Russie.Nei.Visions n°10d

Multiplying Sources as the Best Strategy for EU-Russia Energy Relations

Michael Thumann

May 2006

Research Programme
Russia/NIS

IFRI is a research center and a forum for debate on the major international political and economic issues. Headed by Thierry de Montbrial since its founding in 1979, IFRI is a state-approved organization.

The opinions expressed in this text are the responsibility of the authors alone.

Research Programme Russia/NIS

Institut Français des Relations Internationales
27 rue de la Procession – 75740 Paris cedex 15 – France
tél. : 33 (0)1 40 61 60 00 – Fax : 33 (0)1 40 61 60 60

Russie.Nei.Visions

Russie.Nei.Visions is an electronic collection dedicated to Russia and the new independent states (Belarus, Ukraine, Moldova, Armenia, Georgia, Azerbaijan, Kazakhstan, Uzbekistan, Turkmenistan, Tajikistan, and Kyrgyzstan). Written up in a brief format by key experts, these policy-oriented papers deal with strategic and political issues as well as economic issues.

This collection guarantees Ifri's quality standards (editing and anonymous peer-review).

If you wish to be notified of upcoming publications, please send an e-mail to: info.russie.nei@ifri.org

Michael Thumann has been the foreign editor of *Die Zeit* since December 2001. In 2000, he worked as a public policy scholar at the Woodrow Wilson Center for International Scholars in Washington, DC. Between 1996 and 2001, he was the Moscow bureau chief of DIE ZEIT. From 1992 until 1996, he worked as the South-eastern Europe Correspondent of DIE ZEIT. Michael Thumann has studied history and Slavic languages at the Freie Universität Berlin, at Columbia University in New York, and at Leningrad State University in St.Petersburg.

In collaboration with its partners, Ifri is currently supporting a task force on the future of EU-Russia relations. The first workshop was held on 2 December 2005 in Paris. Four original contributions were then presented: by Andrew Monaghan (security), Thomas Gomart (neighborhood policy), Timofei Bordachev (lobbying), and Michael Thumann (energy). They were debated by Xavier de Villepin, Louis Gautier, Dov Lynch, and Dominique David. The workshop was chaired by Thierry de Montbrial.

This special issue of *Russie.Nei.Visions* gathers all these contributions in one place. At this stage, they must be read as works in progress, intended for critique and thus as fuel for the EU-Russia debate. They will be further enriched through the work of the second workshop, in 2006, and will end by issuing precise recommendations.

The four contributors would like to thank and acknowledge all the participants for their active contribution to this project.

Contents

Abstract

Energy security and gas supply have become issues of central concern for the European Union as reserves in the North Sea are dwindling. Russia is offering to replace the North Sea supplies in the future, but the EU should be aware that Moscow will not be able to fully meet Europe's demand in the future. Russia will remain a significant supplier, but the EU needs to look for other possible sources of gas supply in Northern Africa, in the Caspian Sea region, in the Barents Sea, and in the Persian Gulf. Diversification is the best strategy for enhancing European energy security.

Introduction

Shortly before the German general elections of September 2005, President Vladimir Putin made a surprising yet strategic visit to Berlin. His friend and close ally, German chancellor Gerhard Schröder, was heading for a loss in the elections. Yet the two leaders were determined to put the finishing touches on their perhaps most important bilateral project before Schröder could be voted out of office. A Memorandum of Understanding on the Northern European Gas Pipeline was signed September 8, 2005 in Berlin, between Gazprom and two German energy companies Wintershall and E.ON/Ruhrgas. The ceremony, held under the auspices of Schröder and Putin, triggered a public outcry in the Central Eastern European countries of Poland, Lithuania and Latvia. They felt cheated upon by the Russo-German pipeline which will be constructed on the Baltic seabed and, incidentally, will circumvent the three countries. The Presidents of Poland and Lithuania plainly criticized the project as being directed against their countries. The winner of the Polish presidential elections in October 2005, Lech Kaczynski, won the race on an anti-Russian, anti-German platform referring to German Russian plots to carve up Central Eastern Europe in the past and the gas transit project in the Baltic Sea. In early January 2006, the Russian energy giant Gazprom reduced the flow of gas to Ukraine while trying to push through a tremendous price hike for natural gas consumed by Russia's Southern neighbor. This sparked discussions all over Europe over the reliability of Russian gas deliveries. The dispute was settled by an ambiguous compromise between Russia and Ukraine which will certainly not last long. The passionate debates around pipelines and gas prices indicate that energy issues in Europe are no longer a matter for closed-door conferences but a matter of public scrutiny and political accountability. Rising energy prices are among the primary concerns of European voters, while their leaders have to decide cannily upon energy imports of the European Union for decades to come.

This paper will focus on natural gas imports, which are at the heart of Russian-European energy relations. In contrast to crude oil, which is a more flexible commodity and can be transported across all oceans, natural gas can bind Europe and Russia together, and could also possibly divide them. How should Europe shape its energy relations with Russia in order to avoid pitfalls and controversy about its imports of natural gas? Although the European Commission conducts an energy dialogue with Russia and has outlined a common strategy for its relations with Moscow, the influence of the EU as an actor in EU-Russian energy relations is limited. This was made clear when the Commission was effectively silent when the row over the Baltic Pipeline broke out in the fall of 2005. When shrewd, quiet mediation was required between Russia and Germany on the one hand

and the smaller EU member countries in Central Eastern Europe on the other, the Commission was ineffective. Although the Commission has published a number of very useful strategy papers on this matter, a common EU energy policy with inevitable implications for energy relations with Russia is not yet a reality. This paper will therefore concentrate on the most powerful actors of the present: national governments and some of the big energy corporations in Europe.

Russia's Interests

The changing face of the Russian energy industry is best illustrated by the fortunes of the country's formerly most powerful oligarchs, Michail Khodorkovsky and Roman Abramovich. Three years ago, the two young businessmen were preparing a merger of global scale. Khodorkovsky and Abramovich planned to bring together their companies Yukos and Sibneft in a corporation which would be able to compete on world markets, have Western minority stakeholders, and control one third of the Russian oil production. Today however, Khodorkovsky dwells in a prison camp in the Siberian region of Chita. He has been deprived of his wealth and his citizen's rights, his company Yukos has been effectively nationalized by the Russian state in a dubious legal case. Abramovich has received US$ 13 billion from Gazprom for his stake in Sibneft, and now concentrates on offshore activities, among which his London-based football club Chelsea is the most glamorous venture.

In a historic attempt to reverse the audacious privatization programs in the 1990s, President Putin has brought back most of Russia's energy industry under the Kremlin's control. The national champion, Gazprom, produces roughly one-fifth of the world's gas consumption and controls 30 percent of the Russian oil output. The Russian state has recently increased its stake in Gazprom to 51 percent although the president was fully in charge even before that. Gazprom is a monopoly in many respects. It controls most of the Russian natural gas resources and claims the right to have a say in the transport arrangements of other companies. Gazprom can afford to do so because it is the sole arbiter in the transit pipeline grid it inherited from Soviet times. All producers of gas on the territory of the Russian Federation need to ask the state monopoly Gazprom for permission of transit. As set up in a presidential decree in 1992, Gazprom is in charge of all gas deliveries to Russian consumers and to foreign countries as well. Not surprisingly, the CEO of Gazprom is chosen and appointed by the Kremlin. It is fair to say that even though Russian state interests and those of Gazprom do not always coincide, they nevertheless tend to in most cases. As an instrument of power at home and abroad, the company is arguably more important for the Russian government than the battered Russian army.

But Gazprom is facing the growing problem of a slowly declining gas production and currently-exploited gas fields which are becoming partly exhausted. Thus the reserves of the three biggest fields in western Siberia, Urengoi, Yamburg, and Medveshye, which together produced 85 percent of the Russian gas output in 2000, are dwindling and cannot continue to serve as the backbone of Russian production but for a limited period of time. To compound the problem, Russia has a very inefficient and wasteful system of gas deliveries, and the gas prices of its internal market are too low to encourage consumers to save energy. For reasons of political and economic stability, the Russian government will presumably neither try to adjust prices to world market levels nor coerce Russian companies into a new mode of energy-saving operations. Hence Gazprom is looking for new reserves on the Yamal peninsula in western Siberia and in the Barents Sea which will require daring technical projects and huge foreign investment. A second option is the recent attempt to add the natural gas reserves of neighboring CIS countries to Gazprom's energy resources. In 2003, Russia and Turkmenistan—an important producer of gas—agreed on Turkmen gas deliveries to the Russian system over a period of 25 years.[1] Prices have been set well below world market standards, at US$ 44 per 1000 cubic meters until the end of 2006. Moscow's objective is primarily to inflate Gazprom's reserves but also to prevent Turkmenistan from acting as an independent supplier of gas both to Europe and to the wider CIS. If less suppliers operate in Europe and in the CIS area, Gazprom will be better positioned to sell natural gas according to its designs. As a state monopoly, Gazprom is not used to deal in an environment of competition among many suppliers.

This characteristic has become a primary concern for quite a few countries in Central and Eastern Europe. As a result of the European energy divide during the Cold War, these countries import almost no gas from the North Sea or Northern Africa. How vulnerable some nations are to Gazprom was demonstrated in the fall of 2005, when it announced the quintupling of the price for natural gas delivered to Ukraine. As Kiev chose not to agree on the price hike, the Russian energy company reduced the transport of gas to Ukraine in the first days of January 2006. There are a number of EU-member countries as exposed as Ukraine: Gazprom is the sole supplier to Estonia, Latvia, Lithuania and Slovakia, and provides 89 percent of Hungary's gas, 86 percent of Poland's and nearly three quarters of the Czech republic's. By comparison, Gazprom supplies 27 percent of Italy's gas, 25 percent of France's, 67 percent of Turkey's, and 65 percent of Austria's.[2] On balance, more than half of the European Union's gas imports come from Russia.

Some leaders of Central and Eastern European countries worry particularly about Gazprom's corporate expansion in Eastern Europe. The Russian energy giant has bought into a number of energy-related companies in Poland and Hungary, which provoked angry reactions by nationalist politicians in these countries. Additionally, Gazprom plans to acquire shares in two Romanian gas distributors and a Bulgarian gas company. In 1998, it took over the shares of the Bulgarian gas enterprise Topenergy. The objective is not only to purchase stakes in European companies but to get access to and control of transit routes. Recently, Gazprom won control over the main transit pipeline to Europe on the territory of Belarus, which in exchange was granted lower gas prices for its fragile economy under the authoritarian rule of President Alexander Lukaschenko. From Gazprom's perspective, a similar engagement would make sense in Ukraine and also in south-eastern Europe so that it may have a say in whether Caspian gas and oil suppliers such as Azerbaijan

[1] R. Götz, „*Russlands Energiestrategie und die Energieversorgung Europas*," Stiftung Wissenschaft und Politik, Berlin, March 2004, p. 13.
[2] All numbers provided by the International Energy Agency.

should enter the European market via the Turkish and south-eastern European networks.[3] In Eastern Europe and the Baltic region, Gazprom now has at least 23 big joint ventures involved in gas transportation.[4]

[3] C. Locatelli, “Changes in Russia’s gas exportation strategy: Europe versus Asia”, *East-West Journal of Economics and Business*, September 2004. The transport of Caspian gas to Europe will be dealt with in the last chapter of this article.
[4] J. Dempsey, “Europe worries over Russian Gas Giant’s Influence”, *Energy Bulletin*, October 4 2004, published by *The New York Times*.

Cooperation Between Russia and Europe: the German Example

However, this does not mean that Russian and European interests need to be at odds. The peculiar energy dialogue between Russia and Germany illustrates that cooperation in good faith is possible. Whether this serves the interest of both countries in the long-term, though, remains to be seen. Energy affairs in general lie at the heart of Russian-German relations: Russia has the biggest reserves of natural gas in the world, and Germany is the biggest consumer of Russian natural gas in Europe. The German energy company E.ON controls between 6 and 7 percent of the shares of the Russian energy giant Gazprom. In 2003, no less than 38 percent of German natural gas imports were supplied by Russia, and deliveries are rising.[5] For the most part, natural gas reserves in the North Sea will be exhausted in a decade, but Germany and Europe as a whole share the geographically privileged position of having the world's biggest reserves of natural gas within their reach: the Caspian Sea and Iran, the Gulf area, North Africa, and the resources of Russia.

Former chancellor Schröder made the choice for his country: as far as energy was concerned, he would focus solely on Russia. The country has a stable political system, Schröder replied when criticized for his cozy relationship with Putin: it has the biggest hydrocarbon reserves at its disposal, he said, and it is prepared to engage in a serious long-term energy partnership with Europe and Germany. While the European Union had agreed on a visionary—and so far theoretical—Energy Charter with Russia, Schröder and Putin had already come to terms on quite substantial projects. In April 2005, the German energy company Wintershall of the BASF group signed a memorandum of understanding with Gazprom on a joint exploration of the gas field Yuzhno Russkoye in northern Siberia. According to this, Wintershall will get 50 percent of the share of the field, while Gazprom will be able to participate in the market of natural gas in Germany. At the Hanover trade fair in April 2005, Putin and Schröder presented this deal as a prototype agreement serving the interests of both countries. International analysts, however, emphasized the benefit for Gazprom in the first place because the Russian state company got access to a crucial Western consumer market at a comparably low price.

For Schröder and Putin, energy business is more than just trade. It is a way of clinging on to power and to influence big business and politics simultaneously. Schröder, as a Social Democrat, has always had a close relationship with big corporations rather than small and medium businesses. The organizational structures of companies like E.ON

[5] BP, *Statistical Review of World Energy 2004*.

resemble state bureaucracies in which many German Social Democrats feel quite at home. Putin had no other choice than dealing with Russian business giants like Gazprom in a country with very few small- and medium-sized companies. The recent takeover of more than 50 percent of Gazprom's shares by the state indicates that the Russian economy will continue to depend heavily on the Kremlin's orders in the future. The closest advisors of Putin and Schröder work in energy companies or have worked there. The powerful deputy prime minister Dmitri Medvedev also chairs the board of directors of Gazprom. A close associate of Putin from St. Petersburg, Alexei Miller, worked with Putin in the Kremlin before the Russian president appointed him CEO of Gazprom. In Berlin, Schröder recruited the energy manager Werner Müller to head the ministry of economy in 1998, later on Müller became the CEO of Ruhrkohle AG, a powerful energy company in West Germany. The chancellor's closest associate, Alfred Tacke, an economist with strong ties to the trade unions, had already been close to Schröder during his political career in Lower Saxony. He then accompanied him to Berlin, and was appointed CEO of the energy firm *Steag* in 2005. The energy business also provided the solution to Schröder's career when he left the chancellor's office in the fall of 2005. Putin suggested that he be in charge of the advisory board of the Gazprom-operated Northern European Pipeline Company, which has found a low tax residence in Switzerland and started to build the Baltic Sea underwater supply line in late November 2005.

This project is comparable in size, boldness and costs to the Baku-Tbilissi-Ceyhan pipeline (BTC) which connects the Caspian Sea with the Mediterranean. The recently completed BTC oil pipeline, sponsored by the US and operated by BP, deliberately circumvents Russian territory and thus enables Kazakhstan and Azerbaijan to export crude oil without asking Moscow for transport facilities. Likewise, the German-Russian pipeline would tremendously reduce the significance of the Baltic states and Poland for natural gas deliveries to Europe and Germany in particular. These countries refer to the Russian gas row with Ukraine in the beginning of 2006 and voice the concern that in a not-too-distant future Russia could exploit the gas export to Poland and the Baltic states as a tool of political pressure. With an underwater pipeline in the Baltic Sea, they argue, Russia could shut off the gas pipeline to Warsaw without jeopardizing the lucrative exports to Germany. Moscow argues that it has never used gas deliveries to blackmail Western governments in the past. Warsaw replies that this is true only regarding the West, whereas Georgia, Belarus and Ukraine tell a different story.

European Interests

The example of the close German-Russian energy relationship and the apprehension of Central and Eastern European states demonstrates that European interests in energy issues may differ fundamentally. This is true not only for EU member states but also between big European energy corporations on the one hand, and European consumers on the other. The dominating European energy companies on the whole share Gazprom's interest in long-term contracts of gas distribution. These agreements make sure that delivery and purchase are settled for years if not decades ahead while the fee is agreed upon later, depending on the fluctuations of oil prices. This is a comfortable stance for distributors but it puts consumers in a weak position. Thus E.ON, for example, is currently engaged in a legal battle with the German antitrust authorities (Kartellbehörde) to fight through its right to impose long-term contracts on local and municipal gas distributors. E.ON may refer to the sixth Progress Report of the EU-Russia Energy Dialogue which stresses the importance of long-term gas contracts and calls for the abolition of any destination clauses in gas contracts which might discriminate against Russia as the leading supplier of many European countries.[6]

This is bad news for European consumers. Yet these will find their interest mostly protected by the European Commission, which is trying to arrange a gradual deregulation of the European gas market. Liberalization in this respect means protection from arbitrary price-setting by a few big players on the market. It is important to note that in Europe, unlike in Russia, these companies no longer represent the interests of the state but rather the goals of international shareholders. By contrast, the liberalization of the European gas market follows a logic of competition between different suppliers instead of control by "institutionalized private companies". Europe being the only region of the world with possible access to so many of the world's crucial reserves of natural gas, competition between different suppliers and different countries makes particularly sense for Europe and its consumers.

[6] Sixth Progress Report of the EU-Russia Energy Dialogue, Moscow/Brussels, October 2005.

Possible Points of Controversy

At present, Russia is having trouble establishing good neighborly relations with a number of Central and Eastern European nations which have recently joined the EU. With regard to Poland and the Baltic states, the Northern European gas pipeline project in particular adds insult to injury. Other issues, ranging from disputed border treaties to a new Russian national holiday marking military victory over Poland in the 17th century, have clouded relations. Moscow's contacts with Western European nations like France, Germany, and the United Kingdom have developed much more smoothly throughout the 1990s. Energy contracts can intensify these relations. It is not only the importing nation which depends on a trustworthy supplier, but also the supplying country which needs a dedicated customer. The history of Soviet gas deliveries to Western Europe during the late 1970s and the 1980s suggests that even in periods of tense political relations energy contracts can be maintained.

Nevertheless, there are possible points of controversy between Russia and EU countries which might come up in the future. To begin with, Gazprom's urge to conclude long-term contracts so as to safeguard long-term investment in Siberia can easily be seen to collide with the European Union's drive toward market liberalization.

The deregulation of the gas market is not compatible with long-standing contracts over 15 or 20 years, but requires flexibility by both consumers and suppliers. With the construction of more pipelines to the EU and the introduction of LNG (Liquefied Natural Gas) terminals at European ports, new price regulations could substitute the traditional communication of gas and crude oil prices. Notably, a European spot market for gas could emerge.

However, a more flexible supply of natural gas to Europe should not necessarily be a bone of contention for EU-Russia relations. On the contrary, it can help avert possible disappointments over Russia's ability to become Europe's major gas supplier in the future. To this end, it is imperative to put behind us the notion that Russia and Europe must mutually depend on each other, in the same way that the supplier needs the customer as much as the consumer needs the producer. Today's reality should not be the future's boundary. Politicians who view Russia as the "solution to Europe's energy problems of the 21st century" misjudge Gazprom's capacities. Until 2020, the EU's natural gas imports will grow between 50 and 75 percent. Today, Russia already provides more than half of these deliveries. However, in 2020 it will be able to supply only one third of the European gas imports.[7] According to the planning staff of the

[7] *International Energy Outlook 2003,* International Energy Agency, May 2003.

Russian federal energy agency, gas exports to China and the United States over the next 20 years will grow much stronger than those to the EU. The recently explored gas fields on the Sakhalin peninsula, and the reserves of the Kovykta field near lake Baikal are too remote to add to the European supply. These natural resources will provide gas for China, Korea, and Japan. Similarly, a vast field in Russia's North-west, the Shtokman field, might serve other purposes than contributing to Europe's gas imports. The United States has expressed strong interest in LNG deliveries from Russia to America. The Shtokman reserves would suit these plans perfectly. Quite understandably, Russia is not willing to depend on the EU as the main market for the rest of the century. For its own sake it should not.

As Russia prepares to provide the world's biggest economies with gas simultaneously, European countries will have to look for other sources of supply in their neighborhood. Gas pipelines operate economically within distances of up to 5,000 kilometers. Thus gas producing countries like Algeria, Libya, the Caspian states, Iran, and Qatar are possible contractors for European gas companies. Iran holds the second biggest gas reserves of the world, Qatar the third biggest. Undoubtedly, gas supplies from Iran will require a substantial change in Iran's foreign relations, particularly with the United States. Yet gas pipeline projects entail long-term planning, and usually a decade is needed before any transit is actually done. In light of this, a consortium of energy firms from Austria, Bulgaria, and Turkey—with the Austrian energy company OMV at the top of the list—has provided a feasibility study for the Nabucco project, a pipeline from Turkey to Central Europe via Bulgaria, Romania, Hungary and Austria. By 2006, Turkey and Greece plan to integrate their natural gas networks, which would broaden the options for gas transportation in the region. If completed, this pipeline network will enable the Caspian states of Azerbaijan, and perhaps Kazakhstan and Turkmenistan, as well as Iran to deliver gas to Europe.

Russian politicians have understood at a very early stage that a direct pipeline from the Caspian sea would not only help competitors from the CIS emerge on the European market but also divert their contributions to Gazprom's reserves. Russia is therefore strongly committed to interfering in these plans, and has made this an important aspect of its bilateral relations with Turkey, a key player in the Nabucco project. With the new Blue Stream pipeline in the Black Sea, Gazprom supplies more gas to Turkey than it will able to digest for many years to come. It is therefore difficult for Ankara to renegotiate the existing gas contracts with Russia in order to import more gas from Caspian Sea countries, most notably Azerbaijan.

Recommendations for a European Energy Strategy

The European Union should develop energy relations with Russia as closely as possible, for Russia will remain the most crucial supplier of natural gas to Europe in the decades to come. Joint projects of exploration in western Siberia make perfect sense as long as they are commercially viable and do not fully absorb Europe's capacity to look for other possible resources in the European neighborhood. Future gas transit from Russia to Europe requires more pipelines than the existing two routes. This is why the Northern European Gas Pipeline can prove to be a reasonable addition to the existing grid. It has to be stressed, however that as an underwater pipeline the construction costs for this project will be twice as high as for a pipeline through the Baltic states and Poland. To reduce costs, the Russo-German consortium should invite companies from the UK and the Netherlands to participate in the construction and the operation of the pipeline. Energy officials from both countries have already expressed interest in the North-European gas pipeline.

The European Union must not rely on Russia as the sole non-EU supplier of natural gas in a decade. A closer look at Russian resources and Moscow's export strategy reveals that Europe is not the only market for Russian gas exportation. EU energy strategists should take this into account and encourage European energy companies to search intensively for other sources of gas deliveries. Algeria, Libya, the Caspian Sea countries, Qatar, Iran and Egypt should be on the radar screen so as to enlarge supply and provide Europe with more choices in the future. LNG terminals must be considered as an additional option.

A liberalization of the European energy market with competing suppliers can only be realized if the EU and its member states develop energy cooperation schemes with their southern and south-eastern neighbors and simultaneously with the Russian Federation. To be sure, Russia's exports will not suffer from these arrangements, for Europe's demand of gas imports is rapidly growing and cannot be met by one country alone. In energy relations, happiness is found in multiple pipelines.