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Moving EU – Russia gas relations “Out of the Cold”: a policy view

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Highlights

The warming of EU – Russia gas relations would be considerably beneficial to the EU, and is an achievable goal if a rational approach is adopted. Fundamental to this, is the acknowledgment of three essential issues. Firstly, EU – Russia gas relations cannot be considered independent of the bleak political context. Secondly, the EU will continue to need Russian gas for the foreseeable future. Thirdly, Russia’s dependence on the EU gas market is becoming much stronger than the EU’s energy reliance on Russian gas. Once these issues are acknowledged and accounted for, an improvement in EU – Russia gas relations is achievable and sustainable. It is only a matter of will to negotiate and create stable and viable proposals.



1. EU – Russia gas relations cannot be conceived independent of the bleak political context

To understand the EU – Russia gas relations, one has to accept a key reality: the relationship cannot be appraised independent of the wider political context. International gas production, supply and transportation are not considered as neutral and purely market-based activities, as demonstrated by the Ukraine and Russia gas crises in 2006 and 2009. In both cases, Naftogaz and Gazprom's inability to find acceptable pricing for gas deliveries and transit led to the conflict between Russia and Ukraine, and the resumption of gas deliveries to European consumers was only achieved following the political involvement of the EU. Other examples, including the debates surrounding the Nord Stream and the South Stream pipelines, demonstrate the influence of the wider political context on the gas relations between countries. As recently agreed by the EU's foreign affairs ministers, one of the 5 guiding principles of the EU's policy towards Russia explicitly mentions the strengthening of internal EU resilience, particularly in view of energy security. In terms of this security, gas supply is considered far more influential than oil in determining the EU's energy resilience.

Political relations between the EU and Russia have substantially deteriorated in the past 10 years and may struggle to improve in the coming decade, especially in light of the ongoing conflict in the east of Ukraine and the stalling of the implementation of the Minsk agreement. From the EU's perspective, the full implementation of the Minsk agreement is seen as instrumental to a substantial change in relations with Russia. Regular meetings between the ministers of foreign affairs of Ukraine, Russia, Germany and France have so far failed to improve the situation, as apparent with prolonged sanctions and the general sidestepping of the Crimea issue.

Some progress has been achieved due to involvement in the Syrian conflict and, the ceasefire holding, Russia's withdrawal of part of its troops and the beginning of meaningful talks to find a peaceful solution. And yet, there is a crucial divergence of opinions about postwar Syria. Furthermore, from a European perspective there are a several questions on the level of democracy, the human rights situation, and media freedom in Russia. In the EU, political trust in Russia has disappeared. Similarly,

Russian trust in the EU has deteriorated. A good illustration is a recent article from Russia's minister of foreign affairs Sergey Lavrov. Writing in the journal "Russia in Global Affairs", he reproaches Western leaders for misleading the international community in a couple of cases, most recently in 2011 by forcing change in Libya. Lavrov makes the strong statement that, "uniting Europe without Russia and against Russia always ends with a tragedy"¹.

Consideration of these wider political issues leads to the belief that the future of EU – Russia gas relations lies in a policy that is not based on trust, because no trust exists on any side of the EU – Russia political divide. The Framework Strategy for a resilient Energy Union is quite clear in this respect, stating; "When the conditions are right, the EU will consider reframing the energy relationship with Russia based on a level playing field in terms of market opening, fair competition, environmental protection and safety, for mutual benefits of both sides"².

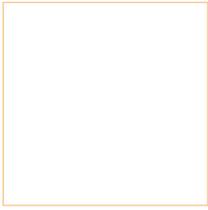
Therefore, any improvement in EU – Russia gas relations has to emerge on the strength of its own merits, and be persuasive enough to circumvent the hostile political context.

Could this come from the current characteristics of the EU – Russia gas relations? Does the EU really need Russian gas? Does Russia really need the EU market?

2. The EU will continue to need Russian gas for the foreseeable future

Gas currently accounts for one quarter of the EU's energy consumption and it is unlikely that the EU will stop consuming gas in the coming 15/20 years. In 2014, the demand for gas in the EU was estimated at 412 billion cubic metres (bcm) (with a rise of 7% in 2015). The International Energy Agency expects that by 2035 the EU gas demand will have reached 550 bcm. A higher carbon price might favour greater usage of gas in power generation vis-à-vis coal and it is expected that the demand for gas will also increase in the transport sector. While energy efficiency measures and the growth of the renewable energy share in the EU will reduce the use of fossil fuels in the EU, this is likely to have a more significant impact on reducing coal and lignite use, rather than gas.

1. Lavrov, Sergey, 'Russia's Foreign Policy: Historical Background', *Russia in Global Affairs*, March 3, 2016
2. <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2015%3A80%3AFIN,25 February, 2015>



Even by 2050, around 10% of power generation could be still based on gas. The process of phasing out nuclear power in some EU Member States might also be favourable for gas use in power generation.

The EU produced less gas through domestic production in 2015, as recorded at 140 bcm. This production will gradually decrease to 55 - 90 bcm by 2035 and, with strong public opposition to the development of shale gas, it is likely to be closer to the lower estimate. The EU may even reduce its own production faster than expected (as evident with the current low price for oil and gas following the North Sea retreat).

The EU is already the biggest gas importer in the world and the demand for gas imports will continue to grow, with the potential to reach the level of 450 bcm by 2035. This could be a serious challenge for the EU. However, there is a good opportunity to attract more gas from different suppliers as the global supply of LNG (liquefied natural gas) is increasing and there are some forecasts of a weakening demand for gas in Asia. The EU's gas market is also more attractive following the implementation of the third internal energy market package, and investments in the interconnections and reverse flow capacities. The European Commission's recently proposed revised Security of Gas Supply Regulation³ will further strengthen the robustness and the transparency of the internal gas market.

To date, there is still no reliable alternative source of gas which could displace the Russian gas supply in a market-based competition due to the unparalleled cost advantages they offer. The OIES paper *"The Political and Commercial Dynamics of Russia's Gas Export Strategy"*⁴ estimates the cost of supply for both Russian pipeline exports and future US LNG exports. Their analysis concludes that; *"While on some levels Gazprom's gas can be seen as much cheaper, if both are compared on a short-run marginal cost basis then the difference is much smaller... Gazprom would have to price its gas at the very bottom end of its marginal cost range"*.

3. Russia's reliance on the EU gas market is much stronger than the EU energy dependency on Russian gas

Russia does not have any credible alternative to the EU market for its gas. In 2015, Gazprom exports to Europe (including Turkey and the Energy Community countries) reached nearly 160 bcm, an increase of 8% compared with 2014. This quantity is beginning to reach the volume of sales in Russia itself, where Gazprom delivered 205 bcm. Reporting on Gazprom's results in 2015 to Russia's President Vladimir Putin, newly reappointed CEO Alexey Miller placed a particular emphasis on the increase of gas sales in EU countries. In his public statements, Miller has made assertions such as, "we can double exports to Europe" and "we can cover whatever demand", which have been supported by President Putin's announcement of plans to increase gas production in Russia by 40% by 2035. With Russian domestic demand being flat, this increase is expected to cover export demand. Russia, as a gas exporter to the EU, faces three main challenges: the transit risks, the increased competition related to the EU's gas supply diversification and the EU's gas market liberalisation with a request for an unbundling between the different activities. Russia's attempts to diversify its markets have produced limited results. In 2015, an agreement was made with China for the export of 38 bcm yearly for 30 years, starting from 2020, through the "Sila Sibiri" pipeline, the construction of which is yet to be completed. An estimated \$70 billion investment is needed for the construction of the pipeline and the development of two gas fields in Eastern Siberia. The current gas price levels are not conducive to this investment. And, attempts to agree on supply through the Altai route from the already developed gas fields in Western Siberia so far have not been successful.

Gazprom has its own growing competitors inside Russia, particularly Rosneft and Novatek. The Gazprom export monopoly has been changed and liberalisation of LNG exports has taken place. By 2017, Novatek could be the second of Russia's gas companies to join the world market (after Gazprom) while Yamal LNG could also supply gas to the EU market. While Rosneft projects are largely behind schedule and mostly target Asian markets, it has won a landmark case against Gazprom in relation to third party access to the "Sakhalin-2" pipeline and is developing an offshore gas field in Vietnam. Each of these

3. <http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52016PC0053>, 16 February 2016

4. Henderson, James; Mitrova, Tatiana, "The Political and Commercial Dynamics of Russia's Gas Export Strategy", *The Oxford Institute for Energy Studies*, September 2015 (<https://www.oxfordenergy.org/wpcms/wp-content/uploads/2015/09/NG-102.pdf>)



examples demonstrates how Russia's gas sector continues to change, with an increasing number of companies looking for new markets.

The repeated gas pipeline building proposals by Russia and Gazprom (South Stream; Turkish Stream; Poseidon; Nord Stream 2) have to be seen as giving clear signals and further evidence that maintaining the flow of gas to the EU is really vital for Russia. The current capacity of all gas pipelines towards the European Union stands at nearly 250 bcm, which is already 90 bcm more than the current demand from Europe. The last two projects (namely: Nord Stream 2 and Turkish Stream) would add an additional 118 bcm in transit capacity. It would increase the overall capacity to nearly 370 bcm, a capacity that will never be fully used. Both of these recent projects are capital intensive and politically sensitive with sanctions making the financing of these projects more challenging. It has even been suggested that a €2 billion loan that Gazprom has agreed with the Bank of China could be used to finance the Nord Stream 2 pipeline project. The fact that Gazprom recently signed a Memorandum of Understanding with the Italian Edison and the Greek DEPA about the supply of gas from Russia under the Black Sea, also provides an indirect statement that, despite complicated political relations with Turkey, the Turkish Stream concept continues to be a priority for Gazprom.

Conclusion

The EU – Russia gas relations could move “*out of the cold*”, not because gas is not a politicised matter, but because these gas relations have their own solid strength.

On the one hand, the EU will continue to need Russian gas for the foreseeable future.

On the other hand, Russia has no credible substitute for the EU market: as a result, its reliance on EU gas consumers is far greater than the EU's dependence on Russian supply. Even if Russia's preference is to continue its gas export policy based on long-term contracts, including the “take or pay” principle, and keeping prices analogous to the oil price, Russia has shown some flexibility, through the use of gas auctions.

In such a framework, one can conclude that improvements to EU – Russia relations could be made. It is only a matter of will to negotiate and to create durable and reliable proposals.

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