



# Trust and European-Russian Energy Cooperation: The Case of Oil and Gas Partnerships and Long-term Contracts

EPRG Working Paper 1409

Cambridge Working Paper in Economics

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**Abstract** This study argues that, in addition to political and economic factors, the level of trust between decision makers influenced outcomes in European-Russian energy cooperation. Drawing on selected cases of commercial partnerships and long-term contracts, it examines the impact of trust and the process by which it was developed or undermined between European and Russian partners. The findings are the following. Firstly, trust appeared to mitigate suspicion and encouraged cooperation between commercial and political actors. Secondly, when trust was present, conflicts of interest were more easily overcome while in its absence, a spiral of litigation and attempts at political coercion ensued. Thirdly, the development of trust was partially determined by history, collective memories and pre-existing political and economic conditions. At the same time, actors had the option to make decisions that could contribute to building trust or not. Fourthly, the analysis demonstrates a wide variation in levels of trust between West European companies and politicians toward Russia. And finally, it underscores the importance of interpersonal relations and energy companies as non-state actors. Because of the size and scope of these projects, the trust factor has implications not only on commercial ventures but also national economies, energy security and international relations.

**Keywords** Trust, natural gas, oil, trade, cooperation, Europe, Russia, Germany, United Kingdom, networks, relations, long term contracts, European Union

## JEL Classification

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Publication July 2014  
Financial Support Cambridge Political Economy Society Trust and EPRG

## Introduction

Much academic attention has recently focused on the causes of conflict plaguing energy trade between European and Russian partners. The question usually posed is whether Russia aims to use its oil and gas resources as a tool to exert political influence or maximise profits. Does politics precede economics or vice versa? There is, however, a critical determinant missing from the discussion, one that, along with political and economic factors, influences outcomes, trust.

This study argues that, in addition to political and economic factors, the level of trust between key individuals influenced outcomes in European-Russian energy cooperation. Drawing on selected cases of natural gas partnerships, it examines the impact and formation of trust between European and Russian partners. The findings are the following. First, trust mitigated suspicion and encouraged cooperation between commercial and political actors. Second, when trust was present, conflicts of interest were more easily overcome while in its absence, a spiral of litigation and attempts at political coercion ensued. Third, the development of trust was partially determined by history, collective memories and pre-existing political and economic conditions. At the same time, actors had the option to make decisions that either contributed to building or eroding trust. Fourth, the analysis demonstrates a wide variation in levels of trust between West European companies and politicians toward Russia. And finally, it underscores the importance of non-state actors, in this case energy companies and relationships between individuals, as a critical determinant of the success or failure of energy partnerships. Because of the size and scope of these projects, the issue of trust has implications not only on commercial ventures but also national economies, energy security and international relations.

In addition to measuring the effects of trust, it investigates the conditions and policies that encouraged the development or erosion of trust in two cases, British-Russian and German-Russian partnerships. The first case is the British-Russian joint venture, TNK BP, established in 2004 between British Petroleum (BP) and investment group, Alpha Access Renova (AAR). The second set comprises German-Russian partnerships between Gazprom, E.ON Ruhrgas (E.ON), and BASF. Two German-Russian partnerships will be examined as one case because the history of one influenced the development of trust in the other. Between the two groups, trust was a determining factor insofar as it coloured the preferences of actors, which influenced their decisions at critical stages of the partnerships. It influenced the choice of commercial partners, the handling of disputes, and the resolve to continue a partnership despite more attractive alternatives. In general, trust between the German and Russian actors explains the high level of cooperation compared to the British-Russian case.

The study comprises three sections. The first examines why the issue of trust became relevant to understanding current trends in European-Russian energy trade. It includes a commentary on the academic debate and a working definition of trust. The second assesses the impact of trust on decision makers at three critical stages of the partnerships, the formation of a joint venture, the first conflict and the conclusion of the contract. The third identifies how trust was developed or eroded and compares the role of trust to political and economic conditions that influenced decision makers. Finally, it poses implications of the findings on wider debates concerning energy trade and trust in commercial and political relationships.

Although the study references other partnerships, the two primary groups of cases are German-Russian and British-Russian joint ventures because they display strong variation of trust levels between West European and Russian parties.

Consequently, the causal relationship between trust and outcomes are more apparent. Information sources are both primary and secondary including journals, periodicals, publicly available trade data, and interviews conducted by the author with experts, company employees, diplomats and policy makers involved in the cases. Because the cases deal with two sets of bilateral relations with the same supplier, Russia, the focus is on the factors that most reflected the preferences and circumstances of the partners, Germany and the United Kingdom. The time frame is from the first interaction of the parties through to the present. The geographic scope is limited to joint ventures between Russian and West European joint ventures because historical circumstances in the east of Europe, namely the legacy of the Cold War, create a different geopolitical orientation to Russia and pipeline infrastructure, which create different conditions in the east. Issues such as nationalism and an entrenched suspicion of Russia make for a different starting point for Russian joint ventures in Eastern Europe.<sup>1</sup> The commodity of focus is natural gas because there are several features of the industry that make it particularly useful in the examination of trust and international energy trade. The restricted modes of transportation by either pipeline or liquefied natural gas (LNG) and the high degree to which Russia protects this industry necessitate both political and economic participation in order to build partnerships. Although the majority of TNK BP's dealings are in oil, it began as an oil and natural gas company, and its inability to develop its natural gas resources is partly explained by trust.

Limitations of this study include the size of the sample set and availability of information. Concerning the first, the focus on just two European-Russian joint venture cases limits what can be said about European-Russian energy trade in general. However, this was mitigated by selecting cases that represented extreme circumstances among a variety of examples available, cases where trust was clearly developed and influenced economic and political outcomes and likewise, where it was, for the most part absent.

The availability of data about the interaction of company executives and politicians was another constraint. Energy companies the size of BP, E.ON and especially Gazprom are micro-economies of their own with subsidiaries that can number in the hundreds. Their decisions can have consequences on entire economies, and, as such, staff members are typically limited by protocol in what they can share with outsiders. However, because these cases are high profile, there has been extensive media coverage. This study has benefited from considerable journalism and previous analysis that includes comments from those privy to discussions and interactions between company executives and politicians. Additionally, interviews with those close to the events provide for a check against information from secondary sources.

## **Trust and international energy trade**

In all of the complexities that an energy partnership entails, why would one explore the issue of trust? First, the actors themselves attribute the success or failure of joint ventures to a question of trust. As former BP CEO, Lord John Browne articulated,

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<sup>1</sup> Russia's 'near abroad' refers to the bordering countries that used to be part of the Soviet Union. The dynamic between these states and Russia is conditioned by the experience of being former Soviet republics and, as such, are different from relations with other former communist states in Eastern Europe. With respect to natural gas, this difference manifests in price. Ukraine, for example, has paid Gazprom significantly less for natural gas compared to Poland, because of legacy trade relations among Soviet republics. Although this is changing, the 'near abroad' states can not be treated in the same way as other European states. For further information on this regional variation, see Trenin, Abdelal, Haslam, and Goldmann.

'All oil companies will now struggle with the issue of trust ... building trust will become even more important as permission is sought to 'develop' oil found in ever more challenging environments.'<sup>2</sup> Those interviewed often brought up the issue of trust to explain the relative success of German-Russian partnerships versus British and American ventures with Russian partners. Therefore, to the extent that actors' perceptions construct their reality, trust, *ipso facto*, becomes relevant.

The second reason concerns the nature of the international state system. In international energy trade, there is no central authority or enforcement mechanism to govern trade. Unlike consumer goods, which fall under the auspices of the World Trade Organization (WTO), there is no comprehensive multilateral trade regime for natural gas. An explanation of why this is the case is beyond the scope of this analysis, but suffice it to say, most states treat energy trade as a security issue because both their economies and military forces depend on access to natural resources. Even supplier countries may become dependent on revenues generated by natural resource exports. Consequently, natural gas trade is negotiated by and large bilaterally.

And finally, trust is relevant to understanding international energy trade because it reveals regional variation in the conditions that shape preferences among decision makers. These conditions can include geopolitics, historical suspicions, business-government relations, and established interpersonal networks. Yet, they are frequently overlooked in academic and policy analyses concerning European-Russian energy trade.

### **Trust as a subject of academic exploration**

One of the challenges of approaching an issue like trust is the conceptual disagreement among scholars on a working definition. Most admit that the issue is problematic from an analytical perspective, yet the level of academic interest speaks to its analytical significance in understanding social phenomena.

There are, however, aspects of the various scholarship that are evident in the European-Russian case, particularly its relationship to risk. As Rousseau et al. point out, 'Across disciplines, there is agreement on the conditions that must exist for trust to arise. Risk is one condition considered essential in psychological, sociological, and economic conceptualizations of trust.'<sup>3</sup> For example, trust as the opposite of risk, as many economists have employed, was clearly evident in the cases of TNK BP, E.ON, BASF and Gazprom. Furthermore, the expectation that partners would adjust their policies to account for each other's preferences, resembling Keohane's definition of 'cooperation', was also evident.<sup>4</sup> Likewise, international energy cooperation relates to commercial and political interests. Complicating matters, domestic and global market features that will vary depending on the individual industrial and supply profile of the state. Trade relations are subject to the parameters of the global market of the specific commodity such as oil, natural gas, coal or cross-border electricity flows. Energy trade is also subject to institutional frameworks, geopolitics and, as this study argues, the level of trust between decision makers which includes all those factors that can influence the development of trust.

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<sup>2</sup> John Browne and Philippa Anderson, *Beyond Business* (London: Weidenfeld & Nicolson, 2010). viii.

<sup>3</sup> Denise M. Rousseau et al., 'Not so Different after All: A Cross-Discipline View of Trust', *Academy of Management. The Academy of Management Review* 23, no. 3 (July 1998): 395.

<sup>4</sup> Robert O. Keohane, *After Hegemony: Cooperation and Discord in the World Political Economy* (Princeton University Press, 2005), 12.

For the purposes of this study, the most relevant literature addressing trust proceeds from international relations, management sciences and economics, however, there is much disagreement among the disciplines. As Rousseau et al. note:

‘Disciplinary differences characterizing trust traditional treatments of trust suggest that inherent conflicts and divergent assumptions are at work (Fichman, 1997). Economists tend to view trust as either calculative (Williamson, 1993) or institutional (North, 1990). Psychologists commonly frame their assessments of trust in terms of attributes of trustors and trustees and focus upon a host of internal cognitions that personal attributes yield (Rotter, 1967; Tyler, 1990; see Deutsch, 1962 for an example of more calculative framing by a psychologist). Sociologists often find trust in socially embedded properties of relationships among people (Granovetter, 1985) or institutions (Zucker, 1996).’<sup>5</sup>

International relations and economics are most relevant to this study because the negotiations at the heart of international energy cooperation are between actors representing the state and firms that have varying degrees of ties to the state. International institutions such as the Energy Charter Treaty or the EU may also play a role, directly or indirectly in their interactions. However, most international energy cooperation takes place bilaterally and between two firms that are tied, to varying degrees to their home states’ interests. Notable examples have examined bilateral relationships and security cooperation.<sup>6</sup> Others have focused on conceptualising and measuring trust in international politics.<sup>7</sup>

Much of the recent scholarship proceeds from management sciences because the issue of trust comes up often in inter-firm negotiations alliances. Management science is itself interdisciplinary drawing analytical tools from across the social sciences but with a focus on firm behaviour. Methodological approaches range from statistics and experimental analyses to game theory and surveys. One analysis in particular is most relevant for this study, Ayios’s examination of Western-Russian business relations.<sup>8</sup>

Another aspect of what makes trust elusive for academic exploration is disagreement among scholars on what trust is and how best to analyse it. Each of the disciplines approaches trust through its own framework and not surprisingly, they have their own popular definitions of trust. As Lyman et al. explain, ‘Trust ... tends to be somewhat like a combination of the weather and motherhood; it is widely talked about, and it is widely assumed to be good for organizations. When it comes to specifying just what it means in an organizational context, however, vagueness creeps in.’<sup>9</sup>

This is why periodically reviews of the conceptual debate emerge.<sup>10</sup> Complicating this lack of consensus, there is an on-going debate on what the best conception of trust

<sup>5</sup> Rousseau et al., ‘Not so Different after All’.

<sup>6</sup> Ken Booth and Nicholas J Wheeler, *The Security Dilemma: Fear, Cooperation, and Trust in World Politics* (Basingstoke: Palgrave Macmillan, 2007); Andrew H Kydd, *Trust and Mistrust in International Relations* (Princeton, N.J.: Princeton University Press, 2005).

<sup>7</sup> Aaron M. Hoffman, ‘A Conceptualization of Trust in International Relations’, *European Journal of International Relations* 8, no. 3 (9 January 2002): 375–401; Vincent Charles Keating and Jan Ruzicka, ‘Trusting Relationships in International Politics: No Need to Hedge’, *Review of International Studies* FirstView (2014): 1–18, doi:10.1017/S0260210514000059.

<sup>8</sup> Angela Ayios, *Trust and Western-Russian Business Relationships* (Ashgate Publishing, Ltd., 2004).

<sup>9</sup> Lyman W Porter, Edward E Lawler, and J. Richard Hackman, *Behavior in Organizations* (New York; London: McGraw-Hill, 1975).

<sup>10</sup> Kurt T. Dirks and Donald L. Ferrin, ‘The Role of Trust in Organizational Settings’, *Organization Science* 12, no. 4 (1 July 2001): 450–67; Larue Tone Hosmer, ‘Trust: The Connecting Link between Organizational Theory and Philosophical Ethics’, *The Academy of Management Review* 20, no. 2 (1 April 1995): 379–403; Roderick M

should be within each discipline. Where economics and political science typically associate trust with reciprocity or cooperation, psychologists and an increasing number of social scientists recognise that trust is a mental process associated with confidence and positive expectations.<sup>11</sup> Although it is not the goal of this study to resolve these debates, it is necessary to identify a conception of trust that is meaningful for the context of international energy cooperation, which the following section will offer.

### Working definition of trust

A working definition must satisfy three conditions in order to be useful for this analysis. The first is analytical precision. It should provide an indicator for identifying and measuring trust given the availability of data and information. The second is insight. As the conceptual disagreement among scholars attests, trust is an elusive concept to examine because its meaning is highly contextual. For instance, experimental research has shown the level of trust will vary between parties when the value of the object entrusted differs.<sup>12</sup> Likewise, levels of trust and the process by which parties build trust can also vary across different industries and cultures.<sup>13</sup> Yet, there have to be general features of trust in those contexts in order to identify when and if parties trust one another. This relates to the first condition concerning analytical precision. The next condition is compatibility with existing scholarship in order to situate the study and contribute to current debates on trust. In this respect, it makes little sense to add to the already crowded field of what the appropriate conception of trust should be. Each discipline has its own dominant views in this matter. Although this project will explain the specific features of trust in the context of international energy cooperation, it must respond to existing conceptions of trust.

With this in mind, this study employs a common definition of trust from political science and economics. It draws on scholarship from international relations whose conception of trust is based primarily on game theory and behavioural experiments:

Trust is the belief that others are willing to reciprocate cooperation in the future.

The advantage of this definition is its simplicity and specificity for identifying trust. It also provides a general indicator that is easy to recognise from interview comments and public statements. Moreover, it is open enough to encompass qualities that relate to trust, and according to some, interchangeable with trust, such as

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Kramer and Karen S Cook, *Trust and Distrust in Organizations: Dilemmas and Approaches* (New York: Russell Sage Foundation, 2004); Barbara B. Bunker and Lewicki, 'Developing and Maintaining Trust in Work Relationships', in *Trust in Organizations: Frontiers of Theory and Research*, ed. Roderick M. Kramer and Tom R. Tyler (SAGE, 1996), 114–39; Guido Möllering, *Trust: Reason, Routine, Reflexivity* (Amsterdam; Boston; London: Elsevier, 2006); Rousseau et al., 'Not so Different after All'.

<sup>11</sup> Rousseau et al., 'Not so Different after All'.

<sup>12</sup> Elinor Ostrom, 'Toward a Behavioral Theory Linking Trust, Reciprocity, and Reputation', in *Trust and Reciprocity: Interdisciplinary Lessons from Experimental Research*, ed. Elinor Ostrom and James Walker (New York: Russell Sage Foundation, 2003), 19–79.

<sup>13</sup> Möllering and Florian Stache, 'Trust Development in German-Ukrainian Business Relationships: Dealing with Cultural Differences in an Uncertain Institutional Context', in *Organizational Trust: A Cultural Perspective*, ed. Mark Saunders (Cambridge: Cambridge University Press, 2010), 205–26; Toshio Yamagishi and Midori Yamagishi, 'Trust and Commitment in the United States and Japan', *Motivation and Emotion* 18, no. 2 (1 June 1994): 129–66.

confidence.<sup>14</sup> For example, the ‘belief’ that others are willing to reciprocate cooperation is similar to having ‘confidence’ that others will reciprocate cooperation. Thus identifying statements and signals that promote confidence becomes important. Furthermore, this characterisation definition allows for measurement of trust in observable acts. For example, when one party fulfils expectations, or in this context, meets its contractual obligations, this will indicate that the actor has likely reinforced trust to the counterparty. Of course repeated cooperation can result for other reasons such as shared interests. This is not necessarily in conflict with the notion that trust develops with repeated interactions. For instance, without shared interests there would be no reason to engage in trade. For this reason this study will turn to data from the semi-structured interviews and recorded statements to identify what may not be apparent in the observable actions, namely the reason actors attribute to explain their actions, be it trust or some other factor. This will address the intention and mental process that constitutes the ‘belief’ component of the observable act, ‘reciprocating cooperation.’ As Hoffman pointed out, data from interviews and statements are the most direct way of identifying trust. If a person acknowledges an action resulting from trust or encouraging its development, then this is most accurate way of identifying trust and evaluating its effects.

The next indicator will draw on signalling theory. The study will use costly signals as another type of evidence for the existence of trust, which it will triangulate with other indicators. In addition to cooperation, signalling theory is another approach scholars have employed to analyse trust.<sup>15</sup> A signal is perceived as too costly to make unless the party making it is trustworthy. And likewise, the party sending the signal is trying to induce others to make a leap of faith.<sup>16</sup> However, what is recognised as a costly signal, one that is enough to induce trust, is contextual. For instance, the official recognition of the German Democratic Republic (GDR), East Germany, was a continued point of contention in West German-Soviet relations that had prevented an elusive trade deal between the countries for the better part of the 1960s. It was not until the Federal Republic of Germany (FRG), or West Germany, offered to recognise the GDR that Moscow took this to be a serious sign of commitment to improving relations.<sup>17</sup> Repeated overtures, such as public statements, were previously disregarded by Soviet authorities, but the recognition of the GDR was perceived as too costly for the FRG unless they were serious about engaging the Soviet Union in commercial relations, or trustworthy.

Hoffman provides a solution to qualifying a signal in the international relations context through what he calls, ‘discretion-granting policies.’ In other words, ‘measuring trusting relationships involves (1) identifying policies that grant other states discretion over outcomes previously controlled by the first and (2) demonstrating that the leaders responsible for enacting such policies did so at least in part because they believed that their counterparts were trustworthy.’<sup>18</sup> A ‘policy change’ puts the trustor at risk while benefiting the other party. This comes closer to being able to identify a costly signal, however, it does not completely address the contextual aspect. One example would be Soviet negotiators at the outset of the game changing trade treaty between the FRG and

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<sup>14</sup> Diego Gambetta and Michael Bacharach, ‘Trust in Signs’, in *Trust and Society*, New York: Russell Sage Foundation, 2001, 148–84; Kydd, *Trust and Mistrust in International Relations*.

<sup>15</sup> Gambetta and Bacharach, ‘Trust in Signs’; Brian L. Connelly et al., ‘Signaling Theory: A Review and Assessment’, *Journal of Management* 37, no. 1 (1 January 2011): 39–67 ; Kydd, *Trust and Mistrust in International Relations*.

<sup>16</sup> Booth and Wheeler, *The Security Dilemma*.

<sup>17</sup> Angela E. Stent, *From Embargo to Ostpolitik: The Political Economy of West German-Soviet Relations, 1955-1980* (Cambridge University Press, 2003).

<sup>18</sup> Hoffman, ‘A Conceptualization of Trust in International Relations’.

the USSR. The lead backchannel interface, Vyacheslav Kevorkov explained, Soviet negotiators recognised the policy change proposal of removing the West Berlin question to be a serious gesture, one that would change the framework of negotiations with the FRG and an important first step in Willy Brandt's *Ostpolitik*.<sup>19</sup> Although policy changes of this magnitude may be relevant to negotiations between policy makers, it does not encapsulate the commercial dimension of inter-firm interactions. For this, the study turns to interviews and the articulated views of industry actors to qualify whether a signal is costly or not.

Finally, the level of cooperation will serve as an indicator for the development and level of trust. In the context of the following cases, German actors repeatedly reinforced this perspective. As one diplomat noted, 'we have every reason to trust Russia as a secure source of supply. They have consistently delivered on their promises for the past thirty years.'<sup>20</sup> With every iteration of cooperation, it is assumed that trust is likely to have developed because, through shared experiences, parties have more information about one another and likewise, more confidence in what to expect.<sup>21</sup> As Hardin notes, 'Although it would be wrong to say that the presence of cooperation implies the presence of trust, it is commonly assumed in much of this work that successful cooperation indicates some degree of trust among the players.'<sup>22</sup> For instance, one single upstream joint venture would represent a lower level of trust than multiple joint ventures along the entire petroleum value chain, upstream and downstream.

In aggregate, these three components will provide an improvement over much extant scholarship because they address both the observable action and the unobservable mental process of trust. As a safeguard, no single action or statement alone is assumed to represent trust. This approach offers a tempered and disciplined framework for identifying and measuring trust, an elusive concept that is all too often assumed or neglected because of its subjective quality as a mental process. The weight that the study will ascribe to each indicator follows the order in which I have presented them with the highest priority assigned to interviews and statements, followed by costly signals, policy changes and finally, levels of cooperation. This order is designed to, as accurately as possible, identify and measure the effects of trust, its formation process and the factors that contributed to its development. It also reflects the weight, which Hoffman proposed for analysing trust in the international relations context.<sup>23</sup> This mixed methods approach is a deeper analysis than most of the scholarship on trust, because it does not assume that reciprocating cooperation is necessarily a reflection of trust. And it acknowledges the obstacles of examining social interactions resulting from mental processes such as trust whereby certainty is unattainable.

## Cases

To ground the analysis and isolate the causal relations of trust to outcomes, the cases are divided into three stages when actors faced critical decisions. The first was the

<sup>19</sup> Jürgen Beves, *Geheimoperation Ostpolitik* ([Köln]: WDR, 2010).

<sup>20</sup> Ralf Dr. Horleman, 'Interview with Economics Advisor to the Ambassador of Germany, Ministry of Foreign Affairs of the Federal Republic of Germany' (Moscow, 29 November 2010).

<sup>21</sup> Robert M Axelrod, *The Evolution of Cooperation* (New York: Basic Books, 1984); Kydd, *Trust and Mistrust in International Relations*.

<sup>22</sup> Russell Hardin, 'Gaming Trust', in *Trust and Reciprocity: Interdisciplinary Lessons from Experimental Research*, ed. Elinor Ostrom and James Walker (New York: Russell Sage Foundation, 2003), 80.

<sup>23</sup> Hoffman, 'A Conceptualization of Trust in International Relations'.



decision to enter into a contractual relation. Why choose to work with one party over another? The second was how to handle a dispute. And the third was whether to continue or defect from the relationship at the conclusion of the contract. These decisions points are common to most joint ventures, and thus, the lessons may be relevant to multiple international joint ventures. The cases illustrate that trust, in addition to political and economic factors, influenced the preferences of actors to initiate cooperative relations, mitigate the effects of disputes and breaches of contract, and swayed preferences to deepen their cooperation over time. The following table illustrates the chain of events of the more detailed case studies.

**Table 1**

E.ON, BASF, and Gazprom	TNK BP (BP and AAR)
<p><b>Stage 1 – contract formation</b></p> <p><i>Ostpolitik</i> and end of Cold War removes political barrier to trade</p> <p>Ruhrgas lobbies government to open talk with Soviet Ministry of Energy</p> <p>Trust is developed at political level.</p> <p>BASF introduced to Gazprom through Ruhrgas and political networks.</p>	<p><b>Stage 1 – contract formation</b></p> <p>End of Cold War removes political barrier to trade.</p> <p>BP reengages AAR after dispute over Sidanco.</p> <p>AAR director, Mikhail Fridman, tries to make amends with Browne.</p>
<p><b>Stage 2 – dispute or breach of contract</b></p> <p>Gazprom stops supply deliveries in 2005 and 2009 as a result of dispute with Ukrainian Naftogaz.</p> <p>Gazprom resumes deliveries under pressure from German partners</p> <p>Schröder and Putin develop close relationship.</p> <p>Both sides discuss how to avert future disruption.</p>	<p><b>Stage 2 – dispute of breach of contract</b></p> <p>Dispute emerges over CEO position and geographic scope of business.</p> <p>Both sides use political channels to exert pressure on the other.</p> <p>BP looks for other options in Russia and engages talks with Rosneft and Gazprom.</p> <p>AAR explores new project in Iraq and Vietnam against stipulations of contract.</p>
<p><b>Stage 3 – contract fulfilment</b></p> <p>New long term contracts are signed.</p> <p>Nord Stream pipeline is announced and construction begins.</p> <p>Germany faces political pressure in EU and from neighbours opposed to Nord Stream.</p> <p>E.ON, BASF, and Gazprom cooperate on other projects including storage, trading, and pipelines in Eastern Europe.</p>	<p><b>Stage 3 – contract fulfilment</b></p> <p>BP breaks its contract with AAR and announces partnership with Rosneft.</p> <p>AAR sues BP and wins case.</p> <p>BP and Rosneft offer to purchase AAR’s shares in TNK BP. Fridman turns down the offer.</p>

According to the working definition of trust, the cases focus of statements and opinions of the actors that reflected confidence, expectations and beliefs that the other party would reciprocate cooperative actions, unless the actors specifically mentioned having trust in the other party or attributed their decisions to trust (*Vertrauen* in German or *доверие-doveriye* in Russian). Likewise, the cases aim to identify costly signals, those actions that were perceived as warranting trustworthiness. With respect to statements of opinions of the actors, these will be examined in the context of the cases that follow. Costly signals, and other factors contributing to the development of trust will be explored in the next section.

### Stage 1 – Contract formation

In the first stage of the contractual relation, partners typically undergo a selection process. Although there is a formal approach that includes an economic analysis, in recent years, political risk has also become an integral component. But, as the cases demonstrate, there was a trust dimension in making the final decision. It was during informal meetings between company executives and politicians that trust influenced the decision to form a contract, in the case of BP and AAR, and remove trade barriers in the German-Russian case.

There were three factors leading to the first contracts. First, commercial incentives were the impetus to exploring the possibility of trade and investment. Next, the political climate, which in both cases had been an historical barrier to trade, was removed. Finally, in the process of the interactions among the actors, the development of trust shaped their preferences to join with the specific partner over other possible options.

In the case of E.ON and Gazprom, German energy companies had a pre-existing interest in trade with Russia. For example, leaders of E.ON's subsidiary, Ruhrgas, were intent on securing a long term energy contract. The political barrier was COCOM, a policy of the West to refrain from trading with the eastern bloc states. COCOM, or the Coordinating Committee for Multilateral Export Controls, was the most wide-ranging.

Initiated by the US and founded in 1946, it comprised of a list of technology products that signatories agreed not to export to the Soviet Union and its allies. 'From its initial meetings of member nations in early 1950 through the 1970s, the United States was a leader in the efforts to inhibit the transfer of military or dual use technologies to the Eastern Bloc countries.'<sup>24</sup> Participating countries included all NATO members minus Iceland plus Japan. The list of products was regularly revised, and with respect to the FRG, it was most restrictive in its early years and with revisions taking place in the 1950s, trade between the FRG and USSR began to grow in the 1960s.<sup>25</sup> From 1961 to 1969, trade volumes between the FRG and USSR grew from USD 346.9 to 739.9 million.<sup>26</sup> In reality, the US was the main proponent of this policy, and until the 1970s, Germany and the UK more or less adhered to COCOM.

However, the interest in oil and gas trade with Russia became more acute by the oil crisis of 1973. The FRG, with an export driven industrial economy, wanted to secure

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<sup>24</sup> Rand C., Major Lewis, 'COCOM: An International Attempt to Control Technology', *The DISAM Journal* Fall (1990): 66.

<sup>25</sup> Gunnar Adler-Karlsson, *Western Economic Warfare 1947-1967. A Case Study in Foreign Economic Policy*. (Stockholm: Almqvist & Wiksell (distr.), 1968) 96.

<sup>26</sup> *Yearbook of International Trade Statistics* (New York: United Nations, 1969).

stable deliveries of energy resources for its industries. Commercial executives also wanted to open new markets for their products in the East.<sup>27</sup>

Another was instrumental for the FRG to engage in energy cooperation with the Soviet Union, a change in political leadership. Traditionally Moscow has maintained better relations with the SPD party compared to the CDU party whose leadership in post-war Germany was highly suspicious of the Soviet Union. With a change of party leadership from Christian Democratic (CDU) to Social Democratic (SPD) in 1972, the prospect of engaging trade with the Soviet Union emerged. The newly elected chancellor, Willy Brandt, wanted to initiate a direct dialogue with the Soviet Union. The new policy was called, *Ostpolitik* or eastern policy. It had two purposes, the promotion of trade between the FRG and the communist states of the Eastern Europe and a political rapprochement with the Soviet Union and GDR.<sup>28</sup>

Under *Ostpolitik*, trust began to emerge at the highest level of politics between the two states. At the outset, Chancellor Brandt and General Secretary Brezhnev opened a back channel of communication through the West German Chancellor's Ministry Secretary and Soviet intelligence officers. This channel was highly secretive, but at a relatively early stage, both sides articulated their intentions to develop open and honest communications. This backchannel was the beginning of trust and resulted in the first trade negotiations. As the Chancellor's Ministry Secretary, Egon Bahr, explained, 'this honest communication laid the foundations for what developed into a trusting relationship...and for the rapprochement of our two countries through trade, [the relationship] worked fabulously.'<sup>29</sup>

Concerning the second German-Russia partnership, BASF and Gazprom, arrived at their first agreement in another political shift between the two countries. BASF was introduced to Russia through a consortium of German banks organised by Federal Ministry of Economics and Technology (BMWi) under Helmut Kohl. The Soviet General Secretary Mikhail Gorbachev was attempting to reform the Soviet economy under *perestroika*, a policy designed to liberalise certain sectors of the Soviet economy.

Helmut Kohl saw an opportunity to move towards German reunification in exchange for aid and technical assistance. At a meeting that took place at Gorbachev's summer residence, they agreed to a commercial package that comprised financial loans and manufactured goods amounting to DM 15 billion. In exchange for Germany's assistance, Kohl sought access to the Soviet market for West German products and Gorbachev's approval for the German reunification. Thus politics was intertwined with BASF's entrance into Russia.<sup>30</sup>

While the development of trust at the political level removed trade obstacles, trust between managers at the organisational level influenced Gazprom's choice of partner in the FRG. Herbert Detharding, the new head of BASF's natural gas subsidiary, Wintershall, had recently joined Wintershall after 20 years of experience in Russia at Ruhrgas.<sup>31</sup> Detharding already had existing relations with heads of the appropriate

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<sup>27</sup> Burckhard Bergmann, 'Statement von Dr. Burckhard Bergmann, Mitglied des Vorstandes der Ruhrgas AG, Essen', in *Energiewirtschaftliche Perspektiven in Mittel und Osteuropa - Chancen und Risiken* (presented at the XXVII. Internationalen Arbeitstagung des Energiewirtschaftlichen Instituts an der Universität Köln, Cologne: Ruhrgas, 1992); Dr. Heinz-Jürgen Schürmann, 'Interview with Handelsblatt Former Chief Correspondent for Russia.' (Berlin, 17 June 2011).

<sup>28</sup> Beves, *Geheimoperation Ostpolitik*.

<sup>29</sup> Ibid.

<sup>30</sup> Tom Bower, *The Squeeze: Oil, Money and Greed in the Twenty-First Century* (London: HarperPress, 2009), 106.

<sup>31</sup> 'Raushalten, Fertigmachen', *Der Spiegel*, 24 January 1994, <http://www.spiegel.de/spiegel/print/d-13683672.html>.

Soviet ministries. This explains Gorbachev's curious decision to offer a field development contract to BASF, a chemicals company, over companies that were far more expert such as Exxon or Chevron.<sup>32</sup>

Thus, the role of trust, which had been developed between Gazprom's predecessor and BASF over a 20 year interaction, played a decisive role in the choice of Russian decision makers to engage BASF through its subsidiary, Wintershall, over any other foreign energy company.

In the case of BP and Russian investment group, Alpha Access Renova (AAR), the starting point was quite different. BP had no experience or contact with Gazprom until the end of the Cold War. Much like the German-Russian case, the removal of political barriers, namely the emergence of democratic reforms and privatisation, made investing in Russia possible.<sup>33</sup> There were several economic factors that influenced Browne's decision to engage invest in Russia. The first was BP's stagnant level of oil and gas reserves. When Browne first assumed the post of CEO, BP itself had recently been privatised and, consequently, under pressure from investors to grow. Establishing itself in Russia would immediately raise oil and gas reserve levels.

However, BP eventually came into conflict with AAR over their first joint venture, Sidanco. Originally founded in 1994, Sidanco was an oil and gas company developing resources in Russia. BP first invested in the company in 1997 with a 10 per cent stake, which they raised to a 25 per cent stake in 2003.<sup>34</sup> Unbeknownst to Browne, one of the investors, the oligarch, Mikhail Fridman, had a standing dispute with another Sidanco investor, Vladimir Potanin.<sup>35</sup> To recover the investment, Fridman began a bankruptcy filing for a portion of Sidanco, the assets of the company belonging to BP. This was a common procedure to acquire state assets at the time, well known to locals but not to BP.

It is important to understand the background of BP's first interaction with its Russian partners in order to make sense of Browne's decision to reengage Fridman for TNK BP. BP was still intent on doing business in Russia for all the previously mentioned reasons. After the Sidanco dispute, Browne sought to make a major investment to make up for the loss of its assets, not to mention saving face with his board of directors. Browne finally made the decision to invest in TNK after a series of face-to-face meetings with Fridman, Khodorkovsky, and Putin.<sup>36</sup> This decision seems unusual given the first experience with Fridman in which Browne admitted, 'why would I want to talk to someone who was trying to steal from BP.'<sup>37</sup> However, it appears that Browne regained confidence through a network of trusted individuals. As he put it:

'Stories that TNK was engaged in bad business practices began to feature in the Russian, British and US press. Stung by our accusations of dishonourable business practices, Fridman made numerous efforts through various channels to speak to me. I refused... But Eventually I did because Lord Janner called me. Grenville Janner was an

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<sup>32</sup> Ibid.

<sup>33</sup> During the Cold War, trade between the West and the Soviet Union was highly restricted, governed by the Coordinating Committee on Multilateral Export Controls (CoCom). CoCom aimed to limit trade with the Soviet Union and its allies particularly with respect to technology and manufacturing equipment viewed by Washington as a strategic advantage of the West.

<sup>34</sup> Anna Raff, 'BP Buys Sidanco Stake for \$375M | Business', *The Moscow Times*, accessed 1 July 2014, <http://www.themoscowtimes.com/business/article/bp-buys-sidanco-stake-for-375m/246956.html>.

<sup>35</sup> Browne and Anderson, *Beyond Business*, 135.

<sup>36</sup> Ibid 142.

<sup>37</sup> Ibid 141-2.

old friend. We were connected through his work in educating people about the Holocaust. He had recently been to Moscow and told me that I should speak to Fridman. "I have been talking to the chief rabbi in Moscow who tells me he knows Fridman. Fridman is better than the other people you were dealing with." So I agreed that I would talk to Fridman on the phone. Then we met.'<sup>38</sup>

Based on these personal interactions, Browne's confidence in Fridman grew while his suspicions of his hitherto first choice, the president of Yukos, Khodorkovsky, were confirmed by Putin. Although Yukos was the largest oil company in Russia, the concern lay with Khodorkovsky's political ambitions. As Putin told Browne at the mention of Khodorkovsky, 'I've had to eat too much dirt from that guy'.<sup>39</sup>

On the Russian side of TNK BP, there were two sets of decision makers. The first was BP's commercial partner, the investment group AAR led by Mikhail Fridman.<sup>40</sup> Economic incentives for AAR were paramount. It needed investment to modernise TNK's production and refining facilities. Moreover, the most lucrative markets for its natural gas asset, the Kovytko field, lay in Europe and Asia. In order to access these markets, AAR needed financial investment and technical expertise.

On the other hand, the development of trust with BP did not appear to play a decisive role on AAR's choice of partner. AAR did, however, have aspirations of expanding beyond Russia and believed it would need to earn the trust of western business partners and their governments in the future. To this end, a partnership with one of the supermajors, such as BP, would help build credibility for a foreign audience.

The second Russian group involved in TNK BP was political, notably President Putin and the Russian minister of energy at the time, Igor Sechin. BP's willingness to assume an equal rather than controlling stake alleviated suspicions of Russian politicians who were concerned about foreign control over Russia's oil and gas industry.<sup>41</sup> BP also agreed to commit to a series of goals, both commercial and social, all of which appeared to help reassure Putin, according to Browne in his account of the meeting.

## Stage 2 - Disputes and breaches of contract

The second stage investigates the decisions of actors when disputes or breaches of contract emerged. When this occurred, actors chose to either cooperate and find a compromise, or retaliate through litigation and coercion. With TNK BP, former British Ambassador, Sir Anthony Brenton, explained that 'diverging interests coupled with personal conflict between the leaders led to conflict.'<sup>42</sup> This explains why BP endeavoured to find a replacement partner for AAR, which was initially intended to be Gazprom. As Yenikeeff notes, 'this was not the first time BP had been unable to change the way it conducted business in Russia. The first example occurred in 2007-8 when BP was reported to be keen on having Gazprom as a partner instead of AAR.'<sup>43</sup> In this case a fallout of trust appeared to play a decisive role in BP's decision to end its relationship

<sup>38</sup> Ibid 142-3.

<sup>39</sup> Ibid 145.

<sup>40</sup> Ibid 144.

<sup>41</sup> Ibid 146.

<sup>42</sup> Sir Anthony Brenton, 'Interview with the British Ambassador to Russia from 2004-08.' (Cambridge, 2 May 2011).

<sup>43</sup> Shamil Yenikeeff, 'BP, Russian Billionaires, and the Kremlin: A Power Triangle That Never Was', *Oxford Institute for Energy Studies*, Oxford Energy Comment, November 2011.

with AAR. On the other hand, two supply disruptions, technically breaches of contract, brought about an increase in cooperation through further joint investments in the German-Russian case. Economic interdependence can explain why Germany chose not to defect from the relationship, but it does not explain why other energy options, such as LNG, nuclear, and coal, were not actively pursued. The alternatives, and the decision to pursue them or not, represent a state's or firm's energy hedging strategy. As Keating and Ruzicka explain, 'In the absence of a trusting relationship that cognitively reduces uncertainty, it follows that states have to engage in hedging strategies. Adopting a hedge reduces one's dependence on and vulnerability to others, for instance "by cultivating alternative partners, projects, and networks." (Meyerson *et al.*, 1996)'<sup>44</sup> And thus, the outcomes begin to make sense only when one factors trust into the analysis.

At TNK BP, the first contract lasted four years, from 2004 to 2008. During this period, the parties were required to maintain existing management structures and could not opt out of the contract by selling their stake in the joint venture. The dispute began when the leaders of the AAR group voiced concerns about staffing issues and BP's appointed CEO, Robert Dudley.<sup>45</sup> Fridman and his Russian partners perceived BP to be intransigent to their suggestions on management issues, such as expatriate staffing, and the development of ventures outside of Russia.<sup>46</sup> The initial contract did not rule out activities beyond Russia, but it did stipulate that both parties had a veto in that decision, both used that veto.

Shortly after the formation of the company, the relations between the BP appointed CEO, Robert Dudley, and AAR's appointed representative, German Khan, began to sour. Both had different ideas about how the company should be staffed. Dudley brought 146 expatriate staff from BP into the joint venture.<sup>47</sup> Fridman and Khan thought most of these positions were redundant and an unnecessary expense to the company. Some Russian managers also believed the presence of expatriate staff who could not interact with the other employees had a demoralising effect on Russian staff.<sup>48</sup> Eventually, personal interactions between Fridman and Dudley degenerated such that BP representatives began to miss scheduled board meetings, which effectively halted executive decision making.

The second issue concerned business interests and the geographical boundaries of the partnership. AAR was intent on collaborating with BP outside of Russia through the joint venture TNK BP.<sup>49</sup> They regularly presented business opportunities to Dudley, and when proposals were rejected, Fridman attempted to make the case to BP headquarters in London. BP, however, viewed TNK BP as a subsidiary of BP and had no interest of collaborating outside of Russia.<sup>50</sup>

What ensued was a very public dispute where both parties resorted to coercion through the press and political channels. First, to address the staffing issue, AAR appealed to the Russian Ministry of Energy to exert pressure on Dudley and British expatriate staff. As foreigners, they were required to renew their working visas every year. Many of BP's staff were also not paying Russian taxes because they were officially registered in the United Kingdom. This provided technical grounds to revoke their visas

<sup>44</sup> Keating and Ruzicka, 'Trusting Relationships in International Politics', 9.

<sup>45</sup> Bower, *The Squeeze*, 450, 462.

<sup>46</sup> *Ibid.*, 448.

<sup>47</sup> *Ibid.*, 463.

<sup>48</sup> Non-attributed, 'Interview with TNK BP Upstream Manager' (Moscow, 26 November 2010).

<sup>49</sup> Robin Pagnamenta, Energy, and Environment Editor, 'TNK-BP Dispute Triggered by Iraq Oil Project Row', *The Times (London)*, 27 June 2008, sec. Business,

<http://www.thetimes.co.uk/tto/business/industries/naturalresources/article2181583.ece>.

<sup>50</sup> Bower, *The Squeeze*, 451.

and as a result, the working visas of expatriate staff, including the CEO, were cancelled. Dudley and his staff were forced to leave Russia, where he managed TNK BP from London.<sup>51</sup>

Reacting to AAR, BP launched its own campaign to exert pressure on AAR. Browne appealed to political channels in the UK and US. At his request, both Prime Minister Blair and President Bush wrote letters to Putin on behalf of BP.<sup>52</sup> When these letters went unanswered, Browne appealed to the US State Department. He knew that AAR had submitted a loan application with the United States Agency for International Development (USAID) programme to fund various projects in Russia. The application for USD \$400 million was ultimately rejected.<sup>53</sup>

At this point, the interactions between BP and AAR had reached a point where BP began to look for other options in Russia. The newly appointed CEO of BP, Robert Dudley was in talks with Gazprom to form a partnership which would allow it to develop and market gas from the *Kovytko* field to customers in Asia. This included discussions on the construction of a new pipeline. BP had also initiated discussions with Rosneft. Likewise, Fridman and AAR continued to explore projects outside of Russia and had even begun negotiations with the Kurdistan Regional Authority in Iraq.

The role of trust in explaining the outcomes of the dispute is particularly poignant at this stage because economic and political factors were in favour of collaboration. First, TNK BP was a highly profitable company. BP had invested USD \$8 billion into the joint venture and extracted fourteen billion in profits from 2004 to 2009.<sup>54</sup> By all accounts, collaboration between the two companies had been successful, and there was no reason why the two companies could not earn profits on new projects within and beyond Russian territory. Politically, there were also compelling reasons to collaborate. In a natural gas partnership with Rosneft and Gazprom, it is likely that BP would have a lower share of any joint venture and assume a passive role. First, the natural gas industry is a highly protected sector of the Russian economy, and working with Gazprom appeared to be risky considering Shell's experience with its LNG venture in the Russian Far East. BP's rival, Shell, had just learned this lesson when it was almost forced out of another joint venture with Gazprom called Sakhalin II.

Despite compelling reasons to collaborate, BP decided against it. The tone of the interpersonal interaction reflects the degree of distrust. As the then British Ambassador described, 'this had turned into a war, and AAR won this round'.<sup>55</sup> Tensions had pushed their interactions to the point of a 'zero-sum' game. A compromise or win-win outcome which would have made better economic sense was out of the question. As one BP employee put it, 'The level of trust is extremely poor.'<sup>56</sup> Rather than cooperating, the actors attempted to enforce their will through political coercion.

Contrary to TNK BP, there were no significant diverging interests between the German and Russian partners that could have led to a dispute. There were, however, two breaches of contract lasting several weeks when Gazprom cut supplies of natural gas to Germany, in 2005 and 2009. Recalling that E.ON and BASF, 'place a premium on stable and consistent deliveries', these disruptions could have led to a dispute, or even litigation, as is currently underway between another German energy company and

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<sup>51</sup> Ibid, 452, 461-3.

<sup>52</sup> Ibid, 456.

<sup>53</sup> Browne and Anderson, *Beyond Business*, 141.

<sup>54</sup> Ibid, 146.

<sup>55</sup> Brenton, 'Interview with the British Ambassador to Russia from 2004-08.'

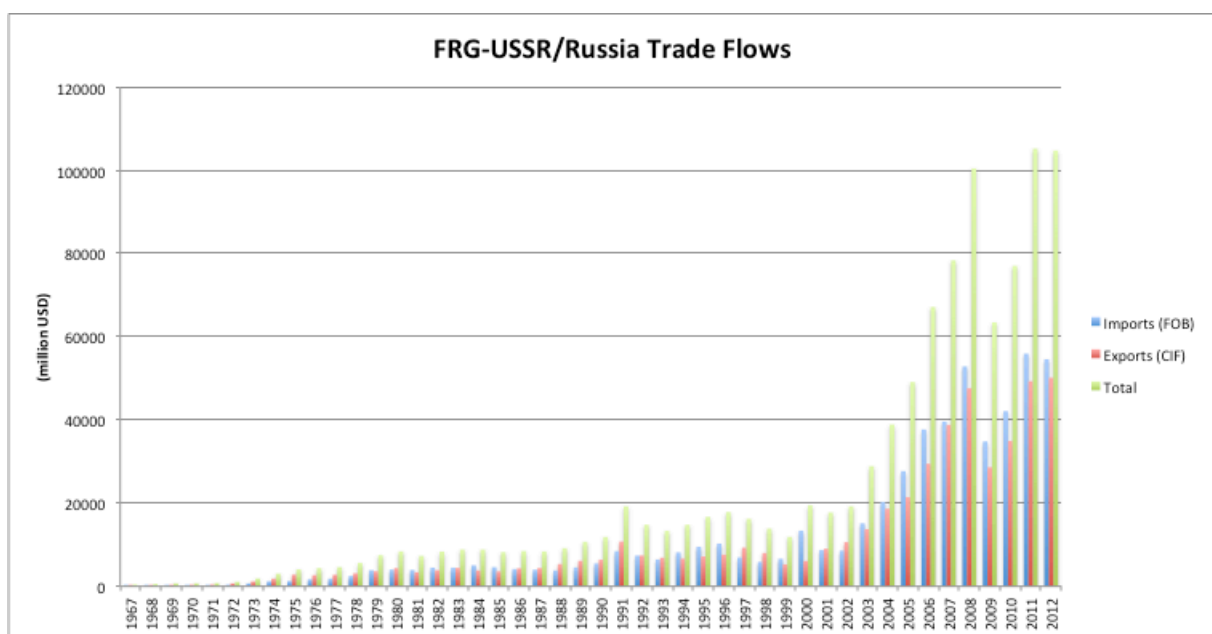
<sup>56</sup> Non-attributed, 'Interview with BP Executive' (London, 23 April 2012).



Gazprom, RWE.<sup>57</sup> The reason for the supply disruptions was a dispute between Gazprom and Ukraine's Naftogaz. Because Gazprom currently transports natural gas to Europe through Ukraine, the dispute affected several countries in central and Eastern Europe. The reaction from the German side was to seek a resolution to the conflict. First, Schröder in 2005, and then Merkel in 2009, mediated the disputes. However, there was no penalty, per se, to Gazprom for the disruptions. Rather, what followed was a deepening of commercial relations between both sides. Trust rather than economics or political factors best explains this reaction. After all, Germany could have developed LNG import capacity at a fraction of the cost of Nord Stream.

After three decades of collaboration, the German-Russian partnerships were no longer commercial transactions, both the economies of Germany and Russia had become interdependent. Defecting from this relationship, although within the boundaries of the original contract, would have economic consequences. Germany depends on Russian gas for 40 per cent of its total supply. Natural gas makes up 23 per cent of German power generation demand and 40 per cent of its total energy consumption.<sup>58</sup> Moreover, a symbiotic trade relationship had emerged, whereby Russia supplies Germany with raw materials and Germany provides finished manufactured goods. This trade dynamic mirrors the historical trade flows between the two countries going back to the 19<sup>th</sup> century and today, Germany is Russia's largest trading partner. Likewise Russia was until Germany's largest market until recently overtaken by China. The dramatic development of trade flows is illustrated in the following graph.

**Figure 1**



Source: Data from International Trade Statistics Yearbook, 1969-2013<sup>59</sup>

If politics, in the form of energy security were dictating the outcomes of the disruptions, one would also expect an effort to find alternatives to Russian gas. Russia

<sup>57</sup> 'Ungültige Vertragsklausel Ermöglicht Jederzeit Kündigung', *Strom Magazin*, accessed 7 July 2014, [http://www.stromseite.de/strom-nachrichten/ungueltige-vertragsklausel-ermoglicht-jederzeit-kuendigung\\_28926.html](http://www.stromseite.de/strom-nachrichten/ungueltige-vertragsklausel-ermoglicht-jederzeit-kuendigung_28926.html).

<sup>58</sup> *The European Union and Russia: A Statistical Comparison* (Eurostat, 2007), [http://epp.eurostat.ec.europa.eu/cache/ITY\\_OFFPUB/KS-77-07-231/EN/KS-77-07-231-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-77-07-231/EN/KS-77-07-231-EN.PDF).

<sup>59</sup> *Yearbook of International Trade Statistics*.

only exports less than 5 per cent of its total exports via LNG, depending rather on pipeline exports.<sup>60</sup> Likewise, a price negotiation with China has been on-going for nearly a decade, and although Gazprom executives often mention Asia as its new market, progress has been slow to arrive at concrete deals with the exception of Sakhalin II's LNG exports. Instead, what ensued was a deepening of energy dependence. Both E.ON and BASF recently signed new long-term contracts with Gazprom to replace the current contracts set to expire in 2020. In the case of BASF, the new contract will raise deliveries of natural gas from 140 bcm to 180 bcm annually through 2035.<sup>61</sup> Likewise, E.ON and Gazprom have jointly invested in new energy companies in Germany and Eastern Europe.

In sum, economic considerations, namely interdependence, played a role in influencing decision makers on both the German and Russian sides not to respond immediately to supply disruptions, however, economic interdependence and energy security do not account for events that followed. Rather than seeking alternative sources to Gazprom such as coal, nuclear, or LNG, both sides chose to further entrench their commercial relations. Where distrust accounts for BP's decision to seek alternative partners that were economically unjustified, trust explains why the German and Russian partners, in response to disruptions, sought to deepen engagement rather than finding alternatives. The new contracts, lasting 30 years, expose German industry to a high degree of risk, but as the board director of BASF explained, 'the partner (Gazprom) addresses our needs for long term energy security, and these long term contracts would only function on the basis of absolute trust'.<sup>62</sup> This sentiment was confirmed by multiple sources interviewed for this research project to explain the formation of these contracts.<sup>63</sup>

### Stage 3 - Contract fulfilment and the decision to continue cooperation or not

At the conclusion of contracts in both cases, the actors had a choice to either continue the partnership or seek alternatives. The next phase for TNK BP was a continuation of the same trend that began as a result of the dispute between the two companies. However, where personal animosities pushed BP to look for alternative partners in Russia, its success in negotiating with Rosneft speak to its relatively good relations with the Kremlin. When one looks at the economics of these outcomes, they make sense when observed in the context of trust.

When BP announced its intentions to form a new joint venture with state-owned Rosneft, it not only signalled its intention to defect from its relationship with AAR, it did so against compelling economic factors to collaborate, not to mention the term of its existing contract with AAR. At its inception, BP had agreed to modernising TNK refineries, fields, and to contribute to social causes. Technically, all of the parties had met their contractual obligations, and despite a disruptive dispute between BP and AAR, TNK BP was a profitable company.

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<sup>60</sup> *Gazprom Annual Report* (Moscow: OAO Gazprom, 2012).

<sup>61</sup> Ralf Neubauer, 'Gazprom Gibt in Deutschland Weiter Gas', *Leipziger Volkszeitung*, 11 November 2011.

<sup>62</sup> *Ibid.*

<sup>63</sup> Jörg Kirsch, 'Interview with Head of Section IIIA, Russian and East European Trade' (presented at the Interview, Berlin, 8 November 2010); Horleman, 'Interview with Economics Advisor to the Ambassador of Germany, Ministry of Foreign Affairs of the Federal Republic of Germany'; Schürmann, 'Interview with Handelsblatt Former Chief Correspondent for Russia.'

Although BP could extricate itself from AAR by selling its shares in TNK BP, it needed the approval from AAR to engage any other company in Russia.<sup>64</sup> When AAR was informed of BP's discussions with Rosneft, the group insisted on TNK BP taking part in the new partnership. In the end, BP signed a contract with Rosneft thereby breaking the terms of its contract with AAR. It appears that Dudley believed BP, in combination with Rosneft, would be able to entice AAR into selling its shares. The immediate result, however, was litigation. AAR sued BP and won the case.<sup>65</sup>

BP's decision to break its contract with AAR and seek partnerships with Rosneft and Gazprom indicates the high level of distrust that had developed for two reasons. First, working with state-owned companies, although potentially risky considering Shell's experience had become a better option than its existing company. Second, by signing a contract with Rosneft, BP broke its contract with AAR thereby exposing itself to the possibility of litigation. Cooperating would have allowed both companies to engage in lucrative projects with Rosneft and Gazprom if the managers could find a way to work together. Thus the interpersonal dynamic made further cooperation untenable.

Likewise, AAR displayed behaviour that cannot be explained by economic factors alone. By most accounts, the value of its shares in TNK BP were valued between U.S. \$22 to 28 billion. As a result of the court's ruling in favour of AAR, BP offered AAR 35 billion for the purchase of its shares. Fridman refused and continued to insist that TNK BP be included in the Rosneft partnership.<sup>66</sup>

With respect to Rosneft, BP appears to have retained good relations with the Kremlin, as demonstrated by Rosneft's willingness to partner with BP in the Arctic. These projects have attracted interest from several western firms, and the fact that Rosneft selected BP speaks to a degree of trust.<sup>67</sup> With the help of intermediaries, such as Gerhard Schröder and Phillip Lambert, the first a trusted advisor to Gazprom and friend of Putin, the second an British investment banker with close ties to politicians in Russia and eastern Europe, BP reengaged the Medvedev administration.<sup>68</sup>

By contrast, the recent developments among E.ON, BASF and Gazprom reflect a deep level of economic interdependence between Germany and Russia, a high degree of trust among the actors developed over three decades, and Russia's geopolitical interests in Europe. Interdependence is the result of a long history of commercial trade, shifting political relations between the Germany and Russia, and the development of trust between key individuals that began in the 1970s. Russia's political interests in the east of Europe are also reinforced by the new joint venture projects between the companies, Nord Stream being one example. Yet, the new chapter of collaboration is only possible with a high degree of trust between the parties because, from a purely economic and energy security perspective, none of them appeared to be optimal for Germany at the time of their conception. Not only were projects such as Nord Stream financially risky,

<sup>64</sup> 'AAR Seeks to Halt BP Rosneft Strategic Alliance', accessed 7 July 2014, <http://rt.com/business/aar-bp-rosneft-davos/>.

<sup>65</sup> Ibid.

<sup>66</sup> 'Rosneft lockt BP mit neuen Vorschlägen', *Frankfurter Allgemeine Zeitung*, sec. Wirtschaft, accessed 7 July 2014, <http://www.faz.net/aktuell/wirtschaft/rosneft-lockt-bp-mit-neuen-vorschlaegen-1641457.html>.

<sup>67</sup> Jacob Gronholt-Pedersen, 'Total, Rosneft Discuss Offshore Projects', *Wall Street Journal*, 16 February 2011, sec. Business, <http://online.wsj.com/news/articles/SB10001424052748703373404576148581358499092?mg=reno64-wsj&url=http%3A%2F%2Fonline.wsj.com%2Farticle%2FSB10001424052748703373404576148581358499092.html>.

<sup>68</sup> Chris Blackhurst, 'Philip Lambert - the Quiet Man behind the Historic BP-Rosneft Deal', *The Evening Standard*, accessed 7 July 2014, <http://www.standard.co.uk/business/markets/philip-lambert--the-quiet-man-behind-the-historic-bprosnest-deal-6557332.html>.

the aggregate effect of the new joint ventures raises the degree of Germany's energy dependence on Russia.

Commercial relationships have strengthened in three areas. The first is joint ventures. The second is equity exchanges between among the companies. And the third relates to personnel. With respect to joint ventures, the major projects were the trans-Baltic pipeline, Nord Stream, the formation of Wingas, the gas trading arm of BASF, collaboration in the development of new storage fields in Germany, and a third tier of investments in existing eastern European companies.

Not only have the company relationships furthered in new joint ventures, E.ON and Gazprom have each taken equity stakes in each other's company. An E.ON representative has been on the board of Gazprom since 1998, and it is the only foreign company to have a seat on its board of directors. Likewise, the deputy director of Gazprom, Alexander Medvedev, no relation to the former president, sits on E.ON's executive board. Recently, E.ON and Gazprom announced negotiations for the acquisition of E.ON's natural gas division, Ruhrgas.<sup>69</sup> Moreover, the new joint ventures, Nord Stream and Wingas, are both divided between the German and Russia sides. Nord Stream is 51 per cent owned by Gazprom with the remaining belonging to E.ON and BASF.<sup>70</sup> Wingas is a 50-50 joint venture co-owned by Gazprom and BASF.<sup>71</sup>

The effects of trust are acutely apparent in the third area of staffing decisions. The choice of directors in the joint ventures may deepen the level of trust between the companies and political leaders. For example, Gerhard Schröder began his commercial career after leaving political office as the chairman of Nord Stream, personally selected by Putin.<sup>72</sup> He was also offered an advisory role at Gazprom. Notwithstanding the controversy surrounding his transition from politics to business, Schröder is still well respected in industry and government, and his ability to lobby for Gazprom interests in Germany reinforces its relationships with German partners. Another example is the former Russian ambassador to Germany, Vladimir Kontenev, became the new director of Wingas, the natural gas trading arm of BASF.<sup>73</sup>

The current head of Nord Stream, Matthias Warnig, also has a long history with Putin. The two claim to have first met in the 1990s in St. Petersburg, when Warnig, representing Dresdner Bank, sought to establish a presence for the company in Russia. Putin at the time was responsible for the city's dealing with foreign companies. But it is possible the relationship goes back much further, to Putin's time as a KGB officer in Dresden in the 1980s. During the same period, Warnig was an officer in the GDR's sister organisation, the *Stasi*. Between the two organisations there was considerable collaboration as former Stasi director, Marcus Wolf, later explained in his memoirs.<sup>74</sup>

On the other hand, the economic case for projects, such as Nord Stream, is mixed. Nord Stream was initiated without the usual commercial guarantees that banks would require to finance the construction of a pipeline. Typically, a project must demonstrate to investors that it has both committed customers and suppliers, which would include

<sup>69</sup> 'Für 3,4 Milliarden Euro Eon verkauft Gasprom-Anteil', *Frankfurter Allgemeine Zeitung*, sec. Wirtschaft, accessed 7 July 2014, <http://www.faz.net/aktuell/wirtschaft/unternehmen/fuer-3-4-milliarden-euro-eon-verkauft-gasprom-anteil-1591203.html>.

<sup>70</sup> 'Wer Wir Sind', *Nord Stream AG*, accessed 7 July 2014, <http://www.nord-stream.com/de/wer-wir-sind/>.

<sup>71</sup> 'Unser Unternehmen - WINGAS GmbH', accessed 7 July 2014, <http://www.wingas.com/unser-unternehmen/unser-unternehmen.html>.

<sup>72</sup> 'Gazprom Liebügelt Mit Gerhard Schröder', *Der Spiegel*, 29 June 2011, <http://www.spiegel.de/artikel/a-764569.html>.

<sup>73</sup> Neubauer, 'Gazprom Gibt in Deutschland Weiter Gas'.

<sup>74</sup> Markus Wolf and Anne McElvoy, *Man without a Face: The Autobiography of Communism's Greatest Spymaster* (New York: Times Books, 1997).

long-term contracts. This was not the case when construction of Nord Stream began. On the other hand, it did address the preferences of German industrial customers over the long term. As the economic advisor to the German ambassador to Russia explained, German industry places a premium on stable and secure supplies.<sup>75</sup> Although the cost of the pipeline is estimated to total € 7.4 billion, E.ON and BASF were willing to pay the premium as insurance against a future supply disruption that may result from a repeat row between Russia and Ukraine. Another advantage for Germany is job creation. Nord Stream was built by the German steel industry, a pattern resembling the first pipelines-for-gas deal between the FRG and USSR in the 1970s.<sup>76</sup> As Nord Stream CEO, Matthias Warnig explained, 'the construction of the pipeline has important benefits to the German economy in addition to energy. The costs of the constructing the pipeline are creating jobs in Germany. It's tantamount to a multibillion euro stimulus package'.<sup>77</sup>

However, as European gas market analysts attested, Nord Stream less little sense in the current state of the market. Unlike oil, there is already a surplus of natural gas in the central European market with the existing pipeline infrastructure. The construction of new LNG plants in southern Europe and the Baltic Sea region will only add more supply to an already full market. As market principles would dictate, this lowers the real price of gas, and thus, the economic viability of Nord Stream and other German-Russian joint ventures, all of which are aimed at adding more supply to the European market.<sup>78</sup>

With respect to energy security, the new joint ventures also appears to be irrational given the EU 3<sup>rd</sup> Energy Package designed to create more competition in the market and break up (unbundle in EU policy parlance) supplier monopolies. They effectively raise Europe's level of dependence on Russia. Since most states treat energy as a security issue, the recent trend points to a high degree of trust between the two countries.

Nord Stream also created antagonism between Germany with its neighbours and controversy at the EU level. Considering the problematic history of Russia with its European neighbours, the new pipeline obviates the only lever of influence they have over Russia in a potential dispute with their status as the only transit route from Russia to the rest of Europe. As Polish foreign minister Radek Sikorski decried, 'that was the Molotov-Ribbentrop tradition'.<sup>79</sup> In Brussels, the focus of the EU Energy Commission has been market liberalisation. The 3<sup>rd</sup> Energy Package is aimed at 'unbundling' energy markets, particularly in natural gas.<sup>80</sup> The results of Nord Stream at the European level reduce the number of market participants and are, thus, anathema to E.U. market liberalisation goals. For both these reasons, Nord Stream presented political obstacles for Germany.

Nord Stream makes the most political and economic sense from Russia's perspective. It frees Gazprom from dependence on transit countries such as Ukraine, Poland and Belarus. Of the three, both Ukraine and Belarus have had pricing and political disputes with Russia.

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<sup>75</sup> Horleman, 'Interview with Economics Advisor to the Ambassador of Germany, Ministry of Foreign Affairs of the Federal Republic of Germany'.

<sup>76</sup> Stent, *From Embargo to Ostpolitik*.

<sup>77</sup> Hubert Seipel, 'Gigant Gazprom: die Deutschen und das Gas aus dem Osten' (ARD, 2009).

<sup>78</sup> Derek Brower, 'A New Gas Bubble Inflates over Emerging Europe', *Business New Europe*, 2010, <http://www.businessneweurope.eu/story2255>.

<sup>79</sup> Stephen Castle in Brussels, 'Poles Angry at Pipeline Pact', *The Independent*, accessed 7 July 2014, <http://www.independent.co.uk/news/world/europe/poles-angry-at-pipeline-pact-476320.html>.

<sup>80</sup> '3rd Energy Package Gets Final Approval from MEPs', accessed 7 July 2014, <http://www.europarl.europa.eu/sides/getDoc.do?language=en&type=IM-PRESS&reference=20080616FCS31737#title1>.

Notwithstanding the geopolitics of energy in Eastern Europe, the most recent chapter of E.ON, BASF and Gazprom engagement has been a significant deepening of interests. To be sure, economic and political factors also play a role. The Russian government, with Gazprom as its main source of revenue, has a strong incentive to maintain good relations with its most important customer, Germany. However, there has been a very clear choice by German and Russian actors to deepen commercial engagements over time. The political climate in Germany, under SPD leadership, which has traditionally maintained better ties with Russia, was likewise favourable for new joint ventures, such as Nord Stream. But the role of personal relationships among politicians and executives was instrumental to pushing new joint ventures forward. One of Schröder's final acts as chancellor was to secure bank loans for financing Nord Stream.

Thus, the aggregate effect of trust is that it influences decisions at both the political and commercial levels toward cooperation. This reinforced decisions to deepen economic interdependence in ways that seem irrational if trust were absent. From a geopolitical perspective, trust also influenced German politicians to 'adjust their policies' in favour of cooperation at the security level, Hoffman's litmus test for the presence of trust.<sup>81</sup> Although projects such as Nord Stream bode well for Russia's political interests in the EU and Eastern Europe, they create disadvantages for Germany. Not only was Nord Stream unpopular among EU member states, it also raised the degree of energy dependence on Russia. Considering Gazprom's history of supply disruptions to other countries in the East, these decisions appear to be rational only when one considers trust in addition to commercial and political factors.

## Summary

To summarise the findings of the cases, trust, among political and economic factors appears to have influenced decision makers toward cooperation rather than defection in the German-Russian case. With respect to the first contract, it pushed decision makers to select one partner over another. Although the dispute between BP and AAR originated from varying interests, a break down of trust exacerbated the dispute leading to litigation and BP's decision to defect from the relationship. By contrast, the presence of trust between the German and Russian parties mitigated a potential dispute when Gazprom twice breached its contract with E.ON and BASF. Despite compelling energy security and economic barriers, German actors deepened their partnerships with Gazprom. Thus, the degree to which trust influenced outcomes varied at each stage of the partnerships, depending on interactions between the two companies and changing political and economic conditions.

Both the British and German cases show how networks were used to select a partner and build confidence with other parties. BASF used relations through a German trade promotion organisation and one key executive from another German company with existing relations at Gazprom. Likewise, BP was introduced to AAR through a political network.

Developing interpersonal relations resulted in a deepening of trust between organisations. Schröder and Putin spent vacations together with their families, and the relationship took on a personal dimension, which likely reinforced their official interactions. Likewise, regular social interactions between Russian and German staff at

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<sup>81</sup> Hoffman, 'A Conceptualization of Trust in International Relations'.

Wintershall could contribute to building trust between the two partners, BASF and Gazprom. The TNK BP case stands in contrast to the German-Russian cases in this respect where there was little to no social interaction between BP and AAR executives.

The role of language was also important in developing trust. This worked to the advantage of German-Russian interactions but inhibited communication, and particularly, social interactions between the British and Russian parties. This allowed for easier communication and actors generally felt more at ease in interactions when no interpreter was present. Although AAR chief, Fridman, could speak English, the language imbalance eventually became a point of contention.

Signalling interest became important for BP in developing trust with the Kremlin. It did so by committing to meet both social and business goals. Browne met several times with Putin to reinforce BP's long-term interests. Likewise, Gazprom's decision to resume deliveries to its German customers despite not having resolved its dispute with Naftogaz demonstrated interest to its partners.

Related to signalling interest was fulfilling expectations. This confirms Ayios's findings that meeting expectations is determining in building inter-organisational trust between Western and Russia firms.<sup>82</sup> In the same way, German executives and politicians repeatedly articulated their trust in Gazprom owing to a long history of contract fulfilment. At the heart of TNK BP's dispute was an unwillingness to fulfil expectations of collaborating with AAR outside of Russia and inviting AAR to be a part of BP's joint ventures with other Russian firms inside Russia.

## Implications

The findings of this study have implications on broader questions of trust and energy cooperation. The following is an exploration of two possible applications. The first represents a pattern exhibited by the development of trust. In both cases a high or low degree of trust became fixed over time.

Cooperation did not necessarily lead to trust in the British-Russian case because interests began to vary, AAR wanted to cooperate internationally whereas BP viewed this as potential competition to its own international operations. BP was also intent on cooperating with other firms inside Russia, in this case Gazprom and then Rosneft. Likewise any partnership between BP and Gazprom could present a competitor to TNK BP. It is telling that both sides were most concerned with the other becoming a competitor rather than a partner. This points to a high level of distrust between the actors, confirmed by one BP executive interviewed.<sup>83</sup> Thus the British-Russian case appears to disprove studies on trust proceeding from cooperation and points to other determining factors such as reciprocity, mutual interests and social interactions.

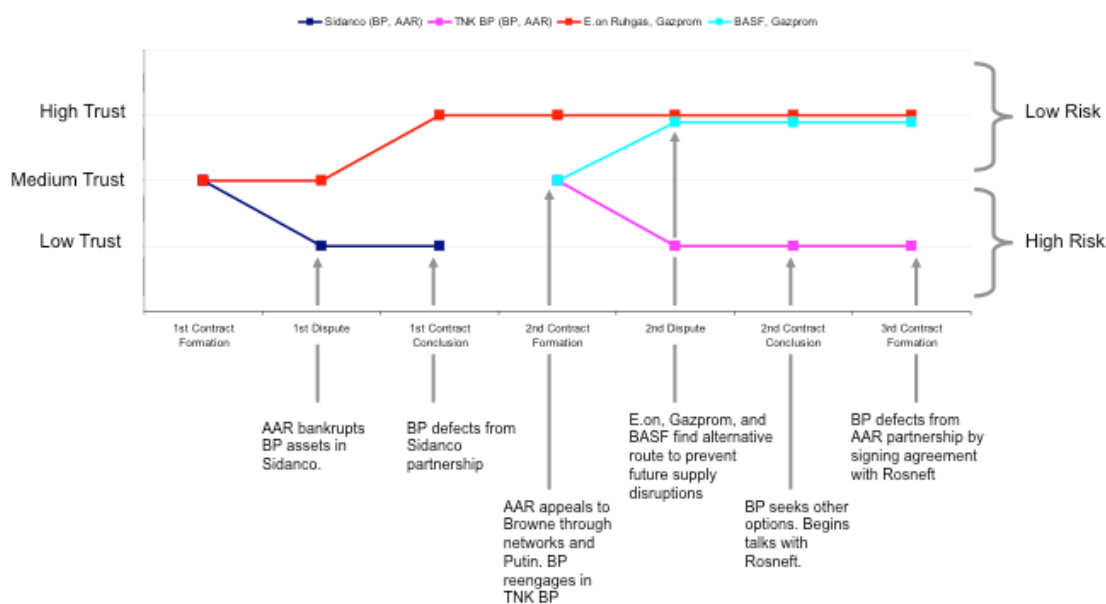
Trust was developed or eroded at the interpersonal level through interactions in the first stage. As it developed in the German-Russian case, preferences of actors deepened economic interactions and likewise, interdependence. At this point, interdependence and trust became self-enforcing, which made the relationship more stable. By contrast, when trust eroded at the interpersonal level, actor preferences worked against the relationship leading to discord. Judging from the two cases, it appears that the trajectory of the development or erosion of trust is established during the first stage. This pattern is illustrated in the following graph.

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<sup>82</sup> Ayios, *Trust and Western-Russian Business Relationships*.

<sup>83</sup> Non-attributed, 'Interview with BP Executive'.

Figure 2



Another implication concerns energy trade and security. Currently, most natural gas contracts are long term and negotiated bilaterally. Unlike consumer goods, energy is treated by most states as a security issue, which explains the absence of a multilateral trade regime for energy that exists for other products, such as the WTO.<sup>84</sup> In this environment, the two cases reinforce Lord Browne's assessment of the primacy of trust with local actors as a determining factor for energy companies. Most of the world's oil and gas reserves are under control of state-owned companies. Private companies such as BP account for eighteen per cent of the world's oil and gas reserves, and consequently, the need to develop trust with not only commercial partners but also political leaders becomes more acute. These individuals, as in the case of Russia, may have preferences conditioned by a variety of factors, of which efficient and profitable hydrocarbon production is only one. Although it is well known that geopolitics and commerce affect energy trade, an analysis of trust speaks to the importance of human interaction as another determining force. Economic cooperation and the development of trust between the actors reinforced cooperation, which then reinforced trust. The results of this analysis emphasise trust as a critical determinant for stable international energy trade. If the interest of states is to establish energy security, it need not be opposed to interdependence, as the German-Russian case attests.

This has particular relevance to energy trade in the EU where the development of a common energy policy has remained elusive for decades. In the absence of a regional energy regulatory framework, member states are left to their own devices in securing energy supplies. This mirrors the failure of previous attempts to create a multilateral trade regime for energy in the international system. The International Energy Agency (IEA), for example, was intended to coordinate supply distribution among its members in case of disruption. As Keohane notes, "The most remarkable aspect of the IEA's behaviour during the 1979 crisis was not what it did, but what it did not do. Despite the effort that had been devoted to establishing an emergency oil-sharing system over the previous years, this arrangement was never activated."<sup>85</sup>

<sup>84</sup> Daniel Yergin, 'Ensuring Energy Security', *Foreign Affairs* 85, no. 2 (1 March 2006): 69–82.

<sup>85</sup> Keohane, *After Hegemony*, 229.



The EU Energy Commission's current approach to dealing with energy security has two elements. First, it has incrementally encouraged cooperation among regulatory agencies through divisions, such as the newly formed Agency for the Cooperation of Energy Regulators (ACER). It has also established broad new regulation to discourage monopolies in the natural gas market through unbundling. Second, it has financially supported projects designed to raise energy security in states deemed as vulnerable, particularly to Russia. In the case of natural gas, this means financial support for new projects, such as Nabucco and LNG regasification terminals. But despite efforts, these projects create market distortions, namely over supply. They can also exacerbate animosities, thus lowering trust, between member states. A row between Germany and Poland over the construction of an LNG facility in Świnoujście is one case in point.<sup>86</sup>

Ultimately, this study illustrates the broad variation of company and country factors in Western Europe, a region thought to have similar market characteristics. Because interpersonal relations, as the cases demonstrated, exert their own pressures on energy cooperation, the development of trust among political and commercial leaders needs to be an integral part of a stable and long-term EU energy plan.

## Conclusion

This study has argued that trust, along with political and economic factors influenced the outcomes of the two cases between British-Russian and German-Russian companies. In the first case, there was an antagonistic dynamic, which led to increased transaction costs in the form of litigation, curbed transportation of supply, stagnated operations, and created obstacles to new projects that would have benefited both parties. With respect to the German-Russian case, the trust relationship contributed to a dynamic where litigation was avoided when breaches of contract took place, the deepening of economic cooperation, and relatively stable fulfilment of contractual obligations. Politics played a role to varying degrees in both instances, but in general, it was used as a tool to penalise partners at TNK BP, while in the German-Russian case, it was used to mediate disputes and mobilise financing for new projects such as Nord Stream.

The development of trust had certain characteristics or determinants, some that were pre-existing while others actor-determined. The impetus was aligned mutual interests. Trust developed over time through repeated fulfilment of expectations and signalling interest. Language, networks and interpersonal relationships were also determining factors to building trust.

Finally, this study posited two implications. The first concerned a pattern from the cases that may apply to other natural gas partnerships. Once trust was established, it appeared to become stable. Actors would prefer to cooperate rather than defecting from

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<sup>86</sup> In response to the announcement of the German-Russian Nord Stream pipeline, which effectively bypasses transit pipelines through Ukraine, Belarus, and Poland, a Polish consortium of companies supported by the E.U. Energy Commission began construction of Poland's first LNG regasification terminal at Swinoujście. This project was delayed by environmental complaints raised by the German government in the European Parliament. In the end, Poland was allowed to proceed with construction, however, gas delivered to this terminal still faces the challenge of distribution. Through which pipelines will this new supply be delivered, and where will it be stored? The main pipelines connecting local pipeline infrastructures are effectively controlled by a partnership between Gazprom and the Polish company, PGNiG. Therefore, without support from Gazprom and Polish energy executives who are part of legacy professional networks, the new supply may be blocked from delivery to its primary consumers in Poland. Other LNG projects in the Baltic states, for example, face similar obstacles.

the relationship despite economic and political pressure to do so. With respect to energy security and the prospects for a common European energy policy, the current approach of the EU Energy Commission is likely to face obstacles because it targets only market regulation and company structures. This study points to the need for a more sophisticated approach that incorporates the unique histories of each state.

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