

After Ukraine: Enhancing Europe's Gas Security

The extreme caution with which European states have reacted to Russia's recent role in Crimea and Eastern Ukraine is linked to the continent's dependence on Russia for its gas imports. This dependency poses security risks for Europe, which are magnified by attempts of Russia's Gazprom to hold sway over Europe's gas deliveries.

By **Iana Dreyer and Jonas Grätz**

Dependence on natural gas imports still poses economic and political risks for the EU. As a consumer, it is interested in competition and diversification, as this keeps prices in check and blunts Russia's political clout. In contrast, the Kremlin's attempts to monopolize deliveries to European gas markets with the help of state-owned Gazprom continue unabated. For several years now, gas supply has become a foreign policy tool in Moscow's hands. In the current crisis over Ukraine, the perceived dependence on Russian gas supplies is an oft-cited reason in Western capitals for not acting in a more forceful manner.

Whereas Russia's president Putin personally serves as gatekeeper for gas exports and investment in Russian hydrocarbons, regulation is the only tool that the EU has at hand to strengthen the resilience of its markets to supply disruptions and price hikes as well as its room for maneuver in foreign policy. The current situation is ironic, as state-controlled monopoly Gazprom depends on the European market for its revenues: The company recently lost its export monopoly of

liquefied natural gas (LNG) and gas price increases in Russia were halted. Competitors are eating away at Gazprom's domestic market share – Gazprom's revenues from the Russian market are now down to 25 percent of its total revenues. This dependence on the EU market adds to Gazprom's determination to resist market reforms in the EU that would increase competition and interconnectedness.

KEY POINTS

- Russia uses its position as prime supplier of natural gas to undermine a competitive European gas market
- The EU should in turn convert its large market into leverage over Russia
- New pipelines like South Stream should be opposed as they weaken the EU's strategic autonomy
- The EU has to stick to its vision of a competitive market and not deviate from its own rules

KEY FACTS

- Until 2011, Gazprom exported gas to the EU primarily via overland pipelines with a total exit capacity of ca. 190 billion cubic meters annually (bcma). 80 percent of exit capacity was in Ukraine.
- In 2011, the **Nord Stream** pipeline from Russia to Germany (via the Baltic Sea) opened. It reached full 55 bcma capacity in 2012. Project cost: €16 Billion. Subsea section is operated jointly with German Wintershall, E.ON, French GDF Suez, and Gasunie of the Netherlands.
- Starting in 2015, **South Stream** with its four strings should carry 63 bcma gas under the Black Sea to Bulgaria, Serbia, Hungary, Slovenia, and presumably Austria. It has a price tag of €54–56 billion, mostly for onshore investments in Russia. At least two thirds of South Stream will carry gas now going via Ukraine. The subsea section is developed jointly with Italy's ENI, German Wintershall, and French EDF. Onshore sections in Europe are developed by Gazprom and the respective states.
- Gazprom is currently in a spat with the EU concerning the regulation of South Stream. It has not requested exemption from the EU's rules, but instead pushes for the introduction of an "open season" procedure that would result in Gazprom's long-term control over pipeline capacity.
- According to the Russian Central Bank, exports to the EU and Turkey were 113 bcm in 2012. On basis of the first three quarters, we estimate exports in 2013 at 136 bcm, constituting 30% of the EU's gas consumption.

The EU cannot afford to be complacent about Russia's behavior. Current trends towards less monopolistic gas markets need to be strengthened as the EU's dependency on imports for its future gas needs will continue to rise. The EU's key aim should be to subject the gas relationship with Russia to the logic of its internal gas market. Competitive markets should do the job of determining imports and exports, and not company monopolies and foreign interests. It is useful to remember that Russia is also the EU's main supplier of oil – it earns much more income from oil exports than from gas – and its first supplier of coal. But these resources hardly play a role in the geopolitics of EU-Russia relations because Russia is not in a position to dominate these more competitive and fungible markets, nor to set the prices Europeans pay for these goods. This is the kind of relationship the EU should aim for, and competitive gas markets are the primary tools to get there. By better leveraging Gazprom's dependence on the EU's gas demand, Gazprom should be nudged towards competitive behavior. The ultimate goal is to reduce monopoly profits, incentivizing Russia to become more competitive in its

natural gas sector. To achieve this, the EU has to stay determined in its pursuit of an interconnected and competitive market, and it has to avoid over-dependence on a single supplier.

Liberalization at risk

In order to grasp the changes that the EU's policy brought let's quickly zoom in to the beginning of the 1990s. Back then, the world of gas was simple. In the then only Western European EU, utilities owned by the state or by national capital guarded national markets. The export monopoly of suppliers thus met an import monopoly in national markets, protecting consumers against the abuse of market power from outside gas suppliers.

After one and a half decades of cautious gas market reforms, a renewed "marketization" of the gas sector was initiated in the EU in 2009. This was complemented by EU-financed investments in cross-border interconnections in Central Europe that ended the exclusive reliance on gas deliveries from one single pipeline originating in Russia. The EU Commission also launched a high-profile antitrust case against Gazprom, the outcome of which could lead to fines.

The EU's reforms have brought some remarkable results. Spot markets have spread from the UK all over north-western Europe, helped by the current economic slump and a global boom in

sea-borne LNG trade. LNG diversifies sources and routes of supply, reducing gas markets' traditional exclusive reliance on pipelines. In light of these markets, European utilities have recently been able renegotiate some of their long-term contracts with the big three suppliers – Norway, Algeria and even reluctant Russia. And thanks to interconnections, the EU's capacity to react to supply shortfalls has been enhanced.

But Gazprom's clout in the EU could be growing again: Liberalization also meant that Gazprom was able to invest directly or indirectly in national utilities or gas trading companies throughout the EU. In contrast to the previous national monopoly model, this meant that Gazprom would control investment and gas sourcing strategies in the EU, whereas EU companies cannot do the same in Russia. Enforcement of the EU's rules is thus of paramount importance to keep Gazprom's power in check.

Supply indicators also hint at Russia's growing clout. EU gas production is down, as the Netherlands had to cut back production due to geological problems, while shale gas production has not materialized. Meanwhile, diversifica-

tion of suppliers is not moving ahead. The US has not been keen to allow LNG exports. As Japanese gas demand has become limitless after the Fukushima nuclear accident, LNG deliveries to Europe have come down to a trickle. The EU's strategy to diversify pipeline gas supplies fell short of expectations. Most future projections see Russia taking up incremental import demand growth in the EU.

Furthermore, the Baltics, Central Europe and South Eastern Europe have mostly not benefited from the EU's marketization as have Western European markets. This is due to the fact that they have made much less progress in opening up their gas markets and integrating them with the rest of the EU. They continue to pay much higher prices than Western Europeans for the same gas from Russia. Investors into pipelines and interconnectors are reluctant to put up the money as high costs, an uncertain outlook for gas demand, and political meddling have reduced incentives to join markets.

As Gazprom fiercely resists reform in EU markets and some stakeholders are uncertain about the benefits of liberalization, the EU's reforms are at risk of being undermined. Strict adherence to the guiding principles of a competitive, diversified market is thus of key importance to avoid a scenario where EU policies create a complex thicket of new regulations, while not improving the overall situation. Russia's big pipeline projects in Europe are central test cases in this regard, as is the antitrust lawsuit against Gazprom.

Bypass pipelines: defeating Ukraine

Moscow is constructing costly new export pipelines to the EU (see key facts box). By the end of this decade, Russia is likely to have doubled the capacity it needs for exports to the EU. There are two aims. First, to create inroads into the EU's gas market with the new, dedicated pipelines, cementing dependence. Second, to neutralize Ukraine as a transit state, enhancing Russia as center of gravity in the post-Soviet space, and to align the Balkans and EU states with Moscow's foreign policy.

Like Nord Stream, the gigantic South Stream pipeline would be filled with gas mostly taken from the Ukrainian transit corridor. It will thus further strengthen Moscow's hand over Ukraine, while weakening the EU's hand. South Stream has already made a major contribution to the defeat of the EU-sponsored Nabucco pipeline project, leaving Gazprom's markets in Southeastern and Central Europe uncontested. South Stream also brings Moscow additional political influence in the Balkans and in Central Europe.

South Stream should therefore not receive any support from the EU. The

only way to turn South Stream into an opportunity is to exploit Russia's determination at building it and subject the pipeline to strict EU competition rules. This should be a no-brainer because the final investment decision has already been taken. However, Russia's opposition to competition has been remarkably successful so far. It has signed agreements with individual member states that violate EU treaties, leaving the EU Commission to renegotiate them to avoid negative fallout. Russia also exploits the EU's open and transparent way of crafting regulatory rules. Gazprom has used its commercial facade to insert itself into the process. It constantly comes up with new pseudo-problems and then pushes for solutions that suit itself. This has already resulted in watered-down legislation, and more is in the pipeline.

Prompting Gazprom to compete

The EU has achieved much by pursuing its market-based strategy to improve the security of its gas supplies. Yet Russia is not behaving like a market actor in the EU. The bloc is not immune to potential creeping rollback of its rules. But there are steps the EU and its member states can take to avoid such a scenario.

First, set the rules of the game for interdependency between the EU and Russia. According to current scenarios, the EU will likely be relying on more Russian gas in the future. This would not be a disaster, if the EU does its homework. The EU's hand will be strengthened if decision-makers do not shun other energy sources. The EU and its member states should thus make clear to Moscow that they have a choice: If Moscow continues to refuse the free market, the future role of gas in the energy mix will be limited in order to reduce risks. As a positive roadmap, the role of gas could grow if Moscow liberalizes its exports and investment regime, protects EU investors, opens up access to its pipelines, and stops hindering EU attempts at diversification – all principles enshrined in the Energy Charter

FURTHER READING

Global energy security and the implications for the EU

Frank Umbach (Energy Policy, 38:3 2010)

A comprehensive summary of the EU's supply security challenges.

Russian gas for Europe: creating access and choice

Tom Smeenk (Clingendael 2010)

An economic and game-theoretic view of Russia's new export pipelines.

The pricing of internationally traded gas

Jonathan Stern (Ed.) (Oxford University Press 2012)

The first effort to comprehensively analyze the evolution and current state of gas pricing around the world.

Treaty (ECT) that Russia pulled out of in 2009. Russia has expressed the desire to re-start negotiations on a new bilateral agreement to succeed the long-expired Partnership and Cooperation Agreement. The EU should condition its acceptance to hold such talks on Russia's willingness to accept ECT-style rules.

Second, stay consistent in the vision of a competitive EU gas market. Even if key companies from Italy, France, and Germany are lending Gazprom a helping hand, the EU has to be clear that this pipeline is value-destructive both from an economic and foreign policy viewpoint. If the EU cannot stop this project, there can be no compromise on exemptions for South Stream. The public interest in a competitive market is more valuable than corporate interests. Any exemption will help Gazprom to turn the pipeline into a tool for monopolizing gas markets, even more so as its new final destination will likely be the Baumgarten hub in Austria. The EU Commission has to bring the bilateral pipeline agreements with Moscow in accordance with EU rules. What is more, the EU should not allow Gazprom and its allies to distort the common market rules beyond recognition. Similarly, the EU anti-trust case must be drawn to a conclusion thoroughly. All of this needs the firm backing of European capitals. They must become fully aware of the negative geopolitical implications of compromising with Gazprom on these issues. Applying the EU's rules may also nudge Gazprom to accept a new, ECT-style regime for bilateral investment protection. By shunning the ECT, Russia has lost protection of new investments in Europe, which puts the EU at an advantage.

Third, implement and interconnect. Both Brussels and key Western European capitals must put greater political weight behind more ambitious, consistent and coordinated application of the EU's Gas Directives, especially in Central and Southern Europe. The aim is to connect them to mainstream EU markets and gas trading hubs fur-

ther west. This should be backed by EU tax-financed investments in interconnecting pipelines, as markets alone won't currently take the risk.

Fourth, continue to pursue opportunities to diversify supply sources. The prospects for bigger pipeline projects in the Southern Corridor are currently bleak, for commercial and political reasons. This might change in future, and there are new potential gas sources in the Mediterranean. Trade talks on the TTIP should be finalized swiftly, to kick-start US LNG exports and thus make gas markets more global, liquid, and less reliant on pipelines and the risk of political capture these pose. The EU Commission should also initiate a Europe-wide debate to move forward domestic shale gas exploration.

Europe's increasing gas import dependence on Russia will be a growing challenge for EU energy security if the process of reform and unification of its gas markets stalls. Russia seems committed to leveraging its role as supplier, and to derive geopolitical benefits from it in a zero-sum manner. Sticking to the EU's internal market rules and investing in interconnection is the only way to reduce vulnerability in the face of Moscow's hard-power politics.

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