

Nord Stream 2: May Cooler Heads Prevail¹

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Within the space of a few months, Russia has conducted a radical strategic change towards Europe in its gas policy. Following the announcements in 2014 of a major shift towards Asia, the cancellation of the South Stream project and its replacement by the Turkish Stream, relations with European gas companies have been strengthened since mid-2015.

Russia's initiatives to replace its European partners are now to be viewed as part of a transformed international gas landscape. Tensions in the liquefied natural gas (LNG) market following Fukushima have given way to market surpluses. These are characterised on the one hand by lower growth in Asian demand for LNG gas, and on the other hand by the arrival on the market of new major exporters such as Australia and the United States. A new era, more favourable to gas importing countries, has opened up since the end of 2014. Moreover, the key pivot to Asia, expected by Moscow in 2014, is still far off. Discussions with Beijing about the project for a Western route proved to be more difficult than expected. Similarly, negotiations between Turkey and Russia on the Turkish Stream project have been very laborious, having been interrupted for several months because of diplomatic rows between the two countries. Finally, Russia's room for manoeuvre has narrowed, given the collapse in oil and gas prices and Western economic sanctions, which are weighing heavily on its economy. And the increased competitiveness of Russian oil companies due to the ruble devaluation will not transform this situation sustainably.

The Nord Stream 2 project

Nord Stream 2 was first announced at the St. Petersburg forum in June 2015. It was formalized by a shareholders' agreement in September 2015 between Gazprom, the German companies Eon and BASF, France's Engie, Dutch Shell and Austria's OMV. The pipeline would allow Moscow to secure its main market in Northwestern Europe in the long term, which represents 58% of consumption of the EU28.² In

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particular, it would give Gazprom the possibility of limiting transit through Ukraine, which at present is the main way for Russia to supply gas to Europe. In 2015, 39% of European imports of Russian gas passed through Ukraine, compared to 30% via the Nord Stream and 27% through Belarus.³

Nord Stream 2 would follow the same route as the first pipeline and would carry the same capacity (55 billion cubic meters (bcm)) starting from 2019 to 2021: in other words, it would be possible to deliver 110 bcm of Russian gas directly to the German border. It would therefore be Europe's main supply route after the Ukrainian route. Technically and economically, this project follows the strategy of the Russian giant of retaining 30% of the European market, while Gazprom already has excess capacity in Europe estimated at 100 bcm per year. It should be recalled that in 2015, the gas flows through Nord Stream 1 amounted to 39 bcm (with a technical capacity of 55 bcm), 64 bcm via the Ukrainian route (technical capacity of 140 bcm) and 37 bcm via Belarus (technical capacity 38 bcm).⁴

Europe in turn must deal with a growing dependence on gas imports, given the expected collapse of its domestic production. According to the International Energy Agency (IEA), EU's gas consumption will be 475 bcm in 2035 (the same level as in 2013)⁵ and its gas imports are expected to increase by nearly 80 bcm in 2035 compared to 2013. The downward trend in domestic production accelerated in 2015, with a decline of 9% compared to the previous year, because of the limits imposed on the production of the Groningen field, which has been hit by earthquakes.⁶ The outlook for European supplies leaves little room for alternatives to Russian gas. Many uncertainties hang over the evolution of imports from North Africa, especially Algeria and Libya. The southern corridor is planned to supply 10 bcm in 2019, via the Trans-Adriatic Pipeline TAP, but further shipments face numerous uncertainties, as do gas transport opportunities to Europe from the eastern Mediterranean. With its many LNG terminals and given the new landscape on the world gas market, Europe intends to focus on LNG imports to enhance its energy security and diversify its sources of supply.

Faced with this growing European dependence on imported gas, the extension of Nord Stream would allow Europe to secure access to a very competitive source of gas over the long term and diversify procurement routes (though not sources),⁷ reducing also transit risks.

It would also guarantee the possibility to European suppliers to put into competition and arbitrate between different sources of gas (from Norway, Russia and LNG) over the long term, in the north western region of Europe, with its strongly interconnected hubs, convergent prices and volumes indexed to 92% on the gas markets.⁸

Moreover, since the announcement of this project, Gazprom has shown itself to be more conciliatory towards European rules and respectful of regulation, following a decade of tensions with the European Commission (EC). Since September 2015, the Russian company has even allocated gas capacity at some European delivery points through the auction mechanisms. Similarly, better conditions for European customers have been obtained during negotiations of contractual terms with the Russian giant, especially in recent months by Uniper (a subsidiary of Eon) and Engie. Thus, the prospect of this major project is maybe promoting a more peaceful dialogue with the Russian partner.

A project leading to divisions

The debate on the extension of Nord Stream however goes far beyond the question of energy, because it involves the political relationships between Russia, Ukraine and the EU, in the context of sanctions imposed in 2014 after the annexation of Crimea. This gas project is therefore leading to strong divisions among Europeans. During discussions at the European Council in December 2015, the project pitted those stressing the merits of its economic and commercial benefits to Europe, primarily Germany, on the one hand, against members who fear greater dependence on Russian gas and a weakening of the energy security of some Member States on the other hand. Poland, Slovakia, Hungary, Latvia, Lithuania, Estonia and Romania are fervent opponents of the project, and expressed serious concerns in a letter to the EC in November 2015. Some states have also stressed to the EC the economic consequences of this project in terms of lost transit revenues. Bulgaria, Greece and Italy are also hostile to the Nord Stream 2, as the pipeline will remove all prospects of their developing an alternative gas corridor in southern Europe. Several voices have also been raised, including that of the CEO of the Italian company Eni, denouncing the risk of gas price increases in southern Europe. Germany in turn sees itself becoming a central gas hub for Europe, as nearly all Russian gas would transit through its

territory. The project is supported at the highest levels of the German government, with Chancellor Angela Merkel invoking its commercial advantages. Debates on Nord Stream have also gone beyond the borders of Europe, and have led the US Secretary of State John Kerry and US Vice-President Joe Biden to express their views on the negative political and economic effects of the project on Ukraine. Kiev will face a shortfall in income of over \$1.6 billion per year. However, as the IEA has recalled, it is unlikely that the extension of Nord Stream will lead to a total bypass of the Ukrainian route, because even with the construction of Nord Stream 2, Turkey, Moldova, the Balkans and part of Italy will continue to be supplied via Ukraine, around 40-45 bcm per year⁹, excluding the Turkish Stream.

Nord Stream 2 is also angering some European leaders, at the time Europe is building an Energy Union, initiated by the Polish President of the EU Council Donald Tusk in April 2014, against the background of the Ukrainian crisis. Maroš Šefčovič, the vice-president for the Energy Union, has stressed that Nord Stream 2 may alter the landscape of the European gas market, without actually allowing Europe to access a new supply source, while increasing Russia's surplus capacity with Europe.¹⁰ Rarely therefore has an infrastructure project lead to so much debate in higher political and diplomatic circles.

Beyond political considerations, the battle between the Russian giant and the EC is in fact taking place on legal issues. Like Nord Stream 1 and South Stream, the Nord Stream 2 project will have to deal with European rules and comply with the requirements of the Third Energy Package concerning unbundling and third-party access, given that the pipeline will pass through the economic zones of several EU Member States. The project promoter cannot be the energy producer, gas network operator and supplier at the same time. Article 46 of the Gas Directive of 2009 provides for the possibility of obtaining an exemption of these provisions for new gas infrastructures such as interconnections, as long as the investment increases competition and improves the security of supply in Europe. Exemptions are granted by national regulators and submitted to the EC for approval, and they are decided on a case-by-case basis, after detailed analysis of a project's compliance with different criteria. This arrangement already existed in the Gas Directive of 2003 and involved several gas

projects, the first being granted in 2005 to the BBL gas pipeline which links the UK to the Netherlands. More recently, shareholders of the TAP pipeline obtained a 25-year exemption for their project from certain rules of the internal market, in particular those concerning third-party access. It may also be recalled that the OPAL pipeline, the landfall of the Nord Stream 1, was exempted to allow transit capacity through Germany to the Czech Republic for 50% of its deliveries, over a period of 22 years, following very tough negotiations with the EC. The latter was to have ruled on full exemption by the end of 2014. But this ruling was never given by Brussels because of the deterioration of relations with Russia.¹¹

Another legal blow to the project, which was unexpected for observers, came from Warsaw in the summer of 2016. The Polish government has been leading opposition to Nord Stream 2, through its competition authority. The latter has indeed been worried about the consequences of this project on the dominant position of Gazprom in the Polish market. With many assets in Poland, partner companies in the project needed to obtain approval from this watchdog, at the risk of being penalized in their other activities. Given the objections raised by the Polish authorities, the consortium partners announced they had given up their plans to form a joint venture, on 12th August 2016. They now need to think again about the organisation of the economic cooperation for the project to be created.

Is this a reflection of a two-speed Europe in gas?

Nord Stream 2 highlights the deep fracture within the European gas market. On the one hand, Western Europe has a liquid market for gas and various sources of supply. It is seeking greater competitiveness and arbitrage opportunities between different sources of gas. On the other hand, Eastern Europe is striving by all means to reduce its dependence on Russia's grip, and increase its room for manoeuvre in negotiating with Moscow. Though they are not yet fully used, the LNG terminals commissioned in Lithuania and Poland give these countries greater weight in gas trade negotiations with Russia. Even Ukraine is gradually freeing itself from the Kremlin's gas supremacy: in 2015, imports by Naftogaz from Russia accounted for 25% of Ukrainian supplies (7 bcm), while the reverse flows coming mainly from Slovakia, but also from Poland and Hungary amounted to 10 bcm. The fears of the critics of Nord Stream 2 therefore go far

beyond the economic losses related to transit. By losing their status as compulsory transit routes for Russian gas to Europe, some Eastern countries fear that the balance of power on gas issues will shift even further in favour of Moscow.

As far as gas is concerned, commercial motivations have often prevailed over political considerations. Investment decisions in large gas infrastructure projects require a high degree of visibility for investors, both in terms of the gas resources that feed the pipeline and market outlets. This uncertainty over resources was an essential aspect of the factors that destroyed the prospects of the Nabucco project, despite strong political support from Brussels. As for the South Stream project, it had to pass through many countries before reaching the main areas of European consumption, with a total cost estimated at \$ 40 billion. Investors in Nord Stream 2 can rely both on the abundance of Russian gas resources and direct access to the main European market at a much lower cost (\$ 9 billion). But if the economic conditions are met for this project, the political obstacles are still numerous.

Given the Polish setback and the recent rapprochement of the Russian and Turkish presidents which has led to the resurrection of the Turkish Stream project, the path to Nord Stream 2 could still be long and bumpy.

1. This paper is an English translation of the Edito published in French on September 23rd, available at: www.ifri.org/fr.

2. Taking into account consumption in Germany, the United Kingdom, France, the Netherlands and Belgium. Data from Cedigaz.

3. Source: "Quarterly Report on European Gas markets", EC, DG Energy, Volume 9, Q4 2015, Q1 2016.

4. Source: Platts.

5. According to the New Policies Scenario of the WEO, 2015.

6. *Ibid.*, EC.

7. See S. Cornot-Gandolphe, « The US Natural Gas Exports: New Rules on the European Gas Landscape », *Études de l'Ifri*, Ifri, June 2016.

8. According to the report of the International Gas Union.

9. *Gas Medium-Term Market Report 2016*, International Energy Agency, June 2016.

10. Speech by vice president Maroš Šefčovič at a conference organised by the European Parliament 6 April 2016.

11. See M.-C. Aoun & S. Cornot-Gandolphe, "The European Gas Market Looking for its Golden Age", *Études de l'Ifri*, Ifri, October 2015.