
RUSSIAN ENERGY AND EUROPEAN
SECURITY

A TRANSATLANTIC DIALOGUE

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Russian Energy and European Security: A Transatlantic Dialogue
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FOREWORD

How to deal with the energy-rich and increasingly assertive Russia has become a source of considerable concern and debate in both the United States and Europe. It is beyond doubt that Russia's new energy leverage represents a challenge to European energy security, European unity, and indeed Europe's unique relationship with the United States. Yet it is also beyond doubt that Europe needs and will continue to need Russian energy and that supplies from Russia are useful alternatives to reliance on the Persian Gulf, particularly Iran. Emotional characterizations of Russian actions are not a substitute for a sober evaluation of actual Russian policies, U.S. and European interests, or principled but practical solutions.

Paul Saunders provides useful insight into American and European thinking about Russia's aspirations and capabilities, the multifaceted realities of Europe's energy dependence on Russia, the many perspectives on Russia within Europe, and how the United States can work effectively with key allies in Europe, and with Moscow, to address both energy security as well as wider U.S. and European interests. Saunders argues that there are red lines which Russia should not be allowed to cross, but he also suggests that the red lines should reflect important U.S. and European priorities rather than reflexive opposition rooted in zero-sum thinking. His recommendations are tough-minded but realistic and policy-makers in the U.S. and Europe will benefit from his counsel.

Dimitri K. Simes
President
The Nixon Center

INTRODUCTION AND ACKNOWLEDGEMENTS

In 2007, The Nixon Center conducted a series of three meetings between U.S. and European experts to discuss the impact of Russia's increasingly assertive foreign energy policy on Europe and European security. The project was motivated by concern over Russian conduct and a desire to compare American and European perspectives and develop coordinated and effective policy responses that would also advance broader and shared transatlantic interests in dealing with Moscow. The German Marshall Fund of the United States provided essential financial support for the effort.

Participants in the three sessions included a broad range of experts on European politics and policies on Russia, energy, and related issues; Russia's foreign policy, domestic politics, economy, and energy sector; transatlantic relations; European security issues; global energy politics and markets; U.S.-Russian relations; and other topics. They were drawn from the United States, the United Kingdom, Germany, France, and Poland and included academics, former officials, journalists, and representatives of businesses and NGOs with a view to including diverse perspectives and backgrounds and stimulating a rich discussion.

The first meeting took place at the Stiftung Wissenschaft und Politik (SWP) in Berlin, with considerable assistance from SWP Researchers Susanne Dröge and Andreas Goldthau. This session focused on topics including Russia's overall relations with the U.S. and Europe, actors in shaping Russian energy policy and their objectives, alternative sources of energy for Europe, and the role of Central and Eastern European

nations. The second workshop, at The Nixon Center in Washington, examined the impact of Russia's elections on its foreign policy, the status and prospects of Russia's energy relations with the U.S. and Europe, Europe's overall energy security picture, and the sustainability of Russia's energy boom. Chatham House hosted the third and final meeting in London, which concentrated on U.S. and European interests and policy options in working with Moscow. James Nixey of Chatham House's Russia and Eurasia Program offered invaluable help in organizing the session

I am grateful to Matthew Fontaine of The Nixon Center staff for his assistance with research, organizing the three workshops, and preparing this document for publication. Rebecca White of *The National Interest* and Christina Haydon of Chatham House were essential as note-takers during the second and third sessions, respectively. Julia Nanay of PFC Energy reviewed a draft of this paper and provided many helpful comments.

Although this paper draws heavily on the discussion during the three workshops, it reflects strictly the perspectives and conclusions of the author.

EXECUTIVE SUMMARY

Even as European concern over Russia’s efforts to use its energy resources for political leverage grows, European demand for gas is itself growing at a rate that can be satisfied only with substantial additional imports from Russia or, alternatively, a major new arrangement with Iran—something troubling to many Americans. At the same time, poor understanding in the United States of Russian conduct and European constraints feeds a highly politicized debate that often produces weak, irrelevant, or even dangerous policy proposals. A more sophisticated approach will be required to advance American and European interests.

Russia is likely to continue its assertive foreign energy policy—and foreign policy—after President Putin steps down from the presidency. However, Russian motives are far more complex than one might think from reading op-ed pages in major newspapers, and the goals of government officials, company managers, and other key political actors are not always identical or even coordinated. Some objectives—like additional profits—are not so different from the goals of Western firms. And while Russia’s vast oil and gas reserves have given the Kremlin new confidence, Russia’s heavy reliance on its “energy power” ultimately demonstrates the weakness of a state that has few other useful foreign policy tools. While Moscow’s behavior has been troubling and should be resisted, it is also clear that Russia has tried applying heavy pressure only to relatively weak states along its periphery.

European nations must decide separately and collectively how to deal with these challenges and may well be most effective by pursuing the

difficult but worthwhile task of putting their own house in order—developing common policies on energy and on Russia—rather than responding in a piecemeal fashion and exposing their differences. For its part, the U.S. should place the Russian challenge in the context of both U.S.-European relations and broader global dynamics in a period of high energy prices, growing demand, and political instability. Of course, America and Europe will be most effective in handling Russia if they do so together, on the basis of their substantial common interests.

Fear that American influence in Europe and elsewhere is waning during a difficult period is a major source of U.S. concern about Russian efforts to influence Europe or drive wedges into the U.S.-European relationship. But Washington can better address these issues by strengthening its ties with major European partners (and others around the globe) than by trying to persuade its allies not to buy energy that they need and cannot get elsewhere at reasonable prices. If the U.S. needs to compete with Moscow, it should compete politically, economically, culturally, and even militarily—all areas of great American advantage—and not over energy that Washington cannot supply.

Within Europe, the U.S. should deal separately with Moscow's sometimes revisionist political aims and its legitimate economic and commercial goals. On both tracks, America should press for U.S.-Europe-Russia dialogue—in the former case, to try to develop and systematize a mutually acceptable role for Russia in Europe and in the latter case, to establish a common set of rules and dispute resolution procedures. While offering strong and public support to all its NATO allies and other countries if threatened, and establishing clear red lines for Russian conduct, Washington should also quietly discourage Central European countries and non-NATO members in particular from provocative behavior intended to mobilize American support against Russia. Any economic dialogue should focus in part on the need for reciprocity in investment policies and on protections for foreign investors, something that Moscow should also want in the context of its highly politicized relationships with the U.S. and Europe, and American officials should vigorously defend U.S. companies operating in or working with Russia.

UNDERSTANDING THE PROBLEM: RUSSIAN ACTIONS AND MOTIVES

Responding effectively to the challenge of Russia's foreign energy policy for Europe requires a clear understanding of Russian conduct and the objectives that underlie it. Much of our public debate, including many editorials and opinion columns, relies on simplistic analysis and bumper-sticker policy proposals that undermine rather than strengthen efforts to understand and deal with Moscow's troubling behavior. Objective analysis is much more likely to get the right results than passionate rhetoric.

Broadly speaking, Russia's increasingly assertive policy has prompted concern in four areas:

- That Russia will threaten to shut off energy supplies or increase prices to extract political concessions;
- That Russia will exploit existing debts for energy supplies or other economic weakness in energy consuming countries to buy or take over assets in those countries' energy sectors or other sectors, with a view to use those assets for political leverage;
- That Russia will unfairly seize the assets of U.S. or European energy companies operating in Russia, or force western firms to sell their assets, possibly at low prices; and,
- That Russia's energy wealth and power will encourage broader assertiveness in Moscow's foreign policy to the detriment of U.S. and European interests.

All of these concerns have some justification. Russian firms have temporarily shut off energy supplies as a negotiating tactic in price disputes (most recently Ukraine and Belarus) and have actively pursued debt-for-asset swaps in nearby countries, with government support; the Russian government has applied pressure on foreign companies (including ExxonMobil, Shell, and BP, among others) that has ultimately dissipated after ownership changes; and the Kremlin has clearly been more assertive in dealing with its neighbors, European governments, and Washington as its wealth has increased. These developments have raised serious questions about Moscow's aims and provoked calls for a firm Western response.

A firm response is necessary, but its specific elements should be driven by a careful and realistic assessment of Russia's behavior, motives, and goals, as well as the U.S. and European interests at stake, the degree of overlap between American and European interests and an evaluation of the prospects for a common approach, and the likely consequences of particular policies. The following section will seek to define the problem by looking at the first of these issues: what Russia has done and why.

The Russian-Ukrainian Gas Dispute

The discussion during the dialogue sessions made clear that for many in the United States and Europe, Russia's confrontation with Ukraine over natural gas prices in January 2006—and Gazprom's decision to reduce the level of gas supplies in an effort to cut off Kyiv without affecting Europe—was a seminal if sometimes misunderstood event. While Moscow had earlier taken a hard line with many of its neighbors in energy disputes, this was the first Russian move to have significant consequences in Western Europe; according to one report, seven Central and West European countries, including Italy and France, lost between fourteen and forty percent of their gas supplies. The fact that Ukraine decided to continue to draw gas after Gazprom reduced the volume on January 1 to eliminate its share, and that Gazprom increased the volume somewhat the next day to attempt to compensate for this (before ultimately restoring supplies to their normal level two days after that, on January 4), had little effect. European officials and

publics were shocked by the events and began to think differently about Russia and its reliability as a major energy supplier. Public opinion data from the German Marshall Fund's Transatlantic Trends 2007 survey supports this conclusion, showing that 58% of Americans and 59% of Europeans "expressed concern about Russia's role as an energy provider." Ironically, as one European participant pointed out, some see Russia as renouncing commitments made and upheld by the Soviet Union not to politicize gas supplies. Of course, another participant concluded, the Soviets desperately needed the gas revenue during the 1980s, when oil prices were quite low; today, on the contrary, prices for both oil and gas are relatively high and Moscow appears to believe that the dynamics of its energy relationships have changed.

One American participant attributed Russia's poor handling of the dispute in part to Moscow's weak decision-making processes, the multiple actors within those processes, and their lack of transparency. Kremlin, government, and company officials can all play important roles in decision-making on energy policy. This process appears informal, however, with many key decisions apparently taken after discussions among small groups outside official channels. What is clear is that there is not an effective policy coordination mechanism to ensure that all relevant actors are included. Russia's Security Council—a loose counterpart of the U.S. National Security Council—has a very broad mandate but limited authority. As a result, many official decisions are taken without input from key government departments. In the case of the Russian-Ukrainian gas dispute, one participant argued, the Russian Foreign Ministry seems to have had a limited role in a process driven primarily by Kremlin officials and Gazprom. This in part accounts for the Russian government's apparent surprise at the breadth and depth of the European reaction to Gazprom's reduction in gas supplies.

Further confusing matters, Russian officials and business leaders often have multiple roles and conflicting interests. At the time of the dispute with Ukraine, the likely successor to President Vladimir Putin, Dmitry Medvedev, was simultaneously First Deputy Prime Minister (having made the transition from chief of the Presidential Administration in November 2005) and Chairman of Gazprom. Though the corporate

interests of the state and Gazprom generally intersected in dealing with Kyiv, their motives likely differed somewhat.

Several American and European participants in the dialogue agreed that for its part, the Kremlin sought to teach Kyiv a lesson and to demonstrate to Ukrainian voters the benefits of a cooperative relationship with Russia in advance of spring 2006 parliamentary elections as a component in a wider effort to increase its influence in the country. This in turn was seen as strengthening Russia's political role in the wider former Soviet region, something viewed by most participants as a key Kremlin goal.

Many suggested that Gazprom as a company had a narrower commercial interest in maximizing gas prices and minimizing the transport fees it paid for gas destined for other European consumers. In fact, some European participants in the dialogue argued that the dispute was strictly a function of the company's rational commercial goals rather than the Kremlin's wider political objectives. One European argued more specifically that it would be abnormal for a company like Gazprom to continue supplying its product in the absence of an agreement with Ukraine, which had repeatedly rejected the company's price proposals during late 2005, and that the shutoff of Ukraine's gas was fully justified on this basis. An American agreed, saying that Gazprom's approach to the crisis was poorly executed but not unreasonable. Another American suggested that if Moscow had been more proactive in its outreach to European governments, it could have significantly mitigated the impact of the crisis on its image.

Though some questioned Gazprom's demand for immediate and sharp price increases, several Americans and Europeans agreed that from Moscow's perspective, the price increase was quite reasonable. On one hand, they said, Gazprom had already agreed to increase its own domestic gas prices (if more slowly) under European pressure resulting from concerns that Russian industry was receiving an unfair subsidy and Russian officials argued that Europeans should be equally concerned about domestic gas prices in Ukraine. At the same time, some said, the Kremlin was essentially taking the position that Kyiv could get lower prices as part of a broader political relationship but

should not expect Russia to subsidize an uncooperative government seeking NATO membership by offering prices below European levels.

In addition to Gazprom's interests as a company, some participants argued, one must also consider the personal interests of Gazprom managers. The complexity of the deal ultimately reached by Gazprom and the Ukrainian firm Naftohaz—channeling gas sales through the mysterious RosUkrEnergo (cut out of the February 2008 Russian-Ukrainian gas deal)—obscured financial flows and created opportunities for individual enrichment. Both companies' unwillingness to shed further light on the arrangement only served to increase suspicion of its purpose.

The Nord Stream Pipeline

Although the Russian-German agreement to build the Nord Stream pipeline under the Baltic Sea from Russia to northern Germany added to suspicion of Moscow's aims in public debates in the United States and Europe, several participants expressed skepticism that the pipeline could allow Gazprom to cut off gas supplies to Poland, through which the Yamal pipeline currently brings gas to Germany. The Nord Stream pipeline is necessary because of growing gas demand in Europe, they said, and would therefore supplement rather than replace existing export pipelines from Russia. Thus Gazprom could not restrict gas deliveries through Poland without affecting other European customers.

One American participant asserted that the Kremlin would be unlikely to do this again after its experience with Ukraine, arguing that Moscow makes a distinction between Western European customers and Central European customers (ignoring the fact that some of the latter are members of NATO and the European Union) that it is prepared to treat more roughly. At the same time, this participant continued, Russian leaders are determined to avoid any form of dependence on former Soviet satellite countries or other former republics of the U.S.S.R. and are thus attracted to the Nord Stream route, which deprives Poland of potential leverage against Russia. A European participant noted that Gazprom's exports to Europe are extremely important to the company; because Russia's domestic gas prices remain

artificially low, nearly two-thirds of the firm's profit comes from the one-third of its gas that is exported to Europe—and the company would be reluctant to risk major EU markets (but perhaps less concerned about losing smaller markets in Central Europe).

One European disputed this assessment, saying that there is no evidence that Russian President Vladimir Putin or other Russian leaders would not cut off gas to Western Europe. Another was less concerned with this prospect than with the possibility that Moscow could sell gas from the Polish route to other customers when current agreements expire in order to force Poland to buy gas exported through Germany via Nord Stream at a higher cost (because the German price would include profits for the German intermediaries).

Ultimately, one European concluded, Poland has much less natural gas than it needs and has to be dependent on someone. Taking into account this reality, and the reality that Russia is the least expensive source of gas, Warsaw should assess its options and make a decision to work with Russia—or not. At a minimum, Polish leaders should recognize that the United States and Europe have limited leverage over the Kremlin and not count on Washington's or Brussels' ability to deliver Russian concessions in every dispute.

A number of participants described the Russian government's strategy in building Nord Stream as an effort to use Gazprom to divide Europe, splitting less dependent countries like France and the United Kingdom from more dependent countries like Germany and simultaneously driving a wedge between Germany, which Gazprom will handle carefully and is courting with the Nord Stream project, and former Soviet bloc states, with whom Russian officials will be considerably more assertive. The group was divided over whether the pipeline would in fact be built; some suggested that it could be up to \$2 billion more expensive than currently estimated but would be completed nevertheless, while others believed it would ultimately prove too costly.

Gazprom's Expansion

Some European participants expressed concern about Gazprom's efforts to expand its holdings in Europe, seeing this as an expansion of the Kremlin's influence in the region. However, others contended that

Gazprom's efforts to acquire downstream assets in its own neighborhood and in Europe mainly reflect a sensible business strategy to diversify into more profitable downstream businesses such as gas delivery, power generation, and petrochemicals, something that would allow the company to increase both its pricing power and its market capitalization.

One American participant noted that Western policy toward Russia since its independence has been based on the idea that integrating Moscow into the West, especially economically, would be a key tool in bringing about a stable, democratic, and prosperous Russia. However, this participant continued, in formulating this strategy most in the West assumed that Russia's integration would be driven by U.S. and European investment in Russia rather than the reverse. Now that high energy prices have provided Russia with sufficient wealth to acquire significant assets in the West, many have become uncomfortable with Russia's economic integration, especially as the direction of Russia's political transition has grown more uncertain. Another participant pointed out that as late as 2005, American foreign direct investment (FDI) was some twenty times greater than Russian FDI and Britain's FDI was ten times higher than Russia's—so Russian companies finally have the resources to invest abroad and have considerable room for growth before nearing Western investment levels.

Others were less worried about Gazprom's expansion *per se* than the tactics the company has employed, especially pressure to convert energy debts into equity stakes in key pipelines or other assets held by debtor governments in the former Soviet bloc. Several Europeans expressed concern that allowing significant Gazprom ownership of distribution networks in Europe would give the company too much market power unless Gazprom (and by extension European gas monopolies) were forced to separate their production and distribution businesses—something that the European firms have strongly resisted.

Russia's Wider Objectives

Notwithstanding the analysis of Gazprom's corporate objectives, the fact that it and other leading energy companies are state-controlled led many participants to view its actions as ultimately serving state

interests. With this in mind, the Kremlin's definition of Russian interests becomes paramount. American and European participants in the dialogue generally agreed that Moscow aims to use its energy wealth internally to develop the rest of its economy and externally to claim a major role in international affairs as what one called "a member of the global board of directors." President Putin has frequently emphasized both objectives, as in a 2006 statement that "existing socio-economic conditions, and also the strategy for Russia's exit from the deep crisis and restoration of her former power on a qualitatively new basis demonstrate that conditions in the natural resource complex remain the most important factor in the state's near-term development." Presumptive President Medvedev has been equally candid, saying in December 2007 that "The attitude toward Russia in the world is different now. We are not being lectured like schoolchildren, we are respected and we are deferred to. Russia has reclaimed its proper place in the world community. Russia has become a different country, stronger and more prosperous."

U.S. and European participants generally agreed that Russian conduct in Europe and elsewhere increasingly illustrates these perspectives. President Putin's opposition to U.S. plans to deploy missile defense systems in Poland and the Czech Republic reflects a view that notwithstanding the two countries' membership in NATO and the European Union, the deployments there would significantly impact Russian interests and should not proceed without Russian consent as part of a wider security agreement. Similarly, Moscow's suspension of its participation in the Conventional Forces in Europe Treaty demonstrates not only dissatisfaction with a deal reached at a time when Russia was unable to resist U.S. and NATO demands but frustration with NATO enlargement and its impact on NATO and Russian commitments under the treaty. The Kremlin similarly asserts that it should have a significant voice in any resolution of Kosovo's status.

American and European participants generally agreed that Russian foreign policy, including Russia's foreign energy policy, were likely to remain broadly similar after the March 2008 presidential elections—especially if President Putin actually becomes prime minister, as he has indicated. One American argued that given Mr. Putin's apparent

expertise on energy issues, he might focus even more intensely on expanding Russia's energy leverage in that post. More broadly, several participants noted, Russian policy reflects a broad domestic consensus that would be likely to endure even without Mr. Putin. Many agreed that Russians see their country as having regained its great power status and believe that resolving key international issues, especially in Europe, should require Russian consent or at least acquiescence.

One European participant described Russia's objective in Europe as "a new Yalta" that would recognize a Russian sphere of influence in areas of the former Soviet Union. An American defined Russian aims in similar terms, but with important historical context: the Kremlin wants to renegotiate its position vis-à-vis the West, he said, because the previous implicit arrangement evolved at a time when Russia was much weaker than it is today. This is difficult for many in the United States and Europe to accept after having become accustomed to Moscow's much more modest influence, and more cooperative behavior, during the 1990s.

A major Russian role in Central Asia is especially important to Gazprom, several participants pointed out, because as the company's production levels off (or even declines) due to lack of investment, and Russia's domestic gas consumption increases, Gazprom will be increasingly hard-pressed to meet its export commitments. Moreover, because gas exports are significantly more profitable than domestic sales, Gazprom will be motivated to keep export levels up and use low-price imported gas domestically. This in turn requires limiting Central Asian gas producers' independent access to markets (otherwise they could demand higher prices). Several agreed that this approach was much more attractive to Gazprom than expensive domestic investments that would not become profitable for years to come. However, one European participant noted, China's growing interest in Central Asian gas may increasingly challenge Gazprom's ability to sustain this model. Most were skeptical that Russia would be successful in building and wielding influence through a so-called "gas OPEC," citing the regional nature of the gas market and competition between some supplier countries.

Some American and European participants contended that as difficult as Moscow has been, its foreign energy policy thus far could not really be described as “hardball” in that Russia has observed limits (though not the limits that many would prefer). The gas cutoff to Ukraine was at a time when a contract had expired and there was no agreement on the renewal price. And the Kremlin seems to have been taken aback by the supply disruptions in Europe. Moreover, Moscow did not demand non-economic concessions. More broadly, one European commented that it is far preferable for Russia to use economic diplomacy to advance its interests than military power. A number of participants added that the United States commonly uses its economic power to apply political pressure and views this as a legitimate and important component of its foreign policy strategy, though obviously with differing goals.

Domestic Factors

Several participants saw important linkages between Russian foreign and domestic policies. For the Kremlin to use energy as a source of leverage in its foreign policy (or as an instrument of its domestic agenda), for example, Kremlin officials must maintain tight control of the energy sector and the wealth it generates. This has implications for both domestic and foreign companies, and (separately from narrower commercial, bureaucratic, and personal motives) is a key reason behind government pressure on domestic firms and recent steps to reduce foreign ownership.

At the same time, one U.S. participant argued, state interests and the interests of Gazprom, other companies, and their managers do not seem identical over the long term. Investment to sustain and increase production is essential to increasing Russia’s international political role under the Kremlin’s current foreign policy strategy, but has been largely ignored by managers with a short-term outlook. Strikingly, according to one European participant Russia loses some 15% of its gas production due to leaks in pipelines. Given that Gazprom, Rosneft, and other major Russian firms are either state-owned or state-controlled, the managers’ current approach requires at least the tacit agreement of government officials—particularly the officials who

represent the Russian government on their boards. One American argued that government officials are not concerned by the lack of investment, however; on the contrary, some may believe that it could even increase Russia's leverage over time if demand goes up and production remains flat. According to this participant, the main proponent of this strategy within Russia is Vladimir Litvinenko, the director of a mining research institute in St. Petersburg who helped Vladimir Putin obtain his doctoral degree during Mr. Putin's service as city official there.

In view of Russia's stagnant or declining production of oil and gas—some saw a supply crunch for gas as soon as 2012—several American and European participants raised questions about the sustainability of Russia's energy boom and the implications it has for Russia's foreign energy policy and wider foreign policy aims. Most agreed that oil prices will be very important, especially as prices in gas contracts are often linked to the price of oil, but that future oil prices are highly unpredictable. One American argued that if Russia faces a production crisis, leverage might in fact shift back to the West.

Even if oil prices remain high, some questioned whether Russia would develop the broadly-based economy its leaders seek. One American described Russia's energy sector as cost-maximizing rather than profit-maximizing—high costs both facilitate and conceal corruption—and contended that this sharply limits the country's prospects. At the same time, the participant continued, the high level of concentration in Russia's energy sector ensures that the cost of bad decisions, poor management, and other mistakes will be magnified. Further, although Russia's federal budget assumes \$61 per barrel oil prices in 2007 and \$74 in 2008, the country's high level of inefficiency means that oil prices would not necessarily need to come down this far to have a wider economic impact.

One European participant argued that Russia's energy leverage vis-à-vis Europe may wane if Moscow makes too many foreign policy mistakes in dealing with the European Union as a whole or its key players. While the process may take some time, this participant asserted that the more Russia exercises its power in energy markets, the faster it will dissipate that power as consumer governments spend more and more

money on alternatives to limit their dependency. And, he added, the EU's import dependence on Russia has already declined from 51% in 2000 to 41% in 2007. An American argued that Russia's energy power today is somewhat overblown in the public debate and that some claims by the Russian leadership have a major impact on attitudes despite being unrealistic when critically assessed.

EUROPEAN REALITIES

Compounding the problems of Russia's conduct are the realities that Europe is indeed dependent on Russian energy, particularly Russian gas, that the dependence is not uniform, and that European governments have widely divergent policies toward Russia. As noted above, the European Union's overall import dependence on Russian gas was 41% in 2007. However, taking gas production within Europe into account, Russian gas is only 27% of overall demand. Europe's oil dependence vis-à-vis Russia is about 15% of total consumption and 30% of imports, although some participants did not see this as a particular source of concern in the presence of a well-functioning global oil market that would allow Europe to purchase oil elsewhere (if at a higher price) if supplies were disrupted. Participants generally agreed that Europe's dependence on Russian energy imports was asymmetrical, in that if Moscow were to shut off energy supplies, Russian firms would forgo only the revenue from the gas or oil they did not sell, while Europe could suffer considerably greater costs as a supply disruption worked its way through complex modern economies.

Europe's Dependence

Participants generally agreed that there is a considerable gap between Western Europe, on one hand, and Central and Eastern Europe, on the other, in their levels of dependence on Russian energy imports. Many of the countries in Central and Eastern Europe were, of course, either component parts of the Soviet Union or members of the Soviet bloc. These countries were deeply integrated into an energy infrastructure and wider economic system designed around heavily

subsidized Soviet gas and oil resources. Building extensive new infrastructure today would be enormously expensive for economies that are both relatively small in the European context and, in some cases, still in transition. The fact that some of these countries are landlocked also limits their options.

In Western Europe, one participant explained, some countries, like the United Kingdom, have significant if declining domestic energy reserves, while others are able to rely heavily on exports from Norway (northern Europe) or North Africa (southern Europe). This limits their dependence on Russia today; however, as gas demand grows, Russian gas imports are likely to become more important.

Germany—the fourth largest consumer of natural gas in the world—sits between Western Europe and Central and Eastern Europe in its gas dependence on Russia. One participant reported that Germany depends on Russia for 43% of its imports, less than the 100% dependence of the three Baltic States, Romania, Bulgaria, and others, but much more than France's 24%, not to mention Spain and Portugal, which do not import gas from Russia at all. Germany also imports 90% of its oil consumption, much from Russia.

An American participant argued that Europe has very limited options in pursuing alternative sources of natural gas due to the current distribution of reserves and production capacity. According to this participant, Russia and Iran are the two principal potential sources of additional gas on a global basis. A European participant agreed, arguing that the planned Nabucco pipeline from eastern Turkey through Bulgaria, Romania, and Hungary, to Austria would initially supply only about 1% of European demand, rising to 3-4% by 2018, and that Qatar is unlikely to develop sufficient liquefied natural gas (LNG) capacity soon enough to meet European needs. Although North Africa is another potential source of additional gas, participants viewed its capacity as insufficient alone and noted Gazprom's attempts to gain leverage there.

One European participant pointed out that Europe's increasing demand for gas will create a 23% demand gap (23% of demand will be unfulfilled, around 200 billion cubic meters per year) as early as 2015

without new imports—and several Europeans noted that this would put heavy pressure on Europe either to increase its dependence on Russia or, alternatively, to reach an arrangement with Iran. Because of the time frame required to develop energy infrastructure, any effort to pursue the Iranian option would have to begin soon—and some companies are already pursuing quiet contacts with Iran, though they are not in a position to move further under the current sanctions regime. Many acknowledged that Washington would very likely try to discourage a major European gas deal with Iran and that this could create significant tension between Europe and the United States.

One European participant expressed optimism that greater LNG imports could allow Europe to reduce its dependence on Russia. However, another European differed, pointing out that LNG terminals are very expensive and are typically controversial in communities concerned about potential environmental and other quality-of-life impacts. This participant expressed doubt that European consumers (households) would be prepared to pay considerably higher energy bills to cover the cost of LNG imports. In any event, the process will take some time and is unlikely to displace a major share of Russian gas on its own.

Internal Differences

European countries' levels of dependence on Russia for energy imports have an impact on their policies toward Moscow but clearly do not define them: governments facing relatively higher energy dependence have been either more or less tough toward Russia (such as Poland and Germany) in dealing with Russia and governments less concerned about dependence have likewise been either more or less tough (such as the UK and France). This is a result of the fact that while energy is a key interest for all European countries, each has other circumstances and objectives that shape key policy decisions. Not to mention that these circumstances and objectives can change over time.

Several participants agreed that the European Union's continuing inability to establish a common energy policy is a major problem for Europe in dealing with its gas dependence on Russia. Europe has been unable to deal with its own energy monopolies, some said, and as a

result has national gas markets rather than one European market. Infrastructure limitations add to this challenge, one participant added, in that national gas networks would need to be linked by connecting pipelines—but this is extremely hard to do because of significant price differentials between markets. Political obstacles to a common energy policy remain substantial.

Broader policy differences toward Russia are also a major obstacle for Europe in dealing with Moscow's new assertiveness. While there are significant differences of opinion within Germany regarding policy toward Russia, the German government has focused on an engagement strategy with Russia to secure essential gas supplies. The British government has a much more difficult relationship with Moscow, a European participant said, especially in the wake of the polonium-210 poisoning of Alexander Litvinenko in London and subsequent tit-for-tat diplomatic tension that is still ongoing. Poland, on the other hand, had an assertive policy toward Russia until its change in government in late 2007.

Participants in the dialogue sessions agreed broadly that Russian-Polish relations are a key element in Europe's broader relations with Russia and discussion in both the Berlin and London workshops focused extensively on ties between Warsaw and Moscow and included Polish participants. Some European participants expressed concern about Poland's approach to the Kremlin, suggesting that Warsaw was essentially trying to settle scores with Russia at Europe's expense by provoking confrontation and then calling on EU members to demonstrate solidarity. Several participants were sympathetic toward Poland's challenges in dealing with Moscow, especially in view of its historical experiences, but nevertheless argued that the time had come for reconciliation. One Polish participant agreed in principle, saying that Russia was a major power and that Poles need to accept the fact that their country is not. This is clearly quite difficult as a practical matter, however. Another Polish participant was disappointed with Europe's weak support for Warsaw and suggested that some EU countries see Poland as a second-tier EU member and also do not particularly mind if its industries are less competitive because of higher energy prices.

In reviewing Poland's gas dependence on Russia, an American participant stated that Poland relies on Gazprom for approximately 60% of its gas imports. A Polish participant added that the country relies almost entirely on coal-fired (95%) and hydroelectric (5%) plants for electricity and uses gas predominantly for its petrochemical industry and residential heating. An American participant argued that Poland's petrochemical industry is largely a legacy of the Soviet period, constructed at a time when Warsaw counted on large volumes of subsidized Soviet gas and Moscow was prepared to provide it to a satellite state. This participant questioned why Europe should enter into a confrontation with Russia to avoid restructuring a Polish industrial sector that may not be viable under current conditions; the answer was that it would be politically very difficult for Poland's government to sacrifice jobs in the petrochemical sector. A Polish participant added that Poland may build 1-2 LNG terminals, possibly in Gdansk, to reduce dependence on Gazprom. But the participant added that this would not be simple, because Poland's natural gas monopoly would want exclusive access to the facility—while the European Union's bureaucracy would probably oppose this.

More broadly, a European participant explained that Russia and Poland have incompatible objectives: Poland (like other Central European states) wants to have leverage over Russian gas as a transit country, while the Kremlin rejects the idea that its former satellites should have any leverage of this or any other kind. Moreover, to the extent that either acts on these goals, it further reinforces the other's concerns and prompts additional steps by the other party.

THE UNITED STATES, EUROPE, AND RUSSIA

The tri-lateral relationship between the United States, Europe, and Russia has evolved considerably since the end of the Cold War, but also demonstrates important continuity. For example, one participant described ongoing concerns in the U.S.—regularly reflected in public debate—that Moscow will “split” America from its European allies, a clear subtext in many U.S. discussions of Germany’s gas dependence on Russia. This leads some American commentators to propose that U.S. leaders help Europeans to develop greater “backbone” in standing up to Russia.

Looking more narrowly at ties between Washington and Moscow, participants in the dialogue generally viewed the U.S.-Russian relationship as weak and deteriorating under the influence of mutual irritation and disappointment. Several U.S. participants further agreed that the relationship is likely to get worse before it gets better—and that a new U.S. administration in 2009 might have an opportunity to start over, but (whichever candidate is elected) would find the task very difficult due to both Russian conduct and American politics. They saw the U.S. as troubled by Russian foreign and domestic policy behavior, including opposition to Bush Administration priorities in Europe, such as Kosovo independence and missile defense, insufficient support for U.S. positions on Iran’s nuclear weapons program, growing pressure on Russia’s neighbors, and the deterioration of Russian democracy. For its part, Moscow resents Washington’s failure to take its perspectives into account on a global basis, particularly in Russia’s

immediate neighborhood, and perceived interference in Russian domestic affairs.

A number of U.S. participants saw the weakness of the U.S.-Russian commercial relationship, including the energy relationship, as a key element of the wider decline, in that in the absence of stronger business ties, constituencies in America and Russia for engagement are limited. Despite considerable interest in closer energy ties after September 11, they saw the energy trade as foundering due to a mismatch between players and expectations on the two sides. Where the Bush Administration sought simply to encourage contacts between U.S. and Russian energy companies, the Kremlin wanted a government-to-government dialogue that never materialized. As a result, when U.S. firms tried to engage with Russian counterparts, they found them uninterested, waiting for a green light from the Russian government that never came in the absence of a broader political understanding with Washington. At the same time, in part because the bilateral energy and wider commercial relationship is weak, the United States has less at stake in confronting Moscow and is more ready to do so than some major European governments.

Many Europeans have a different analysis of these relationships. In the view of one European participant in the dialogue project, the U.S. and Europe take different views toward Russia—and Europe and Russia take different views toward the U.S. While the U.S. and Europe are both worried about developments in Russia, America has tended to take a more zero-sum competitive approach where Europe—which sees Russia as not only difficult, but a neighbor—tends to apply an “interdependence” model that recognizes important mutual needs as well as disagreements. This derives from a sense that America can afford to make mistakes in dealing with Russia, but Europe cannot—Russia is too close. Moreover, this participant continued, both Europe and Russia are also concerned about U.S. foreign policy conduct, especially during the Bush Administration, something seen in the European reaction to Vladimir Putin’s 2007 speech in Munich. Europe has generally shown tolerance in its disagreements with Washington, however, while Moscow has actively sought to balance American power in some areas.

American and European participants agreed widely that the lack of a coherent policy toward Russia—both in Washington and in Brussels and many key European capitals—was a major handicap in working with Moscow. U.S. participants saw policy toward Russia as weakened by a highly polarized political debate in which those who advocate trying to find common ground with Russia are often attacked as being insufficiently concerned by Russia’s domestic failings. As a result, some said, the administration is generally under pressure to be “tougher” on Russia and countervailing arguments for a strategy that seeks to build on mutual interests are comparatively rare. America’s presidential campaigns tend to accentuate this dynamic.

Europe, on the other hand, is deeply divided by differences both within and among key EU member states on handling Russia, in part due to energy but also for other reasons. A few European participants noted that not only Moscow seeks to play on these differences, but Washington does as well. This perception contributed to the frustration some Europeans expressed about Poland’s assertive positions vis-à-vis Russia, in that a significant share of Europeans saw the U.S. as either tacitly or explicitly supporting Polish policies that weakened European unity and provoked the Kremlin.

One American participant suggested that more aggressive Russian behavior could persuade more Europeans to take a harder line toward Moscow. Several Europeans disagreed, however, arguing forcefully that precisely the opposite would happen: as Russian behavior becomes more troubling, they said, many Europeans will be less and less willing to support positions that could lead to serious confrontation. At the same time, they said, divisions within Europe would further increase, making a common EU policy even less likely than it is today.

In fact, one American said, Russia’s growing assertiveness reflects less Moscow’s strength than the weakness of leaders in the United States and the West more broadly. Russia’s power is one-dimensional—built around its energy resources—and there is thus far no clear indication that the Kremlin will succeed with the serious and difficult domestic measures that would be necessary to turn Russia into a real economic (or military) powerhouse in comparison with states outside its immediate neighborhood. (Actually, many commented, high energy

prices seem to make these reforms less rather than more likely in Russia's current environment.) This is precisely the reason that Moscow assertively uses its energy power—the Kremlin has few other tools with which to work. Thus even though the West does have limited leverage over Moscow, the U.S. and Europe could be more effective in dealing with Russia with better-defined priorities and strategies.

On the narrow issue of energy security, participants pointed out other important differences between the U.S. and Europe with implications for their relationships with Russia. First, as noted earlier, was the relatively strong Europe-Russia energy relationship that contrasts with a far weaker U.S.-Russia energy relationship. Second, one European participant said, is the fact that energy security means different things to Americans and Europeans. For Americans, energy security is all about oil, which is available from a well-functioning global market, and about keeping oil prices low. As a result, American efforts to promote energy security often tend to focus on increasing the supply of oil on international markets and the specific source of the oil is secondary; once oil reaches the global market, the market will determine where it should go based on price and other factors (such as the type of oil, the timing, etc.). But when Europeans talk about energy security, they are really talking less about oil than about natural gas. Like America, Europeans also buy oil on international markets, where the United States has contributed importantly to European energy security over the years by trying to maintain stability in the Middle East (a source of a much larger share of European than American oil imports). What is far more significant for Europeans is how they will close the large and looming supply gap for natural gas. The consequence of this is that where America has a general interest in seeing more Russian oil in international markets, Europe has a very specific interest in more Russian gas reaching its power plants, factories, and homes. This also affects American and European approaches to Russia.

American and European participants broadly agreed that an “energy NATO”—something proposed in the United States as a response to Russia's assertive use of its energy leverage in Europe—is not a viable policy instrument. As one participant put it, it was not clear how NATO or a similar organization would respond in an energy dispute.

For example, most considered it unlikely that European governments would support military response to an economic dispute. A European argued that the “NATO” label on a policy initiative of this kind would goad the Kremlin, reinforcing those in Moscow who argue that the Alliance remains directed against Russia notwithstanding NATO assurances to the contrary.

CONCLUSIONS AND RECOMMENDATIONS*

Key Conclusions

A number of broad conclusions emerge from the discussion during the three dialogue sessions regarding dynamics within Europe, Russian conduct, and the U.S. role:

Developments in Europe

- Europe's demand for natural gas will increase significantly over the next 10-20 years and Europe as a whole will probably need more rather than less imported Russian gas during this period, particularly if the United States continues to press European governments and others to isolate Iran.
- As overall European dependence on Russian gas increases, some European countries will remain more dependent on Russian gas than others, with political consequences.
- The European Union is unlikely to reach consensus on a "tough" approach to Russia, even if Moscow becomes more assertive in its foreign policy. On the contrary, more assertive Russian policy may reduce European support for a harder-line policy.

* The assessments and recommendations in this section are solely those of the author and do not necessarily reflect the views of dialogue participants.

Russian Conduct

- Russia will likely continue to use its gas exports for political leverage in Europe, particularly in dealing with former Soviet bloc countries, but is unlikely to provoke deliberately a confrontation with major Western European governments. Moscow will more likely continue efforts to cultivate these states in order to limit opportunities for a common European policy even as it pressures more dependent countries in “new Europe”.
- Russian oil exports will be less useful in exerting political leverage as European countries have access to a global market for oil.
- Russia may be hard pressed to meet growing European demand for gas in the face of declining domestic production and increasing domestic demand. Thus control over Central Asia gas exports will have increasing importance for Moscow.
- Using energy as a foreign policy instrument will require continuing Russian government control over domestic production and may lead to new pressure on independent Russian producers as well as foreign energy companies in Russia.

The United States

- The United States is unlikely to import significant amounts of Russian energy in the near to medium term for both political and commercial reasons and will not be dependent on Moscow in a meaningful way.
- The U.S. is not likely to be in a position to win wide European support for a broadly-defined harder policy line toward Moscow.

Recommendations

These conclusions shape in turn a number of policy recommendations for both Europe and the United States.

While it would be somewhat presumptuous for an American to offer detailed recommendations to either individual European governments or the European Union, few would likely dispute that among the most effective steps Europe could take in dealing with Moscow's assertive foreign energy policy would be to develop consensus on common internal policies on energy and external policies toward Russia. Internal policies could include a variety of measures, such as steps to limit the growth of demand for natural gas (made more difficult by desires to limit carbon emissions), regulatory action that would limit Gazprom's ability to control gas distribution (complicated by the EU's policy on competition), and development of infrastructure like interconnecting pipelines that could develop a better European regional market for gas and additional LNG import capacity (both expensive for companies and consumers), among other options. External policies might include efforts to accelerate increases in LNG imports from other regions and development of new pipelines to supply non-Russian gas, negotiation of an international dispute resolution mechanism to prevent future supply disruptions due to contract disputes (possibly based on elements of the Energy Charter, which Moscow—and Washington—refuse to sign), active efforts to protect the interests of European companies operating in Russia and the former Soviet bloc, and closer cooperation with the United States. Needless to say, none of these are simple and all are likely to require extensive discussion both on the national level and in EU institutions.

U.S. Interests

Though it may also be somewhat presumptuous to offer recommendations for the United States, it is at least a country in which the author has a vote. In considering U.S. policies to address Russia's energy policy and its impact on European security, however, the essential first step is assessing the specific American interests at stake, including security, political, and economic interests, and weighing their interrelationships with broader U.S. concerns in dealing with both Europe and Russia.

Fortunately, Russia's foreign energy policy and its broader foreign policy do not particularly threaten Europe's military security—the

preservation of which is a very important U.S. interest in view of the NATO alliance—at the present time. The Russian government has not made serious military threats against NATO members and does not appear likely to do so in the foreseeable future. A shutoff of energy supplies of sufficient duration to undermine NATO's military effectiveness or the military capability of individual member states also seems unlikely.

America's political interests in Europe in this context include its interests in NATO unity, the maintenance of close and cooperative relationships between the United States and European countries, both individually and collectively, and the maintenance of American influence in Europe. Russia's foreign energy policy can have an impact on the first of these if its political leverage over individual members shapes their decision-making on issues of importance to the alliance. There is no evidence that Moscow has sufficient leverage to achieve this today and it seems unlikely that Russia will develop such influence any time soon. Advancing America's interests in its cooperative relationships with European partners and in continued influence in Europe have more to do with U.S. and European actions than they do with Russia.

U.S. economic interests include maintaining strong and stable trade and economic relations with Europe, encouraging Russia to bring more oil to the global market, avoiding disruptions in energy supplies in Europe (which can have a significant impact on U.S. firms operating or investing there, on European suppliers of U.S. companies, and on Europe's overall economic health and appetite for American exports), developing its economic relationship with Russia to create a stronger constituency within Russia for engagement with the United States, and protecting American companies operating in Europe or Russia from arbitrary government action or unfair business practices. Though the strength of U.S.-European economic ties is not subject to particular Russian influence, many other American economic interests could be affected by Russia's energy policies, particularly if they result in major disruptions of supply in Western Europe. Though Moscow seems unlikely to pursue such a course deliberately, it is not outside the realm of possibility. Challenges to individual companies are more likely.

Moving beyond Europe, the United States has many broader interests in dealing with Moscow. These include very important interests in cooperation with Russia on global problems like terrorism and non-proliferation and regional challenges like Iran. If this cooperation is not successful, Washington has a very important interest in preventing deterioration of the U.S.-Russian relationship to the point that the Kremlin would actively and significantly assist other countries in challenging the United States on a routine basis. Even passive and sporadic assistance of this kind can significantly undermine the United States, and America has an important interest in developing a sufficiently constructive relationship with Russia to avoid it. The U.S. also has an important interest in avoiding undue or unconstructive Russian influence in Russia's immediate neighborhood. Significant Russian influence in the region is both legitimate and likely, but Russian intervention in the domestic affairs of nearby states or domination of the region could undermine American efforts to achieve other goals given Moscow's current foreign policy aims.

U.S. Policy

Many U.S. challenges and concerns in dealing with Russia's foreign energy policy and its current and potential impact on Europe reflect wider developments in the international system, such as the growing influence of energy producing states and their national energy firms. Others are more specific to regional dynamics in Europe and Eurasia. The following recommendations build on both the key conclusions of the dialogue effort and America's broader interests in dealing with Russia on a regional and global basis.

Broadly speaking, the United States should be concerned about—and should oppose—many elements of Russia's foreign energy policy in Europe. This includes establishing (together with our European allies) clear boundaries for Moscow's conduct and defending those boundaries vigorously. At the same time, however, Washington must take care not to define limits that it cannot enforce, whether for want of European support or for other reasons, as this would only encourage more troubling Russian behavior in the future. The U.S. must also exercise sophisticated diplomacy based on a clear sense of priorities in dealing with Russia to reconcile efforts to oppose

inappropriate Russian behavior in Europe with wider goals, including winning Moscow's support in pursuing the U.S. non-proliferation and counter-terrorism agendas.

Perhaps the most common concerns expressed in U.S. debate over Russia's use of its energy leverage in Europe relate to divisions in the transatlantic alliance and within Europe itself or, alternatively, to the growth of Russian influence in Europe. However, focusing narrowly on Russia is not necessarily the best way to address these problems and in one sense only increases Moscow's perception of its own importance. With this in mind, the U.S. should:

- Recognize that much concern about Russia's influence in Europe is in fact driven by fears that American influence in Europe and elsewhere is waning due to U.S. preoccupation with the wars in Iraq and Afghanistan and perceptions that neither has been fully successful, American domestic economic problems, and an unpopular outgoing U.S. administration with declining political capital at home and abroad. American leaders should thus focus on re-establishing U.S. influence rather than seeking to limit Moscow's, which escalates zero-sum competition and is unlikely to succeed so long as Russia has large energy reserves that others want.
- In the same spirit, recognize that worries about NATO unity are not unrelated to U.S. differences with important allies over Iraq, Afghanistan, the international criminal court, climate change, and a host of other issues not principally related to Russia or its actions. Washington should concentrate on strengthening the transatlantic alliance by improving dialogue with key American partners across the board and avoiding steps that unnecessarily alienate them. Likewise, the U.S. should avoid where possible advocating policies that accentuate divisions within Europe.
- To the extent that there is competition for influence between the United States and Russia in Europe, shift the terrain of the competition from energy—which Europe needs and the U.S. cannot provide—to a wider arena in which Moscow is unable to compete politically, economically, militarily, or culturally.
- Reach out to China and to Japan, other potentially significant markets for Russian energy exports, and to Europe to facilitate a

US-Europe-Asia dialogue that would build mutual confidence and blunt Russian efforts to play major energy consuming nations off against one another. This could also help major consumers in discussions with Russia in the G-8.

In addressing Russia's foreign energy policy in Europe more narrowly, the U.S. should:

- Coordinate closely and carefully with individual European governments and EU institutions to maximize the effectiveness of the separate and joint policies pursued by the United States and Europe.
- Strive to understand and separate Moscow's sometimes revisionist political aims from legitimate economic and commercial goals and to respond differentially.
 - Russia's political objectives could be largely addressed in a manner that does not endanger fundamental U.S. or European interests by working to define a mutually acceptable role for Russia in Europe. The United States should work with NATO, the EU, and individual European governments to develop new proposals to Moscow, taking care to define them in positive terms and to avoid damaging important interests. Rather than seeking to expand NATO-Russia cooperation, it may be more useful to consider establishing a new framework.
 - In parallel, the U.S. must develop jointly with Europe a clear set of red lines for Russian conduct that major European governments would be willing to enforce (otherwise they will not be meaningful) and communicate them to Moscow. It will be essential to make clear that the alternative to proposals for cautious and likely difficult engagement is a firmer set of boundaries defined by the U.S. and Europe alone.
 - Moscow's economic and commercial goals, as well as the goals of specific Russian companies, are not inherently illegitimate if pursued according to accepted "rules of the game". The U.S. should promote dialogue between Europe and Russia to establish these rules. This could be done either narrowly or more broadly, through a global dialogue

between energy consumers and producers. One element of such an effort could be a dialogue on secure transportation of energy that would also define clear rules for transit countries.

- Support American NATO allies, including new allies in Central Europe, when seriously threatened by Moscow and establish clear red lines to define the types of conduct the U.S. will resist, such as efforts to topple governments, undermine the territorial integrity of states, or inflict massive economic damage. Simultaneously, make equally clear to U.S. NATO allies—especially those in Central Europe—that while the United States will defend them vigorously against unprovoked Russian threats, Washington will not support or subsidize their own provocative behavior. The U.S. should establish similar boundaries with Moscow in relation to other states in the European neighborhood, such as Georgia and Ukraine, and should likewise discourage their leaders from provoking Russia.
- Engage Russia and Europe in an investment dialogue focused either on the energy sector or more broadly. This should have two key components, reciprocal access to investment opportunities and protections for foreign investors. At the same time, the U.S. should work vigorously to protect U.S. companies active in Russia from arbitrary government action and unfair competition.
- Remember that in Russia's current unstable environment, leaders' personal interests can be a powerful motivating force. If necessary, communicate privately and forcefully to Russian political and business leaders that the United States and Europe will move against their personal assets and interests should Moscow provoke a serious confrontation with the West. However, this must be done cooperatively with Europe to be successful and will probably be ineffective or even counterproductive if pursued unilaterally by Washington.

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