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**The UK & Russia -
A Troubled Relationship
Part I**

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The UK Russia – A Troubled Relationship

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Key Points

- * The fatal poisoning of Alexander Litvinenko and the controversial statements by Boris Berezovsky have brought the UK-Russia relationship to an important moment.
- * An increasing tension is emerging between, on one hand, a UK-Russia political relationship that is short of mutual confidence – and as a result appears to be deteriorating – and a developing professional and technical-level engagement, especially in business and energy relations, on the other.
- * There is an important shortage of expertise and resources devoted to the development of the state to state relationship. This reflects the fact that neither party has been a priority for the other.
- * Serious “values” differences exist between the UK and Russia which undermine the political relationship. London and Moscow espouse different approaches to society, London supporting a bottom up approach, encouraging civil society, Moscow preferring top down control of societal development.

The UK & Russia – A Troubled Relationship Part I

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The United Kingdom and Russia: A Divergent Relationship?

Dr Andrew Monaghan

Under apparently constant tension, the United Kingdom (UK)-Russia relationship presents a paradoxical and interesting picture. The relationship is of strategic significance for both parties – and in many ways reflects a growing partnership following the confrontation of the Cold War. And yet it is beset by a series of important problems which serve to undermine the confidence of both parties in each other. As such, it is reflective of the wider EU-Russia relationship which also shows traits of growing partnership – underscored by positive official statements – and yet tumbling political and popular confidence reflected in dramatic media headlines. Other comparisons being made are also telling, for instance those with the evolving US-Russia relationship. As one commentator recently noted, though the USA is usually “the main target” for “Soviet-style paranoia about foreigners”, Britain is beginning to take “a prominent role in this line of public propaganda too”. This has included criticism of the BBC’s reporting of Russia and articles “gloating over the British hostages captured by Iran”.¹

Unlike the EU-Russia and US-Russia relationships noted above, however, the UK-Russia relationship remains under-explored. If the headlines are eye-catching and reveal certain aspects of it, this is the tip of the iceberg, both in terms of the cooperation and even the difficulties in the relationship. What are the key drivers in the relationship? What cooperation has there been? What obstacles to progress are there?

The UK-Russia relationship is built on established cooperative projects across a broad spectrum. The Department for International Development (DfID), though now withdrawing from Russia, has sought to provide support for the Russian government by funding more than 800 projects to sustain and develop education, health, social care and governance in Russia since the early 1990s. As the UK’s Ambassador to Russia Anthony Brenton has stated, DfID is a “good example of how well the UK can collaborate with Russia on practical matters”.² The UK is also active in other areas, funding Non-Governmental Organisations (NGOs) and supporting projects in Russia as part of the UK Global Partnership Programme (GPP), including the completion of a £21 million storage facility for spent nuclear fuel in Murmansk. Officially opened on 29 September 2006 by HRH Prince Michael of Kent, the facility will hold approximately 3 tonnes of highly enriched fuel for up to 50 years. The GPP has also supported the dismantling of two Oscar I class nuclear submarines at Zvyozdochka shipyard (and recently a Victor III class submarine in cooperation with Norway), contributions to international projects both to enhance nuclear waste storage at other sites and provide sustainable infrastructure to assist other donors to dismantle submarines more efficiently, and non-weapons employment for some 1,000 former nuclear weapons scientists and technicians. The UK has also contributed to the high priority projects to support Shchuch’ye Chemical Weapons Destruction Facility. Additionally, the UK, in cooperation with Canada, will assist in the construction of a chemical weapons

destruction facility at Kizner. The official documentation states that this programme is “now the UK Government’s largest in Russia ... and is delivering real progress on the ground to enhance the safety and security of [weapons of mass destruction] WMD-related materials”. It also points to the evaluation by Chatham House which found the programme to be “well-focused” and making a significant impact on addressing the priorities identified by leaders at the G-8 Kananaskis summit in 2002.³

The chapters in this volume show that such bilateral cooperation is in fact widespread across military, trade and energy dimensions of the relationship. Military cooperation, as outlined by Peter Williams, is driven by the UK’s “Bilateral Programme of Military Activities” which works under the 1997 UK-Russia Memorandum of Understanding (MOU). It was highlighted by the UK’s involvement in the rescue of a Russian submersible, an incident described by Ian Riches, who led the UK rescue team, and one which provided a positive background to President Putin’s visit to the UK in 2005, facilitating a range of other agreements.

UK-Russia engagement is also clearly exemplified by economic and business interaction: the trade relationship amounts to some \$10 billion per year and is growing. As noted by Andrew Gavan in chapter 7, UK companies have invested heavily in Russia. 23 Russian companies are trading on the London Stock Exchange (LSE), with more seeking to list. The energy sector is an area in which there is particularly important engagement, though it has been complex and at times troubled, as argued by Julian Lee and Nazrin Mehdiyeva in chapters five and six. Alongside significant UK interest and investment in the energy sector in Russia, most clearly Shell and British Petroleum (BP) in the oil and gas sectors, Russian companies are also seeking access to the UK market. Indeed the UK gas market is a priority for Gazprom, which has bought a small trading company (which provides electricity to several high-profile clients) and is considering cooperating with UK energy producers to build gas fired power stations in the UK.⁴

Engagement in the energy sector extends into the coal sector. The Russian coal producer Kuzbassrazrezugol is cooperating with Richard Budge in a venture to the value of nearly £1 billion to re-open Hatfield colliery and build a clean coal power station close to the mine.⁵ The UK has also been active in the Russian coal sector, exemplified by a DTI supported technology transfer project to examine the key issues affecting coal mine methane and abandoned mine methane project development.⁶ The UK currently imports little Russian oil and gas, but Russia has become the dominant source for imported coal, providing over 50% of UK steam coal imports. Given that the UK relies on imports for nearly three quarters of its steam coal, this engagement is clearly important. Interestingly, in contrast to the oil and gas sectors, where there is some concern in the UK (as in Europe more broadly) about increasing dependence on imports of oil and gas from Russia because of its potential political unreliability and/or technical inability to fulfil its export commitments, Russia is considered a *reliable* coal supplier - though there are some concerns about Russia’s attempts both to diversify its coal exports and increase the percentage of coal in its domestic energy mix thus reducing the amount of coal available for export.⁷

Yet, apart from the brief glimpse following the rescue of the Russian submersible in 2005, it is the tensions in the relationship that have tended to dominate attention, a trend which has gained strength during the last nine months. During the last three to four years, the UK and Russia found themselves politically at opposite ends of the spectrum over issues such as the break up of Yukos (and the related court proceedings against Mikhail Khodorkovsky) and the “Orange revolution” in Ukraine. Economically, they have also espoused opposite ends of the spectrum, with London

propounding more liberalised energy markets while Moscow supports state-influenced energy monopolies such as Gazprom. Yet it is the pressure on the relationship caused by the fatal poisoning of Alexander Litvinenko in London in autumn 2006 and the (continuing) asylum given by the UK to Boris Berezovsky which have brought the relationship to an important moment.

According to one commentator, Litvinenko's poisoning shook Western thinking about Russia "like nothing else since Chechnya and encouraged a return of the Cold War". As such, it was the "most serious blow to (Russia's) partnership with the West". Despite the fact that the poisoning was a very murky and complex affair, UK journalists, parliamentarians and ministers tended to focus on the issue of whether the Russian state was involved directly or whether it was "rogue elements".⁸ Though not commenting on the Litvinenko poisoning directly, it provided an opportunity for Peter Hain, Minister for Northern Ireland, to state that Putin's success in rebuilding Russian economic stability is obscured by "huge attacks" on individual liberties and democracy. He also stated that the UK's relationship with Russia was "tricky".⁹ Parliamentarians also noted the need to resolve the question of the involvement of the Russian state. David Davis argued that "if it was [involved], given that a British citizen who had been given asylum and was ... under UK government protection may have been murdered on UK soil, it has enormous implications for relations between the UK and Russia".¹⁰

John Reid, the Home Secretary, remained cautious in the aftermath of the poisoning and Litvinenko's subsequent death. Nonetheless, Russian Ambassador Yurii Fedotov was called to the FCO on 24 November and asked to convey to the Russian authorities the UK government's expectation that they should be "ready to offer all necessary cooperation to the investigation". Prime Minister Blair also weighed in, stating that there would be "no diplomatic or political barrier in the way of that investigation going where it needs to go" and reiterating the point that the UK government expected "full cooperation" from the Russian authorities.¹¹

The medium-to-long term impact of the poisoning of Litvinenko on the UK-Russia relationship remains unclear. Nonetheless, it has raised to the fore a series of inter-related long-running strains in the UK-Russia relationship. First, broadly speaking, for many in the UK, it simply confirmed their impressions of Russia and the political trend back to the bad old days of the Soviet Union and the Kremlin wielding power – usually rather tenuous links were made with a number of Soviet assassinations using poison. A certain shorthand way of thinking about Russia has become more entrenched. To be sure, many of these myths are based in kernels of truth, but as Henry Plater Zyberk illustrates in chapter one, there is a highly complex situation in Russia. The complexity and dynamism of the political and economic situation in Russia is reiterated by Mehdiyeva in her in-depth examination of the events surrounding Gazprom's acquisition of a controlling stake in the Sakhalin II operation – another issue frequently distorted by shorthand understandings. It is important to maintain an equally dynamic understanding of this complex situation rather than slip into assumptions of "typical" Russian (or, worse, even Soviet) behaviour, as such assumptions merely serve to cloud our understanding of the real aims and intentions and therefore our ability to approach them effectively.

Second, it began to bring to the fore once again the issue of extradition, which Edwin Bacon examines in chapter two. This is an important thematic issue for the UK-Russia relationship, as discussed below. But it is of note that UK parliamentarians made a clear link between Litvinenko's poisoning and the UK's position on extradition to Russia. Chris Bryant sought to confirm that the

poisoning, and a subsequent meeting between the UK's Director of Public Prosecutions and his Russian counterpart, would not mean that the UK's extradition arrangements with Russia would be changed. The Home Secretary confirmed that extradition decisions "either in the individual case or in our conduct of general judicial proceedings" would continue to be "conducted without reference to political influences bearing on them".¹²

Moreover, the poisoning has had its own impact and exacerbated tensions in new ways. The investigation has not gone as smoothly as possible, with both sides noting that the other could cooperate more effectively. In December, UK investigators were still refusing to rule out the possibility that Litvinenko was killed as the result of a politically motivated conspiracy involving Russian security services. But Russian officials continued to deny any involvement and Sergei Lavrov, Russian Foreign Minister, replied by warning that the uproar in the UK and the "politicisation" of the issue was "damaging our relations".¹³ At the same time, some on the UK side were noting that Russian assistance fell significantly short of what was expected.

Such disagreements have continued into 2007 – Russian officials sought to conduct their own parallel investigation, including a visit to the UK led by Russia's Deputy Prosecutor General, Alexander Zvyagintsev, to interview some 100 people and examine a number of sites. However, Russian prosecutors have accused the UK of failing to provide appropriate cooperation, indeed that Russia had not been given the same level of cooperation as the UK investigation had received while it was in Russia. Foreign Ministry spokesman Mikhail Kamynin noted in February 2007 that the UK's delay in reply to Russia's request to visit the UK caused "regret, especially against the background of the readiness displayed by the Russian side for swift and constructive cooperation in this question at the professional level". Zvyagintsev also stated that requests for UK cooperation were being slowed down by officials from Scotland Yard, the Crown Prosecution Service and the Home Office. He too argued that Russia had not been afforded the same level of cooperation as the UK investigation in Russia in 2006. Yet there was continued speculation that Russia had not been forthcoming in their assistance, preventing interviews with two key people, Andrei Lugovoi and Dmitry Kovtun.¹⁴ Indeed, in January Ambassador Brenton had again urged Moscow to cooperate fully with the UK's investigation.¹⁵

In the wake of the investigations into the Litvinenko poisoning, another long-term issue has again come to the fore in its own right – the extradition of Boris Berezovsky. Berezovsky's widely publicised statements in a UK newspaper that he was preparing a revolution to bring down President Putin by force have generated further tension in the relationship. Russia's Ambassador to the UK stated that the "absence of a reaction [by the UK government, i.e. withdrawing his asylum status and facilitating his extradition] would have some impact on bilateral relations" and produce a "new situation" in the relationship.¹⁶ As with the poisoning of Litvinenko, the full ramifications for the UK-Russia relationship of Berezovsky's statements are unlikely to be clear for some time.

Nonetheless, it comes at a time when there are a series of other problems in the relationship, for instance the harassment of the UK Ambassador in Russia following his attendance at a conference organised by the Russian opposition. The FCO lodged a formal protest about the activities of the pro-Kremlin group Nashi, whose activists have followed Ambassador Brenton and his family, heckled his speeches and protested outside the UK's embassy in Moscow.

Indeed by May 2007, the UK-Russia relationship has come to look more contradictory than ever. Growing engagement in a number of important areas sits

alongside a deteriorating political relationship, with Russia reiterating its concerns about the UK's political "double standards" in their approach to Russia, and the UK concerned both by increasing Russian assertiveness on the world stage and government assertiveness domestically.

Attempts to rekindle the relationship have seen an increasing number of visits by senior officials and businessmen on both sides. Indeed the first UK Cabinet-level visitor to Russia since September 2006 took place in February as Alistair Darling led a top level business delegation. This was followed in early April by another senior business delegation led by the Lord Mayor of London. Senior Russian officials have also visited the UK.

But shortly after Darling sought to re-invigorate UK-Russia energy relations and create a UK-Russia energy forum, hailed the tripling of bilateral trade over the last five years and announced that the UK was the leading investor in Russia in 2006,¹⁷ The Guardian – the same newspaper that published Berezovsky's statements – argued that worsening relations have "unnerved the UK business community". It cited a poll which showed that some 30% of UK business leaders said that the rapport between Britain and Russia was either 'difficult and getting worse' or "strained and unfriendly'. Nearly 50% consider further Russian investment in Britain as a "bad thing", according to the poll.¹⁸ It is of note that the newspaper sought to highlight what is a minority figure – read alternatively, one could understand that some 70% did not think along these lines and a majority did not consider increasing Russian investment a bad thing.

Nonetheless, this report was released on the eve of the London Economic Forum held in April, an event which was clouded by a partial boycott of senior Russian figures. The boycott which was considered by many to be politically motivated move on the part of the Kremlin underscoring the deterioration of the relationship,¹⁹ though some commentators stated that a decrease in Russian involvement had become increasingly likely over the last few years since the Forum was often used to "launch broadsides at the Russian government", thus increasingly infuriating the Kremlin.²⁰

Four interlinking problems in the UK-Russia relationship emerge, some obvious to those who follow the subject, some less frequently highlighted. First, there is a clear values difference between the UK and Russia. Obvious perhaps, this is nonetheless a key theme. Simply, the governments approach their societies in opposite ways: the UK seeks to support a bottom-up approach to a civil society, Russia increasingly adopts a policy of top-down societal organisation. The difference is illustrated by the UK's support for NGOs in Russia, while Moscow has introduced legislation seeking to restrict financing and registration of NGOs, particularly those benefiting from foreign funding. The direct impact on the relationship was illustrated in the re-opening of criminal investigations by Russian prosecutors into the activities of the British Council in St. Petersburg, as the funding of NGOs was linked to espionage by British citizens in Russia. The UK refuted the allegations and stated that it was evidence of the Kremlin's opposition to NGOs, especially ones which promote democracy.²¹

Second, and linked to this, domestic politics in each state has important ramifications which produce direct and indirect problems for the relationship. The two societies are structurally very different, particularly with regard to the separation of powers. The importance of this for the UK-Russia relationship is most clearly reflected in the independence of the UK judiciary system and courts, a situation clearly different to the structure of Russian society. Again, this is perhaps

an evident point, but again its impact on the relationship is tangible: the Russian government has frequently demanded that the UK government facilitate the extradition of certain exiles, particularly Berezovsky and Zakayev. As Bacon argues, the refusal of the UK government to sanction this has been an ongoing sore. The UK government's response is that this is a decision for the courts, which are independent. The gap opens since the Russian courts are not independent from government influence and therefore the Russian government approaches the question of extradition differently. The direct impact of different values approach and societal structure is that the UK courts refuse to allow the extradition of Berezovsky – on the grounds that the evidence is not sufficient, and particularly more recently that he would be unlikely to receive a fair trial in Russia – is a tension in the UK-Russia political relationship.

The indirect twist to this is that it highlights the importance of internal domestic decision-making processes for the relationship. A number of the problematic issues have arisen because of the complexity of the domestic decision-making structures on both sides, rather than a direct clash of interests between the UK and Russia, though this has sometimes been the upshot. On the UK side, for instance, the courts not only have the irregularities of Russia's judicial system in mind when they refuse to allow extradition, they also seek to defend their independence from the UK government as a point of principle in UK domestic politics. In Russia, as Mehdiyeva points out, there is a complex clash of ministerial and personal interests, among other factors, which contributed to the Sakhalin II episode. Thus the acquisition of a controlling stake in the operation was in part a result of internal Russian politicking, rather than some direct assault on the UK interest in Russia. The withdrawal of senior Russian officials from the London Economic Forum this year is another example, since important domestic decisions were about to be made in Moscow and therefore many of these people saw the importance of being as close to the decision-making as possible, i.e. being in Moscow. The point here is not that the external relationship is irrelevant – it is relevant – but to note that there are usually a number of other, additional underlying factors.

Other domestic factors include a lack of expertise and resources. As Bacon points out in chapter two, since the departure of David Manning to Washington, there has been a certain reduction of expert emphasis on Russia at the core of UK decision-making. As Williams points out in chapter three, a shortage of funding for the UK's defence diplomacy undermines the potential for developing the relationship. This of course reflects the fact that both parties have many other priorities to which to attend, and the resources dedicated to each other and the UK-Russia relationship more broadly have been wound down. Simply, Russia has not been a key priority for the UK since the end of the Cold War, and neither has the UK for Russia.

Stemming from this, a top level political connection to draw together the many strands of the relationship together and provide support during moments of tension is lacking. As Bacon argues, the relationship at this level relied heavily on the personal rapport between Prime Minister Blair and President Putin. When this began to unwind, the relationship lost an important driving factor. Bacon concludes that new leaders on both sides are needed to provide this impulse – a point which reflects the importance of the moment in the relationship, since both are due to stand down by summer 2008.

A final point is the impact of the media, reflected in two ways. First, the media's approach to Russia has tended to highlight certain issues, the poisoning of Litvinenko being perhaps the clearest recent example, rather than the less eye-catching project development. However, as Plater Zyberk points out, too often a critical approach to information is lacking and in consequence the complexities of

such issues are frequently overlooked. Other commentators have also questioned the media's approach in the Litvinenko case, which strongly pushed an anti-Kremlin line, despite evidence of "news management", stating emphatically (prior to Litvinenko's death) that "(S)eldom has an attempted assassination been so exclusively reported on the basis of information provided by closely involved parties".²² This, as noted above, creates the broader atmosphere in which the relationship develops, influencing those who take part. The media has another important impact also – much of the criticism of the British military in Russia draws directly on UK media sources.

In August 2006, following the spy scandal of January 2006, Ambassador Brenton firmly stated the strength of the relationship – one which was "too strong to be damaged by such silly allegations".²³ The evolution since then tests Brenton's statement as the apparent gap between the developing relationship and falling confidence grows. Yet the tensions which have undermined confidence in the relationship have also pushed Russia back up the list of priorities for the UK as the relationship reaches an important time for both parties. How the different parties respond to the situation becomes increasingly important. The approach of both the UK government and UK business appears to have been to attempt further engagement. Nonetheless, engagement clearly needs to be more coordinated and robust – and as Gavan notes in the case of business – it must evolve to meet the dynamic situation in Russia. This is a context in which Russia will seek to defend its own interests but also seek to engage partners.

This volume adopts a dual focus approach to examine three key dimensions of the UK-Russia relationship: political, military and energy and business. These three dimensions are examined both in "close up", providing a detailed analysis of key events or subjects (Litvinenko, the rescue of the AS-28 and Sakhalin II), and in wider lens, assessing and analysing the relationship in each dimension more broadly. It thus attempts to come to grips with the three key questions outlined at the beginning of this introduction. What are the key drivers in the relationship? What cooperation has there been? What obstacles to progress are there?

Endnotes

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² DfID is withdrawing because of its global policy of withdrawing from "middle income countries" to focus on the poorest countries. See Press Statement Britain Celebrates its Partnership with Russia in the Development Sphere. 13/03/07.

<http://www.britishembassy.gov.uk/servlet/Front?pagename=OpenMarket/Xcelerate/ShowPage&c=Page&cid=1089123753173&a=KArticle&aid=1173560311342>

³ For a full list of cooperative projects under the umbrella of the GPP, see the Third and Fourth Annual Global Partnership Reports, (2005 & 2006 respectively), prepared by the Foreign and Commonwealth Office (FCO), which has the overall policy lead, the Department of Trade and Industry (DTI), which is responsible for managing the nuclear elements of the programme and the Ministry of Defence (MOD), responsible for the chemical and biological projects. The Third annual report can be found at

<http://www.dti.gov.uk/energy/environment/soviet-nuclear-legacy/annual-report-english/page19047.html>; the Fourth at <http://www.dti.gov.uk/energy/environment/soviet-nuclear-legacy/annual-report-english/page19047.html>

⁴ "Russians Plan UK Power Stations", *The Observer*, 15 April 2007.

⁵ www.dti.gov.uk/files/file31397.pdf, 27 June 2006.

⁶ www.dti.gov.uk/files/file19910.pdf, 5 April 2005.

⁷ For discussions of the concerns about Russian reliability as an energy supplier, see this author's *Russia and the Security of Europe's Energy Supplies: Security in Diversity?*, CSRC

paper 07/01, January 2007. For an examination of the coal sector, see this author's forthcoming *Stakhanov to the Rescue? The Troubled Emergence of a Russian Energy Strategy*, CSRC paper, forthcoming, summer 2007.

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¹² *Hansard*, 27 November 2007.

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¹³ "Russia Warns Over Relations with UK", *Financial Times*, 4 December 2006.

¹⁴ Nonetheless, UK investigators were allowed to sit in on interviews conducted by Russian authorities.

¹⁵ See, for instance, "Russia Says Britain Delays Response on Litvinenko Poisoning Probe", *Mosnews*, 8 February 2007.

<http://www.mosnews.com/news/2007/02/08/complaintdelay.shtml>; "Russia Says UK Authorities Hinder Investigation Into Litvinenko Poisoning", *Mosnews*, 12 March 2007.

<http://www.mosnews.com/news/2007/03/12/ukhindrance.shtml>

¹⁶ "Diplomatic Rift as Russia Says: Give us Berezovsky", *The Guardian*, 19 April 2007.

¹⁷ Press Release – British Cabinet Minister Makes Case for Greater UK-Russian Trade. 6 February 2007. Darling pointed to the growth in bilateral trade of some 20% per year and in the first nine months of 2006 alone, the UK invested \$5.5 billion.

<http://www.britishembassy.gov.uk/servlet/Front?pagename=OpenMarket/Xcelerate/ShowPage&c=Page&cid=1089123753173&a=KArticle&aid=1170252008837>

¹⁸ "Russians Boycott London Forum as Ties Worsen", *The Guardian*, 23 April 2007.

¹⁹ Russian politicians, businessman to boycott London economic forum, *FX News Limited*, 20 April 2007.

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²⁰ "Business Chiefs Suppress Bark at Russian Economic Forum", *EUBusiness*, 23 April 2007 <http://www.eubusiness.com/SMEs/eu-russia.41/>; "Rossiiskii ekonomicheskii forum v Londone proshol pri minimalnoi yavke", *Kommersant*, 25 April 2007.

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²¹ "Russia Reopens Probe of British Council", *Financial Times*, 24 January 2006.

²² "Chechnya, Vendettas – UK Hosts inter-Russian Spy War", *Inside Russia and Eurasia*, Vol.15, No.12, December 2006.

²³ Internet conference with UK Ambassador Anthony Brenton, 3 August 2006.

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Misunderstanding Russia: Alexander Litvinenko

Henry Plater-Zyberk

Almost every anti-Putin conspiracy theory is given a wide media coverage in the UK, with few attempts to analyse it or test the credibility of its suppliers. This serves to warp our views of modern Russia and perpetuate politically heavy, yet evidence-light myths about it. Thus our understandings of the complex evolution of Russia both internally and as an actor on the international stage remain clouded. The murder of Aleksander Valterovich Litvinenko showed most of the UK media at its worst. Emotion and oversimplifications ruled the airways and daily papers. The stories provided by Litvinenko's friends and supporters, all of them highly critical of Vladimir Putin, dominated the coverage. They were largely accepted without their veracity being checked. Serious errors and inconsistencies thus crept in: indeed one newspaper even made Putin a former "close colleague of Litvinenko".²⁴ This chapter seeks to clarify the picture by examining Litvinenko's background and his relationship with the Russian authorities. This is an important issue: it was partly Litvinenko's statements about his involvement in what he claimed to be a planned assassination attempt on Boris Berezovsky that led to Berezovsky being awarded political asylum in the UK. Given the tensions between Moscow and London, particularly over the extradition of Berezovsky, it is crucial that we understand the complexity of the situation and Litvinenko's role.

Litvinenko's service in an elite Interior Ministry unit and subsequent work for the KGB and its inheritors has been presented as a somewhat misguided attempt of a naive young man to improve the world. We were told that he was a model spy,²⁵ although he never worked for any intelligence organisation. In 1985, Litvinenko joined the elite Dzerzhinsky Division of the Ministry of Internal Affairs (MVD) and was assigned to its 4th company, tasked with foreign missions, usually protecting valuable cargo.²⁶ Those who joined the Soviet elite units in 1985 were fit, well trained and were from ideologically reliable families. Litvinenko's family served the system well, a factor curiously downplayed by our media. His grieving father described himself as former MVD captain who worked with mentally disturbed prisoners in Russia's Far East but resigned his commission in 1979, after clashing with his superiors defending someone's human rights. He was able to "retrain" as a psychiatrist.²⁷ No one asked him who in the USSR would give him the opportunity to retrain as a psychiatrist, at the age of 42, after a disagreement with the MVD and who was his employer after that.

Alexander Litvinenko joined the KGB in 1988. However, he had started his unofficial KGB career prior to this, when he was recruited as an informant by his MVD battalion's KGB counterintelligence section.²⁸ In the mid 1990s, like some of his colleagues in security and law enforcement bodies, he began to moonlight for one of Russia's richest and most influential oligarchs, Boris Berezovsky. It was not legal but it was sometimes the only way the state could retain its underpaid security personnel.

In the West, Litvinenko was never asked Mrs Merton's question: "What attracted you, a Federal Security Service officer, to a controversial millionaire?" The two men met in 1994, when Litvinenko took part in the investigation of an assassination attempt on Boris Berezovsky. By 1997, when he joined the FSB Directorate of Analysis and Suppression of Criminal Groups, he had also had a part-time job as a security man for Berezovsky.

Which country would not investigate one of its security officers if he began to moonlight for one of the most controversial businessmen in the land? In Russia such investigations were selective and targeted only at those who stepped out of line. Litvinenko became one of them when in March 1998 he informed Berezovsky that in December 1997 he received an order to kill him. Why did he warn Berezovsky about the threat only in March 1998? Who exactly gave the order and how? It certainly was not Putin. In March 1998, the FSB was not headed by him but by General Kovalev. About eight months later, on 23 November 1998, Litvinenko and several of his FSB colleagues, all of whom worked part-time for Berezovsky, repeated the accusation on ORT, the largest Russian TV channel, controlled by the oligarch. They had not produced a shred of evidence to support their accusations. Litvinenko helped his patron to escape a alleged second assassination attempt in London, in May 2003. Who was trying to kill Boris Berezovsky and how has never been explained. The alleged assassin, Vladimir Teplyuk, filmed extensively by one of Russia's TV networks, should be still available for an interview.

Litvinenko was a one-man disinformation bureau, initially possibly guided by Berezovsky and then increasingly in pursuit of attention. His accusation that Putin ordered a series of bombings in autumn 1999 had no foundation but sounded credible to our media, unaccustomed as it was to the Russian chaos and increasingly addicted to conspiracy theories.²⁹ Litvinenko blamed Putin, though the man still running the country was Boris Yeltsin. By September 1999, those close to Yeltsin's family, including Boris Berezovsky, would have known that Putin was in with a chance for the top job in Russia. Was this an attempt to sow the seeds of doubts about the succession in Yeltsin's mind?

The rest of Litvinenko's accusations against Vladimir Putin and the FSB were equally unsubstantiated. He blamed the Russian president for ordering the killing of a courageous human rights crusader Anna Politkovskaya and said at a press conference in London that the Russian president passed the threats to the journalist through Russian MP Irina Hakamada.³⁰ Hakamada denied the claim. In the summer of 2006, Litvinenko posted a letter on the Internet claiming that Putin was a paedophile.³¹ Yet he provided no evidence to support his claim. This, and the accusation that the FSB was behind the seizure of the school in Beslan, were accepted without challenge by our media.³²

His anti-Putin campaigns went beyond Russian internal issues. In Spring 2006, Gerard Batten, a London UK Independence Party (UKIP) MEP accused Romano Prodi, the former EU Commission president, of working for the KGB. Mr Batten received this information from one of his constituents, Aleksander Litvinenko, who claimed to have received this information from "General Trofimov, the previous FSB chief".³³ Evidently, reporters did not consider it sufficiently important that General Trofimov was never the head of the FSB, although he did once hold the position of one of the deputies of the service. Furthermore, how General Trofimov would know about such a recruitment was difficult to understand: the FSB was not in charge of intelligence operations and Trofimov never worked for the intelligence directorate of the KGB, or its offspring, the SVR. He never worked for the counterintelligence department within the intelligence service or served in any capacity in Italy. All this did not matter. General Trofimov was conveniently dead, murdered with his wife in April 2005, and therefore could neither confirm nor deny the story. Litvinenko had also blamed the Russian special services for shootings in the Armenian parliament in 1999, concluding that, as a result, "Russia's political leadership managed to prevent the signing of a peace agreement resolving the Nagorno-Karabakh conflict".³⁴ Again, he provided no evidence to back up his accusation.

Despite being described as a model spy, Litvinenko's knowledge of intelligence matters was practically zero. That does not mean he did not know any secrets, as he claimed in on page 185 of his book "LPG – Criminal Group of Lubyanka", only to contradict himself ten pages later by writing about such a secret – the FSB laboratory on Krasnobogatyrskaya street which allegedly specialises in poisoning unruly Russians.³⁵ His ten-year career in counterintelligence and security organs gave him a wealth of knowledge about security work in the MVD internal troops units and the crime-fighting organs: knowledge, which like most other things, sells better in the US than in Europe. This is probably why Litvinenko asked first for asylum in the USA. The Americans refused, perhaps on the assumption that his knowledge was of little use and that he could cause problems. There have not been many Russian/Soviet security defectors refused hospitality in the USA. Only when the US refused to accept him did Litvinenko decide to come to the UK, where he was granted asylum not because of the value of his intelligence knowledge, but on humanitarian grounds.³⁶

The Russian security organs knew where Litvinenko lived. Before he died, Litvinenko said that he was monitored by Anatoliy Kirov, First Secretary of the Russian embassy in London.³⁷ This was not of any particular importance. Litvinenko's security awareness was only skin deep. He accepted invitations for conferences abroad where he took no security precautions, mingled freely with the wealthy Russian community in the UK and received journalists at home. He also flooded them with emails containing his increasingly outlandish conspiracy theories. If the Russian state intelligence or security organs wanted to get him, they could have done it a long time ago. They would have no difficulties luring him to a conference in a country less efficient and less concerned than the UK. Polonium, or any other lethal substance, would have been brought in a safe container, in diplomatic baggage. Those handling the substance would not have been exposed to radiation. If the perpetrators of the murder really wanted to confuse the investigators, they would have the means to put Polonium 210 on airlines in several places around the world, not only several British Airways flights. The argument that only the Russian state organs could have had access to the substance is also incorrect. It has been available outside Russia, and for years Chechen fighters were able to buy sophisticated weapons and equipment in Russia. It is only a matter of contacts and money.

Several points emerge from this brief overview. First, Litvinenko's background and relationships with both the Soviet and Russian authorities and other key figures was considerably more complex than many in the UK have allowed. Consequentially, the "information" – or rather "disinformation" – role he played both in the UK and Europe more broadly deserves reconsideration. The widespread, yet relatively simple acceptance of his assertions and, following his death, the similar statements made by his friends and supporters, fit neatly with the perceptions of many about Russia, such as the pervasive and all powerful role of the state and organs such as the FSB (though more frequently the focus is the Soviet KGB) and the continuation of Soviet power. The loose linking of Litvinenko's murder with those of other poisonings "ordered" by the Soviet or Russian authorities, particularly during the Cold War, strengthens such perceptions. Yet these are short hand expositions of complex and completely un-related incidents and only cloud our understandings of the situation. At worst, they have even served to prevent critical thinking about the current political situation in Russia and Russia's role with regard to the wider world.

Nonetheless, despite the media coverage, and perhaps because the incident could become interwoven more deeply with other issues, such as the ongoing disagreement over the extradition of Boris Berezovsky, the short, medium and long term ramifications of Litvinenko's murder for the UK-Russia relationship remain unclear. It is most unfortunate that the Russian authorities did not show more interest in helping the British investigators of the murder, if only to prove their detractors wrong. Proud with their newly achieved power and status, the Russians have decided to play the legal power game, fuelling unnecessary conspiracy theories.

Endnotes

²⁴ *The Independent*, 21 November 2006.

²⁵ *The Times*, 20 November 2006.

²⁶ Litvinenko, A. *Lubyanskaya Prestupnaya Grupirovka*. New York: Grani, 2002. p59.

²⁷ *The Independent*, 16 December 2006.

²⁸ counterintelligence work in the armed formations of all ministries has been conducted by the FSB and its predecessors.

²⁹ This accusation rumbles on in both the media and some academic circles, but there is still little substantial evidence.

³⁰ www.frontline.com

³¹ <http://www.time.com/time/magazine/article/0,9171,1568482-3,00.html>

³² Aleksandr Litvinenko for Chechenpress, 8 September 2004. This web page no longer exists. However the story gave rise to subsequent speculations, for example:

<http://www.kavkazcenter.com/eng/content/2007/03/05/7623.shtml>;

<http://www.time.com/time/magazine/article/0,9171,1568482-3,00.html>

³³ *Il Giornale*, 4 April 2007, BBC Monitoring Service.

³⁴ http://www.armeniapedia.org/index.php?title=Nairi_Hunanian;

<http://www.azg.am/?lang=EN&num=2005050307>

³⁵ Litvinenko, A. *Lubyanskaya Prestupnaya Grupirovka*, New York: Grani, 2002, pp.185 & 195.

³⁶ *Ibid*, pp.10-25.

³⁷ *The Independent*, 27 November 2006; *The Guardian*, 27 November; *The London Diplomatic List*, December 2004, p.63.

The UK-Russia Political Relationship

Edwin Bacon

‘Spy scandal strains relations between Russia and Britain’ proclaimed the headlines.³⁸ The British prime minister and Russian president both sought to downplay accusations from the Russian security services that the UK had been engaged in espionage in Moscow, using agents who were ostensibly working as diplomats in the British embassy. At the highest political level both sides were keen to talk up the continuing good relations between the two countries, building on recent successful summits between president and prime minister and more formal state visits just a couple of years earlier between the Queen and the president. Such good relations, it was emphasised, stemmed from longer lasting modes of cooperation based on trade links, investments and Russia’s relations with such bodies as the EU, NATO, the UN, and the OSCE.

The headline noted above is from 1996. A tit-for-tat agreed withdrawal of four British diplomats from Moscow and four Russian diplomats from London served as a reminder that despite the end of the Cold War and the development of warm relations between Russia and the UK, the collection of covert information still went on between friendly states. This arose in May 1996, just a month after Prime Minister John Major had visited President Boris Yeltsin in Moscow, and less than two years since Queen Elizabeth II had made her historic state visit to Russia in October 1994.

The situation the headline describes, however, could apply to either 1996 or 2006. In January 2006 the Russian state security service, the FSB, named four British diplomats in the Moscow Embassy as spies, producing film footage of what it said were these British spies retrieving data from a fake rock packed with computer equipment and located in a Moscow park. Since the film footage showed the ‘rock’ being taken away by the individual concerned, the FSB had to explain how they were able to display a ‘British spy rock’ to the media. The answer came from the FSB that their agents had spent a month scouring Moscow for similar rocks before eventually discovering one and revealing it along with the earlier film footage.³⁹ Just as in 1996, a meeting between the countries’ leaders – now Prime Minister Tony Blair and President Vladimir Putin – had been held just months earlier, in June 2005, in Moscow and had been talked up positively by both sides. Two years earlier, in June 2003, Putin had become the first Russian leader in 125 years to be granted a full state visit to London.

Superficially then, it would seem that little has changed in Russian-British relations in the past decade. The spy scandals show lingering distrust – the public way in which these cases were resolved is not the norm for firm and long-standing allies. Nonetheless, that no serious breach apparently occurred is indicative of the commitment on both sides to a cooperative and developing relationship. Indeed so often have formal declarations to this effect been made that Russian defence minister, Sergei Ivanov, when opening a meeting with the then British Foreign Secretary Jack Straw in October 2001, declared that it had become a cliché to utter some phrase about the ‘dynamic development’ of Russian-British relations on such occasions.⁴⁰

Underneath the surface, however, much has changed in the UK’s relationship with Russia since the 1990s. Such changes have turned out largely for the worse as the

end of the Blair-Putin era nears. It is this apparent decline in Britain-Russia relations which this chapter briefly explores, concentrating on elite-level relations and outlining a series of developments which have both caused and reflected this decline in relations.

It is important to emphasise at the outset, however, that a focus on high-profile and elite-level events is not the whole story. In fact, issues which make the headlines – such as spy scandals, visa and extradition refusals, and apparent tension between prime minister and president – although seemingly constant irritants, are to some extent ‘surface’ issues with temporary resonance. Under-girding Britain’s relationship with Russia are more permanent interests, such as trade, energy, investment and security.

Furthermore, Britain’s relationship with Russia is conducted in a wider context: contacts are ongoing, agreements are reached, and international obligations signed up to within the context of the United Nations, the G8, the Council of Europe, the OSCE, EU-Russian relations, NATO-Russian relations. That I focus here on the bilateral impediments hampering UK-Russian relations in mid-2006 is not to imply that the relationship is in crisis. Undergirding factors and overarching frameworks provide a context of greater stability and mutual interest than is apparent throughout much of this chapter. Nonetheless, a key element of the relationship does not function effectively.

Blair and Putin – Auspicious Beginnings

Both Prime Minister Blair and President Putin have set great store in personal diplomacy. Blair’s conviction that his persuasive face-to-face charm can exert great influence on international events has been evident on numerous occasions, such as during the Kosovo crisis in 1999 and in the aftermath of 9/11. The former Conservative foreign secretary, Sir Malcolm Rifkind, noted this trait of Blair’s with specific reference to the Blair-Putin meeting of April 2003 in Moscow, declaring that:

The prime minister has this extraordinary belief that personal relations can overcome national interests. They can’t. Where there is sufficient common ground a good personal relationship can make a difference. But no leader can be expected to override national interests ... There is this assumption that because Russia is not communist it will be another western country. We are a long way from that.⁴¹

Similarly, Putin, immediately on taking office, showed himself to be a foreign policy activist. He began a series of foreign trips designed to demonstrate that he is personally engaged in international affairs to a far greater extent than his predecessor, Boris Yeltsin. In his first ten months in office he visited the UK, Germany, France, Italy, Spain, China, Japan, Mongolia, Cuba, North Korea, Belarus, Ukraine, Azerbaijan, Uzbekistan, Turkmenistan, and Kazakhstan. Not only does Putin speak fluent German, but he also made it his business on taking office to learn English, progressing sufficiently to be able to converse with Tony Blair in private during his visit Moscow in 2003.

At the beginning of the Putin era Blair was of particular interest to Russia’s new regime for several reasons. The relatively young British prime minister was seen as a key player in Europe in the coming years. It was Blair perhaps more than any other who had driven the NATO intervention in Kosovo of 1999, thereby

demonstrating his influence both in Europe and in the United States, and was prominent amongst EU leaders in supporting rapid enlargement eastwards. He was therefore seen in Moscow as a potential bridge between Russia and the US. Although Putin was quite able to conduct his own diplomacy with US President Clinton, a good relationship with Blair, who was close to Clinton personally and in policy terms, could only enhance Russia's attempts to rebuild relations with the US, which had been damaged both by the Kosovo conflict and President Yeltsin's increasingly erratic attitude towards the US. Furthermore, with Clinton due to step down at the end of 2000, the Blair-Putin relationship could provide a degree of stability against the background to the change of president in the US.

In addition to these foreign policy reasons for emphasising the importance of the Blair-Putin relationship, there was also a good deal of interest amongst the Putin team in the 'new Labour' project, and the way in which the Labour government in Britain handled the packaging and communication of policies. In short, members of Putin's team thought that they may have something to learn from the Blair camp.

The Blair-Putin relationship initially flourished. Indeed arguably it flourished with unseemly haste on Blair's part in an attempt to steal a march over the other major European powers, specifically France and Germany. The unseemly nature of initial Blair-Putin contacts lies in Blair's ill-advised meeting with Putin in St Petersburg two weeks *before* Russia's presidential election in March 2000, when Putin was, as Russian prime minister, only acting president of Russia and, more importantly, a candidate in the forthcoming election.

Given the readiness of Prime Minister Blair to raise the faltering state of Russian democracy in talks with President Putin in subsequent years, it is unfortunate that this first meeting between the two in effect served to endorse Putin's candidature above those of the other candidates so near to an election. That the Blair camp was aware of this difficulty seems likely given the fact that Downing Street went to the trouble of emphasising that the prime minister's visit was not 'official' but in response to a 'personal invitation' from Putin. It was indeed the case that the initiative for the meeting had come from the Russian side. But such a distinction between 'official' and 'personal' appears sophistic – the meeting resulted in a number of policy-related statements, a photo-call for the press and culminating in Blair reportedly telling the media that his enjoyment of the dialogue with Putin was 'a very good omen for the future', and thereby appearing to endorse Putin's candidature ahead of the polls.⁴² Of course it made perfect sense from one point of view for the British prime minister to forge early positive relations with Putin. The suspicion remains, however, that Putin had an eye on electioneering when inviting perhaps the most eye-catching European leader of the time to St Petersburg a fortnight before polling day, and that the British leader was a little too eager to take this opportunity, rather than waiting a couple of weeks for the Russian people to confirm that Putin was indeed their chosen head of state.

Whatever the precise machinations behind the March 2000 visit, Blair received his reward in kind, with Vladimir Putin making London the destination for his first foreign trip on being elected president – albeit with a stopover in Belarus en route. German Chancellor Gerhard Schroeder had let it be known that he would be glad to have an 'early visit' with Putin, but instead the Kremlin opted for a visit to London in April 2000, in a move which some Russian observers interpreted as marking a break with Yeltsin's focus on the Moscow-Berlin-Paris axis and reflecting Russian unhappiness with German attitudes to the Chechen conflict.⁴³ It is ironic that what Russia should see as Britain's unhelpful attitude to the situation in Chechnya should in later years play such a key role in souring these initially close relations.

Britain and the Chechen Conflict

The complexity of the Chechen conflict has made this a difficult issue for UK-Russian relations. The UK has, to its credit, largely sought a nuanced approach to Russia's actions in Chechnya, sympathising with Russia as a victim of brutal terrorist attacks at the same time as seeking to promote human rights within Chechnya. Nuance, however, does not sit well with more simplistic analogies and conceptualisations which are widely-held and more media-friendly than complex analysis.

After the second Chechen conflict started in late summer 1999, comparisons were drawn, both in Russia and in the UK, with the situation in Kosovo. Earlier that year the use of strong military force by a Slavic power (Serbia) against the civilian population of an independently-minded Muslim region just within its southern border (Kosovo) led to military action by NATO forces, including the bombing of Belgrade. Although some similarities were apparent between Kosovo and Chechnya, and anti-Western voices in Russia began scare-mongering about the dangers of NATO intervention, the British Foreign Secretary, Robin Cook, bluntly made clear the obvious fact that NATO would not be bombing Moscow.⁴⁴

Following the terrorist attacks on New York and Washington on 11 September 2001, the Chechen conflict again fitted neatly into a straightforward interpretation – it was part of the ‘war on terror’ in which Russia was engaged just as much as the United States, the UK, and others. Even before the attacks of 11 September, the US, Russia and the UK had been cooperating in response to the perceived threat of Al Qaeda. After that date, Putin clearly presented Russia as standing alongside the United States, as having suffered similarly traumatic attacks (particularly the Moscow apartment bombings of 1999) and as being – in Chechnya – the frontline of Europe's defence against Islamic terrorism. On one hand, such support for the war on terror was welcome in London. On the other, though more emphasis appeared to be put on *understanding* the difficulties for Russia, the government had criticised Russian action in Chechnya from 1999 onwards and was not about cynically to jettison such views completely.

The apparently straightforward line of UK-Russian cooperation in the ‘war on terror’ was never, therefore, as clear cut as it seemed, largely due to human rights concerns in the UK with regard to the way in which Russia prosecuted the Chechen conflict. The cooperation line has been undermined further since 2001 by Russian opposition to the invasion of Iraq, by the refusal of British courts to extradite Chechen activists to Russia (see below), by the view in Moscow that the West is applying double-standards when criticising Russian action in Chechnya whilst supporting the occupation of Iraq and Afghanistan, and by concerns in the UK that acquiescence to Russian actions in Chechnya might serve to further antagonise disaffected Muslims within British society.

Blair and Putin – a relationship in decline

The state and the status of the Blair-Putin relationship in 2007 are both markedly diminished from that of six years earlier. Russia's increasingly confident stance as a self-styled ‘sovereign democracy’ on the world stage has meant that notions of using the UK as a means of approach to the United States are no longer considered necessary, since direct communication with the US leadership occurs regularly

enough. Furthermore, the imminent departure of Tony Blair from the prime ministership, alongside a series of bilateral grievances, render the utility of Britain-Russian summitry somewhat diminished.

As noted above, the bilateral aspects of the UK's relationship with Russia must be viewed within a wider setting. The bilateral downturn of 2003 onwards was ameliorated to some extent in 2005 and 2006 by the necessity for closer relations between the UK and Russia within the multilateral context, since Britain held the presidency of the G8 throughout 2005, and the EU presidency in the second half of 2005. The handover of the G8 presidency from Britain to Russia required heightened diplomatic contact, but such contact occurred in parallel with declining bilateral relations, running alongside but not touching. As UK-Russian relations seemed to become increasingly tetchy and problematic in many aspects, within the context of the EU, the G8 and other international fora cooperation continued, and – measured by trade and investment statistics – relations flourished. However, at what the Russians call 'the highest level', the previous warmth between Blair and Putin demonstrably cooled, as a range of disagreements emerged.

The management of foreign policy within the Blair administration has meant that the Prime Minister takes more personal responsibility than his predecessors for the mood of relations. Blair's 'presidential' style has to a great extent broken with the traditional practice of cabinet government in the UK, in favour of small groups of advisers close to the Prime Minister influencing policy. In terms of relations with Russia, the tendency has been for the FCO to deal, as always, with the day-to-day relations at the lower level, alongside other departments, such as the DfID, which has a wide range of programmes in Russia, spending over ten million pounds a year on issues such as civil service reform, HIV/AIDS programmes, and conflict prevention.

The Prime Minister and his advisers, however, like to lead in strategic matters, relying on the Cabinet Office for specialist advice. Between 2001 and 2003, Tony Blair's Foreign Policy Adviser was David Manning (now the UK's ambassador in Washington). Manning had served on the Soviet desk in the Foreign Office during the Cold War, in the British Embassy in Moscow as the Soviet Union gave way to the Russian Federation, and as head of the Foreign Office's Eastern Department (dealing with Russia) in the early years of the Yeltsin administration. As an expert in the region himself, therefore, he played a particularly key role in guiding UK policy in relation to Russia in 2001-2003. His departure has both to a certain extent reduced the expert emphasis on Russia at the centre of decision-making and reflected a wider decrease in expertise in Russia in the UK.

Furthermore, from a very positive start which promised a warm relationship, a chill has been apparent in relations between Blair and Putin in recent years. From the Putin side there have been a number of occasions where the Russian president has not shied away from seeking to embarrass Blair publicly. The first noticeable such occurrence stemmed from UK-Russian disagreement over the need to go to war in Iraq in 2003. In an April 2003 meeting in Moscow, Putin punctured any sense of triumph that the British prime minister may have been feeling over the successful toppling of the Saddam Hussein regime by coalition forces, concentrating instead on the fate of Saddam and the weapons of mass destruction, which both Blair and Putin still thought at the time to exist. In a somewhat mocking remark as he sat opposite Blair in a post-summit press conference, President Putin asked rhetorically, 'where is Saddam? And where are these weapons for which the war was started? Well perhaps Saddam is sitting on these boxes in his secret bunker and thinking that he might blast all this stuff and threaten the life of mankind'.

According to one newspaper report from the press conference, none of the Russian journalists present thought that Putin would take a stubborn line with Blair. They were wrong.⁴⁵

Disagreement over the Iraq war between its opponents led by France, Russia, China, and Germany on the one hand, and supporters led by the US, Britain, Spain, Italy on the other, was based on a complex series of issues which lie outside of the scope of this chapter. Nonetheless, a contributing factor to Russian opposition was dislike of a global order dominated by an interventionist United States. The Putin regime's emphasis on the concept of national sovereignty is a reflection of this strongly held view, and in domestic terms it can be seen in Russia's reaction to what it sees as Western interference in issues such as the Chechen conflict and the state of Russian democracy. Irritation on Putin's part at being asked by a British journalist about democracy in Russia led to a further example of Putin publicly making capital out of Blair's domestic political embarrassments at the 2006 G8 summit in St Petersburg. In responding to the journalist's questions, Putin raised the case of Lord Levy, the Labour party fundraiser who had just been arrested by British police investigating whether honours had been sold in return for donations to the party. Blair was said to be 'privately fuming' at this remark aimed at one of his closest advisers.⁴⁶

The list of apparent *faux pas* in the relationship between Blair and Putin is not, however, entirely one way. In May 2005 Prime Minister Blair failed to appreciate the importance to Russia of the Victory Day celebrations marking the 60th anniversary of the fall of Berlin to Soviet troops at the end of the Second World War. U.S. President George W. Bush, China's leader Hu Jintao, Japanese Prime Minister Junichiro Koizumi, Polish President Aleksander Kwasniewski, German Chancellor Gerhard Schroeder and French president Jacques Chirac were all amongst those attending. Britain was represented, however, only by the deputy prime minister, John Prescott. Although Tony Blair apologised, citing the general election of five days earlier and the demands of forming his cabinet, some Russian press reports observed regretfully that he 'considered internal party matters more significant than the Moscow ceremony', and noted similar unflattering criticism in the British press.⁴⁷ It seems likely that Downing Street with hindsight may have considered Blair's absence from the Victory Day celebrations a mistake. Certainly the prime minister went out of his way to explain himself in this regard when he visited Putin a month later as part of the preparation for July's G8 summit in Scotland. Mr Blair emphasised that "On May 9, I was busy forming a new government, and, unfortunately, I was unable to come. But I would like to take the opportunity to commemorate the courage and heroism of the Russian people, who drove back fascism. I would like to remind you that cooperation between Russia and Britain in this endeavor was among the closest of all."⁴⁸

Visas, extradition and NGOs

Although the relationship between Blair and Putin serves as a useful indicator of UK-Russia relations, it is by no means the whole story. On one hand, as noted above, there are consistent mutual interests which foster interaction advantageous to both states in specific spheres of activity, many of which are covered elsewhere in this volume. In particular, when emphasising the positive in UK-Russia relations the focus repeatedly falls on financial and business relations. In trade terms, the UK is a relatively small-scale partner in comparison with other European countries, China, and the United States, accounting in 2004 for 3.1 per cent of the total

volume of Russian exports, with 2.7 per cent of imports into Russia coming from the UK.⁴⁹ Nonetheless these figures were a significant increase on previous years.

Investment data, however, are much more impressive. British investments in Russia in 2005 reached nearly \$8.5 billion, out of a total of \$53.7 billion, while Russian investments in Great Britain were higher than \$12.5 billion, making Russia one of the top foreign investors in the British economy.⁵⁰ London has become a centre for Russian businessmen and investors, exemplified in the public eye by Roman Abramovich's investment in Chelsea Football Club and by the annual Russian Economic Forum, which will meet in London for the 10th year in succession in 2007 and each year attracts many Russian businessmen and high-ranking politicians.

On the other hand, even these areas of activity have raised tensions at the highest levels. The Browder case is one example of apparently arbitrary – even perverse – action by Russia undermining relations. William Browder, an American-born British citizen, is CEO of Hermitage Capital Management, Russia's biggest foreign portfolio investor. He was denied entry to Russia in November 2005, and his efforts to regain his visa were backed by British Foreign Secretary Jack Straw and reportedly raised personally by Tony Blair in his meeting with President Putin at the G8 Summit in St Petersburg, July 2006.

Browder is known for two stances in particular. First, he has been an indefatigable advocate of foreign investment in Russia and unfailingly optimistic about Russia's growth prospects. At the 2005 World Economic Forum in Davos he was almost a lone voice promoting Russia, gathering together a group of influential journalists for a breakfast at which he gave a presentation to make this case. Second, he has fought equally tirelessly for good corporate governance and shareholders' rights in Russia, campaigning for the same with regard to such Russian giants as Unified Energy Systems, Sberbank, Gazprom, and Surgutneftegaz.

There has been no public statement explaining the removal of Browder's right to travel to Russia. A letter to Hermitage Capital Management in January reportedly stated simply that the decision was in line with Russia's immigration law barring entry to those considered a threat to the security of the state, public order or public health. Browder's campaigns for better corporate governance have annoyed senior figures in Russian business and the assumption of many is that this lies behind the decision to ban him from Russia. To refuse him a visa looks vindictive and arbitrary, as well as creating a bad press in the West.

If the British government is agitated by the Browder case, then the Russian government is annoyed at Britain over the refusal of British courts to extradite 16 men – including businessman Boris Berezovsky, Chechen emissary Akhmed Zakayev and executives of the YUKOS oil company – whom it accuses of a range of offences from terrorism, through tax fraud, to plotting to overthrow the government. President Putin apparently remains convinced that such refusals are politically motivated and that if the UK government wanted to, it could arrange for the extraditions to happen. The notion of the separation of judiciary and executive appears to remain somewhat alien to Russia in this particular sphere.

The appointment of Yuri Chaika to the position of Prosecutor General in summer 2006 appears to herald renewed attempts to secure the desired extraditions, but this time with a declared emphasis on preparing more robust legal cases than previously.⁵¹ The Russian Prosecutor General's Office has launched a new case against Zakayev based on charges of instigating ethnic enmity. The Prosecutor

General's Office therefore claims that interviews given by Zakayev which allegedly incite the hatred and the use of force against ethnic Russians come under the UK's law on terrorism which restricts calling for committing or preparing terrorist acts.⁵²

Even so, there is by no means any guarantee of success. Indeed it appears unlikely that unless new evidence or charges are forthcoming, Russia's requests will continue to be frustrated by the British legal system. The UK's official position has been clear, however: Russia must meet two criteria before extradition processes can begin. First, the evidence against these people must be more coherent and convincing. Second, UK courts must be convinced of the guarantee of a fair trial in Russia. The UK official emphasis has been on the independence of the courts and judiciary and inability of the government to influence this for political reasons.

To the Putin team, however, the British stance on these extradition cases represents just one example of what it is increasingly referring to as the West's 'double standards'. At the Conference of Prosecutors General of Europe in Moscow in July 2006 Putin declared that Russia is:

open for honest and non-politicised dialogue on human rights issues. We want this dialogue to focus on finding solutions to concrete problems. There are plenty of problems both in the West and in the East. But it is unacceptable to us that human rights issues should be used as a means of exerting political pressure or pursuing opportunistic aims of any sort ... We find it hard to explain, for example, why some countries refuse to extradite terrorism suspects and even go as far as to give them some kind of 'political' status.⁵³

Continuing frustration with the failure of the UK to extradite Zakayev also led Putin to emphasise his implication that the UK harboured terrorists, arguing "when we are told, 'let's bring up the subject of Syria', or Iran or any more countries that cover [foreign] terrorists, why not mention other countries as well?"⁵⁴

A reflection of this view that issues such as human rights and legal affairs are political affairs both for the UK and for Russia is apparent in the way in which Russia has clamped down on British support for non-governmental organisations (NGOs) in Russia in recent years. The Russian Interior Ministry's Economic and Tax Fraud Service demanded to examine the British Council's financial records in June 2004, with the demands only being dropped after a meeting between Putin and Tony Blair and a halt being called to most of the Council's programs in Russia several months later. However, by 2006 similar demands were being made again.⁵⁵ Echoes of the Browder case can also be found in relation to human rights issues. In November 2005 Professor Bill Bowring, a respected human rights lawyer with many years experience of working in Russia, was held at Moscow's Sheremetovo airport on his way into Russia, before having his multi-entry visa cancelled.

As noted in the introduction to this chapter, spy scandals have remained a constant in UK-Russia relations throughout the post-Soviet era. In addition to the two instances mentioned there, in May 2005 MI5 reportedly warned government departments in the UK of the existence of 32 Russian agents operating under diplomatic cover from the Russian embassy in London. The warning apparently went so far as to identify the number plates of cars used by the alleged Russian agents, and to cite their activity as 'substantial' threat to the UK.⁵⁶

This need not in itself be particularly significant in terms of UK-Russia relations – countries spy on each other, and sometimes spies get caught. What was of particular interest though was the way in which the FSB spokesmen on the

television programme went out of their way to link allegations of espionage to the activities of NGOs. Much of the 22 January 2006 broadcast was devoted to the FSB's case, with documentary evidence, that one of the alleged spies had also been the signatory for financial grants from the UK government to the various NGOs, including the Moscow Helsinki Group and the Eurasia Foundation.

A second broadcast on 29 January continued to give details, from FSB sources, of further NGOs which had received money authorised by alleged British spies. The evidence provided by the FSB for the existence of a British spy network may have seemed convincing, but the evidence that NGOs were receiving money from foreign intelligence agencies, and by implication acting as a front for them, was almost non-existent. Any accredited British diplomat engaged in espionage in Moscow will have a formal position in the Embassy, such as that held by the diplomat in question in this case in the political section. The fact that he may have signed off financial grants in the course of his formal duties is entirely regular for a member of that section. The money granted to those NGOs named by the FSB has long been a matter of open public record and, as Lyudmilla Alekseyeva, chairperson of the Moscow Helsinki Group, pointed out, it is no secret that many NGOs receive money from abroad, that does not make them spies.

Conclusions

A complex range of issues has undermined high level relations between the UK and Russia in recent years, many of which remain unresolved. Four stand out. First, many of the negative elements souring UK-Russian relations have come about because, despite formal declarations and engagement within multilateral fora such as the EU-Russian partnership framework and the G8, there has increasingly been a focus on bilateral elements in the relationship. Under this heading come issues such as the refusal of British courts to extradite men wanted in Russia for alleged offences relating to terrorism, the Yukos affair and security matters; Russian actions such as depriving high-profile British visitors of their visas and putting pressure on the activities of the British Council in Russia and on the funding of non-governmental organisations by Britain; and heightened attention being given on both sides to espionage matters.

Second, decreasing unity on the part of 'the West' in the early years of the 21st century has encouraged differentiation in Russia's foreign policy towards western powers and has intensified competition between European powers with regard to good relations with Russia. Despite frequent arguments by some observers that the era of the nation state is gone and the era of globalisation is here, this is far from the case in Putin's foreign policy and in UK-Russian relations.

Third, the personal impact of Prime Minister Tony Blair as a key interlocutor has declined since the beginning of the century. When President Putin came to power in 2000, Tony Blair was seen by many as the most influential leader in Europe, a man of the future as opposed to the other leaders of key western powers who seemed to be on their way out. Six years later, however, Blair's political stature had diminished, not least because he was nearing the end of his prime ministership, and new leaders in Europe – such as Chancellor Merkel of Germany – were coming to the fore. Furthermore, any role for Prime Minister Blair as a bridge between Russia and the United States was less necessary.

Fourth, and related to the above, there are serious "value" differences between the UK and Russia. Two examples illustrate this. First, there is the difference over the

independence of important elements of non-governmental society, such as the judiciary and big business – highlighted both by the examples of extradition and the discussions surrounding Gazprom’s acquisition of Centrica. Second, the UK support for grass-roots society is at odds with the Russian approach, illustrated by the differing approaches to NGOs.

To put it bluntly, the importance of the Blair-Putin relationship to Russia, and indeed the political relationship between Britain and Russia as a whole, has decreased notably in recent years. This will not remain the case for ever, and even as it has occurred, mutual interests and obligations have continued to keep formal contacts and cooperation on many levels positive. However, simultaneously it raises the importance of the role of other actors, particularly those in business and security fields in maintaining the relationship, while the ability of the political dimension to enhance these contacts or support them in case of difficulty is reduced. It may take the replacement of both Blair and Putin, planned in 2007 and 2008, to provide a public boost to elite level relations.

Endnotes

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⁴⁶ Catherine Belton, ‘Relishing Russia’s Return to World Stage’, *The Moscow Times*, 18 July 2006. p.1.

⁴⁷ Vadim Markushin, ‘Razmyshleniya posle torzhestv. Parad pravdy’, *Krasnaya zvezda*, 12 May 2005. p.1.

⁴⁸ Alla Barakhova, Boris Volkhonsky, ‘Peregovory na vyshem urovne: Vladimir Putin popytalsya prinyat’ Toni Blera kak druga’, *Kommersant Daily*, 14 June 2005. p.9

⁴⁹ In 2004 in total volume of export of Russia the share of the Netherlands accounted for 8.4%, Germany - 7.3, Italy - 6.7, China - 5.6, Switzerland - 4.3, USA - 3.6, Finland - 3.2, Great Britain - 3.1, and Japan - 1.9%. In imports shipments from Germany account for 14.0% of total imports into Russia, China - 6.3, Italy - 4.2, USA - 4.2, France - 4.1, Finland - 3.1, Poland - 3.1, Great Britain - 2.7, and the Netherlands - 1.8%.

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UK-Russia Military Cooperation

Maj. General (retd.) Peter Williams

While the US-Russia military cooperation and assistance programmes constitute far and away the largest single element in the web of bilateral cooperative relationships managed by the Russian Ministry of Defence's (MOD) Main Directorate for International Military Cooperation,⁵⁷ the UK's engagement must rank high among the efforts of the other nations seeking to work closely with the Russian military. The British 'Bilateral Programme of Military Activities', operating under the terms of the 1997 UK-Russia Memorandum of Understanding (MOU) on High Level and Defence-wide Events, provides the political mandate and the structure for these projects.

Since 1994 the UK MOD has been running its most high profile cooperative activity, the Russian Resettlement Programme (RRP). This aims to prepare Russian professional servicemen and women for a new career as they move into civilian life. By July 2006 some £18 million had been spent on providing more than 25,000 Russian officers either with market economy and computer skills or with English language training. The RRP courses last for up to four months and are delivered in six centres across the Russian Federation. This is a mature, well managed project that has regularly been praised by the Russian Minister of Defence, the local media and especially by the graduates themselves and their eventual employers.

UK-Russia military cooperation has also been characterised in recent years by regular high level staff talks between the two MODs, by the annual Royal College of Defence Studies study tour to the Russian Federation and by the visits to Russia by students from the Advanced Command & Staff Course that started in 2005.⁵⁸ It remains an aspiration to initiate reciprocal visits by equivalent Russian staff academies to the UK. It is also hoped that a recent exchange of visits by the Surgeon General and his Russian counterpart may turn out to be the first step in improved cooperation in the field of military medicine and more widely in the area of logistics.

Of the single Services the Royal Navy (RN) is alone in having achieved (in 1998) an MOU between the commanders-in-chief of the respective navies. The UK-Russia naval programme currently has seven main components: Ships visits; the annual BALTOPS exercise under the aegis of NATO's Partnership for Peace (PfP) programme; Junior Officer Training, which may lead to Russian cadets studying English at Dartmouth; Staff Training bilaterally in Portsmouth and St. Petersburg and as part of the series of annual quadrilateral (France, Russia, UK, US) wargames; Staff Talks (every second year); the quadrilateral (Norway, Russia, US and, since June 2003, UK) Arctic Military Environmental Cooperation (AMEC) programme; and Submarine Search and Rescue (SAR) cooperation.

Perhaps the two most interesting and least traditional of these initiatives are the AMEC and the SAR programmes. AMEC sees British military and scientific involvement in a quadrilateral enterprise to address environmental problems in north-west Russia. The UK has agreed to lead on a number of the projects associated with the safe storage, transport and dismantling of decommissioned nuclear-powered submarines. The overall budget for the AMEC project is some £750 million which will be spent over a number of years.

The issue of Submarine SAR support for the Russian Navy was initially raised following the tragic sinking of the Kursk in August 2000. It returned to prominence in August 2005 when a Russian submersible became snagged almost 200 metres below the surface near the naval base at Petropavlovskaya-Kamchatka in the Russian Far East. On this occasion the Russian authorities appealed to the British and US navies for help, resulting in the rescue of the submersible's crew thanks to the efforts of the RN's Scorpio 45 remote-controlled mini-submarine, operated by a specialised submarine SAR unit. The timely arrival of this unit was possible only thanks to the rapid deployment capabilities of a Royal Air Force (RAF) C-17 transport aircraft. (See Chapter 4 for a more detailed examination of the rescue operation). The British-led rescue mission, which also involved Russian, American and Japanese contingents, could justifiably be portrayed as the highpoint so far of UK-Russia military cooperation during the post-Cold War era.

For a long period, relations between the RAF and the Russian Air Force lay fallow. But in 2006 there has been a major advance in bilateral activities. Areas of current interest include Air Safety, SAR and Initial Flying Training. As for the Army, it is developing contacts with Russian counterparts responsible for Peace Support Operations (PSO) and Global Counter-terrorism. These promising areas will augment already well established bilateral cooperation in the fields of Military Topography and Explosive Ordnance Disposal (EOD) issues.

Finally, however, it is worth noting that funding for UK Defence Diplomacy (and, by implication, for UK-Russia military cooperation) is constantly under review and competing for limited resources. The current size and composition of the Defence Attaché Moscow's team, as currently configured, is just about equal to the challenges of maintaining and developing a satisfactory bilateral relationship. Any further reductions, however, might impact adversely on the chances of improving the existing situation.

Endnotes

⁵⁷ In August 2006 the Main Directorate for International Military Cooperation was headed by Colonel General Anatoly Mazurkevich. Bilateral relations are managed by the subordinate Directorate for External Relations (UVS), led by Lieutenant General Vladimir Fyodorov.

⁵⁸ Though ACSC did not visit Russia in 2006.

Saving the AS-28

CDR Ian Riches

The rescue of the Russian Priz-class submersible AS-28 in August 2005 by members of the Royal Navy's Submarine Rescue System (SRS) was a transformation into action of years of planning and practice assisted by an unprecedented international cooperative effort. The Priz was a Submarine Rescue Vehicle with seven men onboard that was on a training mission off the east coast of the Kamchatka peninsula when it became caught in an under water obstruction.

Eight hours after hearing on the BBC that it had become trapped in the Pacific, I was in a Nimrod to Prestwick at the start of the mission to rescue the submersible with the British Government's approval to provide assistance to the Russian Government. Meanwhile my team of contractors, led by Stuart Gold, from James Fisher Rumic Ltd, was loading the Remotely Operated Vehicle (ROV), a Scorpio 45 model and its associated equipment into the RAF C17 that had flown up to Prestwick and was to fly us to the other side of the world. A team of twenty nine people were assembled, including eight from JFRL, two C17 crews and supporting military guards and me. Add that to the several tonnes of rescue equipment we were taking and the Captain of the aircraft suddenly had a problem – we were tight on fuel. At just before 8pm we took off for Petropavlovsk Kamchatsky. Those on the ground who watched the take off remarked that it was lucky there were no mountains around as the C17 struggled to get airborne with maximum all up weight.

Ten and a half hours later, the British Naval Attaché (NA), Captain Jonathan Holloway, greeted me from the tarmac of a wet Russian commercial and military airfield. The presence of the NA as a liaison officer and interpreter smoothed the way for the deployment, since he is also a submarine engineer with intimate knowledge of the rescue system and had arranged for transportation and heavy lift equipment. The Russians provided access to a military airport some 40km from the port of Petropavlovsk and provided the equipment, with the notable exception of the unloading equipment from aircraft to tarmac. I dispatched an advance party led by the NA to the port to survey and prepare the ship that we were to use. Meanwhile a forklift was found, though it could barely lift the ROV (the lightest piece of equipment), and when it did the windows fell out. Speaking back to the UK, where it was now 8am on Saturday morning (it was 8pm on Saturday evening in Petropavlovsk), I was told to expect the US Navy Submarine Rescue team and that they were flying some unloading gear up from Japan. As soon as I was allowed to – which was not very soon – I persuaded the Russians to drive me to the USAF C5 so that I could speak to my opposite number, Cdr Kent van Horn. We quickly agreed that as the British were ahead on the preparations that we would get to use the unloading equipment first. By midnight Russian time the equipment was in the port and we were leaving the airport at last. Even then we still had little idea of the situation onboard the Priz.

After a bus journey over some of the worst roads I have ever come across and some dark, forbidding dirt tracks, we finally got to the port gates but no one would let us in. I suppose it was to be expected – if half a dozen Russians turned up at the gates of one of our Naval dockyards at 0100 on a wet Sunday morning what would we do! Eventually we were in and onboard the imaginatively named Sura-class KIL 27, a 37 year old buoy laying vessel that was definitely showing its age. Thankfully we also met a Russian Naval Officer who had been onboard our ship during a recent

exercise and we had grown to know and like. He immediately briefed the NA, the ROV supervisor and myself and we got a clear picture of what was happening and where and how the Priz was stuck. We knew at this time we had about 22 hours at most before the crew ran out of oxygen, but we also knew that, based on what we had just been briefed, providing the Russians could get us to the site, we could almost certainly succeed in cutting them free.

By 0400 local time we were on our way, pulling large lumps of concrete off the jetty wall as we scraped our way out of the harbour. Six hours later we had successfully set everything to work and KIL 27 was being manoeuvred into position by some small tugs. We would normally operate from a ship that was fitted with Dynamic Positioning or DP. This means that through a combination of thrusters, controlled by computers being fed by a GPS navigation system the ship remains perfectly in one place without the need for anchors. KIL 27 was certainly pre-DP so we resorted to being moored between two other ships that had successfully anchored in 250 metres of water either side of the stricken Priz. The intervention of the NA was crucial to the liaison process that married the British requirements to the Russian desire to do the best to assist the rescue. Enroute, the British operators had briefed themselves on the likely situation by watching Russian videos of the distressed submersible made by a Russian ROV.

By 1130 we had been given permission to launch Scorpio and despite initial Russian insistence on what we were to cut, what we could now see was a very large fishing net and we set about our business. Stuart Gold and his team dealing with the ROV handling and cutting and me fending off the Russian military as required. The ROV work was almost routine. The visibility was exceptional at 10 – 15 metres. This was largely because we were operating 25 metres off the sea bed as Priz was entangled in the nets which were themselves caught around a Cold War underwater listening device. The difficulties came because the nets were so tight we could not easily get the cutting arm into position, but after great teamwork with Stuart on the manipulator arm and Peter Nuttall the senior pilot on the cutter and driving the ROV progress was made. A defect to the cutter, a thruster losing power and an indication of a water leak into the electrics forced us to recover Scorpio to deck with really only one more line to cut. Thankfully my estimate of 30 minutes to fix held and the Russians were again appeased!

By about 1530 we had finally cut everything we could. We had battled with one line that was out of reach, stuck between the hull of Priz and the listening device, Scorpio could not get to it. And throughout Priz gently rocked but showed no inclination of breaking free. We had to take a risk and my opinion was that Priz should use what must have been close to her final shot of high pressure air to blow into her ballast tanks. This would break any final weak ties and she should ascend. So I persuaded our Russian liaison officer, he then had to persuade his boss on the bridge of KIL 27 who then had to persuade the Admiral on the Command Ship, who then had to persuade Sergei Ivanov, the Defence Minister, who by now had arrived onboard the Command Ship unbeknown to us! The order was eventually given and with no drama Priz disappeared from Scorpio's cameras and sonar. At 1620 local time on Sunday 7 August she broke surface, having passed under our bow, on our starboard side to great celebrations all round.

On Monday we were taken to meet Defence Minister Ivanov in the submarine base near to Petropavlovsk. He was extremely grateful for our efforts and those of the US Navy without whom we would have failed. We flew home to a welcome at Prestwick that included a personal call of congratulations from the Deputy Prime Minister.

A number of political and practical points can be discerned from this experience. Politically, the rescue contributed significantly to the positive atmosphere in which meetings were conducted between UK and Russian officials during a visit to the UK by President Putin in October 2005, meetings which resulted in a series of positive discussions including counter-terrorism and trade. Mr. Putin also was the first foreign leader to see COBRA briefing room. As reporters noted, during Mr. Putin's visit to the UK in October both sides, 'both sides seem to want to put aside their differences' and overcome the chill in relations that has emerged in the last two years.⁵⁹ The political benefits of successful practical cooperation, indeed, have hardly been surpassed in the UK-Russia relationship.

Practically, lessons learned from the occasion include the necessity of airport and seaport combinations to be inspected as national policies on such issues are often different in crucial ways: the lack of cargo handling systems which could lift the largest component of the rescue system was one example illustrated by the operation to save the AS-28. The Russians expected that the UK team would have in-built systems for off-loading as their aircraft do. Nonetheless, the benefits of enhanced relations through ship visits and cooperative exercises were illustrated by the positive impact of the previous acquaintance with Russian Naval officers which facilitated cooperation. Indeed the spirit of international cooperation manifest during the rescue was directly attributable to the numerous meetings and exercises in which the British, Americans, Russians and others participate. Submarine rescue is a rather arcane discipline with a small coterie of experts, most of whom are well known to each other. Nonetheless, such an operation relies on much wider collaboration, so the acquaintanceships built up in exercises remain crucial. In this respect, it should be mentioned that despite some difficulties, the Russian Navy has become very much more open in the arena of submarine emergencies. The Russians are now full participants in the Submarine Escape & Rescue Working Group. This NATO group meets annually (in 2004 it met in St. Petersburg) and consists of several working panels covering the full range of submarine emergencies. During the submarine emergency exercise Sorbet Royal in 2005, the Russian participants acted as officers in tactical command for a serial with a Turkish submarine. The openness and willingness of the Russians to share the fruits of their efforts in this area is one of the truly important developments in this field in recent years. In this latest event, almost as soon as their inability to free the AS-28 became apparent, the Russian Navy called for assistance, action which saved the seven crew of the AS-28.

Endnotes

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The UK-Russia Energy Relationship

Julian Lee

The energy relationship between the UK and Russia has both political and more practical, business dimensions. Politically, the energy relationship between the UK and Russia is pursued through both multilateral channels – including the EU-Russia Energy Dialogue, the G8 and the process of Russia's accession to the World Trade Organisation – and bilateral ones, through the UK-Russia Energy Dialogue. However, as the UK's then Minister for Energy the Right Honourable Malcolm Wicks noted in 2005, 'while...government can work on the enabling environment that allows greater economic interaction, it is individual business, big and small, that actually undertake the economic activity.'⁶⁰

The political dimension

On a political level, the energy relationship with Russia has grown in importance for the UK as the country has become a net importer of natural gas and draws closer to becoming a net importer of oil – commodities that Russia holds in abundance. According to the 2006 edition of the BP Statistical Review of World Energy, the UK became a net importer of natural gas in 2004, when demand outstripped domestic supply by 1 bcm. The same source shows that the UK remained a net exporter of oil in 2005, despite an 11% drop in domestic oil production, but further declines in output in 2006 will make the UK dependent on imported oil also. Despite producing more oil than it consumed, the UK has always been active in oil trading, with high-quality North Sea grades being exported around the globe, while UK refineries processed a lower-cost mixture of domestic and imported oil. The UK has rightly identified Russia as an important contributor to the country's future energy supplies, with both oil and gas likely to be imported from Russia. This trade relationship between the UK and Russia should enhance the UK's future security of energy supplies, both through the volumes of oil and gas imported from Russia and through the diversification of suppliers that an increased relationship with Russia will represent.

The bilateral UK-Russian energy relationship was helped by the creation in 1997 of an energy industry working group within the framework of the Russo-British Committee for Trade and Investment. The relationship was given a further boost during President Putin's visit to the UK in 2003, which resulted (among other things) in the signing of a memorandum of co-operation on the construction of the North European Gas Pipeline between Russia and Continental Europe, with a branch connecting the line to the UK. The agreement was followed up during meetings between President Putin and Prime Minister Blair during the UK Presidency of the G8 and EU, when the two discussed increasing the supply of Russian energy to the UK and improvements to the investment climate in Russia. In particular, the UK remains interested in the Russian draft law 'on subsoil', which will define the regime for investment in the country's oil and gas resources, and in the Extractive Industries Transparency Initiative, which seeks to persuade governments and companies to declare openly details of payments made to governments by companies in the extractive industries such as oil and gas.

On a multilateral level, the UK used its Presidency of the EU to push the energy dialogue with Russia, which had originally been formalised in October 2000 during

the sixth EU-Russia Summit. The 2005 EU-Russia Summit in London was preceded by the first ever EU-Russia Permanent Partnership Council (PPC) on Energy, bringing together Russia, the European Commission and the incumbent and succeeding Presidents of the EU. The key objectives of the first meeting of the PPC were:

1. To give political impetus to taking forward the energy part of the Common Economic Space and the Energy Dialogue;
2. To discuss security of supply in the context of international energy markets;
3. To identify initiatives which Russia and the EU can take forward in the near term to deliver tangible benefits.⁶¹

In early 2006, the chief concerns of the EU in its energy relationship with Russia have been in the area of future gas supplies from Russia to Europe, in particular the monopoly status of Gazprom as the sole exporter of Russian gas and that company's ambitions to increase its involvement in the gas markets of the EU countries. In this regard, the EU is pushing Russia to ratify the Energy Charter Treaty (ECT) that it signed in 1994, guaranteeing foreign companies equal investment opportunities and equal access to oil and gas pipelines in Russia. Russia is resisting such pressure, claiming that the treaty, drawn up in the early 1990s when the Russian energy sector was in apparently terminal decline, does not meet the country's own needs and has now become outdated. Russia also claims that implementation of the treaty is inconsistent; arguing that Ukraine, which has ratified the ECT, contravened the Treaty's provisions during its gas pricing dispute with Gazprom at the beginning of 2006 by siphoning off gas destined for other European consumers from pipelines crossing its territory. Yet Ukraine suffered no reprisals, or even criticism, for its action. It seems unlikely that Russia will ratify the ECT in its present form and all parties to the Treaty may need to come back to the table to update some of its provisions in the light of developments in the Russian energy sector over the past decade. Both the EU and Russia will need to exhibit a degree of flexibility in their positions over access to investment opportunities and export pipelines on the one hand, and access to markets on the other.

From the EU perspective, the pricing dispute between Russia and Ukraine and the subsequent disruption of supplies of Russian gas to EU countries raised concerns about the reliability of future gas supplies from Russia. These concerns were perhaps more noticeable among the countries of continental Europe than the UK, since, broadly speaking, continental Europe, particularly Eastern and Central Europe, is already heavily dependent on Russian gas supplies, while the UK is not. As this situation changes in the years ahead, the UK will become more concerned about any disruptions to Russian gas supplies caused by disagreements with former Soviet states such as Ukraine.

Doing business

Despite the rising fear of Europe's growing dependence on Russian oil and gas, the nature of the UK's energy business relationship with Russia is a very different one, dominated not by UK imports of Russian hydrocarbons, but by inward investment into the Russian oil and gas sector by UK companies. From the very earliest signs of a thaw in the Soviet Union's relationship with the outside world in the late 1980s, UK companies were at the forefront of the quest for new opportunities. Now, in BP

the UK can boast the largest single foreign investor in Russia and, through a Shell-operated project off Russia's eastern coast, leading involvement in the country's first ever liquefied natural gas (LNG) project. UK oilfield service companies have successfully transferred the expertise they have developed in supporting operations in the North Sea and elsewhere to inhospitable regions of northern Russia and the ice-bound waters off Sakhalin Island. The relationship between individual UK companies and their Russian counterparts has not always been a harmonious one – no such relationship ever is – and UK companies, like other foreign companies and Russian ones too, have had their share of government-imposed obstacles to overcome. The UK-Russia energy relationship has weathered dramatic changes of direction in Russia, from the chaos of the early years, through the questionable privatisation of state assets during the Yeltsin presidency and the asset-grab by Russia's new oligarchs, to the increasing government involvement under President Putin.

BP's investment in the Russian oil industry, of which more below, through its acquisition of a stake in the Russian oil company Sidanco, is a clear example of the ups and downs experienced foreign companies seeking to invest in Russia. BP took the decision that Russia was too important to ignore in investment terms, but then saw its assets diluted through questionable legal procedures instituted by its partner (TNK) in key areas of its operations. After a protracted legal battle, BP ended up making an investment of several billions of dollars to form a UK-Russian oil major with TNK, creating Russia's third largest oil company in terms of production volume.

Leading the way to LNG

In June 1994, a group of companies led by Royal Dutch/Shell signed the very first production sharing agreement (PSA) between Russia and foreign oil companies for a project known as Sakhalin 2. The Sakhalin 2 contract covered the development of two oil and gas fields (Piltun-Astokhskoye, an oil field with some associated gas, and Lunskeye, a large gas field with some associated condensate) located beneath the icy waters off Sakhalin Island in Russia's far east. The project marked a number of 'firsts' in Russia. Not only was it the first PSA, it was also Russia's first offshore oil project and the country's first liquefied natural gas (LNG) project. Sakhalin 2 also represents the largest single foreign direct investment in Russia.

The project's first phase saw the development of the Astokh feature of the Piltun-Astokhskoye field, which was brought into production in July 1999, to provide a revenue stream for investment in the much larger and more expensive second phase. The second phase of the project includes further development of the Piltun-Astokhskoye field to raise capacity and allow year-round production,⁶² gas production from the Lunskeye field, the transportation of both oil and gas over a distance of 800 km by pipeline from the fields off the northeast coast of the island to its southern tip and the construction of an oil export terminal and an LNG plant. The original schedule for the project saw first oil production by 1999, followed by the commencement of year-round oil production by the end of 2003 and first LNG deliveries in the middle of 2005.

Although the first of these milestones was met, the project subsequently slipped behind schedule, with year-round oil production now not expected until the second half of 2007 (making 2008 the first full year of production) and the first LNG delivery scheduled for mid-2008. At least part of this delay is attributable to the investors' concerns over the security of their project in the face of mounting

Russian opposition to production sharing agreements and the conflicts that emerged between the Sakhalin 2 agreement and the general PSA laws passed in 1995 and 1999. The project's costs have also ballooned, doubling from an initial \$10bn to a current estimate of \$20bn. Under the terms of the Sakhalin 2 PSA, and in contrast to most PSAs, the investors are entitled to receive all the income from oil and gas sales to cover their investment costs and a 17.5% internal rate of return before any of the revenue is shared with the Russian government.⁶³ Not surprisingly, the huge escalation in the project's cost has caused anger in Russia, coinciding with a general hardening of attitudes in Russia towards the three PSA contracts that were signed in the oil sector. PSAs were never universally popular in Russia and by the late 1990s the resurgent Russian oil companies, who had begun successfully boosting their production under Russia's existing tax system, started to see the PSAs as giving an unfair advantage to their foreign oil rivals.

Although Russia passed a law 'On Production Sharing Agreements' in 1995, no further PSAs have been signed. In late spring 2006, the Russian Academy of Natural Sciences suggested that Russian companies should be given controlling stakes in each of the three PSAs operating in the Russian oil sector, claiming that all three projects had failed to meet production deadlines, significantly exceeded project cost estimates and had insufficient participation by Russian companies.⁶⁴ Sakhalin 2 was the only Russian PSA without a Russian partner in the consortium, and state-owned gas monopoly Gazprom had long sought a role in the project. Despite the setbacks, the Sakhalin 2 project is moving steadily towards year-round oil production in the second half of 2007 and Russia's first LNG exports, which are now expected in 2008, and remains a project of key importance for both the Russian oil and gas sector and for Shell.

Shell's other upstream investment in Russia is a 50% stake in the Salym project, which it shares with the independent Russian company Evikhon, a subsidiary of the UK-listed Sibir Energy.⁶⁵ The licence for the field was awarded to Salym Petroleum Development (SPD) in 1998, but significant development activity was delayed for several years while the companies sought to agree a production sharing contract with the Russian government. The Russian government eventually struck the field (along with around 30 others) off the list of those eligible for development under PSAs and Shell and Evikhon decided to proceed with development under existing Russian tax laws. Although production had begun under a pilot scheme from the Upper Salym field in 1995, significant development work on West Salym – the largest field in the licence area – did not get underway until 2004, with production commencing in December of that year. In 2005, the fields were connected by pipeline to the Transneft system, paving the way for a significant increase in output, which is expected to rise to around 120,000 bpd before the end of the decade.

Despite the presence of one of the world's largest oil companies as a 50% shareholder in SPD, the company is still a small player in the Russian oil sector. As a result it has little influence over Rosenergo and Transneft and it has struggled to be able to deliver its output to the export outlets that it would like to use. Nevertheless, both Shell and its partner remain committed to the project, planning to invest a total of \$1.27bn in the project and aiming to raise production to 60,000bpd from the licence area by the end of 2006 when Valedyp, the third field to be developed, is brought into production. SPD is hoping to expand its activities in the Khansty Mansiysk Autonomous Oblast where it operates.

The biggest single investor

On 18 November 1997 at 10 Downing Street, in the presence of the UK's Prime Minister Tony Blair and Russia's First Deputy Energy Minister Viktor Ott, BP's then-Chief Executive John Browne and the President of Onexsimbank Vladimir Potanin signed an agreement that saw BP take a 10% stake in Sidanco, then Russia's seventh largest integrated oil company. The deal also gave BP the right to acquire 45% of Sidanco's 60% stake in Rusia Petroleum, a company that held the right to the Kovykta gasfield close to Lake Baikal in East Siberia's Irkutsk Province. For this stake, BP agreed to invest a further \$172mn at Kovykta, bringing its total investment in the deal to nearly \$750mn. Commentators at the time were divided over the wisdom of BP's move: one analyst suggested that 'this may not be the best purchase BP has ever made.'⁶⁶

In the following years it seemed as though the prophets of doom had been correct. Sidanco's ownership of the licence for part of the giant Samotlor field made it an obvious target for rival Russian oil company TNK. After a protracted battle that saw Sidanco sued for bankruptcy, TNK gained control of Sidanco's most important upstream assets, including the Chernogorneft subsidiary holding the Samotlor licence, and BP announced at the time of its full year financial results in February 1999 that it was taking a \$200mn write-down due to the difficulties that Sidanco was experiencing, representing more than 40% of its initial investment. However, over the following two years a deal was brokered between Sidanco and TNK, under the terms of which Chernogorneft was returned to Sidanco in return for TNK being given a 25% in the parent company in early 2001. At the same time BP, which had assumed the effective management of Sidanco at the end of 1999, saw its management contract for Sidanco renewed for a further three-year period.

Despite these difficulties, as the end of its three-year management contract for Sidanco approached, the UK company took the extremely bold step of announcing the creation of a new joint venture company combining most of its Russian assets with those of TNK to create a single, jointly-owned company TNK-BP. BP would pay TNK around \$2.4bn plus a further \$3.75bn in three annual tranches of its ordinary shares for its 50% stake in the new company. TNK-BP has been a major asset for the UK company since its creation. Despite suffering, along with several other Russian companies, the imposition of retrospective tax demands and the threatened loss of some of its key exploration and production licences, in 2005 TNK-BP contributed more than one third of BP's total crude oil production and 5% of its natural gas production. TNK-BP, which is entirely self-funding, invested \$1.8bn in its operations in 2005 and plans to invest around \$2.5bn in 2006.

TNK-BP is one of Russia's leading oil producers, producing just over 1.8mbpd (including its 50% share in another Russian oil company Slavneft), or around one fifth of total Russian oil production. In addition to its upstream operations, TNK-BP owns four refineries in Russia (plus a fifth in Ukraine) and a network of more than 2,000 service stations across Russia and Ukraine. Most of these carry the TNK logo, but 46 sites in and around Moscow were brought to the partnership by BP and still carry the UK company's brand.

The TNK-BP partnership has brought the operation and future development of Russia's largest oilfield (and the third largest conventional oilfield ever discovered anywhere in the world) under single management. TNK-BP is rehabilitating the field, aiming to boost recovery in the southern section from the current 35% to 50%

of the 44.6bn barrels of original oil in place and to raise recovery in the northern part of the field from 18% now to 45% of the 8.1bn barrels originally in place. These figures may not appear particularly high, with at least half of the oil in the field expected to be left in the ground, but they are not out of line with recovery factors elsewhere in the world and are substantially higher than the 30% recovery rates often associated with primary production in the Middle East.

Among other major projects, the company also hopes to develop the Kovykta gasfield, which lies close to the western shore of Lake Baikal in Russia's Irkutsk Province and the Verkhnechonsk oilfield further north in the same province. But difficulties encountered with Russia's state-owned gas monopoly Gazprom over exports of gas from Kovykta have severely delayed the project and risk pushing the licence holder Rusia Petroleum, of which TNK-BP is the majority owner, into breach of its licence conditions, risking possible revocation of the development licence.

The adoption of Western-style oilfield management principles by TNK-BP has not been without its problems. The company has repeatedly been threatened with losing several of its licences because of an unacceptably high proportion of idle wells on certain fields. The company, like others in Russia, has sought to improve its profitability by shutting in unproductive wells, but this has sometimes been used by Russian officials as an excuse to put pressure on the oil industry, threatening them with the loss of production rights for breach of the terms of their licences. To date, TNK-BP has not lost any of its licences in this way, but the threat remains hanging over the company.

UK independents in Russia

A number of smaller independent UK oil companies have either focused their activities in Russia, or are active in the country. These include:

- Baltic Petroleum Ltd⁶⁷ was formed in December 2004 to invest in oil and gas projects in Russia. The company, through a joint venture with Siberian Energy Group Inc, holds seven exploration licences in the Kurgan region of West Siberia. Baltic Petroleum is also building an oil export terminal at Kaliningrad on Russia's Baltic coast.
- Concorde Oil & Gas, led by former Texaco executives, signed a conditional contract to acquire Pechora Energy for \$25mn. Pechora produces around 250 barrels of oil a day from the Luzskoye field via a single well with two additional wells ready to begin production and owns a dedicated rail terminal for oil transportation.
- Imperial Energy⁶⁸ holds licences covering 22,400 km² in the Tomsk region of West Siberia and has commenced production from two fields through its Nord Imperial subsidiary. Its Allianceneftegaz and Sibinterneft subsidiaries also hold licences in the Tomsk region.
- Sibir Energy,⁶⁹ formed in 1996 by Pentex Energy, a UK independent oil and gas company, has had a turbulent history in Russia. In 1996 it acquired a 20% interest in Evikhon, which gave it a 10% share in the Salym project with Shell and an interest in Yugraneft. By the end of 2000, it had increased these stakes to 82% of Evikhon and 94% of Yugraneft and reached an agreement in principle with Russian oil major Sibneft to establish a joint venture, Sibneft-Yugra, to develop the Yugraneft oilfields, an agreement that was

finalised in February 2001. By the end of 2001, Sibir and the Moscow Government had agreed to create the Moscow Oil & Gas Company (MOGC), combining Sibir's upstream assets with the assets of the Moscow Oil Company, which was incorporated in 2003. Following deterioration in its relationship with Sibneft, Sibir was informed in April 2004 that Yugraneft's interest in Sibneft-Yugra had been diluted from 50% to less than 1% by increases in the charter capital of Sibneft-Yugra, with the newly issued shares owned by Sibneft. Sibir has since been pursuing Sibneft through various courts for restitution of its assets in Sibneft-Yugra, with little success so far. Sibir's other joint venture project, Salym Petroleum Development, a 50/50 joint venture between Sibir's Evikhon subsidiary and Royal Dutch Shell, has been much more successful for the company. Commercial production from the Salym group of fields in West Siberia began in 2005 and had reached nearly 50,000bpd by mid-2006. Output from the fields is expected to peak at 150,000bpd in 2009.

- Urals Energy,⁷⁰ a leading Russian independent oil company is listed on the UK's Alternative Investment Market (AIM), although its corporate head office is in Cyprus and its principal investors are a small group of Russian entrepreneurs with considerable experience in the Russian oil sector. The company has acquired and controls five Russian oil companies with interests in exploration, production and refining in Sakhalin Island, Timan-Pechora, the Republics of Komi and Udmurtia and East Siberia.
- Victoria Oil & Gas⁷¹ owns the licence for the West Medvezhya gas and condensate field near Nadym in Russia's Yamal region, where it is currently undertaking exploration and appraisal work.

UK companies have had a much longer, more substantial and consistent presence in Russia than those of any other country. Although other European companies have invested in Russia, their presence is not nearly so large as that of UK companies. France's Total and Norsk Hydro of Norway are partners in the Kharyaga PSA in West Siberia and ENI is negotiating an asset swap with Gazprom that would give the Italian company a stake in Russia's gas production in return for granting Gazprom access to the Italian market. From the US, super-major ExxonMobil is involved in a major project off the coast of Sakhalin (inherited from Mobil during the merger of the two companies). Chevron has focused on Kazakhstan and the CPC pipeline that crosses Russia, after the Sakhalin 3 project, in which it inherited an interest through its merger with Texaco, was withdrawn by the Russian government. ConocoPhillips has made a much more recent foray into the Russian oil sector through a 2004 deal with Lukoil, which has seen the US company take a 20% stake in its Russian partner. Chinese and other Asian companies are also recent arrivals on the Russian oil scene, seeking access to oil reserves close to their rapidly-growing domestic markets. US company Marathon has had an on-off relationship with Russian oil assets, twice investing in the country and then selling out again.

Leveraging North Sea skills

The involvement by UK companies in the Russian energy sector is not limited to direct investments in upstream projects. The UK oilfield services companies have also been active in Russia and still see the country as an important area of future operations. A few examples illustrate the breadth of this involvement.

- The UK's Abbot Group, through its KCA Deutag subsidiary, owns and operates what it claims to be the most advanced drilling rig in Russia and provides drilling services for a number of operators throughout the country, including Sibneft, RITEK and SPD in West Siberia as well as SEIC on the Sakhalin 2 project. The company has identified Russia as a key area of focus and has recently added a regional head office at Tyumen in West Siberia to its existing offices in Moscow and Sakhalin.
- Getech,⁷² a provider of gravity and magnetic data and related management and interpretation services based at Leeds University, is currently undertaking an Russian aeromagnetic study, using aircraft-borne sensors to search for magnetic anomalies that might indicate the presence of oil or gas. Such surveys can cover wide areas of otherwise inaccessible country to provide initial indications of the presence of hydrocarbons.
- Following other successful projects in Russia, including work at the Kharyaga field in West Siberia, Petrofac, an international oil and gas facilities provider with its Operations Services Division based in Aberdeen, won two contracts at the beginning of 2006 related to the development of the Kovykta gas field in East Siberia. The company has also extended its training services in Russia through the acquisition of a company providing operations and maintenance training in Sakhalin.
- The Aberdeen-based Wood Group, an international energy services company, continued to expand its operations in Russia, opening its first repair facility for electric submersible pumps in West Siberia in 2005 and winning a gas turbine service contract from Russian oil major Surgutneftegaz.
- Aberdeen-based Oil States Industries (UK) ltd began specialist welding work in 2006 for the Shell-led Sakhalin 2 project.

The Russians in Britain

The involvement of Russian companies in the UK energy sector has been extremely limited to date. Although Gazprom has had a presence in the UK since 1999 (see below), it only made its first move into retail sales in the UK in June 2006.

Russian oil companies have yet to establish a presence in the UK. Upstream, their lack of experience in developing offshore oilfields has made the North Sea an unattractive destination for Russia's oil companies. Downstream, with the exception of Lukoil's investment in the USA, Russian companies have limited their international ambitions in refining and marketing to former Soviet and East European countries, although that could be about to change. In June 2006, BP announced its intention to sell its last remaining UK refinery, at Coryton in Essex, and Lukoil has been identified as a possible purchaser as it seeks to expand its downstream assets.

Buying Russian gas?

Russia's state-controlled gas monopoly Gazprom has had a presence in the UK gas market since 1999 when it acquired a 10% stake in the Interconnector, the reversible natural gas pipeline connecting Bacton in Norfolk with Zeebrugge on the Belgian coast that carries gas from the UK continental shelf to Europe in times of

surplus, but more recently has been used to supplement the UK's domestic gas supplies with imports. On the 6 May the same year, Gazprom established Gazprom UK Trading Ltd as a wholly-owned subsidiary in London. The company's name was changed to Gazprom Marketing and Trading (GM&T) in August 2004 to reflect its widening focus to other liberalised markets in Europe. GM&T manages Gazprom's 10% stake in the Interconnector and is also involved in gas marketing and trading in the UK. According to its website,⁷³ GM&T sold approximately 3.5bn cubic metres (bcm) of gas in the UK in 2004, accounting for approximately 3.6% of total UK gas consumption. In 2005, the company supplied 30 customers across Europe; mainly energy wholesalers, power generators and large industrial gas users of gas, as well as having an active involvement in gas trading in the UK and other European markets. The company has also leased gas storage capacity at Humbly Grove in Hampshire, taking 143 bcm, or roughly half of the facility's capacity, until August 2010.

As the UK's dependence on imported gas grows over the coming years, Gazprom is set to play an increasingly important role. It aims to supply 10% of the UK gas market by 2010, selling 13bcm of gas into the country. GM&T plans to sell 70% of this volume wholesale and the other 30% to end-users. Until the end of the decade, gas will continue to be delivered to the UK through the Interconnector, with Gazprom controlling reverse flow capacity (from continental Europe into the UK) of 4.9bcm/yr once the second stage expansion of the line is complete, as well as through other pipelines now under construction and in the form of LNG. Gazprom, through its stake in Wingas, will have access to 2bcm/yr of import capacity through the 15bcm/yr Balgzand-Bacton Line (BBL), which links the Netherlands and the UK and is negotiating an agreement with Gasunie of the Netherlands to secure a further direct stake in the BBL in exchange for a Dutch stake in the North European Gas Pipeline. The company is also investigating the possibility of swaps with Norwegian producers to allow it to make deliveries of gas to the UK through the Langeled pipeline. Gazprom made its first shipment of LNG to the UK's Isle of Grain terminal in April 2006, delivering a 140,000 m³ cargo (equivalent to 0.85bcm of natural gas) that it had bought from Gaz de France. GM&T sees its Humbly Grove storage capacity, together with its ownership of stakes in both the Interconnector and BBL gas pipelines as important first steps in ensuring long-term supply of gas to UK customers.

Beyond 2010, Gazprom is considering the construction of a spur from its North European Gas Pipeline (NEGP) to the UK. The NEGP, construction of which began in September 2005, will eventually carry 55bcm/yr of gas beneath the Baltic Sea from Russia to Germany and could be linked directly to the UK.

To maximise revenues from its growing role in the UK downstream gas sector, Gazprom is keen to gain a presence in the retail gas business and this interest is unlikely to diminish. Suggestions that the UK government was being advised on how it might block a bid by Gazprom for control of Centrica, the largest gas supplier in the UK, provoked an angry response from Gazprom and the Russian government. Both Gazprom and Centrica denied that any formal approach had been made, but Gazprom has confirmed that it is interested in securing access to the UK retail gas sector and aspires to control a 20% share of the UK gas market by 2015. The company took its first small step in this direction in June 2006 with the acquisition of the gas supply business of Pennine Natural Gas (PNG), a privately-owned UK gas supplier based in Wilmslow, Cheshire, which has annual gas sales worth some £10mn and a customer base of around 600 industrial and commercial clients.⁷⁴ The UK's domestic gas and electricity markets have both been identified as possible areas of future expansion.

The issue of ceding a significant stake in the UK's retail gas sector to the state-controlled monopoly holder of gas infrastructure and export rights in the world's largest gas-producing country will have to be addressed at some point in the future. In line with its EU partners, the UK is expected to push for greater transparency in the Russian gas sector and equal access to pipelines and export opportunities for third-party gas producers, including companies like TNK-BP. The next phase in the UK-Russia gas relationship could be the most challenging yet, but the rewards for both sides are extremely attractive.

Conclusions

The UK and Russia have built up a deep, multi-faceted relationship in the oil and gas sector that includes both a political and a business dimension. While the political relationship helps to create the environment in which the business relationships are forged, it is those commercial ties that lie at the heart of the UK-Russia oil and gas relationship. Until now, this relationship has been dominated by the investments of UK oil and gas companies in Russia in exploration, production, refining and products marketing, with the BP and Shell brands both becoming more common sights on the streets of Moscow and St Petersburg. Looking ahead, we can expect to see reciprocal investments, with Russian companies becoming more active in the UK as Gazprom seeks to build up its position in the country's gas retail market and Lukoil considers the purchase of BP's last remaining UK refinery.

The relationship has not been without its difficulties. BP's legal battle with TNK over the core assets of Sidanco and the political furore sparked in both the UK over Gazprom's possible ambition to buy Centrica and in Russia over the revelation that the UK government had sought advice on blocking such an acquisition illustrate the many pitfalls that the relationship has had to overcome. TNK-BP has been criticised by the Russian Natural Resources Ministry over its large number of idle wells and, like other companies operating in Russia has been hit with retrospective tax bills. Shell has come in for heavy criticism over the escalation of costs at its Sakhalin 2 project and for alleged breaches of environmental agreements.

Russia's increasing resource nationalism, while not out of step with moves seen in other oil and gas-producing countries, is unwelcome for all private investors, domestic and foreign. UK companies in Russia need to be reassured of the rule of law and the equal application of that law to all. For its part, the UK government needs to recognise the important role that Russian gas, in particular, can play in the UK's future energy security. Gazprom's monopoly control over Russia's gas pipeline system and the country's gas exports remains a problem for the UK, but the Russian government shows no sign of opening the sector up. If the UK-Russia oil and gas relationship is to flourish, both sides need to recognise the benefits that the other can bring. It would be too easy for a resurgent Russian nationalism or the UK's fear of becoming dependent on imported energy to wreck a relationship that has brought benefits to both parties and stands to multiply those benefits many-fold in the years ahead.

Endnotes

⁶⁰ Malcolm Wicks, speech at the Association of European Business, Moscow, 13 September 2005.

⁶¹ Joint EU Presidency and European Commission Press release on the EU – Russia Permanent Partnership Council on Energy, 3 October 2005, London.

http://www.europa.eu.int/comm/external_relations/russia/summit_10_05/ip05_1218.htm

⁶² Under the first phase of the project production can only be carried out during the ice-free months of the summer. The production season usually runs from early June to mid-December.

⁶³ In a standard PSA only part of the oil (or gas) produced is used for cost recovery (known as ‘cost oil’), with the remainder (‘profit oil’) being shared between the parties to the agreement in a pre-agreed ratio.

⁶⁴ Platt’s Oilgram News, 26 May 2006, p.3.

⁶⁵ In addition to its upstream interests in Russia, Shell is also building a network of service stations in St. Petersburg and Moscow.

⁶⁶ Eastern Bloc Energy, December 1997, p.18.

⁶⁷ <http://www.balticpetroleum.com>

⁶⁸ <http://www.imperialenergy.com>

⁶⁹ <http://www.sibirenergy.com>

⁷⁰ <http://www.uralsenergy.com>

⁷¹ <http://www.victoriaoilandgas.com/>

⁷² <http://www.getech.com>

⁷³ <http://www.gazprom-uk.com>

⁷⁴ *Financial Times*, 23 June 2006, p.22.

Understanding Russia: Sakhalin II

Dr. Nazrin Mehdiyeva

Late on the evening of 17 April 2007, Russian state monopoly Gazprom finalised a deal on the transfer of a controlling stake in the Sakhalin-2 production sharing agreement from a consortium of foreign companies led by Anglo-Dutch Shell. The deal had been agreed in December 2006, following months of pressure from the Russian state. Gazprom accepted to pay US\$7.45 billion for a 50% plus one share in the project.

The Shell-operated Sakhalin-2 is the world's largest integrated oil and gas project currently underway.⁷⁵ It forms an important prism through which to analyse UK-Russia business relations. As a case study, it provides valuable insights into the evolution of Russian strategic thinking with regard to foreign oil companies in general and UK companies, Shell and British Petroleum (BP), in particular. Notably, the Sakhalin-2 case demonstrates the ability of UK companies to adapt to changing circumstances in the country's investment climate.

Gazprom's purchase of the Sakhalin stake and the saga preceding it have reflected strong elements of political manoeuvring aimed at enhancing the Russian state's presence in the oil and gas industry. The deal fits the pattern of evolving Kremlin thinking about the ownership of its subsoil resources, the role to be played by state 'national champions' in the sector and the degree to which foreign corporates should be allowed to lead some of the country's largest projects. These issues tie in directly with the question of the sanctity of contract in Russia and the continued attractiveness of this vast emerging market to foreign investors.

At the same time, the Sakhalin-2 deal is not just another case of energy nationalism. It has elements of a forced but genuine business deal and does not amount to nationalisation or effective expropriation of assets, as witnessed recently in Bolivia, Venezuela and in the course of Russia's own 'Yukos affair'. Second, the way in which the Russian state approached Sakhalin-2 is different from the Sakhalin-1 and Kharyaga PSAs. This element of sophistication in distinguishing between the three agreements indicates the absence of a blanket strategy of nationalisation in Russia's hydrocarbons sector and the perceived strategic significance of Sakhalin-2 to Russia's national interests.

This chapter is in two parts. The first seeks to provide the context within which decisions on Sakhalin-2 were made. It challenges the assumption that the state's intervention in Sakhalin-2 was the result of a sudden outburst of energy nationalism, arguing that unfavourable attitudes towards PSAs prevailed throughout the 1990s. High international oil prices in the past few years intensified the state's desire to re-establish itself in the oil and gas industry, which, coupled with electoral calculations and bureaucratic wrangling, translated old grievances into action. Gradually, it became apparent that Gazprom's entry into the Sakhalin consortium was necessary to salvage the project; yet the terms of the deal were not predetermined from the start. The latter suggests the existence of a number of conflicting policy objectives pursued by the Russian state.

The second part looks at the specifics of the Sakhalin-2 case and argues that although in many respects the state's interests overlapped with those of Gazprom, the Kremlin's primary objective was not to leverage Gazprom's entry into the consortium but to ensure that a greater share of profits accrued to the state. The

fact that this was achieved without legally revising the PSA highlights that, despite being a forced deal, Sakhalin-2 was not in any way an instance of nationalisation. It is therefore not comparable to the Yukos affair, in which the state's objective was to destroy the company using tax legislation. However, while Yukos is unlikely to be repeated, administrative methods of pressure developed in the Sakhalin case are already being applied to TNK-BP and its vast Kovykta field.

Attitudes to production-sharing agreements

Sakhalin-2 and the nature of Shell's involvement in Russia are unique in many respects. The project is one of only three PSAs signed in Russia. Even in the 1990s, when oil prices were significantly lower than they are today, Russia regarded the PSAs as a temporary arrangement in the industry, suitable perhaps for a handful of technologically very challenging greenfield projects in new and difficult to develop oil regions. Moscow never intended to make the PSAs the basis of its fiscal regime in the oil sector, in sharp contrast to other oil-rich former Soviet republics – notably, Azerbaijan and Kazakhstan. The Russian authorities did not finalise the PSA framework law until 1995. Even then, its implementation was stalled by the fact that it contradicted much of Russia's other legislation.⁷⁶ Informal and bureaucratic impediments, but, above all, psychological resistance to signing what were perceived to be essentially 'colonial agreements' played a paramount role in preventing the signing of new PSAs.

Indeed, Russian officials - even those of liberal persuasion - repeatedly complained that the PSA regime was more appropriate for underdeveloped and less 'civilised' states, and that the signing of such agreements was humiliating for Russia. Frustration with PSAs was compounded by perceptions of overly slow progress at Sakhalin-1.⁷⁷ Although a tender to develop Sakhalin-3 under a PSA was held in 1993, negotiations to finalise it lasted eleven years, until in January 2004, the government revoked the exploration licence of the group led by Exxon and Chevron. Deputy Prime Minister Viktor Khristenko stated that there was no reason for Russia to develop the field under either a PSA or regular taxation regime, and that the field would be auctioned off when its development became expedient.⁷⁸ Remarkably, the other two blocs of Sakhalin-3 were not even included in the list of deposits that could be developed under the PSA regime.

In this context, Shell's ability to negotiate the Sakhalin-2 PSA, overcoming psychological barriers as well as extremely cumbersome bureaucratic procedures and the unfinished legal framework, constituted a remarkable achievement in its own right. Authorised by presidential decree in 1994, Sakhalin-2 became the first PSA concluded in Russia, a year before the PSA law came into effect.

It was implicit that along with opportunities in Russia's nascent energy market came substantial risks. Perceptions that the PSAs did not correspond to Russia's needs and national interests, present already in the early 1990s, were bound to become more manifest at a time of rising international oil prices and/or under a government more susceptible to the ideas of statism and resource management.⁷⁹ The terms under which the Sakhalin-2 PSA functioned, its size and the absence of a Russian partner in the consortium made it particularly vulnerable to arbitrary political pressure and state action.

Policy direction

Rent-seeking and unexpected revisions of oil taxes are common among petro-states. According to a recent study conducted by Wood Mackenzie, in Russia, future profits lost for private firms due to tax changes since 2002 amounted to \$50 billion. In this list of oil-producing states tinkering with their oil tax policy, Russia held first place but was followed immediately by the UK, where profits lost for the private sector stood at an estimated \$38 billion.⁸⁰ Yet Russia made the headlines, primarily thanks to widespread perceptions that it was a risky place, headed by an untrustworthy and authoritarian government. Viewed through the prism of these perceptions, many observers tended to exaggerate the exceptionality of the Russian government's claims that it was not receiving its fair share of profits.

To be sure, in Russia the reversal of the earlier policy of allowing private and foreign oil companies ownership of large equity stakes has been abrupt and accompanied by a gradual practical consolidation of the political rhetoric of Russia as an energy superpower. To make matters worse, the policy of re-asserting state control over the oil industry first became apparent with the destruction of a private - and the country's largest - oil producer Yukos and the transformation of state company Rosneft into a national champion.

Still, to date Russian energy nationalism has remained limited to a series of *ad hoc* actions against domestic and foreign oil majors, often motivated by an array of domestic political considerations and not just the state's determination to establish control over hydrocarbons. The absence of a coherent overarching energy strategy has been detrimental to Russia's investment climate because it has confused the rules of the business game, fuelling fears that Shell's Sakhalin-2 troubles and pressure on TNK-BP over the Kovykta field presage another Yukos.

Yukos analogies are misplaced partly because they fail to account for the political ambitions of Yukos founder and former CEO, Mikhail Khodorkovsky, and the uncompromisingly rigid stance he chose to adopt with regard to the state. In addition to the obviously absent political dimension, both Shell and, even more so, BP have shown willingness and ability to adapt to changing circumstances. Despite pressure over Kovykta, BP intends to expand its presence in Russia. There is a growing understanding that stability of existing and new projects can be ensured through partnerships with either Gazprom or Rosneft. The Sakhalin-2 case shows that this approach is likely to pay off. Indeed, the decision taken at a Kremlin meeting in January to split all new offshore oilfields, including on Sakhalin, between Rosneft and Gazprom indicates that the state will continue to enforce its presence in the industry.⁸¹ But at the same time, this decision is unlikely to aid the emergence of a coherent energy strategy and may, in fact, intensify rivalry between the state companies.

Electoral dimension

That President Vladimir Putin would use the country's energy resources to achieve a range of foreign and domestic policy objectives had become apparent by July 2006, when Russia hosted the G8 summit in St Petersburg. Defending the country's right to be in the G8, Putin emphasised that his country alone had four times more oil and gas than all other G8 members taken together. Apart from the foreign policy aim of re-establishing Russia's great power status, the domestic goal of restoring justice by rectifying mistakes of the early 1990s has become equally prominent, not

least because it has proved consistently popular with the electorate. In fact, vociferous campaigns unleashed against all three PSAs – for cost overruns, under-production and alleged environmental damage – formed part of the authorities' broader efforts to restore Russia's national pride and appeal to the sense of justice of the Russian people. Other such efforts included selective prosecution of oligarchs – first and foremost, Khodorkovsky, but also Vladimir Gusinsky and Boris Berezovsky.⁸²

Indeed, many of Moscow's policy moves that have caused international concern have been central to strengthening Putin's standing domestically and achieving the consolidation of his regime. The Russian-Ukrainian (January 2006) and the Russian-Belarusian (January 2007) crises provide vivid illustration of this, as the government and public appeared united on the acceptability of risking Russia's reputation as a reliable energy supplier to achieve a narrow set of political and economic goals vis-à-vis Ukraine and Belarus, respectively. To a degree, the same logic applies to the PSAs, as Russia has been willing to sacrifice part of its political capital as a business-friendly destination to take control of the Sakhalin-2 project. This is not to say that government policy of recent years, particularly the expanding role of the state in the oil and gas sector, has been driven by popular demand. However, the fact that state preferences were in line with those of the public reinforced the trend towards greater state interventionism.

Pressuring foreign and domestic companies has been used as a way to garner popular support ahead of the electoral cycle of 2007-08. Over a period of several months, the scope of the campaign against Sakhalin-2 appeared to broaden, as the government became keen to demonstrate that all oil companies, domestic and foreign, would be investigated if suspicions arose over their environmental record. Indeed, in part, this was an attempt to reduce the political impact of the attack on Shell. However, it was also a way to show that Russia was now becoming a "civilised country" where strict adherence to environmental legislation was "natural".⁸³ The Prosecutor-General's Office issued a statement that it would introduce additional measures to strengthen legal supervision of the companies' compliance with environmental rules, while the deputy head of Rosprirodnadzor, Oleg Mitvol, cited audits conducted at Lukoil, Rosneft, Gazprom Neft and TNK-BP.⁸⁴

In this respect, foreign companies provided a convenient target, and Kremlin top aides did not miss a chance to accuse them of not fulfilling their Russian Content requirements and of being interested "only" in exporting Russia's raw materials.⁸⁵ Mitvol's statements that "we no longer view foreigners as a special category" and "we don't write different laws for them"⁸⁶ – widely broadcast on Russian television -- have resonated with the Russian electorate.

Sakhalin-2 case study

The Sakhalin-2 PSA was particularly vulnerable to pressure from the Russian state. The size of its proven reserves, its prospects as Russia's first LNG producer and the concomitant strategic value of the project help explain why it was treated differently not only from licensed projects but also the Sakhalin-1 and Kharyaga PSAs.⁸⁷ The failure of Sakhalin-2 to meet the initial production arrangements and the doubling of costs on conditions unfavourable to Russia gave policy-makers a legal excuse to revise or otherwise alter the terms of the 1994 agreement.⁸⁸ Rising energy nationalism across the globe created an external dynamic that further influenced Russia's policy-making establishment, building a political momentum for promoting

Gazprom's entry into the consortium, composed until then exclusively of foreign companies. The fact that Gazprom had been interested in acquiring a large, possibly controlling, stake from Sakhalin Energy since 2004 was an additional factor that worked alongside, though not always in synchrony with, the state's emerging scheme of controlling strategic subsoil deposits.⁸⁹

Strategic importance

Sakhalin-2 comprises two offshore fields, Piltun-Astokhskoye and Lunskoye, which contain an estimated 150 million tonnes of oil and 500 billion cubic metres of gas. The project's Phase 2 envisages the construction of a liquefied natural gas (LNG) plant and an LNG export terminal on Aniva Bay. At the projected export capacity of 9.6 million tonnes (or 13.3 bcm) per annum, the LNG plant in Prigorodnoye, in the southern part of the island, will be Russia's first, and the world's largest, plant to liquefy natural gas.⁹⁰ An 840-kilometre pipeline to connect the Lunskoye field in the northeast of the island to the LNG terminal in the south is also being built. The start of production is currently scheduled for summer 2008, making Sakhalin-2 Russia's first LNG project. Almost 98% of the amount to be produced in the first year has already been pre-sold on long-term contracts, mostly to Japan, and some to South Korea and the United States.

Despite these advantages, Sakhalin-2 was increasingly becoming the subject of criticism. The start of offshore oil production, initially scheduled for 1998, was delayed until the following year, while geological and technical complexities of the project meant that even then oil was produced on seasonal basis, rather than all-year round. This is still the case today.⁹¹ Gas production from the Lunskoye field is yet to begin. Moreover, last year, production at Sakhalin-2 lagged significantly behind Sakhalin-1, with the former producing 1.6 million tonnes of oil and 263.6 million cubic metres of associated gas. Oil production remained unchanged from 2005, and is significantly less than 2.56 million tonnes and 1.1 billion cubic metres of gas produced at Sakhalin-1.⁹² Yet the key reason for the state's involvement in Sakhalin-2 was the doubling of its total cost estimates. Initially projected at around \$9-11 billion, its cost has since been revised to \$21.9 billion, in part owing to higher costs of labour and steel, inflationary pressures in Russia and the weakening of the dollar.

According to the terms of the PSA, the Russian state will only start receiving its share of profits after the foreign consortium recouped its costs. Moreover, at a real rate of return less than 17.5%, the state will receive a mere 10% of the profits, while Sakhalin Energy will receive the remaining 90%. At a rate of return equal to 17.5%, the state will split profits with the consortium on a 50-50 basis. It will only receive 70% of the profit when the rate of return reaches 24% and above. The cost of \$22 billion meant - on the calculation of the Russian authorities - that the country would not benefit from the project until 2013-14 at the earliest.⁹³ Shell argued that, despite increased costs, the project remains "highly beneficial" to Russia, and according to Sakhalin Energy, at the price of \$35/barrel, the project would bring into the Russian treasury an estimated \$50 billion. At the price of \$50/barrel, this figure would reach \$80 billion.⁹⁴

Nevertheless, Andrei Dementyev, deputy minister of Industry and Energy, said that Sakhalin-2 was "the worst" of the three PSAs. Revealing the general mood in the government, Dementyev complained that at the production rate of 1.5-2.0 million tonnes of oil per annum, extracted from the Piltun-Astokhskoye field, Russia received only \$20 million in royalties and nothing in profits. He claimed that, at

prevailing oil prices, if a standard tax regime were applied, Russia would receive between \$300-400 million dollars annually.⁹⁵ Dementyev's comments were by no means exceptional. A report prepared by the Russian Academy of Sciences, for instance, also claimed that together the three PSAs had cost Russia \$11-12 billion dollars.

Such assessments were followed by calls to revise or amend the PSA – on a mutually advantageous basis. Speaking at the EU-Russia summit in Helsinki in late 2006, President Putin said that the parties needed to sit down at the negotiating table and find a solution. He noted with clear irritation that proposed cost increases were unacceptable, as Russia would not get “anything for another ten years”.⁹⁶ During Russian parliamentary hearings in October, Dementyev told the Federation Council that his ministry was holding talks with Sakhalin Energy to introduce amendments to the project's “economic model”, but that it was unlikely to lead to changes in the terms of the PSA. In late November, a Russian top Audit Chamber official, Sergei Abramov, said that the government wanted Shell to take an initiative in offering improved terms for the PSA. He added that Russia would not unilaterally revise the agreement, but it would not at the same time endorse a new budget. Natural Resources Minister Yury Trutnev made similar statements, noting that Russia would “happily agree” to scrap the PSAs “if the companies suggested it”.⁹⁷

This state of affairs seemed to imply a stalemate, had it not been for a fierce environmental campaign and technical checks that were being conducted in parallel with these more placatory statements of the president and energy officials. The state's tactic of applying suasion and administrative power throughout negotiations revealed the existence of conflicting state goals and the absence of a pre-determined solution to Sakhalin.

Pressuring Shell

The Kremlin's first public expression of concern with Sakhalin's ecology came in September 2006, when the Ministry of Natural Resources (Minprirody) suspended the State Environmental Expertise Review, a key permit that it had itself issued three years earlier. Phase 2 of the project was brought to a partial halt, giving ground to fears that losses from Sakhalin Energy's possible failure to meet its contractual obligations could amount to \$10 billion. At the same time, Minprirody and Rosprirodnadzor threatened to stop the project altogether, cancel the PSA and sue Sakhalin Energy for up to \$50 billion in compensation in international arbitration courts, if they found sufficient evidence that the project had caused “irreparable damage” to Sakhalin's environment. Rosprirodnadzor accused the consortium of polluting Aniva Bay, causing deforestation by, among other things, digging pipeline glades of unauthorised width, and causing soil erosion by dumping clay and sand into the rivers essential for the spawning of salmon. In an escalating series of statements, Mitvol accused the Sakhalin consortium of concealing knowledge of these environmental violations. After inspecting the project in October, Trutnev declared that a criminal case would be opened, as the consortium had violated five articles of the criminal code. Some of the violations, he stated, were punishable by prison terms of up to seven years.⁹⁸

Sakhalin Energy sought to respond to Russian government enquiries “as fast as possible”, according to the consortium's CEO Ian Craig, but in less than three weeks (between late September and mid-October), Sakhalin Energy received 27

requests, each of which required “thousands of pages of documentation”.⁹⁹ In October, Shell CEO Jeroen van der Veer stated that the company firmly believed that all significant environmental challenges had been “fully and adequately addressed”. In the same month, van der Veer met Trutnev to discuss the alleged violations, after which the minister proclaimed that a “180-degree turnaround” had been achieved. He said that Shell was now taking a more “constructive approach” to Russia’s environmental concerns, acknowledging existing violations and proposing ways to improve the situation. Yet to maintain a degree of leverage, he emphasised that “absolutely any sanctions” remained possible if Shell’s proposals proved unsatisfactory.¹⁰⁰ Although Sakhalin Energy did not have an impeccable environmental record and had acknowledged some violations,¹⁰¹ the bluntness of the authorities’ campaign and Mitvol’s subsequent outright rejection of all measures proposed by the consortium as a “joke collection” suggest underlying political motives.¹⁰²

There was indeed an element of bureaucratic rivalry and an attempt on the part of the environmental agencies to establish themselves as key players in Russia’s oil and gas industry. Over a period of four months, the environmental campaign gained a momentum of its own and unfolded in ways that occasionally openly contradicted the Kremlin line.¹⁰³ Nevertheless, Trutnev and Mitvol must have been given the green light to attack Sakhalin-2 on environmental grounds by the presidential administration and, conceivably, Putin himself.

By mid-November, Shell’s patience was wearing thin. Speaking at a round table in Helsinki, the head of Shell in Russia, Chris Finlayson, said that the Russian government needed to send unequivocal signals that foreign companies were still welcome in the country.¹⁰⁴ In a separate interview, Craig stated that the fairness of the deal could be debated today, when \$13 billion had already been invested, but “it’s a debate about dividing up a share that simply would not exist, had we not set them up then”.¹⁰⁵

Remarkably, despite the pressure that was being applied on Sakhalin-2, the state was cautious not to disrupt the overall production schedule of Phase 2. For instance, when Minprirody suspended twelve water use licences of the project in early December, a subcontractor of Sakhalin-2, Starstroi, stated that the decision would not affect the schedule, as the construction of pipelines and river crossings was almost complete.

Within the government, a consensus existed on the need to resist a rise in reimbursable costs until Shell was prepared to offer improved terms in return for the government’s approval of the new expenditure plan. Gradually, Gazprom’s participation in Sakhalin Energy began to be seen as an acceptable way to bring forward the timeline when Russia would reap first profits from Sakhalin-2. The main advantage of this solution was that technically the PSA would be left intact. At a Helsinki business conference in November, Chris Finlayson stated that Shell was “very much looking forward to welcoming Gazprom to the project as a leading shareholder”.¹⁰⁶ This signalled that the parties were gradually moving to a common denominator. The main issue to be resolved now was price.

Gazprom’s rationale

Gazprom had long wanted to enter the consortium by swapping a 50% in its Zapolyarnoye field in West Siberia for a blocking stake (25% plus one share) in Sakhalin Energy. That negotiations were underway became publicly known in 2005.

However, Shell's announcement days later of the new cost estimates for Sakhalin-2 enabled Gazprom to stall negotiations and demand more favourable entry terms.¹⁰⁷

Gazprom had several reasons to enter the consortium. The first was its desire to consolidate fully its grip on the country's gas exports. Although Gazprom's monopoly had already been inscribed in law, it did not include the gas or LNG produced at Sakhalin-2. This created a problem for Sakhalin Energy.¹⁰⁸ Gazprom's desire to be the sole exporter of Russian gas coincided with the Kremlin's political objective of not allowing independent producers and foreign companies access to the country's gas network, as this would reduce the state's control over a key 'strategic material'. That Gazprom had little doubt regarding its ability to coerce Shell to surrender control of the project is apparent from the agreement it signed on November 15 with the administrations of Sakhalin Oblast and Primorsk Krai to gasify the regions using production from Sakhalin-1, 2 and 3.¹⁰⁹

Liquefying gas in particular reduced the consortium's dependence on the monopoly because LNG was to be transported to its final destination by tankers and not Gazprom-controlled export pipelines. Consequently, Gazprom had a substantial interest in acquiring a stake in the consortium – not only to strengthen its monopoly on gas exports but also to acquire greater control over the country's LNG. Indeed, by participating in Sakhalin-2, Gazprom will be exposed to LNG technology and expertise, which it currently does not have and which it will need if it decided to liquefy gas from other major deposits, such as Shtokman in the Barents Sea.¹¹⁰

Gazprom does not hide its ambition to become the world's largest energy company, quadrupling its market capitalisation from the current \$300 billion. Acquiring a stake in Sakhalin-2 will advance this aim as well as allowing the monopoly to become an important player in the LNG market, which is expected to grow at an average annual rate of 2% until 2030. Even prior to the entry into Sakhalin Energy, Gazprom bought and delivered over 800 million cubic metres of liquefied gas to overseas customers. According to Medvedev, the company has already developed a programme of replacing piped gas with its liquefied equivalent.¹¹¹ Suggestions have already been made to liquefy Sakhalin-1 gas output at Sakhalin-2 facilities, which would undeniably benefit Gazprom.¹¹² Over the long run, Gazprom will seek to acquire sufficient LNG production to influence gas prices. This would enable the Kremlin to consider seriously the idea of leading a 'gas OPEC', even if such an organisation remains largely informal and its efficacy constrained by the rigidity of the pipeline gas market.

Finally, by acquiring Sakhalin-2, Gazprom will target Asian customers and seek to diversify away from Europe. This is in line with the Kremlin's goal of becoming a global energy supplier. The gas pipeline, which may run alongside the Eastern oil pipeline from Taishet to Nakhodka, is yet to be officially approved by the cabinet. In any case, spiralling costs, difficult terrain and insufficiently developed gas deposits in East Siberia mean that the completion of this project is some years away. The importance to Gazprom of Sakhalin-2 therefore is clear, since in the meantime it will start producing next year and has already secured customers on long-term contracts that will last over 20 years.

The project must deliver its first cargoes on time to establish a reputation as a reliable source of LNG.¹¹³ It was perhaps this consideration, coupled with Gazprom's complete lack of experience in LNG technology, that has provided a powerful argument in favour of retaining Shell as project operator. Had Gazprom taken on the day-to-day operations at the project, production schedule would have almost certainly been disrupted, provoking a harsh reaction from the governments

of consumer states. Nevertheless, Gazprom will replace Craig with its own nominee once LNG deliveries get underway.¹¹⁴ It has already nominated Aleksandr Medvedev, the head of Gazprom's export department, and Stanislav Tsygankov, the head of the monopoly's foreign relations department, as non-executive directors of the consortium. Its representatives will eventually take half of the seats on the Sakhalin Energy board, although the replacements are unlikely to be immediate.

Terms of entry

The doubling of cost estimates and environmental concerns by Sakhalin Energy provided a convenient pretext for Gazprom not to surrender its stake in Zapolyarnoye, while leveraging its way into Sakhalin Energy. The newly agreed distribution leaves Shell with a 27.5% stake, while Mitsui and Mitsubishi, having ceded 10% each, are left with 15% and 10% respectively. Gazprom now owns 50% plus one share.

The price that Gazprom eventually paid for a majority stake in the consortium reflects roughly its currently estimated market price of \$8 billion. However, in the absence of a relentless environmental campaign from Rosprirodnadzor, the market valuation is likely to have been higher. The cost of \$22 billion implies that for a 50% share Gazprom would have had to pay \$11 billion.¹¹⁵ In reality, Gazprom has paid \$7.45 billion and received guarantees that previous owners will assume \$3.6 billion as non-refundable costs. To be sure, the consortium surrendered the right to recover this capital expenditure on a priority basis in December, after the government insisted that the partners carry engineering risks, which it considered as "non-market factors" caused by technical decisions that inflated costs.¹¹⁶ Consequently, \$3.6 billion represents a discount that Gazprom has received thanks to harsh regulatory pressure applied by the state.

The fact that in late March, the Russian government announced that it would not file a suit over environmental damage caused by Sakhalin-2 lends credence to the argument that the state's campaigning was, to a large extent, designed to secure Gazprom's entry into the consortium. Indeed, that the environmental probes would recede had been implied strongly by President Putin at the time of announcing the deal with Sakhalin Energy, when he assured the new consortium that "we are capable of solving any questions".¹¹⁷ Moreover, on the day of the signing of the final agreement in April, the Ministry of Industry and Energy approved a new budget for Phase 2 at \$19.4 billion. Gazprom's leading position in the consortium made the deal acceptable to the government, both on strategic and economic grounds.

Remarkably, the government appears to have also secured guarantees that the new consortium will pay it dividends, starting in 2010, which will be linked to the price of oil and gas.¹¹⁸ To achieve this, the shareholders of Sakhalin Energy issued the Russian government with one non-voting (Class R) share, entitling it to a percentage of profits from sales of the Sakhalin-2 output.¹¹⁹ The Energy Ministry said, without specifying, that the new agreement contained a clause aimed at protecting the state's economic interests.

The fact that Gazprom as a new majority shareholder will have to assume a proportionately larger burden than Shell of paying dividends to the state demonstrates that collecting profits at a time of high oil prices has been more important to the state than either marginalising Shell or enabling Gazprom to enter the consortium on financially favourable terms. Moreover, contrary to previous speculation that Gazprom would not pay the consortium until it sees profits from

LNG deliveries, the monopoly undertook to pay the amount in full immediately upon the signing of the final documents.¹²⁰ No less importantly, the new deal, while serving the interests of the state, does not amount to a formal revision of the PSA, which would have severely damaged Russia's reputation and jeopardised the project's production schedule.

TNK-BP comparison

Russia's energy strategy is still taking shape, but the general outlines are already apparent. Factors that have played an important role in the unravelling of Sakhalin-2 will also influence the outcome of negotiations over the vast Kovykta gas field, owned by TNK-BP through Rusia Petroleum. They are also likely to affect the ownership structure of TNK-BP, although the change is likely to come through Gazprom's buyout of the Russian – and not UK – share of the joint venture.

It is almost a foregone conclusion that Gazprom will take over the Kovykta field, which is of strategic importance to Russia in view of its size and closeness to the Chinese market. The Russian authorities, who are threatening to revoke the project's licence, have made it clear that if TNK-BP were to lose the Kovykta licence for unfulfilling its contractual obligations, the bidding would be open only to Russian investors. Rusia Petroleum was given until the end of April to increase production from 33.8 million cubic metres (2006 output) to 9.0 billion, as stipulated in the licence.¹²¹ This is simply unrealistic. The main reason for such under-production has been Gazprom's persistent refusal to allocate pipeline capacity to export gas abroad, while regional demand in Irkutsk Oblast has been inadequate to ramp up production. Rusia Petroleum's repeated attempts to revise production quotas have been refused on various grounds.¹²²

Pressure on TNK-BP has been rising steadily over the past months, leading TNK-BP CEO Robert Dudley to suggest that the terms of Gazprom's acquisition of a Kovykta stake would be settled by mid-2007.¹²³ Like Shell, TNK-BP believes that bringing Gazprom on board will allow the Kovykta project to proceed; it will also provide a measure of political guarantee.¹²⁴

The cancellation of Rusia Petroleum's licence and its subsequent re-auctioning currently seem less likely than Gazprom's entry into the project. Threats to halt the project are – and are understood to be – the state's tactic to use administrative measures as a bargaining tool.¹²⁵ This in large measure resembles the Sakhalin-2 scenario. However, the state-preferred configuration is by and large already accepted as inevitable by foreign companies, and further relentless pressure on TNK-BP may prove counterproductive. Already in 2005, Dudley said that working with state companies was not in itself a “negative development” and that this new configuration could be “effective” if the state created “a clearly defined set of rules for everyone to play by”.¹²⁶

TNK-BP is presently Russia's third-largest oil producer, which plans to invest around \$15 billion over the next decade. It is also interested in participating in the construction of the Eastern gas pipeline, an offer that in the light of spiralling costs may become increasingly attractive. Gazprom's refusal so far to consider TNK-BP as a partner in this major undertaking may change once it enters the Kovykta project and buys out a 50% stake of TNK. Given the understanding that currently exists in BP and TNK-BP regarding the state's desire to direct all strategic projects, the state's continued crude use of administrative measures as bargaining tools will

reduce these companies' confidence in Russia, which in turn will harm the country's oil sector. Needless to say, it will also negatively affect Russia-UK relations.

In the Kovykta negotiations that are currently underway, the main sticking point appears to be price.¹²⁷ The fact that the price of Gazprom's entry remains negotiable shows that Russia has not gone down the route of nationalisation but is being torn between conflicting goals and desires. On one hand, the Russian state seeks to ensure that foreign involvement is kept under control and the state maintains the capacity to manage or, at least, direct hydrocarbons projects. On the other, Russia's highest officials continuously attempt to reassure investors, both domestic and foreign, that Russia is business-friendly. The latter is done not only through public pronouncements but also legislative measures, such as the new law on the subsoil.¹²⁸ The idea behind the law, which has attracted much criticism in the West, has been to dispel investor uncertainties by specifying which deposits the state deems strategic.

Currently, the way to reconcile the state's objectives appears to be through introducing Russia's national champions into strategic projects, preferably as majority shareholders. Yet the Kremlin's contradictory desires are among the most misunderstood factors in the West, as suggested in a recent speech by UK Trade and Industry Secretary Alistair Darling when he said that "commercial considerations should be the beginning, middle and end of business relations" between Britain and Russia.¹²⁹ Darling's statement echoes what van der Veer, Craig and Dudley have repeatedly stated in the past concerning legal certainty, a more secure investment climate and guarantees that agreed contracts are not rescinded in an arbitrary manner. Yet, unlike the CEOs of Shell and BP, who realise that oil and gas will remain a national security issue for the Kremlin, Darling spoke of the need to reduce economic nationalism and protectionism. Such somewhat simplistic interpretations will be highly unwelcome in Russian policy-making circles, straining relations at the diplomatic level. This may be offset by the envisaged creation of a British-Russian Energy Forum to promote bilateral energy dialogue.

Conclusions

The Kremlin's burgeoning energy strategy is being influenced by a plethora of domestic and external factors, which will likely result in a more difficult – but not unfriendly – business environment for international oil companies. Under-carpet inter-ministerial rivalries, personal ambitions of individual government officials and competition between national champions will present serious challenges to the formulation and implementation of a coherent strategy. This will have direct implications for foreign oil companies. Early entrants that have already established themselves in the Russian energy market, such as Shell and BP, will neither withdraw nor be excluded, although they will have to maintain a degree of flexibility in adjusting to continuously changing rules of the game in the country's hydrocarbons industry.

Endnotes

⁷⁵ Prior to Gazprom's entry, the Sakhalin Energy consortium included Shell Sakhalin Holding (55%), Japan's Mitsui Sakhalin Holding (25%), Mitsubishi's Diamond Gas Sakhalin (20%).

⁷⁶ OECD Working Papers, Rudiger Ahrend and William Tompson, “Realising the Oil Supply Potential of the CIS: The Impact of Institutions and Policies”, Economics Department Working Paper No 484, ECO/WKP (2006), 12 May 2006.

⁷⁷ Jonathan Stern, *The Future of Russian Gas and Gazprom*. Published for the Oxford Institute for Energy Studies. Oxford: OUP, 2005), Ch. 3, pp.149-152.

⁷⁸ The governor of Sakhalin, Ivan Malakhov, is currently pressuring Moscow to auction the licence for Sakhalin-3 this year. (“Companies mull response after government annuls rights to Sakhalin-3”, *Interfax Petroleum Report*, 6 - 12 February 2004; “Sakhalin governor wants Exxon to use Shell LNG plant”, *Reuters*, 13 February 2007.)

⁷⁹ Speaking in October 2006, the head of the Russian Audit Chamber, Sergei Stepashin, said that a “political decision” on Sakhalin-1 and 2 was reached at a time when “there was no money in the country, there was galloping inflation and it was necessary to somehow support the oil and gas industry”. He added, “From the economic point of view, it is totally obvious that this was not advantageous, but we are obliged to observe the signed international agreements.” (*Interfax*, October 13, 2006)

⁸⁰ “Barking louder, biting less”, Energy and nationalism, *The Economist*, online edition, 8 March 2007.

⁸¹ The decision is expected to be formalised through amendments to the laws on the subsoil and offshore (“Shel’f na dvoix”, *Vedomosti*, 22 January 2007).

⁸² The Kremlin openly condemns the decision by the UK authorities to grant asylum to Berezovsky, whom they call “the embodiment of robber capitalism”. VTsIOM studies suggest that such rhetoric resonates with the Russian electorate. For instance in June 2005 every second Russian believed that the Khodorkovsky case would lead to similar trials of other Russian oligarchs. In this group, 56% approved of tough action against oligarchs and big business, while only 10% opposed it. In a way, by choosing not to take the prosecutions and nationalisation further, the Kremlin showed a degree of restraint and moderation.

⁸³ “Russian watchdog says claims on Shell just a start”, *Reuters*, 14 November 2006.

⁸⁴ “Russian prosecutors say they are targeting oil firms”, *Reuters*, 26 October 2006.

⁸⁵ “Putin aide says Russia got little from Sakhalin deal”, *Reuters*, 14 November 2006. Sakhalin Energy argues that in 2006 alone, it awarded to Russian companies 83% (or \$1.1 billion) of all new contracts for the provision of services and supply of material and equipment. The consortium estimates that it currently exceeds its Russian Content requirement of 70% in terms of man-hours of services and the volume of material and equipment. (“Russian content: Russian companies in the Sakhalin II project”, <http://www.sakhalinenergy.com/en/> , accessed on 6 April 2007). Indeed, independent estimates suggest that unemployment on Sakhalin Island has fallen to 1% since the start of the Sakhalin-1 project and the implementation of Phase 1 of the Sakhalin-2 PSA.

⁸⁶ “Moscow tries to allay investors’ fears”, *The Moscow Times*, 15 November 2006. p.5.

⁸⁷ Of the three PSAs, Kharyaga is the smallest. At its peak, it will produce 3.5 million tonnes of oil per annum. Following environmental inspections, the authorities announced that they had found numerous breaches, including under-production, excessive gas flaring and a host of technical and safety violations. Project operator Total was fined (around \$13,500 in total) in March, but its proposal to rectify the breaches was accepted in April, and the company is no longer under imminent threat of losing the licence. The Kremlin initially seemed keen for a Russian partner to take a stake in Kharyaga. However, Lukoil and Zarubezhneft decided to opt out, while Rosneft and Gazprom showed little interest. In the light of the project’s small size and the apparent lack of interest from Russian companies, the authorities have allowed it to proceed without changing the terms of agreement. In any case, Transneft’s monopoly on the pipelines, which Total uses to evacuate oil from Kharyaga, gives the state a lever over the project. Sakhalin-1, like Kharyaga and Sakhalin-2, has also faced environmental probes, which are yet to be resolved. However, the outcome of these checks will be different because Sakhalin-1 has Rosneft as a partner and is already producing on a commercial scale.

⁸⁸ Incidentally, out of six projects on Sakhalin Island, Sakhalin-2 was, until the conclusion of the deal with Gazprom, the only one without a Russian partner.

⁸⁹ The draft of the revised subsoil law has passed its first reading in parliament, after almost two years of bureaucratic infighting.

⁹⁰ Moreover, there are currently plans to expand the plant’s capacity to 16 million tonnes a year.

⁹¹ For complaints expressed in the Russian press, see “Gazprom takes over Sakhalin-2, while Sakhalin-1 is under scrutiny”, *ITAR-Tass*, 19 April 2007.

⁹² Production at Sakhalin-1 rose dramatically from only 400,000 tonnes of oil and 200 million cubic meters of gas in 2005.

⁹³ “Minister: Sakhalin-2 will be stopped if it caused “irreparable damage”, *Prime Tass*, 20 October 2006.

⁹⁴ Statement by Chris Finlayson, quoted by *Reuters*, November 23, 2006. A Sakhalin Energy press release quoted in “Minister orders report on Sakhalin II eco-damage, operator admits guilt”, *RIA-Novosti*, 25 October 2006.

⁹⁵ “Need to revise Sakhalin-2 oil production sharing agreement seen”, *Rossiyskaya Gazeta*, 24 October 2006.

⁹⁶ “Putin hopes for Sakhalin-2 deal with Shell”, Combined Reports, *The Moscow Times*, 23 October 2006. p.7.

⁹⁷ Trutnev and prosecutors criticize more projects”, *The Moscow Times*, 25 October 2006. p.5.

⁹⁸ The Prosecutor-General’s Office confirmed that environmental violations entailed penalties ranging from fines to prison terms (up to five years). (“Sakhalin-2 may face Russian criminal case”, *Dow Jones Newswires*, 27 October 2007.)

⁹⁹ For Craig’s statements, see “Russian prosecutors say prison possible in Shell Sakhalin case”, *Bloomberg*, October 27, 2006.

¹⁰⁰ Quoted in “Shell addresses Sakhalin complaints”, *Wall Street Journal*, October 17, 2006, online edition.

¹⁰¹ In 2003, the European Bank for Reconstruction and Development declared Sakhalin-2 “unfit for purpose”. Sakhalin Energy then spent \$300 million re-routing a pipeline that could endanger the world’s only population of grey whales and agreed to the creation of an independent advisory panel to monitor the impact of Sakhalin-2 on whales (“Whale protection: Sakhalin Energy”,

www.publications.parliament.uk/pa/Id200304/Idhansrd/vo040226/text/40226w02.htm, 26 February 2004, WA73). Following the start of the Mitvol-led environmental campaign, Sakhalin Energy reportedly admitted cutting down more trees than permitted, exceeding its water usage quotas and causing temporary problems with river crossings. (Arkady Ostrovsky, “Out on a Limb: how the Kremlin has been making life difficult on Sakhalin”, Comment & Analysis, *Financial Times*, 23 November 2006. p.15.) The consortium has promised to rectify the violations. It also committed to invest \$120 million in the upgrade of local waste management service and another \$400 million in the infrastructural modernisation of the island (*Energy and Commodities Digest*, 23 November 2006).

¹⁰² Mitvol quoted in “Russian body may sue Shell, axe Sakhalin deal”, *Reuters*, November 10, 2006. Some data appears to have been manipulated. When inspecting Sakhalin, Mitvol was reportedly told that some of the dead fish in the area had simply completed their two-year life cycle. However, he urged the environmentalists to hush up, presenting it instead as an instance of Shell’s “barbaric” behaviour. (Ostrovsky, *Financial Times*, 23 November 2006.) Meanwhile, the Russian media regularly published reports of fish and crabs dying en masse off Sakhalin’s eastern coast (see, for instance, *RIA Novosti*, October 16, 2006; *ITAR-TASS*, November 17, 2006.).

¹⁰³ For instance, during his visit to France in September 2006, Putin praised Total, inviting it to bid for other projects in Russia. On the same day, Mitvol issued a statement harshly criticising the Total-led Kharyaga project, which put the president in a rather embarrassing position at a press conference. There was also a fair amount of infighting between Mitvol and his immediate senior, Sergei Sai, on whom he called to resign along with other “delinquent officials”. Mitvol then faced disciplinary proceedings and threatened with dismissal.

¹⁰⁴ “Shell demands clear signal on Sakhalin-2”, *The Moscow Times*, 24 November 2006. p.5.

¹⁰⁵ Quoted in Abrahm Lustgarten, “Shell Shake Down”, *Fortune*, 5 February 2007.

¹⁰⁶ Statement by Chris Finlayson, quoted by *Reuters* and in “Shell Demands Clear Signal on Sakhalin-2”, *The Moscow Times*, 24 November 2006. p.5.

¹⁰⁷ Despite its vast potential, the Zapolyarnoye field is still at a very early stage of its development and will need billions of dollars of investment before it can be brought on stream. Therefore, its price can only be assessed approximately on the basis of its estimated reserves potential. (Michael Bradshaw, “Battle for Sakhalin”, *The World Today*, Chatham House, vol. 62 (11), November 2006. pp. 18-19.) Meanwhile, Sakhalin-2 had already

received investments of around \$10 billion and the start of LNG production was already in sight. This underlined the predatory nature of Gazprom's negotiating tactic of exchanging stakes in undeveloped projects that still require massive capital investment for those that are close to the production stage.

¹⁰⁸ It is unclear whether the legislation on Gazprom's monopoly status extends to LNG. Several companies, including Russian private company Lukoil, have appealed to the government for clarification and argued in favour of LNG's exclusion. The point is that all gas produced within the framework of the Sakhalin PSA was outside of Gazprom's control.

¹⁰⁹ *Vedomosti*, 16 November 2006. Rosneft controls a majority stake in Sakhalin 3 and a 20% share in Sakhalin-1. As discussed below, Gazprom is currently intent on buying gas from Sakhalin-1 for liquefaction at its facilities.

¹¹⁰ It is noteworthy that at the height of the environmental campaign against Sakhalin-2, Shell expressed a desire to work with Gazprom on the development of the Shtokman field. Shell made the offer after Gazprom had announced that it would not allow foreign companies ownership of equity stakes in the field and would welcome them only as subcontractors. The offer was perhaps an attempt to demonstrate Shell's openness to compromise and ability to work with Gazprom ("*Shell ne otkazalas' ot Shtokmana*", *Vedomosti*, 25 October 2006).

¹¹¹ Statement in *Vedomosti*, quoted from an interview in "Gazprom planiruet stat' krupneyshey energeticheskoy kompaniyey mira", *RIA Novosti*, 3 April 2007; "Gazprom's \$1 trillion objective", *Bloomberg*, 10 April 2007.

¹¹² "Sakhalin governor wants Exxon to use Shell LNG plant", *Reuters*, 13 February 2007. The idea is not entirely new. In late 2004, project operator ExxonMobil said that the joint venture would consider liquefying its gas, rather than piping it (David Pilling and Enid Tsui, "Exxon rethinks natural gas delivery option", *Financial Times*, 5 November 2004). Yet Rosneft's ownership of a stake in Sakhalin-1 consortium and its rivalry with Gazprom could potentially undermine any infrastructural consolidation, leaving Gazprom with an option to buy gas from Sakhalin-1 at international prices.

¹¹³ Throughout the months of environmental campaign, Shell insisted that extended environmental probes could cause delays in completing certain elements of the project, but that they would jeopardise the project as a whole and the delivery schedule would be respected.

¹¹⁴ Statement by Gazprom's deputy executive chairman, Aleksandr Medvedev, in "Gazprom lands Sakhalin-2 stake", *Upstream*, 20 April 2007.

¹¹⁵ The price is likely to have been higher for a 50% plus one share.

¹¹⁶ "S'ekonomili \$3.6 milliarda: Noviyе detali sdelki po Sakhalinu-2", *Vedomosti*, 28 December 2007; "Gazprom completes the purchase of Sakhalin-2", *Izvestiya*, 18 April 2007.

¹¹⁷ "K Sakhalinu-2 stalo men'she pretenzii", *Vedomosti*, 7 February 2007.

¹¹⁸ "Sakhalin-2 podelitsa b'udjetom", *Vedomosti*, 27 April 2006.

¹¹⁹ The Wall Street Journal quoted an undisclosed source as saying that the amount would be "something under a billion dollars every year". Guy Chazan, "Russia to get dividend in Sakhalin-2 deal", *The Wall Street Journal*, 26 April 2007, p. A3.

¹²⁰ "Dobralis' do Sakhalina", *Vedomosti*, 17 April 2007.

¹²¹ "TNK-BP dali srok", *Vedomosti*, 12 February 2007.

¹²² "U TNK-BP mogut skoro otobrat' Kovyktu", *Vedomosti*, 24 January 2007.

¹²³ "TNK-BP CEO sees mid-year Gazprom deal on Kovykta", *Reuters*, 26 January 2007.

¹²⁴ Assessing the effect of the deal with Gazprom, van der Veer said that it "stabilises our position in the Sakhalin II project in Russia, with a strong partner." (2007 strategy update: Refocusing the portfolio for long-term growth, www.shell.com 1 February 2007).

¹²⁵ In November 2006, TNK-BP paid 1.44 billion in back tax claims. The timing may be coincidental, but the fact that in the same week the Prosecutor-General's Office opened a criminal investigation into licence violations of a TNK-BP's gas subsidiary Rospan International could not but heighten suspicions (see, for example, "TNK-BP pays Russia \$1.44 bln of back-tax claim", *Reuters*, 10 November 2007).

¹²⁶ Dudley, Speech delivered at the Russian Economic Forum, 12 April 2005.

¹²⁷ "Pust' Putin podelit", *Vedomosti*, 21 March 2007.

¹²⁸ For more on the state's divergent aims, see *Oxford Analytica*, "Russia: Strategic deposits law will boost state power", 13 July 2006.

¹²⁹ Speech at the Russian Economic Forum, held in London on April 23-24. “Darling calls for clearer rules”, *The Moscow Times*, April 25, 2007, p.5; “UK warns Russia against economic nationalism”, *Reuters*, April 24, 2007.

Russia for the Russians? A View from a Western Business Advisor

Andrew Gavan¹³⁰

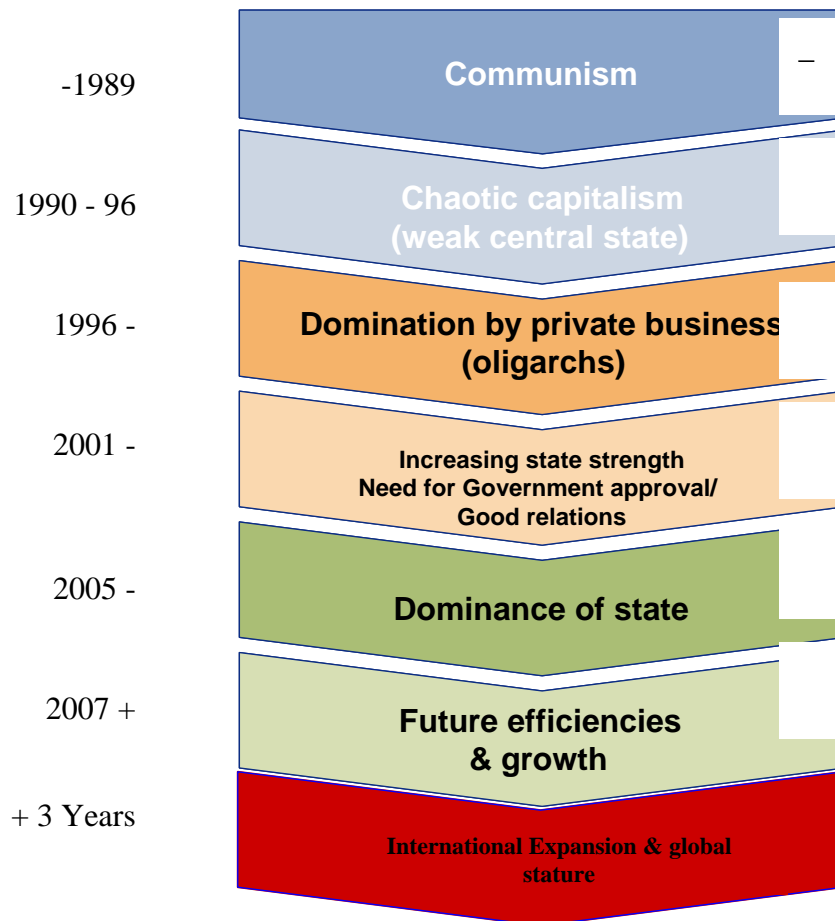
I am based in London and Russia has been my major source of profitable work over the years 2001 – 2005. More of this work has now been taken “in house” as Russia develops self sufficiency, yet the opportunities have now also spread to the emerging CIS countries. The UK is uniquely well placed to continue to engage successfully with this dynamic powerhouse in mutual interlocking economic interests. Sabre rattling on either side has been and remains unhelpful. Though Russia has clearly reclaimed its self determination, it will not operate in isolation from the West. Russia and the UK both want to do business, and there is a profound hunger to marry western capital and experience with the enormous potential of Russian businesses, mediated by the London Stock Exchange (LSE), and facilitated by sympathetic UK-Russia political dialogue. It is hard, stimulating, fast paced, and requires sharp attention to danger and opportunity. I want this to continue. It benefits us both, UK and Russia.

Background

Since Russia’s abrupt transition in 1990 from communism to capitalism, any three year period looks markedly different at the end than the beginning. Russia has experienced over the last 15 years, a vivid, dynamic compression of the western capitalist experience, which took place for western countries over a much more prolonged timescale. Russia has experienced and thrived through rapid change and extreme crises.

Russia is now adding its own distinctive feature, the appetite and even need for a strong centralised state. The current administration has performed a classical seizure of the primary drivers of production, distribution and communication, and a country in disorder has been made resurgent. And now Russia operates from a position of strength and Realpolitik. Business prefers this clarity and stability to chaos.

Yet I also see the Russian drivers, business and political, as far too dynamic, intelligent and ambitious, to revert to the ossification of the communist years, pre-glasnost. Russia is not isolationist, it seeks inbound and outbound investment, with the aim of strengthening the Russian economy, but not selling the family silver. The evolving stages of Russia’s economy and governance and what I see coming next are summarised in the following diagram:



The initial period of chaotic capitalisation involved blood on the streets in the struggle for business control and the environment of a weak state. Investment in Russia by western capital in these initial years required both a very bold or altruistic approach, and long term strategic vision. There was no certainty or stability over fundamental business issues of property rights, shareholder protection (especially minority shareholders), legal contract observance and enforcement. It was not an amenable place for western capital looking for reliable defined investments. Nonetheless, US and International Investment Banks opened in Moscow, and energy companies such as Shell and BP invested where previously access had been severely restricted (e.g. to known businessmen such as Dr Armand Hammer of Occidental Petroleum).

In western capital markets, sharp stock exchange recessions flush out the weaknesses in mis-trading companies and drive them into bankruptcy. In a similar way, the foreign currency exchange collapse in Russia of [1998] after the heady years of state privatisation, exposed the raw and brutal realities of securing business ownership under trading and financial pressure. Investment Banks closed their Moscow operations after suffering severe losses in the \$40bn default, BP had its investment seized in a locally engineered bankruptcy proceeding, and the West seemed to withdraw from Russian governance.

Second Decade: 2001 - 2006

I first landed in Moscow Sheremetyevo airport on 11 September 2001. The twin towers had been attacked and destroyed in New York. Western stock markets halved in value and business froze expenditure until the patterns of this unfamiliar

world took shape. My work is in Mergers, Acquisitions and Disposals (M&A), and such catatonia terminates business, except that in Russia I found business to be exuberant and booming, on the upward rebound from the 1998 currency shock.

Oligarchs had clearly emerged as the dominant owners of the Russian economy. They were the tallest poppies, and in a sense the ones left alive after the control battles of the early 1990s. Ownership structures were designed to be opaque and separated. The owners' drive to the next "leap in value" after the privatisations, to attract western capital for investment, exit and status, required public ownership disclosures as group conglomerates listed on western stock exchanges. Thus they brought in western advisors such as myself.

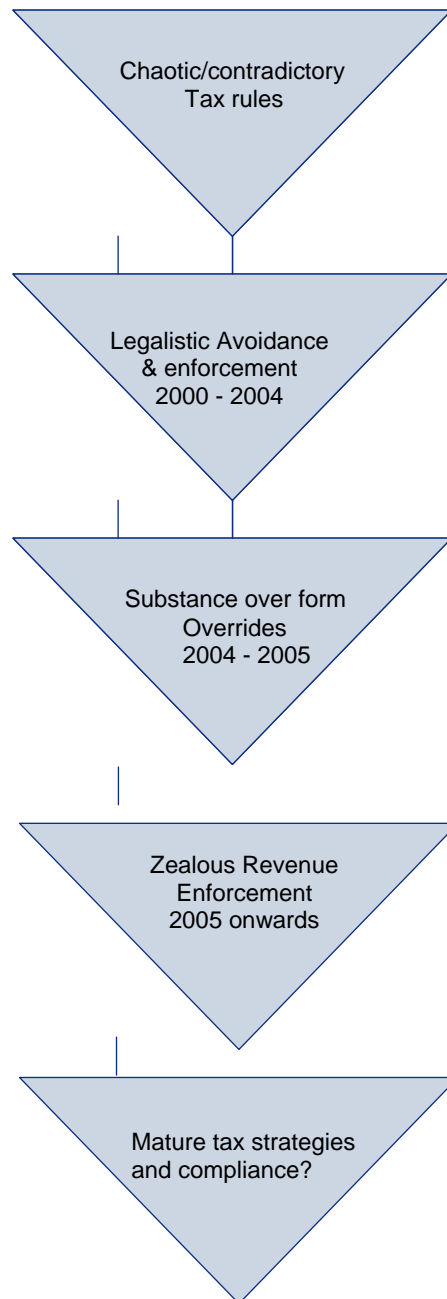
This drive and ambition to secure the economic wealth of their companies coincided from 2000 onwards with the gradual recovery of central Russian state strength under President Putin. One of the fascinations of Russia is to see it wrestle urgently with the fundamentals of organising a state and society to replace communism. Mercenary self interest alone cannot provide the coordination and support that a state needs to grow its essential infrastructure of education, health, population, transport, over the short and long term. The state, as the current administration is demonstrating, can also identify and pursue wider strategic and macro economic aims.

To the evident surprise of rational Russian businessmen, western investors and business have perceived the emerging Russian economy as unpredictable and dangerous, as well as profitable and expanding. Initial concerns over association with, or misappropriation by, criminal groups, have been replaced by anxiety over state clampdown on tax underpayments, alleged environmental law breaches and other state challenges to ownership title.

Nonetheless, the UK-Russia business relationship – reflecting the wider Western-Russia business context – has begun to thrive. I am encouraged by the recent move of the UK Institute of Directors to offer advice and training on corporate governance rules and responsibilities in practice, to Russian executives. UK business has also moved to invest in Russian oil (BP), retail (Dixons, Kingfisher) and property and consumer goods (Gallagher, Scottish & Newcastle). Investment banks are returning to Moscow: for instance Morgan Stanley and Deutsche Bank through purchase of United Financial Group in Moscow. Private Equity Funds are also beginning to seek Russian and CIS investments.

Taxation

My expertise is tax. This is no Cinderella discipline: it is fundamental economic lifeblood to the state. Russia, over a short period of years, is a classic telescoped recent study of the same process which western states have gone through. It illuminates the economic development and governance of the Russian state. The broad pattern which the Russian tax regime has followed and is anticipated to follow is illustrated in the following diagram:



In the initial years of corporate taxation, an unfamiliar practice for the government and people of an ex-communist state, there was such a plethora of rules and regulations, with frequent multiple changes and contradictions, that it was impossible to comply. Total taxes could in principle exceed 100% of profit. Cash tax compliance was poor and enforced erratically. Though the tax system has matured and individual tax rates dramatically lowered to 12% to improve compliance and payment, the corporate tax system has remained very legalistic. The attitude of the owners and drivers remained that it was their money, even that “Taxation is theft!” It was explained to me that court judgements followed very strict rules of legal interpretation and enforcement, because if a decision was left open to judicial discretion, it became open to corruption, of simply being bought.

This combination of rigid laws and non-compliant attitudes led from 2000 onwards to brazen legalistic tax avoidance techniques. These were primarily designed to move profits from the Russian tax zone to very low tax “offshore” or onshore tax exempt areas, but without any substantial economic justification or real commercial substance. They were purely “paper” devices. One illustration of this is

avoidance of oil production duties on the sale of newly piped oil from the well. In Russia, to maintain well head pressure, water is piped underground, so the oil is mixed with water when it emerges. The avoidance trick used was to document a sale of the water, with the oil included for free, on the grounds there was no production duty on water. In the UK and USA, when such brazen and outrageous tax avoidance techniques with no economic reality have been attempted, the Revenue authorities have responded with physical raids and criminal prosecutions. No state can allow its tax collection, its funding lifeblood, to be unilaterally escaped.

From KPMG's experience of the UK and USA, we therefore predicted a judicial and statutory clampdown on such techniques. This happened first to Yukos, in 2004, which was at that time the largest Russian oil company. Most commentators interpret the prosecution of Yukos and Mikhail Khodorkovsky as the removal of a political opponent to the government. The evidence for this is not simply the startling new multi-billion dollar tax bill, multiplied by several years, plus interest and penalties. It is also the remorseless restriction of the ability of Yukos to finance a cash settlement, by fettering trading, restricting auction bidders for assets and refusing any timetable extension. This culminated in engineered bankruptcy and continued prosecution of employees. Commentators therefore see ulterior motives in the specific prosecution of Yukos. However, my view as a tax specialist is that some such form of a generic and punitive clampdown was inevitable in the Russian tax environment, and one which follows similar patterns in the approach of the UK and USA Revenue authorities. If a state is starved of its cash lifeblood it will go to war: it is necessary to render unto Caesar what is Caesar's.

The development of judicial confidence, to find that such legalistic avoidance devices can be seen through as "shams" without economic reality, is a clear sign of a maturing state in Russia. Tax remains a case study for the wider picture. After the Yukos decisions, high-profile major companies rushed to review and comply with their current tax obligations and dismantle their avoidance mechanisms where they lacked economic reality. Their aim was clear compliance going forward, and limited additional tax payments for prior years. The Revenue authorities, encouraged by the successful Yukos prosecution, pursued back years taxes on a number of other major corporations. These were settled for significant sums, but not of a scale to endanger the companies' survival. This is encouraging: an over aggressive Revenue authority will discourage investment. In approaching western investors for capital, an additional reason now given by Russian businessmen is that it acts as a brake on over-zealous officials seeking to promote their careers. It is not an absolute defence, though: it did not save Yukos.

The pattern of tax development matches the wider picture: tax must be paid, but not any and all sums demanded by Revenue authorities. The role of the tax advisor is to stand between the tax payer and government and keep balance in their social contract. Taxpayers must comply accurately with their correct obligations. Governments must not act capriciously or excessively. And it is a full time job for a tax advisor to create robust structures, giving proper relief for economic expenditure such as finance costs, and stopping taxation of "phantom" unrealised profits by Revenue authorities. This is the balance that the Russian tax system will stabilise towards, just as the UK and USA oscillate around this same median.

It is developed international tax practice to outlaw artificial structures without genuine economic and commercial substance. This leaves many robust methods for enhancing after-tax profits in a transparent and Revenue approved way. Russia, in accordance with western practice, is likely to further tighten its transfer pricing rules to control movement of profits outside its tax charging area. There are also

clear steps being taken in enforcing import/export duties and procedures to prevent “grey” imports avoiding charge. So there is a progressive review by the Russian tax authorities of tax mitigation strategies adopted in Russia, building on the success of closing down wholly artificial structures without economic reality apart from the avoidance of tax, and also indications that a properly implemented tax compliant approach can be successfully defended by the taxpayer.

Yet there is also the perception that tax and other laws are enforced selectively for other purposes, e.g. the blanket import ban on Georgian wine. While Revenue authority raids on premises to seize documents will always strike a chill in any country, the focus of commentators attention has moved more recently to the environmental law violations alleged by Mr Oleg Mitvol, head of Russia’s Environmental Agency, challenging the title validity of non-Russian state controlled groups to major assets such as Sakhalin-2 oil and gas (Shell consortium), east Siberian Kovykta gas field (TNK-BP joint venture company), and other major extractive industries, most recently Imperial Energy, one month after reporting a major oil discovery.

State Champions

The macro-economic strategy of the current Russian administration has seen the explicit creation of state-aligned industrial groups in key sectors, with the aim of bringing their development under Russian management and encouraging the growth of the other sectors of the Russian economy. These areas include oil, gas and electricity (generation and distribution are partly privatised, whereas the transit grid is retained by the state), ports and shipping, nuclear power and civil and military aviation. The approach of western investors to these, and indeed any other economic areas possibly perceived as of major strategic importance to the Russian government, needs to take account of this. Key preparatory actions include gaining central government approval, the completion of all legal approvals and licenses (even if time consuming – and without taking shortcuts), the clear demonstration of benefits of the investment to Russia (e.g. cash investment; technology development; knowledge transfer; international expertise and experience; governance improvement; competitive advantage) and the acceptance of a minority stake (49/51, rather than 50/50). They will also have to pay taxes on profits and accept State interest in control and distribution of money flows and take professional advice.

Business Opportunities

The issues are multiple and complex. It is wrong to see Russia simply as an oil and gas play. Indeed, gas itself was overlooked as a low value commodity, until recently when the price soared and delivery disputes arose. If oil and gas have the largest current share of the Russian economy, the vibrancy of the Russian economy means that there are other hugely attractive areas for investment. These include mining (coal, copper, gold, diamonds, titanium, uranium), heavy industry, banking and consumer finance, telecoms, real estate, retail, sophisticated engineering (Aerospace, automotive components), consumer products and tourism. It is worth noting that the educated middle classes in the major cities are strikingly hard working, and highly skilled in precise disciplines such as mathematics, physics, engineering, languages. They are motivated to succeed. Yet there is also a huge underclass problem in the wider countryside, with lack of ambition and local prospects, further dulled by alcohol.

Russia, it seems, is also seeking to develop itself as a centre for business contacts and development. More is produced, planned and advised domestically in Russia rather than with imported expertise, the domestic stock exchange grows in strength and value, and outward expansion is growing as major Russian companies seek global stature (Gazprom, Lukoil, Rusal, Severstal, Norilsk Nickel among others). As a consequence, the UK seems to be losing its prominent place as a destination for Russian companies. The late withdrawal of senior Russian delegates to the recent London Russian Economic Forum, can be taken as reflecting urgent domestic concerns and the growing importance of Russia's own St Petersburg conference.

Nonetheless, the LSE has become the preferred destination for Russian companies seeking a Western Listing, after Lukoil became the first full Russian listing. Indeed, the special success of the LSE in attracting Russian companies must also be emphasised. Russian business initially aspired to the New York Stock Exchange (NYSE) as the global centre of finance and status. Yet as Russian companies were deciding where to locate their first full western stock exchange listing, the NYSE was introducing inflexible and onerous rules (Sarbanes-Oxley), concerns were held over US litigation risk, and the NYSE appeared more suited to US businesses. By contrast, the LSE thrives on international businesses, the time zone and travel between UK and Russia is better, and the listing approach more case specific. We hoped that the inaugural listings of Russian companies on the LSE would be a forerunner of more to come from Eastern Europe. And so it has proved, with a long list of major Russian industrial companies listing on the LSE, followed by similar operations from Kazakhstan and the other developing CIS countries. It has been a huge success for the LSE. The attractions of a western stock exchange listing to a Russian company include: capital for investment, market valuation, international status, increased defence to official pressure and cash release. It is in the interests of Russian businesses to improve corporate and country governance, since both will reduce the country and corporate price discount currently made for market risk.

Conclusions

Russian business and political interests increasingly are both solidifying their basis in Russia and have a global horizon. Russia now is looking globally to secure business partners, in Europe (particularly in France, Germany, Italy), and further afield in China, India, the Far East and the Middle East. The ambition of businesses in the top 10 of world rankings is to achieve number one status globally, within a short timeline of a few years. Russia is also a strong business partner with whom the UK should continue to engage profitably.

This requires Realpolitik: Russia will pursue its own interests. There have been tremendous successes, such as the LSE, and BP's investment in TNK-BP (formally signed on a day when PM Blair and President Putin met in London). There have been horrors, such as Sibir Energy's £100M investment diluted to nil by a share issue trick. The Russian administration's drive to restore control has appeared brutal and threatening. Yet business can and should continue, with eyes wide open to both opportunity and danger. It is in the interests of Russian businesses to improve corporate and country governance, since both will reduce the country and corporate price discount currently made for market risk. The role of UK companies needs to evolve to meet the dynamic situation in Russia, or their role will fade. Russia seeks to succeed in a global economy, and the UK needs to engage as a significant partner in that context.

Endnotes

¹³⁰ The views expressed in this chapter are those of the author and do not necessarily represent those of KPMG.

Author Biographies

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Andrew Gavan is Partner, Mergers, Acquisitions & Disposals Tax, KPMG. Andrew has specialised since 2001 on assisting Western investors in Eastern transactions, frequently visiting Moscow. He has led KPMG tax teams on many major and international transactions, including Lukoil's (Russian oil company) listing on the London Stock Exchange and BP's \$7bn acquisition of 50% of TNK (oil and gas) in Russia.

Julian Lee is a specialist in oil market analysis, Russia, the Caspian Sea, and West Africa at the Centre for Global Energy Studies in London, producing major studies on the oil and gas industries of these regions. Julian is also Deputy Editor of the *Global Oil Report*. He holds an MSc Degree in Operational Research from the London School of Economics.

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Dr. Andrew Monaghan is Founder and Director of the Russia Research Network. He is also a Research Consultant to the Academic Research Branch of the NATO Defence College Research Branch in Rome and a Senior Research Associate at the Conflict Studies Research Centre, the UK Ministry of Defence think tank based at the Defence Academy of the UK.

Henry Plater Zyberk graduated from SSEES and is a Senior Lecturer at Conflict Studies Research Centre of the UK Defence Academy.

Commander Ian Riches, OBE, joined submarines in 1979, and has since been involved in operational control of all submarines in UK waters and the running of the Maritime Warfare Centre Faslane, where he was responsible for developing tactical guidance on submarine torpedoes. He moved to Abbey Wood in Bristol to become the Submarine Escape and Rescue Equipment Project Manager in December 2003. In 2005 Ian led the team that rescued the AS-28 Priz off the eastern Kamchatka coast. As a result he was presented with the Order of Maritime Achievement by President Putin in October 2005 and was then awarded the OBE in Her Majesty The Queen's Birthday Honours in June 2006.

Major General (Ret'd.) Peter Williams, CMG OBE, was the first Head of the NATO Military Liaison Mission in Moscow from May 2002 until June 2005. During his career he served for over four years in the British Commanders'-in-Chief Mission to the Group of Soviet Forces in Germany (BRIXMIS) and was Military Assistant to SACEUR (with special responsibility for Soviet and East European issues) from 1990 to 1992, a period that saw the initial steps by NATO to build a post-Cold War military relationship with the Soviet Union. He retired from the British Army in December 2005.

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Want to Know More ...?

See:

Foreign Affairs Select Committee, House of Commons *Relations with the Russian Federation* Third Report 1999-2000, HC 101 28 February 2000 (available online at

www.publications.parliament.uk/pa/cm199900/cmselect/cmcaff/101/10102.htm).

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