direct single-source negotiation, with the justification that only Chinese investors expressed interest); and transparency in negotiations – is there state aid involved? What are the benefits that the Chinese partners get which makes the investment attractive to them, but not anybody else? What has been discussed so far? Who finances the project? Who will control the asset etc.?

At the first sight, the above-mentioned Russian investments might look (and indeed are often presented by the media and various commentators) as indications of Russian interests acquiring local strategic assets for the purpose of bankrupting Romania's strategic industries. In reality, there is little evidence for such an assessment. In most cases, closure or reduction of locally-acquired companies was simply an economic decision. For example, the refining capacity, which in 1989 exceeded 30 million tons per year, had to rely even then to an annual gross oil production of below 10 million and in continuous rapid decline after its peak in 1976. In the '80s, Romania was importing oil and reexporting refined products at a huge loss: in 1980, Romania was losing an estimated 900,000 USD per day from this irrational policy²³².

The closure of excess refining capacity reflected economic and market conditions rather than a deliberate policy of reducing Romania's refining assets (OMV Petrom, in its turn, closed its loss-making Arpechim refinery). The closure of Mechel's reflected the economic conditions after the economic crisis of 2008; while losses incurred by TMK, a producer of pipes mainly for the oil industry, for a number of years indicated the low productivity of the oil industry during periods of low oil prices. Indeed, most of the companies mentioned above do not hold any dominant position over domestic consumers in their respective markets; even where Russian companies gained control over a large share of Romania's total assets in a sector (such as aluminum), most of the production was directed at exports in an internationally competitive market. The not infrequent discourse of Russia's acquiring strategic assets for divestiture thus reflects more the anti-Russian public mood than proven facts.

changed rather quickly following the strong lobby of large electricity consumers and coal-fired electricity plants. Other forms of support, such as the cogeneration bonus scheme, led to very few new investments because of the dire situation of district heating systems.

²³¹) For example, Chinese investors expressed interest in coal fired plants and in nuclear reactors 3&4, as well as the Tarnița pump storage. In all cases, so far there is no clear commitment from the Government. In all cases, there are concerns of: transparency in selection of the partner (no public procurement, but direct single-source negotiation, with the justification that only Chinese investors expressed interest); transparency in negotiations (is there state aid? What are the benefits that the Chinese partners get which makes the investment attractive to them, but not anybody else? What has been discussed so far? Who finances the project? Who will control the asset? Etc)

²³² <http://countrystudies.us/romania/58.htm>

The natural gas factor

A more nuanced case concerns the energy sector, particularly gas. Russia enjoys a virtual monopoly in the countries in the region (Eastern Europe, both EU and non-EU), where it relies on the control or influence of the pipeline infrastructure built before 1989. Unlike most of the other countries (Ukraine being an exception), Romania also has substantial domestic production. In theory, Gazprom would have two interests to protect:

- To ensure it has the monopoly over the gas imports in Romania (for the share of consumption that cannot be covered by domestic production)
- To ensure that Romania does not become a competitor for Gazprom in the region, by starting to export to consumers in countries where Gazprom now enjoys a monopoly or a strong dominant position.

Oddly enough, Gazprom's interests happened to coincide with the interests of some Romanian oligarchs, so it is difficult to ascertain to what extent major policy decisions in recent years concerning the gas market were made under Russian influence; or whether Russia was simply "free riding" on local corruption and bad governance.

Thus, before 2013, Romania consumed between 12-14 bcm of gas per year, of which between 70-85% were covered from domestic production, shared equally between the two producers OMV Petrom and state-owned Romgaz; the remaining (30-15%) was imported from Gazprom through Russian-(Gazprom, Vimetco) controlled intermediaries such as WIEE and Conef. Variations in consumption were largely caused by weather conditions in winter, as gas is used for both individual heating and most CHPs producing heating in the remaining district heating systems. About 20% of the total consumption²³³, or roughly the quantity imported, was purchased by a supplier, Interagro, which was supposedly using the entire quantity for the production of fertilizers in its own factory, most of which were exported in the EU market.

Not entering into all details, the entire gas market was de facto regulated, including for large industrial consumers such as Interagro (or more precisely, in the semi-deregulated market of the large industrial consumers and their suppliers, suppliers such as Interagro's gas supply business were required to follow the shares of domestic and import quantities, but they could freely negotiate prices with domestic producers and importers). For all the others in the fully-regulated market, both the prices for gas and the shares of import vs domestic production were regulated; the gas commodity price was a weighted average of imported and domestic production. To keep gas prices low, Romanian authorities had the option to manipulate either the share of domestic production or, much easier, the price for domestic gas production. Roughly, domestic gas was valued at some 150-170 USD/1000 cm, whereas imported gas varied between 300-350-380-450 USD/1000 cm²³⁴. In certain years (2009-2010, with the pretext of the crisis), large gas consumers such as Interagro or the CHP Elcen were provided "domestic-only gas" through a special law²³⁵, being allowed to purchase gas at the lower domestic prices. This tilted the balance between imports and domestic production for the rest of the market, with losses amounting to some 200 million EUR).

²³³ ANRE annual reports (2012)

²³⁴ Import contracts are notoriously non-transparent even today. It cannot be discerned what were the prices and conditions at which WIEE or Conef bought gas from Gazprom and if the price increases were dictated by Gazprom or the spoils of the intermediaries. In fact, this is quite irrelevant for the purpose of this report: both WIEE and Conef are controlled by Russians (Gazprom owns 50% of WIEE, Conef is partly owned by Mashitskyi from Alro).

²³⁵ <http://tefuralafactura.ro/cat-te-fura/gaze-pierderi-neliberalizare/>, detailed explanations in Romanian by EFOR

From the regulation of the market, as well as from the special legislation issued in 2009-2010, the main beneficiary was Interagro, owned by the richest Romanian oligarch at the time, Ioan Niculae. The regulated domestic price generated the following effects:

- A fake reference price for the sales of state-owned company Romgaz, which could sell directly to Interagro in a “legally liberalized market for large industrial consumers after 2007”, at regulated prices. Even though Interagro, in the semi-deregulated market, could freely negotiate prices with gas producers and had only to follow the shares of import vs domestic production, it managed to negotiate with state-owned Romgaz at the regulated, low price. Romgaz could easily explain to the Court of Accounts or any other controller entity that “since there is no functional market, the only price reference could be the regulated price”. On top of this advantage, Interagro could obtain bulk discounts from the state-owned Romgaz²³⁶.

- Indirectly, Gazprom and its intermediaries benefited from the price regulation. They could safely increase the prices more than a normal monopoly which at least fears the decrease of demand if prices become too excessive. Gazprom and intermediaries knew that they would have a guaranteed market for a certain quantity of gas and that Romanian authorities would simply decrease the prices of domestic gas in response, to keep the weighted average regulated price at a low level.

- This wasteful and absurd policy could only continue as long as the gas was regulated; a possibility to export would have immediately deregulated the market, as domestic producers (particularly the business-oriented private OMV Petrom) could sell at better prices in the region instead of the low regulated prices at home. Indeed, Interagro was the fiercest advocate against deregulation of the gas market for households²³⁷, though, in theory, large industrial consumers “had been liberalized since 2005”. In fact, after 2009, discussions between Romanian authorities and the European Commission on the transposition of the Third Energy Package revolved around a circular argument. Physical exports could not take place because of technical reasons (lower pressure in the Romanian system, 12-15 bars, compared to pressures in adjacent systems, 40-45 bars; no interconnectors). But EU could not finance investments in physical interconnectors as long as Romania did not allow exports legally (the gas regulation requiring certain quantities of domestic vs imported quantities to be sold to domestic consumers were an implicit ban on exports of the regulated domestic production). In turn, Romanian authorities explained there is no reason to allow exports by law as long as there is no physical interconnection for exports etc. Romania actually lost EU financing for the physical interconnection allowing exports (reverse flow) to Hungary (Arad-Csanadpalota) in part for its failure to prepare the project and in part for its gas market regulation incompatible to EU’s Third Energy Package. There is no clear evidence whether the delays in interconnection projects (Hungary, Moldova, or accessing the old Soviet-times pipeline from Ukraine to Bulgaria) and the insistence on postponing deregulation of the gas market were caused by incompetence, bad governance or influence from Interagro to postpone indefinitely the exports as a means to obtain “cheap domestic gas” for as long as possible.

²³⁶ There is currently an on-going prosecutors’ investigation on whether there was corruption involved when special legislation was issued in the benefit of Interagro; and whether the discounts and price advantages were obtained legally or through corruption. It would be quite difficult to prove the actual corruption if there is no evidence of actual bribes or undue influence. In any case, this is poor governance and, arguably, illegal state aid: a state-owned company provided one particular player with below-market prices, subsidizing the production of fertilizers which valued less than the real price of the inputs (gas).

²³⁷ <http://www.researchromania.ro/2014/03/cu-cat-va-creste-pretul-gazelor-urmatorii-doi-ani/>. Interagro, through a business association CONPIROM, contracted Deloitte to prepare a report showing the disasters of deregulation of the gas market for non-households by end-2014. Until end-2014, there was a fierce opposition to deregulation. The market for non-households was deregulated and the announced disaster did not happen. Indeed, it was only the energy-intensive Interagro which went bankrupt, unlike its competitor in the fertilizer business, Azomures.

As mentioned, it is uncertain to what extent there was any explicit collusion between local vested interests, such as Mr. Niculae, and Russian interests on this matter; what is clear is that their interest were nicely aligned. Indeed, Russians would have been just as interested in the status quo because it ensured that (1) Romania could not export gas in neighboring countries, where Gazprom had a monopoly; and (2) the gas regulation allowed Gazprom and its intermediaries to increase prices for Romania more than they could have done in a simple monopoly position. However, some media reports indicate there might have been a connection between local groups of vested interests, including Interagro, and Russian businesses, with a potential influence on policy making at top levels.

Box: bad public governance in local and Russian deals

In 2005, DV Alesandru was appointed deputy minister in the Ministry of Economy, in charge with the energy department which also coordinated state owned companies in energy, such as electricity producers like Hidroelectrica or Nuclearelectrica, and gas producer Romgaz. In his brief, 8-month career as a deputy minister, he was involved in a series of dubious deals. For example, Alesandru owned a company producing equipment for the gas extraction industry; he won in a contested tender a contract with Romgaz just 3 days before being appointed deputy minister in charge with Romgaz.

During his mandate, there were indeed some deals involving both Romanian and Russian interests. Alesandru facilitated a contract between Nuclearelectrica and Alro, the aluminum company owned by Vimetco, the contract being approved in a Government Memorandum. The contract was concluded at preferential, below-market prices²³⁸. In exchange for the services thus rendered, after Alesandru had been released from his position in the ministry, Alro first appointed him a board member of Alro's subsidiary company Conef Gaz. Shortly afterwards, Alro transferred to Alesandru's family company 30% of the shares of Conef. Conef is one of the gas intermediaries used by Gazprom for its contracts between 2010-2030. Alesandru was later appointed director of Interagro, which purchased its share of imported gas from Imex Oil, a subsidiary of Conef, at apparently good prices²³⁹.

Interconnections and geopolitics

Romania's position on the regional interconnection plans has been mildly supportive, at least declaratively. Unlike its neighbors, Romania never fully supported projects going against the common EU policy, such as South Stream (or now Turkish Stream). In principle, the Romanian authorities (Ministry of Economy / Energy; Transgaz as operator of the gas transmission system) have always been lukewarm-positive to all projects involving interconnections in the region that could become a European priority, involved Romania and were likely to obtain EU financing at some point (AGRI-LNG, Nabucco, Eaststring, Giurgiu-Ruse interconnector; BRUA; interconnection with Moldova and Ukraine etc.). But there was a gap between declarations and actions, especially before end-2014 – the moment when the gas market became liberalized for non-households and Interagro stopped benefiting “cheap domestic gas”²⁴⁰.

²³⁸ Alro benefited from below-market contracts with other state owned electricity producers, most notoriously with Hidroelectrica. Hidroelectrica's contracts were investigated for illegal state aid by the European Commission in 2012-2015. The investigation contributed to the termination of such contracts in a rather radical manner: Hidroelectrica went through a bankruptcy procedure. In the end, EC ruled the contracts were not illegal state aid after all. http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2017.083.01.0001.01.ENG&toc=OJ:L:2017:083:FULL

²³⁹ <http://www.evz.ro/omul-punte-dintre-voiculescu-si-rusii-de-la-alro-si-gazprom-cine-arde-gazul-ieftin-romane-96134.html>

²⁴⁰ Apart from the liberalization of the gas market, a different event helped: in April 2015, Mr. Niculae was sent to jail for illegal campaign financing in exchange for trying to appoint a minister for energy. He also has another file

Thus, Romania first postponed as much as possible the gas market liberalization (regulation being an implicit ban on exports). It also delayed the reverse flow on Arad-Szeged interconnector, opened in 2010, from which Romania can only import today (and export negligible quantities). The connection with Bulgaria (Giurgiu-Ruse) was delayed by almost 4 years and it has only become operational at end-2016. The connector to Moldova (Iasi-Ungheni), delayed by 2 years, was opened only in August 2014 (though even today it allows the export of only very small quantities of gas, the full project requiring additional investments in both Romania and Moldova, unlikely to be finalized in the next 3 years).

Most interesting is the situation of the old transit pipeline Isaccea-Negru Vodă, by which Gazprom exports through Ukraine and Moldova to Bulgaria and the Balkans. Though it legally belongs to Romania (Transgaz) ever since construction during Ceausescu's nationalist regime, is not accessible from the "domestic" network of Transgaz. There is only one entry point at the border, one of the two points by which Romania imports gas for its own domestic consumption, but the transit pipeline is not physically accessible for Romanian gas to be exported to Bulgaria, Ukraine or Moldova. The transit pipelines, built in 1974-1996, had been indeed reserved for Gazprom in an agreement signed in 1996 and the entry and exit points for the gas transit were reserved for Gazprom. The three pipelines were reserved for Gazprom's exclusive rights to export to Bulgaria and the Balkans by end-2015; 2016; and 2023, respectively. There was extensive discussion between EU and Romania on the subject, particularly on:

- Transgaz' unwillingness to disclose available capacity (the quantities of gas transited through Romania in recent years were declining, which meant that the pipelines would have available capacity for other suppliers. The total transit capacity is 28 bcm, roughly 9 bcm per pipeline). Romanian authorities argued that, since the pipeline is not physically accessible, there was no real "available capacity".

- Renegotiation of the IGA with Russia and third party access to the transit pipelines immediately after the on-going contracts expire, meaning, gaining control of the entry and exit points and, later on, building physical interconnections with the "domestic" network.

In 2010-2015, Romania dragged its feet in the matter. To the reluctance to publish available capacity and prepare a credible plan for effective third party access and diversification, EC responded with an infringement on the Third Energy Package and a lawsuit at the ECJ²⁴¹. Though the first pipeline was "free" of any obligation to Gazprom by end-2015, Romania obtained a derogation from the EU to allow an extension by 9 months with Gazprom. Finally, in July 2016, Transgaz prepared interconnection agreements with Ukrtransgaz and Bulgartransgaz for the entry and exit points; however, by end-2016 the agreements were not finalized, because of "objective reasons" with both Ukrainian and Bulgarian TSOs and, anyway, "the only gas that could transit is from Gazprom".

It is difficult to discern whether this reluctance was caused by Gazprom's pressures; lobbies of local interests to block exports that would have immediately liberalized the market; or Transgaz' inability to undertake a project (which could be caused, for example, by the successive regulations for state owned companies to disburse as much as 90% of their profits to the budget, instead of making investments). It should be noted, however, that Bulgartransgaz is controlled by Gazprom, and that Moldova and Ukraine are members only of the Energy Community, which means even lesser leverage to fully enforce EU's Third Energy Package on unbundling and third party access. This was fully recognized by the EC, for example, when it made the decision in 2011 to support the Romania-Moldova gas interconnection through a new

on his name (and 40 people from the Ministry and SOE Romgaz), concerning the special laws for cheap gas from which he benefited. Though the latter file will probably not end in convictions, it affected the appetite of people in the ministry and state-owned company Romgaz to enter deals with Interagro that might be regarded as suspicious.

²⁴¹ <http://economie.hotnews.ro/stiri-energie-12331700-romania-primit-cererea-chemare-judecata-curtea-europeana-justitie-intr-proces-declansat-comisia-europeana-vezi-care-este-rolul-rusiei-acest-proces.htm>

Romania's projects and initiatives to interconnect in a broader regional market and become an exporter were not without delays and risks. As recently as March 2017, Romania's Parliament discussed to postpone the gas market liberalization for households by April 1, which had been agreed upon with the EC during the negotiation of the financing for BRUA. The new legislation, pushed strongly for by the regulated gas suppliers Engie and EON who feared losing a guaranteed share of the market, was barely avoided at the last moment. The postponement would have put at serious risk the grant financing for the BRUA project, as EC officials warned Romanian authorities in a letter²⁴². Again, this is another example where Russian interests only need to free-ride on local lobbies, Romanian or West European, which happen to have the same narrow goals.

Making a mess out of it – still a possibility for the future

In short, there is little evidence of direct Russian interference in the energy sector in Romania, and much of the suboptimal decisions, corruption or bad governance, could be just as well explained by local factors, vested interests or simple incompetence. The only direct evidence about possible Russian intervention concerned the protests in 2013-2014 against Chevron's fracking and shale gas exploration in several towns and villages in Eastern Romania²⁴³. In the end, Chevron withdrew from the entire region, though probably the decision was based more on the poor prospects in Ukraine and limited gas finds elsewhere, including Romania. This development also coincided with another, much broader protest against the mining project in Roșia Montană, which gathered up to 30,000 protesters in Bucharest; some of the Bucharest-based activists against Roșia Montană also helped mobilize protests against shale gas and went to the small villages and towns, which means that such protests could be organized even in sleepy towns and villages without this necessarily meaning that it was supported by organized Russian efforts. It could not be ruled out for the future, but it cannot be proven in the present.

No guarantee that EU policy has the upper hand

The fact that Russian influence cannot be definitely pointed to, it does not mean that Romania is free from any kind of danger. It simply means that, so far, Romanian players, unwittingly, did most of the work for the Russians, without Kremlin needing to become visible or invest too much of their resources in a country where anti-Russian mood is prevalent. However, the situation might change dramatically if Romania clearly moves in a direction contrary to Kremlin's wishes, e.g., if it becomes serious about implementing the Third Energy Package, interconnecting its gas market with neighbors who are now at Gazprom's mercy etc.

Right now, the highest inconvenience for Russian interests is if Romania indeed finds substantial gas reserves in the Black Sea, and which can be exported to the very dependent countries in the region, relatively small in size and with low gas consumption. The two obvious candidates would be Bulgaria and Moldova.

²⁴² <http://economie.hotnews.ro/stiri-energie-21638353-risca-romania-piarda-180-milioane-euro-pentru-gazoductul-brua-plateasca-amenzi-uriase-catre-comisia-europeana.htm>

²⁴³ https://www.nytimes.com/2014/12/01/world/russian-money-suspected-behind-fracking-protests.html?_r=0

CRIMINAL COURSE



A map of the Neptun resort area, showing the coastline and the locations of several hotels. The hotels are represented by colored shapes with labels:

- NEPTUN XIX 1** (Blue shape, bottom left)
- NEPTUN XIX 2** (Blue shape, bottom right)
- EX -25 LUCEAFARUL** (Brown shape, middle left)
- ISTRIA XVII** (Blue shape, middle left)
- MIDIA** (Pink shape, middle left)
- EX -27 MURIDAVA** (Red shape, top center)
- EX -28 - EST GOBALCESCU** (Red shape, top center)
- EX -29 EST RAPSDIA** (Pink shape, top right)
- EX -30 TRIDENT** (Pink shape, top right)
- PELICAN** (Pink shape, top left)

The map also shows the coastline and the sea area.

There is a risk that Russia, in order to discourage the operations of these oil companies, could simply create a climate of uncertainty by all sorts of military display and navy drills in the Black Sea close to the area. Even though a part of these resources are concessioned to Lukoil, this does not necessarily limit the risk. It might be more favourable to Russian interests to not bring Lukoil's finds to the market than to allow competitors in the region. Or, on the contrary, Russian

navy drills and noise in the Black Sea could be targeted to discourage everybody else except Lukoil. Since Lukoil's concessions are located to the East of the area, they might be connected to the future Turkish Stream pipeline, which has good chances to be finalized by 2019 at a capacity of 15 bcm. Transgaz itself took into account, at least as a theoretical possibility, that the Black Sea deposits be connected to Turkish Stream.

Turkish Stream

Romania's authorities have never really supported the idea of the construction of a pipeline (South Stream / Turkish Stream) that would help Russian gas avoid transiting Ukraine, though they have not opposed it very clearly either.²⁴⁴ The finalization of Turkish Stream (expected in 2019) has become more certain and it would indeed be against Romania's policy interests. For the moment, Transgaz makes some 60-70 million EUR yearly through transit tariffs for the three pipelines from Isaccea-Negru Vodă (20-23 million per pipeline). That amount could be lost once Turkish Stream is in place and substitutes Ukrainian transit, or in any case diminished even if the pipeline finally becomes physically accessible for Romanian gas.

Conclusions and recommendations

In short:

- Romania, being least dependent on Russian energy sources or technologies and with a strong anti-Russian public mood, has never directly supported projects or ideas that would favour Russian interests in the energy sector.
- However, local lobbies and various groups of interests have undermined good governance and EU energy policy, such as the Third Energy Package and gas interconnections, for their own interests. There is relatively little evidence of direct links between these groups and Russian businesses, oligarchs or politicians. There are some cases where Russian companies obtained the same kind of sweet deals like and along-side local well-connected oligarchs, e.g., preferential electricity contracts from state owned companies. Without resorting to direct, visible influence, however, Russia "free rode" on the local bad governance. This has delayed the energy market opening and the risk of Romanian gas becoming a regional competitor to Gazprom. The new gas resources in the Black Sea (amounting to some 100 bcm) could represent a real choice for countries in the region like Bulgaria (3 bcm/year consumption), Moldova (1 bcm) or even Hungary (10 bcm).
- At the same time, similar negotiations on large-scale projects, with non-transparent, non-competitive procurement, requiring exceptions from EU's state aid and implying non-transparent contract negotiations take place, but with Chinese investors.
- The fact that Russians have so far avoided direct interference does not exclude that such could happen in the future. This might be the case if Romania really becomes a regional competitor for Gazprom, with its reserves in the Black Sea, thus undermining Russia's old strategy to gain influence in the Balkans. It would take little efforts from Russia to create just enough uncertainties, e.g. with navy drills, to discourage the costly development of the deposits in the Black Sea.
- The implementation of EU's rules, such as creating competition on the electricity and gas markets, restrictions on state aid, promotion of interconnections, prohibition of long-term contracts for the transit pipelines etc., through direct pressures such as infringements and investigations, helped to limit the local bad governance and corruption in the gas and electricity

²⁴⁴ In 2009-2010, there were indeed discussions with Russia on the possibility of South Stream crossing Romania. The discussions were only in principle and never materialized in any kind of formal agreement or, at least, full declarative support. <http://www.ziare.com/adrian-videanu/south-stream/videanu-transgaz-a-primit-invitatia-de-participare-la-south-stream-nu-statul-roman-999023>. In short, Romania declared itself open to any sort of interconnection project, without seriously making any commitment before 2014.

sectors. The energy regulator ANRE has been instrumental after 2012 in enforcing deregulation and increase of competition in the electricity and gas markets.

- The cranking up of the anticorruption fight over the past years, relying on increasingly assertive prosecution and judiciary, leading to convictions in certain cases of corruption (preferential deals with state-owned companies, for example) also had a substantial contribution to discouraging the conclusion of new corrupt deals. The requirement to improve governance of state-owned companies (imposed through legislation on corporate governance of SOEs since 2009 and partly implemented) also supported the professionalization of companies, particularly Transgaz, Romgaz, and electricity producers.

Recommendations for EU:

- Continue the practice of credible infringement procedures on breaches of EU Directives. The main risk in Romania will occur in October 2017, when the mandates of the Board members of energy regulator ANRE expires. The new board members would be appointed by Parliament. It is critical that EC keeps an eye on ensuring that the selection criteria and process leads to the appointment of credible, professional and independent people.

- Support financially interconnections to develop a regional energy market, in particular for gas. Financial support should be strictly conditioned on full implementation of EU Directives – the most recent example is the deregulation of the gas market on which financial support for the interconnection project BRUA depended.

Recommendations for the US government, Congress and Senate:

- Support (even financially) investments in the regional interconnections for gas and electricity, in EU and with Moldova and Ukraine.

- Ensure that gas developments in the Black Sea are not at risk because of Russian navy drills, particularly as one of the companies involved is Exxon.

- Fully support publicly EU's energy policy in the region, to ensure level play competition, which would benefit US companies such as Exxon. Resist temptations to undermine the EU for various reasons: at this moment, there is no better arbiter of good governance in Europe than the EU Commission

Recommendations for both Brussels and Washington:

- Encourage and help the governments of Central and Eastern Europe to explain to their citizens the tangible benefits of free, open and integrated markets in energy (or anything else). The cooperation across borders according to rules is not the first instincts of politicians in the region. They tend to fall prey to populism easier than their peers elsewhere, especially when disputes occur in a sector – energy – which is by tradition considered “strategic”, i.e. opaque, dominated by the state and exploited by powerful vested interests pretending to speak on behalf of the wider public in order to obtain lucrative, ad hoc deals.

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