

## Where do we stand and where to go?

“KAS-DENKFABRIK” 7TH DECEMBER 2012 IN MOSCOW

### EU-Russia-Energy relations

#### WORKING PAPER

##### Introduction

Since the beginning of the EU-Russia Energy Dialogue the parties have put emphasis on their mutual interdependence and the complementarities of the two systems. They hoped that cooperation in the energy sector would be the "locomotive" for further, wider forms of a pan-continental cooperation in other spheres entailing more complicated solutions. Against such premises full of hope, the current picture is painted in rather gloomy colours. With the European Commission's antitrust probe against Gazprom (September, 2012), the EU-Russia energy relations have reached a new low point since the gas crisis of Ukraine (January, 2009), although nowadays most disagreements regard market technicalities rather than geopolitical exacerbations. The field for the dispute to be contended is the European gas market. The current, topical interests of the European Union - promotion of competition, lower gas prices and supply diversification, collide with some of Russian aims - increase/recovery of the lost European market share and preservation of the oil-linked long-term contracts, as a fundamental means of ensuring security of demand.

##### The interdependency between EU and Russia

The issue of the interdependency between the two parties has been widely discussed in the recent years. Nevertheless, it is worth recalling its main features, highlighting the changing dynamics of this relationship, as well as sweeping away some prejudice and misunderstandings. To start with Russia, its economy and, allegedly, the stability of its political regime is tightly intertwined with the fate of oil prices. Almost half of the federal budget income comes from oil and gas revenues (i.e. mineral extraction tax, VAT and excise taxes, and export fees). In 2012, the break - even oil price skyrocketed at 116 US dollars per barrel, thus exposing the Russian State finances to a high degree of vulnerability. For some aspects - corruption, authoritarian rule, and lack of incentives for non-energy business, low level of government spending on education - it is fair to say that the country is affected by the "resource curse".

The EU market makes up almost 60% of the value of the country's oil and gas exports. The continuing economic crisis and the shifting consumption trends across the EU cast doubts on the future level of imports. It should be noted that oil to a greater extent

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than gas is the truly critical item in Russian Federation's State budget, as Gazprom benefits from great fiscal exemptions, while the more privatized oil sector does not as well protected. Nevertheless, in the context of EU - Russia energy relations, oil does not figure as major critical element (although a very delicate one) - certainly not as natural gas, which has generated disagreement and disputes at all levels of the supply chain.

The dependence on the European market is thus to a greater extent a problem affecting Gazprom's balance sheet, rather than the Russian State budget. True, the Kremlin has a clear interest in defending the gas giant's position vis-à-vis the European Commission's "attacks", as it accounts for 8% of Russia's GDP (2011) and it is involved in several social projects. However, it would be incorrect to superimpose uncritically the interests of the two entities - Gazprom and the Kremlin - particularly in recent years, as the company's popularity dropped among Russian citizens. However dependent on gas sales to Europe, Gazprom has proved to be sluggish in implementing a much needed diversification of export strategies. It has been lagging behind in the development of LNG capacity and in carrying out its oft - voiced "Eastern Program" so to connect its East Siberian fields to the Chinese and the Pacific Rim's markets. China never agreed to pay "European prices", thus encouraging Gazprom to sit on the fence and wait for better days. Now that in the European markets both its profits and the demand for Russian gas are declining, Gazprom has little other options than seeking for a (rather costly) safety valve on its Eastern flank.

It is worth noting that the volumes Russia would avail for the East Asian markets would very hardly be marketable, due to lack of infrastructures and extremely long distances, in the EU. Thus, the Eastern Program does not constitute a threat in terms of depletion of reserves that otherwise could be provide for volumes to be shipped Westwards. If ever, the problem for European consumers would lie in the fact that Gazprom would shift part of its capital expenditure in the development of

upstream areas not connected to its networks. Even so, in the short- and medium-term, selling gas to Europe will remain far more profitable than shipping volumes through extremely costly pipelines to Eastern Asia. Yet, a more concrete "diversification" card from the European market is Russia's own domestic front. Preconditions to this scenario would be a continuous process of gasification of the country along with the growth of domestic prices. Thereby, the Russian market would grow ever more attractive for Gazprom with respect to Europe.

Moving further to analyse the EU's dependency on Russian gas, firstly, we should underscore that despite widespread suspicions (when these may not be referred to as "hysteria") on Gazprom's behaviour, particularly after the Ukrainian Gas Crises of 2006 and 2009, Russia's share of European gas imports had been decreasing constantly in the last two decades: in 1990, such a figure amounted to 75% of the overall import; in 2010 the share decreased to 33% (i.e. 24% of total gas consumption). The rapid growth in LNG capacity in the EU continues eroding Gazprom's market positions. The EU as a whole is therefore steadily decreasing its dependence on Russian gas.

The problems of dependency on Russian gas thus lie at regional level, as Eastern and South Eastern European states' network interconnections and gas supply portfolios largely reflect the historical features of status quo ante the collapse of the Soviet Union. That is to say, a system of unidirectional East-West flows managed under a monopoly regime. Bulgaria, Romania, Slovakia, the Baltic States and Finland rely on Russian gas for an amount close to 100% of their supplies. Other former Warsaw Pact members display interesting figures as well. Sure enough, these countries are very vulnerable to supply disruptions, the outcome of the gas crisis in Ukraine of 2009 being an all too evident example of how the region may suffer for its uncomfortable positioning within the Eurasian gas distribution networks. The Czech Republic, Slovakia,

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Hungary, Serbia, Bosnia-Herzegovina, Greece, Macedonia and on the top of them, Bulgaria, all suffered cuts accounting for more than 75% of their gas supply from 6 to 20 January 2009. It is to be noted that the area is not merely over-dependent on Russian supplies, but perhaps most importantly, on the transit routes of the Ukraine, a "cash-strapped" country entertaining extremely controversial gas relations with Moscow. As a matter of fact, neither the Soviet Union nor the Russian Federation had ever cut gas supplies to their end customers. The bad reputation Gazprom had earned as a supplier is due to its pricing disputes with states in the post-Soviet space, mainly with Belarus and Ukraine. Despite such "collateral damage", Russia remains a reliable supplier.

The means the European Commission has designed to cope with the vulnerability of East European countries are of various nature - the call for an increased cooperation between MS under the banner of "solidarity"; the construction of new interconnectors and the creation of additional reverse flow capacity; energy efficiency measures and, among others, the Third Energy Package's market based mechanisms, which were devised to increase the competition. The Nabucco pipeline project, which will be discussed further, was yet another means for "liberating" the area from Gazprom's hold. As the EU's domestic production will continue its decline<sup>1</sup>, Russia will still play an important role as a relatively reliable partner. Therefore, Brussels will need to engage Moscow basing their relationship on their complementary interests, which - we will say it en passant - span much beyond the energy sphere.

#### **The creation of an EU single gas market and the erosion of Russia's interests**

In recent years, the EU energy policy has taken a turn for the worse with regards to Gazprom's interests. That is why, broadly speaking, Moscow's perception is one of Brussels waging a conflict on Russian gas supplies at various levels and on different fields. Though it has often been regarded as

an "open secret", the urge for diversification from Russian supplies has recently become an overtly expressed goal (European Parliament's resolution on Energy Security, June 2012). Sure enough, a number of the EU's main targets in the energy sphere - diversification of energy supplies, development of LNG import capacity, achievement of greater energy efficiency, among others - does not play in favour of Russia's long-term gas export to Europe. Taking into account decarbonisation goals, natural gas is viewed as viable transitional fuel to 2030. For the following period, the EU Roadmap until 2050 does not characterize gas as a strategic winner, although Russia, along with the EU Gas Advisory Council (GAC), praises it for its low carbon footprint and its relative affordability.

The Third Energy Package (TEP) and Brussels' efforts to increase competitiveness within an EU single market took the challenge to a new level. The "unbundling" requirements represent an obstacle for the Russian gas major to operate in the EU downstream sector - it is to say, the part of the supply chain where most of the profits are made. Furthermore, the "Gazprom clause" is being regarded as a form of protectionism against Russia.

Another bone of contention between Moscow and Brussels is that of gas pricing formulas, a field where Gazprom's position has been eroded dramatically in the last 3 years. For decades, a system of long-term contracts (LTC) based on oil-indexed prices and including a "take or pay clauses", managed to guarantee a fair balance between security of demand and supply, thus providing for stable relations and deliveries between Soviet Union and its European customers (even at the times of Cold War). However, some recent developments on the world stage - the "shale gas revolution" in the USA and the consequent massive rerouting to the European shores of considerable LNG volumes that were originally bound to the Atlantic basin - have rapidly and almost unexpectedly overturned the status quo.

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The TEP had thus far failed to achieve a fully liberalized and competitive market, for the EU was lacking diversified sources of supply. The situation started changing since mid-2009, as new streams of LNG, primarily of Qatari origin, reached the European market, thus increasing its liquidity, bringing prices down and exerting pressure on LTCs based on oil-indexed prices. Hence, nowadays, new customers have little incentive in striking long-term deals with Gazprom (especially once these are compounded with the rigidity of the "take or pay" clause) as long as there is abundance of cheaper, flexible supplies of gas. Meanwhile, traditional, big customers (E.ON and ENI, among others) succeeded in renegotiating their contracts and achieving discounts.

It is thus no surprise that it is witnessed to several urges, including those coming directly from the EU, for de-linking gas prices from oil and aiming at the expansion of spot pricing mechanisms. It is worth mentioning that such a drift in pricing formulas has just started occurring in LNG-hungry Japan, and is supported by other Governments of the Asia-Pacific region, although it has yet to be seen what extent such a "revolution" will reach.

In addition, Moscow feels that the TEP undermines its legitimate concerns of security of demand, as it jeopardizes the predictability and handling of its future supplies to the EU. A major Russian concern is how the complex and long-distance transport of gas across the EU to its customers will be arranged. The Gas Target Model is still being discussed between EU Member States, their aim being the harmonization of their regulations, fiscal regimes, network codes, etc., in which regards there is still a significant level of uncertainty.

Moreover, it is not clear yet how to create capacity in case of bottlenecks for single years. The draft Target Model provides the possibility to book capacity on a year-by-year basis for up to 15 years. However, given the longevity of the upstream infrastructure and the heavy investments

needed, there is an interest (not merely on the supplier side) to allow for long-term capacity booking. The Russian Federation and other gas exporters have a vital interest in solving these issues to continue marketing gas reliably and on the current scale. The recently created EU-Russia Gas Advisory Council (GAC) is addressing some of these issues, so to create a new fair balance between suppliers and consumers' interests by combining the security of demand with the principles of flexibility and competition. In particular, it has been agreed that EU Transmission System Operators (TSO) would cooperate in order to guarantee the delivery obligations at the exit points of the networks. The transit of volumes within the EU would be coordinated with regards to possible routes, taxation system, splitting of revenues among TSOs, the setting of an overall tariff, etc.

Finally, it should be pointed that the growth of the European Commission's institutional power and its direct engagement in what is perceived as a "war" on Gazprom, increased the Kremlin's resentment to a critical level. Moscow has risen its eyebrows facing measures such as the call for "a wider regulatory area" in the field of external energy relations (i.e. a unilateral assertion of EU's "normative power") and the request of exchange of information on negotiations with third countries, before and after these take place.

The commission's spectacular raids in the offices of Gazprom's European branches (September 2011) and its antitrust probe against the Russian gas major (September 2012) induced the Kremlin to overtly accusing Brussels of putting in jeopardy the whole system of EU-Russia relations. The DG Competition based its case on three charges: 1) prevention of gas trading across national borders; 2) hindering diversification of supply; 3) unfairly linking gas and oil prices. Put into such a critical situation, many observers argue that Gazprom's business model is doomed to be severely affected, although the Kremlin seems far from being yielding.

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## The Great Pipeline Competition

Ever since the collapse of the Soviet Union, most of the pipeline projects on the Eurasian continent have aroused a great deal of controversy and suspicions on both sides. This also owes to the fact that pipelines are not profit centres. Instead, they are widely regarded as geopolitical vectors aiming also, though not exclusively, at the exertion of political influence on a region.

The Nord Stream pipeline, connecting the Russian upstream sector to the German market, runs along the bottom of the Baltic Sea, thus bypassing problematic transit countries such as Belarus and Ukraine and privileging Gazprom's first customer within the EU - Germany. Despite claims that the pipeline would increase European energy dependence on Russia and that it would entail potential environmental damage, the infrastructure was inaugurated in November 2011 and a second leg was opened in October 2012 (its total capacity of 55bcm per annum, is yet far to be fully exploited). Promoted by the Kremlin and agreed by the German Government, it is operated by the Nord Stream AG (Gazprom 51%, Wintershall 15.5%, E.ON Ruhrgas 15.5%, Gasunie 9% and GDF Suez 9%). More controversial is the South Stream, a pipeline project sponsored by Russia and supported by some MS, particularly by the second Western importer of Russian gas - Italy. Designed to bypass the most critical transit state in EU-Russia gas trade - Ukraine, the pipeline would ship to the Balkans up to 63bcm (an amount which, combined to the capacity of Nord Stream, would almost annihilate Kiev's relevance in East-West gas trade). Several observers raised doubts on the economic viability of the project, for it is regarded as excessively costly and as it is being pushed forward against a background of uncertain future gas demand in the EU market. Sure enough, combined with the Nord Stream and the existing East-West pipelines, this project would ensure Gazprom a huge extra capacity of transit. Many agree that the primal aim for Gazprom building the South Stream is of a geopolitical nature, i.e. to forestall the

construction of the rival projects included in the EU's "Southern Corridor", which are designed to serve roughly the same Southeast European markets. As has been the case with Nord Stream, critics point out that the project would realize a mere diversification of transit routes, while keeping the position of Russia as a dominant supplier in the Balkan States perfectly intact. For its part, in recent years the European Commission has been keen in endorsing a range of pipeline projects aimed at opening a new energy corridor for diversifying gas supply to the continent - the notorious and so far unfortunate "Southern Corridor". The Nabucco, the Trans Caspian pipeline, the Nabucco West, the ITGI, the TAP and the TANAP form the long list of "pipedreams" that has been made thus far.

The main rival of South Stream, Nabucco is dead and buried for its lack of suppliers. It was originally designed to ship 31bcm of which, so far, only 16bcm from the Shah Deniz II field (Azerbaijan) would be available.<sup>ii</sup> The necessary remaining volumes, in the EC's vision as well as in the US' grand schemes, would have been taped from Iraqi Kurdistan, Turkmenistan (through the Trans Caspian pipeline project), or even Iran. It is little surprise, however, that up to now such volumes have failed to materialize. On a final note, very recently the German shareholder RWE has announced it intends to leave the project. As the smaller competing projects (TAP and ITGI, 11bcm) were also lagging behind, a rather interesting development took place. The Azeri state has pushed forward its interest in marketing its gas from the Shah Deniz II. In cooperation with Turkey, which is striving to become a major gas transit hub, Baku took the initiative and set the most promising project of the area. The Trans Anatolian Pipeline (TANAP) would ship 10bcm to Turkey's European border. After that, it would yet to be seen which small-scale project would transit the gas to Europe - the Nabucco West to the Balkan states (i.e. roughly on the South Stream's "game reserve"), or the Trans Adriatic Pipeline (TAP) to Italy. None of these two projects would be achieved, Turkey may

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stand in an excellent position to purchase a great deal of this Azeri volumes.

A final mention should be made of the Trans Caspian project. Such a pipeline was planned to ship 10bcm of Turkmen gas through the Caspian Sea on the Azeri shores, thus feeding the Nabucco. Brussels and Washington have been lobbying for its construction for years. The status of the Caspian as a lake and the treaties between USSR and Iran (1921, 1940) imply that the project needs the approval of all littoral states, but Teheran and Moscow are far from assenting. Quite the opposite, as the Kremlin has repeatedly asserted, the construction of the Trans Caspian is a "red line" its Western promoters should not cross, for the sake of the stability of the region.

### Conclusions

It should be finally recalled that it is in the interest of the EU to settle on some Russian concerns on security of demand and finding an optimum balance with that of its supplies, as the uncertainty on the EU demand side effects negatively the necessary investments in the upstream. Against a background of continuous decline in conventional gas production in the future decades (even providing that decarbonisation policies will constrict gas demand), the EU has a stake in cooperating with the Russian Federation, which will remain an unavoidable supplier of gas in the future. In order to pick up and resume the dialogue, which is nowadays limited to a series of tactical and small-scale measures, the two parties will need to define a cooperation strategy. As a first requirement, Moscow and Brussels should sweep away their defensive attitudes based on their mutual perceptions.

The perceptions of the two actors add problems to market and legal technicalities discussed in the present summary. On the one hand, Russia is suspicious about the EU's attempts to assert its "normative power", although it has managed to reformulate the concept of unidirectional approximation to the European acquis into

that of convergence of the two systems. In this respect, the future of the Energy Charter (or whatever other prospective legal framework favoured by Moscow) is still highly uncertain. Russia's suspicions have been exacerbated by the attempt of the EC to checkmate Gazprom with its antitrust case. "It is the law" is the answer to Russia's complaints, but was this action politically sound? This is yet to be assessed. Russia's defensive posture and anxious attitude may thus be further encouraged.

On the other end of the pipeline, the EU is groping in the dark of its economic crisis and has become more inward-looking than ever. Furthermore, the "shale gas revolution" in the US, combined with the rapid expansion of the LNG trade, significantly contributed to erode Gazprom's market power. The perception of the Russian gas major as an almighty energy giant is fading, as it faces a number of severe structural problems and, at least according to some pessimist observers, it is doomed to lose its status - is it going to adjust to market rules? Will it be hived off into parts? Will it continue its declining trajectory? In recent years, the promising discoveries and opportunities found along the gas frontier complete a picture in which the EU, will it to overcome its financial problems, may not be as dependent on, neither as apprehensive about Russian gas supplies as it had been in the late 2000s. However such perception may be detrimental at present for an EU-Russian rapprochement, it is possible that in the mid- to long-term such factor will contribute to a necessary de-politicization of the energy relations between Brussels and Moscow. The EU may eventually show a friendlier face to Russia, but will Russia be ready to greet back?

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<sup>i</sup> We maintain hereby prudent estimations on future domestic shale gas production in the EU and Sahara region, as well as that of East Mediterranean offshore.

<sup>ii</sup> Six of these 16bcm would be delivered to Turkey, the dominant transit of the project.