PIPLINES, POLITICS AND POWER
The future of EU-Russia energy relations

Edited by Katinka Barysch
Pipelines, politics and power

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Contents

Editor’s acknowledgements

1 Introduction
Katinka Barysch 1

2 Energy geopolitics in Russia-EU relations
Dmitri Trenin 15

3 The EU-Russia Energy Dialogue
Christian Cleutinx and Jeffery Piper 25

4 Trust, not double standards: What Russia expects from the EU
Sergey Yastrezhembsky 35

Box: Putting flesh on the bones of energy solidarity
Pawel Swieboda 40

5 Do we have a shared future in energy?
Konstantin Kosachev 45

6 Win-win co-operation is possible in energy
Andris Piebalgs 53

Box: First responsibility, then solidarity
Vaclav Bartuska 57

7 Russia’s slowing production: Policy failure or strategic decision?
Clifford Gaddy and Barry Ickes 61

8 Dynamic development in Russia’s gas sector
Tatiana Mitrova 71

Box: The money benefits of diversification
Daniel Gros 79
Russia is the world’s largest gas producer. The EU is the world’s biggest gas market. The two are neighbours. Logically, the EU and Russia should have a well-developed energy relationship. The EU gets over 40 per cent of its gas imports from Russia, and two-thirds of Russia’s gas exports go to EU countries. Russia is also the source of almost a third of the EU’s oil and a quarter of its coal imports. European companies are among the biggest investors in the Russian oil, gas and electricity sectors. At the same time, Russia’s energy giants want more access to the EU market, to raise capital and buy power stations and pipelines.

EU-Russia energy relations should be straightforward, mutually beneficial and fast-growing. But they are not. Many Europeans today perceive their reliance on Russian energy, in particular gas, as a threat. Some say that Russia uses energy as a political weapon and cannot be trusted as a supplier. Others worry less about Russia’s willingness to sell energy abroad than its ability to do so. Despite record-high global prices, Russia’s output of oil and gas is stagnating, as Russian companies are not investing enough in the exploration of new fields. At the same time, they talk about selling more gas to Asia and entering into the global market for liquefied natural gas (LNG). The European Union is therefore reinforcing its efforts to find alternative sources of supply, both geographically (mainly from North Africa and the Caspian region), and through developing renewable sources, clean(er) coal and, in some countries, nuclear energy.
From a Russian point of view, the European debate is all over the place. The Europeans keep demanding that Russia expend huge sums to develop complex new fields. But they struggle to give Russia a clear idea about how much gas they will want to buy from it in, say, 20 years time. They want Russia to allow western energy companies to invest more in the Russia energy sector. At the same time, they are drawing up new rules to prevent Russian companies from buying pipelines in the EU. Despite noble words about ‘EU energy solidarity’, companies from individual EU countries are happy to sign long-term bilateral supply deals with Russia. Some of these companies have teamed up with Gazprom to build new offshore pipelines that other EU countries perceive as a threat to their energy security. And then Russia gets blamed for a strategy of ‘divide and rule’.

Of course, EU-Russia energy ties do not exist in a political vacuum. They are an integral part of a political, economic and security relationship that is becoming more complex and difficult. Tensions in EU-Russia relations have been rising for a number of years. The Europeans have struggled to find a way of dealing with a Russia that erodes democracy at home, bullies its neighbours and obstructs international initiatives, for example in Kosovo. An increasingly self-confident and cash-rich Russia, on the other hand, is in no mood to be lectured by an EU that it perceives as both weak and arrogant. The war in Georgia in August 2008 has made matters worse. The Europeans acknowledged that they should take on more responsibility for stabilising their eastern neighbourhood. But at the same time they felt powerless in the face of Russia’s attempts to solidify and expand its influence there. Many observers remarked that the EU’s dependence on Russian energy tied Europe’s hands in responding to the Georgia crisis.

The role of energy in EU-Russia relations

What, then, is the role of energy in EU-Russia relations? Some people say that it defines the relationship. They claim that Germany,

Italy and other countries that buy a lot of Russian gas (and whose companies have lucrative investments within Russia) will be cautious about criticising Moscow. For the new member-states in Central and Eastern Europe, on the other hand, the threat from Russia’s ‘energy weapon’ is one more reason for the EU to ‘get tough’ on Russia. From this perspective, energy ties cause the divisions that have-paralysed the EU’s policy on Russia. The best advice for the EU would be to play down the energy issue in its relationship with Russia, since putting it at centre stage will always leave Moscow with a stronger hand. At the very least, the EU must develop an effective energy policy by integrating its own gas and power markets and defining its energy objectives abroad more clearly. Only then can it hope to speak to Russia with one voice.

Other observers take a more positive view on the role of energy in EU-Russia relations. They point out that energy dependence is mutual: up to a quarter of Russia’s GDP, some two-thirds of its export earnings and half of its federal budget revenue come from oil and gas. And the EU is by far the biggest and most lucrative market for Russian energy sales. In a relationship where common interests appear increasingly hard to find, energy should stand out as the area where constructive co-operation is still possible. It is around this interdependence that EU-Russia relations can and should be rebuilt.

No single publication can cover all the complex technical, economic and geo-strategic issues that define EU-Russia energy relations. What this report does is to present a fascinating variety of viewpoints on many of the key questions. Does Russia use energy as a weapon for political ends? Should the EU welcome Russian investment in its energy sector? What does energy solidarity mean? Why is the Nord Stream pipeline so contentious? What drives Russian oil and gas output? What is the right legal framework for the development of EU-Russia energy relations? Can the EU reduce the share of oil and gas that it buys from Russia? Are Russia’s own diversification plans realistic?

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2 Tomas Valasek, ‘What does the war in Georgia mean for EU foreign policy?’, CER briefing note, August 2008.

Many of the views expressed in these pages are original and unorthodox. Some authors try to take a cool, analytical look at developments in energy markets. Others make manifestly political arguments. Some of our contributors contradict each other openly, which shows that there is no ‘right’ interpretation of current developments in EU-Russia energy relations. All of them make a valuable contribution to a debate that will continue to be at the heart of the relationship between the EU and Russia.

Outline of the report

Dmitri Trenin, from the Carnegie Moscow Center, sets the scene in chapter 2 by placing EU-Russia energy relations in a broader political context. Yes, energy relations have become harder to manage at exactly the time when Russia’s foreign policy has become more assertive. But what is the connection? Trenin argues against the widespread assumption that the Kremlin uses energy as a political weapon. “Russia’s business is business”, he writes. Many of Gazprom’s moves, such as the sharp increases in gas prices charged to Ukraine and other CIS neighbours, have been interpreted as crude tactics in a new Cold War, based not on nuclear deterrence but the lingering threat of freezing homes and idle factories. However, Trenin argues that Gazprom is attempting, admittedly in a heavy-handed way, to maximise its profits and market share. The West should not fear ‘Russia, Inc.’ but do as much business with it as possible: “The higher the degree of mutual dependence, the less likely it will lead to politically motivated threats.”

Chapter 3 switches to an EU perspective. Christian Cleutinx and Jeffery Piper have been intimately involved in the EU-Russia Energy Dialogue since its inception in 2000. They refute the general perception that the EU only woke up to the importance of its energy relationship with Russia after Gazprom cut off gas to Ukraine at the start of 2006. Co-operation between the EU and Russia in the energy sphere dates back to the early 1990s. And – again contrary to conventional wisdom – the two sides are making progress. However, not all is well, as Cleutinx and Piper readily acknowledge. Russia does not invest sufficiently in the exploration of new fields and therefore may be unable to meet growing European demand. At the same time, it is becoming harder for European companies to invest in Russia, both de facto (BP and Shell have had to considerably reduce their ambitions there) and de jure (Russia’s new law on ‘strategic’ sectors consigns international oil majors to the role of junior partners). Nevertheless, the authors are confident that the EU and Russia – building on the Energy Dialogue’s many small successes – can use the negotiations of their new Partnership Agreement to overcome current misunderstandings and differences.

Sergey Yastrzhembsky, until recently in charge of EU relations in the Kremlin, agrees in chapter 4 that energy interdependence requires co-operation between the EU and Russia. He, too, praises the Energy Dialogue. But he also feels “disappointed” by an EU that looks at Russia with suspicion and engages in double standards. The Europeans highlight the importance of open energy markets, but do not act accordingly. The ‘third party clause’ in the EU’s new Gas Directive says that only energy companies that ‘unbundle’ their generating, transport and sales activities would be allowed to buy pipelines and other downstream assets in the EU. Does that mean that Russia needs to break up Gazprom? “In essence”, Yastrzhembsky writes, “this is an attempt to interfere in the domestic policies of third countries, primarily (but not only) Russia.” Similarly, the EU insists on transparent, market-based pricing for energy. But then it reproaches Russia for putting pressure on Ukraine and other transit states to move to such pricing.

Konstantin Kosachev, the head of the Duma’s foreign affairs committee, goes one step further in chapter 5 and accuses the Europeans of scaremongering. What is the point, he asks, of “scaring European citizens with the authoritarian gas bear from the east who feeds on fledgling democracies”? The Energy Dialogue is
not based on equality, but is designed to minimise the risks that many Europeans see emanating from Russia. The EU has presented Russia with a long list of things to do, from ratifying the Energy Charter Treaty to reducing state involvement in its oil and gas sector— all simply to reassure Europe that Russia is, after all, a reliable supplier. As for the source of these suspicions, Kosachev points to the EU’s eastward enlargement, which, in his view, has impaired the EU’s ability to think strategically. The EU seems more willing to rely on energy from faraway Islamic countries than to build a true energy partnership with Russia, which would entail equal access for investment, the full recognition of the partners’ respective interests and, above all, the presumption of innocence.

Andris Piebalgs, the EU’s Commissioner for Energy, strikes a more positive note in chapter 6. Energy is a good basis for the development of the broader EU-Russia partnership, he argues. Yes, there are concerns about a looming ‘gas gap’ as early as 2010, since new production cannot keep up with fast-growing domestic demand as well as export obligations. But there are possible solutions, and these are best achieved if the EU and Russia work together. For example, Russian energy companies currently ‘flare’ most of the gas associated with oil extraction. The volumes are huge—equivalent to a quarter of the gas that Russia sells to Europe, according to some estimates. To reduce this wastage, Russia not only needs to outlaw flaring but it also needs to allow independent oil and gas companies access to consumers. In other words, it needs to loosen Gazprom’s pipeline monopoly—a demand that the Europeans have been making for many years.

But what if Russia does not actually want to produce more energy? The stagnation in Russian oil and gas output may not be the unwanted by-product of ill-advised government policies (not only Gazprom’s monopoly but also the re-nationalisation of much of the oil sector and exorbitantly high energy taxes). If so, will all the EU’s efforts to get Russia to liberalise its oil and gas sector be futile in terms of enhancing European supply security? This is the troubling question that underlies the analysis offered in chapter 7 by Clifford Gaddy and Barry Ickes, two eminent American economists specialising in Russia. After years of growing by 8 per cent or more, Russia’s oil output has been shrinking since 2007. Since Russia has satisfied much of the additional global demand in recent years, this production decline is having a noticeable impact on the global oil price. If Russian oil producers responded to sky-high prices by ramping up production, the risk of a sudden collapse of the global oil price—always considerable—would increase further. So would Russia’s pernicious addiction to energy profits. Gaddy and Ickes therefore think that the Putin regime deliberately uses uncertainty about property rights and high tax rates to encourage domestic producers to leave their crude in the ground.

Looking at the gas sector, Tatiana Mitrova, a leading Russian energy expert, offers a more upbeat outlook in chapter 8. She says Gazprom has both the financial muscle and the strategic planning capacity to retain its position as the world’s top gas producer. The company seeks to diversify its export markets away from Europe, and to shift the focus of its production activities gradually from the established but declining giant fields in West Siberia to new developments such as Yamal and Shtokman. These developments, however, will be hugely expensive. For Russia to raise the necessary capital, two things need to happen. First, domestic gas prices must continue to rise. This will not only provide Gazprom (and other energy companies) with additional money to invest, it will also encourage energy savings and a shift towards alternative sources such as nuclear and coal. Second, Gazprom needs security of demand. Rather than launching into a panicky debate about how to reduce their ‘over-dependence’ on Russian gas, the Europeans should sign new long-term supply agreements with Russia.

Pavel Baev, from Norway’s International Peace Research Institute, also counsels the Europeans not to worry too much about whether Russia will want to sell it gas in the future. There is no doubt that Russia finds the fast-growing Asian and LNG markets attractive,
and that its political relationship with the US would benefit from a stronger economic underpinning in the form of energy sales. But in chapter 9, Baev takes a sober look at Russia’s ambitious diversification strategy. The US-Russia energy dialogue remains moribund. The flexible, global LNG market is alien to Gazprom’s monopolistic corporate culture. And the expansion into Asia is proceeding at a snail’s pace. The much-hyped political rapprochement with China notwithstanding, Russia still sells only 5 per cent of its oil exports to its biggest neighbour. Most importantly, perhaps, persistent underinvestment in new fields means that Russia will simply not have the additional quantities of oil and gas needed for diversification. It would be much better off selling the limited amounts of oil and gas it has available for export westwards, where no multi-billion infrastructure development is needed. “In this period of relative scarcity”, concludes Baev, “diversifying into new markets is a luxury that Russia can ill afford.”

Roland Götz, one of Germany’s foremost experts on Russian energy, in chapter 10 looks at Russia’s diversification strategy from a slightly different angle: that of pipelines. Russia is shifting from transit pipelines (those that go through Ukraine, Belarus and other neighbouring countries) to direct ones, such as the offshore Nord Stream and South Stream routes. Many Europeans assume that the rationale for this move is political: Gazprom is a tool that the Kremlin uses to punish those former Soviet countries that try to escape its domination. Gazprom’s pipeline strategy therefore reinforces fears that Russia uses energy as a political tool. However, Götz argues that such a strategy makes good commercial sense: offshore pipelines do not require Gazprom to pay transit fees; they strengthen its hands in commercial negotiations with transit countries; and they help to ‘cordon off’ lucrative gas markets, such as Turkey’s, against unwanted competition. Götz warns that Europe is reacting to Gazprom’s strategy in the wrong way, by trying to buy gas from highly uncertain sources such as Turkmenistan, and by building pipelines of dubious commercial viability, such as Nabucco. Instead, the EU should acknowledge that it can only expect security of supply if it offers Russia real dialogue about security of demand and transit routes.

Daniel Gros, director of CEPS in Brussels, disagrees. The Europeans can only gain by diversifying their sources of gas supply. Gazprom, he argues on page 79, acts as a monopolist vis-à-vis the gas companies of the EU member-states, which means that it sets the gas price as high as it can get away with. If the Europeans had more alternative sources of imports, Gazprom would have to lower its price. Gros provides a simple calculation that shows that the Europeans could easily spend €30 billion on projects such as Nabucco and new LNG terminals and fully recuperate the investment through lower gas prices. However, since the benefits of diversification would be dispersed among Europe’s consumers, the EU may have to intervene directly to get the necessary investments off the ground.

Pawel Swieboda, who heads the demosEUROPA think-tank in Warsaw, also thinks the EU should play a role in building strategic infrastructure (page 40). This is only one of the ways in which the EU can shift the debate about ‘energy solidarity’ from vacuous rhetoric to practical action. It should also encourage the construction of more interconnections between national power and gas markets so that those countries that rely heavily on Russian gas (most Central and East European countries) and electricity (the Baltics) are better linked to the wider European market. The EU should invest more in strategic gas storage, and hand over management of such storage sites to an EU-financed agency. And the EU should reinforce efforts to achieve energy efficiency, not only within the EU, but also in its co-operation with Russia where the potential for energy savings is enormous. Without energy solidarity and commonly defined energy interests, Swieboda says, a common EU energy policy will remain elusive.

Vaclav Bartuska, the Czech Republic’s energy security tsar, takes a different line on energy solidarity on page 57. Unusually for
someone from a new member-state, he sides with those who argue that the EU cannot be expected to shoulder the financial burden of guaranteeing energy supplies to 27 countries (an argument made frequently in Germany and other rich, big countries that could expect to pay the lion’s share of such investment through the EU budget). What the new members need, writes Bartuska, is “not more protection but more responsibility”. Their calls for energy solidarity at the EU level are simply a cheap and easy way to deflect attention from their own inactivity. It is 17 years ago that the Central and East European countries emerged from Soviet domination. Yet, with the exception of the Czech Republic, they have done next to nothing to reduce their energy dependence on Russia. They should now bite the bullet and make the necessary investments in infrastructure, rather than shifting the blame onto the EU.

Such disagreements about energy solidarity are one of the reasons why it took the EU so long to agree on a mandate for a new bilateral treaty with Russia, to replace the 1994 Partnership and Cooperation Agreement. The EU officials contributing to this volume express the hope that the negotiations about the new agreement may offer an opportunity to construct a reliable, mutually agreed legal framework for EU-Russia energy relations. That framework was initially supposed to be the multilateral Energy Charter Treaty that regulates investment, transit and other important energy issues. Russia signed the treaty but has refused to ratify it. Many EU officials hope instead to include some of the ECT principles in the new EU-Russia agreement. However, EU members remain deeply divided over what the EU’s stance towards Russia should be, and the Georgia war will considerably delay the conclusion of the new agreement. So perhaps the issue of ECT ratification by Russia will return. Andrey Konoplyanik, who used to be the Energy Charter Secretariat’s Deputy Director-General, certainly thinks it should. In chapter 11 he argues that trying to export the acquis to big energy producers such as Russia is a non-starter. Instead the EU should focus on resolving its remaining disagreements with Russia over the ECT and its Transit Protocol. If Russia ratified the ECT, EU-Russia energy relations would be governed by a set of rules that applies to the entire emerging Eurasian energy market (see box on page 103).

Katinka Barysch is deputy director of the Centre for European Reform.
Russian oil and natural gas at a glance

<table>
<thead>
<tr>
<th>Oil</th>
<th>2006 (billion barrels)</th>
<th>Gas</th>
<th>2006 (trillion cubic meters)</th>
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<tr>
<td>Oil reserves</td>
<td>80</td>
<td>Gas reserves</td>
<td>48</td>
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<td>Oil reserves, as percentage of world</td>
<td>7 per cent</td>
<td>Gas reserves, as percentage of world</td>
<td>12 per cent</td>
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<tr>
<td>Saudi Arabian reserves</td>
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<td>Iranian reserves</td>
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<td>US reserves</td>
<td>30</td>
<td>US reserves</td>
<td>6</td>
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<tr>
<td>Oil production, 10 million barrels per day</td>
<td>822.2 billion barrels per day</td>
<td></td>
<td></td>
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<tr>
<td>Oil production, as percentage of world</td>
<td>12 per cent</td>
<td>Gas production, as percentage of world</td>
<td>21 per cent</td>
</tr>
<tr>
<td>US oil production</td>
<td>7 million barrels per day</td>
<td>US gas production</td>
<td>524 billion cubic meters</td>
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<td>Oil exports</td>
<td>7 million barrels per day</td>
<td>Gas exports</td>
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<td>Oil exports, rank</td>
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<td>Gas exports, rank</td>
<td>1</td>
</tr>
<tr>
<td>Oil exports to US</td>
<td>70,000 barrels per day</td>
<td>Gas exports, to Europe</td>
<td>111.1 trillion cubic meters</td>
</tr>
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</table>

Source: Energy Information Agency

Source: Industry reporting.
2 Energy geopolitics in Russia-EU relations

Dmitri Trenin

In 2005, as the Kremlin began to prepare for the first ever Russia-hosted G8 summit in St Petersburg, it identified energy security as the dominant theme. But less than six months before the summit, scheduled for mid-2006, the gas price conflict between Gazprom and Kyiv resulted in a four-day disruption of supplies to Ukraine. Many Europeans and Americans subsequently accused Moscow of using energy as a weapon. Energy security became synonymous with security against Russia. Speaking on the eve of the NATO summit in Riga in November 2006, US Senator Richard Lugar proposed the creation of an ‘energy NATO’.

In the minds of many, the geopolitics of energy relationships has replaced or absorbed the traditional geopolitics of military balances. In Russia, oil and gas, rather than the army and the navy, are being touted by ascendant conservatives as the country’s most important assets. In Europe, concerns about the Fulda Gap have been succeeded by concerns over the Nord Stream pipeline. And Gazprom acquisitions are regarded with almost the same anxiety as local Communist party gains were in various western countries during the Cold War. Indeed, the arrival of some new version of the Cold War, fought in part with energy weapons, is repeatedly prophesied.

Should one worry about Russia as an energy superpower? The short answer is No, because Russia’s energy policy is much more about seeking profits than about establishing political domination. To give a long answer, one needs to analyse the ambitions, interests and objectives of the parties involved, as well as their resources.
Russia will remain an energy power

Russia wants to be a great power, which means, under 21st century conditions, an independent global player. In recent years, Vladimir Putin has decided to call off Russia’s previous strategy of integrating with the West. This decision was based on the leadership’s general reading of Russo-Western relations from the 1990s to the early 2000s, but it was prompted by two important developments. One was Mikhail Khodorkovsky’s move to sell his Yukos oil company to American buyers; the other was the advent of ‘colour revolutions’ in Georgia and Ukraine, two important transit countries for Russian energy. Russia’s decoupling from the West occurred, of course, against the backdrop of the US war in Iraq, a country with the world’s third-largest oil deposits. By the mid-2000s, energy was playing a key role in Russia’s re-orientation from pro-Western to independent great power.

In order to achieve the stated goal of strategic independence and international prominence – epitomised, for example, by the goal of becoming the world’s fifth largest economy by 2020 – Russia is determined to use its few but important comparative advantages, above all its oil and gas. Russia is home to just over 6 per cent of proven oil reserves and it accounted for 12 per cent of global oil production in 2006. It also has about a quarter of the world’s natural gas deposits and is responsible for a fifth of total gas production.

Windfall profits from energy exports have allowed Russia to gain financial power, and the trickling down effect has benefited many other sectors of the economy. But the government is also keenly aware of the need to modernise the oil and gas sector and to make progress with the development of other parts of the energy sector, such as clean coal and internationally competitive nuclear energy. Russia’s energy specialisation is here to stay, certainly for the medium and possibly long term.

The Russian leadership assumes that international energy prices will stay high for some time, periodic fluctuations notwithstanding.

Alternative sources of energy, save for nuclear power, will not make a major impact on the market in the foreseeable future. Moreover, on nuclear, as well as coal, and electricity generation more broadly, Russia is in a strong position. While the notion of Russia as an energy superpower is an exaggeration, Russia as an energy power is credible, especially if it manages to become a more advanced producer and more efficient consumer. When a number of Russian companies decided, with prodding from the state, to create an international award capable of competing with the Nobel Prize, they opted for “Global Energy”.

The expansion of Russia, Inc.

Russia’s interest in energy is overwhelmingly business-related. At the beginning of the 21st century, Russia’s business is business. ‘Russia, Inc.’, as the country’s politico-economic system is sometimes called, is seeking above all to increase the capitalisation of its largely state-owned giants, such as Gazprom, Rosneft and the now-reformed electricity company UES, to the benefit of shareholders and stakeholders in the Kremlin and outside. In their view, what is good for Gazprom (or the others) is good for Russia. The growing number of IPOs in the past five years reflects this endeavour. But they are only the tip of the companies’ and their beneficiaries’ ambitions.

Gazprom has been aggressively seeking to acquire infrastructure abroad, such as transit pipelines and gas distribution centres and networks, ranging from Beltransgaz, the Belarusian gas transit and distribution company, to proposed gas hubs in Central and Western Europe. What may look like a clever and sinister strategy to expand Russia’s political influence within the expanded borders of the European Union is in fact a business-driven effort to win lucrative markets. In a similar vein, private Russian oil companies such as Lukoil have been buying up refineries and gas stations across Europe, and a metals firm, Severstal, made an unsuccessful bid for Arcelor. Indeed, Russia’s idea of integration
with Europe could be summarised as cross-investment and reciprocal stock acquisition.

In a sweeping proposal to the German Chancellor Angela Merkel, in 2007, Putin offered a major assets swap, under which Gazprom would acquire assets in Germany’s gas distribution networks in exchange for German acquisitions of Russian upstream assets. Though Germany spurned this initial offer, the idea of a grand energy bargain is not off the table. Meanwhile, Gazprom has been busy strengthening its bilateral ties with Europe’s top energy companies. Germany’s E.ON and BASF, Italy’s ENI and Enel, Gaz de France and the Dutch Gasunie have all concluded long-term deals with Gazprom.

The most dramatic changes by far, however, have happened in the former Soviet space. From 2005 onwards, Gazprom has been abolishing its system of de facto imperial preferences which had allowed various CIS states to buy Russian gas at hugely discounted prices. This came as part of Moscow’s general policy to shift its relations with the CIS on a more commercial basis. What many outsiders saw as a cold-blooded Kremlin attempt to strangle an independent-minded and democratically oriented Ukraine was largely a desperate and fairly heavy-handed effort to make Ukraine pay a more adequate price for the resources it consumed. True, it was the 2004 Orange Revolution that jolted the Kremlin out of its former complacent mood. But the new approach applied across the board, from revolutionary Ukraine and Georgia, to Moscow’s allies in Minsk and Yerevan.

The timing of price hikes was staggered (Belarus was given a grace period, so as not to undermine President Alexander Lukashenko ahead of a poll), and the actual prices charged differed somewhat (Russia-friendly Armenia got a better deal than a more hostile Georgia), but no one was spared. The ‘former’ Soviet Union ceased to exist: from Gazprom’s (or Moscow’s) perspective, everyone was now abroad. Russia no longer considered itself a former and future empire; instead, it started to act as a great power vis-à-vis its smaller neighbours.

Clearly, that game was about politics, and energy did play a role in the Kremlin’s calculations. But then, subsidised gas prices are as much a policy tool as prices raised to ‘European’ levels. In the 1990s, Moscow hoped to buy the loyalty of Kyiv and others by charging them only a fraction of the price it demanded of the Balts, the Poles or the Germans. When it finally saw that that was not working, it changed tack. Another, and more insidious, way of buying influence was engaging in opaque schemes in the gas trade. The Russo-Ukrainian relationship in the 1990s and the early 2000s is a prime example of this. After the Orange Revolution, both techniques have been on the way out. Russia has lost its illusions, but is marginally richer as a result. Ukraine is free at last, even if it has to pay for it.

This display of harshness toward the former borderlands, however, was never meant to beat Europe into submission. Gazprom had no reason to do so. First, because EU member-states were paying top prices for Russian gas; and second, because any attempt to blackmail the Europeans (and make them turn away from Russia) would have been foolish, given how dependent the Russian budget is on the proceeds from gas and oil exports, 60 per cent of which go to the EU. All the Russians might have hoped for, foolishly, was to win Europe as a partner in bringing Kyiv back to its senses. In fact, the Ukrainians, shut off from Russian supplies, creamed off gas exports destined for the EU and got away with it. The Russians were then squarely blamed for temporary shortfalls in EU countries. That was a bitter lesson, but the Russians needed it.

Even before the Ukrainian gas crisis, Gazprom had had a similar problem with Belarus. Politically, authoritarian Minsk is a far cry from pluralist Kyiv. Belarus had become even more addicted than Ukraine to cheap oil and gas supplies from Russia, some of which it resold at a substantial profit. When Gazprom in 2004 briefly
interrupted gas shipments to Belarus, citing Minsk’s non-payment, few people in Europe noticed except for the Poles. When Russia halted the oil flow to Belarus in early 2007, Europe was soon up in arms. The Kremlin was appalled. It had believed for years that the West had wanted Russia to put pressure on Europe’s “last dictator”. Russia, of course, did not mean to punish Lukashenko: it wanted him to pay up and fulfil his old promise to sell Beltransgaz to Gazprom.

**A direct route to Europe**

Together, Ukraine and Belarus, as transit countries, have controlled the lion’s share of Russia’s oil and gas exports to Europe. Since the Kremlin came to view both as unreliable, it decided to substantially reduce Russia’s dependence on them. In 2006 Gazprom, with Ukraine’s co-operation, replaced barter payment for transit across Ukraine with money transactions. This simplified the payment procedure, reduced haggling, and increased Russian revenue. More important, however, was Moscow’s decision to shift gas export pipelines from land to sea, and thus to decrease the need for transit, if not eliminate it altogether.

This trend started in the early 2000s, when Russia stopped the flow of oil through pipelines to ports in the Baltic states, using instead its own Baltic Sea terminals, Primorsk and Ust-Luga. The Estonians and Latvians saw this move as punishment for what the Russians claimed were unduly harsh naturalisation and integration policies that left hundreds of thousands of local Russian residents stateless. More to the point, Russia wanted to develop its own port infrastructure and keep the money in the country. Already in the 1990s, Gazprom had built the Blue Stream pipeline across the Black Sea to Turkey, thus avoiding the politically hazardous land route along the Caucasus coast.

But it was the 2005 Nord Stream deal between President Putin and Chancellor Gerhard Schröder that attracted most attention. This pipeline – initially scheduled to be ready by 2011 – will transport gas across the Baltic Sea from Russia to Germany, and on to the Netherlands and possibly other EU countries. Nord Stream’s obvious objective is to go around Poland, Belarus and the Baltic states, all deemed a potential (or real, in the case of Belarus) nuisance.

A similar move followed in 2008, when Russia and Italy agreed to construct a South Stream pipeline along the bottom of the Black Sea and across several Balkans countries – but not Ukraine. Some fear that South Stream, if realised, could make the EU-favoured Nabucco pipeline superfluous. Nabucco would bring Central Asian and theoretically also Iranian gas to Europe, thereby reducing the EU’s reliance on Russian gas and pipelines.

Prior to announcing South Stream, Russia had secured agreements with Kazakhstan, Turkmenistan and Uzbekistan on the continued transport of their gas across the Russian territory, in return for a substantial increase in the prices Russia pays for this. Instead of a proposed pipeline across the Caspian which would pump gas into the Nabucco system, the Central Asians have announced that they will upgrade the littoral pipeline going north to Russia. The pipeline competition is far from over, with Central Asian states clearly enjoying practising what they call multi-vector foreign policies. Moscow, for its part, is not only seeking to undermine Nabucco; it has already destroyed Ukraine’s hopes of receiving cheap Turkmen gas. Seen from Kyiv, Gazprom’s activities in Central Asia look like efforts to build a ‘gas caliphate’. Yet, there are likely to be several ‘caliphs’ in this game.

**A gas OPEC?**

Vladimir Putin once called the idea of a gas OPEC “interesting”. Moscow, however, is not particularly keen to become the organiser of a new gas community. It values its sovereignty of decision-making and prefers to keep its hands free, pragmatically siding with various partners as its interests demand. Central Asia is being managed on
The cases of Russia’s alleged recent use of energy as a weapon require closer scrutiny. With respect to Ukraine, Belarus and other CIS countries, one can argue that discounted gas prices represent a more credible instrument of political influence than world-level prices, which require no payment in kind. In any event, an energy weapon can only be used once, in a suicidal strike which creates a temporary disruption for the consumer, but permanently cripples the producer. The Russians are not jihadis.

Russia’s refusal to pump oil to Latvia’s Ventspils Nafta from 2003 or Lithuania’s Mazeikiu Nafta from 2006, which obviously have more than technical reasons behind them, represent the blatant use of strong-arm tactics in economic disputes.5 Basically, Russia believes that the Baltic states are not (or at least not yet) in the same category as its established large customers in Western Europe, and so it feels free to respond more brutally when it sees its interests infringed. This does indeed constitute a case of using energy as a weapon, but in the form of a border skirmish rather than full-scale war.

Diversification of imports and exports is a good thing in principle, with the European Union eyeing Central Asia and Iran as well as LNG, and Russia looking at East Asia and also LNG. For the foreseeable future, however, the energy bond will represent the economic hard core of the relationship between Russia and the EU.

Gazprom is Russia, and Russia is in a competitive and nationalistic mood, neither of which promises an easy relationship in the future. Yet, the more assets Gazprom acquires in Europe, and the more assets Europeans acquire in Russia, the higher each party’s stakes in the other’s economic health and prosperity, and the more vulnerable each one is to the threats the other party may face. Like Russia, Gazprom wants to make money, be strong, rich and respected. There is no ‘geopolitics of energy’ per se. Gazprom’s
moves are often misconstrued as a tool of some political strategy. The reality is different: energy is a political business, but it is business first and last.

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3 The EU-Russia Energy Dialogue

Christian Cleutinx and Jeffery Piper

To read much of the press today, one could believe that the European Union only woke up to the challenge of energy security towards the end of 2005, with the informal EU summit at Hampton Court, and the January 2006 gas dispute between Russia and Ukraine. Apparently, it suddenly dawned on EU policy-makers that Europe’s indigenous hydrocarbon production was not endless and that the EU would become increasingly dependent upon the international market for its energy imports.

This is clearly false. Internally, the EU has been very active for many years in constructing a fully integrated EU-wide electricity and gas market, promoting the necessary additional infrastructure through the trans-European energy networks programme, ensuring that all member-states hold sufficient oil security stocks, and promoting energy efficiency, energy savings and the use of renewable energy sources. All of this has been given renewed impetus following the March 2007 European Council, but much of the groundwork had already been done.

Externally, the EU-Russia Energy Dialogue – established at the October 2000 EU-Russia summit – was the first real energy policy dialogue set up with an external energy partner. Russia, as the EU’s key energy trading partner and neighbour on the European continent, was a natural choice, as it had been in 1999 for the first of the EU’s ‘common strategies’ under the then newly-ratified Amsterdam treaty.

6 At this summit, EU leaders endorsed targets to reduce the EU’s greenhouse gas emissions by 20 per cent (or 30 per cent as part of a post-Kyoto agreement), achieve energy savings of 20 per cent and increase the share of renewable sources in total energy consumption to 20 per cent, all by 2020.
The Energy Dialogue, from the outset, had a clear mandate to “enable progress to be made in the definition of an EU-Russia energy partnership and arrangements for it”. The underlying objective was to construct an effective energy community between the EU and the Russian Federation. This would build upon the well-established energy trading relations which, in the oil sector, dated back over 150 years, while the first imports of Russian gas by pipeline to Austria occurred in 1968. Already in June 1991, at the EU summit in Dublin, the then Dutch prime minister, Ruud Lubbers, introduced a proposal for a ‘European energy community’, with the aim of developing energy co-operation among the states of Eurasia. This idea was maybe too ambitious for its time. Nevertheless, it has since grown into a multilateral treaty – the Energy Charter Treaty – which today has 53 signatories across Europe and Asia, as well as Australia (see box on page 103).

Energy is the challenge and the solution

Russia is today the EU’s foremost external supplier of oil, gas and coal. This relationship between close neighbours is entirely logical and mutually beneficial, given the substantial energy reserves in Russia and the reliable and growing market in the EU for imported energy.

Clearly any relationship between close neighbours has its ups and downs, and it is evident that the recent past has not been one of the easiest periods in EU-Russia relations. The energy sector is both a key part of this challenge and a major part of the answer.

The responsibilities for the recent bumpy patch are shared. Within Europe, there are those who criticise Russia for an alleged strategy of ‘disaggregation’ – striking bilateral deals with individual EU member-states – in an attempt to prevent the development of a common EU energy policy. However, in reality, Russia has been exploiting the inability of the EU member-states to speak with one voice. Russia’s perceived strategy is in fact the mirror of the EU’s weakness, not the cause of it.

For the EU, the key to its security of supply is market integration and solidarity. Individual EU countries would worry a lot less about their dependence on Russian supplies if there was an effective integrated EU-wide energy market, with all the necessary physical interconnections to encourage a policy of full solidarity. Indeed, the solidarity principle is one of the cornerstones of the Lisbon treaty and applies specifically to the energy sector.7

The EU is fortunate to be surrounded by three of the current major gas exporters – Russia, Norway and Algeria. But reserves for future production of natural gas are mainly concentrated in Russia and the Middle East. Therefore, Russia is and will remain our key supplier. However, the challenge is to bring Russian gas to the market. Russia’s reserves are geographically distant from markets – be they European or other – and are located in climatically, if not geologically, challenging environments. This necessitates huge capital investment and it is here that the EU has major concerns.

The concern is about Russia’s ability – not willingness – to deliver sufficient quantities of gas to the EU in the future. The Europeans worry about a forthcoming supply crunch, given the very significant growth in internal Russian gas consumption and a perceived lack of investment to develop new production sites.

By 2030, gas imports into the EU could rise by another 200 billion cubic metres (bcm) a year, from around 300 bcm today. At the same time, the most recent forecasts from Russian experts are for an increase in gas exports of some 100 bcm per year by 2030 to all destinations, including Asian markets. Given these unavoidable physical limitations and given that a reasonable diversification of supply and demand is always, in all sectors of the economy, a prudent policy, the EU is looking to diversify its supply sources for...
A recent example of this difference of approach can be found in Russia’s new law on foreign investment in strategic sectors. While clarifying the investment situation, there is a risk that the overly restrictive nature of the law with respect to third country companies could result in a slowing down of foreign investment in the Russian oil and gas sector. If energy output declines as a result, the loser will not just be the EU consumer and EU companies, but also the Russian state and Russian citizens who will not reap the full benefit from taxes and other revenues resulting from the current high international hydrocarbon prices.

Increasing interdependence between the EU and Russia on the European continent is natural and should be evaluated positively in the light of security of supply and security of demand, but it has to be balanced in terms of market access.

Turning to the issue of energy infrastructure, Russian and European companies have undertaken several important projects designed to enhance our common energy security. These should not be seen as competing projects bearing in mind the additional gas imports that the EU will require. There should be enough gas demand for all of them – the question is whether there are sufficient supplies.

One of the most contentious is the Nord Stream gas pipeline, which is expected eventually to transport 55 bcm of gas by 2015. The results of the environmental impact assessment under the ESPOO convention should answer a number of the concerns that have been raised about this pipeline. But it is also important to project clearly where the gas to fill the pipeline will come from. The gas must not be diverted from existing pipelines.
The achievements of the Energy Dialogue

All these issues are discussed in an open way in the framework of the EU-Russia Energy Dialogue, including in the three thematic groups where the EU member-states, the Russian government, industries from the EU and Russia, and the Commission all play a crucial role.

Some experts have suggested that there is a lack of progress. To answer this comment, it is important to begin by underlining that the dialogue is pragmatic. It adopts a bottom-up approach in identifying key issues of common interest that can be built upon. There are no big political declarations, but work is being done and steady progress is being achieved.

A recent example has been the joint reflection on how better to exchange information and mitigate the kind of supply problems encountered in January 2006 and 2007. This resulted, at the EU-Russia summit in October 2006 at Mafra in Portugal, in an agreement to establish an early warning mechanism. Such a mechanism will identify supply and demand problems in advance and permit Russia and the EU to be prepared to minimise the impact of any disruptions in the short, medium and long term. It has already demonstrated its utility in practice. The strong support that President Dmitry Medvedev expressed for this mechanism in his Berlin speech of June 5th 2008 is welcome.

The Energy Dialogue’s list of successes is much more extensive than this. It has contributed to:

★ Russia’s ratification of the Kyoto protocol – a major success given that without the ratification of Russia, Kyoto would not have come into force;

★ enhancing maritime safety for the transportation of heavy oil by tanker;
In June 2008, the Commission finally received the mandate from the member-states to open discussions on a new EU-Russia agreement. These should build in a constructive manner on the experience and achievements of the EU-Russia Energy Dialogue and other bilateral dialogues. The new agreement will offer a real opportunity for building a mutually respectful framework within which trust can be re-built by addressing issues of real concern to the benefit of all citizens of the European continent.

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The authors have been involved with the EU-Russia Energy Dialogue since its inception in October 2000. However, the views expressed in this article are those of the authors and do not necessarily reflect those of the European Commission.

To conclude, the EU and Russia are mutually dependent in the energy sector. The structure of the overland energy transportation network on the European continent is a clear attestation of this fact. And this will not change. Russia will remain the key energy exporter into the EU and the EU will remain the key energy market for Russia.
Energy is a priority area of co-operation between Russia and the European Union, equally important for both sides. In recent years, their interdependence and integration in energy has been growing further. Therefore, energy security – security of supply for the EU and security of demand for Russia – has become ever more important.

The EU-Russia Energy Dialogue is among the central issues of the ‘road map’ for the common economic space. Its importance goes beyond the bilateral relationship, and directly affects global energy security.

The basic principles underlying our dialogue with the EU in this area, as well as with the rest of the world, were clearly defined at the G8 summit in St Petersburg in 2006: transparency, predictability, stability of energy markets, mutual responsibility of producers and consumers based on more equitable risk-sharing, and security of supply as well as demand. Russia depends on stable long-term European demand in no lesser degree than the EU depends on our stable supply. We see this interdependence as positive.

Our discussions on energy have allowed our EU partners to understand our policy in this area, to overcome suspicion and to stop searching for non-existent imperial designs. However, regretfully, from time to time, we are disappointed.
We are particularly surprised at this proposal against the background of ongoing consolidation in the European energy sector, such as the merger of the Belgian-French Suez and Gaz de France. We also wonder to what extent this ‘protection mechanism’ complies with the legal commitments of the Partnership and Co-operation Agreement, in particular article 28, which deals with non-discrimination against Russian companies and subsidiaries.

In the same vein, the European Parliament in 2007 adopted a resolution on energy. All its Russia-related content can be summarised in one phrase: while the EU is seeking full access to Russian resources and pipelines, the European Parliament is unwilling to let Russian investors buy into the EU energy sector. Would the EU be happy if the Russian parliament adopted a similar resolution?

We keep stressing to our European partners that we need to deal with each other on equal terms. Russia should get adequate access not only to energy distribution assets in the EU, but also to other sectors that are as important for the EU economy as energy is for Russia. For example, the Russian electricity sector is in the process of being restructured. Foreign companies have been actively participating in this process, both in privatisations and through investments in new infrastructure. Enel and E.ON have both been buying power stations in Russia.

We clearly need guarantees that existing agreements on the operations of Russian companies in the EU energy sector will be complied with. Otherwise, those in Russia who oppose deeper energy integration with the EU will have yet another reason to support the re-orientation of energy supplies to the east or to the US.

**No blackmail by transit states**

There is another aspect I would like to focus on. Our western partners seem interested in Russia moving to purely market-based,
I want to emphasise once again that Russia’s policy is aimed at establishing transparent rules and conditions for energy cooperation, and moving towards market principles for all the countries we deal with, including the transit ones – which say they prefer to deal with us not on the basis of political considerations.

The Energy Dialogue, like any dialogue, is a two-way street. We expect reciprocal steps from the EU, in particular non-discriminatory access for Russian companies to various segments of the EU energy market. Clearly, EU-Russia energy relations will never be completely smooth and trouble-free. But difficulties should not become an obstacle in the development of EU-Russia relations. On the contrary, our efforts to overcome such difficulties should set the pace for our wider co-operation.

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transient pricing mechanisms for the delivery of energy supplies to countries such as Ukraine and Belarus. We have already seen attempts by countries located between the EU and Russia to blackmail both of us. We must counter such attempts with a joint, clear and strong policy. Difficulties with transit countries may be another argument for constructing new pipelines designed for supplying energy directly to the customer. Unfortunately, EU countries have often used problems with transit countries to reinforce fears about Russia.

Our energy policy priorities therefore include diversifying supply routes, reducing our dependence on transit countries and speeding up the construction of new pipelines. Projects such as Nord Stream, South Stream and the trans-Balkan oil pipeline between Burgas and Alexandroupolis have to be seen against this background. Nord Stream was approved by the European Commission and is being implemented jointly by Russia, Germany and, since November 2007, the Netherlands. However, certain EU countries are putting spokes in the wheels of this project, in spite of the fact that it pursues a common EU-Russian goal, namely the diversification of supply routes, while at the same time reducing the political, economic and environmental risks of energy transit.

On the more positive side, the South Stream gas pipeline across the Black Sea is progressing. The successful completion of this project will contribute to reliable, long-term gas supplies to EU member countries. Italy will be one of the main beneficiaries, so it is no coincidence that South Stream is a joint project of Gazprom and Italy’s ENI.

According to current estimates, in addition to the existing Yamal-Europe export route, the completion of these two projects will substantially increase our gas exports to Europe, to 200 bcm per year from 150 billion in 2007. Norway, Europe’s second largest outside supplier, sold 88 bcm that year.
Putting flesh on the bones of energy solidarity

Pawel Swieboda

The fragmentation of the European energy market dates back to the 1970s, when EU member-states responded in an individual fashion to the oil crisis. Some countries, like France, diversified their energy mix. Others proceeded to rapidly explore their own reserves, as the UK did in the North Sea. Germany built up strategic reserves of gas and invested heavily in infrastructure. The Sinatra strategy of “do it my way” has been at the core of today’s inability to build a strong and coherent European energy policy. It has been magnified by the competition policy of the European Commission which in the 1990s took national markets, rather than the European one, as the point of reference in its decisions on mergers and acquisitions. It will not be easy to reverse that situation. And without reversing, or at least correcting it, Europe will never be able to bargain with Russia from a position of strength.

Solidarity and a better understanding of the commonality of interest among European countries is key. The reasons are three-fold. First, energy is not like other commodities sold in markets. Its supplies are finite and concentrated in certain countries. Market failures and distortions are widespread. The need to prevent and adapt to climate change has become imperative. As a result, strategic and joint planning is needed for European energy security. Second, there is no reason why energy should be excluded from the scope of the single market – especially at a time when energy prices and insecurity about supply have a growing impact on the wider economy. However, given the different starting points to the project of building a single market in energy, solidarity will be needed. Thirdly, the EU also needs to stick together to ensure the best possible terms in agreements with producer nations, particularly Russia. Given that Russian gas supplies to the EU are governed by long-term contracts, co-ordination among key European actors is a must to ensure that Russia does not play off one recipient against the other.

In practice, solidarity in the field of energy can be achieved through the following steps:

★ helping to introduce the single market in the field of energy and overcoming remaining barriers;
★ encouraging energy efficiency;
★ investing in strategic infrastructure – pipelines and gas storage;
★ co-ordinating positions vis-à-vis Russia and other producer nations and ensuring transparency of dialogue with third countries.

It is due to the lack of solidarity that we do not have a European grid and pipeline network. We tend to forget such fragmentation was the norm in Europe before the 1970s: motorways, rail tracks and telephone lines ended at the border. Means of communication, and to a lesser extent transport, have since been integrated Europe-wide. But energy has lagged behind – and does so today.

At the Barcelona European Council in 2002, the EU members pledged to increase interconnections between their national electricity grids to at least 10 per cent of the installed generation capacity by 2005. Leaders recognised that inadequate cross-border infrastructure made it impossible to fully integrate markets. Yet a lot of regions still suffer from insufficient interconnections. As a result, some countries have an oversupply of power while others struggle with shortages. The problem of interconnection is also apparent in the gas market. Here, the lack of sufficient cross-border pipelines prevents the emergence of genuine competition and the strengthening of the role of energy hubs. This situation allows Russia to exert more control over the European gas market through a matrix of special relationships with a select group of operators. The dominant EU doctrine of full market liberalisation is a prerequisite for the efficient use of existing infrastructure. But it is not enough. Differences between national markets make it very difficult for a single European regulator to emerge, which would be needed to iron out cross-border bottlenecks and allow for more investment in interconnecting infrastructure.

Solidarity is not about getting energy security on the cheap. Poland ranks second in the EU in terms of energy security because of its enormous coal reserves, according to the Brussels think-tank Bruegel. Gas plays a secondary
role in the energy mix of the country, way below the EU average share of just over 20 per cent. Nevertheless, Poland worries about the impact that decisions on the location of gas pipelines have on the functioning of the market. In spite of the growth of the LNG sector, gas is still mostly transported through pipelines. This means that being able to control the network gives producer nations enormous leverage over consumers. Some EU countries have agreed on new pipeline plans with Russia after Moscow promised them an enhanced role as a hub for Russian gas imports. But Europe as a whole is worse off as a result. Intra-EU divisions make it easier for Moscow to dictate terms when it comes to the pricing of gas and the conditions of supply contracts.

In an ideal scenario, the EU should work out a strategic plan as to what kind of pipeline network it needs to ensure sufficient diversity of supplies. Once it has defined its priorities, the EU will find it easier to strike the necessary agreements with supplier nations and private sector companies. Europe also needs more investment in strategic gas reserves. The EU gas market would function much better if sufficient gas were always available in case of supply shortages. Given the strategic importance of well-functioning energy markets, European gas storage should be operated by an EU agency and its operation financed from the EU budget.

The challenge of climate change means that the EU should place more emphasis on targeting demand for energy, rather than trying to secure ever greater supplies. The potential for energy savings and efficiency remains enormous, not only in the EU but also in the energy producing nations. Given the huge energy inefficiency of the Russian economy, Moscow and St Petersburg provide, in a certain sense, for bigger reservoirs of energy than new gas fields in more distant parts of the country. The EU and Russia need more co-operation in the field of energy efficiency, as well as innovative financing as offered, for example, within the Northern Dimension programme.

Solidarity is not a free lunch. But to calculate and distribute the costs is difficult. Investments in strategic infrastructure will be necessary at the European level but the benefits will often be unequally distributed among member-states and many will accrue in the form of lower prices for end-users. Given the importance of EU policies in energy and climate change, the EU should use its ongoing budget review to earmark more funding for these areas. It should identify investment projects of European interest, which could be financed through a Europe-wide energy tax. Such steps would enable the EU to make a real difference to the energy security of its member-states and people.

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Do we have a shared future in energy?

Konstantin Kosachev

It is quite strange that, instead of uniting the whole of Europe (to which Russia belongs geographically, historically, culturally and psychologically), the question of energy has, in recent years, become an issue dividing the continent. It is a source of tensions that requires considerable efforts and resources to defuse. It is strange because we have here the classic case of a consumer and a supplier who are equally dependent upon each other and who share an obvious economic interest. At one time, this led to the famous ‘natural gas pipeline’ project between the Soviet Union and Western Europe. Implementation of this project provided the impetus for a sea change in the international climate.

These days, however, instead of working out how to create a unified European (or even Eurasian) energy system – that is, a model for the future – we dwell on how to construct mechanisms of mutual control and insurance – models of the past. This completely unnatural situation, which flies in the face of both common sense and economic interest, has arisen because the energy issue has become excessively politicised.

Does Russia stand to gain from this? Those aware of the situation in our country and the leadership’s plans to modernise virtually the whole state – from the mechanism of government to the economy – will tell you straight that Russia really has no time for such games at present. What on earth is the point of scaring the average European with the “authoritarian gas bear from the East” who “feeds on fledgling democracies”? 
If we analyse the real content of the Energy Dialogue between Russia and the EU (and the West as a whole), it is not clear what objective basis there is for all the sinister intentions Russia is supposed to harbour. Take, for example, the problem of energy security. This is a problem that simply does not exist for Russia, at least not in the form confronting most European countries, which are almost entirely dependent on energy imports. Nevertheless, it was Russia which, during its G8 presidency, first posed the fundamental question of energy security, an issue of primary importance not so much for itself as for its partners. Yet what do we hear in response? One of the two candidates for the US presidency considers that Russia should be expelled from the G8.

When Europeans invite Russia to “consider the issue of energy security” what they mean, more often than not, is “to consider how Russia can alleviate the fears of its partners in Europe”. Naturally, we understand EU members’ apprehensions, particularly when Gazprom’s negotiations with Ukraine and Belarus over gas pricing deteriorated radically. And of course we try to take those concerns into account by always insisting in our negotiations with transit states that, regardless of the outcome of our discussions, European interests should be safeguarded.

Imagine we responded to the concerns of our western colleagues in the same way as they treat our misgivings over NATO’s expansion to incorporate our neighbours, the deployment of strategic weapons close to Russia, or the condition of Russians in the Baltic states – that is, virtually ignore their concerns. This would provoke a fresh wave of indignation in Europe and the US over Russia’s “treachery and selfishness”. For some reason, the approach demanded of us in one sector – that of energy – is deemed not to apply to the no less important area of security. We are made to understand that energy is like Kosovo, a “particular and unique case which cannot be a precedent”.

Nevertheless, I suggest we look at how Russia is trying to resolve our common (yes, we consider them common) problems. We are exerting considerable efforts and investing large sums in order to deliver energy resources directly to consumers, via routes to the north and south which avoid unreliable transit countries. How do some Europeans respond? They attempt to block direct supply routes at all costs. They prefer yet again to see Russia as the threat. At one level or another, this is already turning into a comedy of the absurd in which it is becoming increasingly difficult for us to comprehend our partners’ logic.

Or rather, their logic is difficult to comprehend if we see it through an exclusively economic prism. From this perspective, it is certainly difficult to see why a customer would avoid a direct relationship with the supplier. But if you look at it politically, all becomes clear. There is a certain movement afoot to realign Ukraine (in particular) within Euro-Atlantic structures, while simultaneously using supplies of cheap gas from Russia to ensure peace and stability inside Ukraine during this difficult period. It is quite easy to understand how this helps the EU. But where is the political (let alone the financial) interest for Russia? Or, at the very least, how does it make sense for Russia? We are given no answer to this simple question.

There is another argument which is frequently implied, even if it is not presented to us openly. It is said that Russia is not a completely democratic country (this is the most restrained of the epithets we hear from politicians and the media in Europe and the US), that it does not belong to the western world, and therefore its intentions are unpredictable. Russia could decide to use Europe’s dependence on Russian supplies to blackmail EU countries and to exploit its natural resources as an energy weapon. Europe must therefore try to neutralise as far as possible the risks of relying on Russia.

Co-operation? Or self-defence?

To that end Moscow is invited to ratify the Energy Charter Treaty and its Transit Protocol, which would completely guarantee European interests. We do not doubt for one moment that it would
safeguard those interests since these documents have been drafted with just that in mind. Therefore, Russia would accede entirely on the terms of its European customers. Furthermore, the customers do not regard themselves as necessarily bound by the agreement’s provisions. It was on the EU’s initiative that the infamous article 20 was included in the draft Transit Protocol (the provision on regional economic integration), which would in effect relieve EU member-states of any obligation to adopt the norms of the protocol on their own territory by making the document binding on non-EU members only (see chapter 11).

To be frank, Europe is using this sort of scheme not so much to work with Russia as to defend itself from it. Virtually all offers the EU has made to us are not so much models of co-operation as mechanisms to neutralise Russia as a risk factor. There is an enormous list of what Russia should do: it should promote access to its pipelines by others. It should allow foreign companies unsupervised development of its hydrocarbons and, to this end, should curtail all state involvement in this sector. It should raise domestic energy prices (so pensioners in the polar regions buy their household gas and heating at higher prices than those in warmer Ukraine). It should sign all relevant documents on the customer’s terms, and so on. And this is just the list of what Russia should do in the energy sector; we could give plenty of examples of similar obligations in other areas.

Why should Russia do this? Is it in order for Russia to be treated reasonably, have its interests taken into account, have access to European markets and to the assets of the continent’s leading companies and bring about a pan-European energy market with all its members having a vote that counts? Nothing of the kind! All this is demanded of Russia in order that it cement its reputation as a reliable supplier and remove its partners’ apprehensions and doubts. Since Vladimir Putin refused to agree to such an ‘equal’ exchange – resources and pipelines in exchange for honeyed words – there are those who are now pinning hopes on the new Russian president. It is said he would confirm his reputation as a liberal and a democrat if he accepted the EU’s terms.

But to us a democrat is first and foremost someone who acts in the interests of the people who elected him. The electorate cannot grant a mandate for agreements that are detrimental to Russia. The result would be perverse indeed: the model democrat becomes someone who forgets about the elderly and the children in the country’s north and who attaches greater importance to other countries’ interests, who drags his country into NATO against the will of the people or who allows the deployment of strategic weapons systems (again, without seeking popular approval). Perhaps those who consider that our values diverge from those of others are not so wrong after all?

**Does Russia have to prove itself?**

It is time we abandoned the logic that says Russia must prove itself and adopt without question all the conditions dictated to it. We must abandon the logic that treats any other behaviour on Russia’s part as a threat to the West, as a sign of authoritarianism, of an ‘energy war’, that the ‘Russians are coming’ and so on. The starting point for a genuine dialogue must be the recognition that each party has its own interests. These interests do not always coincide (between supplier and consumer this is natural), but that certainly does not mean that they are mutually exclusive and insurmountable. On the contrary, they are naturally complementary. For decades the EU has been, and remains, our largest economic partner, and we have no reason to lament this.

It would be entirely in Russia’s interests to co-operate with its main trading partner in the energy and other sectors, and not just for commercial reasons. But the terms have to be reciprocal. The sentiment “first you have to prove yourself... and to that end sign here...” belongs to the past. In reality, a pan-European energy strategy has to be based on trust, on respect for the partners’
interests, strict equality in terms of give and take, and the
presumption of innocence and of the absence of ill intent.

The most unpromising approach to the EU-Russia Energy Dialogue
would be to wait until Russia becomes so weak or ‘democratic’ that
it will agree unconditionally to the terms offered to it. Russia is not
some humble supplicant knocking on the doors of Euro-Atlantic
institutions. Beyond its borders to the east is no economic vacuum
but the most rapidly developing region on earth with the greatest
economic prospects.

Russia has 26.6 per cent of the world’s natural gas reserves, between
6.2 per cent and 13 per cent of all known oil reserves and about 20
per cent of known coal reserves. Our country leads the world in the
trading of pipeline gas and as an oil exporter is equal first with Saudi
Arabia. These realities by themselves should discourage the
Europeans from using the language of ultimatums and pre-cooked
schemes that are designed purely to guarantee a comfortable
existence for their originators.

Our European colleagues would be well-advised to give some thought
to the following facts: the EU today imports more than 80 per cent of
its oil and 60 per cent of its gas. According to estimates from the
European Commission, by 2030 the EU’s import dependency will
have risen to over 90 per cent for oil and 80 per cent for gas.

We know that about 75 per cent of the world’s oil reserves are
located in Islamic countries. In 2002, at a meeting of the
Organisation of Islamic Conference, the Malaysian prime minister,
Mahathir Mohamad, said that oil was the only commodity possessed
by Arab countries that the world needed, and that a reduction in oil
production could be used to defend the interests of Muslims. To
recognise the full extent of Europe’s failure to appreciate Russia as a
(potential) strategic partner, one only has to compare western press
comments in recent years about OPEC countries and Russia, which
is the West’s neighbour and its spiritual and cultural partner.

Europe’s strategic mistake

This is, in my opinion, the most serious strategic mistake of European
politicians, and one that could eventually cost the EU its global
leadership. The extent to which Atlanticist considerations (which
resurface whenever Europe draws closer to Russia) are responsible
for this mistaken choice is not important for the moment. Nor is the
mentality of politicians from the EU’s new member-states which runs
through EU corridors. But it is clear that in the rush for quantitative
expansion – probably dictated by the aftertaste of the Cold War and
an eagerness to take deserters from the enemy camp, rather than any
real need on the part of Euro-Atlantic institutions – Europe has lost
out in terms of quality.

In the 1990s, there was a real opportunity to include Russia in the
processes of European institutional integration. All that was needed
was a willingness to sign up to such trivial concessions as the rights
of Russians to receive equal benefits as Europeans from such
integration. But there were those who believed that Russia was
already in a corner and that it could be hooked up to Europe as a
‘raw materials appendage’ with nothing given in return. Someone
decided that while Russia slumbered it was more important to accept
Poland and the Baltic states – and now Ukraine and Georgia – into
the EU and NATO, not out of necessity but out of spite.

Former German Chancellor Gerhard Schröder once said in an
interview with Le Monde that the question Europeans should be
asking themselves is how they wish to see Russia. Should it be a
country closely bound to Europe by political, economic and cultural
ties? Or do they want Russia, whose life we make difficult, to become
established as an Asian great power?

The reason why Russia does not unilaterally converge towards the
EU is not that Russia is not ready for European integration or to
absorb western values, as some claim, implying that one should
either await Russia’s transformation or stimulate that transformation.
It is rather that, even in its wildest dreams, the EU cannot imagine
Win-win co-operation is possible in energy

Andris Piebalgs

Russia is the most important external energy supplier to the European Union. In 2005, 42 per cent of our gas, 32 per cent of our oil and 24 per cent of our coal imports came from Russia. On the other side of the coin, European companies are Russia’s most important foreign investors and the EU is Russia’s most important export market, for energy and overall. It goes without saying that Russia will remain the single most important source of EU energy imports, to the benefit of both parties. Consequently, both sides must treat each other in the spirit of genuine partnership.

Our interdependence means that energy is a sector which can serve as a basis for the further development of the EU-Russia strategic partnership. The specific objectives of our Energy Dialogue – as originally formulated – are to improve investment opportunities in Russia’s energy sector, upgrade and expand energy production and transportation infrastructure, minimise the environmental impact, encourage the opening-up of energy markets, and promote energy efficiency and energy savings.

As discussed in different fora and in the meetings of the EU-Russia thematic group on energy strategies, scenarios and forecasts, the EU will need to import increasing amounts of oil and natural gas. Analyses of the precise data differ, but it is a fact that the EU’s indigenous production from the North Sea is dropping and that it will import increasing amounts of oil and gas from Russia.
Looking at the Russian supply side, it is obviously of major interest for the EU to see what quantity of hydrocarbons, in particular natural gas, the EU can realistically expect to import from Russia – taking into consideration the depletion of Russia’s ‘big three’ gas fields. Are upstream investments sufficient for Russia to continue as a ‘base load’ producer for the EU? Or will the continued increase in Russian domestic gas consumption and the late start-up of new natural gas fields such as Shtokman mean that there will be a shortage of gas in the years 2010-15? Preliminary figures from the EU suggest that that the independent producers in Russia have the potential to contribute substantially to gas exports to the EU by 2013-14. Nonetheless, the EU needs to have full clarity on Russian supply projection, and it needs to be able to respond to potential shortages.

Gas Flaring

In order to reduce the risk of a ‘gas supply gap’, the EU and Russia have a common interest in enhancing their co-operation to reduce gas flaring and improve energy efficiency in Russia. According to some analysts, the volume of associated gas flared in Russia corresponds to as much as 25 per cent of total Russian gas exports to Europe. The EU therefore welcomes Russia’s determination to expand co-operation in these areas and pursue a dialogue with the EU, particularly about approximating its legislation and regulations on energy efficiency and renewable energy, and sharing the knowledge and experience of the EU in these fields.

On gas flaring, we welcome recent developments at governmental level to oblige companies not to flare their gas. However, this should be accompanied by measures to allow the companies to commercialise the unflared gas. In other words, independent producers should be allowed to access the pipelines operated by Gazprom in order to be able to sell their gas.

Post-PCA negotiations

An adequate legal framework is necessary in order to safeguard trade and investment activities in the energy sector between the EU and Russia. The new agreement between the EU and Russia (to replace the current Partnership and Co-operation Agreement) should address all the necessary aspects and rules. These rules should enable companies from both sides to gain reciprocal and equivalent access to energy resources, networks and markets. Such a framework for investment would contribute to security of supply. It would allow and promote the development of hydrocarbons in Russia by independent companies, thus increasing the efficiency and diversity of investment and helping to mitigate the potential ‘gas gap’.

Pipelines strategies

The EU is rethinking its infrastructure policy with a global vision, including Russia, Central Asia and the Caucasus, and is linking this work to current energy forecasts. Under the new ‘strategic energy review’ and the green paper for the trans-European energy networks which are being prepared by the Commission, we need to define a new pipelines strategy that links the internal market with third countries.

The EU and Russia have a joint interest in building a long-term partnership, based on mutually beneficial energy relations. To this end, the successes achieved until now with the Energy Dialogue need to be further expanded. A true EU-Russia strategic energy partnership should provide certainty, security and predictability in the long term to both sides, to the degree possible and desirable in an open market environment. This, together with full transparency, will pave the way for the necessary long-term investments by both sides in existing and new production, as well as in the necessary transport infrastructure.

In conclusion, I would like to reiterate that the EU and Russia have much to offer each other. Our co-operation is not a one-way street,
but a mutually beneficial partnership that should aim not only at developing our energy sectors, but also at providing a solid basis for fruitful co-operation in other areas.

*Andris Piebalgs is the EU Commissioner for Energy.*

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**First responsibility, then solidarity**  
**Vaclav Bartuska**

There is no free lunch. And there is no energy security without the willingness to pay for it – with money, hard work and political capital. So when someone tells you that Europe can achieve its energy security primarily through solidarity, be aware. Yes, we should stick together. Yes, we are the largest trading bloc in the world, with half a billion customers. And yes, if we create a single market in energy, we will be much stronger vis-à-vis our suppliers. But solidarity should not mean a free ride for those who did not do their homework.

Let us presume that Russia decided to increase substantially gas prices for Poland or Slovakia. It could get away with it because these countries do not have alternatives (at least in the short term): they either agree to the rise, or are left without gas. If, on the other hand, Algeria tried to squeeze France or Britain, it would find itself pretty fast out of the market: Britain and France have invested in, among other things, LNG terminals and can buy gas from multiple sources. They cannot be easily blackmailed.

To put it simply: most of the Central and East European countries did very little to lessen their energy dependence on Russia. They have had plenty of time since the collapse of Communism in 1989-91. But governments and people in the region mostly felt that joining NATO and the European Union would bring sufficient security in all areas. Only in January 2006, during the Russo-Ukrainian gas crisis, did these governments appreciate their vulnerability – and also that neither NATO nor the EU provides energy security. So their call for solidarity seemed the fastest (and cheapest) solution.

But under the noble rhetoric about unity lies a more fragmented reality. For example, the Baltic countries – Lithuania, Latvia, Estonia – regularly ask for political support to join the biggest European electricity network, UCTE. On the
face of it, nothing should be more straightforward: the three victims of the Soviet regime want to join another Western club. Yet the fact is that 17 years after gaining independence (and four years after joining NATO and the EU), the Baltic three are still on the post-Soviet grid IPS/UPS that covers all 15 former Soviet republics plus Mongolia. The Baltics are there because it is profitable: cheap electricity from Russia, plus no need to worry about technicalities. On the other hand, UCTE requires expensive steps: each member must keep spare capacity (to be able to replace the biggest electricity source within 15 minutes), have national centralised control of the grid and so on – not an easy task, as Central and East European countries from Poland to Bulgaria learned when they joined the UCTE. The Balts probably found this price too high and the energy offers from Russia too irresistible.

**Eastern Europe has not invested enough**

This is the reason why the last 15 years has seen so little energy investment in Eastern Europe. Britain built a large LNG capacity because it made economic sense; it can now handle up to 40 bcm of gas a year coming from various outside suppliers. Meanwhile, many former Soviet satellites were paying truly Soviet prices, well below the market ones. Why bother with new infrastructure if the current system provides subsidised energy?

The Czech Republic is the only country in Central and Eastern Europe which diversified its oil and gas supply – long before the topic of energy security became fashionable. We built an oil pipeline from Germany in 1994-96, at the cost of CZK 12 billion ($400 million at the time) and concluded a long-term gas contract with Norway in 1997. The wisdom of these steps was questioned by many of our friends and neighbours.

Now, however, following a series of scares and crises, the same people ask for a unified European response, to prevent Russia from further raising energy prices for its Central and East European customers. On what grounds? And what can the EU really do?

One parallel is at hand: the price of oil has risen tenfold over the last seven years. Surely that benefited the oil producers (including Russia) and hurt customers, including the EU. So what did the European Union do to prevent this price rise? The short answer: nothing. The long answer: nothing because there was nothing it could do. The EU has no instruments to influence the price of commodities, at least in the short term. What it can and should do is to limit its reliance on energy imports. The Commission’s push for greater energy savings and energy efficiency has a vital role to play. To put it simply: we cannot influence the price of raw materials, but we can lower the amount we need. This is where European solidarity would be in order: to support structural changes in all member-states that would lead to higher energy efficiency, lower energy demand and less dependence on energy imports from problematic countries.

Just don’t call for any ‘solidarity’ that would be specifically aimed at Central and Eastern Europe. This region needs more responsibility, not more protection. Back in the early 1990s, when the Czech-German negotiations about the new oil pipeline were underway, the Czech Republic was neither a member of NATO nor the EU. The Germans were not urged by anyone to be sympathetic to the Czechs. They helped us because they saw our determination to get things done, and our willingness to bear the costs. Actually, there was not a single moment when the Czech or German authorities used the word solidarity in these negotiations; nor was the word Europe mentioned. Perhaps that is why the pipeline was actually built.

Vaclav Bartuska is Ambassador-at-Large for Energy Security, Czech Republic
In 2007, Russia’s crude oil output started to decline, after eight years of sustained production increases. Since this growth in Russian production during the last decade has been an important moderating force on oil prices globally, the decline is a cause of general concern for consumers worldwide. There are three principal explanations proposed for the slowdown. The first is that Russia is simply running out of oil. A second is increasing state control over the oil sector. A third is the government’s confiscatory tax regime.

Each of these proposed explanations has some validity. But as usually presented, they also include faulty assumptions about the oil industry and the nature of political power in Russia. We argue that the slowdown is neither inevitable nor the undesirable but necessary consequence of bad policy. Rather it is the result of a conscious and rational but complex decision-making process at the top level of the state leadership. The complexity of the decision-making stems from, on the one hand, the risks that inevitably confront Russia as an oil producer and, on the other hand, the inherent contradictions in the leadership’s effort to manage an ‘addiction to rent’ that characterises the Russian economy.

Peak oil?

Russia is not running out of oil. The country has vast unexplored potential. However, it is running out of ‘easy’ oil. This is the oil that had been bypassed in the 1980s on account of ill-advised extraction
practices in the late Soviet years and not lifted during the 1990s owing to the post-Soviet economic disarray. Thanks to the availability of this oil left in the ground with infrastructure already in place, Russia was able to increase its output from 305 million tons per year (mty) in 1999 to 470 mty in 2005 – a 54 per cent increase (see graph opposite).

Now, however, the era of old oil is over. The marginal new oil is harder to recover and located in colder and more remote areas. It will demand lots of time and money. Russia has oil, but the question is how much it will cost to develop it, and what the prospects are to recover those costs – that is, the future price of oil. The fact that neither lifting costs nor the sales price can be reliably predicted defines the biggest problem for Russia’s oil industry. All investments in future production are highly risky.

State takeover?

Graph 2 (see page 64) suggests why it is so tempting to blame the production decline on state control. In late 2004 and early 2005, after 14 quarters of expanding output at annual rates of 8 per cent and more, growth rates suddenly plunged to 2-3 per cent a year. Since the middle of 2007 output has been shrinking. The rise in growth rates occurred when private companies dominated the oil sector. The decline came soon after the major private company, Yukos, was taken out of the hands of its owner, Mikhail Khodorkovsky, and turned over to the state-owned company Rosneft.

For many observers, this timing leads to a simple conclusion: Russia’s declining performance is directly attributable to the state’s takeover of the sector. The inefficiency of state policy is underscored by the fact that output drops while prices soar. When Yukos and the other private companies were expanding production most rapidly, the price of oil was around $30 a barrel. Since 2004, it has climbed to well over $100 a barrel. This is taken as further evidence of the inefficiency of state-controlled companies. They, in contrast to private companies, do not heed market signals.


Source: Soviet and Russian statistical yearbooks, various issues
entrepreneurial vision, new management techniques, and modern technology. These were precisely the attributes that Russia’s new private owners possessed. Equally important, these owners were highly motivated to recover the bypassed oil quickly because their property rights were so tenuous. The threat of expropriation that hung over their heads even before the Yukos affair made them seek to produce as fast as possible, before any threat materialised. As we have suggested elsewhere, the Putin regime uses the degree of insecurity of property rights as a conscious instrument to regulate depletion rates in the oil sector.16

Finally, it is important to address the argument that Russian producers today are not ‘properly’ responding to high prices by producing more. Oil is not like other commodities. It is easier to store in the ground than to produce. Hence, the decision of how fast to produce today depends not on the current price but on how the current price compares with expected future prices. A producer who knew that today’s prices were inevitably going to decline in the future would produce as much as it could today to take advantage of the windfall. If, on the other hand, it was certain that prices would be higher tomorrow, the wise strategy would be to delay and shift depletion to the future. This logic applies to a private and a state-owned company in equal measure. Optimal depletion in either case can be fast or slow, depending on the future price path. Once again, the problem is that future prices are so uncertain.

Where will oil prices go?

Many would of course dispute that there is much uncertainty. The consensus certainly seems to be that high prices are here to stay. But the history of ‘expert’ forecasts about the future of oil should give pause for thought. From the beginning of the oil era, forecasts about the amount of oil and its price have been famously wrong at every turn.17 Top oil executives – like virtually everyone else – were wildly off the mark in predictions they made just a few years ago. The chairman of Royal Dutch Shell predicted in early 1999 that oil would sell for $14 a barrel in 2004. The actual price turned out to be $40.18 In 2002 his more prudent successor refrained from specifying a precise figure and instead offered a range of prices, from a low of $14 to a high of “over $30 a barrel” (which, however, he said, was “unlikely to be sustainable”).19 In February


17 In 1874 the state geologist of Pennsylvania, the nation’s leading oil producing state, estimated that the United States had only enough oil to keep the nation’s kerosene lamps burning for four years.


2005, the CEO of BP stated that “the fundamentals now suggest ... a price which stabilises at around $30 a barrel”. Within a year, the price was up to $60 and clearly did not stabilise.

In a common sense view, the fact that oil price predictions have been notoriously wrong is not strange. In the very short term, prices are sensitive to completely unpredictable political and economic events. For a producer like Russia, what matters are the factors that might cause prices to fall significantly. And while most short-term political events would produce an upward price shock, there can be both medium-term and short-term events that could conceivably push prices down. On the demand side, extremely high price levels will induce greater efforts to develop alternative fuels and for consumers to reduce demand. On the supply side, completely new deposits may be discovered, and new technologies may make it possible to exploit existing ones more cheaply. A particularly heavy consideration is that those fields that the Gulf producing states currently keep out of production could be brought on stream. A major development on any one of these points could be enough to bring expectations of future prices sharply down. Oil producers would then race to speed up current output to take advantage of the windfall before it disappeared. And, of course, their behaviour would only hasten the price fall.

### Taxes, risk and addiction

There is no question that a high enough marginal tax rate on oil will limit production. It is equally indisputable that Russia does indeed have a very high marginal rate of over 90 per cent on some oil (despite tax cuts enacted in 2008). The inadequacy of the argument as it is usually presented is that it implies that the negative impact of high taxes on production rates is somehow the unintended result of a policy error. We suggest, in contrast, that precisely this effect is intentional. It is motivated by two considerations. One is to reduce Russia’s exposure to the risk of a fall in world oil prices. The other is to control what we refer to as the addictive nature of the Russian economy.

Currently, the government heavily taxes the windfall earnings that Russian oil companies derive from today’s very high oil prices. It invests the proceeds in a special sovereign wealth fund (earlier called the ‘stabilisation fund’, now divided between a ‘reserve fund’ and a ‘national welfare fund’). If oil taxation was significantly lower, oil companies would instead invest these windfall earnings in expanding reserves and production capacity. The resulting increase in oil output would, in turn, increase total government revenue from oil. But it would also further increase the exposure of the Russian economy to the risk of a fall in the price of oil – the exact risk we have been discussing.

Elsewhere, we describe the current Russian regime as the managing board of a corporation – Kremlin, Inc. – whose business is rent management. The rent in question is the total value of Russia’s oil and gas, a value that is currently running at around half a trillion dollars a year, less the cost of getting it out of the ground.

Note that we are not speaking solely of the cash earned from exports of these commodities, because much of the value stays at home. But that value, like the export earnings, is distributed. There are three main ways in which this takes place. One part of the value is distributed as profits to owners and shareholders. Another part is paid as taxes – export tariffs, excise taxes, oil depletion taxes, value-added taxes and profits taxes. And the third part is distributed as ‘informal taxes’, which encompass a variety of mechanisms of rent-sharing, ranging from the directly criminal (bribes, kickbacks) to the legal but carefully manipulated (corporations’ ‘voluntary’ contributions to social projects, excess costs of production, and

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20 John Browne, speaking at the Institute for International Economics, Washington, DC. To be fair, Lord Browne very correctly qualified his statement by adding: “But that isn’t a forecast. Events always override the fundamentals.”

public-private partnerships). It is control of all these rent flows that is the key to the power of the Putin regime.

What makes the rent management problem particularly complicated is that the Russian economy is ‘addicted’ to the rents. The addiction dates back to the late Soviet era. The massive influx of rents from the 1970s oil windfall flowing into an economic system that had no notion of opportunity cost altered the physical structure of the economy. Factories, cities, and entire industries were built on the assumption of a continued flow of value from oil. That structure, and hence the addiction, was inherited by post-Soviet Russia. During the extreme low rent period of the 1990s, the addiction manifested itself in idiosyncratic forms which we described as Russia’s virtual economy.22 But the addicts held on, and the new windfall of this decade revived them.

Russia’s current leadership has learned from history. It has learned that mismanagement of the oil rent in the boom of the 1970s and early 1980s was a key cause of the downfall of the USSR. The story of Putin’s tenure as president can be framed as a search for an economic management model that accepts the reality of addiction but avoids the disastrous effects which the rent addiction had on the USSR. The Putin/Medvedev leadership is in some sense aware of the nature of Russia’s addiction. It knows that in an economy that suffers from addiction to resource rents, an increase in rents is likely to lead to an increase in addiction. If the leadership is faced with (what it perceives as) a temporary increase in oil prices and it allows production to expand, addiction will ratchet up, the flow of rents required to maintain the system will be higher, and the withdrawal stage will be more painful. Hence it would prefer to avoid the incremental addiction.

In other words, a major problem facing Putin as supreme decision-maker in this rent-addicted economy is how to avoid increasing the level of addiction in response to the perceived transitory increase in oil prices. Given the nature of the Russian economy (its ‘genetic predisposition’ to addiction) and the regime that runs it, incremental flows cannot easily be prevented from creating addiction. Hence, the best strategy is not to earn them in the first place. This is where the tax regime comes in. A high tax regime not only serves the purpose of collecting the rents to the centre. It also prevents oil production from responding to the transitory increase, and hence limits the creation of a new group of addicts. Should there be a need for a marginal increase in output, the tax burden can be temporarily eased, as appears to be happening at the time of writing.

Russia has enough oil to expand current levels of output. But a major expansion would be time-consuming, costly, and, most importantly, risky. On the one hand is the pure financial risk. The West wants Russia to invest in new deposits. The West will of course benefit from greater supply, but if the price should fall, Russia will bear all the risks. If, on the other hand, the oil price continues to climb, a production expansion would expose Russia to a different kind of risk, that of runaway rent addiction. Control of the rent flows is the main day-to-day concern of Russia’s current leadership.

The Putin government cannot eliminate Russia’s addiction to rents. Nor does it want to. The Putin/Medvedev regime’s power rests on it. But Russia’s leaders know that, unbridled, it can destroy. The first eight years of the Putin regime were devoted to creating optimal mechanisms for managing the addiction, that is, organising the distribution of the rent and regulating its flow. The degree of state control and the level of taxation, and the deterrent effect of both on production are not a mistake but elements of policy choice. They are instruments for regulating the volume of rents. As Lukoil vice president Leonid Fedun

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The future of Russia’s gas industry is key not only to the country’s energy sector and its wider economic development, but also to the European market. Its starting position is good, after a successful turnaround in recent years. It has left behind the problems of the 1990s, in particular the crises of non-payments and the trend of falling investment in exploration and production. Gazprom, the leading producer, has consolidated its assets. It has also liberalised investor access to its shares, which led to a four-fold increase in market capitalisation. Higher gas prices, at home and on world markets, have helped Gazprom to stabilise its finances, with the result that between 2000 and 2006 its debt-to-capital ratio almost halved (from 17 per cent to 9 per cent). At the same time, the market share of independent gas producers has risen from 10 to 16 per cent, which has given them additional capital to invest.

**Exports: from big pipeline to big business**

Perhaps the most important change since 2000 has been the change in Russia’s gas export strategy. The old export strategy made the Russian gas industry look like a ‘big pipeline’: it was oriented towards one external market, namely Europe; it sought to maximise export volumes; and it only relied on resources within Russia. The two governing principles were no foreign participation in production, and sales at the border.

Russia’s new export strategy would be better described as ‘big business’. It involves diversification of markets and transport routes;
maximisation of profits; growing imports and transit of Central Asian gas; and the increasing engagement of both Russian gas companies in global markets and foreign companies in domestic gas production.

Russia is on track to increase its gas exports by 25 per cent between 2005 and 2015 and it will maintain its strategic position as the world’s largest gas exporter. But it will have to continue changing its export policy, namely by reducing its sole focus on the European market while entering new, attractive markets elsewhere.

Russian gas supplies to Europe are expected to grow only moderately, partly because of the EU’s politically motivated quest for the diversification of supplies. More importantly, however, Europe keeps reviewing its gas demand forecasts, as alternative energy sources, including renewables, become more attractive against a background of higher gas prices. Over the last five years, the forecast for EU annual gas demand for 2005-20 has been lowered by 150 bcm per annum compared with 2005. In the latest projections from the International Energy Agency and the European Commission, European import requirements for 2005-20 were up to 40 per cent lower than they had been in the 2002-03 forecasts. That means that even under an optimistic scenario, European demand for Russian pipeline gas will not exceed 200 bcm by 2020, compared with 154 bcm in 2007.

European demand is saturated, as well as being driven by political factors. At the same time, the Russian policy of moving to European prices for gas exports to CIS countries will slow, perhaps even halt, demand growth there. CIS countries will also increasingly look for alternative sources of gas. Russia is therefore exploring new markets, and primarily the rapidly growing market for LNG. In the next few years Russia will enter the LNG markets of the Pacific and then the Atlantic basins. It intends to increase its share in the global LNG market to 10 per cent as early as 2015 (which would mean that 15 per cent of Russian gas exports would take the form of LNG by then). Meanwhile, Russia will develop pipelines to ship gas from Siberia and the Far East to China and South Korea. These exports are projected to make up 20 per cent of the total in 2020. This geographical diversification of Russian gas exports is often perceived in Europe as a threat to the security of gas supply.

The vicious circle of energy insecurity

Gas relations between Russia and Western Europe date back to 1968, when the Soviet Union first supplied gas to Austria. They continued to develop despite the Cold War. Now, however, they have entered a difficult period. Consumers are worried about security of supply, while producers are concerned about security of demand.

The EU, which currently imports around 30 per cent of its total gas needs from Russia, has long been talking about the need to diversify its sources of supply. It is looking at ways to obtain more pipeline gas from Central Asia, the Middle East and North Africa, as well as LNG. However, the alternative sources – from Iran to Turkmenistan, and from Algeria to Nigeria – tend to be countries with high political risks and unstable economic systems. And so are many of the countries through which new transit routes would have to run. Moreover, the distance of these new suppliers from core European markets suggests the need for huge investments in transport infrastructure. Together with the costs of green field projects in hitherto underdeveloped areas, this raises doubts about the commercial viability of many of these alternative sources.

Nevertheless, the EU’s diversification plans are fuelling concerns among Russian gas producers. Conversely, Russia’s aspiration to increase energy exports not only to the west but also to the east is causing concern in the EU. So these concerns are creating a vicious circle. European consumers fear that Russia may not only shift resources (financial and managerial) to developing new gas projects
for Asia but also that supplies that currently go to Europe may be diverted. Such fears are unfounded, however. Eastward exports would come from gas fields in Eastern Siberia and the Far East, which are too far from the European market to be exported westwards in a commercial way.

**Why we need long-term contracts**

While there is little doubt that both the EU and Russia are serious about diversification, it is necessary to bear in mind that these strategies only affect additional supplies. Existing Russian gas supplies to the EU take place under long-term contracts, lasting 20-25 years. Such long-term contracts play a stabilising role in the gas business. So when European experts express doubts over whether Russia will be able to satisfy Europe’s growing import demand, they need to be clearer what they are talking about.

Of course, Russia will not be able – or indeed willing – to cover the entire growth in European gas demand. But we need more certainty about the amount that the EU will want to buy from Russia. The only way to do this is to sign long-term contracts. The infringement of such contracts is punishable by costly sanctions, which is the main reason why Russia has never violated its supply obligations. Given the large, and growing, capital requirements of new gas projects such as Yamal and Shtokman, the certainty that long-term contracts provide becomes all the more important. It is not helpful if the Europeans continue to express their doubts about future supplies from fields that have not even been contracted. Obviously, Russia will not have strong incentives to invest massive sums in the development of new fields and transport infrastructure without having signed appropriate long-term contracts.

The negative rhetoric of recent times notwithstanding, many European companies have concluded new long-term agreements with Russia. These will strengthen Russia’s role in the European energy market further, with annual supplies rising to at least 165 bcm in 2013. These new agreements show that business takes a positive view of the reliability and commercial viability of Russian gas supplies. However, these contracts do not require the development of the big new fields such as Yamal and Shtokman. To attract the huge investments needed in these regions, Russia requires additional long-term guarantees for bigger volumes.

**The geographic shift in gas production**

Between now and 2030, the geographical pattern of Russian gas production will change dramatically as production moves to new areas. The fall in output from the giant fields (Medvezhye, Urengoy and Yamburg) in the north-western Siberian area of Nadym-Pur-Taz will initially be compensated by developments in other northern areas, notably in the Tyumen region and the Yamal peninsula. In the European part of Russia, there will be the giant offshore project of Shtokman, which will also involve LNG production, and new developments in the Caspian area which will bring the share of Caspian gas in total Russian production from 7 per cent in 2005 to 15 per cent in 2015. In addition, new production and processing projects will be developed in Sakhalin, Eastern Siberia and Yakutia, which will raise their share in total Russian gas production from 1.2 per cent in 2005 to 13 per cent in 2030.

These plans to increase and diversify gas production will require adding at least 10 per cent to the length of Russia’s existing pipeline network by 2015, and up to 25 per cent by 2030. This includes building new LNG plants and expanding the Unified Gas Supply System into the Siberian and Far Eastern regions, first to give consumers there access to gas and secondly to use the network for exports to the Asia-Pacific region, if and when these are commercially attractive. This development of gas production and transportation will require enormous capital expenditure of at least $150 billion by 2015, especially since the costs of upstream developments are rising fast worldwide.
To slow down the growth in gas demand, Russia would have to intensify its efforts to save energy and to replace gas with other sources, such as coal and nuclear. The main tool to achieve this will be higher domestic gas prices. The government’s 2006 decision to let gas prices rise gradually to European levels (minus transport costs and export duty) by 2011 is therefore particularly important. The gas price increases will help to reverse the trend towards relying more and more on gas for domestic energy, which is detrimental to Russian energy security. But it does not mean that domestic gas demand will be reduced in absolute terms. Even on the most optimistic projections, gas consumption in Russia will increase by almost a quarter by 2015 (compared with 2005) and by 40 per cent by 2030.

Power plants will remain the main gas consumers. They are projected to account for around 40 per cent of total gas consumption until 2030. But even this share can only be maintained with massive restructuring of the power sector, given fast-growing electricity demand. Russia would have to rely increasingly on non-fuel sources, in particular nuclear and hydro power. (Their combined share in power generation would need to rise to around 45 per cent in 2030, from 34 per cent in 2005. The share of gas in electricity generation would fall from 69 to 58 per cent.)

Moreover, new power plants and especially the expansion of existing ones around Russia’s larger cities would have to rely primarily on coal. But relatively cleaner gas will still be needed for combined heat and power plants in urban areas and central boiler-houses with electric power generators. Gas demand will not only have to slow in the power sector but also in transport, industry and the residential sector. Many processes, for example the compressor stations along Russia’s 155,000 kilometre pipeline system, will be electrified and powered by coal and nuclear energy.

The challenges for the EU-Russia energy relationship are real. But none of the problems discussed above is unsolvable. None can destroy the mutually beneficial energy relationship between the

The biggest challenge for many global oil and gas majors is limited reserves. But the biggest problem for Russian gas companies is financing the tremendous capital expenditure needed to develop new production capacity, as well as improving cost management. Higher gas prices – both domestic and on global markets – would be the best way to reduce the risk of under-investment in the Russian gas sector.

Global gas prices have already risen from $250 per 1,000 cubic metres in 2006 to $340 in 2008, and they are expected to stay high. And at home, the Russian government has announced gradual gas price liberalisation over the coming years (see below). These price developments will allow Russian gas companies to fund huge new investments from profits. They are also stimulating interest from foreign investors, primarily for projects demanding complex technologies and management skills, such as offshore production (for example the participation of StatoilHydro and Total in Shtokman), deep-lying deposits (like the Achimgaz joint venture between Gazprom and Wintershall in Siberia) and LNG production (most notably the stakes of Shell, Mitsui and Mitsubishi in Sakhalin-2). At the same time, the participation of foreign oil majors in developing Russia’s biggest fields will be limited by the new law on strategic sectors, which seems reasonable given the strategic role of the gas industry for the Russian economy.

Prices are the key to gas sector development

Well over half the gas that Russia produces is consumed at home, and the Russian economy is hugely inefficient in its energy use. The main problem is that although the economy has grown strongly since 1999, the government has maintained caps on domestic gas prices. Because of these artificially low prices, gas demand has continued to grow – by an average of 2.3 per cent a year in 2000-06, far outstripping average growth in overall energy consumption (1.3 per cent). The share of gas in the energy balance has continued to rise, from 49.6 per cent in 2000 to 52.7 per cent in 2006.
EU and Russia that has developed over past years and decades. Russia and the EU complement each other, in terms of geographical proximity, existing transport infrastructure, and their long-standing relationship.

In the gas business – long-term by its very nature – the main condition for fruitful co-operation is mutual trust. The risks involved in a highly interdependent energy relationship are so high that no amount of hedging can eliminate them. The threat that one of the parties will behave in an opportunistic way always remains. On the other hand, the benefits derived from co-operation and an efficient international division of labour surely make it worth while for each party to understand the intentions and fears of the other, and to find a mutually advantageous compromise.

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Daniel Gros

The money benefits of diversification

The EU-Russia energy relationship could be described as a bilateral quasi-monopoly. Russia is the main supplier of natural gas for Europe and Europe is, for obvious geographical reasons, the main natural outlet for Russian natural gas production. However, since there is only one Russian producer (Gazprom, intertwined with the Russian government), but many competing EU consumers (the large, usually national gas distribution companies), it might be more correct to describe Gazprom as a monopolist producer facing a multitude of consumers.

As a (quasi-) monopolist Gazprom will be able to set its price above the marginal cost of producing gas. The ability of Gazprom to earn a monopoly rent from its privileged position as the main supplier to the European gas market will obviously depend on the degree to which alternative supplies can be brought to Europe. The greater the potential competing supply, the lower the monopoly rents Gazprom will be able to extract. At present, non-Russian supply is strictly limited by the transport capacity of existing pipelines (mainly from Norway and North Africa) and the very limited number and capacity of LNG terminals in Europe. If additional pipeline capacity (connecting Europe to Central Asian or Middle Eastern producers) were available, Gazprom would have to lower its price.

Given this situation, it is possible to estimate the benefit that EU countries would reap from constructing additional pipelines or LNG import facilities. We start from the value of Gazprom’s sales to the EU, which amount to around €30 billion annually. Assume that

25 Putting a value on EU gas imports is not straightforward. Gazprom’s own website reports that gas sales to ‘Europe’ were worth about $28 billion in 2006. Since that year, oil prices have almost doubled, which implies that natural gas prices will have risen by up to 50 per cent. This implies that for 2008 and onwards, Gazprom’s sales to ‘Europe’ will amount to around €30 billion.
Additional import facilities would allow EU consumers to negotiate a 10 per cent price reduction with Gazprom. The return from such an investment would be €3 billion per annum. In principle, this gain would be available for an indefinite period of time. At a discount rate of 10 per cent, the net present value of a project which could force Gazprom to lower its prices to Europe by 10 per cent would thus be around €30 billion. This is a large sum – larger than the cost estimates of the various alternative pipelines projects that are being discussed today or the cost of constructing generous new LNG facilities in various member countries.

This illustrative calculation shows that alternative sources of gas imports could yield very large benefits for Europe. However, no single national gas distributor would reap this benefit, especially if EU regulation allows gas importers to pass on the (elevated) prices they pay to Gazprom to their own consumers. There is thus no private sector company in Europe that would have an incentive to invest in alternative routes for gas imports into Europe. This is a classic case for government intervention.

Reality is of course more complicated than these simple calculations. New pipelines only make sense when they lead to places where gas is available. But there is no need to find alternative producers of a similar scale to Russia. Gas demand does not respond quickly when prices rise or fall (what economists call low elasticity of demand). This means that even a relatively small amount available from an alternative source can have a strong impact on the price paid by Europeans.

The securing of additional gas supplies to Europe should deliver an extra benefit: stimulating Gazprom to invest more in its own production capacity. Since the demand for natural gas is quite inelastic, additional Russian supplies may result in lower prices but not higher quantities sold. So Russia – as a monopolist – has little interest in investing in more capacity. By contrast, if Russia had to sell its gas in a competitive market, the only way to increase revenues would be by selling more gas. All in all, it should be clear that European consumers can only benefit if competition in the natural gas sector increases.

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Gazprom Group’s gas sales to EU countries in 2006, bcm

Source: Gazprom
The fact that Russia is endowed with richer and more varied energy resources than any other country in the world does not in itself determine its destiny; but it certainly has massive political repercussions. Falling global oil prices were one of the strongest drivers of the bankruptcy and collapse of the USSR in 1991, and another price fall in 1998 brought Russia’s economy to the brink of calamity. Hedging against such disasters is logically one of the central security goals of any Russian leadership. Many seemingly irrational economic decisions, particularly the strengthening of state control over the energy sector, might begin to make sense if understood as measures to manage security risks.

Both Vladimir Putin, when he was president, and his successor, Dmitry Medvedev, have stressed repeatedly that their country is the West’s most reliable energy supplier. However, the EU has on many occasions expressed concern about Russia’s sustained underinvestment in new fields. These concerns have now been exacerbated by Russia’s emerging strategy for diversifying its markets, mainly towards China and the Pacific.

If Moscow managed to pursue this diversification, it may, to some degree, be able to choose in which direction to export its oil and gas. Although this would be Russia’s dream as a producer, it could mean a nightmare for consumers, who may have to bid against each other. For transit countries, it could eliminate any leverage they might have. However, Russia’s diversification plans are likely to be less feasible than the Kremlin believes and less
malign than the Europeans fear, particularly since Russia prefers long-term arrangements.

**A breakthrough to the US market?**

There are many good reasons for Russia to attempt to capture a share of the colossal US energy market that exceeds 20 per cent of global primary demand for both oil and gas. These attempts made some progress until the end of 2003, when the Russia-US energy dialogue collapsed after the imprisonment of Mikhail Khodorkovsky, who had been one of its main proponents. With the forced bankruptcy of Yukos and the incorporation of its assets into Rosneft, the most promising diversification project – the oil pipeline to a new terminal in ice-free Murmansk (in the extreme north-west on the Barents Sea) – was abandoned. Instead, the Kremlin decided that the main direction for exporting oil from green fields in West and East Siberia should be eastwards, through the East Siberia-Pacific Ocean oil pipeline (ESPO, see below). Russia’s decision in 2007 to invite Total and StatoilHydro, rather than US bidders, to help develop the Shtokman gas field, together with Gazprom’s pressure on the Sakhalin-1 project (operated by Exxon Mobil) have not helped to improve Russia-US energy relations.

The incentive for Moscow to reverse this trend and attempt to enter the US market is primarily political: without an economic foundation, the security relationship is subject to fluctuations and even the arms control system has become unstable. While Washington’s main energy interest is oil, Moscow could supplement small exports of oil (for instance, from the Sakhalin-3 project) with more substantial exports of LNG (primarily from Shtokman). The East Siberian Arctic shelf could make an attractive target for joint exploration, which could help dispel mounting speculation over geopolitical competition in the Arctic. Another topic for a renewed US-Russia energy dialogue could be the development of hydrocarbons in the Caspian area. Those predicting a new ‘great game’ typically presuppose a clash of interests between the US and Russia, but they underestimate the space for co-operation.

The problem with these options is that, even if they were pursued any time soon, implementation would be delayed far into the next decade. It is also probable that if and when Medvedev asserts his authority over Russian foreign policy, the traditional obsession with the US would become less pronounced, as the post-Soviet generation has different reference points. The political incentives for ‘conquering’ the American market could then dissipate. Finally, Gazprom’s strategy for LNG, approved in April 2007, remains ambivalent – not only because domestic technology is lagging behind, but also because the more flexible LNG market is alien to its monopolistic business philosophy.

**Flying with the dragons?**

Putin’s claim that in ten to 15 years Russia would channel 30 per cent of its energy exports to Asia has left many experts pondering about the wisdom of promising the impossible. The growing affinity between Moscow and Beijing has been unmistakable. But the convergence of their ‘prosperity-without-democracy’ statist ideologies does not make Russia less reluctant to become a ‘raw materials appendage’ to a rising China. So Moscow eyes other Asian markets with greater interest. After many years of friendly talks, less than 5 per cent of Russia’s oil exports now go to China. And Medvedev’s inaugural visit to Beijing
Currently, Russia’s domestic consumption of oil is growing faster than production. And operational costs are growing even faster, so that the tax breaks for the oil companies announced in May 2008 hardly provide sufficient incentives to invest in immensely costly projects. If oil output continues to stagnate, East Siberian oil may continue to be shipped westward, as was the case in 2008. Exporting through existing pipelines to Europe makes more economic sense than blazing a trail through the prohibitively expensive eastern corridor.

The situation with gas is even more uncertain. During a visit to Beijing in March 2006, Putin promised to begin exporting gas to China in 2011 and to aim at 60-80 bcm a year through two new pipelines. These plans already look unrealistic in terms of timing, and all but impossible in terms of scale. One key project here is the development of the giant Kovykta gas field north of Lake Baikal. Gazprom has forced TNK-BP to sell the license to develop Kovykta (although the bargaining has dragged on into 2008). However, Gazprom has not yet presented even an initial plan for developing these deposits. Nor has it done so for the Chayanda gas field in Yakutia, which it was granted in April 2008. Apparently Gazprom wants to keep Chayanda and Kovykta in ‘reserve’ for the long-term. Moreover, it is unlikely that gas from Sakhalin will be sold to China, partly because this gas is covered by binding contracts (mostly with Japanese and South Korean companies), and partly because Gazprom has prevented Exxon Mobil from exporting Sakhalin-1 gas to China.

That leaves the Yamal peninsula, which is said to contain the country’s biggest gas reserves. The proposed Altai pipeline would deliver 30-40 bcm of Yamal gas a year to Xinjiang Province in China’s Northwest. Whether this project gets off the ground depends partly on the current negotiations over price. China has traditionally insisted on paying much less than the Europeans. It
has no interest in dealing with the Chinese giants, perhaps fearing their aggressive business style – and perhaps reckoning that they could not be subjected to political pressure like BP.36

Caspian tug-of-war

Since Russia is running behind with the development of new Siberian gas fields, it has to make up any existing and future shortfalls through growing imports from Central Asia. But Russia is not the only country that wants more Central Asian gas. In mid-2007, Putin managed to strike a ‘grand bargain’ with the leaders of Kazakhstan, Turkmenistan and Uzbekistan. This deal envisages that Central Asian gas sales to Russia will rise from the current level of 55-60 bcm annually (of which 40 bcm come from Turkmenistan) to 100 bcm (70 bcm from Turkmenistan) at the beginning of the next decade. For this deal to be implemented, Russia and its partners need to build a new pipeline along the eastern shore of the Caspian Sea. But this could turn out to be the easy part. The more difficult task will be to bring about the required increase in Turkmen gas production. The country’s upstream sector has not seen new investment or even proper maintenance for a long time. Gazprom, as well as western oil majors, have yet to gain access to Turkmen resources. Meanwhile, Turkmenistan signed a deal with China in 2006 that envisages investments in the development of new gas fields on the right bank of the Amu-Darya river, and the construction of a gas pipeline to China via Uzbekistan and Kazakhstan.

Gazprom will only be able to supply both the domestic and European market in the next decade if it makes a sustained effort to develop new fields, focus its investment programme accordingly and cut down on acquisitions and ‘politically correct’ activities, like building stadiums for the 2014 Sochi Olympics. However, although Gazprom is heavily indebted and lacks the technology and know-how required to develop complex new fields, particularly offshore, it remains reluctant to work with foreigners. It may pick some European companies as junior partners in particular projects, but it

has now in principle agreed to pay a ‘European’ price, calculated on the basis of world crude prices rather than China’s domestic coal price as previously. But Gazprom now has to cover huge construction costs and so is demanding more.34 Another question concerns timing: multiple cuts in Gazprom’s investment programme (including in 2006 and 2007) will delay the development of Bovanenkovo and other Yamal green fields into the second half of the next decade.

The most important factor in Russia’s diversification plans is that of production volumes: by the time the new fields start producing gas, annual production from Gazprom’s existing giant West Siberian fields (the ‘big three’: Medvezhye, Urengoy, Yamburg) will have declined by perhaps 100 bcm per year from the 2006 level. Domestic consumption, in the meantime, has been rising far more rapidly than Gazprom had envisaged. Despite the gradual rise in domestic prices (most recently by 25 per cent price in January 2008), the absolute gap between what Gazprom’s domestic and European customers pay has never been wider (close to $2.50 per 1,000 cubic metres). Any shift away from cheap gas would be hugely unpopular with Russian industrial gas users as well as consumers. Growing domestic demand means that the planned moderate production growth of 50 bcm to 2015 could be entirely consumed inside the country.35

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For now, Sino-Russian tensions remain hidden under the soft layers of rhetoric about ‘strategic partnership’ within the Shanghai Co-operation Organisation. On the surface, Moscow appears less worried about China than the prospect of a trans-Caspian pipeline that would connect Turkmenistan to the planned Nabucco pipeline (favoured by the Europeans), or even by the far-fetched idea to transport Turkmen gas to Pakistan via Afghanistan. In
reality, however, the main concern is about being outmanoeuvred by the Chinese.

That is why Gazprom has agreed to pay its Central Asian partners ‘European’ prices for imported gas as early as 2009. Instead of endless bargaining the payments would be calculated by a formula based on the current price of oil.37 This generous increase would prevent Gazprom from profiting from the resale of cheap Central Asian gas to the Europeans (although in fact since 2006 Gazprom has exported more gas to Ukraine than it has imported from Turkmenistan). The move towards ‘European’ prices for imports and exports is already forcing Ukraine to reduce its vast and wasteful consumption of gas. Such savings may be the only way for Gazprom to prevent a ‘gas crunch’ between now and the second half of the next decade, when new fields are expected to start producing.

Since even the mid-term prospects for Russia’s energy sector are uncertain, only a moderate increase of exports to the Asia Pacific region, first of oil and then LNG from the Sakhalin projects, appears economically rational. Russia will require extraordinary levels of investment to bring about the necessary increase in energy production. These sums can only be secured if the Russian state relaxes its control over the oil and gas sectors. Even if the government avoided the temptation to ‘milk’ the energy sector, for instance to finance the development of nanotechnologies and increase social spending, the trend towards stagnant energy output would continue in the near future. In this period of relative scarcity, diversifying into new markets is a luxury that Russia can ill afford. If the Kremlin sticks to energy ‘pragmatism’, the bottom line invariably means falling back on its most reliable market, which is Europe.

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A pipeline race between the EU and Russia?

Roland Götz

For its gas exports beyond the CIS, Russia is moving from transit pipelines (those that go through other countries on the way to final markets) to direct pipelines, mostly built offshore. This move strengthens Gazprom’s bargaining power vis-à-vis transit countries such as Belarus, Ukraine and Moldova. At the same time, the Europeans are trying to diversify their sources of energy by importing gas from the Caspian region and by constructing a southern gas corridor that circumvents Russia. The EU and Russia appear to be engaged in a ‘pipeline race’. Both sides are reacting to perceived threats, and in doing so they are fuelling each other’s suspicions. But rather than building ‘political’ pipelines of dubious commercial value, the EU and Russia need to take a step back and assess their respective strategies in a sober light.

Gazprom has the de facto and (since 2006) de jure monopoly over Russian gas exports. It aims to diversify its export routes in two ways: first, shifting from transit to direct pipelines for its exports to Europe; and second, by exporting more to non-European markets. Traditionally, most Russian gas exports have reached Europe through an established system of transit pipelines. The so-called Brotherhood pipeline is Russia’s largest and oldest gas export route. It traverses Ukraine, Slovakia and the Czech Republic and ends in Germany. Offshoots stretch to Hungary, as well as to Turkey, having crossed Moldova, Romania and Bulgaria. The Yamal-Europe pipeline, which was completed in 2005, crosses Belarus and Poland on its way to Germany. However, these pipelines can pose a ‘transit problem’ because they are not totally...
In the future, Gazprom aims to rely much more on direct pipelines (see table opposite). Already, Russia sells gas directly to Turkey through the Blue Stream offshore pipeline across the Black Sea. And it is planning a number of further offshore projects, most notably the Nord Stream pipeline across the Baltic Sea to Germany and the South Stream pipeline across the Black Sea to Bulgaria, as well as a small onshore pipeline to Finland. Further direct pipelines are planned to new markets, for example the Altai pipeline to China, which will cross the short Russian-Chinese border segment between Kazakhstan and Mongolia, and one running from Eastern Siberia to China.

The capacity of Russian transit pipelines to Europe will stagnate at roughly 200 bcm a year, while that of direct pipelines is projected to increase to the same level. As a result, the total capacity of pipelines from Russia to Europe will grow from the present 200 bcm to more than 400 bcm by 2020, and to about 500 bcm by 2030. But Russian gas exports to Europe are unlikely to grow much beyond 200 bcm. The obvious implication is that there will be considerable overcapacity in westward pipelines. Why?

Data source: Manfred Hafner, ‘Gas corridors between the EU and neighbouring countries’, Brussels, December 2006, supplementary calculations added by the author.
The most common explanation for Gazprom’s pipeline strategy is political: Gazprom is acting as a protracted arm of the Kremlin. It is threatening and punishing those CIS countries that are trying to escape from Russian dominance. As part of this punishment, it is moving gas and oil exports from transit states to new, offshore pipelines. However, this argument underestimates Gazprom’s autonomy. Although the Russian government is indeed Gazprom’s majority shareholder, the company is not necessarily obliged to protect the interests of the state. By supplying the domestic market at low prices, Gazprom is already serving state aims (and the interest of energy-intensive industries such as fertilisers and steel). But apart from that, it seems that Gazprom is using its links to the administration to promote its own commercial interests, and the interests of its private share-holders, such as the German E.ON. Some of Gazprom’s most spectacular moves, such as increasing the gas price in Ukraine at the beginning of 2006, and in Belarus a year later, actually ran counter to Russia’s policy of regaining influence in post-Soviet countries. But such steps obviously served the commercial interests of Gazprom.

**Gazprom’s strategy: profits and market domination**

At first glance, Gazprom’s plan for creating overcapacity in export pipelines appears very costly. It relies on relatively expensive offshore technology rather than the cheaper option of extending existing onshore pipelines. But this does not necessarily mean that Gazprom’s diversification strategy is uneconomic. Building and operating offshore pipelines is indeed much more expensive than onshore pipelines. On the other hand, there are no transit fees (or negligible ones if a pipeline goes through the ‘economic zone’ along another country’s coastline). In the long run, these savings can offset higher capital costs. More importantly, however, building direct pipelines is an instrument of Gazprom’s wider corporate strategy to maximise its long-term profits and market share.

For example, by building the Blue Stream pipeline from Russia to Turkey in 2001-02, Gazprom sought to ‘cordon off’ the Turkish gas market against competitors from the Caspian region, notably Turkmenistan. With the same objective in mind, Russia foiled plans for a major pipeline from Iran to Europe, a predecessor of the planned Nabucco pipeline. Gazprom’s current plans to extend Blue Stream (Blue Stream II) and to construct South Stream (which will run from Southern Russia to the Bulgarian Black Sea coast) are also part of its attempt to keep competitors out of the Turkish as well as the main European markets. So market domination is the first strategic aim of Gazprom’s pipeline policy.

The Yamal-Europe pipeline (through Belarus and Poland to Germany) and the planned Nord Stream in the Baltic Sea represent a different strategic approach. Both provide alternatives to the extensive Ukrainian transit pipeline system. They therefore diminish the bargaining power of Ukraine in transit fee negotiations and assist Gazprom’s objective of acquiring its gas transport system. The Baltic pipeline exerts similar pressure on Belarus. Gazprom’s second strategic aim therefore is to strengthen its negotiating position vis-à-vis transit countries and to obtain a larger share of the profits from gas exports.

Gazprom’s third strategic aim is to increase ‘security of demand’ by identifying new markets outside of Europe, principally the worldwide LNG market and the Chinese/North East Asian market for pipeline gas. Until recently, the combination of long-term contracts and the pegging of gas prices to those of oil had provided Russia with sufficient security in the European natural gas market. However, several developments are making the European market look less secure. First, competition from African suppliers is growing, in both pipeline gas and LNG. Many Europeans fear that the EU is becoming increasingly dependent on Russian natural gas.

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As a result, Russia’s share of total European gas imports could actually drop – from two-thirds today to less than half after 2020 – as imports from Africa and the Middle East grow faster than those from Russia. Second, as Europeans become serious about fighting climate change, they will rethink their use of alternative sources of energy, including biogas and nuclear energy.

Gazprom’s decision to halt gas supplies to Ukraine and Belarus in pricing disputes – and its dash to build new direct pipelines – has unsettled the countries in its neighbourhood. The EU’s Central and East European member-states, in particular the Baltic countries and Poland, are calling for a solidarity-based EU energy policy or even an ‘energy NATO’. The Nord Stream pipeline weakens the negotiating position of transit countries, both current and potential, vis-à-vis Gazprom and Russia. Therefore, the Baltic countries, Poland and other Baltic rim countries, such as Finland and Sweden, have reservations about this project. Some are attempting to delay it or are calling for it to be stopped altogether. The environmental reasons that Sweden and the Baltic countries are citing seem to be a pretext. The Baltic countries have also proposed an alternative onshore pipeline (the so-called Amber pipeline). Such attempts to delay or stop Nord Stream ignore the advanced stage of this project and merely contribute to the growing tensions between Russia and its immediate neighbours to the west.

Great game on the Caspian Sea?

Some observers say that the countries of Central Asia and the Southern Caucasus have become part of a ‘great game’ on the Caspian Sea. The region’s gas reserves account for some 6 per cent of the global total, only slightly less than those in Africa. The Europeans want to gain direct access to Caspian gas, hoping that such diversification would diminish Russia’s dominance in the EU market and also strengthen the negotiating position of Caspian gas producers vis-à-vis Russia.

Not all Caspian states have exploitable energy resources. Kazakhstan has the largest oil deposits in the Caspian Sea region, while Turkmenistan has the largest natural gas reserves. However, statements about the actual size of Turkmen reserves are extremely unreliable since they either come from official sources of dubious credibility or anonymous sources that cannot be verified. Credible estimates put the country’s medium-term potential for annual gas production at approximately 150 bcm, of which 130 bcm would be available for export. However, assuming that Turkmenistan honours its long-term supply agreement with Russia – which locks in 90 bcm per year until 2020 – it would only have 40 bcm available for exports, not only to Turkey and on to Europe, but also to China and Iran, which already have supply contracts.

Infrastructure is another problem. Turkmenistan already has (or will soon have) links to the Russian and Chinese markets, but not to Europe. The US has led calls for the construction of a trans-Caspian gas pipeline, mainly for geo-political reasons. A possible route for the trans-Caspian pipeline would be from the Turkmen port city of Turkmenbashi (previously Krasnovodsk) to Baku in Azerbaijan. However, there are various reasons why the project has not yet materialised. These include the unresolved legal status of the Caspian Sea, environmental concerns voiced by Russia, doubts about the availability and reliability of Turkmen gas supplies and the deteriorating security situation in the Caucasus.

This leaves Azerbaijan with its long-term export capacity of about 30 to 40 bcm as the biggest gas exporter in the region. Azerbaijani gas has been shipped directly to Turkey (and Europe) since the completion of the South Caucasus Pipeline in 2007. The SCP runs from Baku through Tbilisi and on to Erzerum, largely along the
export priorities, however, are difficult to discern. Tehran is planning to construct a major pipeline to Pakistan and India and to conclude swap deals with Gazprom that would enable it to make indirect exports to Europe and to supply Europe by way of Turkey. Iran is also planning extensive LNG deliveries to China and South East Asia.

For the foreseeable future, Europe’s main suppliers of natural gas will continue to be Russia and Africa, in that order. Therefore a truly viable European energy policy should not rely on commercially dubious ‘political’ pipelines but should instead focus on increasing Gazprom’s trust in the reliability of European transit routes and in the security of the European gas market. This means that the EU’s energy policy needs to address questions such as how to secure delivery and distribution of gas and how to provide more stable demand forecasts. It also needs to consider the economic viability, efficiency and environmental sustainability of energy supplies. This expanded concept of energy security should be a core subject for discussion in the EU-Russia energy dialogue.

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The Energy Charter dates back to a political initiative launched by the then Dutch Prime Minister Ruud Lubbers at an EU summit in 1990. The end of the Cold War offered an unprecedented opportunity to overcome Europe’s economic division. Energy was the logical place to start since there was already significant east-west co-operation in this sphere, as well as physical links through existing oil and gas pipelines. Developing common rules of the game in this capital-intensive sector would reduce political risks related to the dissolution of the USSR and COMECON, facilitate the transfer of western capital, technology and know-how into the former Soviet Union (FSU), and increase energy exports from the FSU to the West, in particular the EU. A political declaration on international energy cooperation, the European Energy Charter, was adopted in December 1991, followed by the legally binding Energy Charter Treaty (ECT), which was signed in December 1994 and entered into force in April 1998.

The ECT has two distinctive features. Firstly, it is the only body of legally binding international rules that is tailored specifically to the energy sector. Unlike other international economic treaties, it therefore takes into account the wider range of risks faced by energy companies (for example, geological risks) and the extraordinarily high capital needs of the energy industry. The ECT covers such areas as energy investment, trade and transit, and energy efficiency. It offers dispute settlement for disagreements between states, and between states and investors.
the treaty is designed to provide for stable relations between the foreign investor and the host government. Stability is particularly important in a sector where projects are highly strategic and capital-intensive, and where risks have to be assessed over the long term. The legal framework of the ECT helps to reduce non-commercial risks, such as discriminatory treatment, direct or indirect expropriation, or breach of individual investment contracts. In the early 1990s, when the treaty was negotiated, investment protection meant mostly protection of western companies in the east. Nowadays it also benefits the expansion strategies of eastern companies in western markets.

The ECT is based on the principle of non-discrimination by requiring member governments to apply national treatment (treating foreign and domestic companies equally) or a most-favoured nation regime (extending the maximum access granted to one foreign investor to all others), whichever is more beneficial. Once an investment has been made, these obligations are legally binding. But for the pre-investment phase, when the investor is still negotiating market access, the ECT uses ‘soft’ legal language and requires the parties to “endeavour” to meet these principles. The member-states initially intended to add a supplementary investment treaty to the ECT, to expand national treatment to the pre-investment phase, but this work has been suspended since 1998.

Another priority for the ECT is to promote reliable international transit flows. This is particularly important because in Eurasia a large share of oil and gas is delivered through long-distance pipelines that cross several national borders and jurisdictions. Under the treaty, member countries are obliged to facilitate energy transit in line with the principle of freedom of transit and not to interrupt or reduce established energy transit flows. Meanwhile, work continues on the specific Energy Charter Protocol on Transit. This will expand the operational clauses of the ECT’s article 7 on transit, for example by defining what ‘available transit capacity’ means, or clarifying ‘freedom of transit’ in terms of non-discriminatory and competitive access to available capacity, the methodology of setting transit tariffs, and so on.

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Regulating energy relations: 

Acquis or Energy Charter?

Andrey Konopolyanik

At their June 2008 summit in Khanty-Mansiysk, the EU and Russia agreed to start negotiations on a new bilateral Partnership Agreement (PA) to replace the Partnership and Co-operation Agreement (PCA), which reached the end of its initial ten year lifespan in 2007. One of the key objectives of the PA is to develop a joint legal framework for the long-planned ‘common economic space’, which also includes energy.

It has still not been decided whether the PA should have a chapter specifically devoted to energy and, if so, what its content should be. If there is to be such a chapter, one of the questions that the EU and Russia will need to address is: what should be the relationship between the energy chapter of the bilateral EU-Russia agreement and the multilateral Energy Charter Treaty (ECT).

Russia signed the ECT in 1994. But although Moscow applies ECT rules on a provisional basis and has been actively participating in the Energy Charter process (see box on page 103), it has not ratified the treaty. When the Russian State Duma (parliament) last discussed the ECT, in January 2001, it concluded that it would not revisit the question of ratification unless a number of conditions were fulfilled. These included two clarifications regarding the ECT’s provisions on transit (in article 7) and the finalisation of a special

\[\text{One clarification concerns the link between transit and internal transportation tariffs (article 7.3); the other the conciliatory procedure for transit dispute resolution (articles 7.6-7.7). For more details on the ECT and the debates surrounding it see www.konopolyanik.ru.}\]
protocol on transit. In fact, an agreement on the Transit Protocol would offer the most practical way to resolve the outstanding disagreements on article 7.

But the protocol cannot be adopted before the ECT is in force because only countries that have ratified the ECT can ratify protocols attached to it. At the same time, however, Russia is reluctant to adopt the ECT without the Transit Protocol, fearing that such a course would damage its energy and economic interests. The way out of this deadlock is to finalise and sign the Transit Protocol and then submit it together with the ECT for simultaneous ratification to the Duma.

On the eve of the G8 St Petersburg summit in 2006 (under the Russian presidency), the EU attempted to get Russia to ratify the ECT, without having finalised the Transit Protocol. These attempts bore no fruit – except that Russian leaders stepped up their opposition to any kind of ‘fast-track’ ratification of the ECT without the protocol. Many observers misinterpreted or misconstrued their statements as a refusal on the part of Russia to ratify the ECT in principle. This, in turn, triggered renewed criticism of Russia for allegedly opposing the primacy of law in international relations.

The whole issue of ECT ratification has become highly politicised since Russia strongly resents western pressure to ratify the treaty before its substantive concerns have been met. Russian officials often put forward arguments against the ECT that are not based on its actual provisions, but rather on mistaken interpretations spread by western officials and journalists. The best example is the common claim that the ECT would force Gazprom to allow non-Russian companies access to its pipeline system (at domestic tariffs). This is not the case. Since such disagreements are not based on the treaty, they cannot be resolved at a technical level. They will only go away if the other ECT members stop trying to ‘force’ Russia to ratify the treaty and instead discuss Russia’s substantive concerns within the Energy Charter framework without opening a Pandora’s box of renegotiation.

The Energy Charter process can help address substantive issues in various ways: first, as a forum for discussing practical issues, such as risks in the international energy markets, with a view to finding solutions based on international law; second, by working out non-binding agreements, best practice and guidelines in contentious areas; and third, by adding new legally binding rules, for example through treaty amendments and protocols. The Energy Charter framework gives its members all these options – although the process of reaching agreement becomes more complex for the more binding instruments.

Gas exporters do not want the acquis

Both the EU and Russia know that they need a mutually agreed, common legal framework for their economic and energy relations. They are contemplating three different routes to constructing such a framework. Only one of them is promising.

The EU often talks of its desire to ‘harmonise’ its legal system with that of third countries, in particular neighbouring ones. But what it really means by that is the ‘export’ of EU internal legislation (acquis communautaire) to third countries. Such an approach might be realistic for some transit states, and perhaps certain energy producers that regard the EU as a model for economic development. However, the big gas exporters will want to remain outside the EU’s legal reach.
and continue to develop and manage their resources independently, to maximise the rents they collect. They might not wish to ‘unbundle’ (that is, break up) their vertically-integrated companies, nor grant mandatory third-party access to their energy infrastructure because this can complicate project financing. Instead, they may prefer negotiated third-party access, which was the rule in the EU before it adopted the Second Gas Directive in 2003. But while Russia and other big gas suppliers to the EU reject harmonisation on the basis of the acquis, most of them are either members or observers of the ECT (see map page 114). In terms of energy market liberalisation, the ECT does not go as far as EU’s Second Gas Directive. It stays at the level of liberalisation required by the First Gas Directive from 1998.

A second – but equally unpromising – approach is to incorporate some of the ECT principles into the energy section of the new PA. This idea was first voiced by some Russian officials, then echoed by some of their European colleagues. But no-one has clarified how this would work in practice and how ECT principles would be worded in the new EU-Russia treaty. There is a risk that two different standards for applying ECT principles would emerge, which may be especially tricky for the different dispute settlement procedures of the two treaties. Moreover, negotiating a new multilateral agreement (between Russia, the EU and its 27 members) ‘based on ECT principles’ would be no less lengthy and complicated than resolving the remaining issues relating to the ECT and the Transit Protocol. This is especially so since whatever the EU and Russia agree in the PA talks cannot fall behind the ECT. The ECT is part of the acquis in the sense that it represents the minimum standard of liberalisation for its members (the equivalent of the First Gas Directive). Individual ECT member-states can of course go further in developing more open and competitive markets, as the EU did when it adopted the Second Gas Directive.

There is therefore only one realistic way to create a common Russia-EU energy space: on the basis of the existing, mutually acceptable ‘common denominator’ that is the ECT. Only in this case will the Russia-EU energy space be compatible with the common rules of the emerging Eurasian energy market. This market today comprises 51 ECT member-states and 20 observers in Europe, Asia and North Africa which are connected by pipelines and electricity grids and other energy infrastructure. The energy section of the new PA could then be very brief. It could just mention that the legal framework of the common Russia-EU energy space “shall include the ECT”, which would mean that in substance the Russia-EU energy space could go beyond the ECT.

Rather than trying to resolve energy differences in the framework of the PA negotiations, the EU and Russia should focus on resolving Russia’s substantive concerns so that it feels able to ratify the ECT. Informal consultations between Russia and EU experts held in 2005-06 have already resulted in some possible solutions for the draft Transit Protocol. But there are still some difficult outstanding issues.

While there has been some progress on the draft Transit Protocol, Russia began to indicate new concerns regarding ECT ratification, without, however, presenting an exhaustive list of such concerns. This ‘open list’ has made it all but impossible for the EU and Russia to agree on a balanced compromise for both the Transit Protocol and Russia’s ECT ratification.

Russia, meanwhile, is concerned about the EU’s unwillingness to apply the multilateral Transit Protocol within its own borders.

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48 The original draft of the EU’s Third Gas Directive from September 2007 would have made it illegal for energy producers/importers to also own transmission and distribution systems. In June 2008, EU energy ministers agreed that vertically integrated energy companies could retain ownership of pipelines and power grids, provided they run them as a strictly separate businesses. This compromise, however, was vetoed by the European Parliament.

49 Virtually all major capital-intensive energy infrastructure projects in the EU (gas pipelines, inter-connectors, LNG terminals and regasification plants) are financed on the basis of a derogation from mandatory third-party access.

50 In this case, the date on which the energy chapter of the new PA becomes effective should be linked to Russia’s ECT ratification.
The EU argues that a clause on implementation of Transit Protocol rules in ‘regional economic integration organisations’ (REIO) renders it inapplicable. The EU’s version this clause (as suggested for article 20 of the Transit Protocol) states – contrary to ECT provisions – that only energy flows that cross the entire REIO area should be considered ‘transit’, and not those that cross only the territory of individual member-states. In practice, this would mean that Russian gas deliveries to, say, Germany or Italy through the territory of other EU-27 countries would not constitute transit (to the contractual delivery points along the old EU-15 border). They would be covered by the more liberal rules of the acquis, and not the ECT. Russia argues that this would affect its long-term contracts and therefore increase commercial risk and the price that consumers have to pay for gas. Since the EU countries make up more than half of the ECT’s membership, the negotiations about the Transit Protocol will get nowhere – and Russia will not ratify the ECT – until this question is resolved.

Towards a resolution

After experts from Russia and the EU narrowed their differences in mid-2006, they moved the discussions about the Transit Protocol back to the multilateral level among all ECT members in 2007. By the end of 2008, they will decide whether to continue these discussions informally or upgrade them to official negotiations.

To finalise the Transit Protocol, all of Russia’s substantive concerns about opaque interpretations of ECT transit provisions need to be dealt with. Whether the ECT members followed Russia’s position would depend to a large degree on Russia’s negotiators. Russia, on its part, needs to provide the ECT member-states with a complete and exhaustive list of the concerns that prevent it from ratifying the treaty. I have no doubt that the ECT countries would then take

Russia’s concerns very seriously.

The following sequence of steps would allow the EU and Russia to reach an agreement on energy matters, and also facilitate the negotiations on the new Partnership Agreement:

★ ECT members finalise and sign the Transit Protocol;

★ Russia presents an exhaustive list of its other (non-transit-related) concerns regarding ECT ratification;

★ ECT members address all concerns that have a multilateral character;

★ the Duma simultaneously ratifies the ECT and the Transit Protocol;

★ the EU and Russia include a provision in their new Partnership Agreement that the legal framework for the Russia-EU common energy space shall be the ECT and related documents;

★ once all ECT member-states are on an equal footing, it becomes possible to promote the ECT to other states and to discuss the expansion of its substance to strengthen international energy co-operation among producer, consumer and transit states.

Andrey Konoplyanik was Deputy Secretary General of the Energy Charter Secretariat from March 2002 to April 2008.

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51 According to the ECT (and I), “REIO means an organisation constituted by states to which they have transferred competences over certain matters a number of which are governed by this treaty.”
Common rules for the evolving Eurasian energy market:

Energy Charter Treaty or EU acquis?

<table>
<thead>
<tr>
<th>Map colour</th>
<th>Countries</th>
<th>Applicable rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>European Union: 27 member-states</td>
<td>EU legislation (acquis), including in energy, fully applies</td>
<td></td>
</tr>
<tr>
<td>Energy Community Treaty: 27 EU members plus seven South-East European countries (Croatia, Serbia, Montenegro, Bosnia, Macedonia/FYROM, Albania, Kosovo/UNMIK) plus five observers (including Turkey, Georgia)</td>
<td>EU acquis on the internal electricity and gas markets applies</td>
<td></td>
</tr>
<tr>
<td>EU candidates: Croatia, Macedonia and Turkey; Serbia and other Balkan countries hope to obtain candidate status</td>
<td>Croatia and Macedonia applying energy acquis as members of Energy Community Treaty; Turkey in the process of alignment with acquis, but full compliance not expected until closer to accession date</td>
<td></td>
</tr>
<tr>
<td>European Neighbourhood Policy: CIS (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine) and Northern Africa (Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, the Palestinian Authority, Syria, Tunisia)</td>
<td>Enhanced energy co-operation based on national action plans with Ukraine and Moldova (as well as Israel, Jordan, Morocco, the Palestinian Authority and Tunisia); partial application of EU energy policies and legislation possible in the future</td>
<td></td>
</tr>
<tr>
<td>EU-Russia Strategic Partnership agreement: EU and Russia</td>
<td>New treaty to be based on shared principles and objectives; applicability of acquis rejected by Russia</td>
<td></td>
</tr>
<tr>
<td>Energy Charter Treaty (ECT): 51 signatories in Europe and Asia, of which 46 have ratified</td>
<td>ECT rules fully applicable to all members; EU has gone further in liberalising its internal energy market; but not clear whether its demands that other ECT member-states follow are realistic</td>
<td></td>
</tr>
<tr>
<td>ECT observers: 20 countries in Europe, Asia, Middle East, Africa, North and Latin America</td>
<td>Shared ECT aims and principles but ECT rules not binding; unlikely to accept the more liberal rules of the acquis</td>
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</table>

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The future of EU-Russia energy relations

Edited by Katinka Barysch

Does the Kremlin use energy as a political weapon? Why is Russia’s oil and gas output stagnating? Can and should the EU try to reduce its dependence on Russian hydrocarbons? Are the EU and Russia engaged in a pipeline war? What does energy solidarity mean? What rules should govern EU-Russia energy relations? These are just some of the questions addressed in this report by more than a dozen eminent experts, officials and politicians. Russia is, and will remain for the foreseeable future, the EU’s single most important energy supplier. For Russia, the EU is by far the biggest and most lucrative market. Therefore, energy will remain at the heart of what is an increasingly difficult and complex relationship.

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