Russia's Gas Policy in Asia: The Driving Forces and the Nature of Institutional Changes

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Abstract

Russia's turn to Asian energy markets started well before punitive sanctions were imposed by the international community. The international community politicized trade in energy after having interpreted Russia's position on the Ukrainian crisis as a demonstration of Russia's imperial ambitions and attempt to rebuild the Soviet Union against the Ukraine's sovereign will to seek closer economic ties with the European Union (EU) and not with the Russia-led Eurasian Economic Union (EEU). Before the sanctions, Russia had been progressing toward establishing alternatives to the EU markets and securing its strategic economic interests in the Asian gas markets. Uncertainty inflicted on Russia's energy-dependent economy by the sanctions has caused a new round of institutional changes in Russia's gas policy as a whole and its Asian dimension, in particular. This paper analyses the premises and consequences of recent (pre- and post-Ukrainian crisis) institutional transitions in Russia's natural gas governance and explores the opportunities and limitations Russia has for the implementation of its eastern natural gas policy.

Keywords: Institutional change, natural gas policy, Russia, Eastern Siberia and Far East (ESFE[1]), Northeast Asia (NEA[2]).

[1] Eastern Siberia includes such regions as Buryat Republic, Irkutsk Oblast', Krasnoyarsk Krai, Republic of Khakassiya, Tuva Republic and Zabaikalje (Trans-Baikal) Krai. Another abbreviation used throughout this work is RFE, which stands for the Russian Far East, a region consisting of nine territories: Amur Oblast', Chukotka Autonomous Okrug, Jewish Autonomous Oblast', Kamchatka Krai, Khabarovsk Krai, Magadan Oblast', Primorsky Krai, Sakha Republic, and Sakhalin Oblast'.

[2] The geographical boundaries of NEA remain loose and are often interpreted variously depending on a purpose of a specific inquiry. This study centres on NEA as being informed by the Russian Federation, Japan, the People's Republic of China (China) and the Republic of Korea (Korea). While analysing Russia's gas relations with the latter three, the article refers to them as NEA-3.

1. Introduction

It does not take an economist to figure out the principal parameter defining the health of Russia's budget. The Russian economy is a notorious illustration of a proneness to external energy market shocks. Russia's Gazprom alone generates 8 per cent of Russia's GDP and 20 per cent of budgetary revenues. The oil and gas sectors together contribute some 52 per cent of revenue, make up over 30 per cent of GDP, and account for more than 40 per cent of investment and 75 per cent of merchandise exports. [3] Heavy dependence on hydrocarbon resources leaves the Russian economy extremely vulnerable.

The EU has been Russia's major energy partner. In 2013, Russia shipped 138 bcm, or 63 per cent of total gas exports to the EU; Russian gas occupied 29.5 per cent in EU imports and 23 per cent in EU gas consumption. The two are locked into deep symmetrical (producer/exporter vis-a-vis consumer/importer) dependency, but have found themselves divided by a widening gap of institutional inconsistencies. Path dependence that dominated incremental energy policy transformations on both sides has expectedly resulted in Russia, with its state capitalism paradigm, being set far apart from liberalistic, mastering single energy market EU. However, as Russia started experiencing problems in the European gas markets, it opted for diversification to Asia. The importance of Asia as a new destination for Russia's energy exports was underscored in the Energy Strategy (ES) 2020 and ES 2030 adopted in 2003 and 2009, respectively,[4] and in Gazprom's Eastern Gas Programme (EGP) endorsed in 2007. [5] The ES 2020 envisioned that as much as 30 per cent of Russia's oil and 15 per cent of gas would be exported to China, Japan, and South Korea. Diversifying Russia's energy ties was re-emphasised in 2009, and the ES 2030 targets for the three countries' total shares were set as 22 per cent to 25 per cent for oil and 19 per cent to 20 per cent for gas (Shadrina 2010). Diversification to Asia fits well into a broader context of the ESFE social-economic development. Russian President Vladimir Putin has repeatedly accentuated that development of the ESFE is the government's top task (Putin 2004; Putin 2013). Since 2012, the ESFE has been seeing a nearly permanent stream of institutional shifts (Shadrina 2014a).

[3] NOVAK, A. (2013) Theses of Speech of the Minister of Energy "*Priorities of the Russian Energy Policy*" at Brookings, USA. 6th December 2013. [Online] Available from: http://minenergo.gov.ru/documents/razrabotka/17481.html. [Accessed: 2nd January 2014]

[4] GOVERNMENT ORDINANCE № 1234-R (2003) *Energy Strategy of the Russian Federation till 2020.* 28th August 2003. Energeticheskaya Srategiya Rossii na Period do 2020 Goda. 2003. [Energy Strategy of the Russian Federation to 2020]. Available from: http://www.domenergy.ru/files/Files/strategy.pdf. [Accessed: 3rd September 2013]; GOVERNMENT ORDINANCE №1715-R (2009) *Energy Strategy of the Russian Federation till 2030.* 13th November 2009. Energeticheskaya Strategiya Rossii na Period do 2030 Goda. 2009. [Energy Strategy of the Russian Federation to 2030]. Available from: www.kuzesc.ru/laws/Rasp_Pravit/RP_1715.doc. Accessed: 3rd September 2013]

[5] THE MINISTRY OF ENERGY OF THE RUSSIAN FEDERATION ORDER NO. 340 (2007) *The Program of Creation of Unified System of Gas Production, Transportation and Supplies in East Siberia and the Far East with Possibility of Exporting Gas to China and other Asia-Pacific Countries*. 3rd September 2007. Available from: http://bestpravo.ru/rossijskoje/rx-normy/r9n.htm. [Accessed: 8th June 2008]

Imposition of punitive sanctions by the international community in 2014[6] threatened the prospects for Russia's energy relations with the West and the EU, in particular, Russia's major energy partner. Purely a political move, the sanctions were premised on Russia's position on the Ukrainian crisis, which was interpreted as a demonstration of Russia's revived imperial ambitions and its attempt to rebuild the Soviet Union against the sovereign will of Ukraine to seek closer economic integration with the EU and not with the Russia-led EEU.[7] Motivated by the political divergences with Russia over the third party matter, developed nations imposed economic sanctions on Russia, thereby increasing transaction costs for Russian and IOCs businesses. The energy sector has been targeted as it is crucial to the Russian economy.

Sent to a new level of uncertainties in the traditional markets, Russia is attempting to counterbalance externalities and decrease transaction costs. It is doing so by reinforcing its plan to use the potential of the Asian energy markets. The initial move to Asia was rational because Northeast Asian countries (NEAs) reveal a certain affinity with Russia's dominant regulatory paradigm built on the principles of state capitalism (Shadrina 2010, 2014ab). Such greater institutional compatibility, as well as the specifics of regional gas markets allowed Russia to pursue a more proactive and diverse gas policy in the region. Under the sanctions, however, Russia has been forced to reform its gas policy institutions again adjusting them to a new reality. Such an imposed nature of changes leaves Russia with a suboptimal outcome.

This paper argues that: (i) energy policy institutions decrease transaction costs; (ii) uncertainty drives institutional changes in energy policy; and (ii) institutional (in)compatibility presents the contracting parties with the choice between "cooperation" and "conflict"; and (iv) corresponding (as versus autonomous) institutional changes improve institutional compatibility, thereby enhancing cooperation. This paper centres on Russia's gas links with the NEA countries, but the empirical evidence is often built through comparison of institutional constructs of Russia's gas policies in Asia and Europe. In doing so, this paper formulates and addresses the following questions. Why and in which particular way are Russia's gas policy institutions in Asia different from that toward the EU? What are the driving forces behind institutional evolution in Russia's gas policy as regards Asia? And does Russia stand to benefit from continuing such a bi-modular approach (that is, Europe versus Asia) or a transformation to a universe policy mode would be more rational?

2. Theoretical Framework: Institutions and Institutional Change

In this paper, institutional changes in Russia's natural gas policy are analysed upon the concepts of New Institutional Economics (NIE) (Menard 2004; Ostrom 2005; Menard & Shirley 2012). Institutions are treated as "humanly devised constraints that structure political, economic and social interactions" (North 1991, p. 97) and "contribute to the perpetuation of order and safety within a market or society" (North 2005, p. 6). Continuous evolution and/or modification of uncertainty explain the continuous

[6] Initiated by the US and EU sanctions were supported by Japan, Canada, Australia, Iceland, New Zealand, Norway, Lichtenstein, Switzerland, Montenegro and Kosovo.

[7] RIA NOVOSTI. (2014). *Putin Podpisal Zakon o Ratifikatsii Yevraziiskogo Ekonomicheskoko Soyuza* [Putin Signed the Law Ratifying the Eurasian Economic Union]. [Online]. October 2014. Available from: http://ria.ru/economy/20141003/1026803135.html. [Accessed: 3rd October 2014]

character of institutional alterations (North 2005, p. 6). From two generic types of institutions - formal (juridical, established in law) and informal (customs, traditions, codes of conduct, among others), the latter are more stable and often act as restraining the process of institutional change. In a non-ergodic world, institutional changes - which "can result from changes in formal rules, the informal norms, or the enforcement of either of these" (North 2005, p. 20-22) - provide only temporal solution. Having addressed the existing uncertainties, the altered institutions, even if optimal at a time, gradually become inefficient in tackling a new level of uncertainties, which they, altered institutions, have created.

While defining uncertainty is practically an undoable task for all the multifaceted nature of this phenomenon, distinguishing some dimensions of uncertainty appears to be justified methodologically and essential for setting the analytical framework. Within the scope of energy governance, the *origin* of uncertainty appears to be one of the most principal characteristics. Uncertainty may emerge from within or outside; in other words, it can be of domestic or external nature. *Time* and *pace*, at which a particular uncertainty emerges and transforms into a comprehendible case, which can be appropriately addressed through certain institutional changes, are other important characteristics. Along this division, evolutionary/ gradual and revolutionary/ drastic institutional changes can be identified. Adding the *scope* of uncertainty as another criteria to this rough typology helps distinguish between relatively simple (involving one or a limited number of weakly connected issues) and complex (embracing large diversity of factors with unpredictable outcome of their interaction) uncertainties. A large scope uncertainty would require more substantial institutional changes including profound transformation of informal institutions. This article examines institutional changes caused by complex external uncertainty that emerged swiftly and is yet developing.

Institutional transformation is a cyclical process where *perceived reality* informs *beliefs* which shape *institutions*, which in turn form *policies* that bring about changes and result in *altered perceived reality* reflected in *altered beliefs*, and so on." (North 2005, p. 83). Institutional changes are "incremental, gradual, and constrained by the historical past" (Ibid, p. 64), or path dependent, because the decisions that are being made today are shaped by the past experience and in their turn they influence the future decisions. Static approach to institutional changes centres at given (exogenous) drivers. In turn, the dynamic analysis of institutions differentiates between evolutionary or spontaneous vs. design perspectives (Williamson, 1996; Vatn, 2005). The evolutionary change of institutions is not the intended outcome of a certain action, but the unintended outcome of behaviour; it is a self-enforcing (not requiring an authority's action) change. Design approach to institutional change implies the intended result of individual or collective choice. Institutional changes can be stirred by some so-called drivers, which roughly can be presented as culture (in a broad sense, including values, norms, conventions, etc.), technology and state (as a key decision-maker that drives other actors to change their institutions). When engaging in the process of institutional change, the actors typically seek either improvement of efficiency or protection of their own interest. Consequently, institutional setting and institutional change are often analysed in the categories of theory of transaction cost or vested interest approach.

Institutions are made to reduce the transaction costs, the *ex post* costs that result from the contracting. Transaction cost theory embraces such concepts as asset specificity, uncertainty (of transactions) and frequency (of transactions). Specificity of assets in the energy sector has very particular bearings because the inflexibility of the party who endures the most of sunk costs creates a problem known as a

hold-up problem. Gas disputes between Russia and Ukraine in 2006 and 2009 are telling illustrations of this very nature. Lucidly, the only way to eliminate a hold-up problem between the contracting parties is to jointly bear the sunk costs, thereby creating an authentic incentive for sharing the risks associated with the transactions with the asset. Transactions are embedded into uncertainties, both with respect to the behaviour of the contracting parties and with respect to market developments. Following this line, Russia's diversification away from the European gas market to Asian consumers appears nothing but absolutely logical: as Russian suppliers face growing uncertainties in traditional European gas markets following the adoption of the Third Energy Package, they restructure their export portfolios to favour Asia. Because the frequency of interactions is inversely related to transaction costs, for the purpose of ease of regular dealings, the contracting parties create certain routines and implicit mutual understandings that reduce the need for formal enforcement mechanisms. Frequency is a quality of long-term (or at least long-term-oriented) relationship where *ex ante – ex post* gap is non-existent, negligible or manageable. In other words, to commit a long-term relationship the contracting parties need either to have homogeneous or very compatible formal and informal institutions or be ready to attune their differences to a mutually acceptable extent. The Russia-EU long-term energy relationship has been increasingly challenged by a very dissimilar nature of their energy policy institutions. Progressively dynamic process of institutional changes towards supranational model governing the liberalised gas market in the EU have been contrasting sharply with Russia's incremental and path dependent statist approach to its gas policy.

3. Energy Governance in Russia

3.1. Before the Ukraine

Genuinely strategic and vitally significant contributor to the entire society's economic wellbeing, Russia's fuel-energy complex (FEC) is poorly governed. [8] The effectiveness of energy governance is affected by a tangle of problems resulting from overlapping mandates of federal authorities; vested interests of the regulators; conflicting interests within and across three tiers of energy governance (federal, regional, and business); lacking discretionary power of energy governance agencies in the regions where the development of energy resource takes place; exclusion of the local communities from the process of energy governance; and so on (Shadrina 2010; Shadrina and Bradshaw 2013; Shadrina 2014a).

The quality of long-term energy policy in Russia has been questioned (Miller 2009ab; Mitrova 2014; Milov 2014). Recent developments yet demonstrate that strategic programming of FEC is far from accurate. Indeed, when presenting long-run energy projects in the ESFE the Institute for Energy Strategy, which is tasked by the Russian government with drafting new Energy Strategy 2035, [9] omits mention of a controversial Altai gas pipeline project (Shadrina 2014b; Shadrina 2015), but other

[8] REVENUE WATCH INSTITUTE. (2013) *Resource Governance Index.* [Online] Available from: http://www.resourcegovernance.org/sites/default/files/rgi_2013_Eng.pdf. [Accessed: 3rd February 2014]

[9] INSTITUTE FOR ENERGY STARTEGY (no date) *Osnovnye Polojeniya Energeticheskoi Strategii Rossii na Period do 2035 Goda* [Main Provisions of Russia's Energy Strategy until 2035]. [Online]. Available from: http://www.energystrategy.ru/index.htm. [Accessed: 2nd February 2014]

documents, [10] as well as recent e-accounts of the industry news[11] imply high probability of the Altai project implementation. Omission of the project with annual export capacity of some 30 bcm reflects on efficacy of energy planning in Russia. Another example is Gazprom's Eastern Gas Programme (EGP), which has not been revised despite a number of significant events, such as Rosneft's and Novatek's entry into the gas business and development of their own production and export strategies challenging Gazprom's earlier plans for the Asian markets.

Since 2012, and prior to the Ukrainian crisis, there has been significant transformation of Russia's gas policy institutions as regards Asia. The Russian government adopted policy papers, put in place new organisational provisions and assigned substantial financial resources for the enhanced development of relatively poorly performing (compared to Russia's centre) regional economies of Eastern Siberia and the Far East (Shadrina 2014a). Not surprisingly, energy has been defined as a core growth generating sector in the region. The institutional transformations for both regional and sectorial development (new regulatory agencies, tax breaks, export levy exemptions, etc.) reflected a *developmentalist* paradigm the Russian government has been following. Energy with its synergy potential was set to play a role of a driver for the region's growth. Unquestionably, external, export, Asia-linked potential of energy sector is seen as a key variable in these developmental projections.

Institutionally, Russia's gas policy toward NEA differs from that vis-à-vis Europe (Shadrina 2010, 2014ab, 2015; Shadrina and Bradshaw 2013) (Table 1). Domestically, the focus is putting in place institutions capable of triggering the growth in the ESFE's output. Aside from addressing the domestic socio-economic agenda, development of energy resources in the ESFE allows Russia to more fully explore new geo-political dimensions. Through the development of its eastern gas (and oil) provinces, Russia is attempting to hedge against the outcomes of Europe's policy of supply diversification. On the other hand, as a gas supplier to NEA, Russia can reasonably seek more prominent roles in the matters of regional security and cooperation. Russia can manoeuvre in a context of highly complex relations among the states in NEA. It, for instance, has certain support of South Korea, which is interested in having Russian pipeline gas via the project that in one of its versions embraces China and the DPRK. [12] Japan, too, has been repeatedly emphasising the prospect of having Russian pipeline gas and the relevant negotiations continue[13] despite the division over territorial disputes. Russia has no formally

[10] Schema Territorialjnogo Planirovaniya Rossiiskoi Federatsii v Oblasti Federaljnogo Transporta (V Chasti Truboprovodnogo Transporta) [Russian Government Order on The Roadmap of Territorial Planning in the Russian Federation in the Area of Federal Transport (in the Part of Pipeline Transport)] *The Russian Government Order* #1416-p. 13 August 2013.

[11] RIA NOVOSTI (2014) *Kontrakt o Postavkah Gaza RF v Kitai Mojet Bytj Podpisan do Kontsa Goda* [Contract on Russia's Gas Supply to China Can be Signed by the End of the Year] [Online] Available from: http://ria.ru/economy/20141004/1026926316.html#ixzz3FFJlatx8. [Accessed: 4th October 2014]

[12] LEE, Y. S. (2011) The Gas Pipeline connecting South Korea, North Korea, and Russia: Effects, Points of Contention, and Tasks. *KINU Policy Study* 11-05. [Online] Available from: www.kinu.or.kr/upload/neoboard/DATA02/rps11-05.pdf [Accessed: 13th May 2014]

[13] INAJIMA, T., URABE, E. (2014) Japanese Lawmakers to Lobby Abe for Russian Gas Pipeline. *Bloomberg.* 28th May. [Online] Available from: http://www.bloomberg.com/news/2014-05-27/japanese-lawmakers-to-push-abe-on-russia-natural-gas-pipeline.html [Accessed: 28 May 2014]; TANAKA, T. (2014) Russia pitches undersea gas pipeline to Japan. *Asia Nikkei*. 15th October [Online] Available from: http://asia.nikkei.com/Politics-Economy/International-Relations/Russia-pitches-undersea-gas-pipeline-to-Japan [Accessed: 16th October 2014]

binding institutions with the NEA as a whole region. Energy institutions in place are mainly inter-governmental, designed to facilitate bilateral energy diplomacy and commerce (Shadrina 2014a, 2015).

Table 1: Typology of Russia's Energy Institutions: EU versus NEA Perspective

		order-creating	**issue-specific**
		inform the overall environment for actors interactions, provide fundamental conditions for reaching agreements and guaranteeing their fulfilment	address specific spectrum of issues confined locally, sectorally or both through a diverse set of direct and indirect incentives
formal	have organisational structure in which actors (principals and agents) exercise authority over the controlled resources	EU: European Commission, Parliament, DGs, etc. NEA: none	EU: DG for Energy; Energy Charter Treaty; Energy Dialogues; national energy regulators; energy companies, etc. NEA: national energy regulators; energy companies, NOCs; Energy Dialogues; Russia-China Investment Cooperation Committee; Russia-China Investment Fund; Russia-China inter-governmental agreement on energy cooperation; etc.
informal	composed of ideas, beliefs, norms and rules informing practices that create path-dependence and resist radical change in favour of incremental transformations	EU: individualism; efficiency; democracy; rule of law; internationalisation; integration; sustainable development; etc. NEA: loyal, stable, long-term (business) relations over efficiency; dense and very sophisticated web of inefficient practices (*amakudari* in Japan; friendly contracts in Russia, etc.); developmentalism; sustained economic growth; sustainable development; etc.	EU: energy security concept – liberalised energy market automatically yields energy security; etc. NEA: government needs to correct energy market inefficiencies to ensure energy security; resource diplomacy; resource nationalism; etc.

Source: adopted from Shadrina, 2015.

The Ukrainian crisis has created numerous uncertainties for Russia's gas policy in Europe. The sanctions inflicted perceptible damage to Russia's energy sector (and broader, spreading to the rest of its energy-dependent economy) and induced further transformation in Russia's gas policy toward Asia.

3.2. Who Started First? Politicisation of Energy

Russia has been reproached on many occasions for the politicisation of energy, especially in its relations with the former Soviet countries. The arguments were such that in pursuance of its (geo)political agenda Russia practices price discrimination/ differentiation, voluntary changes the volumes and altogether cuts off the supplies and so on, as the means of conviction of independence-from-Russia-minded counterparts. In reality, politicisation of energy has not been an alien practice to the EU and the US (Kashcheeva 2014). The intrigue of the current moment, that the developed economies readily embraced sanctions against Russia, is that there appears to be a solid motive for them to pursue the sanctions. The US, for instance, has dramatically increased indigenous gas

production (Grushevenko and Meljnikova 2014) and is increasingly seen (and promoting itself) as a new gas supplier to the world market and the EU, in particular. Motivation of the EU lies totally outside of economic reasoning, because driving the bilateral relationship toward the breaching the established, commercially attractive gas supply linkage with Russia cannot be explained by anything other than purely (geo)political considerations. In the past several years, the EU has been extremely energetic while strategising its energy supply with a specific emphasis on assigning Russia as small as only possible role in it. In doing so, the EU planners were often forgoing economic rationality. Such are the cases of the Third Energy Package implementation, intended LNG purchases from North America, and projected indigenous/shale gas production. The EU's achievements with the commercialisation of energy can be contested, as there is evidence of market efficiency and supply security being profoundly undermined (Meljnokova 2014; Van Renssen 2014; Westphal 2014).

For self-interested US and EU, the Ukrainian conflict has become a comfortable background for the application of energy politicisation paradigm.[14] Introduced in March 2014 and expanded in the following months, sanctions lucidly displayed full-fledged politicisation of energy by the West. Russia's oil and gas sectors were targeted directly through the restrictions imposed on trade and investment transactions between Russian and international companies. By doing this, the EU acted according to statist paradigm, disregarding the code and violating the conduct of a true believer in libertarian values. Even though the European companies with commercial interests in Russia have been vocal in expressing their dissatisfaction with the interference of the supranational institutions into business, their appeals to not mix business and politics were the least taken into account.[15]

Russia was hit hard by the very weapon it used to be so customarily accused of using. It is worth noting that there is a sheer difference between the context of the former accounts of Russia's alleged politicisation of energy and the current application of political gear by the West, including the EU. Suppose, in the past Russia had indeed resorted to non-economic means of persuasion of its counterparts, but, and this is very important, on all those occasions Russia had some solid economic grounding, a claim that rested in the realm of commercial discipline disregard of which by its counterpart has been leading Russia to trigger one or another kind of punitive measures. Indeed, in energy relations with Russia, Ukraine has a reputation of a counterpart that does not necessarily respect contracts: defaults and delays in the payments for shipped (and often even consumed) gas, attempts to renegotiate the agreed price, frequent claims for a higher transit fees and so on, were more of a norm rather than emergency. In 2014, awkward as it may be, Russia's Gazprombank, which has been providing loans to Ukraine's Naftogaz so that the country could (despite its $5.5 billion in debt for the earlier supplies) receive gas, has also been put under the sanctions. Now, as the EU has no commercial claims toward Russia, its action is completely politically motivated. What is more, the EU and the US have a political and diplomatic agenda with the Russian government, but they exploit energy business

[14] The USA's sanctions against Russia [Online] Available from: http://www.treasury.gov/resource-center/sanctions/programs/pages/ukraine.aspx; the EU sanctions against Russia [Online] Available from: http://europa.eu/newsroom/highlights/special-coverage/eu_sanctions/index_en.htm; Sanktsiya na Sanktsiyu: Zaprety, Vvedyonnye Rossiei I Zapadom [Sanction against Sanction: Russia's and the West's Bans] [Online] Available from: http://ria.ru/infografika/20140901/1020205622.html [Accessed: 9th October 2014]

[15] Ulrich Speck, a scholar at Carnegie Europe, stresses that Germany deliberately politicised bilateral economic relations by backing the EU official position in the aftermath of the Ukrainian crisis and believes that such an estrangement will have prolonged negative impact on business.

at both sides as a bargaining chip. In this context, it is interesting to speculate about what could be the EU's response in the Ukraine crisis if Russia ratified the Energy Charter Treaty (ECT) in 2009. It appears that by having no legally binding institutions similar to the ECT's range and scope (Romanova 2014), Russia predetermines its insecurity against the EU's politicized treatment of its energy ties. Being more of a crisis management and energy diplomacy forum, the Russia-EU Energy Dialogue[16] does not embrace the frameworks appropriate for addressing complex issues in Russia-EU energy relations.

3.3. Institutional Changes under the Sanctions

Over the past decade, the energy market has been mainly favourable for Russia. The government's attempt to establish larger control over surging export revenues resulted in the advent of state capitalism. Since the early 2000s, Russia's energy policy exemplifies gradual expansion and tightening of administrative institutions (Table 2). In the wake of the 2008 global financial crisis and great recession, Russia has painfully realised the limitations and risks of its energy dependent economy. Although the goal for innovation-driven development was articulated, lacking coherence, unsystematic steps that were made in that direction (creation of Skolkovo Centre, setting development of nanotechnology as a national project, etc.) resulted in what was coined *conservative modernisation* (Shadrina, 2010). Meanwhile, it became clear that Russia's east which was nearly ignored for the most part of the market reforms, demands the government's attention. Essential to Russia not only for the sake of the country's territorial integrity, but also because of its favourable geographic location in the direct proximity to the major Asian economies (which all are the large energy importers), the ESFE eventually turned into the Russian government's top priority. In the late 2000s, Russia's Asian gas policy was reinforced by institutional changes of responsive, levelling-off and incentivising character, which reflected the logic of region-specific and sector-specific development. In the wake of the Ukraine crisis, however, Russia's institutional changes were stirred by rigid external politicisation of Russian energy. Russia's energy governance institutions are changing in a reactive (but not retaliatory) mode to adapt national energy sector to the restrictions imposed by Russia's major energy partners on its trade and investment. There has been a round of institutional changes, which by their origin (stirred in from outside versus evolved from within) and scope (universal versus targeted) can be referred to as *externally imposed.*

[16] RUSSIA. MINISTRY OF ENERGY. (2014) *Energodialog Rossiya – ES. 13ii Obobshchayuchii Doklad* [Energy Dialogue Russia – EU. 13th Summarising Report]. Moscow. [Online] Available from: http://minenergo.gov.ru/upload/iblock/ece/ecef70b71b1fe04742545dcd647ca0fa.pdf. [Accessed: 2nd February 2014]

Table 2: Russia's Energy Governance Institutions upon "Within – Outside" and "Universal – Targeted" Balance in Transformation

		Scope	
		Universal	targeted
Origin	stirred in from outside	**Responsive:** to seize the existing opportunities for the expansion of Russian energy business → to diversify energy export towards Asia: tax breaks for oil developed in ESFE; limited LNG export liberalisation since 1 December 2013; etc.	**Retaliating:** to protect Russia's economic interests that are being violated → to correct a partner's commercial discipline: termination of deliveries to non-paying consumer; price discrimination*; etc. **Imposed:** enforced by the unfavourable business environment deliberately created by once-partners → to assist national energy companies in solving financial limitations: provision of additional funds to national energy companies from the National Wealth Fund; creation of independent international payment system; etc.
	evolved from within	**Levelling-off:** to fulfil national development priorities (region-specific) → to revive ESFE: creation of wide range of developmentalist institutions in the region (free economic zones, zones of enhanced development, etc.); etc.	**Administrative:** to oversee development of key sector → to regulate the number and quality of industry players: licencing of explorative & extractive activities, etc. **Incentivising:** to enhance output (sector-specific) → to promote development of greenfields in ESFE & Russia's North, offshore and unconventional deposits: severance, property, profit and export tax exemptions, foreign investment, some mitigation of foreign investment regulation, etc.

Source: author.

Note: * - in interpretation according to theory of microeconomics.

As sanctions were imposed on Russia's energy majors – Gazprom, GazpromNeft, Lukoil, Surgutneftegaz, Rosnfet (BP owns 19.75%) and Novatek (Total holds 16.96%), it is acknowledged that the sector cannot avoid short- as well as long-term impacts. [17] Under the sanctions, the European and US companies are banned from importing equipment and technology, as well as providing services (drilling, geophysical and geological exploration, logistics, etc.), which can be used for development of the Arctic deposits, deep water and unconventional energy resources. There are about 200 service companies, 25% of the market is occupied by the international majors, such as Schlumberger,

[17] Neftegazovaya Vertikalj [Oil and Gas Vertical] [Online] Available from: http://www.ngv.ru/. [Accessed: 15th October 2014]

Halliburton, Weatherford and Baker Hughes. Schlumberger, for instance, downsized its business in Russia.[18]

ExxonMobil was forced to close immediately nine out of 10 joint projects with Rosneft.[19] Due to the environment protection considerations, some time was granted to wrap up ExxonMobil's operations in the Universitetskaya-1 project in the Kara Sea. Shell shelved its operations through joint venture with GazpromNeft (Khanty-Mansiiky Neftegazovy Soyuz, established in 2013), which was developing shale oil project in Khanty-Mansiisky Autonomous District.[20] While GazpromNeft intends to continue the project, Shell's drop-out would result in $2-3/ b higher costs. The prospects of another GazpromNeft-Shell JV - Salym Petroleum Development (established in 2003, develops shale oil of the Bazhenov Formation) is uncertain.

Concluded in the 1990s, production sharing agreements (PSA) - Sakhalin -1, Sakhalin – 2 and Kharjyaga, with ExxonMobil, Shell and Total, respectively - are not affected by the sanctions. According to the Russian Ministry of Energy, the PSA operators' gas production grew by 4.2 per cent and their share in total gas production was 4.1 per cent in 2013.

In recent years, there has been growing competition in Russia's gas sector. Novatek, a private company, has been active in increasing gas production and successful in marketing new LNG projects. In 2013, Novatek's output grew by 3.7 per cent, accounting for 7.9 per cent of Russia's gas production. In new circumstances of uncertainty, however, Novatek's potential partner Indian ONGC re-assessed the risks and abandoned its earlier plans to purchase a 9 per cent share in Novatek's Yamal LNG project.[21] Similarly, a number of other projects with IOCs' participation have seen significant alterations (Table 3).

[18] Shans na Evolyutsiyu [Chance for Evolution] *Kommersant.* 21st October 2014. [Online] Available from: http://www.kommersant.ru/doc/2593986 [Accessed: 21st October 2014]

[19] KLIMENTJEVA, L. (2014) ExxonMobile Svernula 9 iz 10 Sovmestnyh Proektov s Rosneftjyu [ExxonMobile Shelved 9 out of 10 Joint with Rosneft Projects] *Vedomosti.* 30th September [Online] Available from: http://www.vedomosti.ru/companies/news/34029091/exxonmobil-svernul-9-iz-10-sovmestnyh-proektov-s-rosneftyu#ixzz3FvjcuZGK [Accessed: 30th September 2014]

[20] DZYADKO, T., PODOBEDOVA, L. (2014) Rosneft Nashla Sposob Kompensirovat Zatraty na Daljnevostochny SPG [Rosneft Found a Way to Fund Dalnevostochny LNG] [Online] 23rd September. Available from: http://top.rbc.ru/economics/23/09/2014/542496dfcbb20feba0485f3a [Accessed: 29th September 2014]; DZYADKO, T. (2014) Shell Priostanovila Sovmestny Proekt s Gazpromneftjyu iz-za Sanktsy [Shell Stopped Joint Project with GazpromNeft over Sanctions] [Online] October 3rd 2010. Available from: http://top.rbc.ru/business/03/10/2014/542e9f90cbb20f6a1cb8c08c. [Accessed: 3rd October 2014]; KOGTEV, Y. (2014) Estl li Jiznj pod Sanktsiyami [Is There Life under the Sanctions] RusEnergy. 3rd September. [Online] Available from: http://www.rusenergy.com/ru/comments/comments.php?id=74181 [Accessed: 4th September 2014]

[21] Indiiskaya Goskompaniya Otkazalasj ot Pokupki Doli v Yamal SPG [Indian SOC Revisited its Plan to Join Yamal LNG Project] [Online] 20th September. Available from: http://slon.ru/fast/business/indiyskaya-goskompaniya-otkazalas-ot-pokupki-doli-v-yamale-spg-1163701.xhtml. [Accessed: 21st September 2014]

Table 3: Principal Developments in Russia's Gas Sector (as of the end of 2014)

Company	High Probability of Implementation	Uncertain Prospects	Scrapped Project	Recent Developments under Sanctions
Gazprom (GP)	the Power of Siberia (PoS), gas pipeline, max 38 bcm/y, commissioning 2018	the Altai, gas pipeline, 30 bcm/y, 2018 3rd train LNG plant Sakhalin II, 5 Mt/y	Vladivostok, LNG plant, 5 Mt/a (→15 Mt/y)	GP starts PoS construction; GP announces negotiations on Altai; GP abandons new LNG projects opting for less costly additional train under Sakhalin II, which IOCs oppose foreseeing additional costs and lower operating profit; GP retains monopolist position in pipeline sector; GP's main strategy is to expand gas export to China
Rosneft (RN)	Additional oil exports to China (up to 50 Mt/y)		Daljnevostochny LNG plant 5 Mt/a (→15 Mt/y)	RN seeks access for its 8 bcm/y gas from Sakhalin I to GP infrastructure; Federal Antitrust Agency is to make final decision; RN is affected by the bans and is less likely (compared to the prior to the sanctions) to succeed in its LNG strategy; oil may remain RN's major business in the short-term; China is RN's major and growing oil importer
Novatek (NT)	Yamal, LNG plant 15 Mt/y	Arctic 1, Arctic 2, Arctic 3, LNG plants		3 new Arctic LNG export projects approved 13.10.2014; NT is affected by sanctions, but is likely to proceed with its LNG business

Source: author.

While the Ministry of Economy estimates that the sanctions' all-out effect on the Russian economy will be seen in 2016-2018, the immediate negative impact has already been felt in the energy sector. This is due to two aspects: technology and finance. As far as technology is concerned, the government promotes the idea of import-substitution, but also considers some, limited to only uncontested necessity,

options for foreign machinery and technology purchases, most of all, from China.[22] A ban on borrowing in the international financial markets is another severe restriction for Russia's major energy companies. Gazprom, Rosneft and Novatek turned to the government for help in financing their investment programs. Rosneft, for instance, is seeking $42 bn. In 2013, its investment programme was around RUB 600 bn ($15.5 bn) and was expected to rise to RUB 730 bn ($17.8 bn) in 2014. Rosneft's total required investment in offshore exploration are estimated at $500 bn. Novatek applied for some RUB 100-150 bn ($ 2.5-3.7 bn). According to the Ministry of Economy, the government considers purchasing bonds issued by the sanctions-hit companies using up to 40 per cent of the National Wealth Fund. Externally, China is yet again assessed as the most probable lender to Russian energy companies either in the form of loans or through the upfront prepayments in the large-scale energy projects, as has been the case in several energy projects in the 2000s.

Overall, it appears that dramatically changed under-sanctions business environment interrupted Russia's move toward (limited) liberalisation in the sector of gas pipeline infrastructure, as well as LNG export. Rosneft was especially eager to get access to Gazprom's pipeline infrastructure in the Sakhalin Island in order to make its costly Daljnevostochny LNG project more viable. Under the sanctions, Rosneft considers the inclusion of Daljnevostochny LNG plant into the Sakhalin I PSA,[23] which is likely to be rejected by the partaking IOCs. Now, as Gazprom finds its earlier Vladivostok LNG plant unrealistic and intends to limit the new LNG plants construction to one additional train at the currently operating LNG project under the Sakhalin II PSA, it is certainly very reluctant to share the limited pipeline capacity of its own infrastructure with Rosneft, thereby avoiding to support a potential competitor in the same export markets. So far, Novatek's LNG strategy did not undergo drastic alterations, however uncertainty about financing, as well as downward oil price dynamics may cause some correction. In Novatek's Yamal project Chinese Sinopec holds 20 per cent. In line with statist thinking, the government has come to the rescue, assisting the affected businesses financially and logistically.

In the pipeline sector, after ten years of negotiations, Gazprom signed a US$ 400 bn contract envisaging a 30-year (starting from 2018) gas supply. The 21 May 2014 deal involves the construction of the Power of Siberia gas pipeline with an annual capacity of 38 bcm, for which an estimated US$ 55 bn of Russian and US$ 22 bn of Chinese investments are necessary.[24] In October 2014, Gazprom disclosed its negotiations with China on another, thought to be shelved for many years to come, pipeline project – the Altai - of annual capacity 30 bcm. This project, also known as the Western Route (vs. the Eastern Route, aka the Power of Siberia), was initially favoured by Gazprom, not least because some gas deposits and infrastructure have been developed along the prospective route (from the deposits in Yamal Nenets and Khanty Mansiisk Autonomous District through Tomsk and Novosibirsk

[22] PODOBEDOVA, L., DZYADKO, T., LEMESHKO, A. (2014) Neftyanym I Gazovym Kompaniyam Ukazali, Gde Zakupatj Novoe Oborudovanie [Oil and Gas Companies are Ordered where to Purchase New Equipment from] [Online] 17th October. Available from: http://rbcdaily.ru/industry/562949992671578 [Accessed: 19th October 2014]

[23] STARINSKAYA, G. (2014) Minenergo Sdelaet Vybor Mejdu Rosneftjyu I Gazpromom [Ministry of Energy Will Choose between Rosneft and Gazprom] Vedomosti. 29th September [Online] Available from: http://www.vedomosti.ru/companies/news/33792481/vybor-otlozhili#ixzz3FviKzkDM. [Accessed: 29th September 2014]

[24] *RIA Novosti* [Online] 21st May 2014. Available from: <http://en.ria.ru/russia/20140521/190004220/Russia-China-Ink-Historic-Gas-Supply-Deal.html>; *The Xinhua News Agency* [Online] 21st May 2014. Available from: <http://news.xinhuanet.com/world/2014-05/21/c_1110798887.htm> [Accessed: 21st May 2014]

regions, Altai Krai, Republic of Altai to China's Xinjiang region). Some (not many) experts claim that the Altai could turn Gazprom into a swing exporter, implying the possibility for Gazprom's manoeuvring by the flows of gas exports between Europe and China. Rather unexpectedly, given the significant volumes of contracted pipeline gas from Central Asia (Shadrina 2014b), China resumed its interest in the Altai project. Gazprom is enthusiastic about the agreement on the Altai to be sealed in 2015. There are estimates that the Altai has high chances to commence even before the (under-construction) Power of Siberia.

4. Russian Economy's Resistance in the Short-Run

Over January-September 2014, the rouble depreciated by 19 per cent and the Central Bank's foreign currency interventions caused Russia's foreign reserves decrease by 11 per cent (to $ 454.2 bn). During this period, the MSCI's Russia index fell by 25.328 per cent, whereas the decline in the developing markets averaged 2.59 per cent. 22.5 per cent drop in the Brent oil price together with the world geopolitical risks and ongoing conflict in Ukraine attributed to greater uncertainty about the Russian economy, according to Moody's, which downgraded Russia's rating to Baa2 with negative outlook on 18th October 2014.[25] The Ukraine crisis has undoubtedly started to take a toll on Russia.

4.1. Unfortunate Coincidence: Sanctions and Falling Oil Price

While the need for Russia's economy diversification is not questioned, the country's near future economic well-being almost entirely rests upon oil prices for two key reasons. First, the oil price defines the Russian government's ability to maintain its socio-economic guarantees at a certain level, going below which may lead to societal and political instability. Second, the oil price determines the Russian energy companies ability to expand their business in a more sustained, e.g., technology and innovation intensive, manner. This, in turn, sets the conditions for the future efficiency of Russia's energy sector and, given its multiplier role, Russian economy at large.

There is great speculation about the short-term dynamics of oil prices. The majority of expectations converge on the declining trend for oil prices, which is certainly a very negative development for the Russian economy. In this regard, two aspects, or rather their interplay, need to be attended. First, while a price under $90/b is generally comfortable for the major producers of conventional oil, such as Saudi Arabia, too low price is against the interests of the Middle Eastern governments, which need to remain watchful about Arab-Spring-like sentiments and maintain appropriate social guarantees to their populations. Second, while there is certain room of resistance at the US shale oil producers side (who are largely credited for the price fall as a result of created by them supply glut), too low a price will halt their unconventional energy businesses, because these require continues investments. Production costs of shale oil in the US vary significantly, ranging from $34 to 67/b and above. While some projects are likely to be shut down by low – under $90/b - oil prices, those with costs of around $53/b appear to be safe. Price at $76-77/ b are seen as comfortable for the US producers. Overall, the decline in oil prices is unlikely to continue for very long and is unlikely to result in extremely low prices. This may be

[25] *Vedomosti*. 19th October 2014 [Online] Available from: http://www.vedomosti.ru/ [Accessed: 20th October 2014]

comforting news for Russia, whose companies have significantly higher production costs (a result of severe climate, difficult geology and outdated equipment and technology, inefficient production management, etc.). Consequently their level of comfort is $90-95/b.[26]

In the current situation, Russia seems to have not many options, but to continue export diversification to the Asian energy market, restructuring its economy along this path. The Norwegian model of efficient energy export-based economy is respected in Russia; it is time to start this type of experiment on Russian soil (and offshore).

4.2. Weathering the Storm: China's Role

In the last several years, a number of large scale undertakings have progressed toward the beginning of exploration and extractive operations, but Russian energy companies are facing difficulties to fund their projects. Prior to the sanctions-caused pulling out, the IOCs' share in Russia's oil and gas sector output was estimated at about 1/4. The IOCs role in Russian FEC varies from being relatively unimportant (up to 20 per cent) in case of brownfileds to considerable 40-60 per cent for unconventional gas and oil projects and vitally significant 80-100 per cent in offshore production.[27] The newly launched projects have been arranged either through the borrowings in the international financial markets or FDI by the IOCs-partners of Russian energy companies. The sanctions eliminated both options. Moreover, the Russian business reacted by inflated capital outflow, which, according to the Central Bank, is likely to reach $ 90 bn for the entire 2014 and $ 35 bn in 2015. The Ministry of Economic Development assesses capital outflow at $ 100 bn for 2014 and $ 40 bn in 2015.

Shortage of capital is a serious problem, which Russia is attempting to solve through closer cooperation with China. Chinese financial institutions have been providing the loans and the NOCs have been practicing the upfront prepayments against the future deliveries to the Russian companies. While these channels will be continued in the future, Russia and China are moving into new areas of financial cooperation. In July 2014, Russia and China were among the initiators of another project in the area of international finance meant to decrease their reliance on the US dollar. Established by BRICS, the Asian Infrastructure Investment Bank (AIIB)[28] is hoped to assist in strengthening the investment activity in the member states.

So far, the Russian rouble has played a rather insignificant role in international transactions. According to the Bank for International Settlements, its share was a mere 0.9 per cent in 2010 and 1.6 per cent in 2013. The sanctions fortified Russia's sentiment for the de-dollarization of the national

[26] OVERCHENKO, M. (2014) Saudovskaya Araviya, na Kotoruyu Prihoditsya Tretj Nefi OPEK, Gotova k $80 za Barrelj [Saudi Arabia, Producer of 1/3 OPEC's Oil, is Ready for $80/b] *Vedomosti*. 14th October 2014 [Online] Available from: http://www.vedomosti.ru/companies/news/34673281/saudovcy-deshevo-sebya-cenyat [Accessed: 14th October 2014]

[27] VYGON, G. (2014) Rolj TEK v Rossiiskoi Ekonimike: Donor ili Driver Rosta? [FEC's Role in Russian Economy: Donor or Driver?] International Investment Forum Sochi 2014. 19th September. [Online] Available from: http://energy.skolkovo.ru/upload/iblock/c0f/Vygon_SOCHI_20140919_16x9.pdf. [Accessed 2nd October 2014]; VYGON, G. (2014) Chto Meshaet Rossiiskomu TEK Statj Dvigatelem Ekonomiki [What Prevents FEC from Turning Into Driver of Russia's Economy] 10th October. [Online] Available from: http://daily.rbc.ru/opinions/economics/09/10/2014/54352e30cbb20f621ee9fc01. [Accessed: 10th October 2014].

[28] PANDA, A. (2014) BRICS Announce New Development Bank. *The Diplomat.* 17th July. [Online] Available from: [Accessed: 18th July 2014]

economy and hastened practical steps toward that end. In this regard, China has been active demonstrating its utmost interest and readiness to support Russia in such a move. Russia and China have been practicing small scope trade settlements in their national currencies – rouble and yuan - since 2010. Now, the ruble-yuan trading volume is on a rise. In 2014, GazpromNeft switched to the ruble in oil exports to China.[29] Trade with other countries, such as Argentina, India, Turkey, and Vietnam and is increasingly expected to be mediated through a similar scheme.[30] Among 38 documents signed during Chinese Prime Minister Li Keqiang's visit in Russia in October 2014,[31] Russia and China signed an agreement to open a yuan-ruble swap line worth 150 bn yuan ($24.5 bn) for a period of three years (with prolongation possible following agreement of the two sides), which is to facilitate trade and investment.[32] Moreover, Russia and China are working on setting a new system of interbank transactions analogous to SWIFT, which Russia has been threatened to be denied access to. Addressing the Russian business' problem with access to the international Visa and MasterCard payment systems, Russia and China are involved in the creation of an alternative payment system.

Russia-China cooperation in the financial sphere is an illustration of bilateral cooperation for the sake of decreasing transition costs, which Russian energy producers face as a result of imposed diversification towards new markets (direct outcome of a chronic inconsistency between Russia's and the EU's energy institutions) and denied access to the international institutions for trade and investment (direct outcome of the sanctions).

5. Conclusion

Russia's energy governance can be perceived as a three-tier - national, regional, and business – phenomenon. Without a doubt, to reach a satisfactory extent of institutional cohesiveness at a national level, the counterparts need to engage in a coordinated transformation. In other words, the changes need to be unidirectional - advancing liberalisation or vice versa promoting regulation. Interestingly enough, Russia has been putting in place a system of *limited liberalisation* oriented mainly toward Asia, but remains reluctant to change its traditional energy institutions toward the West. This certainly has a reason behind. In the East, Russia has been working literally from the white sheet, while approaching a new gas market; it could use a more flexible approach. In the West, Russia has been kept hostage of huge sunk costs of existing Europe-oriented gas pipeline infrastructure. It appears that Russia's position could be much better secured provided it had some formal legally binding institutions. The latter are

[29] RIA NOVOSTI. (2014). *Gazprom Neft' Continue to Supply Oil Abroad for non-Dollar Currencies.* [Online]. October 2014. Available from: http://en.ria.ru/business/20141003/193625509/Gazprom-Neft-To-Continue-Oil-Supplies-Abroad-For-Non-Dollar.html. [Accessed: 4th October 2014]

[30] RIA NOVOSTI. (2014). *Putin: Russia Needs True Breakthrough in Coming Years.* [Online]. October 2014. Available from: http://en.ria.ru/russia/20141002/193557056/Putin-Russia-Plans-No-Restrictions-on-Capital-Flow.html [Accessed: 4th October 2014]

[31] STARINSKAYA, G. (2014) Soglashenie o Postavkah Rossiei Gaza v Kitai Vstupilo v Silu [Agreement on Russia's Gas Deliveries to China Enacted] *Vedomosti.* 14th October [Online] Available from: http://www.vedomosti.ru/companies/news/34673251/ostalos-tolko-dobyt-gaz#ixzz3G57ox2x2 [Accessed: 14th October 2014]

[32] KRAVCHENKO, E. (2014) Bank Rossii Zaklyuchil Valyutny Svop s CB Kitaya na $24.5 bn [Bank of Russia Concluded $24.5 bn Swap with Bank of China] *Vedomosti.* 14th October [Online] Available from: http://www.vedomosti.ru/finance/news/34673731/rubl-menyayut-na-yuan#ixzz3G4zlQmaG [Accessed: 14th October 2014]

preferable, as they make the cost of politicisation high and that is exactly why Russia attempted to initiate the Conceptual Approach to the New Legal Framework for Energy Co-operation in 2009[33] and proposed a Convention on International Energy Security in 2011.[34] This demonstrated Russia's willingness to be a party in a system of formal institutions for the international energy governance. The division however happened over Russia's and the West's failure to bridge their differences on the treatment of energy security as a two-faceted phenomenon: security of demand for Russia and security of supply for the EU. The institutional complexity of Russia-EU energy relations is aggravated further by a third party factor – Ukraine, which is Russia's major transit link with the EU. Ukraine has clearly *opportunistic* type of energy institutions. Maintaining transit relations with Ukraine in its current form would further increase transaction costs for Russia and the EU and preserve their perpetual exposure to the imminent risks. Eliminating the risks associated with transit, e.g., clearing energy relations with the EU off a third-party factor appears to be a sound choice for Russia.

In Asia, looking beyond short-term benefits, Russia needs to adopt a more proactive policy. For instance, Russia needs to assess the possibility of joining the becoming-regular LNG buyers meetings of Japan and India (South Korea and Singapore are also invited to participate) and LNG producer-consumer conference by Japan, India, Singapore, Taiwan, Thailand, Australia, UK, US, and others, where a common strategy for LNG pricing, as well as the aspects of LNG transportation, infrastructure, etc., are being discussed. Russia also would benefit from establishing a connection with a newly launched by the energy research institutes of Japan, China and South Korea energy cooperation initiative, where LNG trade and unconventional gas production are discussed, among other topics. Asian gas consumers have dramatically intensified information exchange, which is a principal step toward structuration of unconnected regional gas markets. In the pipeline segment, Russia may benefit from closer re-examination of its ability to address Japan's and South Korea's interest in setting gas pipeline links with Russia (Shadrina 2015). With China, Russia needs to understand the scope of China's potential demand for Russian gas. Frequently circulated assessment that China does not need significant volumes of Russian Altai's gas in its west because of the Central Asian deliveries, while China's east is not developed enough to receive the volumes Russia would be interested to ship in order to make the project Power of Siberia feasible, seems to be lacking plausibility. Otherwise, why would China have resumed negotiations on the Altai project? Gauging China's interest in more precise form would help Russia define its price and pricing strategy vis-a-vis China.

Domestically, Russia, like many other energy exporters, faces "efficiency – equality" trade-off. Notorious inefficiency of the Russian energy sector, in all its segments and throughout different stages of value chain, is acknowledged.[35] However, purely rational approach to resource management that embraces abolition of export levies, tax holidays and so on, is likely to compromise the government's

[33] Conceptual Approach to the New Legal Framework for Energy Cooperation (Goals and Principles). April 2009. [Online] Available from: http://archive.kremlin.ru/eng/text/docs/2009/04/215305.shtml [Accessed: 3rd October 2009]

[34] Statement by H.E. Mr. Sergey V. Lavrov, Minister of Foreign Affairs of the Russian Federation, at the 66th Session of the UN General Assembly, 27th September 2011 [Online] Available from: *http://www.rusmission.org/policy/36. [Accessed: 6th December 2011]*

[35] MOE, A. (2014) Russian Oil: Challenges and Possibilities. p. 17-19; HENDERSON, J. (2014) Domestic Gas Sector in Russia – Gradual Progress towards a Competitive Market. p. 23-25, in *Forum*. The Oxford Institute for Energy Studies. August. [Online] Available from: http://www.oxfordenergy.org/wpcms/wp-content/uploads/2014/09/OEF-97.pdf. [Accessed: 5th October 2014]

ability to maintain the existing safety net thereby jeopardising rather fragile social stability.[36] Also, the energy sector is seen as a driver for regional economies' development; especially so in the case of the ESFE.

A result of sanctions, Russia observes a phenomenon of "politically motivated" diversification (Kashcheeva and Tsui 2014), which differs for small firms mainly operating in the spot market and large companies with backward vertical FDI. The former adjust their trade transactions swiftly, while the latter tend to adhere to term contracts in the short run, but modify their long run strategies. It is unfortunately very improbable that the Ukraine crisis will not have repercussions for Russian energy sector, but in order to lessen the related hazards it is important for the Russian government to maintain its pre-sanctions energy policy without any drastic changes in its major course. The IOCs need to build certain assurance about Russia's government intention to respect the concluded agreements and adhere to the energy policy institutions at least not less IOC-friendly than prior to the sanctions. Any retaliatory measures turned against the IOCs (such as nationalisation of foreign assets, which is being discussed in Russia's Duma, for instance) will effectively, and for many years to come, divert vital foreign expertise and capital from the Russian energy sector.

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[36] MAKAROV. A., Director of Energy Research Institute of Russian Academy of Sciences, Talk at The 11th Moscow International Energy Forum "Russian Fuel Energy Complex in the 21st Century". Moscow, 8-11 April 2013. Available from: http://www.mief-tek.com/. [Accessed: 2nd February 2014]

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