



The Baltic Litmus Test for Gas

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Highlights¹

- Much has been written and commented, in recent years, about the Baltic States and their delicate position – both geographically and politically speaking – concerning security of gas supply and energy independence from Russia.
- While it's no secret that the region has for a long time been quasi-totally dependent from Gazprom imports, the profound, sometimes inevitable reasons of such vulnerability are not evident. At the same time – and consequently - the implications and 'side effects' of some energy policy and regulatory choices taken in this region are not the same as in any other country in Europe.
- If we do not understand this, it becomes very difficult to see why the decision to open an LNG terminal in this region (Klaipeda) is welcome as 'a symbol of energy independence'; and it becomes even harder to accept that the sudden, unfair price increase to gas customers by the incumbent company is publicly justified as the answer to the 'inadequate' choices - legitimately taken - by a country's government.
- As the title suggests, since they joined the Union in 2004, the Baltic countries have been the theatre of a delicate test for EU-Russia relations – which we might consider as still ongoing.
- Since then, Lithuania, Latvia and Estonia have undergone a resolute path towards liberalization and diversification of energy sources – which will eventually lead these countries to becoming a single entry-exit zone in 2020. But the road has been long and rocky.
- That's what this work by former Commissioner Andris Piebalgs is about, seen with the eyes of an expert and at the same time a 'local' belonging to the region (Andris Piebalgs is from and has lived most of his life in Latvia).
- This paper is not really a Policy Brief strictu sensu, but rather a photography: by reading it, the reader is not told any 'pre-packaged' truth but, on the contrary, he/she is guided through the recent history of the Baltic states and given the instruments to find out – by himself – the 'why' and 'how' of the delicate gas policy choices made by the Baltic countries.

1. Highlights by Ilaria Conti, Florence School of Regulation



In the autumn of 1994, Carl Bildt (who at that time was the Prime Minister of Sweden) published an article in *Foreign Affairs* with the headline ‘The Baltic Litmus Test’. In the article he argued that the European Union’s attitude towards the Baltic States will show its ability to pursue the integration process in Europe while Russian conduct towards Estonia, Latvia and Lithuania will show the true nature of its commitment to international norms and principles.

Although the Baltic states joined the European Union in 2004, Jonathan Stern (chairman of the Natural Gas Programme at the Oxford Institute for Energy Studies) made the following observation in October 2012: “20 years after the end of Soviet Union the Baltic States remain completely dependent on Russian gas, despite an apparent conviction throughout the region that this relationship has been, and remains, economically exploitative and a continuation of Soviet subjugation”. A few years later, the implementation of the third package in the internal energy market legislation has started to address this shortcoming.

Natural gas came into the Baltic region in the 1950s, using infrastructure mostly built during the Soviet times. Today the total length of pipelines in the Baltic States is nearly 20,000 km (2880 km in Estonia, 6206 km in Latvia and 10507 km in Lithuania) whereby gas is delivered via Gazprom-owned pipelines from Russia. The pipeline’s history is responsible for its complicated structure where gas to Estonia is delivered via Latvia while the pipeline to Latvia goes via Lithuania.

There are three particular features of this gas network. First, natural gas transits to Russia’s Kalinin-grad district goes via Lithuania. Second, as opposed to most other Eastern European countries, there are no transit pipelines for gas delivery to Western Europe. Third, Latvia has a large gas storage capacity of 4.4 bcm (billion cubic meters) and a peak output of around 30 million cubic meters a day.

Gas provides a significant portion of the energy demand of the Baltic States. For instance, gas accounts for around 25% and 10% of the total energy mix of Latvia and Estonia, respectively. Natural gas supplies a third of Lithuania’s total energy demand making it the fourth most gas dependent country in the EU after the Netherlands, the United Kingdom and Hungary. For comparison, the EU average dependency on gas is around 20%.

The majority of gas used by the Baltic States is needed for the production of electricity. This is particularly the case for Lithuania, whose dependence on gas increased significantly following the closure of the Ignalina nuclear power plant (as agreed during Lithuania’s EU accession negotiations). Estonia on the other hand is less dependent on gas due to its massive use of oil shale. The EU has agreed to support the installation of new power production capacities based on the use of natural gas; currently installed gas power generation is 2658 MW, 1441 MW and 200 MW for Lithuania, Latvia and Estonia, respectively. Another important use of gas is for the production of heat as used by individual households and industry. Altogether there are one million direct gas consumers in Baltic States.

Due to the broad use of electricity among both individuals and companies, it can be argued that everyone is dependent on the supply of gas. Change in industry structure and more efficient energy use has more than halved the demand for gas in absolute figures since independence. In 1990, the Baltic states consumed 10.3 bcm (Estonia 1,5 bcm, Latvia 3,0 bcm, Lithuania 5,8 bcm) whereas in 2014, the demand has more than halved to 4,2 bcm (Estonia 0,4 bcm, Latvia 1,5 bcm, Lithuania 2,3 bcm). National gas companies such as Eesti Gaas, Latvijas Gaze and Lietuvos Dujas serve as distributors who purchase gas from Gazprom. In each of these companies Gazprom is an important shareholder and thus has a strong influence on the supply of gas to the three ‘gas islands’ of Estonia, Latvia and Lithuania.



Due to the strong reliance on gas for the production of electricity, the region was fully exposed to risks in insecure supply and unfair pricing. In 1993, gas supply to Estonia had been cut in an attempt to influence a decision on its citizenship policy. Although it was a short supply cut, it sent a message that Russia's interests should be considered. In February 2004, gas supply to Lithuania was stopped as collateral damage during Russia's gas dispute with Belarus. Additional supply from storage facilities in Latvia could only cover 50% of demand due to insufficient interconnections.

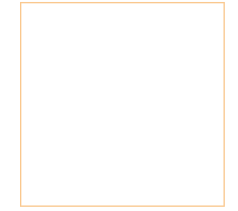
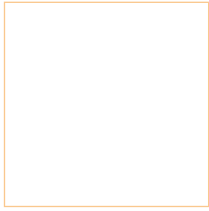
Further to this, the oil sector can also be manipulated to pursue political goals. For example, Lithuania has an oil refinery which was supplied by an oil pipeline from Russia. After a Polish company privatised the refinery, the pipeline started to 'leak' and couldn't be repaired. All the requests from the company, the Lithuanian government and the European Commission to restart work on the pipeline were unsuccessful. As a result, the Butinge oil terminal was built and started operation in 1999.

These examples demonstrate the region's supply vulnerability. Subsequently much political consideration has been placed into how to diversify the supply of gas. Early attempts have been unsuccessful due to insufficient cooperation on the part of the Baltic States and the lack of engagement by the national vertically integrated companies. High gas prices provide another worry. In the early 1990s, gas prices in the Baltic States were much lower than in Western Europe. They started to increase in the second part of 1990s and early 2000s and have been influenced by the accession of Estonia, Latvia and Lithuania to the European Union. Within the period between 2005 and 2007, the gas price increased 2.4 times. From 2008, gas prices within the region have been at the same level as Western Europe or higher. These increases have damaged the competitiveness of the economy and negatively impacted the welfare of households.

Gazprom has argued that the gas price in each European country is based on netback market pricing principles, which are linked to the price of oil. The Baltic countries have provided the counterargument that the region's closeness to the Russia's gas production areas should not allow for a higher gas price than that of Western Europe. In 2012, gas prices in Lithuania reached \$497 per thousand cubic meters, which was 15% and 30% higher than the German and European average, respectively. The accusation of unfair pricing was further corroborated by Gazprom's Vice President Valery Golubev, who publicly stated on 11 February 2012 in *Moskovskie Novosti* that the reason for such a price increase was "Vilnius's inadequate behaviour while restructuring the gas sector".

Unable to find a satisfactory solution to the problem of high gas prices, Lithuania made an official complaint to the European Commission. In September 2012, a formal antitrust investigation was launched whereby Gazprom was investigated on three suspected anti-competitive practices in Central and Eastern Europe: hindering the free flow of gas from country to country, preventing the diversification of the supply and imposing unfair pricing through oil-based contracts. Although the investigation was finished by the end of 2013, developments have been delayed due to a change in the European Commission. In April 2015, Commissioner Vestager sent a letter to Gazprom with the conclusion of the investigation: that Gazprom uses its monopoly position to fragment the European market and impose unfair pricing.

In September 2015, although Gazprom had responded by recognizing the EU's objective to create a common energy market, it failed to acknowledge its antitrust behavior. It took a year for Commissioner Vestager to come up with a settlement proposal: Gazprom is to commit itself in no way to hamper free movement of gas in the EU, to use 'swap' deals from Hungary, Poland and Slovakia to increase liquidity in Estonia's, Latvia's and Lithuania's markets,



to link gas prices to competitive benchmarks and to agree to more efficient price reviews. In a statement on the 13th of March 2017, Commissioner Vestager said that the commitments “address our competition concerns and provide a forward looking solution in line with EU rules. In fact, they help to better integrate gas market in the region”.

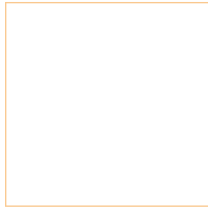
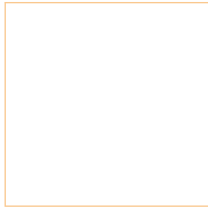
The deal is a necessary step to create an EU-wide gas market. During the arbitration processes between 2011 and 2014, Gazprom was forced to agree on changes in the pricing and the use of ToP (take-or-pay) principle in Western Europe. Now the same procedure will be applied in the Central and Eastern Europe market. In Russia, these binding commitments are seen as an acceptable logical compromise due to the clear recognition that Europe is and will stay the most important market for Russian gas. And in increasing global competition, Gazprom can't afford to be complacent, otherwise it will lose its market share. The deal will be honoured not only because of the fines that can be imposed, but also because it allows for a more competitive Gazprom strategy in relation to the European markets. Unfortunately, there is no clear recognition of the deal in official Gazprom communications. A good example is Gazprom's president Miller's speech in the Saint-Petersburg Economic Forum on the 1st of June 2017 where the settlement isn't mentioned but there is a lot of praise for oil indexation in the contracts and strong criticism of the spot market.

The settlement in the Baltic states has received mixed reviews. Although there is a clear recognition that it is a step in the right direction, there is also an opinion that the commitments made by Gazprom don't go far enough. Some of the strongest criticisms come from Lithuania where there are demands for compensation from unfair gas pricing procedures in the past (estimated to be around €1.5 billion). Another demand is that additional commitments from Gazprom are needed such as automatic contract price revision based on gas price fluctuations in the hubs, application of the commitments to short

term contracts and gas delivery to any point. On the 5th of April 2017, Lithuania's minister of energy Zygimantas Vaiciunas even made a statement, that “no Gazprom's commitments could be practically feasible. So there would be no real benefit for Lithuania and other Baltic consumers.” The proposals have been submitted to the European Commission and the final decision is expected soon. Whatever the final outcome, it will diminish Gazprom's dominance in the Baltic gas market.

The process of diversification of the gas supplies started with the implementation of the third internal energy market package legislation. In 2011, Lithuania decided on unbundling the ownership of the incumbent gas company and separating gas supply from gas transmission and distribution. The decision started a conflict with Gazprom and required lawsuits to resolve. Still the ownership unbundling has been done and the gas grid moved in the hands of the state. In December 2011, Lithuania's government decided to proceed with the plans for a floating gas terminal in Klaipeda. Despite expectations of a delay due to national elections, it started operation at the end of 2014. The first LNG cargo from Norway arrived and the absolute dependency on Russia for gas supplies had been broken. This was achieved by a tailor-made regulatory scheme, which imposes the mandatory off-take of gas imported through the LNG terminal and a levy on a gas transmission tariff for the benefit of the LNG terminal's operator. It is a temporary scheme that has been necessary for the success of diversification of gas supply. Interestingly, further negotiations with Gazprom have brought a considerable reduction in the gas price. The gas terminal in Klaipeda became a symbol of energy independence and a commercial success. The LNG distribution station will be launched in 2017 to supply gas to districts that are not connected to the grid.

Estonia decided on the ownership unbundling in 2012. Latvia has been much slower. Exclusive rights to ensure a gas supply has been granted to 'Latvijas gaze' until April 2017. The decision about ownership



unbundling was taken at the end of 2016 and the gas market was liberalised in April of 2017 with no objections from Gazprom. The government is still considering their ownership options for the gas grid, where one of the options is 100% state ownership.

Liberalisation of all three markets, independent operation of the transmission networks, existing interconnections and gas storage now allow for the development of a single entry-exit zone. Today the infrastructure between Latvia and Lithuania is sufficient, but different rules and long notification periods required before gas is actually transported are hampering an efficient use of that infrastructure. Studies demonstrate that a single price zone will reduce the cost of meeting demand and the number of transactions for the shippers, and will bring improvements to the security of supply. By 2020, there will be a full market merger with a single balancing zone and a complete harmonisation of balancing rules. A new 'super TSO' will be established to manage all of the zone's balancing and settlement.

The next step is very much related with the Baltic-conector. It is a 150 km pipeline connecting Finland with Estonia (the offshore, Finnish onshore and Estonian onshore parts are 81 km, 22 km and 47 km long, respectively) that is estimated to cost around €250 million (75% of which will be financed by the European Union) and will be in operation by December 2019. Finland is preparing new gas market legislation and will open its market at the beginning of 2018. This will enable a movement towards a common Finnish and Baltic gas market with a single entry-exit zone by 2021. Although gas is 7% of Finland's energy mix, it is comparable in volume to the gas markets of the Baltic States combined. Finland has depended on a long time from only one supplier: Gazprom. In 2016, the first LNG terminal in Pori started its operations thereby diversifying Finland's gas supplies. In 2017, two more LNG terminals will start their operations.

Another interconnection that is being considered is the one between Lithuania and Poland. It is called

GIPL (Gas interconnection Poland Lithuania) and it is 530 km pipeline with an initial capacity of 2.4 billion cubic meters a year. The cost of the project is €558 million and estimated benefits €830 million. The principal challenge to the project was that on the Polish side, the expected costs are higher than the expected benefits. In order for the project to continue, ACER made a recommendation for a compensation to be paid to Poland from the countries that will receive a "significant positive net impact" from the project. ACER has made a recommendation of €85.5 million compensation to Poland (from Lithuania €55 million, from Latvia €29 million and from Estonia €1.5 million). GIPL will provide additional liquidity and increased security of supply to both Poland and the Baltic states.

The recent developments in the gas sectors of Estonia, Latvia and Lithuania clearly demonstrate that the third package of the internal energy market legislation has been a success. There is now a dynamic development in the previously stagnating gas sector. Already today, the FSRU in Klaipeda provides an example of the benefits in the diversification of supply. The interconnections to Finland and Poland will provide for additional liquidity and competition that will be of benefit to consumers. Furthermore by 2020, we will see a single entry-exit zone in the Baltic States that is very similar to the Belgium-Luxembourg zone. The winners of this transformation are customers who will benefit from better prices and improved security of supply. As for Gazprom, it has decided to adapt to the new reality.

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