CENTRE FOR EUROPEAN REFORM
briefing note

# THE EU-RUSSIA ENERGY DIALOGUE

*By Charles Grant and Katinka Barysch*

Russia is the EU's biggest neighbour. The EU is Russia's most important trading partner and source of foreign investment. Yet EU-Russia relations have often suffered from discord over contentious issues such as trade quotas, rules on visas, the Kaliningrad enclave or human rights in Chechnya. So it is all the more important for both sides to identify areas of common interest. Energy is such an area.

Russia sends more than half its oil and gas exports to the EU – which in turn relies on Russia for about 20 per cent of its gas and 17 per cent of its oil. These shares will go up further after 2004, when ten new members – some of which rely almost entirely on Russian energy – will join the EU.

The EU and Russia acknowledged the importance of this mutual dependency by launching a bilateral energy dialogue at their Paris summit in October 2000. The purpose, according to that summit's communiqué, is "to raise all issues of common interest relating to the [energy] sector, including the introduction of co-operation on energy saving, rationalisation of production and transportation infrastructures, European investment possibilities, and relations between producer and consumer countries." The dialogue involves regular meetings of experts, as well as high-level political discussions during the annual EU-Russia summits. Both sides have put high-ranking and experienced officials in charge of the dialogue, namely François Lamoureux, the European Commission's director general for energy and transport, and Viktor Khristenko, a deputy prime minister in the Russian government.

Subsequent summits have declared a number of infrastructure projects to be of "common interest", including several projected gas and oil pipelines, and the interconnection of the two electricity networks. The basic idea behind the dialogue is a simple balancing of interests: the Russians need more European investment to develop their energy resources, while the Europeans need secure, long-term access to Russian oil and gas.

However, progress since 2000 has been mixed. There have been some notable successes, for example the establishment of a technology centre in Moscow in November 2002 and the start of several pilot projects for energy savings. But on many of the more important issues – pipelines, gas supply contracts, electricity sector restructuring and nuclear fuel supplies – the two sides continue to disagree.

There are several reasons why progress has been slow. First, energy is hugely important for the Russian economy. Even a government as reform-minded as that of President Vladimir Putin will tread carefully when it comes to energy market reform. Second, the EU-Russia energy dialogue involves a host of participants that do not always see eye-to-eye. The Russian government and the EU may agree on the importance of bilateral co-operation. But the key players in this field are private or state-controlled companies that often have their own agenda. Third, the energy dialogue is not only, or even primarily, about country-to-country sales of oil and gas. It has many implications for national economic policies, in particular energy market liberalisation. Last but not least, the question of energy sector reform has become intertwined with other

EU-Russian negotiations, in particular the ongoing talks on Russia's accession to the World Trade Organisation (WTO) and the fate of the Kyoto Protocol on climate change.

The EU uses both the WTO negotiations and the energy dialogue to push Russia to open up and deregulate its energy markets. At present, the gas market, including export pipelines, is entirely dominated by the state-controlled gas giant, Gazprom, while the electricity market is in the hands of the UES power company. The Russian government is, in principle, committed to reforming both 'natural monopolies' by separating the production side from the transmission and distribution of energy. In early 2003, the Russian parliament adopted a package of laws to prepare the ground for breaking up UES. But on Gazprom restructuring the government has made little progress.

The EU is interested in Russian energy market reforms for several reasons. First, energy prices in Russia are only a fraction of their world market levels. The EU argues that this gives Russian exporters an unfair advantage, notably in energy-intensive sectors such as aluminium or fertilisers, and that therefore Russia should not join the WTO unless it is prepared to raise energy prices. But everyone in Russia, whether they are pro- or anti-WTO, regards this as an unreasonable demand. The issue of energy prices has become the biggest bone of contention in the negotiations over Russian membership of the WTO – and since the EU is Russia's biggest trading partner, it has considerable influence over the progress of those negotiations.

"There is no evidence that our energy pricing structure causes real and serious damage to firms in the EU or other member-states, which would be a precondition for it being defined as subsidies prohibited by the WTO," wrote Maxim Medvedkov, Russia's chief WTO negotiator, in a recent essay (Medvedkov, Lamy, Yasin et al, "Russia and the WTO", CER, December 2002). He warned that "if Russia were to push up energy prices to world market levels too quickly, the result would be economic devastation on a scale that would easily outweigh the economic benefits of WTO accession." The Russian side claims that low domestic energy prices are the result of its abundant supplies of natural gas (which fires most Russian power stations) and hydro-power.

Both sides appear to have softened their stance to some degree. Russia no longer refuses to discuss energy prices in the framework of WTO talks. And the EU no longer tries to set a firm target for domestic Russian energy prices. "We have shifted our position, we no longer insist on EU energy prices for Russia," said Richard Wright, the EU's ambassador to Russia in May 2003, at a Helsinki seminar organised by the 'Russia in a United Europe' committee. "What the EU asks is that prices of energy to industrial users should be above loss-making levels. The trouble now is that we don't know at what price Gazprom sells gas at a loss."

The second reason why the EU is pushing Russia on energy market reform is that there is a growing mismatch between the EU's own efforts to liberalise its energy markets and the supply of Russian gas through a monopolist, namely Gazprom. EU countries have committed themselves to fully liberalising their energy markets for industrial users by 2004 and for households by 2007. However, Russia supplies its EU customers under long-term supply contracts, many of which contain so-called territorial restriction clauses: even if one EU country receives more gas than it needs, it is not allowed to sell it on to its neighbours. The clauses are in breach of EU single market rules. They allow Gazprom to sell gas to different EU countries at different prices, and they prevent the EU from developing a functioning EU-wide gas market. The Commission has been negotiating with Gazprom on this problem and reports some progress.

A third reason is that the EU fears that as long as Gazprom remains in sole charge of Russia's gas, Russian supplies may not keep up with rapidly growing EU demand. Gazprom's output has been more or less flat for the last decade, as the company has failed to invest sufficiently in the development of new gas fields. Meanwhile, Russia's privately-owned oil majors sit on huge gas fields that they do not exploit commercially because Gazprom does not allow them access to lucrative export markets.

The Russian government undoubtedly understands the issues at stake. In an April 2003 working paper, the European Commission reports that during a round table attended by Russian ministers and EU commissioners in December 2002, the Russian delegation "underlined that they take as a reference some elements of the EU model for the reform of their own energy market, notably the separation of the transportation function from production."

But the Russian government may shy away from radical reform for political reasons, especially since it faces a parliamentary election in December 2003 and a presidential one in early 2004. Gazprom itself appears staunchly opposed to any suggestion that it should be broken up or give independent gas producers access to its pipeline network. Industrialists, as well as UES, fear that higher gas prises could render them uncompetitive. But some insiders remain optimistic. Mihail Khordokovsky, chief executive of Yukos, Russia's largest oil company, is one of them. "The market will deregulate and independent producers will get access to the system," he predicted at the Helsinki seminar. He said that independent producers – such as his own company – would help to increase exports "and take perhaps 20 per cent of the export market."

Similar problems plague the EU-Russia dialogue on electricity. Russia is increasingly keen on linking its own electricity grid to that of the enlarged European Union. This would enable UES not only to sell surplus electricity to EU consumers, but also to make up for temporary shortages in its own market by importing power from the EU. The EU says that in order to sell into the European market, Russia must apply EU-level standards of nuclear safety and environmental protection – which of course it does not – and that it must get rid of the 'unfair' subsidy that UES receives in the form of cheap gas from Gazprom.

The dialogue on oil is less politically charged, partly because Russia has already privatised and liberalised its oil industry. Just like the US, the EU is keen on diversifying its oil imports away from the volatile Persian Gulf region. Russia and other producers in the former Soviet Union offer themselves as a natural alternative. Indeed, Mr Khordokovsky predicts that – with North Sea production declining and Russian exports growing – the EU will rely on Russia for 25 per cent of its oil needs by 2010, up from 17 per cent at present.

But while Russian crude oil production has risen fast in recent years (to 8 million barrels a day in 2003), Russia has failed to install sufficient new export capacity in the form of pipelines and tanker terminals. Russia's private oil companies have suggested a number of new projects, including a pipeline to Murmansk, a deep water port in the Russian far north which would serve as a hub for exports to the US and the EU, and another pipeline to the fast-growing Chinese market. However, Russia's state-owned pipeline operator, Transneft, is loath to give up its monopoly. The Russian government sees the potential benefits of drawing private investment into the oil transport infrastructure. But it also likes the influence it wields over the powerful oil barons by controlling the export routes through Transneft.

In the oil sector, the EU-Russia energy dialogue has focused mainly on improving the conditions for European investment in the Russian oil sector. The EU has long pushed Russia to establish a workable framework for production sharing agreements (PSAs), which are commonly used in emerging market economies to secure the legal and tax environment for large-scale investments in natural resources. Russia has been dragging its feet. It claims that the recent decision by BP to commit almost $6 billion to its Russian ventures is proof that PSAs are not needed. The EU insists that PSAs are still essential for high-risk projects, such as off-shore oil exploration. To lure more European money into the Russian oil sector, the EU is also working on a scheme that would insure EU companies against losses stemming from the weakness of Russia's legal system. In the past, EU companies have lost significant sums because their Russian partners have used local courts and prosecutors to gain control of the Europeans' investments.

Two issues have recently moved to the top of the EU-Russian energy agenda and threaten to hold up progress in other areas. One is the import of nuclear materials from Russia. The EU's current rules do not allow the Union to buy more than 20% of its uranium from non-EU suppliers. Since some of the accession countries are highly dependent on Russian nuclear fuel supplies, enlargement will push the EU above this threshold. The Commission wants to amend the relevant legislation so that the Union can increase its imports of Russian Uranium. But some EU governments, influenced by corporate lobbying, have prevented the Council of Ministers from giving the Commission a mandate to change the rules. This has upset the Russians, who are understandably keen to increase their exports of uranium.

For its part, the Commission is concerned about Russia's refusal to ratify the Kyoto Protocol on climate change. It argues that Russia could benefit from participating in emissions-trading schemes. The Commission is also miffed about the lack of Russian interest in the several pilot projects that have been established on energy conservation. As the Commission working paper observes, "the combination of low energy prices in Russia and an undemanding Kyoto target for the first commitment period (2008-12) means that energy efficiency and energy saving have not been given a high priority."

The obstacles for a well-functioning energy partnership remain formidable. But self-interest on both sides is likely to sustain the dialogue in the coming years. The energy relationship is simply too important for either side to drop the dialogue. In the long run, if the dialogue makes progress and proves its value to all parties, it could become formalised in an EU-Russia energy treaty. Some Russian and Commission officials have floated the idea of a treaty that would cover rules on investment, security of supply, competition, technical co-operation and free circulation of energy. The energy dialogue has the potential to link the EU and Russia through solidarités de faits – the term used by Jean Monnet, the EU's founding father, to describe how countries could become bound together through collaboration on concrete issues.

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