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Abstract

Russia's decision to cancel construction of the South Stream pipeline to Europe reflects a change in strategy toward its western customers. This change has been long in the making as Europe has sought to reduce its gas demand and diversify sources of supply away from Russia. Looking forward, Europe may indeed seek to import more Russian gas in the future, but then Russia may be in a stronger position since it will also be selling gas to Asian customers, particularly China.

Growing Pressure for Change

In one sense Russia's interaction with Europe in the gas sector has never been stronger. Although gas exports to the continent in 2014 fell to 147 bcm (from a post-Soviet high of 163 bcm in 2013), Russian gas nevertheless accounted for over 30% of supply to European customers, a reflection not only of stagnating demand in the region and a lack of viable alternative sources of gas, but also of the importance of energy exports for Russia to its current western markets.

Despite these strong ties, however, Alexei Miller, the CEO of Russia's monopoly pipeline gas exporter Gazprom, strongly signalled in a statement issued in mid-January 2015 that Russia sees a significant change in its role in the European gas market, asserting that:

"The principle of our strategy in relation to the European market is changing. The decision on stopping South Stream is the beginning of an end to our operation model of the market [sic] within which we oriented ourselves towards supplying [gas] to the end consumer... But you can't win love by force. If the buyer doesn't want the purchase to be delivered home, well then perhaps he needs to get dressed and go to the store, and if it happens in winter, get dressed warmer. Well he could also take some package...which can well be the Third Energy Package, but what counts most is that it should not be empty. In our case the store is certainly the delivery point on the Turkish-Greek border."¹

Although the recent decision to cancel the South Stream pipeline project, which was due to bring 63 bcm of gas from Anapa, on the Russian Black Sea, to Varna, in Bulgaria, and from there on into South-East Europe, is the clearest manifestation of this change in strategy, in fact multiple catalysts have been building over the past decade towards a crescendo of disagreement between Gazprom and its European counterparts during the past 12 months. The origin of the current disputes and

the ultimate catalyst for action have been the same—the issue of gas transit through Ukraine—but multiple other factors have also been at work and it is important to consider the history briefly before assessing the potential for future commercial and political relations.

Accumulating Disputes

Since the break-up of the Soviet Union in 1991, Russia and Ukraine have struggled to address the problem of transitioning from a situation where one country combined significant state-owned gas reserves and a vast pipeline system stretching to the borders of Europe to a new reality where one country controls gas supply while another both relies on that supply and also has significant influence over its delivery to important export customers. Through the 1990s and early 2000s, Russia and Ukraine debated the balance of a fair gas price and cost of transit, with Gazprom always keen to see the price approach international levels, while Ukraine supported its need for low prices through its implicit strategic position within the Russian sphere of influence and its provision of security of transport for Russian gas exports. Various remedies to the pricing issue were attempted, including the direct supply of Central Asian gas and the use of intermediaries, such as RosUkrEnerg and EuralTransGas, who provided a buffer for Gazprom in negotiations with Naftogas Ukrainy and the Ukrainian authorities. However, by the mid-2000s it had become clear that, with European gas prices rising rapidly in line with the oil price, Gazprom would need to take a direct hand in negotiations if the price discount enjoyed by Ukraine was to be reduced.

This new Russian strategy led to the start of a series of annual negotiations (normally held in late December) where the next year's gas contract was discussed, including agreements on price and volume. Given the importance of the outcome to both countries, the debates tended to continue to the very last moment, with the underlying threat of a cessation of supply from the Russian side matched by the threat of a cut in transit of exports to Europe by Ukraine. This threat finally materialised in 2006, when at the height of the annual dis-

1 Interfax, 6 Dec 2014, "Europe will have to care about delivering Russian gas from Turkish border."

agreement, Ukraine started to syphon off gas intended for the European market, causing shortfalls in a number of countries in the south-east of the continent. Although no Gazprom customer suffered a complete cessation of supply, and the interruption was brief, and indeed was hardly noticed in some countries, the impact of the incident on Russian export strategy was profound. For President Putin, who is widely regarded as the primary driver behind Gazprom's key decisions, it confirmed his view that Russia needed to continue its tactic of removing Ukrainian transit risk, already started via building the Yamal Europe pipeline, the Blue Stream pipeline to Turkey and the plans for the Nord Stream line across the Baltic Sea, by creating a new line through the Black Sea (South Stream) to finally free Russia of its reliance on a potentially disruptive neighbour.

This plan was re-confirmed in 2009, when a much more serious price dispute with Ukraine, catalysed by an initial agreement that would have seen Russian gas sold at, or even higher than, international prices that was subsequently rejected by a newly-elected Ukrainian government. Russia initially refused to supply gas to Ukraine unless it paid the agreed price, and then, following allegations of "theft" of gas by Ukraine to replace the lost volumes, supply through the pipe was shut down in its entirety, cutting off European customers for two weeks in the depths of harsh winter weather. However, although this dispute confirmed Russia's "transit avoidance strategy" and its plans for South Stream, it also caused deep concern in the EU over the security of Russian gas supply, and raised the question of the need to diversify to alternative sources as well as the imperative to enforce market rules to help the diversification process.

The announcement of the Third Energy Package (TEP) in 2011, which outlined the EU goal to create a liberalised gas market in Europe via the unbundling of vertically integrated gas companies and the imposition of third party access rules and publicised tariffs, marked the start of this progression, but also caused huge concern for Gazprom as it would mean a significant shift in its traditional business model. In particular it threatened its pricing structure, which had always been based on a long-term oil-linked methodology, and its plans for access to customers via controlled infrastructure. These issues became manifest in two clear ways. Firstly, Gazprom's use of the Nord Stream pipeline, running from the Leningrad region in Northwest Russia to the Baltic coast in Germany, was interrupted by an EU Competition Commission ruling that the onshore pipeline connected to it (OPAL) could not be monopolised by Gazprom, and limited use of its firm capacity to 50%. Gazprom argued that it was the only conceivable user of the pipeline and should have access to all 36bcm of

capacity, but the EU remained firm and Gazprom's ability to use Nord Stream was cut by 18bcm, leading to a long-running legal dispute which appeared to have been resolved prior to the Ukraine crisis, which then prevented publication of the decision. Secondly, in 2012 DG COMP challenged Gazprom's commercial practices and pricing methodology in eight Central and East European countries, alleging that it was preventing competition and abusing its monopoly position by charging high oil-linked prices. The case is ongoing, with an initial ruling expected in the first half of 2015.

Decreasing Demand and Growing Diversification

Furthermore, this increasing level of dispute between Gazprom and the EU has been taking place against a backdrop of declining European gas demand and increasing attempts to find alternative sources of gas supply. The most notable example of diversification is the planned arrival of 10bcm of Azeri gas via the TANAP and TAP pipelines from the end of this decade, while the continuing growth of shale gas production in the U.S. has provided increasing hope of LNG exports arriving at Henry Hub-linked prices from 2016. Meanwhile European gas demand has declined as a result of the continuing effects of the 2008/09 economic crisis and the rise in the use of renewable energy and cheap coal imports in a number of countries. This combination of measures has led to gas consumption falling from 577 bcm in 2008 to 528 bcm in 2013,² with the outlook for demand growth remaining relatively bleak, as most forecasters do not see demand recovering to 2008 levels before the mid-2020s at the earliest.³

Within this context, Russia's strategy of pursuing the South Stream project was seen as a potential threat to Europe, despite ostensibly solving the security of transit risk posed by Ukraine. Russia's plans were seen as undermining European diversification plans in the south, but more overtly as a challenge to the TEP itself, because Gazprom signed a series of individual inter-governmental agreements with countries in south-east Europe that would have provided exclusive access for South Stream gas in contradiction to the new third party access rules. Essentially the EU made it clear that South Stream gas imported through any new onshore pipelines via EU countries such as Bulgaria, Hungary and Austria, would need to comply with TEP rules, which largely ignored the fact that rules on access to new capacity would not be

² Total for EU35 provided by Eurostat.

³ For example Honore, A. (2014), *The Outlook for Natural Gas Demand in Europe*, OIES, p.64, IEA World Energy Outlook 2014, p. 139.

finalised until 2018. Gazprom continued a debate with the European Commission and some progress towards a resolution appeared to be made until all discussions were halted by the annexation of Crimea and the start of the conflict in Ukraine in February/March 2014.

At this point all commercial negotiations on pipeline, supply and pricing issues were overwhelmed by political priorities on both sides, with Gazprom asserting that it would continue to build South Stream regardless of EU objections. Meanwhile the Commission remained firm in its decision that the onshore section was illegal under TEP rules, and reinforced this decision by issuing a statement of objections against the Bulgarian procurement process for pipes, which brought construction to a halt in that country. For Gazprom, a crunch point was reached in December 2014, when the pipeline was on the point of being laid, with one string of pipe having been purchased and already located at Varna, with another on order, and pipe-laying vessels having been contracted and ready to begin operations. At this point it became clear that a huge amount of money, already in shorter supply because of falling oil prices, could be wasted on a pipeline that might remain empty, or at least under-utilised, for years, so Russia decided in early December 2014 to cancel the project.

A Turning Point

However, far from implying a cessation of relations with Europe, the cancellation of South Stream looks to mark a turning point in Russia's gas export strategy and a re-assessment of its efforts across all its export markets. As Miller's statement implies, Gazprom will continue to make its gas available to Europe, ostensibly on its own terms, but implicitly acknowledging the force of the TEP. At this early stage, when anger and annoyance at EU decisions is clearly driving Russian rhetoric, it is difficult to understand exactly what Gazprom intends or can achieve, but one clear message is that it plans to focus its efforts on Europe's one expanding gas market, namely Turkey. It aims to ensure that it can supply this important customer without interruption, with the new "Turkish Stream" pipeline essentially using much of the South Stream route (and all of the purchased pipe) to deliver gas into the Istanbul region. In this way the 14 bcm of gas that currently transits Ukraine before using the trans-Balkan pipeline to reach Turkey can be sent directly via the new pipeline. This will secure Turkish supply and provide the opportunity to expand sales as the market grows, and Gazprom hopes that it can also use Turkish Stream to send 10 bcm of gas into south-east Europe by reversing the flow in the trans-Balkan line. Achieving this goal would imply the construction of two pipelines, covering from a half to the total 63bcm

potential capacity of the line. It is unclear if this will be allowed under TEP rules, providing another possible area of dispute with the EU.

Gazprom's other plan, to send all the gas it currently supplies to Europe via Ukraine to a new hub on the Turkey/Greece border, is equally questionable. It would imply the construction of a full 4-line Turkish Stream and would also rely on the construction of new interconnectors by independent operators on the European mainland to move the gas to end-users. In addition it could necessitate the re-negotiation of all of Gazprom's existing supply contracts, if Miller really means what he says about providing Russian gas at a new Greek hub. Such an outcome may be inevitable in 2019, when Russia's current transit agreement with Ukraine expires, and so Gazprom may just be anticipating this event, but in any case the discussion of a re-direction of some or all of the volumes currently passing through Ukraine involves some significant legal considerations. As stated earlier many of the initial Russian assertions on this issue need to be treated with caution as they are likely driven by anger at the EU as much as by logic, but nevertheless it would seem that the combination of weak gas demand, EU legislation, a sense that Russian gas is much less welcome in the EU and a re-assessment of the global gas market is changing Gazprom's attitude towards Europe. Two other recent events in December 2014 would seem to confirm this view.

Firstly, Gazprom announced the cancellation of a deal with BASF under which it would have increased its stake in Wingas, a German gas marketing company with activities across Europe, from 50% to 100% in return for equity in upstream assets in West Siberia.⁴ This move essentially signalled the reversal of Gazprom's previous intention to market its gas to end users in Europe more aggressively, perhaps understanding that this might again attract the attention of the EU competition authorities. Secondly, Gazprom gave up its attempts to have the EU decision on access to the OPAL pipeline reversed by allowing a deadline for a renewal of the negotiations to pass at the end of the year.⁵ Again, this would appear to signal that Gazprom plans to take a more passive approach to its gas sales in Europe, essentially implying to European buyers that the gas is available if it is wanted but that Gazprom is no longer going to actively press for access to specific infrastructure. To paraphrase Alexei Miller's comments following the cancellation of South Stream, "you can't force the buyer to

4 Wall Street Journal, 18 Dec 2014, "BASF, Gazprom call off asset swap amid political tensions."

5 Natural Gas Europe, 23 Dec 2014, "OPAL exemption process to be reset."

take your gas... if he doesn't want it delivered to his border then he can come and get it from a hub of our choice.”

Given Europe's clear antipathy towards Russia and a desire to reduce dependency on its gas, delivering supply to a distant hub would seem to be a rather risky strategy, but Putin and Gazprom have reasons to be relatively confident in their stance. Firstly, the contractual commitments between Gazprom and its European customers mean that gas exports are unlikely to decline much, if at all over the next decade. Secondly, even if those contracts were to be renegotiated as a result of Gazprom's new strategy, there is every likelihood that the European requirement for Russian gas will increase not decrease over the next 10–20 years, as demand rebounds from its current lows and indigenous supply continues to fall. Europe's import requirement is likely to rise by as much as 100 bcm by 2030, and it is hard to see sufficient alternatives to Russian gas that could meet this demand. As a result, Gazprom has an innate confidence that demand for its gas in the west will not decline over the longer term, but rather that its bargaining position could get much stronger over time.

Thirdly, Gazprom has developed a clear diversification strategy involving the opening of a new market in the East, where demand is growing fast and imports are more urgently needed. The particular focus to date has been on the Chinese market, with the signing of one pipeline deal completed in May 2014 and the potential for a second at some point in 2015, which could see Russian exporting as much as 68bcm by the early 2020s.⁶ Furthermore, although Gazprom's LNG plans would currently seem to be on hold due to the impact of lower prices and sanctions, in future Russia could also start to supply Pacific markets via sea, and additional sales to China could also take place via an existing pipeline in the Far East of Russia from Sakhalin Island.

As a result, sanctions, Russia's perception of EU legislative tactics, Europe's plans to reduce dependency on Gazprom and the outlook for European gas demand have finally spurred Gazprom into a commercially rational gas export strategy spanning west and east that the company has been contemplating for more than a decade.

About the Author

James Henderson is a Senior Research Fellow at the Oxford Institute for Energy Studies, where he specializes in analysis of the Russian oil and gas sectors and their interaction with the global energy economy. He is also a visiting professor at the Skolkovo Management School in Moscow and lectures on energy issues at a number of universities in Europe.

Further reading: please see overleaf

The result is that, even in a worst case scenario in Europe where customers only buy Russian gas at the lower end of the take-or-pay range (assumed to be 70% in Figure 1 overleaf), Gazprom's exports to non-CIS countries would dip to a low of 120 bcm for the next 2–3 years before rebounding towards levels seen in 2013. In a more benign scenario, where European customers purchase 100% of their contracted gas the figures would be as much as 50bcm per annum higher, showing the potential upside for Gazprom if Russia is correct about the future need for its gas in the West.

Conclusion

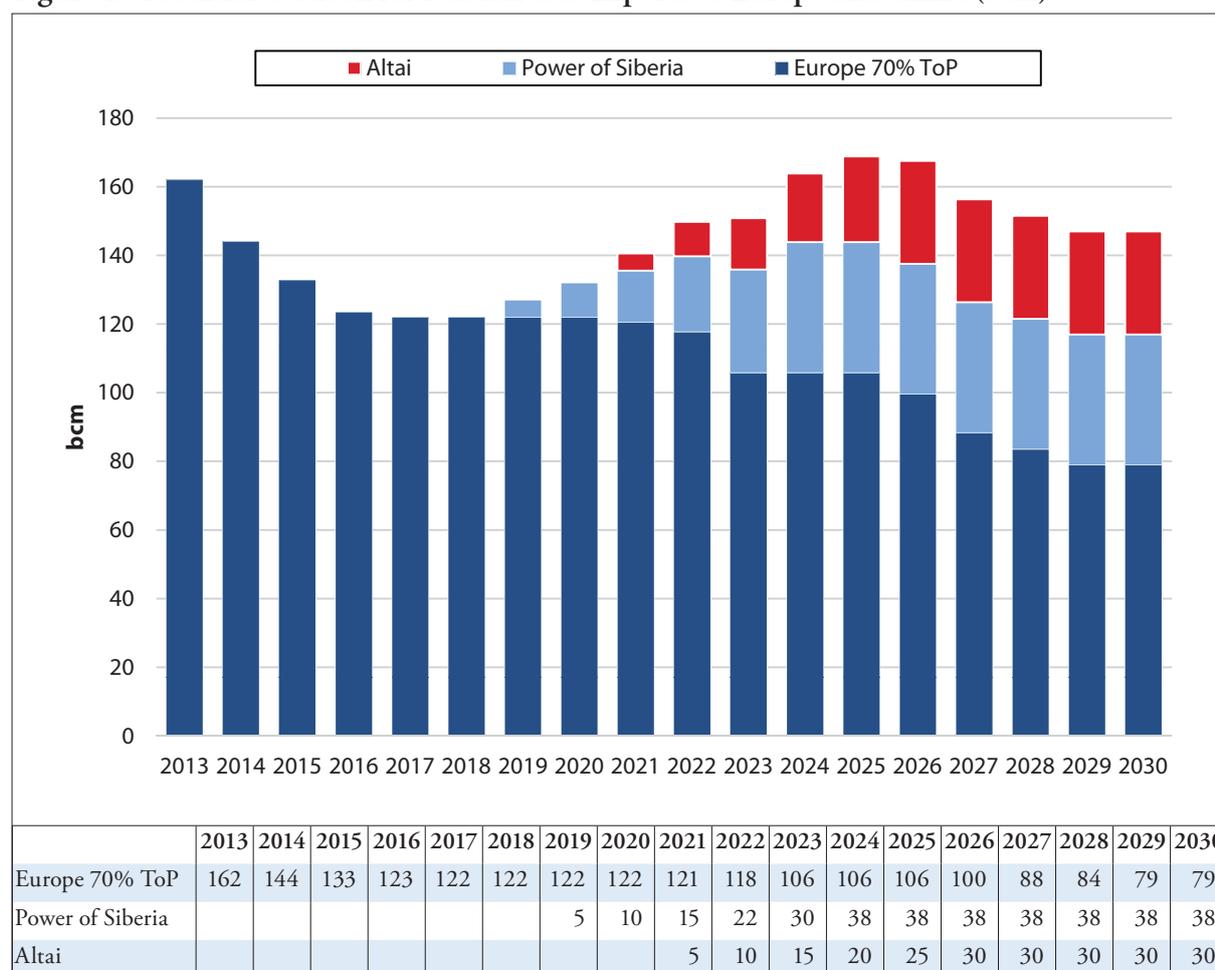
This analysis might suggest that it should be Europe that should be worried rather than Russia, especially as gas via the Altai pipeline to China will be coming from the same source as exports to the west, allowing for potential arbitrage. However, a more realistic outcome is that, while all sense of a strategic energy partnership between Russia and the EU has disappeared, in reality commercial relations will remain strong. Russia will not want to become reliant on exports to a single powerful customer, such as China, and will use its European options as a balancing item in the same way that sales to Asia are currently being used to make a geo-political and commercial point to European leaders. Furthermore, total sales to Europe are likely to remain the biggest source of revenue for Gazprom, albeit that China could become the biggest single customer, and as a result, although the relationship between Russia and its customers in the west is likely to remain politically fractious for the foreseeable future, the mutual benefits of a rational commercial outcome in the energy sector are likely to prevent any significant breakdown in gas trade. Furthermore, if Gazprom does pursue a strategy of increased trading on hubs rather than delivery to end consumers, its powerful bargaining position as a low cost producer with vast gas resources close to Europe could ultimately result in an expanding market share over the long term rather than the decline which currently seems to be the EU's preferred outcome.

⁶ Financial Times, 10 Nov 2014, “Putin snubs Europe with Siberian gas deal that bolsters China ties”

Further reading:

- Stern, J., Pirani, S., Yafimava, K. (2009) *The Russo-Ukrainian Gas Dispute of January 2009: A Comprehensive Assessment* NG 27, Oxford Institute for Energy Studies
- Honore, A. (2014) *The outlook for natural gas demand in Europe* NG 87, Oxford Institute for Energy Studies
- Stern, J. et al (2014) *Reducing European Dependence on Russian Gas: Distinguishing natural gas security from geo-politics* NG 92, Oxford Institute for Energy Studies
- Henderson, J. (2014) *The Commercial and Political Logic for the Altai Pipeline* Oxford Energy Comment, Oxford Institute for Energy Studies
- Stern, J., Pirani, S., Yafimava, K. (2015) *Does the cancellation of South Stream signal a fundamental re-orientation of Russian gas export policy* Oxford Energy Comment, Oxford Institute for Energy Studies
- Henderson, J., Pirani, S. (2014) *The Russian Gas Matrix: How Markets Are Driving Change* Oxford University Press for Oxford Institute for Energy Studies

Figure 1: Potential Outlook for Russian Gas Exports to Europe and China (bcm)



Source: Author's analysis

From South Stream to Turkish Stream: Underlying Reasons and Consequences of Transformation

By Natalia Ulchenko, Moscow

Abstract

The decision to halt South Stream, and reconfigure the project as Turkish Stream came as a surprise to many, and, indeed, the current geopolitical context makes reaching forecasts about the future development of large-scale energy projects almost impossible to make with any certainty. Keeping this in mind, this article lays out some thoughts on why Russian–EU negotiations on South Stream stalled, and the prospects for the future development and fulfillment of Turkish Stream. It suggests that the realization of Turkish Stream remains uncertain, and that its future will largely be determined by the wider context of development in Russia–Turkey, Turkey–EU and Russia–EU relations.

This article offers an interpretation of the recent and swift developments relating to the halting of the South Stream natural gas project, and the announcement of its reconfiguration as Turkish Stream. However, given the certain uncertainty surrounding this issue, it makes no claim to provide a final and exhaustive review of the subject, but is rather a reflection on the possible directions in which developments may go in forthcoming years. It is not that the interested parties are reluctant to make statements or comments regarding these drastic changes. However, these decisions and statements have been made under the influence of a complex global geopolitical setting that is still in a state of flux. In the current context, it is difficult, if not impossible, to make forecasts with any degree of certainty. Indeed, the destiny of the Turkish Stream project is itself not yet clear. This article thus aims to draw attention to some key points whose significance and consequences have already been defined with a good deal of certainty.

What Happened between Russia and the EU?

The primary task in accounting for the switch from the South Stream to the Turkish Stream project is to consider the key factors that have changed in Russian–European energy relations and which shaped the context in which this choice was made.

Firstly, it is important to remember that the project was initially conceived as “an important step towards the implementation of Gazprom’s strategy to diversify the routes for supplying Russian natural gas to Europe”.¹ In light of the current situation in Ukraine and the current uncertain global economic context, it would appear that an important aspect of such diversification is to develop a replacement route to that of gas shipments via Ukraine, so that Russian gas can be delivered to consumers in South-Eastern and Southern Europe via an alternative

route. “The role of Ukraine, as a transit country, will be reduced to zero”, Gazprom head Alexey Miller said on December 6, 2014, adding that “Gazprom has *de facto* abandoned Ukraine as a transit party”.² The effective contract with Ukraine that deals with the transit of the Russian gas expires in 2018. From that year on, Russia has resolved to renounce the transit services offered by Ukraine. “There are no other options for Europe to mitigate the risks associated with gas transit through Ukraine, except to rely on the new Turkish Stream gas pipeline”, Gazprom head Alexey Miller told journalists on January 14, 2015, following his meeting in Moscow with Maroš Šefčovič, Vice President of the European Commission, who is heading the Project Team “Energy Union”.³

The second change is that the intention is no longer to supply gas directly to the territory of European nations, and instead it will be made available up to the Turkish⁴ and Greek borders, from where the Europeans will have to make their own arrangements for it to reach their consumers. The objections to this new plan voiced by Maroš Šefčovič do not seem sufficiently convincing. Firstly, Šefčovič believes that the proposed volume of gas (reference is made to a projected volume of 63 billion m³ per year), “is, most likely, not needed for Turkey and the countries of South-Eastern Europe”.⁵ However, taking into consideration that this gas will be shipped *instead* of, and *not in addition* to, the gas that is currently being transported through Ukrainian territory, such a volume

1 [Gazprom Annual Report, 2013.](#)

2 “Miller o blokirivke ES ‘Yuzhnogo potoka’, nulevom tranzite Ukrainy i perekhode na novuyu model’ raboty”, *Moskovskii Komsomolets*, 6 December 2014.

3 “‘Yuzhnyi potok’ zakryt okonchatel’no”, *Neft’ Rossii*, 16 January 2015.

4 This is why the new project was named the “Turkish Stream”, at the suggestion of Turkish President R.T. Erdogan

5 “‘Gazprom’ ne sobiraetsya sozdavat’ infrastrukturu po ‘Turetskomu potoku’ v ES”, *Energetika i ZhKKh*, 16 January 2015.

does not seem to be unreasonably excessive. Indeed, in 2013, the amount of Russian natural gas shipped in transit via Ukraine was 86 billion m³. In other words, the proposed volume is, in fact, lower than the current level. Secondly, in an interview with *The Wall Street Journal*, Maroš Šefčovič said: “We are tired of being worried every summer if we would have enough energy in winter”.⁶ However, it should be acknowledged that Russia’s plans to develop the South Stream project were targeted at “building up a new sustainable infrastructure for gas supplies together with the European counterparts”.⁷ Indeed, in its updated version, the Turkish Stream, as well as discussions in the years prior to this, can be seen as aimed at insulating the European consumer from the impacts of any Russian–Ukrainian disputes over gas supply long before the present Ukraine crisis erupted. Finally, Maroš Šefčovič believes that as a result of the reconfiguration of the pipeline route, the reputation of Gazprom as a reliable supplier will be damaged, as “contracts always carry a reference to the point of gas delivery—and it is not the frontier between Turkey and Greece”.⁸ But, with respect to this last observation, it should be remembered that the EU was largely implicated in using protraction techniques to hinder the implementation of the project, which has eventually led to a change in the point of delivery. “If we are not welcome there [in Europe], it means we need to look for some other options, and the option that is being exercised now implies that we will bring all the gas volume to the EU frontiers”, S. Kupriyanov, a spokesman for Gazprom, has noted.⁹

Perhaps, the arguments put forward by Maroš Šefčovič are easily refutable because they lack substantiation, and seek to conceal the main reason that has caused the EU’s discontent with the South Stream project. However, the point is that Russia’s decision puts the EU in a most precarious position, whereby it is now confronted with an uncomfortable choice: Accepting the new version of the Russian project would effectively imply Ukraine’s exclusion from the gas transit system, which would have significant associated economic and geopolitical losses for Ukraine. Similar consequences might have been entailed if an earlier version of the project—the South Stream—had been accepted by the EU. However, during these initial stages of the project’s development, Russia was not accentuating so strongly its intention to force Ukraine out of the gas transit deal.

In a recent report, Edward C. Chow draws attention to several important factors underlying the Russian–European energy relationship.¹⁰ Europe will continue to import oil and gas from Russia, while Russia cannot shift its oil and gas export to Asia in the near-term. Hence, the Russian–European energy relationship is one of codependency. And, thus, ultimately it boils down to the economic terms for the trade of energy from Russia to Europe, and whether either side is politically willing to lessen its degree of dependence on the other and bear the higher costs of supply diversification by shipping or receiving oil and gas over greater distances utilizing expensive new infrastructure. Taking this into account, the best solution for all parties would be to ensure that Russia and Ukraine reach an agreement. The best case scenario would be an economic agreement.

However, currently for Russia, it is seen as preferable not to seek an agreement with Ukraine, but to strip it of its status as a party to the negotiating process. This choice was largely made according to political considerations. And, in view of the realities underlying the current conditions of bilateral relations between Russia and Ukraine, this decision has assumed an irreversible nature just because of its political implications. It is noteworthy that when Alexey Miller explained Gazprom’s decision to reconfigure the South Stream gas pipeline route, he specified that the main reason was the lack of commitment and hesitation on behalf of the EU in matters relating to its implementation, but not the Third Energy Package, whose terms might have been agreed by the EU and Russia. In this context, we can see that a key aspect in the Russian stance is that the termination of gas transportation via Ukraine is a matter of top priority, which for Russia must be addressed without any discussion. While the terms of gas sales to the European market are also a priority issue, but one which Russia considers can and must be negotiated. Insofar as the conclusion reached by Edward C. Chow on the codependency of Russia and Europe in terms of gas trade is correct, the EU and Russia have agreed to set up a high-level working group that should be entrusted with developing concrete aspects of the new plan to supply gas to the South-Eastern Europe.

What Can Be Expected in the Relationship between Russia and Turkey?

Having outlined several factors that saw Russian–European cooperation over the South Stream project stall, the article now turns to assessing the prospects for the recon-

6 “EU Energy Chief Says Russia’s Turkish Stream Gas Project Won’t Work”, *The Moscow Times*, 23 January 2015.

7 “Gazprom’ ne sobiraetsya sozdavat’ infrastrukturu po ‘Turetskomu potoku’ v ES”, *Energetika i ZhKKh*, 16 January 2015.

8 *Vedomosti*, 15 January 2015.

9 “Gazprom’ ne sobiraetsya sozdavat’ infrastrukturu po ‘Turetskomu potoku’ v ES”, *Energetika i ZhKKh*, 16 January 2015.

10 Chow, Edward C., “Energy Codependency” in Cohen, C. & Gabel, J. (eds) *Global Forecast 2015. Crisis and Opportunity* (Center for Strategic and International Studies, Washington DC., 2014), p. 44.

figured project of Turkish Stream within the context of the past, present and future Russian–Turkish relationship.

On the one hand, the Turkish Stream agreement between Russia and Turkey opens up new vistas for the development of bilateral interaction. Throughout the years in which the Justice and Development Party (JDP) has been in power, an ambitious plan to turn Turkey—a country lacking its own energy resources—into an international energy hub has been advocated and pursued. Under this policy-concept, Turkey's lack of energy resources is deemed as compensated for by the advantages that its geopolitical situation affords it, allowing it to play a critical role in linking energy-resource producing (Russia, Caspian Sea region countries) and energy-resource consuming countries.

In view of these ambitions, a provision within earlier agreements between Turkey and Gazprom that banned Russian gas from being re-exported to any third-countries became a stumbling block for the further development of the relationship. Hence, the recent removal of this provision is significant. Had it remained in place, Russia's share in the Turkish natural gas market would have been likely to decrease in relative terms over the long-term, due to the growing role played by alternative suppliers with whom Turkey has sought closer energy ties in recent years (notably, Iran and Azerbaijan already have significant stakes in the Turkish natural-gas market), even though in absolute terms the volume of gas imported from Russia would have remained the same. However, the sudden and unexpected decision to remove this provision has made it possible for Turkey to realize its ambitious strategic plan of becoming an international energy hub by extending the scope of its partnership with Russia.

It should be borne in mind that the politics of natural gas supplies to the Turkish market will not be significantly affected by the Gazprom decision, as the Turkish Stream pipeline is expected to replace the gas volume currently received by Turkey through Ukraine and the Balkans. But, as far as the transit arrangements are concerned, one actor among the global natural gas producers will be the first to take advantage of the new opportunities offered by Turkey, and there is no reason why this could not be Russia.

On the other hand, however, it should be remembered that Turkey found itself in an identical situation several years ago, and this did not lead to greater Russian–Turkish energy cooperation. During a visit by the then Turkish President, Ahmed Necdet Sezer to the Russian Federation in the summer of 2006, the prospect of constructing the Blue Stream–2 natural gas pipeline was discussed. This pipeline was supposed to duplicate the existing natural gas pipeline from Novorossiysk, but to do so from the Turkish port of Samsun and be bifurcated, in

one direction, to the South of Turkey and then to Israel, and in another, to the West and on to Europe. However, in 2005 negotiations regarding Turkey's application for membership in the EU were to the fore. Against this background, a decision by Turkey to implement the Blue Stream–2 project would have been seen as signal that Turkey was throwing down a challenge to its European partners, because it likely would have meant the shelving of the NABUCCO project (implying that Caspian Sea region natural gas delivery to Europe would be made not through Turkish territory but via Russia), which would have negatively impacted on Europe's core aim of diversifying its natural gas supply sources. So, Turkey was compelled to renounce the implementation of the Blue Stream–2 project, as it was apprehensive that pursuing it would have created serious problems for its relations with the EU.

During this period, the priorities of Turkish foreign policy could be clearly traced. For example, a 2007 election declaration issued by JDP referred to Turkey's relations with the EU and the US as “well established”, while emphasizing that they did not constitute the only options available, whereby Turkey did not intend to adhere to the logic of the Cold War or restrict the development of its contacts with the “biggest international actors in Eurasia, as Russia, China, Japan”. The declaration, however, stressed that “the government would make efforts towards the earliest implementation of the NABUCCO project”.¹¹ Ultimately, in 2007, Russia clearly formulated its own position on transnational natural-gas projects, making a formal announcement on its intention to pursue the South Stream project that bypassed Turkey.

As with the case of the Blue Stream–2 project, the most significant influence on the Turkish Stream project will be exerted by the present leadership of Turkey through its assessment of the relevance of and prospects for its relations with the EU, for whom the implementation of the Turkish Stream is burdensome both politically and economically (as a section of the gas pipeline is due to be constructed by the EU across its own territory). After the 2007 elections, Turkey—while formally pursuing the course of seeking EU membership and remaining a strategic partner of the US—has begun to more persistently position itself as an “influential global power”, which “has abandoned the posture of a country that reacted to international crises and resorted to defensive tactics”, and which “after formulating a regional and global vision, has become an actor blazing the trail for international development”.¹² The current program of the Turkish government explicitly illustrates that the

11 AK Party [JDP], *Güven ve İstikrar içinde durmak yok yola devam* (2007), p. 205, p. 226.

12 *Ibid.*, p. 210.

role of Turkey in the international arena has been greatly modified: today's Turkey is characterized "not as a country that follows other countries, but as a country that is followed by other countries". For the JDP government, partnership [on an equitable footing] is acknowledged to be a model for the advancement of relations with the US, while the basis for their advancement is deemed to be furnished through mutual respect. And the further progress in forging closer ties with the EU is conditional upon a very exacting request to allow visa-free movement for Turkish citizens within the EU territory.¹³

Western analysts contend that a process of strategic differentiation has been in evidence within Turkish foreign policy, referring to the example of Turkey distancing itself from European foreign policy by refusing to uphold the sanctions regime against Russia, with Russia considered to be "an important partner and a significant actor in regional cooperation".¹⁴ Turkish President Erdogan is strongly political invested in this revised version of Turkey's foreign policy, and is too sophisticated a politician to yield to the pressure from the EU concerning Turkish Stream. Rather, he is more likely to use this cost-free new leverage of Russian gas in his dealings with Europe. It is most likely that Erdogan will wish to position Turkey as a mediator in negotiations over the new format for gas deals between Russia and the EU, and then, perhaps, to go beyond the role of mediator on gas deals alone . . .

Although the Turkish Stream has many advantages for Russia, there is a certain risk in the fact that Turkey is not going to undertake any resolute actions, especially during the initial stages of the project. Many times in history it has been the case that, during periods in which relations between Russia (USSR) and the West are strained, Turkey reaches its peak of strategic importance, as it leverages greater interest from both sides to gain the maximum benefit for itself by employing the proven tactic of balancing opposing poles. This time of importance comes to an end when Turkey ultimately has to make a final choice between the two. This is why the Turkish political elite will try to evade this moment of definitive decision for as long as possible. So, alongside the point made by some analysts that Turkey has no clear vision for the future of Turkish Stream, it is also necessary to add that Turkey will be in no hurry to develop such a vision. Perhaps, it will make a few steps in this direction,

but Gazprom's expectations that by the second quarter of 2015 Russia and Turkey will sign an agreement on the Turkish Stream pipeline project may well not materialize.

There is also a certain degree of concern that Turkey's newly acquired strategic leverage—the Russian natural gas on its territory—could also be used adversely in relation to Russia itself. After the announcement was made about the reconfiguration of the South Stream route, many posed a question: "Is it feasible that Turkey will be another Ukraine?" Over recent years, some Russian analysts have suggested that the Turkish natural gas market is nothing more than a *bazaar*, because Turkey has been rather insistent in asserting its interests in all issues associated with the price of Russian natural gas. The basic arrangement behind the reconfiguration of the South Stream route involved a 6% price discount for Turkey. However, there is a certain rationale to assuming that Turkey, with its ambitious plans to become an energy-hub, has more far-reaching plans than simply retaining a portion of gas destined for European consumers on its territory. As for tough bargaining over the price, Turkey is likely to be true to itself for the time being and afterwards.

Finally, within the Turkish Stream framework, some complementary cooperative-tracks for Russia and Turkey may be identified in connection with the hypothetical situation in which, having agreed to a new route for gas shipments, Europe will entrust Gazprom with the responsibility of developing the gas supply infrastructure. Under such a scenario, thanks to Turkey, Gazprom will be provided with extra possibilities to comply with the requirements set out under the Third Energy Package, in particular, to allow a third parties to have access to the natural gas pipeline. For instance, either it might be possible to sell natural gas to Turkey and for it then to be supplied to Europe as gas from Turkey, or it might be possible to sell gas to Europe through Turkish gas traders (such traders have now emerged in the Turkish gas market—in the natural gas imports and wholesale sector—within the framework of market liberalization), which Gazprom has already bought a stake in (Bosphorus Gaz) or plans to buy a stake in (Akfel Gaz). These opportunities look more tentative than realistic at this stage, but they can turn into reality upon the completion of the Turkish Stream, within a period of three years.

About the Author

Dr Natalia Ulchenko is an Associate Professor at the Institute of Afro-Asian Studies (Moscow State University) and the Head of the Department of Turkish Studies at the Institute of Oriental Studies (Russian Academy of Sciences). She is an expert on Turkey's economic and political developments and international relations.

13 62. Hükümet Programı (2014), pp. 169–170.

14 Ibid., p. 174.

Energy Cooperation Between China and Russia: Uncertainty and Prospect of Development

By Li Lifan and Wang Chengzhi, Shanghai

Abstract

This article considers the burgeoning natural gas alliance between Russia and China. It suggests that the two countries are committed to developing their cooperation on constructing new pipelines and expanding their energy trade relationship. However, some challenges still remain. They must also manage the impact of the decline in international oil prices, and work out how best to coordinate their energy cooperation within China's "one belt and one road" strategy.

On November 9, 2014, China National Petroleum Corp (CNPC) and Gazprom signed a new Memorandum of Understanding (MoU) about the supply of natural gas from Russia to China. Gazprom has committed to supplying 30 billion cubic meters per year (bcm/y) for 30 years from Western Siberia to North-western China through the proposed Altai pipeline (we will refer to this pipeline as the Western route), with a notional start date of 2019. This new memorandum comes in the wake of the agreement signed in May, 2014 on gas supplies along the so called Eastern Route, and which was hailed as a sign of the new level of Sino–Russian natural gas cooperation. Additionally, the CNPC also signed an agreement with Rosneft on the so-called Oil Cooperative project for the Vankor Oil Field in Eastern Siberia. With this agreement, the two sides have demonstrated their intention to cooperate on the exploration of this oil field, and at Russia's invitation, the CNPC has pledged to purchase a 10 per cent stake in the field from Rosneft; the agreement also sets in place the principles for trade between the two parties. It thus seems that China and Russia are entering into a new "natural gas cooperation alliance". In the context of the decline of the international crude oil price, alongside Western sanctions on Russia, some important questions have arisen: How will Chinese–Russian energy cooperation develop in this context? What will be the impact of such cooperation? And is there any uncertainty about the future implementation of these energy agreements?

Quality and Uncertainty of the Natural Gas Pipelines Along the Eastern and Western Routes

At the present time, China and Russia have different attitudes toward, and judgments on, the expectations, implementation and international environment with regard to the two routes.

First, the legal status of the two projects is quite different. As has been publicized, the protocol on the Western route is only an agreement, specifying the amount,

time-limit and routes of gas supply. It is not a contract that is legally binding. The protocol on the Eastern route, signed in May 2014, is, however, a formal contract, which confirms and guarantees the future implementation of the project, and outlines both parties' legal responsibility for its implementation. This is a fundamental difference to the protocol on the Western route.

Second, Chinese and Russian expectations about and prioritization of the two routes are different. Generally speaking, the Chinese side is more interested in the Eastern Route, while Russia is more interested in the Western one. In terms of the volume of supply, the Eastern Route will render 38 bcm/y, and a supply contract has been agreed for 30 years. Although many details of the supply contract have not been finalized yet—such as financing and advanced payment—the gas supply for the Eastern Route is guaranteed by the fact that all of this volume will come from the gas reserves from a new gas field in Siberia. By comparison, the protocol agreed on the Western route is nothing other than a framework agreement, with many uncertainties unresolved as to its future implementation and viability.

For the Russian side, however, the construction of the Western route pipeline is expected to bring more profit than the Eastern route. Since Western Siberia is a place rich in matured gas fields and shelves, and—given the country's mining capacity—the construction of a single pipeline would be sufficient for the task of supplying the agreed volume of gas. On the contrary, the construction of the Eastern route requires the exploitation of the Chayanda and Kovykta gas fields in Eastern Siberia—an undertaking that will require a significant amount of investment. This is pushing Russia to turn to the Western Route. At the present time, with the Russian economy facing a downturn owing to the sanctions applied by the West in response to the Ukraine crisis, the Western Route—as compared to the Eastern Route—seems preferable, as it requires less investment and a shorter time-frame for construction, and is thus expected to realize a stable cash flow quicker by exporting natural gas to China faster.

However, in a buyer's market the buyer is always keen on diversifying the sources of its imports. China's western provinces have already begun to import gas from Central Asia, and the import of Russian gas into western China via the Western route would not only impact on the current China–Central Asia gas trade structure and make China more dependent on a single supplier, but it would also increase pressure on the transportation capacity of “the West to East” gas pipeline network for delivering much needed energy to eastern China. Considering that both the center-of-economic-gravity and greatest market demand lie in the eastern part of China, there is no urgent need for China to build the Western route pipeline. In the meantime, Northeastern China is currently lacking LNG (Liquefied Natural Gas) import equipment and facilities, and thus Beijing would like to give priority to the construction of the Eastern route pipeline.

Generally speaking, then, both Russia and China have their own respective advantages to use within their negotiations over their energy cooperation: Russia is able to push for high pricing based on its abundance of energy resources; while China can also leverage significant pricing-power because of the huge market opportunities it can offer exporters, and because of its alternative existing gas supply arrangements with Central Asia (including LNG) and the exploitation of its own natural gas fields.

The Decline of the International Oil Price and Its Impact on Energy Cooperation Between China and Russia

In 2013, revenues from oil and gas exports accounted for 68% of Russia's total export revenues. According to Russia's financial forecast for 2014, oil and gas was expected to account for 48% of the total export revenue. Morgan Stanley has estimated that should the price of crude oil fall by \$10/cubic meter this equates to a loss of \$32.4 billion in oil and gas revenue for Russia, which would represent 1.6% of Russia's GDP. Calculating by this ratio, Russia's GDP for the last few months of 2014 suffered a loss of around 4.8% as result of the decline in oil prices, which equates to a \$60 billion decline in the government's budget revenues. Recently, the Russian federal government submitted a draft budget for 2015 to parliament, stating that the governmental budget can only be balanced if the international oil prices returns to \$96 per barrel or above.

Meanwhile, the decline in the price of crude oil has reduced the cost of raw materials for Chinese manufacturers, enlarging their gross profit as a result, with the first batch of such beneficiaries likely to include companies dealing with aviation, cruises, consumer goods,

shipping and manufacturing. However, the decline in global oil prices is not likely to be a long-term trend, and Chinese enterprises should continue to extend overseas business by investing in the upstream industry abroad. In addition, the fall in oil prices will stimulate the depreciation of other energy prices, such as iron, ore and coal, which means that the cost of economic operations will also be reduced. The decline in international oil prices has led to reduced investment in oil production and pipeline construction worldwide, which is unfavorable for Chinese companies seeking to pursue a “going out” strategy, especially for those focused on the Russian mining business. Therefore, Chinese oil or gas companies should take measures to maximize profit based on their respective conditions in face of the current downward trend of international oil prices that is expected to last in the near future.

Historically, China has lacked a mechanism for anticipating energy price fluctuation, as well as substantive oil storage facilities. In July 2008, the international oil price soared to \$140/barrel and China misjudged this pricing trend. It believed that the price would keep rising as oil was considered a non-sustainable source of energy. As a result, when it then sharply fell, China lost a lot of foreign reserves, and as a result of the depreciation of the dollar (the currency in which oil is traded) during the past 10 years and China's huge investment in the government bonds issued by Western countries, much of these losses will never be recouped. Taking this into account, China can benefit from Russia's experience in early forecasting of critical moments in the trajectory of international price of oil.

In the current period of low oil prices, China has gained more influence within the international market as the largest buyer of oil and gas products. The next stage for China–Russia negotiations, in our opinion, is for Russia to take a more positive approach towards the construction of the Eastern route pipeline, paying particular attention to matters such as prepayments and cooperation modes. Considering that China has been a loyal partner within the Sino–Russian strategic cooperative partnership, energy cooperation between China and Russia is very unlikely to come to a stop in the near future due to any minor disputes. Indeed, China does not want to exclude the possibility of further cooperation with Russia in the exploration of energy resources in the Arctic region and the deep-processing of such energy products. While for Russian energy enterprises, the huge investment capital available via the Chinese-driven and supported Silk Road Fund—created last year to support connectivity across Asia and Eurasia—offers significant opportunities to realize the “dream” of Russian revival.

How to Promote the Sino–Russian Energy Cooperation Along the Silk Road Economic Belt

Russia largely holds a positive attitude towards China's "one belt and one road" proposal, on which China's new foreign policy conception of a New Silk Road is based: this is the Silk Road Economic Belt and the Maritime Silk Road. This policy focus includes cooperation with Russia on energy exploration and infrastructure construction, because this is considered of strategic importance to both countries and their relationship to the international energy market. For Chinese–Russian energy cooperation to further develop within the context of the New Silk Road project, the two states should focus on three areas:

Firstly, the full implementation of their existing agreements, and a further expansion of bilateral energy trade. With the significant agreements reached on bilateral trade of energy products during the last year, it is necessary for both states to promote the construction of the two agreed major pipelines by tackling the technical and financial problems related to their realization as soon as possible, in order to guarantee the start of gas supplies in 2018 and then a gradual increase in the volume of gas flow after that.

Secondly, enhance the connectivity between the two states' energy industries within the framework of Silk Road Economic Belt. Both sides should concentrate on

speeding up the construction of the Western route pipeline and promote agreements on the construction of new pipelines, in order to substantially improve the capacity for energy transportation between Russia and China, diversify the modes of energy transportation between them, conduct research on offshore oil and gas transportation opportunities, reduce pressures on the security of energy transportation, and build a new pipeline to the Indian Ocean aimed at enhancing transporting capability in the future.

Thirdly, deepen Sino–Russian cooperation on energy technology. There is great potential for Sino–Russian cooperation on the exploration of non-conventional oil and gas, and the development of new energy technologies, including cooperation on their utilization. For example, Russia plans to upgrade its public transportation system by substituting gas for oil and applying zero-tariffs on electric vehicles, and would likely be interested in investing in the relatively developed new energy vehicle technology that has been developed in China. At the present time, cooperation between Chinese and Russian enterprises on new energy fuelled automobiles is gradually taking shape, and successful cooperation between the two countries' on such new energy technologies and their utilization could then be used as an example for similar cooperation among other countries rich in gas reserves located along the Chinese "One Belt and One Road" New Silk Road route.

About the Authors

Li Lifan is an Associate Research Professor at the Shanghai Academy of Social Sciences. He is the Assistant Director of the Institute of International Relations and Executive Director of the Center for Russia and Central Asia Studies. Wang Chenzhi is an Assistant Professor at the Shanghai Academy of Social Sciences. He is a Research Fellow within the Institute of International Relations.

ABOUT THE RUSSIAN ANALYTICAL DIGEST

Editors: Stephen Aris, Matthias Neumann, Robert Ortung, Jeronim Perović, Heiko Pleines, Hans-Henning Schröder, Aglaya Snetkov

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Research Centre for East European Studies • Publications Department • Klagenfurter Str. 3 • 28359 Bremen • Germany

Phone: +49 421-218-69600 • Telefax: +49 421-218-69607 • e-mail: fsopr@uni-bremen.de • Internet: <www.css.ethz.ch/publications/RAD_EN>