Trust and European-Russian Energy Relations –
The Case of Oil and Gas Partnerships and Long Term Contracts

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Presentation Overview

1. Why focus on trust?

2. Introduction to research project

3. Findings

4. Implications and questions
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## Two Perspectives in Western Europe

### Why so different?

<table>
<thead>
<tr>
<th>Germany-Russia</th>
<th>UK-Russia</th>
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<tbody>
<tr>
<td>Gas investments along entire value chain – upstream and downstream</td>
<td>Volatile oil investment and failed gas investment.</td>
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<tr>
<td>Stable and long term contracts; disputes resolved privately</td>
<td>Very public disputes between partners leading to litigation</td>
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<tr>
<td>Productive commercial and political relations</td>
<td>Contentious commercial and political relations</td>
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Emergence of trust

In interviews with policy makers and company employees, trust came up repeatedly as a determining factor for cooperation.

“We work better with the Germans because we know each other, and they don’t try to control us. We can trust them.”

“Trust is the glue that holds it all together. Without it, you can’t begin. If you lose it, the project falls apart.”

Dr. Leonid Grigoriev
Director Russian Institute Energy and Finance
Member, EU-Russia Energy Dialogue

Bjørn Tore Godal
Statoil, Board of Directors
Constraints necessitating trust in gas negotiations

• No substantive multilateral trade regime providing negotiations framework

• No robust enforcement mechanisms for dispute settlement

• High start up costs

• Political and economic ramifications

• Geopolitical context
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European-Russian Energy Relations

Mutual interdependence: Europe as consumer and Russia as supplier

Europe is largest gas market in the world: 496 million tons (2010)

Russia is Europe’s largest supplier: 33%

E.U. and state level relations

Source: Eurostat
Methodology

Triangulation Approach – Multiple Empirical Analyses

- Semi-structured interviews
- Historical process tracing
- Subject observation – ethnography
- Analysis of public & private statements
Case comparison of joint ventures and long term contracts

1. Germany – Russia: High trust case
2. U.K. – Russia: Low trust case
3. Norway and LNG as BATNA cases
4. Japan, Kazakhstan, Qatar, U.S. and Canada (reference cases)
What is trust?

Most common social science conception – trust is the belief that others are willing to reciprocate cooperation in the future (Bacharach and Gambetta, 2001; Kydd, 2005)

Trust as a ‘meso-concept’

The body of work suggests that it may be a ‘meso-concept’, integrating microlevel psychological processes and group dynamics with institutional arrangements (House, Rousseau, and Thomas-Hunt, 1998)
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# Findings (effects of trust)

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<td>Influenced preferences to engage with partner</td>
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<tr>
<td>Influenced scope of first partnership</td>
<td>Politics was used as a tool of coercion rather than cooperation</td>
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<tr>
<td>Minimised effects of dispute</td>
<td>Dispute led to attempts to defect from relationship</td>
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<tr>
<td>Deepened level of cooperation after dispute</td>
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[www.eprg.group.cam.ac.uk](http://www.eprg.group.cam.ac.uk)
Findings

• ‘High trust’ and ‘low trust’ cultures – There are distinct behavioural preferences whereby Russian actors emphasised relationships and social interaction over contracts whereas British and Norwegian focus was on contracts and process.

• Relationships and trade institutions are mutually opposed – with the development of trade institutions, relationships become less important as learned behaviour changes over time. In East, trust appears to function as a trade institution in lieu of formal contracts – historical legacies (bumaga terpit’ vsye)

• German actors appeared comfortable in both environments.

• Social interaction and interpersonal relationships defined the most stable European-Russian partnerships (Saunapolitik)

• Language played an important role by allowing negotiators to communicate directly in informal settings – it promoted social interactions and the development of interpersonal relationships

• Level of trust became less flexible over time. Once opinions formed it became progressively difficult to change them.
Joint venture profiles

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<tr>
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<th>B₁-R₁</th>
<th>G₁-R₁</th>
<th>N₁-R₁</th>
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<td>Oil joint ventures&lt;br&gt;Exploration &amp; production&lt;br&gt;Onshore&lt;br&gt;(Russia)</td>
<td>Gas joint venture&lt;br&gt;Pipelines for gas&lt;br&gt;Onshore&lt;br&gt;(FRG, GDR, Poland, USSR)</td>
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Trust formation stages

- **High Trust**
  - **High Risk**
  - **Low Risk**
  - **Low Trust**

1. **1st Contract Formation**
   - $G_1$ and $R_1$ sign pipelines for gas contracts.
   - $B_1$ invests in $R_1$ assets forming $B_1-R_1$.

2. **1st Dispute**
   - $R_1$ bankrupts $B_1$ assets in $B_1-R_1$.
   - No dispute in $G_1-R_1$ partnership.

3. **1st Contract Conclusion**
   - $B_1$ defects from $B_1-R_1$ partnership.
   - $G_1-R_1$ contracts completed.

4. **2nd Contract Formation**
   - $R_2$ director appeals to $B_2$ director through networks and Putin.
   - $B_2$ reengages in $B_2-R_2$.
   - $G_1$ deepens contracts and introduction of $G_2$ to $R_1$ and $R_2$.

5. **2nd Dispute**
   - $G_1$, $R_1$, $R_2$ and $G_2$ find alternative route to prevent future supply disruptions.

6. **2nd Contract Conclusion**
   - $B_2$ seeks other options. Begins talks with new Russian company.
   - $G_1$ and $G_2$ form new joint ventures with $R_2$ in Europe and Russia.

7. **3rd Contract Formation**
   - $B_2$ defects from $R_2$ partnership by signing agreement with new Russian company.
   - $G_1$, $G_2$ and $R_2$ renegotiate contracts because of changing market conditions. Other German company with little Russian experience move into arbitration.
Trusting, Fast & Slow

(Trust formation in Kahneman’s framework - evaluating trustworthiness)

1st System
(Based on associations)
- Fast evaluations
- Default preference for cognitive process

2nd System
(Rational & reflective)
- Slow evaluations
- More effort required for cognitive process

- Shared history, either positive or negative
- Ideological legacy
- Stereotypes and associations
- Cultural affinity
- Reference cases
- Perceived social contract

- Fulfilling expectations
- Signalling interest (costly signalling)
- Previously observed behaviour
- Demonstrated expertise
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Obstacles Facing UK-Russian Negotiations

- Memories and associations do not promote trustworthiness
- Previous interactions were limited and contentious
- Poor political relations
- Business practices are opposed, social emphasis v. technocratic processes
- Today cards are stacked again Nord Stream 3 & 4 from a trust perspective BUT more favourable than Germany and Russia when that relationship began
Ostpolitik - a model for building trust?

- Policy of rapprochement between the FRG (West Germany) and USSR
- Informal back channel of communication was critical to building trust
- Driven by mutual interest in trade and political stability – original policy was conceived and lobbied by industrial firms
- Breakthrough in negotiations occurred between Foreign Minister Egon Bahr and Soviet negotiators – FRG had to balance concerns in Washington for a gas trade deal.
- Outcome – “pipelines for supply deal” – barter structure for first LTC between German consortium headed by Ruhrgas and the Soviet Ministry of Petroleum & Minerals

FRG'S CHOICE - WHOM TO TRUST?

U.S. as guarantor

FRG
(W. Germany)

USSR
(Russia)

Middle East

Most trusted

Least trusted
Implications

• Appears to be two different trust dynamics in gas cooperation

1. Transactional (low trust culture), based on contracts, process and international conventions – this dynamic is a low level of trust because of lower vulnerability, however, it yields shorter term cooperation and is less flexible under changing circumstances

1. Relational (high trust culture), based on explicit and implicit expectations communicated between actors through repeated professional and social interaction – this is a high level of trust because of higher vulnerability, but it is more flexible and promotes higher levels of cooperation compared to transactional trust

• Relational trust is likely to be more effective with partners from regions with low levels of energy governance (where government and commercial institutions are less developed, ergo most of the world)

• Gas is more political than oil and requires higher level of trust

• Building trust for partnerships will require interaction at both commercial and political levels – this may be uncomfortable for some European politicians
Questions: 1. How important is trust?

Its importance varies depending on the partners. Typically, relational trust is more important in partnerships involving participants in countries with less developed trade institutions. Because of previously mentioned circumstances

In countries with nascent trade institutions, relational trust is a requirement to initiate and maintain the partnership. Without trust, the risk is tantamount to making an investment without a contract and no enforcement mechanisms.

\[
\text{Investment cost} \leq \text{value of trust}
\]

Extreme example: Nationalisation of assets

Even in countries with developed trade institutions, trust is likely to influence preferences of decision makers, all things being equal.

I. Partnership vetting
II. Dispute or breach of contract
III. Conclusion of contract – end partnership, renew or expand partnership?
The Opportunity Cost of Distrust

Examples from the cases:

1. BP in Russia – 8 years of stranded gas assets (Kovytyka field) at the height of the European gas market; two new projects in Iraq and Vietnam to which it no longer has access; partnership with Rosneft that now belongs to ExxonMobil

2. Statoil and Rosneft – loss of top field licenses in Barents Sea, best fields were assigned to ENI and ExxonMobil despite Statoil’s greater experience in developing fields in the Norwegian-Russian maritime border region

3. Russian-Japanese collaboration – most partnerships have failed since the 1970s, and current cooperation is constrained by distrust resulting from the border dispute; after Fukushima, Japan’s energy security premium has doubled despite the most obvious gas source at its border

4. Energy security premium for eastern European states
2. What causes distrust?

- If one or more partners come from a ‘high trust’ culture, little or no social interactions among negotiators can cause distrust.

- Lack of regional specialists as part of the negotiations process, this become more important when or more partners is from a ‘high trust’ culture.

- Not fulfilling expectations.

- Excessive risk aversion.

- Infrequent communication.

- Associative factors (1st system) depending on the individual partners.

- Misalignment of high trust/low trust signals.
3. What can companies do to improve trust in natural gas partnerships?

- People, people, people (human capital issue) - Recruit and assign the right people, especially in positions of leadership and negotiations (points of contact with the partnership's counterparts) and ensure they have the appropriate ‘soft skills’, generally speaking, regional specialists who speak the language and understand the culture.

- Raise the level of social interaction in addition to formal meetings if one or more parties are from ‘high trust’ cultures.

- Create a ‘trust’ channel for communication.

- Take risk (within reason after initial assessment) that sends the right signals.

- Create a list of signals that both sides understand.

- Devise a strategy to address the ‘1st System factors’.

- Identity both explicit and implicit expectations, and fulfill them – expectations will vary depending on cultural preferences (high or low trust cultures).