

Zeyno Baran
Senior Fellow and Director of the Center for Eurasian Policy, Hudson Institute
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“Central and Eastern Europe: Assessing the Democratic Transition”
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Chairman Lantos, Ranking Member Ros-Lehtinen, members of the Committee:

Thank you for calling this important hearing today; I greatly appreciate the opportunity to testify.

I believe it is not possible to have a meaningful discussion of political and economic reform in Central and Eastern Europe without also looking at the region's energy situation—especially because Russia is currently using its position as the primary supplier for many countries to influence political and economic developments. I am grateful, Mr. Chairman, that you have already raised this issue before Congress: at a hearing in March, you declared that “[a]s long as Russia uses its energy sector as a foreign policy instrument, it will continue to enjoy the upper hand.”

Accordingly, my testimony will focus on the vitally important question of energy security. In many Eastern and Central European countries, the energy sector occupies a dominant position in the economy. Ties between the energy sector and state tend to be very strong. More often than not, there is a single state-owned (or partially state-owned) oil and gas vehicle, which is the largest and most profitable company in the country. Corruption and a lack of transparency in the energy sector actively retard development in other sectors of the economy and in society as a whole.

The task of reforming the energy sector—and therefore of securing the democratic transition—in such countries is made all the more challenging because of their overwhelming dependence on Russian oil and gas supplies. It is frequently argued—in Congress and elsewhere—that America’s dependence on foreign energy must be reduced if not eliminated altogether. More specifically, there is considerable fear that such dependence leaves America beholden to countries that might not share our values. In

Eastern and Central Europe, the degree of dependence far outstretches our own. Oil from Saudi Arabia and Venezuela combined comprises 25 percent of American total imports. However, according to Eurostat, no fewer than 7 countries in Eastern and Central Europe rely on Russia for *more than 90 percent of their total oil imports*. Three more countries in the region receive more than 60 percent of imports from Russia—including Bulgaria, which is 89 percent dependent.

PERCENT OF EUROPEAN OIL IMPORTS PURCHASED FROM RUSSIA

Country	Dependence
United Kingdom	13%
Spain	15%
France	15%
Austria	15%
Italy	23%
Sweden	26%
Netherlands	27%
Greece	29%
Germany	34%
Belgium	41%
Romania	63%
Czech Republic	69%
Finland	78%
Bulgaria	89%
Lithuania	94%
Slovenia	95%
Latvia	95%
Estonia	95%
Poland	96%
Hungary	97%
Slovakia	99%

Source: Eurostat

The degree of dependence is just as significant, if not more so, for natural gas. Five countries in the region depend on Russia for their *entire* natural gas imports, while six others depend on Russia for over 60 percent of imported supplies. The natural gas aspect of energy dependency attracts little attention in the United States, since it is not really a concern for us—while over 90 percent of our natural gas supply comes from Canada, our northern neighbor does not represent a significant threat to American interests.

PERCENT OF EUROPEAN GAS IMPORTS PURCHASED FROM RUSSIA

Country	Dependence
Switzerland	13%
Netherlands	17%
France	23%
Italy	32%
Germany	40%
Slovenia	51%
Romania	63%
Poland	63%
Czech Republic	75%
Hungary	77%
Austria	78%
Greece	84%
Bulgaria	100%
Slovakia	100%
Finland	100%
Estonia	100%
Latvia	100%
Lithuania	100%

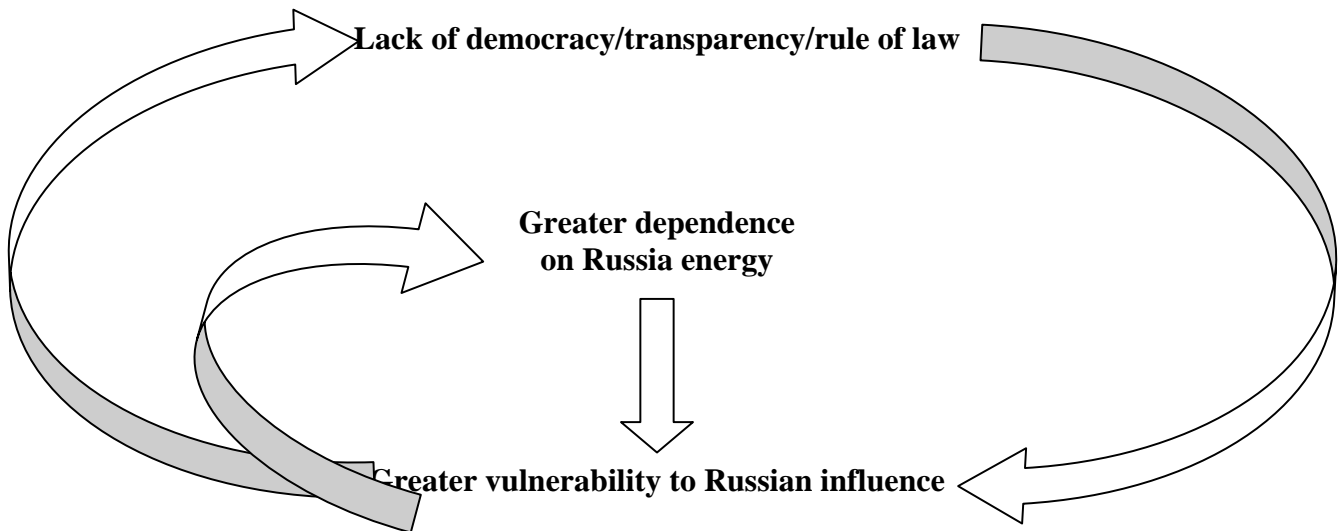
Source: Eni WOGR, 2006

So what does this say about the vulnerability of Eastern and Central European countries? In particular, what does this say about their ability to resist leverage applied by Russia?

During the Soviet period, maintaining control over satellite states was a clear objective for Moscow, and most of the existing energy infrastructure was deliberately designed with this goal in mind. The Soviet Union is no more, but this powerful instrument of control still stands—and Moscow is still not shy about using it.

Broadly speaking, Russia uses this leverage to accomplish two related objectives: raising revenues and suppressing democratization and economic liberalization. First, Moscow is able to parlay increased energy dependence into greater revenues—much of which is believed to end up in the bank accounts of Russian energy company executives, many of whom also occupy key positions in the Russian government. At the same time, greater energy dependence also increases Moscow's political and economic influence over

importing countries. The Kremlin seeks the suppression of democracy and liberalism for similar reasons: In an environment where transparency and the rule of law are lacking, Russian energy companies (and therefore the Russian government) can exert much stronger influence on government policy. Shady deals and corrupt business practices are far easier to carry out in such an environment. And while those that participate profit immeasurably from this corruption, their profit inevitably comes at the expense of the state and its citizens. Thus, this creates a self-sustaining cycle, since greater reliance on Russian energy and low levels of transparency or rule of law serve to increase Moscow's leverage.



The various “gas intermediary” schemes in **Ukraine** aptly illustrate the link between energy security and democracy—and how a lack of both is harmful to a country in transition. While I will discuss the Ukrainian situation in detail, as so much is already known about it, similar dynamics exist in many of the Central and Eastern European countries.

In essence, these schemes take advantage of the lack of transparency and poor rule of law that characterize the Ukrainian energy sector to establish third-party “intermediary” companies for the sale of natural gas from Russia to Ukraine. Hypothetically, such an intermediary could be needed to facilitate relations between the two countries. In reality,

it is difficult to understand precisely what these intermediaries do—or how they earn such obscene amounts of money for their “services.”

The current intermediary, RosUkrEnergo (RUE), is only the latest to profit from this lucrative business. Prior to RUE was EuralTransGas (ETG), and prior to ETG was Itera. In each case, the ownership and business practices of these intermediary companies are extremely opaque, with the true beneficiaries and shareholders obscured behind a complex international network of shell companies and offshore trusts.

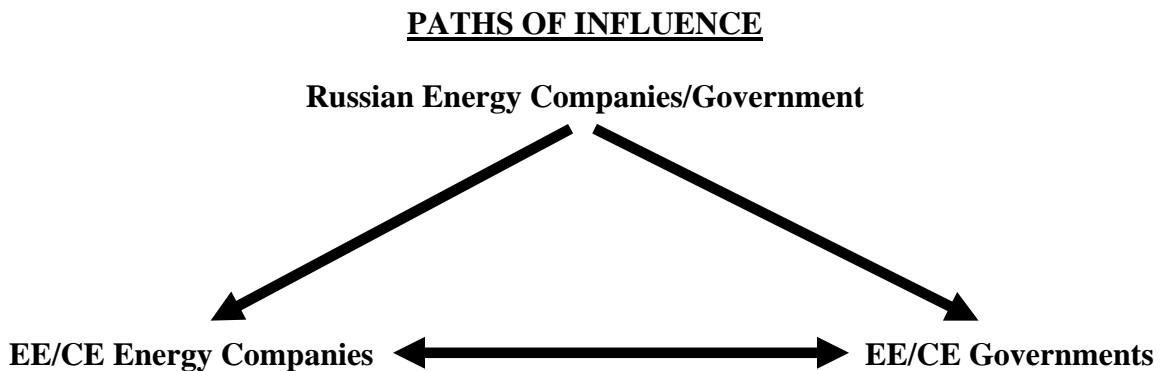
EuralTransGas had no pipelines or gas storage facilities of its own; and its total work force was just 30 people. Essentially, ETG purchased the gas from Russia’s Gazprom and immediately sold it to the Ukrainian firm Naftohaz Ukrayiny—at a hefty markup. Global Witness reported that ETG earned some \$2 billion in 2003 from this process (its only full year in operation). That same year, the company reported profits of just \$220 million. Aside from the \$425 million it paid Gazprom for transportation services (since, of course, it had no pipelines of its own), it is not clear what other operating costs ETG had—leaving over \$1.3 billion unaccounted for. Requests for details on exactly what services ETG performed have been met with vague responses or outright silence.

ETG’s contract was abruptly and mysteriously terminated in July 2004, and the firm was replaced by RosUkrEnergo, which performed exactly the same “service” and is nearly as opaque. 50 percent of RUE is owned by Gazprom. The other 50 percent is owned by CentraGas Holding AG, which is being managed by Raiffeisen Investment on behalf of a consortium of Ukrainian businessmen and companies. Requests to disclose the identities of these investors have all been turned down by the Vienna-based investment company.

RUE also has some very suspicious links to Naftohaz Ukrayiny. At one time, both the chairman and deputy chairman of Naftohaz—Ukraine’s state-run oil and gas vehicle—were serving on the 8-person coordinating committee of RUE. Moreover, RUE has a number of business ties to ETG.

The exact details of RUE and ETG remain unknown, but the broader picture is clear: a small number of individuals, most likely close to political leaders in both Ukraine and Russia, became very rich for doing very little. The markups these intermediaries charged (and that RosUkrEnergO is still charging) have cost the Ukrainian people billions of dollars. The vast sums of money made through this extortion are used to influence Ukrainian politics and promote Russian interests—a clear subversion of democracy. And as stated earlier, Russia’s two primary interests are to raise money for the Russian state, and to maintain the opacity and corruption of the importing country's economic and political environment.

Ukraine is only one of many Eastern and Central European countries subject to Russian pressure. With a single supplier occupying so dominant a position, an energy embargo (or even the threat of one) by that supplier can be a powerful lever. Moreover, Russia is using a variety of methods to purchase interest (and therefore control) in the oil and gas companies of the region. Thus, Moscow pursues two paths—direct and indirect—to influence Eastern and Central European governments.



Hungary provides an instructive example. Hungary receives 77 percent of its natural gas imports and 97 percent of its oil imports, from Russia. Moscow, and specifically Gazprom, has been trying to gain even greater control of the Hungarian energy industry, thereby shaping government policy.

And it has been succeeding to some degree—as the *International Herald Tribune*'s March 12 story title so clearly stated: “Hungary chooses Gazprom over EU”. The story describes: “As the European Union struggles to achieve a common energy security policy, the Socialist-led government of Hungary has broken with the bloc by joining forces with Gazprom, the Russian energy giant, to extend a pipeline from Turkey to Hungary. The joint project would compete directly with an EU plan to construct its own pipeline to reduce dependence on Russian energy supplies.”

Indeed, as the EU and the US are actively working to diversify European gas away from Russia (by supporting a pipeline project called Nabucco to transport gas from the Caspian region via Turkey, Bulgaria, Romania and Hungary, ending in Austria), Moscow has used its economic relations with Hungary (trade between Hungary and Russia increased by 70% over the last year), to try to pull Budapest away from its EU and NATO allies. As in Ukraine, energy played a key role in this effort.¹

In 2000, an Irish-registered company called Milford Holding acquired a significant stake in Borsodchem, Hungary's primary chemical company and owner of a pipeline distribution network. It was soon revealed that Gazprom was the real force behind Milford Holding. Shortly thereafter, a series of obscure, recently created companies began snatching up Borsodchem shares. Fearful that Gazprom or other Russian actors might be behind these firms as well, the Hungarian government rallied local companies and banks to fight off further intrusion and prevent a Russian takeover.

After the EU and the US reacted strongly to Hungary's decision to choose a potential partnership with Gazprom over its existing commitment to Nabucco, and after it became clear that the Hungarian opposition would not allow a direct takeover of MOL, the Kremlin may now be pursuing another approach: using Austria as a Trojan horse to gain control of the Hungarian company.

¹ While in the interest of time I will not discuss Moscow's strategy in other Nabucco countries listed above, we can observe similar dynamics in these countries as well. For more, please see my upcoming article entitled “EU Energy Security: Time to End Russian Leverage” in *The Washington Quarterly*'s Autumn 2007 issue.

Currently, the Austrian energy giant OMV is believed to be pursuing a hostile takeover of Hungarian MOL—the latter country’s largest company. If successful, this would give OMV control over nearly all of Hungary’s oil and gas infrastructure. It has been speculated that Russia could be ultimately behind this takeover bid.² A full 50 percent of OMV’s ownership is held by individuals or companies with a stake of less than 5 percent. As such, these small stakeholders do not have to reveal their identity. In any case, 31 percent of OMV is owned by the Austrian state, which is susceptible to more “traditional” Russian pressure tactics. (Austria gets around 80 percent of its gas imports from Russia.)

Given the dominant position that a company like MOL has in the Hungarian economy—along with the political influence that its position entails—the implications of it being controlled by Russian interests are serious indeed. Via MOL, Moscow could easily work to increase Hungarian dependence on Russian energy, which would ultimately undermine the last two decades of democratic reforms in that country.

Based on past behavior, we can also assume that if Hungary does not cooperate, it is likely to face reprisals from Russia. Disputes between Russia and the “uncooperative” Baltic states have led on multiple occasions to the halt of pipeline deliveries of oil. In January 2003, Russia ceased supplying oil via pipeline to Latvia’s Ventspils Nafta export facility. This embargo, which followed Riga’s unwillingness to sell the facility to a Russian energy company, continues to this day. In July 2006, Moscow shut down a pipeline supplying Lithuania’s Mazeikiu Nafta refinery, which is the largest company in Lithuania and one of the biggest oil refineries in Central and Eastern Europe. As with Ventspils Nafta, this shutdown came after a Russian company failed to obtain the energy infrastructure it coveted. (Russia claimed that this cutoff was the result of technical difficulties, yet refused all offers from third parties to examine the damaged pipe or assist

² See for example, Vladimir Socor, “An Austrian back door for Russian takeover of Hungary’s Energy Sector?” in *The Eurasia Daily Monitor*. July 24, 2007--Volume 4, Issue 143.

repairs in any way. Although this incident is suspicious enough on its own, it becomes a clear case of political manipulation given Russia's status as a repeat offender.)

Even though there was a muted reaction from the rest of the EU, the strong position adopted by Lithuania and Poland—whose PKN Orlen bought the refinery—was ultimately the correct one. The two states thus made clear that they would do all they can to reduce their dependence on Russia, and push the EU to come up with a unified position—as it is not merely gas molecules, but also the unity of the EU and of its foreign and security policy that is at stake. This issue became clear during the dispute between Poland and Germany ahead of the June EU summit. This diplomatic row was ostensibly over Russia's failure to remove its embargo on Polish meat products but more broadly involved the perceived reluctance of Berlin to stand up to Moscow on a whole host of issues, not the least of which was energy. Poland was particularly disturbed by the Russian-German Baltic gas pipeline that will bypass Poland, as it recalled similar agreements between Moscow and Berlin in the past; this time, as an EU member, Poland (and many other Central and Eastern European countries) want Western Europe to remain committed to their EU partners, and not Russia.

In closing, let me quote from the July 12 *Economist* article describing Europe's inability to come up with a united and coherent policy in dealing with Russia's energy strategy, which concluded: "...the striking oddity is that just as in the last cold war, Europe's security still depends so much on the Americans." Thankfully, the United States is accomplishing a great deal. However, most of the engagement the US has on energy issues in Eurasia is taking place at the deputy assistant secretary level; we also need Cabinet-level engagement to send a more effective political signal. After all, Putin himself is directly involved on the Russian side.

Diversification away from Russian energy sources is not only important for the European and Euro-Atlantic community's safety and security, but also because of the essential role it plays in the democracy promotion efforts in Central and Eastern Europe—as well as in other parts of the former Soviet space such as the Caucasus and Central Asia. Once we

recognize that it is impossible to achieve political and economic reform in Eastern and Central Europe without decreasing its reliance on Russian energy, we will be able to work more effectively with these countries to help them complete their democratic transformation.