Zero Option in the Virtual Pipeline Race:
Russia and the EU Need to downsize their Energy Ambitions

*Dr. Pavel K. Baev**

Introduction

The spring and summer of 2009 witnessed spectacular – at times even grotesque – competition between Russia and the EU regarding the development of new gas flows into Southeast Europe (SEE). The EU-sponsored conferences in Sofia and Prague sharply disagreed with the gathering in Sochi called by Prime Minister Vladimir Putin and bi-lateral talks in Moscow and in Baku between the presidents Dmitri Medvedev, Ilham Aliyev and Gurbanguly Berdymukhammedov.[1] Gazprom's CEO Aleksei Miller confidently asserted at an annual meeting in late June that the *South Stream* pipeline would carry up to 35 percent of Russia's gas export to Europe by 2015, and a couple of weeks later, the intergovernmental agreement on the *Nabucco* pipeline was signed with much fanfare in Ankara – followed by the Russian-Turkish energy deal in August.[2]

Formally, the EU has no objections to including the *South Stream* pipeline in its vision for the 'Southern corridor' while Russia is openly indifferent to the *Nabucco* project, so that Putin merely offered some advice: 'Before investing billions of dollars in a pipe to be buried in the ground, one should first see where to obtain the gas to pump through it'.[3] As things stand in mid-2009, both projects appear to be on track, opening two parallel streams of gas into the SEE markets by the middle of the next decade.

Indeed, neither the EU nor Russia have taken into account the growing and potentially devastating impact of the current recession, which has made the most meticulous energy forecasts from 2006-2008 strikingly irrelevant. This denial can be interpreted as the psychological response of over-grown, though reasonably successful bureaucracies that have suddenly lost confidence and direction. It is clear that, sooner rather than later, the EU and Russia will have to come to terms with reality and downsize their respective energy ambitions accordingly.[4] It is possible that *Nabucco* and/or *South Stream* might not survive this 'correction'. This paper will examine the possible execution and consequences of such a 'zero option'.

Fragile fundamentals and pointless planning

Gas business is believed from the immanently volatile oil market in its greater stability secured by long-term contracts and materialized in systems of pipelines that lock producers and consumers in a permanent relationship. Yet, in the second half of the current decade, this field has become increasingly turbulent and now all key fundamentals look decidedly uncertain. In

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* ***Dr Pavel K. Baev*** is a professor and researcher at the International Peace Research Institute (PRIO), Oslo, Norway. He is grateful for the support received from the *Norwegian Research Council* in his research into Russian policy in the field of energy.

[1] For a balanced analysis, see Timothy Krysiek & Katherine Hardin, 'Conditions for Cooperation? The Evolution of the Fourth Corridor Pipelines and the South Stream', *CERA Report*, April 2009; one sound Russian perspective is Mikhail Zygar, 'The war of streams', *Kommersant-Vlast*, 18 May 2009.

[2] Ed Crooks, 'No friends, only partners in pipeline realpolitik', *Financial times*, 6 August 2009.

[3] At the joint press-conference with Italian Prime Minister Silvio Berlusconi on 15 May 2009; see (http://premier.gov.ru/eng/visits/ru/106/2876.html).

[4] This analysis draws on Pavel Baev, 'Competing designs for Caspian energy highways: Russia and the EU face reality checks', *PONARS Eurasia Memo* 55, Washington: Georgetown University, May 2009.

January 2006, the ‘gas dispute’ between Russia and Ukraine became an eye-opener for many European customers, who were forced to realize that transit issues were only part of a complex problem hidden under a shocking lack of low transparency in key arrangements.[5]

In the aftermath of that high-resonance mini-crisis, concerns in the EU were centered on Gazprom’s ability to deliver adequate volumes over the next decade as the powerful company was clearly not investing enough in its core assets, while demand in Russia was growing fast.[6] Alongside worries about *Gazprom*’s politicized behavior, were demands for reducing emissions and going ‘green’, despite the fact that natural gas is one of the cleanest energy sources. Thus, a powerful lobby advocating ‘diversification’, had developed multiple networks in Brussels. It has focused its activity on a set of guidelines known as ‘20-20-20’, elaborated in a number of documents, including the *Energy Security and Solidarity Action Plan* (November 2008). This specifically prescribes that should oil prices come close to $US 100 per barrel, the EU gas import will decrease by 3-5 percent in 2020 compared to 2005[7].

Gazprom was quite upset about this deliberate violation of its favorite principle of ‘security of demand’. Nevertheless, it was inclined to interpret it as a triumph of wishful ‘green’ thinking. It did increase investments in developing the extensive Bovanenkovskoe field in Yamal (*peninsula in north Russia*, editor’s note), but its main response to the EU’s ‘political phobias’ was to cultivate partnerships with such European majors as E.ON or ENI that had their own reasons for sabotaging the Commission’s plans for liberalization – and could mobilize effective support from their ‘mother-states’. That could have been a sure-win strategy, but the ‘gas war’ in January 2009 inflicted further damage on *Gazprom*’s business reputation and caused an astounding 40 percent drop in the volume of its export to the EU in the first quarter.[8] Miller and other *Gazprom* top executives tried to put on a brave face and assured that the flow would return to normal in the second half of the year. However, they need to consider the possibility that a declining demand in the EU is beginning to look like a serious prospect.

Undoubtedly, there are many variations behind the EU and its general directives; for example, diversification for Spain means gaining access to Russian piped gas. In SEE, energy consumption is significantly lower than the EU average (not to mention that several countries in this region are not members of the Union). Brining standards of development up to EU levels can only be achieved by creating new industrial consumers in addition to expanding services and tourism. However, prices are highly elastic in this market, creating a ‘gas bazaar’ dilemma for producers and consumers: the former launch expensive projects, such as *South Stream*, aiming at covering the costs by delivering big volumes at high prices, while the latter can avail of such deliveries, only if prices are reasonably low. *Gazprom*’s unquestionable assumption that ‘the era of cheap hydrocarbons is over’ finds few buyers in the Balkans.

Could Ukraine become an acceptable alternative?

A point, often overlooked in debates on the Southern corridor, is that its opening would inevitably marginalize Ukraine’s role on the European energy-political scene. Indeed, the latest Russian plan for *South Stream* aims at a capacity of 63 bcm, leaving only about 40-45 percent

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[5] One recent example is the decision of the European Commission to impose heavy fines on German and French ‘majors’ for forming a cartel; see ‘Antitrust: Commission fines E.ON and GDF Suez €553million each for market-sharing in French and German gas markets’, Brussels, IP/09/1099, 8 July 2009 (http://ec.europa.eu/competition/index_en.html).
[6] See Nadejda Victor, ‘Russia’s gas crunch: looming shortfall poses a tough choice’, *Washington Post*, 6 April 2006.
[7] One meaningful analysis is Pierre Noël, ‘Beyond dependence: How to deal with Russian gas’, *Policy Brief* 9, European Council on Foreign Relations, November 2008.
[8] For a brief assessment of the damage, see Elena Mazneva, ‘Market is lost’, *Vedomosti*, 16 June 2009.

of its EU export transiting Ukrainian territory. The current deal between Moscow and Ankara envisions a pipeline route across the Turkish exclusive economic zone (EEZ) in the Black Sea, directly depending on a second trunk of the *Blue Stream* pipeline (increasing its capacity to 24 bcm), which would cut Ukrainian transit by another 5 percent, while the *Nord Stream* pipeline across the Baltic Sea would diminish it by at least another 10 percent.[9]

Gazprom's (and Putin's) intention to reduce Ukraine's ability to control its export has never been in doubt, but what is less obvious is the anti-Ukrainian profile of the *Nabucco* project. Its first trunk (planned capacity 10-15 bcm) could have mostly political and psychological impact, but the full capacity of 30-35 bcm would constitute a significant flow of gas from yet unclear (but definitely non-Russian) sources. Combined with an increased import of liquefied natural gas (LNG), this plan would reduce the share of EU gas import that crosses Ukraine to 30 percent or lower.[10] It can not be excluded that both the *Nabucco* and *South Stream* projects could become a reality, and that would, to all intents and purposes, eliminate Ukraine from the European gas-political map. A major feature on this map, instead, would be Turkey, which aims at becoming a 'gas hub' by concentrating major gas flows and developing a capacity for trading – and not mere transit.

There is no certainty within the EU, and particularly among the SEE states, that such a 'gas hub' would be a better arrangement that the current 'recurrent conflict'. Turkey is as prone as Ukraine to extracting the maximum commercial and political advantage from control over crucial gas pipes. Its economic situation is no less precarious and the recession is affecting the government's behavior. Moreover, there is an additional complication: Turkey's EU accession bid has been put on hold – perhaps indefinitely – and frustration over this failed effort could prompt its political elite to pressure European interests as a reminder of broken promises.[11]

While pushing forward the *Nabucco* project, the European Commission is not blind to, and is not at all enthusiastic about, the possible strengthening of Turkey's energy profile. Hence the blitz-talks with the Ukrainian leadership on modernizing the gas infrastructure in spring 2009 resulted in a joint declaration that caused considerable upset in Moscow.[12] *Gazprom* understands better than anyone the urgent need to upgrade the pipelines and pumping stations in Ukraine, which have been heavily used since Soviet time without adequate maintenance. However, Putin and Miller are categorically against giving any funds to Kiev for that purpose, despite any promises given to create an independent and transparent operator. Their master-plan has been to reduce Ukrainian state control over the gas infrastructure to a purely symbolic share of ownership, while making *Gazprom* the effective manager, perhaps in partnership with E.ON and a few other European 'champions'.

These 'evil' intentions, which amount to stealing the 'jewel in the crown', are totally unacceptable to the Ukrainian leadership; furthermore, they are greatly concerned about losing transit privileges. While it is difficult to agree entirely with the Prime Minister Yulia Timoshenko, who told reporters at the Munich security conference that 'to raise questions

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[9] On Russian perspectives, see Natalya Grib, 'The South flood', *Kommersant*, 18 May 2009; Ali Aliyev, 'The offshore pipe', *Expert*, 15 May 2009.

[10] For a well-organized review of opinions on this issue, see Katinka Barysch (ed.), *Pipelines, Politics and Power: The Future of EU-Russia Energy Relations*, London: CER, 2008

[11] A 'politically correct' assessment of Turkey's gas policy is presented by Olli Rehn, EU Commissioner for Enlargement, in a speech 'Turkey as an energy hub for Europe: prospects and challenges', 4 March 2009 (http://www.europa-eu-un.org/articles/en/article_8535_en.htm); for a sharper analysis, see Katinka Barysch, 'Turkey's role in European energy security', *CER Essay*, London, December 2007 (http://www.cer.org.uk/pdf/essay_turkey_energy_12dec07.pdf).

[12] On the talks, see Alan Riley, 'EU-Ukraine gas deal is no pipe dream', *Wall Street Journal*, 22 April 2009; and on the Russian reaction, see Ali Aliyev, 'Irritable Russia', *Expert*, 24 March 2009.

today about bypassing Ukraine with alternative pipelines is a senseless idea'[13], there is, nevertheless, a point in her parochial argument, since the Ukrainian option is certainly the most sensible as far as cost-efficiency is concerned. The European Commission has promised 2.5 billion euro to modernize the Ukrainian gas infrastructure. While this may be less than a half of the total cost, the capacity of this pipeline system could then be expanded to 150 bcm. On the other hand, the preliminary cost estimate for the first trunk of *Nabucco* is about 8 billion euro and the bill for the *South Stream* could reach 20 billion euro.[14] The major obstacle in contemplating the Ukrainian option seriously in the EU is petty bickering among elite groups. However, there is a chance that the presidential elections, scheduled for 17 January 2010, might make Ukraine more governable, while the very probable departure of Viktor Yushchenko from the political arena would remove a major irritant for Russia.

Russia reconsiders its relations with Gazprom – more than a 'what if' story

The central role of natural gas in Russian foreign policy is not based only on the specific quality of this energy source, which happens to be so abundant (even if hard to get) in Russia, and makes it so valuable for Europe. It is primarily a consequence of the unique involvement of the Russian leadership in the highly monopolized gas business, which started early in the Putin era and has evolved into such a deep fusion of interests that now it is impossible to establish whether *Gazprom* is an instrument or a goal-setter for the Kremlin.[15] The reconfiguration of the Russian leadership with Dmitri Medvedev's promotion to the presidency has changed little in this respect; the ruling duumvirate continues to identify closely with *Gazprom*'s agenda and to lobby enthusiastically for every deal.

This unprecedented symbiosis has been an important source of strength for *Gazprom*, increasing its penetrating power into the European markets; however, it has also alarmed many states and the EU agencies, which have come to view this penetration as a hostile takeover. These tactical advantages have thus translated into a strategic handicap; now every political problem for Moscow in European relations, for instance delays in negotiating a new Partnership and Cooperation Agreement (PCA), resonates negatively in the gas business. This effect may be less prominent in dealings with Turkey; however, the mobilization of political and bureaucratic effort in the EU around the *Nabucco* project, which could seriously weaken *Gazprom*'s positions in the SEE markets mid-term, would have hardly happened without the reassessment of Russia's trajectory after the war with Georgia.[16]

There is, however, nothing permanent about this amalgamation between the Kremlin and *Gazprom*, and the deepening recession is already testing this bond by establishing for fact that the interests of the Russian state are not exactly congruent with those of *Gazprom*. The plan to increase domestic gas prices to the level of export prices has been abandoned, and the increasing deficit in the state budget has forced the Finance Ministry to demand a serious increase of taxation for *Gazprom*.[17] Sharply falling revenues and profits have caused a 15 percent cut (and perhaps as deep as 25 percent) in *Gazprom*'s 2009 investment program and in

[13] See the entry in her blog 'Yulia Tymoshenko at the Munich security conference', 7 February 2009 http://www.tymoshenko.com.ua/ukr/news/first/7020

[14] See 'He who pays for the pipeline calls the tune', *The Economist*, 16 July 2009.

[15] One relevant analysis is Svante E. Cornell & Niklas Nilsson (eds), *Europe's Energy Security: Gazprom's Dominance and Caspian Supply Alternatives*. Washington DC: Johns Hopkins University, 2008.

[16] See Matvei Ganapolsky, 'The price of words', *Ezhednevny zhurnal*, 16 July 2009, http://ej.ru/?a=note&id=9285

[17] On the tax increase for *Gazprom*, see Dmitri Butrin, 'The reserve monopoly', *Kommersant*, 2 July 2009.

2010 the available resources are set to decline yet further.[18] Common economic sense dictates shelving (if not abandoning altogether) the plan for the extremely expensive *South Stream* project and it is only obstinate political will that keeps it on track in this impossible situation.

Putin may remain committed to this pipeline no matter what, but his own political future cannot be taken for granted in an economic and social environment that has changed so drastically, compared to the 'golden years' of prosperity that had been confidently promised to continue until 2020.[19] The over-centralized political regime, based on distribution of steadily expanding petro-revenues, has obviously outlived its purpose, and Russia's recovery from the devastating recession would depend upon adopting more flexible and efficient political mechanisms.[20] The character of such a transfiguration cannot be perceived at this moment in time (and it is useless to speculate about Putin's personal choices and options), and parallels with the previous crisis on 1989-1992 are hardly informative – but they could give some idea about the correlation between the depth of economic crisis and the scope of political revolution.

It is entirely possible that Russia would avoid any major political breakdown and benefit from a 'soft' evolution of the political system; there are few reasons to believe, however, that in the course of such an evolution *Gazprom* would manage to preserve its unique access to and connection with the political leadership. Without this patronage, the *Gazprom* business empire would first crumble on the margins (for instance, cutting off *Gazprom-Media*), then let go several self-sufficient units (like *Gazprom-Bank* and *Gazprom-Neft*), and then would have to separate the transportation into a separate company.[21] Such a de-monopolization could follow the draft plan for reforming *Gazprom* from early 2003 and would take a few years, but if a convincing start were made, the EU could perform a re-evaluation of the risks for its energy security, and that might result in curtailing its plans for the Southern corridor, including the hapless *Nabucco* pipeline.

Conclusions

The cumulative impact of an interrupted trend in energy security in SEE (the sharp drop, followed by uncertain oil prices, and two major events: the Russian-Georgian war and the Russian-Ukrainian 'gas war') can not be fully measured as yet. It appears possible that the immediate 'lessons learned' by the EU and Russia – centered respectively on constructing the *Nabucco* and the *South Stream* pipelines – are seriously misconstrued. The main shortcomings of these lessons regard resources and risks. The EU has assumed that 10-12 billion euros is an acceptable price for a project that has no guaranteed sources of supply and that the risk of alienating Russia, which would still remain its main source of gas, is manageable. Russia has convinced itself (or rather Putin – himself) that 25 billion euros should be wasted (rather than invested) on a project that could never cover the expenses and that the risk of undermining Ukraine's balance of payments would be rather an opportunity.

Sticking to positive thinking regarding the in-crisis (rather than post-crisis) near-term future, one would hope that these lessons could be disproved through a reassessment of

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[18] On *Gazprom*'s investment prospects, see Petr Netreba, 'Cuts are performed business-like', *Kommersant*, 14 July 2009.

[19] See Pavel Baev, 'Ten years at the helm: Putin holds a photo shoot and visits Turkey', *Eurasia Daily Monitor*, 10 August 2009.

[20] One sound analysis of this transformation is presented by Nikolai Petrov in the lecture 'Russian political mechanics and the crisis', *Bilingua*, 25 June 2009 (http://www.polit.ru/lectures/2009/06/25/crisis.html).

[21] Extensive analysis of the *Gazprom* problem can be found in Boris Nemtsov & Vladimir Milov, *Putin and Gazprom*. Independent Expert Report, Moscow 2008 (http://www.milov.info/2008/08/putin-i-gazprom/).

resources rather than through coming face-to-face with the risks. Indeed, Russia can hardly remain in denial very much longer after the end of 2009 as the true scale of its budget deficit is acknowledged and demands for spending begin to exceed the actual size of the accumulated financial reserves. The issue for the EU is not so much how to raise funds to launch the *Nabucco* project, but rather how to collect and deliver a ‘rescue package’ to Ukraine, which struggles to pay its monthly gas bills to Russia and could be forced to declare sovereign default before the forthcoming presidential elections. Important as it is for political leaders to provide reassurance, they should be aware that an ‘it-will-pass’ message can lead to the folly of denial; the EU and Russia will eventually come out of the crisis – but not to the *status quo ante*.