THE EU–RUSSIA GAS RELATIONSHIP

183

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NEW PROJECTS, NEW DISPUTES?

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- Russia is an important supplier of gas to several member states of the European Union and is likely to retain this role until at least 2030 thanks to long-term contracts with European companies and the competitiveness of its gas exports.

- However, the EU–Russia gas trade is facing three sets of challenges: uncertainty over the regular transit of Russian gas via Ukraine next winter; Russia's plans to build new infrastructure for its gas exports to the EU, bypassing Ukraine; the implementation of EU rules to liberalise the internal gas market, which in turn affects the business of Russian energy company Gazprom. As the EU and Russia will remain interdependent in the gas sector for the next decade at least, it is in the interests of both sides to resolve these issues.

- In terms of EU energy security, the vulnerability of Eastern and Southern European member states to supply disruptions is the main issue concerning gas imports from Russia. Integrating these countries into EU and international gas markets and diminishing their dependence on the Ukrainian transit corridor would reduce their vulnerability.

- The EU should continue to integrate and liberalise its internal gas market. Gazprom has the resources to adapt to these changes and will most likely remain a key supplier in the EU gas market. Hence, the EU should also strengthen the security of its gas imports from Russia while diversifying its suppliers and, most importantly, reducing its consumption of fossil fuels.

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Energy trade is the chief economic driver of EU–Russia relations. Russia is the main supplier of oil, gas and coal to the European Union, as well as one of its main providers of uranium. In 2013, Russia supplied 39% of the gas, 33% of the crude oil and 29% of the solid fuels imported by the EU.[1] These figures acquire particular significance in the context of the EU's overall dependency on foreign energy sources. In 2013, the Union imported over half of the energy it consumed. Due to the declining domestic production of fossil fuels and the phasing out of nuclear power in some member states (notably Germany), this dependency is expected to grow in the coming decades.

If Russia is an important energy supplier for the EU, the EU is a vital market for Russian energy sales. In 2013, crude oil, petroleum products and natural gas sales accounted for 68% of Russia's total export revenues, with most of these exports heading to the EU. Crude oil and petroleum products constituted over half of Russia's export revenues, while the share of gas was 14%.

Despite its lesser economic role in the broader EU–Russia energy relationship, the gas trade has been the main source of controversy and the most politicised topic. This is due to the technical difficulties experienced by EU member states in East-Central Europe in importing gas from other suppliers, and their consequent vulnerability to disruptions in the flow of Russian gas. Most East-Central European member states have few or no backups for Russian gas in the sectors where it is used, notably household heating.[2] Moreover, several EU members will most likely remain dependent on substantial imports of Russian gas at least until 2030.[3]

With the outbreak of the conflict in Ukraine, fears about possible disruptions to the gas trade with Russia have increased. Approximately half of EU gas imports from Russia flow through Ukrainian territory. Moreover, the EU and Russia have been locked in several disputes concerning their gas trade. The disputes concern the infrastructure through which Russian gas will be channelled to Europe in the near future, the commercial practices of Russia's state-run company Gazprom (which has a legal monopoly over Russia's pipeline gas exports), and European legislation liberalising the EU energy market.

After reviewing these issues, the paper will argue that the EU and Russia will remain strongly interdependent in the gas sector for at least another 10–15 years. It is therefore in the interests of both sides to resolve outstanding issues. Meanwhile, the EU should reduce the vulnerability of those member states that are most exposed to supply disruptions. Most importantly, it must strive for the decarbonisation of its economy, as this will allow it to both tackle climate change and reduce its dependence on imported fossil fuels, including Russian gas.

The gas trade and the conflict in Ukraine

Due to their immediate relevance, securing Russian gas flows via Ukraine is the first challenge that needs to be addressed. Russian gas is shipped to Europe via pipelines. There are three main routes: the Ukrainian pipeline network (built during the Cold War), the Yamal-Europe pipeline (via Belarus and Poland, built in the 1990s) and the Nord Stream pipeline (inaugurated in 2011 and providing a direct link between Russia and Germany via the Baltic Sea). In addition, Finland and the Baltic countries have their own direct pipeline connections to Russia. Between 2004 and 2013, the share of Russian gas in total EU gas imports oscillated between 30% and 45% (Table 1).

Until the mid-2000s, the flow of Russian gas to the EU took place without major disruptions. However, the scenario changed in 2004 when the Orange Revolution occurred in Ukraine, resulting in Kiev's adoption of a pro-NATO and pro-EU foreign policy stance. The Russian leadership attempted to use Ukraine's dependence on Russian gas imports to thwart its foreign policy reorientation. While Ukraine had previously benefitted from discounts on

1 Eurostat, Main origin of primary energy imports, EU-28, 2003–13.

2 For five member states – Finland, Latvia, Estonia, Bulgaria and Slovakia – Russia is the only supplier of gas. However, Finland has backups in the sectors where Russian gas is used and would therefore have alternatives if Russian gas supplies were disrupted.

3 See R. Dickel et al., Reducing European Dependence on Russian Gas: Distinguishing Natural Gas Security from Geopolitics, OIES Paper 92. Oxford: Oxford Institute for Energy Studies, 2014.

Table 1. Main gas import partners of the EU, percentage of total gas imports, 2004–2013. Source: Eurostat.

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Russia	44.4	41.3	40.0	39.2	38.2	33.7	30.1	32.0	32.3	39.3
Norway	24.2	24.0	25.9	28.3	28.5	29.5	27.6	27.6	31.3	29.8
Algeria	18.0	17.6	16.3	15.3	14.7	14.2	14.0	13.0	13.6	12.8
Qatar	1.4	1.5	1.7	2.1	2.3	5.4	9.5	10.9	8.4	6.6
Libya	0.4	1.7	2.5	3.1	3.0	2.9	2.7	0.7	2.0	1.8

Russian gas (a Soviet-time legacy), Gazprom started to demand higher prices, in line with or even higher than prices for Russian gas in Western European markets. In 2006 and 2009, disagreements between Moscow and Kiev over the price of gas resulted in disruptions to the flow of gas towards European markets, which seriously affected the economy and society in several Eastern and Southern European countries.[4] Although these crises subsided and the regular flow of gas resumed, the vulnerability of several EU member states had been exposed.

In 2014, despite the escalation of the Ukraine crisis, Russia provided approximately 42% of EU gas imports. On the other hand, nearly 53% of Russian gas exports went to the EU (Figure 1). However, Russia appears to be reorienting its exports more and more towards the Nord Stream route and the Belarusian transit corridor, away from Ukraine. As Table 2 shows, the reorientation started before the Ukraine crisis. From 2012 on, volumes of gas shipped through Nord Stream grew considerably, while volumes transiting Ukraine decreased.

To understand this process, it is important to note that, due to the current conflict with Ukraine, Russia has an interest in diminishing Kiev's leverage as a transit country for its gas exports to the EU. Furthermore, Gazprom owns majority stakes in both the Nord Stream and Yamal pipelines, whereas the Ukrainian state-owned Naftogaz controls the Ukrainian transit pipelines. Hence, Gazprom has an interest in becoming less dependent on the Ukrainian corridor.

Nonetheless, as of 2015 the Ukrainian transit pipelines remain essential for the EU-Russia gas trade. Their capacity is much larger than those of Nord Stream and Yamal, and it is boosted by an additional 30 billion cubic metres (bcm) of storage capacity in Western Ukraine. Even if Nord Stream and Yamal were used at full capacity, they would be insufficient to channel the entire amount of gas that the EU imports from Russia. Moreover, several Southern and Eastern European countries are entirely dependent on the Ukrainian corridor for their imports of Russian gas.[5] The energy security of Bulgaria and of most other Balkan countries is further complicated by the fact that they do not have the infrastructure to import gas from elsewhere in emergency situations.

Tensions between Moscow and Kiev have increased dramatically since February 2014. The conflict has had an impact on Russian gas deliveries to Ukraine, which are essential for winter heating and the functioning of the Ukrainian economy. Following disputes over the price of gas and the repayment of Naftogaz's debts to Gazprom, the Russian company suspended gas deliveries to Ukraine in the summers of 2014 and 2015. However, contrary to what happened during the gas crises of 2006 and 2009, the flow of Russian gas to the EU through Ukraine has not been significantly affected so far.[6] This was also thanks to the EU's success in mediating a deal and providing financial guarantees for the resumption of Russian gas deliveries to Ukraine from November 2014 until June 2015.

However, deliveries were halted again in July 2015 upon expiry of the agreement reached the previous

4 See S. Pirani et al., The Russo-Ukrainian gas dispute of January 2009: a comprehensive assessment, OIES Paper 27. Oxford: Oxford Institute for Energy Studies, 2009.

5 Austria, Bulgaria, Croatia, Hungary, Romania, Slovakia and Slovenia are wholly dependent on the Ukrainian transit corridor for their imports of Russian gas.

6 Russia stopped gas supplies to the Ukrainian markets, but continued to channel gas to the EU via the Ukrainian transit pipelines.

Figure 1. Russian gas export pipelines to the EU, 2014. Source: Bruegel, 2015.

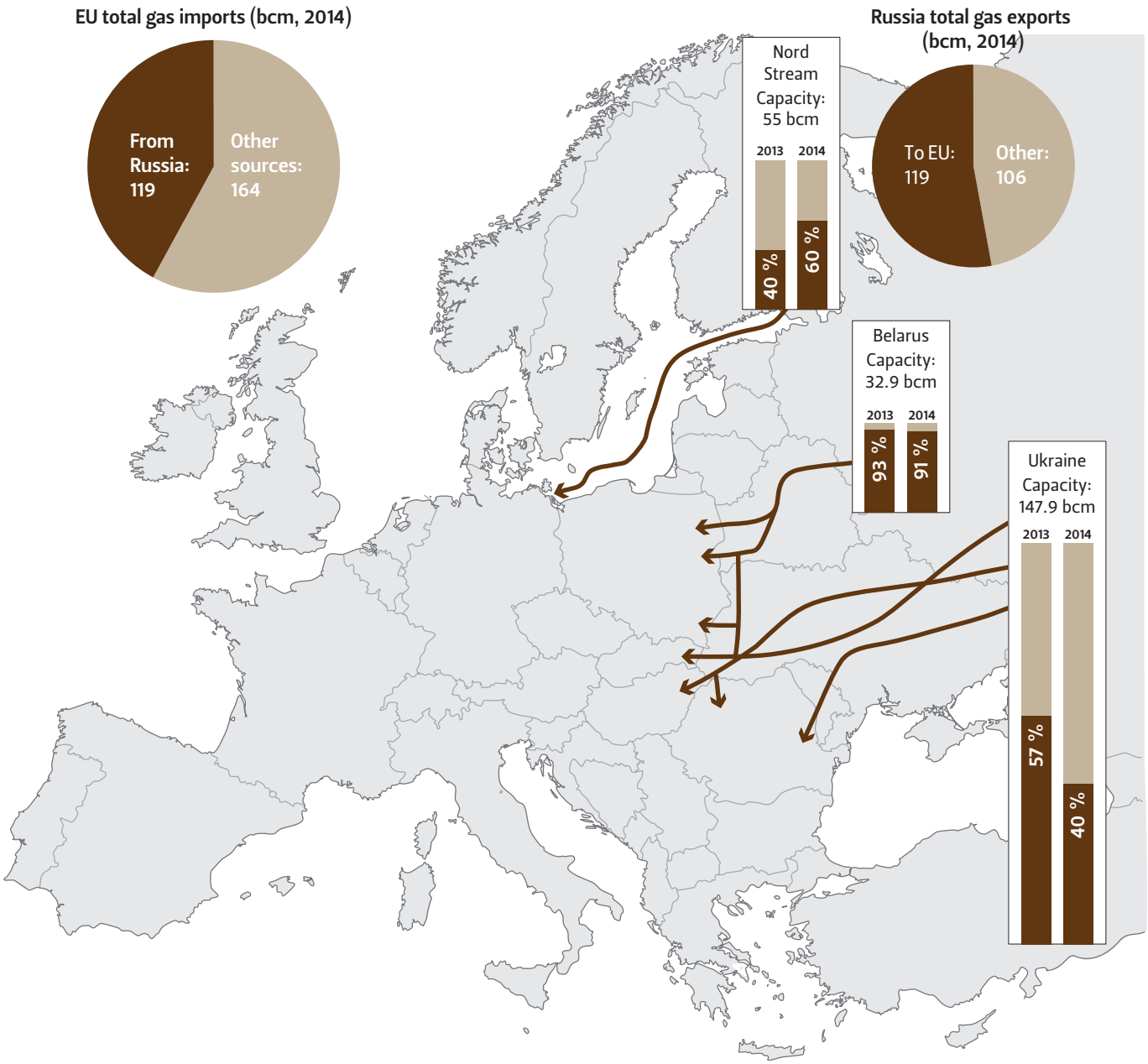

Table 2. Transit routes and volumes of Russian gas exports to the EU, 2011–2014.
Source: European Commission, Quarterly Report on European Gas Markets 7/4 2014, Naftogaz Ukraine.

Transit route	EU entry points	Capacity (bcm/year)	Actual total flow (bcm/year)			
			2011	2012	2013	2014
Nord Stream	Germany	55	0.5	10.6	22.1	32.8
Yamal–Europe	Poland	32.9	22.8	25.0	30.6	29.8
Ukraine	Slovakia, Hungary, Poland, Romania	147.9	101.1	81.2	83.7	59.4

NB: The table does not show Russian gas exports to the Baltic countries and Finland; volumes of gas via Ukraine shown include those exported to Turkey and other non-EU countries in the Balkans.

October. Negotiations for a new agreement proved difficult, as Moscow and Kiev disagreed on the size of Ukraine's price discount and the duration of the new deal. During the summer, the EU temporarily supplied gas to Ukraine with reverse flows, namely by channelling gas that it bought from Russia back to Ukraine. However, reverse flow gas would not be sufficient to ensure a stable supply for Ukraine in the winter. For this, Ukraine needs to refill its underground storages with additional gas from Russia, as well as EU loans to buy the gas.[7]

In late September, an agreement was reached: Russia will sell gas to Ukraine at a price of approximately 227 dollars per thousand cubic metres until 31 March 2016, with a discount of around 20 dollars compared to Gazprom's initial offer. The EU committed to facilitating the financing of Ukraine's purchases. Together with the World Bank and the International Monetary Fund, Brussels will make 500 million dollars available for this purpose by the end of the year.

The agreement was welcomed by all sides, which have key interests at stake: Ukraine needs Russian gas for house heating and to keep its industry working; Gazprom needs secure and reliable transit for its gas sales to lucrative EU markets; the EU needs stable Russian gas supplies to satisfy its energy demand.

Future infrastructure of EU–Russia gas trade: Ukraine, Turkish Stream or Nord Stream II?

The second challenge to address concerns the infrastructure through which Russian gas will reach the EU in the next decade. While the European Commission appears to be keen on integrating Ukraine into the EU energy market and preserving its strategically important role as a transit country, Moscow would like to end its reliance on the Ukrainian pipelines. Gazprom has announced that it intends to phase out gas transit to the EU via Ukraine by 2019. This would weaken Ukraine's negotiating position vis-à-vis Russia and deprive it of the substantial revenues (around 3 billion dollars in 2014) that it earns from the transit of Russian gas across its territory.[8] In order to achieve this, Gazprom would have to build additional infrastructure. Currently, the company is pursuing two options: Turkish Stream and Nord Stream II.

Following the cancellation of the South Stream project in December 2014, Gazprom announced that it would build Turkish Stream, a pipeline that will reach Turkish territory via the Black sea and, from there, the Greek-Turkish border. From there, additional infrastructure would have to be built by the European Union, thereby sparing Gazprom additional costs. The Russian company would also avoid the legal challenges that hampered South Stream, notably the EU's Third Energy Package (unbundling the ownership of energy production from that of energy distribution), as Turkish Stream would not run on EU territory.

If built according to plan, Turkish Stream would have a total capacity of 63 bcm/year, out of which 14 bcm would be sold to Turkey and the remaining 49 bcm would become available for sale at the EU's border. The Turkish and the Greek governments have shown strong interest in the project, which would allow them to earn considerable transit revenues and strengthen their position as European gas hubs. Greece's and especially Turkey's good political relations with Russia increase the likelihood that the pipeline will be built. However, the European Commission's response has been negative so far. The main reasons for this are that Turkish Stream would require large infrastructural investments in South-Eastern Europe, weaken Ukraine's strategic position and further EU dependence on Russian gas.

Expanding the Nord Stream pipeline, bringing its capacity from 55 to 110 bcm/year, is the other option advocated by Gazprom. For this purpose, the Russian company signed a shareholders agreement with its European counterparts BASF, E.ON, ENGIE, Shell and ÖMV at the Eastern Economic Forum in Vladivostok in early September 2015. However, for this project Gazprom would have to face the challenge posed by the Third Energy Package. On the one hand, another exemption from the package will be

7 The Commission estimated that a further 4 to 6 bcm of direct imports from Russia are needed.

8 Transit countries receive payments from gas suppliers for allowing the passage of gas across their territory. If Russia reroutes its gas sales to other pipelines, Ukraine will also lose its leverage in the EU-Russia gas trade.

necessary for additional volumes of gas (the existing lines of Nord Stream already have one). On the other hand, Gazprom is still waiting for a decision from the European Commission concerning the full use of the OPAL pipeline, which can transport Nord Stream gas from the Baltic coast to Central Europe. At the moment, due to the rules of the Third Energy Package, Gazprom can only use 50% of OPAL's 36 bcm/year capacity.

It is highly unlikely that Gazprom will fully implement both Turkish Stream and Nord Stream II. With Yamal-Europe and Nord Stream already operational, either project will suffice to transport sufficient gas to cover the whole EU demand and end reliance on the Ukrainian transit corridor. Implementing both would require large investments and result in significant over-capacity.[9] However, if Gazprom opts for Nord Stream II, it is possible that one line of Turkish Stream (namely one fourth of the overall project) will be built: it would channel Russian gas to the Turkish market and allow Gazprom to end its reliance on Ukrainian and Balkan transit for gas sales to Turkey. At the current stage, Gazprom may be advocating both projects to promote competition between its Northern European and Turkish partners, thereby increasing the chances that at least one will be implemented.

If the Russian company does not manage to mobilise sufficient political and financial support from its foreign partners, it may well end up without either Turkish Stream or Nord Stream II, and have to rely on the Ukrainian transit corridor for longer. As sufficient infrastructure for gas trade with Russia already exists, the EU has little incentive to actively support new pipelines. However, if external or corporate funding is available for these projects, they may still be built. Even so, the consequences for EU energy security should not be exaggerated. With the increasing integration of the European gas market and the diversification of suppliers, access routes will become less relevant: gas will be bought where it is cheaper and then channelled to the countries that need it.

9 Gazprom is under financial pressure also due to parallel infrastructural projects in the Russian Far East, notably the Power of Siberia and Altai pipelines, which have been designed to carry Russian gas to China.

The Third Energy Package and antitrust investigation

The third challenge to the EU-Russia gas trade – and arguably the most significant one for the future of Gazprom in the EU gas market – stems from EU legislation on the liberalisation of the internal energy market. In 2009 the EU adopted a set of directives and regulations, cumulatively referred to as the Third Energy Package, that are aimed at the liberalisation and integration of national gas markets. The requirement of unbundling the ownership of gas production from that of gas distribution is arguably the most contentious issue in the EU-Russia gas trade, particularly with regard to Gazprom's modus operandi.

Gazprom's business strategy includes both the extraction of gas and its shipment to markets via pipelines in which the company holds a majority stake. As this conflicts with the legislation of the Third Energy Package, Gazprom has sought exemptions from the relevant EU rules. This strategy worked when a decision had to be made on granting an exemption to Nord Stream, in 2011-2012, mostly thanks to the better state of EU-Russia relations and German lobbying in the EU. However, the strategy faced much stronger opposition from the European Commission when the issue became relevant for South Stream (2013-2014). As the Ukraine crisis escalated, the EU reassessed the political significance of its dependence on Russian gas and became reluctant to support another Gazprom-owned pipeline.

Between 2008 and 2010, Russia signed intergovernmental agreements with the countries which were meant to host South Stream infrastructure (Bulgaria, Serbia, Hungary, Greece, Croatia, Austria and Slovenia). However, in December 2013 the European Commission stated that the agreements had to be renegotiated because they were in breach of EU law, notably of the provisions preventing energy producers from simultaneously owning energy transmission networks. The Russian-Bulgarian agreement also violated EU rules concerning state aid and competition. The Commission's position on South Stream is likely to have played a role in Vladimir Putin's decision to cancel the pipeline project in December 2014.

In an attempt to challenge the Third Energy Package, in April 2014 Russia filed a dispute at the World

Trade Organisation (WTO), the institution that governs the global rules of trade between nations. Moscow argues that the Package discriminates against Russian natural gas pipeline transport services and service suppliers. In particular, Russia objects to the requirement for granting access to natural gas and electricity networks to different operators, which forces Gazprom to cede stakes in the infrastructure it owns and market shares. The case is now subject to WTO arbitration.[10]

The confrontation between the European Commission and Gazprom continued as Brussels decided to go ahead with an antimonopoly investigation against the Russian company. The European Commission is tasked with monitoring the correct application of EU competition rules and has a wide range of inspection and enforcement powers, such as investigating businesses, holding hearings and granting exemptions. The investigation against Gazprom was formally launched in September 2012, with Gazprom suspected of breaching Articles 101 (restriction or distortion of competition) and 102 (abuse of dominant position) of the Treaty on the Functioning of the EU. Subsequently, negotiations took place between Gazprom and the European Commission, with the objective of settling the matter without taking it to court.

In April 2015, new EU Competition Commissioner, Margrethe Vestager, decided to take the investigation forward, and the European Commission duly sent its Statement of Objections to Gazprom. The Russian company is suspected of three anti-competitive practices. First, it may be hindering cross-border gas sales within the EU by imposing 'destination clauses' in its contracts with some energy companies. Destination clauses require the purchased gas to be used in a specific territory, thereby preventing the re-export of imported gas. While such clauses have been removed from Gazprom's contracts with Western energy companies over the last decade, they still feature in agreements with East-Central European member states. The Commission suspects that destination clauses are geared to a 'divide and rule' policy through which Gazprom – as the dominant gas provider in the region – is able to charge different prices in East-Central European countries.

The second anti-competitive practice concerns unfair pricing. Due to the fragmentation of the EU's gas market, Gazprom has charged higher prices to some countries – in particular Poland, Bulgaria and the Baltic states – and lower ones to other EU member states that have similar or lower supply costs.[11] In addition to this, Gazprom's price formulae linking the gas price to that of oil products (a practice called oil indexation) seem to have favoured the Russian company much more than its customers. In the last few years, as the price of oil remained higher than spot prices of gas in the European market, Western European companies were able to negotiate discounts with Gazprom. Doing this proved much more difficult for East-Central European member states, which lacked the infrastructure to import cheaper gas from other sources.

Thirdly, the Commission suspects that Gazprom may have made the supply of gas to Bulgaria and Poland conditional on obtaining concessions regarding pipeline projects. This involved the participation of Bulgarian state companies in the South Stream project and Gazprom's prerogative to control investment decisions regarding the Yamal-Europe pipeline.[12]

In late September 2015, Gazprom proposed formal talks with Brussels to settle the case. The Russian company may argue that, in order to maximise profits, it has the right to charge different prices in EU member states, as the average price of gas imports varies significantly among them. It may also claim that it is up to each EU member state to ensure it has the necessary infrastructure to import gas from different suppliers and make its market more competitive, thereby pushing prices downwards.

However, Gazprom will find it difficult to defend destination clauses, as it had already agreed (back in 2002) to drop them in future contracts and did

10 In July 2015, the Dispute Settlement Body of the WTO established a panel to investigate the dispute. Unless WTO members reject it by consensus within 60 days of its presentation, the panel's report will become the Dispute Settlement Body's ruling or recommendation. For additional information, see https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds476_e.htm.

11 Supply costs include, for instance, the cost of transporting the gas to destination markets.

12 For a more detailed analysis, see EGF Gazprom Monitor 47.

so with its Western European partners. In order to settle the issue, the Russian company may also have to remove such clauses from contracts with East-Central European countries. As for the third anti-competitive practice, Gazprom may have to partially reconsider its control of the Yamal pipeline, while the cancellation of South Stream has already solved the issue pertaining to Bulgarian participation in it.

Most likely, Gazprom will attempt to reach a settlement with the European Commission on outstanding issues before the case is taken to court. The Russian company has the resources to lower its gas prices in East-Central Europe and still make a profit, while simultaneously avoiding a conflict that may have an impact on all of its gas sales in the EU (including those in the more lucrative West European markets).

If there is no settlement, the case can be taken to the EU's General Court and, if the decision is appealed, to the European Court of Justice. The legal case may last several years and, if Gazprom loses, it may be liable both for paying a large penalty (up to 10% of its annual turnover) and for private compensation claims from European energy companies.[13] This prospect makes the legal avenue particularly unattractive for the Russian company. Therefore, the European Commission has sufficient leverage to negotiate an amicable solution in accordance with EU market rules, and simultaneously maintain a viable business relationship with Gazprom.

Interdependence vs vulnerability

Most likely, the EU and Russia will remain interdependent in the gas sector for at least another decade. Unless a major escalation takes place in the Ukraine crisis, energy trade will continue without major disruptions, with the proviso that the EU will be more reluctant than in the past to support new pipelines involving Gazprom. Within this context, both sides have an interest in resolving outstanding disputes and in pursuing a viable business relationship. The EU can do this by securing the Ukrainian transit route for Russian gas and by diversifying its import routes and partners

13 The new EU Directive on Antitrust Damages Actions, agreed by the European Parliament and Council in April 2014, significantly increases the likelihood of such private claims.

Furthermore, the EU should continue to promote the integration of its domestic gas market. With the implementation of the Energy Union, the EU will further connect national energy markets and reduce the risk of individual member states being affected by supply shocks.[14] By becoming less vulnerable to gas supply disruptions, the EU will preclude potential Russian attempts to politicise the gas trade.

While strengthening the security of gas supplies, EU leaders should bear in mind the Union's chief goal of reducing consumption of all fossil fuels (including gas), as declared in the EU's 2020 and 2030 frameworks for climate and energy and in the European Commission's Energy Roadmap for 2050. This means that EU investments and efforts should be directed primarily at boosting domestic sources of renewable energy and energy efficiency, rather than at expensive fossil fuel infrastructure.

14 See M. Siddi, The EU's Energy Union: Towards an integrated European energy market?, FIIA Briefing Paper 172. Helsinki: Finnish Institute of International Affairs, 2015.

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