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## Friction or Fiction? The Gas Factor in Russian–Belarusian Relations

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### Summary

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- Throughout the post-Soviet period natural gas relations between Belarus and Russia have been chronically interwoven with political issues – in particular the proposed union of the two countries. Russia has supplied Belarus with heavily subsidized gas in exchange for military concessions and political loyalty.
- Despite a number of conveniently timed accords signed during the Yeltsin era, the Russian–Belarusian Union has remained largely academic.
- Putin, however, has proved more pragmatic than his predecessor, presenting his Belarusian counterpart with a stark choice: integration on Russian terms or higher gas prices.
- Given Belarus's transit role for Russian gas exports to Europe, these political issues have important implications for supply security.
- They also shed light on the way in which Russian foreign policy is made and the relationship between the government and the state-owned gas monopoly Gazprom – an issue of strategic concern given the government's current clampdown on the energy industry.

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## Introduction

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The Belarusian President Alexander Lukashenko – known for his outlandish comments – reputedly said: ‘Belarus’s unique situation lies in the fact I am indebted to no one.’<sup>1</sup> His words are not without a modicum of truth. Western Europe has little in the way of leverage over Belarus’s unpredictable president. His eleven-year reign has seen the country shift towards greater isolation as relations with the West have soured owing, in part, to the non-democratic practices of Lukashenko, such as a clamp-down on the media and the alleged fixing of his September 2001 re-election.

But look to the East and factor in energy, and the story is altogether different. Not only does Russia represent an important political ally, it has also been Belarus’s primary source of cheap fuel. Belarus depends on Russia for its annual gas demand of 18 billion cubic metres (bcm) and has been chronically indebted to Gazprom throughout the post-Soviet period.

Since 1992, Russia has supplied the Commonwealth of Independent States (CIS) with subsidized gas, and prices for Belarus have typically been lower than anywhere in the region.<sup>2</sup> Energy subsidies have helped boost the standard of living in Belarus and with it the popularity of Lukashenko, who is thus dependent upon Russian gas both for the country’s economic health and for his own political staying power.

For Russia, Belarus represents a key transit route. The opening in 1999 of the Yamal–Europe pipeline delivering gas to Poland and Germany increased Gazprom’s exports across Belarus from 7% to 15%. Furthermore, it should not be forgotten that Belarus represents an important market of some 10 million gas customers.

This paper looks at how this gas interdependence has affected political relations between Belarus and Russia from 1993 to the end of 2004. During this period, supplies to Belarus have been reduced temporarily in all but three years, with the commercial disputes often resulting in high-level political tensions. Does the gas factor reveal a more cynical edge to the fraternal rhetoric of Russia and Belarus? Does it conflict with their integrative ambitions? Or is it a source of cooperation?

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## Generating power: the political nature of gas

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To understand this gas dynamic it is necessary to consider the technicalities of the industry. Natural gas is an inherently political commodity owing, in part, to the rigidity of transport options. There are just two choices for moving gas: by pipeline or by water, shipped as liquefied natural gas (LNG). Both require a fixed infrastructure linking source to consumer. Although LNG is somewhat more flexible, it is usually only economically viable for very long distances where a sub-sea line would be more expensive. To understand the problem it is useful to differentiate between what Keohane and Nye call *sensitivity and vulnerability*.

*Sensitivity* is the cost of modifications or cessation of transactions between countries within the original policy framework.<sup>3</sup> *Vulnerability* is the cost of these changed transactions once remedial measures have been taken.<sup>4</sup> Since bringing alternative supplies on-stream takes time – leaving the consumer without gas for a protracted period – the *vulnerability* in natural gas contracts is very high.

Russia has exploited Belarus’s gas vulnerability in three key ways:

- pricing policy, namely subsidies with the threat of increases;
- restriction of gas supplies, ranging from small reductions to a full cut-off;
- debt management solutions with linkage to other issues.

For its part, Belarus can use its transit role as a counter-lever since full cessation of supplies would also mean disruption for Russia’s consumers in the Baltics, Poland and, with the opening of the Yamal pipeline, Germany. It is also technically complicated to implement a total cut-off because of the need to maintain a certain pressure in the pipeline.<sup>5</sup> Belarus can also use transit tariffs as a negotiating tool.

Despite these counter-levers, the interdependence remains asymmetrical in Russia’s favour. It is a dynamic process, however. The power ratio of interdependent countries changes over time, perhaps in response to external influences, domestic conditions or indeed the personality and political acumen of a given leader.

The concept of interdependence has been defined variously in the theoretical literature. For the purposes of this paper, however, interdependence is defined as a relationship that would be costly to break. Keohane and Nye argue:

Where there are reciprocal (although not necessarily symmetrical) costly effects on transactions, there is interdependence. Where interactions do not have significant costly effects, there is simply interconnectedness.<sup>6</sup>

In focusing on the consequences, rather than quantity, of interdependence this definition allows for an analysis of the power politics arising from such a relationship. Loss of autonomy is always a side effect of an interdependent relationship as the parties are constrained by their need for one another.

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## Political background

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Following the end of Soviet rule, one of the main questions facing Russia was how to relate to the fourteen newly emerged sovereign states. This issue formed part of the wider debate in Russia on whether the country should pursue integration with Europe, as advocated by the ‘Westernists’, or whether its geographical position afforded it a special role between East and West, as envisaged by the ‘Eurasianists’.

Russia's relations with the former Soviet Union were characterized by a high degree of economic and political interdependence, and this was particularly evident in the energy industry. Russia inherited the lion's share of Soviet oil and gas assets and consequently dominates supplies to energy-importing countries, and controls the pipelines on which the Central Asian exporter countries depend for transport of their gas. In a sense, the myriad gas pipelines crossing the region symbolize the intense economic interdependence of the former Soviet states.

### **Russian foreign policy phases**

The period of foreign policy from January 1992 to February 1993 is often referred to as the 'romantic' phase of Russian foreign policy owing to what is seen as excessive focus on the West at the expense of Russia's own national interests and the former Soviet Union. It is true that Russian President Boris Yeltsin focused primarily on forging post-Cold War relations with the West, with little attention devoted to the CIS.

But a challenge to the pro-Western line was already in evidence towards the latter part of 1992. Foreign Minister Andrei Kozyrev found himself increasingly under fire for what the opposition saw as kowtowing to the West and neglect of the former Soviet Union. By March 1993, this argument had forced the government to consolidate into a new foreign policy orientation, one that sought to re-exert its sphere of influence in the former Soviet Union and to pursue a 'Russia first' policy in its relations with the West.

Kozyrev's departure in January 1996 ushered in a new and distinct foreign policy era. His successor, Evgenii Primakov, formerly head of the Foreign Intelligence Service and a specialist on Middle Eastern affairs, moved to reassert Russia's status as a great power. He stressed the importance of integrative tendencies in the CIS, but also the need to maintain good relations with the West. At the same time he expanded the foreign policy focus to China, the Far East and the Middle East. In September 1998, following the August devaluation of the rouble, Primakov replaced Sergei Kirienko as prime minister, a position he held until May 1999. During this time he is believed to have maintained a strong hand in Russia's foreign relations, and his replacement, Igor Ivanov, was heavily influenced by him.

The advent in 2000 of Vladimir Putin as president of Russia marks the beginning of the latest phase in Russian foreign policy, one characterized by a more realistic approach to relations with the outside world. Although Putin has continued to assert Russia's great power status he acknowledges that 'the means were lacking to maintain what was considered Russia's rightful place in the world'.<sup>7</sup> Like Primakov, Putin stressed the importance of relations with the other CIS countries. The importance of energy to these relations is underscored by Putin's appointment in July 2004 of energy minister Victor Khristenko to the position of special presidential envoy for integration with the CIS.

Since 1992 the CIS has been as much a vehicle for the separation of member countries from the

hegemony of Russia as for their integration. The CIS countries can be viewed along a spectrum with those such as Belarus advocating closer relations with Russia at one end, and at the other those, such as Ukraine, seeking to maintain their newfound sovereignty.<sup>8</sup> Other inter-state groupings have emerged to undermine the basic framework of the CIS. These include GUUAM (an alliance of Georgia, Ukraine, Uzbekistan, Azerbaijan and Moldova), the Eurasian Economic Community (comprising Tajikistan, Kazakhstan, Kyrgyzstan, Belarus and Russia) and of course the Russian–Belarusian Union.

The most recent alliance is the Common Economic Space (CES) formed by Russia, Kazakhstan, Belarus and Ukraine with the intent of creating a free-trade zone, including a unified tax and customs system. An agreement on the formation of the CES was signed in Yalta in September 2003.

### **The Russian–Belarusian Union**

Belarus has close historical and cultural ties to Russia as well as being its second largest trading partner. Lukashenko was elected president in 1994 partly on the back of his Russo-centric foreign policy. His predecessor, Stanislau Shushkevich, had advocated close ties with Russia but had nevertheless emphasized the country's newfound sovereignty. Under Lukashenko, Belarus moved to strengthen its relationship with Russia, and the idea of eventual reunification of the two states gathered momentum.

For Russia, the prospect of some form of restoration of its lost empire had popular appeal – in 1997, 62 per cent of Russians supported integration with Belarus.<sup>9</sup> At the same time, Belarus's borders gave it a geostrategic significance: a merger of the two states would accord both with the Eurasianist vision of Russia as bridge between East and West and with the Westernist desire to move closer to Europe. It could also set a precedent for Ukraine to return to the fold of mother Russia, creating a pan-Slavic union.

For Russia, relations with Belarus have been primarily a matter of military and security issues, whereas Belarus has viewed the relationship mainly in terms of economic gains reaped by closer ties. One of these, energy – in particular the continuation of subsidized prices – has been a key component.

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## **Economic background**

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Russia holds one-third of the world's natural gas reserves and is the largest gas exporter in the world. It accounts for more than one-quarter of European gas demand, making it the region's largest external supplier. The Russian economy, in turn, depends heavily upon energy exports. Russia's 38%-state-owned gas monopoly, Gazprom, is the world's largest gas company and mainstay of the Russian economy. The company accounts for some 25% of federal budget revenues and is responsible for 90% of Russian gas production.

Gazprom's exports to Europe accounted for two-thirds of the company's total revenues in the early



years of this century.<sup>10</sup> Gazprom depends upon Ukraine and Moldova as well as Belarus for the transit of its exports. Today 95% of the company's exports travel through these countries. Ukraine is by far the most important transit country, with 90% of Russia's gas export capacity passing through it in the 1990s, but with the opening of the Blue Stream pipeline in 2003, and the Yamal pipeline in 1999, this dependency has reduced to 80%.

While exports to Europe are a lucrative source of revenues, sales to the former Soviet Union have been plagued by the twin problems of non-payment and politically driven subsidies. The non-payment problem – which reached its peak between 1996 and 2000 – has also hampered the domestic market, where state-regulated prices have been kept artificially low, again for political reasons.

Although Belarus offers the quickest and cheapest path to Europe, plans to bring the Yamal line up to full capacity have been delayed, partly as the result of the thorny gas relationship between Russia and Belarus, and Gazprom's strategy of reducing its transit vulnerability. It is uncertain whether the second string of the Yamal line will be built; Gazprom is currently considering an alternative pipeline route that would deliver gas to Europe via Finland and the Baltic Sea, bypassing Ukraine and Belarus, at a cost of \$5.7 billion.

Gazprom's transit vulnerability has been exacerbated by the non-payment problem. The company has been in frequent conflict over delinquent debt – not just with Belarus, but with Moldova and Ukraine. The unauthorized use of Russian gas by CIS countries has added to the problem, Ukraine being the worst offender.

Owing to European dependency on Russian gas, transit issues and supply diversification have been an area of key concern to the European Commission, which has stressed the need for energy dialogue with Russia.

This economic importance has ensured Gazprom a strategic role in Russian domestic politics. During the 1990s, it enjoyed the political patronage of the former head of Gazprom, Victor Chernomyrdin, who held the post of prime minister between December 1992 and March 1998.

Although Chernomyrdin and Gazprom did not necessarily see eye to eye on all issues, this close relationship with the state raises the vexed question of how far Gazprom is able to influence the state on foreign policy issues and vice versa. Under Putin, the state has moved to strengthen its influence on the Russian energy industry, starting in 2001 with a reshuffle on the Gazprom board, which saw Putin loyalists appointed to key positions. In 2004 the state began its evisceration of the oil giant Yukos, followed by the announcement of a merger of Gazprom with the 100%-state-owned oil company Rosneft – a move that would effectively raise the government's stake in Gazprom from 38.37% to more than 50%. Gazprom was tipped to take over Yukos's production subsidiary, Yuganskneftegaz. However, in a surprise move Rosneft acquired the subsidiary through a shell company. At the time of writing it is unclear what the government's

intentions are towards Yuganskneftegaz, although it has stated it will not be part of the merger of Rosneft and Gazprom. Even without Yuganskneftegaz, Rosneft's merger with Gazprom would create an energy giant company of immense political power.

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## Setting the tone: 1993–4

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The nature of the gas dynamic was established early on by three factors. First, Gazprom demonstrated its willingness to use gas reductions, as necessary, in response to Belarusian debt. Second, the Russian government manipulated gas prices in exchange for political and economic concessions. Third, Gazprom and the government recognized early on the strategic importance of the transit routes and set their sights on gaining control of the gas transit assets of these countries. This, of course, included Belarus's Beltransgaz.

Following the collapse of the Soviet Union, Russia and Belarus signed a so-called 'zero option',<sup>11</sup> whereby Belarus swapped its share of former Soviet assets abroad for cancellation of its debts, the bulk of which were owed to Gazprom. However, by August 1993 Belarus's gas arrears had mounted to \$100 million, and Gazprom cut supplies. Although Belarus was able to pay with the help of an IMF loan, this proved to be the first of the periodic debt disputes that have dogged the two sides to the present day.

As the importance of the CIS grew in Russian foreign policy, so too did gas relations. In September 1993, Russia made its first move to gain control of Belarus's gas transmission network with the signing of an agreement on the transfer of Beltransgaz to Gazprom. Under the terms of the agreement, Belarus agreed to lease Beltransgaz's assets to Gazprom for 99 years and to ensure the 'uninhibited [*svobodni*] transit of Russian gas across its territory for export'.<sup>12</sup> In exchange, Russia would increase supplies to Belarus over a 15-year period: to 21 bcm by 1995, 26 bcm by 2000 and 33 bcm by 2010.<sup>13</sup> Since these quantities exceeded Belarusian demand forecasts, there may have been a tacit agreement that Belarus could re-export some of the gas.

In controlling Beltransgaz, the Russian government would increase security of supplies exported across Belarus, and at the same time remove a potential political lever. The Belarusian parliament did not ratify the agreement, however, and ensuring control of Beltransgaz has remained a goal of Gazprom and the Russian government ever since.

The first clear instance of the linkage of gas to political issues came in April 1994, when Moscow and Minsk signed an agreement on a proposed monetary union, wherein Belarus agreed not to charge Russia for the stationing of troops on Belarusian territory in exchange for subsidized energy prices.<sup>14</sup>

Although this agreement was never implemented, the above factors defined at an early stage the nature of the Russian–Belarusian gas relationship, demonstrating a high level of politicization from the

start. It is useful to make a comparison with Ukraine, which took a different path from Belarus, rejecting Russia's early attempts to swap gas debt for military concessions.<sup>15</sup> These divergent paths were to set the tone of gas relations for years to come.<sup>16</sup>

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### Price politics and the Russian–Belarusian Union: 1995 to mid-1996

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In the mid-1990s, the issue of natural gas supplies became inextricably linked with the notion of the reunion of Belarus with Russia. Although Belarus's gas debt had by January 1995 re-accumulated to \$428 million, no cut-offs occurred during this year. There are a number of possible reasons. First, the linkage of gas to other issues continued. In January, Lukashenko and Yeltsin signed an agreement on a customs union that Lukashenko said would allow Belarus to pay domestic Russian prices for energy.<sup>17</sup> Secondly, talks on the Yamal pipeline were under way and Gazprom was perhaps reluctant to upset the negotiations. Finally, it was a time when Russian nationalist forces were gathering momentum, voicing their strong support of reintegration with the CIS and, in particular, reunification with their Slavic neighbour Belarus. The presidential election due in June 1996 had put pressure on Yeltsin to be seen to advocate closer ties with the CIS. In February 1996, another zero-option agreement was signed by Moscow and Minsk, cancelling Belarus's debts for energy and credits in exchange for a number of important military concessions. Moscow would be allowed to station its troops in Belarus free of charge, and Minsk would forgo compensation for plutonium contained in the nuclear missiles removed from its territory and for the cost of cleaning up damage caused by the Chernobyl accident.

Lukashenko had been under considerable pressure to make such a deal. At the time the terms of the zero-option deal were being debated, Gazprom sent a telegram to Belarus demanding that the country repay its gas debt immediately or face a reduction.

This zero-option deal was supplemented by a pre-election agreement in April 1996 on the creation of the Union of Sovereign Republics. However, the agreement remained largely academic; no timetable was established for its implementation. Although the agreement's only reference to gas relations was a vague stipulation for the creation of a joint energy system, Lukashenko once again claimed it would guarantee subsidized energy prices.<sup>18</sup> Perhaps Lukashenko was referring to a February 1996 agreement between the two countries 'on pricing politics'. The agreement stipulates that Belarus should receive natural gas at prices based on internal Russian prices, taking into account additional transportation costs. Domestic Russian prices are regulated by the state.

Why did Gazprom apparently accept such commercially unfavourable agreements? Closer integration with Belarus did accord with the company's own foreign and domestic policy. First, it too was supporting, both financially and morally, the re-

election of Yeltsin – and closer ties with the CIS were an important platform. Second, reintegration with Belarus was in its favour since construction had already started that year on the Yamal pipeline: a full merger of the two states would help to increase transit security for gas being transported via Belarus to Europe. It could also encourage Ukraine to join the union, further easing the transit dilemma.

Moreover, Gazprom reportedly received financial compensation for the zero option in the following way: Belarus gave Gazprom a 'promissory note' (*veksel'*) to cover its accumulated debt of \$916,791 million. The company sold the promissory note to the Ministry of Finance in exchange for \$650 million in the form of tax exemptions and \$200 million in cash. Belarus then failed to pay the promissory note.<sup>19</sup>

Such deals would later complicate the Russian government's efforts to extract prompt tax payments from its gas giant.

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### Commerce moves centre stage: mid-1996 to 1998

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The latter part of 1996 saw a shift in government relations with Gazprom, in part because of pressure from the International Monetary Fund (IMF) to loosen the bear hug of state and industry. Already, in March, the government had been forced to cancel Gazprom's tax-free 'stabilization' fund as a condition of an IMF loan.<sup>20</sup> The fund had accumulated an estimated \$500 million in unpaid taxes and duties in 1993 alone.<sup>21</sup>

In the autumn the government launched its tax war against the main offenders. At the same time Gazprom began its own campaign against domestic and foreign debtors, and Belarus was no longer an exception. In December Gazprom reduced supplies by 50%. It marked a turning point in the way that Gazprom would conduct its Belarusian foreign policy for the next two years.

In 1997 and 1998, the fiscal campaign against tax debtors as well as economic crisis at home continued to weaken the intense politicization of Russian–Belarusian gas relations, although other factors also played a role. First, Yeltsin had been safely installed as president for a further four years, reducing the need for a display of CIS integration. Second, the oil and gas industry was becoming increasingly sceptical about the prospects of a full merger of Belarus and Russia.<sup>22</sup>

However, commercial imperatives were the most important factor. In demanding tax payment from Gazprom the government was in a weaker position to ask the company to make commercial sacrifices for the sake of geopolitics. This was true both for the domestic non-payment problem and the CIS debts.

In March 1997, the government ordered the chief executive officer of Gazprom, Rem Vyakhirev, to pay the federal treasury \$1.2 billion in back taxes. Gazprom responded by intensifying its own campaign against CIS debtors. In the case of Belarus, supplies were reduced three times in the space of a year: in July 1997 deliveries were cut by half; in April 1998 by 30%; and in June 1998 by 40%.

In June 1997, Gazprom agreed to pay some \$2.5 billion in back taxes. Nevertheless, tensions had started to surface between the company and reformers in the government. Deputy Prime Minister Boris Nemtsov had in April called for a review of a trust agreement, which allowed Vyakhirev personal control of 35% of the state's 40% stake in Gazprom.

### **Taxing times**

The relationship between Gazprom and the government came under even greater strain in the first half of 1998. In June Russian tax police seized the assets of two Gazprom subsidiaries in a bid to boost revenue collection. Gazprom, arguing it had not received sufficient support from the government in increasing payments from its domestic customers, responded by cutting gas supplies to non-paying customers in St Petersburg and the Urals. This was the first time that serious domestic cuts had occurred since Gazprom was forbidden, by decree, to implement them. The company's move was thus a mixture of defiance and financial desperation. As the gas giant's relationship with the government deteriorated, rumours emerged that Yeltsin would reappoint Chernomyrdin to the government to help improve relations with Gazprom.

Despite the domestic tensions there was still coordination in the foreign policy of the government and Gazprom towards Belarus during this time. In an attempt to support Gazprom's debt-recouping efforts, Prime Minister Sergei Kirienko visited Minsk, in June 1998, although the talks met with little success.

In 1998, Gazprom had hoped to receive from Belarus payment in cash for 70% of gas supplies. The previous year, Belarus had paid for just 8% of supplies in currency, the rest by barter.<sup>23</sup> Belarus complained it was not in a position to make such payments and in May an agreement was signed under which Minsk would pay for 26% of gas supplies in cash. Nevertheless, the payment situation did not improve and Gazprom imposed the June 1998 reduction after Belarus's debt reached \$270 million.<sup>24</sup>

Since 1994 an independent Russian-managed gas trader, Itera, had also started to supply the CIS market. The fact that Gazprom granted Itera the right to supply gas to its jealously guarded export markets prompted considerable speculation in the Russian press over possible cross-ownership between the two companies. A full analysis of Itera and other independent gas companies lies beyond the scope of this paper. It is sufficient to say that the relationship between Gazprom and Itera was not one of competition, since the latter was allowed only to supply Belarusian gas need not accounted for by Gazprom. Itera still needed permission to use Gazprom's transmission network, and the charges incurred were higher than those for Gazprom itself. At that time Itera's principal market was Ukraine. It began to supply Belarus in 1998 with 1.1 bcm of gas, and deliveries increased over the years (see below).<sup>25</sup>

At the political level, union talks continued throughout 1997 and 1998, but there was mounting criticism among Russian elites about the economic costs

that such a merger would entail. This did not stop Lukashenko from trying to politicize the gas tension. He used union talks to complain bitterly of Gazprom's 'unbrotherly behaviour', and claimed that Russia owed Belarus some \$410 million for the stationing of its troops. Gazprom responded that it was not a charity.

Natural gas dominated talks on the Russian–Belarusian union, and at the end of 1998 Primakov and Belarusian Prime Minister Sergei Ling devised a creative debt repayment scheme. This coincided with a re-emphasis on the union by Primakov. Under the deal, Belarus would obtain \$200 million in credit from certain banks to pay Gazprom. Gazprom, in turn, would transfer this sum to the budget for taxes. The Ministry of Defence would then invest this money in the army, which would be obliged to buy Belarusian goods with the money received. These purchases would enable the Belarusian government to return the money received to the bank. For the remaining, \$350 million, Gazprom would receive \$50 million in goods from Belarus for its own use, \$100 million in currency and the remaining \$200 million in state bonds.<sup>26</sup>

The deal was a diplomatic success for Belarus and a far cry from the more stringent conditions that both Gazprom and the government had tried to impose earlier that year. It marked the start of a re-politicization of Russian–Belarusian gas relations and the first point of divergence in the foreign policies of Gazprom and the government.

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### **Re-politicization: 1999**

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In 1997–8, Gazprom, with the backing of the government, had started to normalize commercial relations with the CIS and to regard the region as potentially operating in the same manner as the European market.<sup>27</sup> Gazprom had grown accustomed to less political interference in its relations with Belarus, and tried to continue in the same vein in 1999. However, in this year the relationship was once again hostage to political issues.

In early 1999, Belarus, citing the brotherly relationship of the two countries, demanded domestic Russian prices. Gazprom agreed to lower the price from \$40 per 1,000 cubic metres (mcm) to \$32/mcm.

In a bid to receive the lowest price possible, Minsk negotiated directly with the government, pushing the price down to \$30/mcm – twice as low as the price of gas delivered at that time to Moldova and Ukraine.<sup>28</sup> According to Beltransgaz it had succeeded in lowering the price through direct negotiations with the Russian government,<sup>29</sup> apparently circumventing Gazprom. However, Gazprom continued to impose stricter terms on Belarus and in February reduced supplies by 12%.

It is hard to prove a direct price conflict here between the government and Gazprom, and yet it was a time when tensions were surfacing in both foreign policy and domestic political issues.

Indeed, Vyakhirev said in a July interview that gas



relations with Belarus were too politicized.<sup>30</sup> In September 1999, Putin made his first visit to Belarus as Russian prime minister. He announced that Belarus was a foreign policy priority and agreed to cancel \$70 million of the country's gas debt.<sup>31</sup> The basis of the debt cancellation is unclear. However, the same month saw the first gas flow through the Belarusian leg of the Yamal pipeline, which had been conceived primarily as a means of avoiding transit through Ukraine, and as a more reliable route.<sup>32</sup> Russia's increased transit dependency provided Lukashenko with a new commercial lever of influence, namely lower transit tariffs in exchange for reduced gas prices.

On the domestic scene, Gazprom's political sympathies had shifted away from Yeltsin to Moscow Mayor Yuriy Luzhkov. This was dangerous for the Kremlin because of the impending parliamentary and presidential elections. Gazprom could mobilize its huge funds and mass media outlets to fund its chosen candidate. Rumours abounded that Vyakhirev would be sacked. In the event, a June reshuffle saw the return of Chernomyrdin to the position of Gazprom Board Chairman, although Vyakhirev retained his post as CEO. The state also increased its representation on the board of directors from four persons to five. Although the move had little practical impact, it was a warning to Vyakhirev and foreshadowed the more substantial clampdown that would take place under the Putin administration.

The re-politicization of the gas relationship of Russia and Belarus coincided with talks on a new treaty on the creation of a Union State. The treaty was signed in December 1999, perhaps to coincide with the parliamentary elections and in anticipation of the impending presidential election. The Russo-Belarusian State was still popular among Russians, 72% of whom were in favour.<sup>33</sup> The Treaty may also have been a valedictory gesture from Yeltsin, who announced his resignation on the eve of the new millennium.

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### 'Gas poisoning': 2000–04

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Putin's presidency brought with it a cooling of relations between Minsk and Moscow. Although Putin advocated CIS integration, his stance was more pragmatic than that of his predecessor and he was quick to announce that a union of Belarus and Russia would take years to implement.<sup>34</sup> He indicated also that more stringent commercial conditions would apply. In one of his first post-inauguration speeches Putin stressed the need to receive gas payments, even from those countries politically close to Russia.

Gas supplies to Belarus were reduced temporarily by 40% in April 2000, and there were threats of further reductions the following month, after Belarusian debt reached \$260 million.<sup>35</sup> Nevertheless, the gas relationship between the two countries seemed to strengthen in October, when Russia, exasperated by the Ukraine's alleged theft of gas from its pipelines, announced it would build a new link line

through Belarus, bypassing Ukraine. Gazprom estimated that it had lost over \$720 million in 1999 owing to Ukrainian theft of its gas, while Ukraine's debt had mounted to around \$1.5 billion.<sup>36</sup>

Given Belarus's low payment record, Gazprom's move was more indicative of poor relations with Ukraine than a particularly strong relationship with the 'brother republic'. It may have been designed in part to pressure Ukraine into ceding control of its transmission network and to demonstrate that other transit options were possible, albeit at a cost. The bypass project would have set the gas giant back \$1 billion – an expensive option since it would entail the re-routing of existing exports, rather than expansion of transit capacity.

In November 2000, Gazprom agreed to continue to supply Belarus with cheap gas the following year at a price of \$30/mcm. In exchange, it would receive heavily subsidized transit fees – reportedly three times lower than charges for gas crossing Ukraine and Moldova.

Major changes took place in 2001 on the domestic political scene. Putin moved to regain control of Gazprom by appointing presidential loyalists to key positions. In May, Vyakhirev was replaced as Gazprom CEO by deputy energy minister Alexei Miller, a member of the so-called 'St Petersburg Clan' – a group of reform-minded officials who had known Putin during his time in the city in the 1990s. They contrasted with the other major elite faction to emerge under Putin, the *siloviki*, a group comprised of officials from the military and security. The *siloviki* have a statist approach to the economy, including control of energy assets. The St Petersburg clan are themselves divided into economic liberals, such as Miller, and former KGB workers (*chekisty*).<sup>37</sup> The ousting of Vyakhirev was part of Putin's broader clampdown on the Russian oligarchs. Reshuffles on the Gazprom board continued throughout the following months until only two Vyakhirev-era deputy chairmen remained.

Meanwhile, Russian–Belarusian gas relations had proceeded without significant incident. Beltransgaz was able to meet its gas payments with the sale of its promissory notes, and barter, in the form of tractors. But this proved to be a lull before a storm that by early 2004 had culminated in a political stand-off between Moscow and Minsk.

The seeds of the dispute can be traced back to April 2002, when Russia and Belarus signed an agreement whereby Gazprom would supply the republic with cheap gas on condition that it would create a gas transport joint venture based on Beltransgaz. Under the terms of the agreement, Gazprom would receive up to a 50% share in Beltransgaz. There was no mention of prices in this agreement, but a separate agreement 'on pricing politics', signed the same day by the two nations, stipulated that prices of gas to Belarus would be the same as domestic Russian prices for the next five years.<sup>38</sup>

These agreements coincided with some important political developments. In August 2001, President Putin and his Belarusian counterpart held talks on the integration of the two states. However, Putin is reported to have been less conciliatory than his

predecessor; he sought an integration agreement on his own terms, putting paid to Lukashenko's cherished hope of a 'merger of equals'. The Russian president is said to have offered Lukashenko two choices. The first was integration akin to that of the European Union, with some shared political structures but with proper commercial relations (e.g. no guarantee of energy subsidies). The second was for Belarus to be incorporated fully into the Russian Federation as eight separate districts (*oblasti*) and subject to Russian law.<sup>39</sup>

Presidential elections for the union would be held in March 2004, coincidentally with the Russian presidential elections. Since the outcome was biased towards Putin – and the position of vice president was non-existent under the Russian constitution – Lukashenko would be forced to abandon his ambition of a powerful role within the union. Needless to say, Lukashenko, unwilling to be relegated to role of governor, rejected the offer as an attempt to strip him of power and his country of sovereignty.

Putin, quick to remind Belarus that the size of its economy was only 3% of Russia's, put forward a proposal in the same month for the creation of a currency union by 2004. Lukashenko described the proposal as 'even insulting'.<sup>40</sup>

At the same time, relations between Gazprom and Belarus deteriorated for two reasons: first, the April agreement ceding part-ownership of Beltransgaz remained unfulfilled; and, second, Belarus was reluctant to pay higher prices for gas. According to the Russian newspaper *Kommersant Den'gi*, Beltransgaz had paid for just \$19–20/mcm of gas since the spring. However, Gazprom was only supplying 10.2 bcm of the required 18.5 bcm. The rest was from Itera, which charged \$28/mcm.

Itera then raised its price to \$36/mcm. Unwilling to accept the increase, Belarus consumed its Gazprom gas quota 15–20% more rapidly than planned. Gazprom sent a warning to Belarus to halt the unsanctioned gas usage but the request was ignored. On 1 November Gazprom reduced supplies by half with a demand for immediate debt repayment and an official request for the privatization of Beltransgaz. The move cast doubt on whether the bypass project proposed in 2000 would come to fruition. It also prompted a tirade from Lukashenko during a state visit to Moscow. Declaring the gas reduction a political decision by the Kremlin, Lukashenko threatened to abandon the idea of integration and warned of a 'cold economic war'. He accused Russia of 'unbrotherly' behaviour and economic blackmail, arguing that it was using the energy dependency to form a union on Russian terms and trying to gain control of Beltransgaz – something the nationalists in Belarus saw as a Russian ploy to dominate their country.

Days later Belarusian Prime Minister Genadii Novitskii arrived in Moscow to placate the situation. He apologized for Lukashenko's outburst, which, he said, had arisen from misinformation. He promised to repay the debt and to begin the process of privatizing Beltransgaz.

As promised, the Belarusian parliament lifted restrictions on the privatization of Beltransgaz on 25

November. Belarus also agreed to pay Itera's prices, which reportedly now stood at \$40/mcm, to cover its 1.23 bcm gas needs in November and December.

### **Pipeline pressure**

In 2003, natural gas continued to cast a shadow over Russian–Belarusian relations and remained closely intertwined with the question of integration. Nevertheless Gazprom continued to honour its side of the 2002 agreement, providing Belarus with domestic gas prices.

Belarus's continued reluctance to move forward with the privatization of Beltransgaz created tensions at the political and commercial levels. By the end of the year, Gazprom responded to deteriorating relations by demanding that the contract for gas deliveries in 2004 be reviewed and that prices be raised from \$28/mcm to \$50/mcm. In 2003 Gazprom was supplying only 10.2 bcm of Belarusian demand; the remainder came from Transnafta (1.5 bcm) and Itera (6.3 bcm) at prices averaging \$42/mcm. Since gas from the independent companies was more expensive, Belarus sought to increase supplies from Gazprom.

Equally important, the two sides failed to agree on the price of Beltransgaz: Gazprom estimated the company to be worth \$600 million, while Belarus put its value at \$5 billion.

Minsk and Moscow were unable to reach a compromise, and on 1 January 2004 Gazprom suspended gas supplies to Belarus. Itera and Transnafta assumed full responsibility for deliveries, but in February they too were forced to impose a reduction after failing to agree on the terms of a new, short-term contract.

The dispute reached its climax on 18 February when Gazprom imposed a total cut-off, leading to an escalation in the diplomatic row. This was perhaps a nadir in Russian–Belarusian relations. For Lukashenko, it was no longer a question of 'unbrotherly' behaviour, but 'terrorism at the highest level'. He announced that relations between Russia and Belarus would be 'poisoned by gas for a very long time'.<sup>41</sup> These were no extempore remarks. His words appeared in a lengthy declamation on Belarus's official presidential website.

Belarus responded to the cut-off by siphoning gas destined for Europe via the Yamal pipeline. The total cut-off lasted less than a day; nevertheless it raised serious supply concerns in Europe, and highlighted the fact that Gazprom had not solved the transit issue. Indeed, it was the first time in Gazprom's 30-year history of gas exports that total cut-off had occurred in a key transit country.

Gazprom's largest petrochemical unit, Sibur, joined Itera in supplying Belarus. Since Sibur was a Gazprom unit, the gas giant continued to receive higher prices for gas while taking a firm stance with Belarus. Itera and Transnafta (which Lukashenko accused of being 'a 100% daughter company of Gazprom') played a similar role. Thanks to these suppliers the cut-off was less brutal, thus mitigating the political damage.

Gas negotiations took place throughout 2004. In July, Russia agreed to grant Belarus a loan of \$175



million to pay for the gas. A month later the two sides announced that they had found a temporary solution to the problem: Gazprom would resume supplies at a price of \$46.68/mcm, while Belarus would increase its transit tariff for Beltransgaz's transmission network from \$0.55 to \$0.75/mcm/100km. The two sides also agreed to allow an independent auditor to evaluate Beltransgaz.

Russian–Belarusian relations also improved at the political level. In spring 2004, the Belarusian parliament ratified the country's entry into the Common Economic Space. As part of the CES agreement, the 18% value added tax on goods imported to member countries would be levied in the country of destination rather than origin, thus reducing tax payments to the Russian budget.

The VAT issue was raised by Belarus in negotiations over gas prices for 2005. Since Beltransgaz would be paying tax on gas imports, the price of gas in 2005 would *de facto* increase. Therefore, Belarus argued, prices should be lower than in 2004. Gazprom stood its ground, however, and at the end of 2004 the two sides agreed that prices would remain unchanged for the coming year. For its part, Belarus intends to receive from Russia \$146 million in credit to cover the additional tax payments. Transit rates through Belarus will remain the same – a favourable outcome for Gazprom.

The gas conflict of 2004 can be interpreted on a number of levels. First, Gazprom has long aimed at control over Beltransgaz, which controls 6,000 km of the country's pipelines. This would ensure greater reliability of Gazprom's supplies to Europe; on a political level an important lever of manipulation – transit capacity – would be removed.

Secondly, at the purely commercial level Belarus has continued to default on its gas bills. The timing, however, suggests that other factors are also at work. The deteriorating gas relationship coincided with Putin's attempts to form an integration agreement at terms most favourable to Russia, as well as negotiations over the terms of the CES and currency union. If Lukashenko had been prepared to accept Putin's union proposals the gas conflict might never have occurred.

Improved relations with Ukraine have also reduced some of the motivation for giving Belarus preferential gas prices. Ukrainian–Russian gas relations have warmed since 2002. In 2004 both sides agreed to increase Ukraine's transit capacity and the amount of Russian gas passing through Ukraine by 5 bcm in 2005 to 19 bcm from 2010.

Do these developments mean that Belarusian gas relations are becoming decoupled from political concerns? Russia's loan to Belarus for payment of its gas was a politically astute solution to the conflict. It allowed Gazprom to impose more stringent commercial terms while maintaining fraternal rhetoric and integrative tendencies. This satisfied both the St Petersburg liberals, who favour Western-style economics, and the *siloviki*, who are keen to see greater Russian dominance in the CIS.

The gas relationship between Belarus and Russia

has become more settled following an agreement in April 2005 between Lukashenko and Putin, whereby Gazprom will maintain the current gas price in 2006 in exchange for tax breaks for the construction of gas infrastructure and favourable transit tariffs. Gazprom and Beltransgaz also agreed to commission three compressor stations on the Belarus section of the Yamal pipeline in 2005, aimed at bringing it up to target capacity.

At the political level, Lukashenko's regime continues to draw criticism from the West. On 21 April, during a visit to Lithuania, Condoleezza Rice, the US Secretary of State, encouraged the Belarusian opposition to oust their tyrannical leader. Russian foreign minister Sergei Lavrov responded that 'the democratic process and the process of reform cannot be imposed from the outside'. On 22 April, Lukashenko and Putin held a Union summit and signed a raft of agreements on economic, technological, military and humanitarian cooperation.

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### Conclusions: 'ink on paper' integration?

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Chernomyrdin described the 1996 Union Treaty as 'no more than ink on paper'.<sup>42</sup> Nemtsov echoed this view some years later: 'The Union agreement exists only on paper. Neither in the economic ... nor political sphere does it work. This is shown in the human rights issues and the situation with Gazprom.'<sup>43</sup> The notion that the union is largely rhetoric is present also among Belarusian elites.<sup>44</sup> This poses the question of how far gas has motivated or hindered the proposed union.

It would be erroneous to suggest that Russian–Belarusian gas relations have been governed entirely by politics, or politics by gas. Crippling the economy of Belarus clearly would not be in the interests of Russia, whose own economy is so tightly intertwined with the rest of the CIS.

Nonetheless, the preceding analysis suggests that the Russian government has been prepared to use the gas weapon as necessary, particularly in realizing security and military goals. Natural gas has helped it to receive military concessions<sup>45</sup> and political loyalty at a time when most CIS states were engaged in asserting their independence. It is also a vehicle for integration on Russian terms.

Given Lukashenko's image in the West as 'Europe's last dictator', Russia will not allow him an important political role in a united state. For this reason the merger will not proceed until there is a change of leadership. Nevertheless the combination of Russia's weakening grasp on the CIS, EU enlargement and Ukraine's westward shift means that the idea of a Russian–Belarusian Union is politically important to Russia – both as an indication of CIS cohesion and as a possibility for the future. In the meantime, Russia's main focus for integration will be the Common Economic Space.

So what role has gas played in Belarus's calculations? Clearly, Lukashenko has not championed

the union idea solely to obtain cheap energy. Close ties with Russia bring numerous other economic benefits; in political terms, Belarus's alienation from the West makes Russia an important ally. Perhaps too, in the pre-Putin years, Lukashenko felt he had a real chance of a key political role in the Russo-Belarusian state.

Nevertheless, natural gas supplies and subsidies have been a strong motivation for keeping the union rhetoric – as opposed to reality – alive. And this motivation has increased in importance, as Lukashenko's own prospects for a powerful political role in a merged state have faded. In this sense, the gap between rhetoric and reality has widened as the years have passed. Putin has called Lukashenko's bluff. The Belarusian president's sporadic bursts of brotherly affection no longer bring the benefits they once did.

Gas has generated a form of coercive cooperation in Russian–Belarusian relations. A gas cut-off is a serious economic sanction, and its use has understandably resulted in diplomatic rows. And yet, without the lure of cheap energy, would Lukashenko have been more tempted to forge better relations with the West? In his own words: 'I should have conducted all these years the same politics as Leonid Kuchma and the government of Ukraine: play with Russia but simultaneously enter the EC, NATO, and have had those relations that they have with the US.'<sup>46</sup>

The apparent shift of Ukraine and Moldova towards Europe in recent months could present Lukashenko with a new foreign policy opportunity. It remains to be seen how well he exploits it.

For Gazprom, the proposed union increasingly became seen as more the problem than the solution. Former Gazprom vice president Pyotr Rodionov stated in 2000 that the proposed merger of Russia and

Belarus had interfered with gas relations.<sup>47</sup> In the early years the merger presented as a viable means of gaining control of a key transit route. A further incentive was the safe re-election of Yeltsin – not to mention financial compensation in the form of tax breaks. Also of prime importance in this dynamic is the fact that the Russian government has continued to allow Gazprom a monopoly on all exports to Western Europe. Yet there are constraints as well as incentives. When tensions have surfaced – as in 1999 – the government has been able to use the threat of staff reshuffles to tame its gas giant.

There are restrictions, however, on how far the government can use gas supplies and prices as a political lever. Continuing with the subsidized prices and lenience towards Belarus could set a dangerous commercial precedent. For example, in July 2004 China linked Russia's bid to join the World Trade Organization with China's own desire to receive subsidized gas prices.<sup>48</sup> Moreover, the former Soviet Union is potentially a large and profitable market and there is a limit to how long Russia can continue its preferential pricing scheme. Indeed there has already been talk of increasing gas prices for the Baltic states (Latvia, Lithuania and Estonia) to the level of other European countries. Even as domestic Russian prices rise – bringing with them a concomitant increase in CIS export prices – overuse of the gas weapon could have increasingly harmful economic repercussions for Russia.

Nevertheless, Gazprom's bargaining-chip potential, Russia's current weakness in the CIS and Putin's clamp-down on domestic energy companies all mean that the gas behemoth will continue to be a tool of coercion – and integration – for the foreseeable future.

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<sup>1</sup> Ekaterina Gregorieva, 'Obeshayu, krasivo budet', *Izvestiia*, 21 July 2004.

<sup>2</sup> For instance, in 2003 Belarus paid just \$30/1,000 cubic metres (mcm) for its gas, compared with \$50/mcm for Ukraine and \$100–\$125/mcm in Western Europe.

<sup>3</sup> Keohane and Nye (2001), p. 11. Clark A. Murdock also differentiates between sensitivity and vulnerability: 'If a state has national means or can arrange for international coping mechanisms to deal with a potential vulnerability at relatively low cost, by definition that state is sensitive rather than vulnerable.' 'Economic Factors as Objects of Security: Economics, Security and Vulnerability', in Klaus Knorr and Frank N. Trager (eds), *Economic Issues and National Security* (Lawrence, KS: Regents Press of Kansas).

<sup>4</sup> Keohane and Nye (2001).

<sup>5</sup> A full cut-off reduces the pressure in the pipeline to zero. This pressure has to build up again before supplies can be restarted and can take days. Thus a 100% cessation of supplies is an extreme measure. Reducing pressure in low-pressure, distribution pipelines is even more complicated; it can be both dangerous and extremely time-consuming, requiring considerable manpower.

<sup>6</sup> Keohane and Nye (2001), p. 8.

<sup>7</sup> *Ibid.*, p. 356.

<sup>8</sup> Sakwa (2002), pp. 379–80.

<sup>9</sup> Sakwa (2004), p. 232.

<sup>10</sup> EIA, Russia Country Analysis Brief, May 2004, available online.

<sup>11</sup> A form of mutual debt cancellation.

<sup>12</sup> Agreement (*soglashenie*) between the government of the Russian Federation and the government of the Republic of Belarus on the transfer of the Belarusian state enterprise for the transportation and delivery of gas 'Beltransgaz' into the structure of the Russian joint-stock company, Gazprom, Moscow, 8 September 1993.

<sup>13</sup> *Ibid.*

<sup>14</sup> Markus (1996), p. 15.

- <sup>15</sup> In Ukraine, the political power of natural gas and the government's willingness to employ the gas weapon surfaced prior to the Massandra summit in early September 1993, which was to address important security issues, namely the status of the Black Sea Fleet and Ukraine's nuclear disarmament. A week before the summit Gazprom reduced supplies of gas to Ukraine by 25%, citing Ukrainian non-payment as the reason. At the summit itself, Russian negotiators allegedly surprised the Ukrainian delegation by suggesting a cancellation of Ukrainian gas debt in return for full control of the Black Sea Fleet and the relinquishing of Ukraine's nuclear warheads. Russia warned it would halt gas supplies if these demands were not met. Unlike Belarus, Ukraine at that time did not acquiesce to these demands and Russia chose not to implement its threat.
- <sup>16</sup> A comparative approach to the transit countries is part of the author's broader research into CIS gas politics. See also Markus (1996).
- <sup>17</sup> Markus (1996), p. 15.
- <sup>18</sup> Ibid.
- <sup>19</sup> 'Gazprom – mishen' interesov', *Moskovskie Novosti*, 27 November 2001. See also *Moskovskaia Pravda*, 11 June 1999.
- <sup>20</sup> Rutland (1996), p. 12.
- <sup>21</sup> Ibid.
- <sup>22</sup> For example, Vladimir Medvedev, President of the Russian Union of Oil and Gas Entrepreneurs, said that a real union of Russia and Belarus would not happen. *Izvestiia*, 17 June 1998.
- <sup>23</sup> Andrei Makhovskii, 'Gazprom perekiril kran Belorussii', *Vremia MN*, 17 June 1998.
- <sup>24</sup> Ibid.
- <sup>25</sup> *Expert*, 18 November 2002.
- <sup>26</sup> *Izvestiia*, 17 October 1998.
- <sup>27</sup> Interview with Gazprom General Director Yurii Komarov, *NG. Politekonomia*, 17 March 1998.
- <sup>28</sup> Semen Novoprudskii, 'Tovarish ne ponimaet / Gazprom protiv zhelaniya Belorussii poluchat gaz po Rossiiskim tsenam', *Finansovyiye Izvestiia*, 18 March 1999. See also *Sevodnia*, 2 April 1999.
- <sup>29</sup> Ibid.
- <sup>30</sup> 'Rem Vykhirev nedovolen Belorussiei', *Vremia MN*, 7 July 1999.
- <sup>31</sup> *Vedemosti*, 9 September 1999.
- <sup>32</sup> The pipeline is supposed to reach full capacity by the end of 2005.
- <sup>33</sup> Sakwa (2004), p. 232.
- <sup>34</sup> Donaldson and Noguee (2002), p. 211.
- <sup>35</sup> *Segodnya*, 12 May 2000.
- <sup>36</sup> 'Out of the Loop', *Business Eastern Europe*, The Economist Intelligence Unit, 30 October 2000, vol. XXIX, no. 44.
- <sup>37</sup> See Sakwa (2004), p. 62 and *Business Eastern Europe*, 15 November 2004.
- <sup>38</sup> Resolution (*postanovleniia*) 'on the signing of an agreement between the government of the Russian Federation and the government of the Republic of Belarus on the creation of equal condition in the sphere of pricing politics', 12 April 2002, No. 236.
- <sup>39</sup> 'Bolshoi belorusskii tupik', *Moskovskii Komsomolets*, 11 September 2002.
- <sup>40</sup> Michael Lelyveld, 'Ukraine: Kyiv May Gain from Russia's Row with Belarus', *RFE/RL*, 23 August 2002.
- <sup>41</sup> This article is available in Russian on the official Belarusian presidential website: <http://www.president.gov.by/>.
- <sup>42</sup> Markus (1997), p. 58.
- <sup>43</sup> Quoted in 'O proshlom belorussii. Soedinit' ezha c uzhom nevozmozhno', *Politburo*, 2 December 2002.
- <sup>44</sup> Löwenhardt et al. (2001), p. 612.
- <sup>45</sup> Defence integration is one area that has seen relative success in Russian–Belarusian relations during the post-Soviet period, unlike political and economic union. For an analysis of this issue see Deyermond (2004).
- <sup>46</sup> *Argumenti i fakti*, 13 November 2002.
- <sup>47</sup> 'Gazovie prioritety russiskoi diplomati', *Diplomaticheskii Vestnik*, February 2000.
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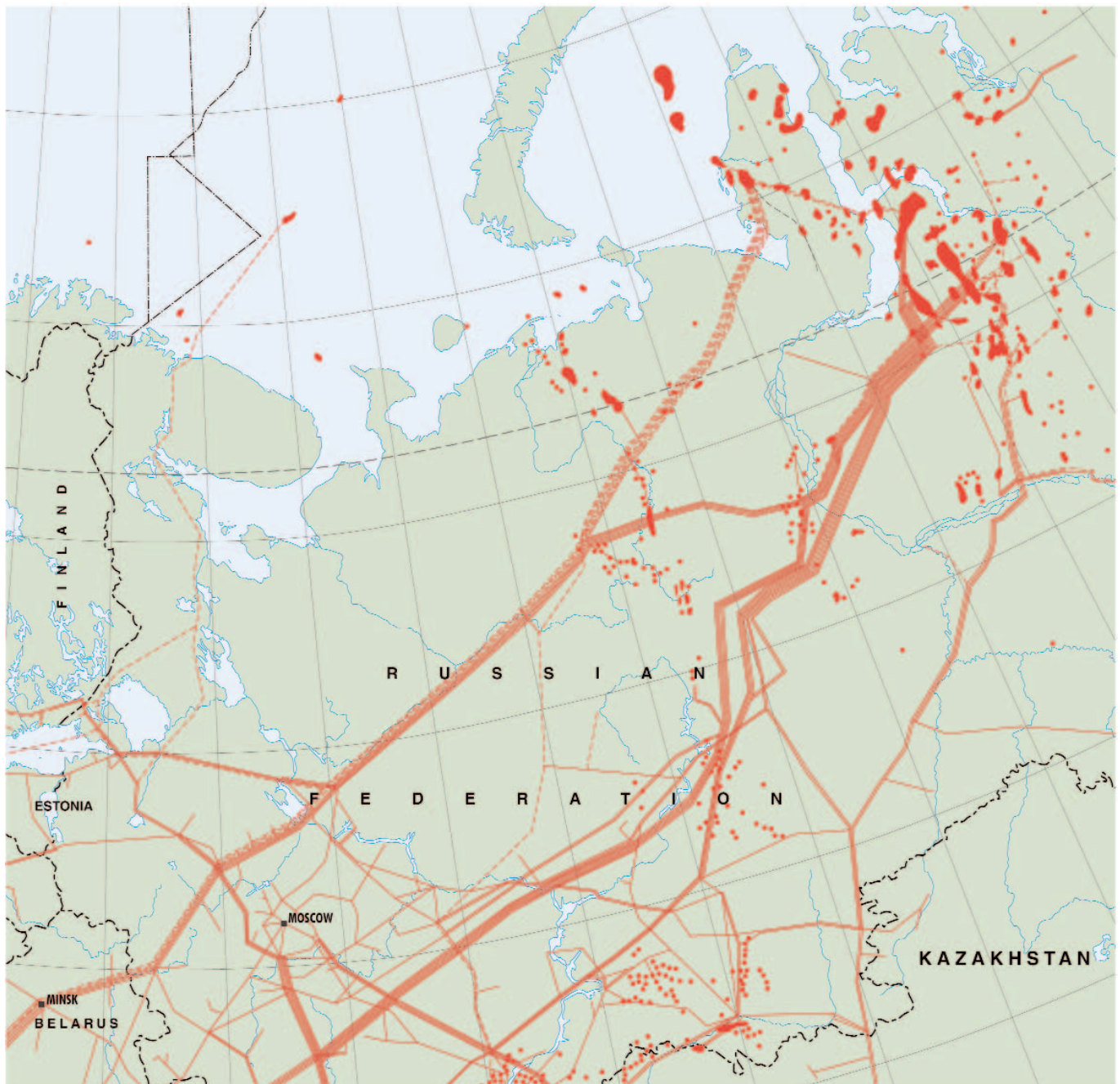
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## RUSSIAN FEDERATION'S GAS GRID TO EUROPE



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