

## Crisis in Russia-EU energy relationship

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Veröffentlichungsversion / Published Version

Arbeitspapier / working paper

Zur Verfügung gestellt in Kooperation mit / provided in cooperation with:

SSG Sozialwissenschaften, USB Köln

### Empfohlene Zitierung / Suggested Citation:

Meister, S. (2009). *Crisis in Russia-EU energy relationship*. (DGAPaktuell, 4). Berlin: Forschungsinstitut der Deutschen Gesellschaft für Auswärtige Politik e.V.. <https://nbn-resolving.org/urn:nbn:de:0168-ssoar-128869>

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## Crisis in Russia-EU energy relationship

*The Ukrainian-Russian gas conflict of early 2009 has inflicted sustained damage on the trust between Russia and the EU. Whereas the Russian side criticizes Brussels for not exerting sufficient pressure on Kiev and for putting the same blame for the escalation of the conflict on Gazprom as on Kiev, the critics within the EU feel confirmed in their warning of too great a dependence on Russian energy. Both the Russian suggestion for a new energy framework agreement as well as for a Eurasian energy forum met with little support within the EU. On the other hand, the Russian Premier Vladimir Putin has called into question, as a matter of principle, the Russian signature under the Energy Charter Treaty. At the same time, Russia is continuing to develop its bilateral energy relations with individual EU member states with the Nord Stream and South Stream projects. At an international gas conference that was conducted by the DGAP Russia-Eurasia Center on 19 May 2009, it emerged that despite the high degree of mutual dependence and the serious effects of the financial crisis on the entire energy sector, neither side is ready for compromise at the moment. Russia and the EU should reconsider their energy policy and demonstrate more readiness for conciliation. It remains the supreme goal to de-ideologize energy policy and to turn it into an important pillar of strategic bilateral relations.*

### Following the summit of Khabarovsk

The EU-Russia summit in Khabarovsk on 21/22 May 2009 was determined mainly by the subject of energy security but yielded more or less no result. The EU-Russia relationship seems to have arrived at a new low, as there are different positions on quite a number of issues. The Russian proposal for a new security architecture has so far met with little agreement within the EU. On the other hand, the new EU project of an Eastern partnership is regarded by Russia as a project competing for the post-Soviet space. However, it is the issue of energy that has made the two sides adopt a course of confrontation since the gas conflict at the beginning of the year 2009. The interruption in the supply for Europe of nearly three weeks has once more fanned the debate within the EU on the diversification of energy supply and has reinforced the

trend towards promoting alternative energy sources and pipeline projects. This has put the gas industry in Europe under even more political pressure, especially as it has been under growing scrutiny by the European regulatory bodies for years anyway.

### EU liberalization policy in the energy sector

The EU Commission has been driving its unbundling and liberalization policy especially in the gas sector for years, aimed at breaking up the influence of a few large groups and introducing more competition for the benefit of the customers. At the same time, energy policy within the Union is still determined very much by national views; a situation the Commission aims to change with its policy of liberalization. The Third Energy Package, adopted by the European Parliament on

22 April 2009, envisages the separation of grid operation and generation of energy. The originally planned complete ownership unbundling of the energy companies and their electricity and gas transmission networks had been weakened by compromise. Meanwhile, the member states are able to choose from among three possible options, in which there is not only the complete separation but also the possibility of the energy groups remaining the owners of the grids and having them operated by independent companies. In contrast to this policy of unbundling, the aim of Russia and especially of Gazprom is to be able to offer the entire value-creation chain also on the European energy market in the future. This is what the Russian government wants to achieve through a new legal framework agreement on energy cooperation. This includes long-term agreements with the purchasers, guarantees for investments and access to the attractive European end-customer market.

### Russian counter proposals

Also as a reaction to the gas crisis of January 2009, the Russian side has presented two concepts that are to replace the Energy Charter and consider more strongly the interests of Russian companies. At the Russian-German Forum on Fossil Raw Materials in St. Petersburg on 27 March 2009, the President of the Russian gas company, Valerii Yazev, presented the concept of a Eurasian energy forum to an international audience for the first time. This forum is to consist of all the major energy producers of the Euro-Asian region, act independently of the respective national governments and place the transit of raw materials under international control. Apart from this concept hailing from the Russian gas industry, the Russian presidential administration published proposals for a new Energy Charter on 21 April. These call for a new universal international energy document that is to replace the Energy Charter. The fundamental principles of this agreement are the equal responsibility of recipients, suppliers and transit states of energy resources for energy security, the maintenance of state sovereignty concerning national resources, the unimpeded access to international en-

ergy markets and the protection of existing and future investments in this area. Furthermore, guarantees are demanded for the transit of energy resources and products, which strengthens particularly the rights of the producing countries.

It is especially the transit protocol of the existing international Energy Charter Treaty that is being criticized by Russia, as this would mean the loss of the monopoly over the pipelines held by Gazprom. With its new proposals for an international energy treaty, Russia is attempting to strengthen its own position and to play a more active role in the energy debate with the EU. Fundamentally, the existing structures and thus the monopoly position of Gazprom for the delivery of raw materials from the post-Soviet space is to be protected. Russia wants to leave the current supply contracts untouched and distribute the risk of supply failures evenly among the exporters, transit countries and recipients. The Russian side finds fault in the EU for setting up rules with its energy policy without having included supplying countries such as Russia sufficiently in the negotiations on drawing up these very rules. Furthermore, Russia feels treated unfairly by the energy policy of the EU. The Vice Chairman of Gazprom, Alexander Medvedev, criticizes that, on the one hand, Russia is held responsible for the interruptions in supply of 2006 and 2009 and that, on the other hand, projects for diversifying energy supplies to Europe such as Nord Stream and South Stream are being criticized within Europe as increasing the dependence of Europe on Russia. It is a fact, however, that the EU only depends on gas supplies from Russia in a share of 25 percent. Russia, in contrast, exports more than 80 percent of its energy to Europe.

### Conflict surrounding Ukraine

A major contentious issue between Russia and the EU is that of how to treat Ukraine. The declaration signed between Brussels and Kiev on 23 March on the modernization of the Ukrainian pipeline system met with harsh criticism from Moscow, as it did not include Russia. Representatives of the Russian government

and Russian companies raised the point that it was not possible to modernize the Ukrainian pipeline system that channelled 80 percent of Russian gas supplies to Europe without the participation of Gazprom. The company Gazprom stressed that this pipeline infrastructure manufactured in the Soviet Union was synchronized completely with the Russian system and that neither could function independently from one another. The cost for the modernization amounts to US \$ 5.5 billion according to the Ukrainian government, a sum that is to be supplied by international financiers. Indeed, it seems to make sense that a consortium consisting of European, Russian and Ukrainian companies should modernize, maintain and develop further the Ukrainian installations. It has to be considered that the Ukrainian side does not want to put this infrastructure under Russian control and that a consortium should also comprise several non-Russian companies.

### A new gas conflict?

The Russian leadership and Gazprom have been warning of a renewed gas crisis with Ukraine for weeks. On the one hand, this line of argument is aimed at stressing the importance of the own projects (Nord Stream, South Stream) for European energy security and at meeting the criticism from the EU member states concerning the too heavy dependence on Russian supplies. On the other hand, there are indications that Ukraine is really facing insurmountable payment difficulties. The Ukrainian gas monopolist Naftogaz has used up all of its own gas reserves due to a lack of funds over the past months and has not been able to re-fill the stores again. In the first quarter of 2009, Naftogaz only purchased 2.5 billion m<sup>3</sup> of the 35 billion m<sup>3</sup> of gas ordered. In addition, Naftogaz has to repay US \$ 500 million of a foreign loan in September 2009. During a meeting of the prime ministers of Ukraine, Yulia Tymoshenko and Russia, Vladimir Putin, no agreement was achieved on financing the debts and the necessary reserves for the winter season. Prime Minister Tymoshenko had enquired about a US \$ 5 billion loan in Moscow already in February, in order to restore the solvency of Naftogaz. It emerged that despite exclud-

ing the intermediate agent Rosukrenergo, there was still no clarity established on the amount of the debts, the handling of ordered but not accepted deliveries and payment modalities. As the Ukrainian position is going to remain solid until the elections scheduled for January 2010, interruptions in the supply cannot be excluded for the winter ahead.

### Options for EU action

What shall the EU do? The EU cannot step aside and stay out of the energy relationship between Russia and Ukraine, as its member states are the ones who are going to bear the brunt of any renewed interruptions in the supplies. Ukraine is in a precarious economic and political situation, which it will not be able to maneuver out of on its own. In order to secure long-term supplies through Ukraine, the solvency of Ukraine itself needs to be restored. This requires at least a partial privatization of the Ukrainian energy industry (Naftogaz is 100 percent owned by the state), as well as higher domestic prices for energy, the promotion of energy efficiency and renewable energies. It remains to be seen whether the planned presidential elections will really lead to a stabilization of the domestic political situation. However, the EU should put forward long-term offers to Ukrainian politics, e. g. joint projects in the area of energy efficiency and thus promote the modernization of Ukrainian economic and energy structures. At the same time, it is not very promising to exclude Russia from such important strategic projects as the modernization of the Ukrainian pipeline system. With the participation of Russian companies in the modernization of the Ukrainian infrastructure, these could be included in the responsibility. Thus a lighthouse project could be created serving the improvement of the energy relationship between Russia and the EU as a whole.

Russia, Norway and Algeria will remain the major gas suppliers of the EU for a longer period of time. According to more or less all scientific forecasts, gas consumption will rise in the EU; and Russia, with the greatest gas reserves worldwide, is a supplier there is

no alternative to in the medium term. It is important to drive on the diversification of routes and the development of LNG terminals. Furthermore, the relations with the supplier countries should be developed in the long term, in order to create greater security. The secure delivery of gas and oil should be guaranteed also through legal treaties entered into by the supplier countries, which would need to be financed through a higher gas price. They should be held liable for any interruptions in the supply. The gas crisis has made clear that a review is necessary of the European and in some countries also of the national security systems for energy. Energy should play a greater role in the foreign relations of the EU. Brussels should adopt this subject more, in order to be able to act as a more influential player. This would add authority to projects such as Nabucco and open up new scope for negotiation vis à vis the Central Asian countries.

### Entwinement and Juridification

The global financial crisis has once more underlined the mutual dependence of Russia and the EU in the energy sector. The decline in European economic output, connected with a lower consumption in raw materials and a drop in prices, hits the Russian energy industry and thus the income of the Russian state directly. Over the first three months of the year 2009, Gazprom's gas deliveries to Europe declined by just under 40 percent as compared to the same period last year. At the same time, the share in the European gas market has dropped from 25 to 18 percent. This development also has something to do with the rigid pricing policy pursued by Gazprom as compared to other competitors. Thus, the group has secured the monopoly concerning Central Asian deliveries with high price agreements, which are difficult to limit again now.

According to information from the company, Gazprom expects its income to collapse by at least 45 percent as compared to the previous year 2009. However, the group requires enormous financial funds in order to conduct its large-scale investment projects. At the moment, Gazprom confirms the continuation

especially of its strategically important projects such as Nord Stream, South Stream and the development of the Shtokman gas field in the Barents Sea. The planned investments for 2009 amount to US \$ 30 billion. At the same time, Gazprom has foreign debt of just under US \$ 50 billion. The estimated cost for the first leg of Nord Stream stands at EUR 7.4 billion. Apart from the Hermes guarantee in the amount of EUR 2 billion, Gazprom enquired with the Italian exporting agency SACE about a suretyship of up to EUR 2.14 billion in May 2009, due to problems on the international lending market. The cost for South Stream will increase massively with the planned doubling (from 31 bn. to 63 bn. m<sup>3</sup>) of the capacity. Whereas Gazprom quotes a price of EUR 8.6 billion, Western experts expect the cost to be in the range of EUR 22 to 25 billion.

It becomes clear that the Russian gas monopolist does not only require cooperation and technical know-how but even more urgently western loans and investments. Only close cooperation and a further integration of the Russian and European gas industries are able to guarantee European energy security in the long run. It seems to be all the more important not to put forward political arguments on the subject of energy but rather to develop joint projects. The modernization of the energy infrastructure and supply of Ukraine suggests itself as such a joint strategic project.



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The Energy Dialogue Russia – the European Union:  
Gas Aspect  
19 May 2009, 10.00–16.00  
Organizer:  
Center Russia/Eurasia of the DGAP,  
Russian Gas Society (RGO)