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The EU-Russia Energy Dialogue: Competition Versus Monopolies

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Abstract

Russia and the European Union have clearly entered a new stage in their energy relations, defined by a growing asymmetry between a strengthened national monopoly on the supply side and a gradual opening of markets in Europe. In this context, a multitude of new approaches to EU-Russia energy relations have been voiced recently by a wide variety of experts. Unfortunately, many of them involve "defensive" solutions, driven by lack of mutual trust on both sides. Is a positive approach nevertheless still possible? The paper argues that competition is a key universal value in the development of a new and sustainable energy relationship between Russia and Europe. It is clear that EU competition regulators should take the lead in setting up a new framework for EU-Russia energy relations in the future. The success of their endeavors will not only determine the security of energy supply for European consumers, but also that of the Russian and Eurasian energy markets.

Introduction

Russia and the European Union have clearly entered an new stage in their energy relations. Old realities have faded away, as wholesale energy supplies from Russia to the European border are inevitably being replaced by deepening market integration. The increasing maturity of Russian energy companies is driving their desire to enter the European energy markets, while European companies are seeking upstream energy production partnerships within Russia in order to secure their downstream market positions in Europe.

The political environment is also changing: on the one hand, competition rules in the EU are becoming a more determining factor, as traditionally vertically integrated energy markets are changing to become more liberalized and opened, while on the other, centralization and concentration of control are gaining more and more influence on the supply side, in Russia. This is happening at the time when European dependence on energy imports is rapidly growing (the new European Commission's Green Paper, *A European Strategy for Sustainable, Competitive and Secure Energy*, recognizes that, in the next 20 to 30 years, around 70% of the EU's energy requirements will be met by imported products, compared to 50% today[1]), and Russia remains one of Europe's vital suppliers of energy, likely only to increase its position in the future.

In this environment, a multitude of new approaches to EU-Russia energy relations have been voiced recently by a wide variety of experts. Many of them, unfortunately, involve "defensive" solutions, driven by lack of mutual trust on both sides. On the Russian side, this is manifested by preventing European investment in the upstream production of oil and gas, while on the European one, it is through the diversification of energy imports in order to minimize dependence on Russian supplies. It is clear that such approaches are politically driven, rather than reflecting a natural convergence of Russian and European markets backed by geographical proximity and historical economic ties.

But is there a room for positive approach? The purpose of this article is to consider one particular aspect of the EU-Russia energy relations: the gap between the EU Commission and its avowed principles of free-competition on the one hand, and the energy monopolies of Russia and Europe on the other.

[1] Commission of the European Communities, Green Paper, *A European Strategy for Sustainable, Competitive and Secure Energy*, Brussels, 8 March 2006, <http://ec.europa.eu/energy/green-paper-energy/index_fr.htm>.

Stumbling Blocks in the EU-Russia Dialogue

As a rule, Russia tends to build separate relations with European nations on a country-by-country basis, in respect to both governments and energy companies. This has stemmed from quite a natural, historical, development: most political and commercial relations in the energy sector were established long ago in the Cold War era, when the common EU institutions were not yet functioning effectively, at least in the area of energy policy. Most of these relations were based on bilateral agreements between vertically integrated European companies, nationwide or regional monopolies—frequently with tight connections to national politicians and governments—and Russian companies that featured an even greater extent of vertical integration and political connections. Bilateral ties have thus developed very much as cartel-like relations, which tend not to be very transparent, and very protective of the market position of European importers of Russian energy resources. The contractual framework was developed to fit this format, including many elements concerning the protection of the market power of European gas importers (long-term contract duration, destination clauses) in return for conditions favorable to gas exporters ("take or pay" conditions). This was particularly true with regard to gas supplies, where vertical integration largely continued to dominate both in Russian and European cases.

However, as the European integration pressed on, new approaches to common European policy and rules of the game began to emerge, which promoted fair competition and open markets policy, thus challenging the established framework of relations with Russia and the European countries importing its energy. Moreover, the internationalization of energy markets also began to change the energy market's landscape—particularly in the area of gas supplies, due to the rapid development of new pipelines, and more particularly to the increase in LNG supplies, which inject the market with greater flexibility. It was obvious that the old framework (single supplier-single, wholesale buyer) did not exactly fit into the new competition-friendly format of the European energy market. Multiple disputes involving the European Commission on one hand, and Russian and European energy monopolies on the other, had raised several key issues of disagreement:

- the dispute (subsequently resolved) over "destination clauses" in long-term gas supply contracts between European companies and Gazprom that were clearly protecting European partners of Gazprom from competition;

- the dispute over Russian ratification of the Energy Charter Treaty, and Russian reluctance to allow free access to European markets for Central Asian gas;
- most recently, the tensions between Russian state-linked energy monopolies' ambition to enter Europe's downstream energy markets, and the wariness of European competition authorities to such a development.

Breaking the deadlock of this old model of Russian-European energy relations and bringing it into a new, more competitive environment is key to ensuring that energy relations will be sustainable in the future. As the International Energy Agency has recently noted in one of its background papers, "the growing asymmetry between stronger national monopoly trends in energy markets structure among suppliers and a slow progression towards market opening in Europe are widely recognized."[2] As the IEA puts it, the lack of market diversity throughout Eurasia creates distortions: this is the case, for example, with the sales of Central Asian gas to European consumers by Gazprom at a considerable price differential but also, more generally, because European consumers face the risks involved in a monopoly market: lack of transparency and sustainability of Eurasian energy supplies. Yet it is important for Europeans to understand that the position of Russian monopolies is to a large extent supported by certain national European companies—from Germany, Italy, or others—particularly those that have inherited the legacy of vertically integrated monopolies and thus have their own reasons to be reluctant to the opening of European energy markets and the introduction of competition.

[2] IEA working paper.

The Losers Are the Consumers

This alliance is disadvantageous to both Russian and European energy consumers. European gas consumers have already been affected by this situation more than once. Russian gas deliveries were disrupted voluntarily on two occasions, for example: first during the Russian-Belarus gas crisis of January 2004, and second during the Russian-Ukrainian gas crisis of January 2006—both of which involved intentional gas supply cuts by Russia that were not backed by proper measures to ensure the continuation of gas transit through both Belarus and Ukraine. Yet deliveries have also been disrupted involuntarily, when the extreme winter temperatures of January and February 2006 saw peak seasonal demand for gas in Russia, transit countries, and Europe as a whole translate into gas shortages for many consumers in all these areas. Although most end-users of gas were not directly affected by these supply disruptions due to large underground gas reserve stocks in Western Europe, which helped to mitigate the consequences of disruptions, these are still worrying trends, particularly when considering the likelihood of both types of crises occuring again in the coming winters. This risk remains quite high, both because Russian gas relations with both Belarus and Ukraine continue to feature high degree of medium- and long-term uncertainty, and because the possibility of physical unavailability of gas throughout Eurasia in the peak-demand winter periods remains strong due to declining gas production of Gazprom's mature gas fields, and under-investment in the development and production of new gas areas in the past decade. On this last subject, for instance, the Institute of Energy Policy[3] foresees a deficit of gas supplies to Russian and European customers of 100 billion m^3 per year in 2010 compared to actual demand. Even the West has started to worry openly about Gazprom's ability to provide Europe with enough gas: "Gazprom has not invested enough in developing new fields or enhancing recovery in existing fields to offset the decrease in its three major gas fields," Mr. Claude Mandil, executive director of the International Energy Agency, said in an interview given to the International Herald Tribune in July 2006.[4]

European companies purchasing gas from Gazprom, however, tend not to disclose the information on the real situation concerning supply disruptions, preferring instead to fiercely defend Gazprom in public, by claiming that "everything is OK," "supplies are reliable," "we (and only we) can handle Gazprom," and "most problems exist only in the imagination of politicians and journalists." This can be partially understood because of these companies' need to deal with Gazprom, and that any critical remarks

[3] Editor's note: This Institute, based in Moscow, headed by the author of this article.
[4] J. Dempsey, "Energy Agency Criticizes Gazprom," *International Herald Tribune*, 6 July 2006.

they might make would likely have an immediate and negative effect on these relationships. But this interpretation of the situation is simply misleading the Europeans into misjudging the extent of the real risks involved in Russian gas supplies, and thus limiting Europe's ability to work out the effective solutions of the Russian supply problems. This position also gives Gazprom a lot of additional political leverage, as well as increasing gas market inequalities on the European space.

It is important to understand that Russians are also suffering from this monopoly environment in the gas sector: shortages of gas supply due to systematic under-investment in developing new areas of production during the history of Gazprom's existence has led to severe constraints to economic development and climate change policy. For the first time, the Russian power industry faced limited gas supply during the summer months of 2006, a time traditionally low in demand. In January and February 2006, gas supply cuts to power stations in central Russia reached 80-85%, as compared to base contractual volumes. The power generation sector was forced to switch to alternative fuels, first with fuel oil, and then with coal as well. It is obvious that this is rather costly (Russian power stations spent an additional US$ 50 million a week during this period on the purchase of fuel oil), and that it leads to severe increases in carbon dioxide emissions (according to calculations by RAO UES, the Russian power monopoly, average carbon emissions at the Russian power stations from burning of fuel oil are 40% higher than when burning gas).

It is also obvious why these problems remain unsolved. A company in a monopoly position prefers to invest in the expansion of its monopoly power rather than engage in more long-term and risk-laden upstream production development projects. In the past three years, for instance (2003-2005), and after more or less sustainable windfall export revenues, Gazprom has spent nearly 14 billion euros on the acquisition of shares in companies operating *outside* the gas sector—in oil, petrochemical, power, equipment manufacturing, and construction sectors—backed by the state's strong support and by policies targeted to increase the Russian state's influence in these sectors, which are clearly associated with political goals. This is more than had been invested in the development of upstream gas production in a decade.

Such a strategy is to be expected from a monopoly that is unchallenged by competition: rent-seeking and expansion of monopoly power become priorities, rather than modernization and customer satisfaction. Modernists and reformists in Russia have long clamored for a fundamental resolution of this issue by limiting the monopoly environment in the Russian energy sector (particularly gas), by encouraging market reforms in the Russian gas sector, including the restructuring of Gazprom and the encouraging of competition, and thus indirectly resolving the problem of under-investment in the development of upstream gas production. But such plans were prevented by President Vladimir Putin, for whom retaining a monopoly was critical in order to maintain leverage in various issues of domestic and international politics.

European Divisions and Disillusions

It is clear that the practice of relying on non-transparent bilateral ties between historically vertical-integrated European energy monopolies and Gazprom will not be sustainable in the future if the goal is to meet Russia and Europe's goal of "energy security." This is a crucial issue when considering that, according to the European Commission, "...the EU needs to have a clearly defined external energy policy and to pursue it, at the same time at both national and Community level, with a single voice."[5]

It is, of course, up to Europeans to decide how to best achieve this goal. Yet it is time to recognize that leaving the Russia-Europe energy dialogue to European downstream gas monopolies and the various governments that back them is an approach that is doomed to failure. First of all, this old model will not help prevent supply crises, caused either by under-investment or political maneuvering. What is worse, it tends to mislead the European public, labeling the legitimate concerns over the Russian energy supply reliability as "white noise."

It should instead be widely recognized that, at least in energy affairs, common European institutions should be given a more important role in negotiations with Russia. Naturally, a lot of these questions remain purely commercial in nature. However, the following principles are nevertheless important to bear in mind:

- the choice of partners in upstream development by Russian energy monopolies should not become the exclusive market of a select few Russian and European companies operating on the European energy markets in a way that threatens competition;
- the development of long-term contractual partnerships should involve competitive access to all wholesale energy buyers in purchasing gas from the suppliers;
- access to downstream assets on European markets should be provided while taking into account the monopoly role of certain suppliers in the upstream energy production sector, in such a way that it encourages the opening of the production sector to competition.

Thus, competition turns out to be a key universal value in developing the new sustainable energy relationships between Russia and Europe. If strict compliance with competition rules is ensured, the opening of markets will provide greater interdependence between the parties, and governments will be forced to take this into account; at the same time, this

[5] Commission of the European Communities, Green Paper, *A European Strategy for Sustainable, Competitive and Secure Energy*, Brussels, 8 March 2006.

will minimize the risk of downstream monopolization by the energy producers. Competition rules must therefore block the downstream mergers and acquisitions, most desired nowadays by Kremlin, which tend to threaten European energy markets with such monopolization. For instance, while the new Russian law ("On Natural Gas Exports," signed into law by President Putin on 19 July 2006 and which legalizes Russian gas export monopoly *de jure*) is in force, the whole concept of Gazprom gaining access to the European energy markets that are opening up for competition ought to be rethought. Indeed, there can hardly be any effective downstream competition with a total legal monopoly on the supply end.

Russia must also recognize this fact. In addition, stronger enforcement of EU competition rules would very likely encourage changes within Russia itself, as the institutionalization of a monopoly environment there would seriously limit the opportunities for expansion of companies like Gazprom on the European markets, whereas privately-owned companies without monopoly status would find this much easier—as was the case, for instance, of Russian private oil companies Yukos and Lukoil, which had no problem acquiring important energy assets in Slovakia, Lithuania, Rumania, Bulgaria.

The competitive choice of European partners in establishing energy production joint ventures in Russia is also critical, as this can influence the market monopoly situation on both ends of the supply chain. At the moment, this process is extremely non-transparent—witness the process of selecting partners for the development of Shtokman offshore gas field in the Barents Sea, which has been going on for over two years already and still has no end in sight. Even long-term partnerships with Gazprom, considered "solid" by the public, do not guarantee access to Russian upstream: German E.ON-Ruhrgas, for example, the largest direct investor in Russian hydrocarbon industry by far—controlling 6.4% stake in Gazprom—was not able to negotiate a solid agreement on access to South Russkoye gas field in Eastern Siberia for years. Only in July 2006 was a framework agreement on this issue reached with Gazprom, while the actual signing of the final agreement has been delayed again.

The arbitrary and selective process for choosing partners in the upstream development of gas production under non-transparent criteria currently appears to be the prominent way of doing business. At the end of the day, however, this process can and should be influenced by European competition regulators, as even Gazprom had been announcing serious expansion on the European market, both in quantitative terms (up to 178 bcm of gas supplies by 2008, and up to 10 bcm to UK market alone by 2010) and qualitative ones (plans to acquire downstream European energy assets). On the other hand, European energy supplies are not so dependent on Gazprom that the situation warrants desperation: for most EU-15 countries importing Russian gas, the share of Gazprom's supplies in the primary energy consumption is below 10% (Austria and Finland being notable exceptions), and of the new EU member countries, only in Hungary and Slovakia do the shares of Russian gas supply come close to representing a third of primary energy consumption. These, however, are precisely the countries that would benefit from the Baku-Tbilisi-Erzurum and Nabucco pipelines when they start delivering non-Russian gas imports—which is how Gazprom's market positions in Southeastern Europe will be most severely challenged.

Dependence on imports of Russian gas in Europe is therefore considerable, but it is not catastrophic enough to prevent tough action against monopolistic trends, particularly in the area of competition protection.

European countries' dependence on Russian gas

Country	Imports of Russian gas in 2005, mtoe[6]	Primary energy consumption in 2005, mtoe	Percent Share of Russian gas supplies in primary energy consumption
Hungary	8.1	24.9	32.5%
Slovakia	4.9	18.2	27.2%
Turkey	16.2	89.7	18.1%
Austria	6.1	34.6	17.7%
Finland	4.1	25.6	15.8%
Czech Republic	6.7	44.4	15.0%
Bulgaria	2.8	20.3	13.7%
Italy	19.7	183.9	10.7%
Romania	4.1	39.8	10.2%
Germany	31.4	324.0	9.7%
Poland	6.3	91.7	6.9%
Greece	2.2	33.5	6.4%
France	11.9	262.1	4.5%
Netherlands	3.6	94.7	3.8%

Source: BP Statistical Review of World Energy 2006 (primary energy consumption), Gazprom (gas exports from Russia to the relevant countries).

[6] mtoe: million tons oil equivalent.

Conclusion

Gazprom is therefore not entirely protected from competition threats, and its desire for further European market expansion could meet a fair amount of resistance from the compliance requirements set by European competition authorities. This process could not only lay a foundation for a further, albeit partial, opening of the Russian gas sector (although this is questionable) but, what is more important, it could weaken the basis for supporting monopoly trends on the Eurasian energy markets which already exists in Europe, in the form of "post-integrated" European energy monopolies.

It is clear that EU competition regulators should take the lead in setting up a new framework for EU-Russia energy relations in the future. The success of their endeavors will not only determine the security of energy supply for European consumers, but also for the Russian and Eurasian energy markets.

It is important that an absolutely even approach be taken with regard to Russian access to downstream European energy assets (so desperately desired by Kremlin and Gazprom these days) and European access both to Russian upstream production and to gas supplies from the Central Asian countries of Turkmenistan, Kazakhstan and Uzbekistan. Governments and companies that tend to challenge EU competition rules by blocking access to gas resources or gas transit from third countries should not be allowed to acquire assets on the opening European markets. Legislation that *de jure* monopolizes gas supplies to Europe from the east should be renounced, and direct relations between European gas consumers and alternative gas suppliers, be they Russian or Central Asian, should be encouraged—this is the way competition works. Such separate deals will no longer only benefit Europeans.

Once that message gets through, attitudes in both Russia and in those European countries which, at present, pursue a "separatist" energy dialogue approach with Russia, may fundamentally change.