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The bear and the beaver:
Russia and European energy security

by Gerald Stang

Winter is long over, and with it the worry, for a few months at least, that a Russian gas cut-off could leave Europe in the cold. This year, however, the fading threat has the appearance of being more than merely an annual phenomenon. While Europe's energy security will be a challenge for decades to come, three recent developments provide reason for increased optimism.

First, the situation in Ukraine, while menacing in the short term, has brought political focus to the energy security of central and eastern Europe. This has taken shape in a new Energy Union for Europe, launched in February. Second, Russia finally threw in the towel on the South Stream gas project, its extravagant effort to permanently crowd out other gas suppliers by overbuilding capacity connections to Europe. Third, energy security improvements across the EU have incrementally but inexorably adjusted the balance of power between Russia and its gas customers to the west.

These developments have been complemented by other trends, especially the increasing flexibility provided by new types of natural gas contracts, and the flatlining of European energy demand. Due to economic stagnation, increased renewable energy use and improvements in the energy efficiency of the economy, Europe's primary energy imports in 2014 were their lowest since 2002. But conventional gas reserves in the Netherlands, the UK and Denmark are dwindling, and domestic shale gas seems increasingly unlikely to replace them. The EU will thus continue to look outside to meet its gas needs. With European firms retaining contracts to import gas from Gazprom for decades to come, it is Russia's massive reserves and oversized export plans that loom largest.

Before Crimea – and after.

In January 2006, when Moscow first cut off gas exports to Ukraine and downstream Europe, Russia supplied around 40% of EU gas imports. Over the decade that followed, a worried Europe sought to diversify away from Russian imports, taking advantage of the increasing flows of liquefied natural gas (LNG) onto world markets. But North African exports have been stagnating, a new pipeline from Russia opened up (Nordstream), and LNG shipments increasingly headed to high-priced Asia. In 2013, less than a quarter of Europe's LNG import capacity was in use. While the price differential with Asia has since moderated significantly, LNG still constitutes a relatively small part of European gas imports and Russia and Norway continue to be the dominant two suppliers. In fact, Russia's share of the market is now similar to what it was in 2006.

When Russia temporarily shut off gas to Ukraine in June 2014, the summer weather, plus the relatively full gas storage facilities across the continent, kept much of Europe largely unfazed. But the summer insouciance was not universal and seemed increasingly misplaced as the Ukraine crisis dragged on. Supply cuts were felt in Slovakia, Austria, Romania and Poland in September and October 2014. It is likely no coincidence that three of these countries neighbour Ukraine and have either begun, or plan to begin, reverse flows of gas into Ukraine, providing it with an alternative (if limited) option to buying gas directly from Russia. Only intense diplomatic efforts by successive EU energy commissioners, striking deals between Russia and Ukraine in October 2014 and March 2015, kept the gas flowing throughout the winter.

As bi-directional interconnections to Ukraine expand, it is becoming an integral part of the European market rather than merely an upstream transit space. This process was long envisaged, notably as part of the Energy Community initiative, but has been pursued with renewed vigour and resources over the last year. Bringing Ukraine closer to the EU in energy terms may have a stabilising influence on the country, but it also moves the frontiers of the European energy market further east, adding new interests that are more exposed to – and more likely to be perceived as a threat by – Moscow.

Threat perceptions have heightened on all sides since the annexation of Crimea, contributing to suspicion of Russia, even among its closer European partners. This growing distrust may help explain the rapid progress towards a long-mooted Energy Union for Europe. The Energy Union reframes the three pillars that have been at the heart of EU energy policy since 2006 – energy security, sustainability and competitiveness – providing important policy continuity in laying out five dimensions for the Union to pursue in the years ahead:

- Energy security, solidarity and trust
- A fully integrated European energy market
- Energy efficiency contributing to moderation of demand
- Decarbonisation of the economy
- Research, innovation and competitiveness

The dimension on energy security and solidarity is of particular focus this year: the communication on the Union emphasised the particular need for diversity in suppliers and supply routes. But efforts to expand relations with alternative suppliers and transit partners may have faltered had Russia's South Stream project survived.

The South Stream turnaround

Russia's giant South Stream plans took shape after the disagreement with Ukraine which led to the 2006 gas cut-off. In November that year, a joint venture between Russia's Gazprom and Italy's ENI was announced for a pipeline to bring gas across the Black Sea into southeast Europe, bypassing Ukraine. Gazprom signed deals with seven European governments and the project was locally supported in southeast Europe.

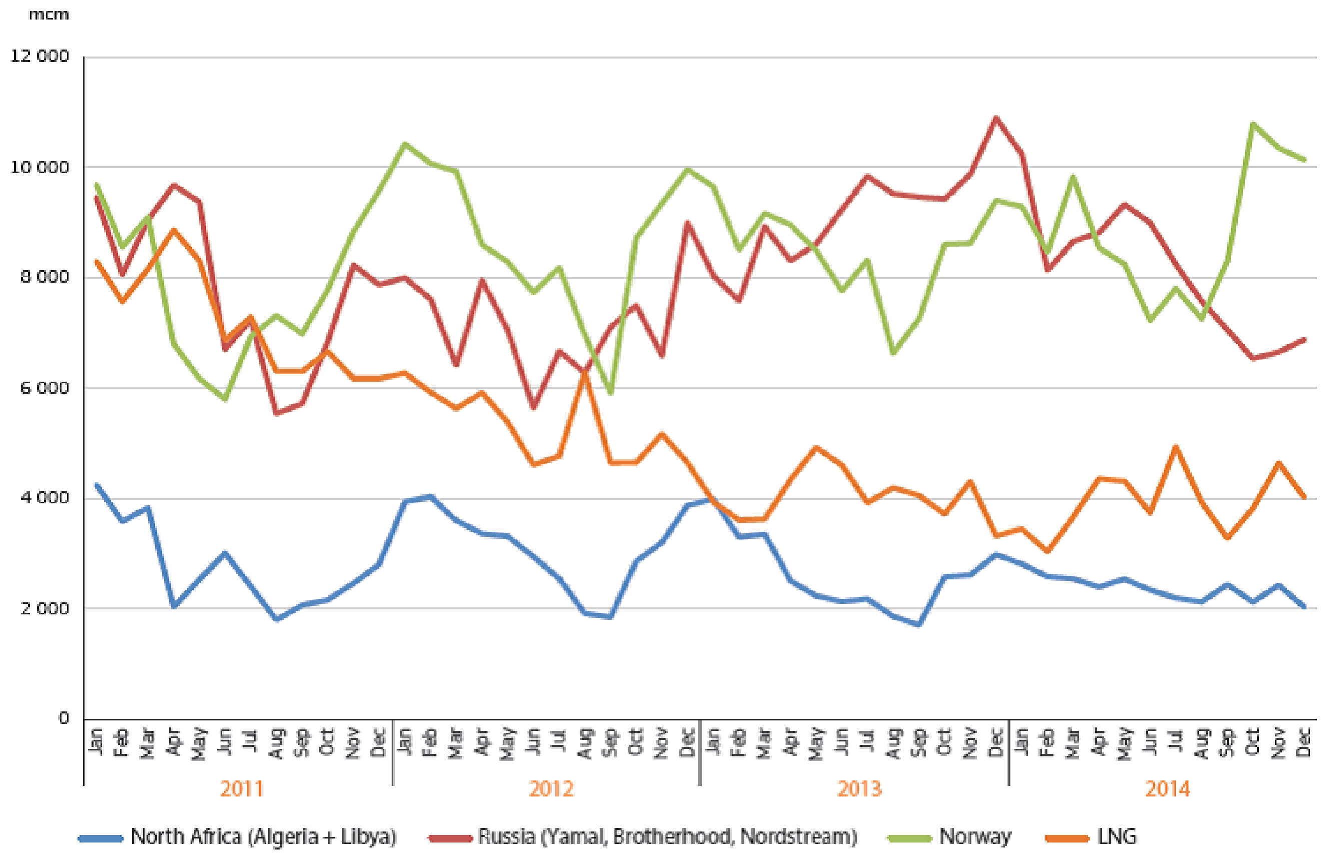
But the project would have hurt supplier diversification efforts by locking a major infrastructure route into place, thus making other investments unappealing and guaranteeing a dominant role for Russia in European gas markets. South Stream was also seen as bad for Russia. Moscow spent a decade and billions of euros on extravagant circuitous pipelines rather than forging a constructive relationship with its neighbour and economic partner Ukraine. The huge costs also damaged Gazprom's bottom line, reducing its capacity to develop new fields and pipelines for supplying China.

But with EU approval looking unlikely and energy revenues plunging, President Putin killed the project in December 2014. After years of declarations that Russian gas must bypass Ukraine to reach Europe, there have even been recent hints that Russia is willing to negotiate continued partnership with Ukraine after 2019. But this does not mean they have given up on Ukraine bypass options. Gazprom has declared plans to replace the South Stream project with Turkish Stream, shipping gas to Europe via Turkey. It has also announced an agreement with several European gas firms to double the size of NordStream, which passes through the Baltic Sea to Germany. But with their dubious economic and political viability, at least at their envisaged scale, these projects may remain pipe dreams.

Power shifts

The death of South Stream reduces Russian chances of regaining more leverage over European gas markets, as market space remains open to alternative suppliers. Supplier diversification, however, is far from the only goal for guaranteeing energy

Physical pipeline flows and LNG imports into the EU 2011-2014



Source: European Commission, 'Quarterly Report on European Gas Markets', market Observatory for Energy, Director General for Energy, Volume 7, Issue 4 (4th quarter 2014)

security. The communication on the Energy Union highlights the need to complete the internal energy market so that no parts of the continent remain isolated and vulnerable to undue external influence. It also stresses the need for more efficient energy consumption, with the Commission estimating that 1% in energy savings can reduce gas imports by 2.6%.

While some member states, particularly in Western Europe, feel confident of their energy security (thanks to a combination of a varied energy mix, diverse suppliers, and significant emergency reserves), fewer eastern member states have the same level of comfort. For example, as of 2014, more than 95% of EU LNG import capacity was located in Western Europe. The recent conflict over Ukraine has highlighted these continental differences, but also shone a spotlight on the work that has taken place over the last decade on a multitude of issues to improve Europe's energy security.

While Russia pursued grandiose projects with little to show for it, Europe has beavered away at multiple issues that win few headlines. It has, for instance, stress tested member state energy systems to find ways of reducing vulnerability to energy shocks. It has also been updating gas security of supply regulations, pushing for increased transparency in gas contracting, increasing gas storage requirements, and helping member states implement the Third Energy Package. And it has been making investments in 'projects of common interest'. New gas storage facilities have been developed across eastern Europe, pipelines now connect Hungary with Romania, Croatia and Slovakia, and new reverse flow lines connect Austria and Slovakia. Interconnectors from Lithuania to Poland and Latvia are scheduled for 2019 and 2020, and an interconnector between Serbia and Bulgaria may arrive even sooner.

The Lithuanian connections will be especially important following the opening of country's new LNG import terminal in December 2014. Poland's LNG terminal is expected to start operations in late 2015, while Estonia, Finland and Croatia are all planning new terminals. The Lithuanian terminal had an immediate impact, with Gazprom lowering gas prices once Lithuania had a second option for at least some of its supplies. As its ability to dictate conditions to physically and politically isolated buyers has diminished, Gazprom has renegotiated dozens of supply contracts since 2009, modifying take-or-pay obligations and cutting prices.

This trend will likely be strengthened further by the European Commission's decision to proceed with its long-expected competition case against Gazprom, arguing that it broke EU rules by pursuing unfair pricing and hindering cross-border sales in Europe. This case adds to a substantial history in the EU of not bowing to Russian pressure over pipelines. The Nordstream pipeline has been in place since 2011, but the Commision's Competition Authority has capped the usage rate of its OPAL leg to Germany at 50%, refusing to grant a special exemption to the regulation requiring pipelines be open to third party use. No exemption was to be expected for South Stream either, but in choosing to ignore this reality, the Russians misunderstood the power of their position.

Gas, dependence and leverage

It has long been argued that mutual dependency would ensure the continued functioning of the Russia-EU gas relationship – the EU gets the gas while Russia gets the cash – but this did not prevent supply disruptions in the past, nor is it sufficient to guarantee cooperation in the future. Russia is highly exposed to negative consequences of a potential gas cut-off, as low oil prices and sanctions are already hurting the economy and the government's finances.

But in a country where Putin retains both absolute control and significant public support, there is also more willingness to accept negative consequences in the pursuit of a particular geopolitical goal. And despite economic sanctions disrupting energy investments, which will real have long-term impacts, Russia is confident of the strength of its vast and relatively sophisticated energy industry. The narrative that Russia is reliant on Western technology is only truly relevant for certain energy projects in the Arctic and in offshore situations.

Russia is seeking to strengthen its hand further by developing other customers. Unfortunately for Moscow, the cost of sending Russian gas to Asia is enormous, even from eastern fields that will not send gas to Europe. The bill for this investment may be difficult to pass on to its primary Asian customer, China, which has decades of experience as an obstinate negotiator with Russia. Russia may eventually send plenty of gas to China (though history suggests that rhetoric will continue to flow for many years before gas does) but it is unlikely to be as profitable as Europe has been.

So Russia remains the dominant gas provider for Europe and will be for years to come. It has enough reserves to supply Europe with all its energy needs until the continent is decarbonised later this century. And with South Stream has been cancelled, Russia still needs its Ukraine route to meet commitments to its primary customers in Europe. So, is the EU stuck with the *status quo*? Not quite.

EU energy policies paying off

Europe has already recalibrated Russia-EU energy relations more in its favour. South Stream's failure, and the dubiousness of its announced replacements, means that the balance of gas suppliers into Europe is unlikely to change drastically. Boosted by improved solidarity, expanded LNG options and trends toward more spot-market and short-term gas deals, the EU has reduced the market-defining power of its largest supplier. And it has not needed any major new sources of gas to do so. LNG shipments come from around the world. The Southern Corridor will bring gas from the Caspian region and beyond, though less than previously planned. Moreover, the EU's energy commissioner and the HR/VP have announced plans to expand energy partnerships in the Mediterranean, most notably with Algeria. These will all contribute to a European version of the Obama administration's 'all of the above' energy strategy, bringing gas from many sources and increased negotiating leverage to Europe.

Despite their extravagant declarations and reactionary piques, Moscow and Gazprom are being outmanoeuvred by a Europe with a clear vision of its energy future: transparent, flexible, apolitical markets open to competition from all sides. As global gas markets become increasingly interconnected and fluid, gas is gradually becoming a more normal commodity market, which, in turn, would allow prices to move toward the long-run marginal cost of supply. This means Russia can continue to be in a very profitable position, though one that grants it less political leverage over its customers.

Gerald Stang is a Senior Associate Analyst at the EUISS.

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