

## Assessing Russian Commitments to the 2015 South Stream Deadline

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In comparison to its Western counterparts, *Nabucco* and ITGI (Interconnector Turkey-Greece-Italy), the case of *South Stream* appears to be simple. *Nabucco*, for example, faces a number of significant difficulties, most of which are almost non-existent in the Russian project: it includes half a dozen relatively small energy companies without substantial market portfolios or supply assets, and it is constrained by an unresolved leadership issue, despite all the US political and EU moral and financial support. Turkish transit - with all its economic and political considerations - will be a “hard nut” to crack in the future, and the coordination of a large number of different, and often divergent interests, makes any prognosis for a final deadline rather difficult.

In this light, *South Stream* appears to be a clear-cut project. Its implementation depends almost exclusively on Gazprom. With a strong supply status and a huge European market portfolio the company really does not have to care much about finding incremental supply volumes or demand for its pipeline, and avoiding the major markets on its route, Moscow has a strong bargaining position vis-à-vis the small transit countries. Hence, in contrast to *Nabucco*, the completion *South Stream* is a “single actor issue”, where Russian determination and capabilities play an almost decisive role.

### *Challenges and doubts*

*South Stream* has a short, but spectacular history. In June 2007, ENI and Gazprom signed a memorandum on the project, while Putin had floated the idea among Balkan leaders in Zagreb some days earlier. Intergovernmental agreements were signed with Bulgaria, Serbia and Hungary in January-February 2008. In 2009 the project moved to the next phase: most of the feasibility studies are due by the end of the year, opening the way for business contracts with binding elements to be signed. After several modifications to the original plan, *South Stream* is designed to have a capacity of 63 bcm, and according to semi-official Gazprom estimates, its construction would cost up to €25billion<sup>1</sup>. Russian political leaders, Putin and Gazprom officials stated several times that the network is going to be operational by the end of 2015.

The speed and impetus of the project is indeed striking. The nickname “blitzpipe” - used in non-official European slang - is absolutely fitting, especially in comparison to the slow progress of other pipeline projects in the region. Moscow really seems to be determined and ambitious, keen to have a new, huge transit corridor in the foreseeable future. Despite these appearances, there is still some room for skepticism. Critics generally raise two significant sets of issues, which might pose a threat to the project.

A) The first set of concerns deals with the question of feasibility, going back to the more general problem of the credibility of Gazprom’s deadlines. We have witnessed, for example, a serious underestimation of the complexity and risks of the *Nord Stream* project, causing – at least – a significant delay in construction. The Shtokman-field, which used to be a priority project some years ago, was promised to be on-line as early as 2013 - an unrealistic deadline,

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<sup>1</sup> „Truba na trillion”, *Vedomosti*, 06.02.09.

even according to some of the partner companies<sup>2</sup>. The development of the Bovanenkovskoye field, a flagship project on the Yamal Peninsula, is still difficult to assess because of insufficient information on its progress. Technological delays and postponements are usual phenomena in the industry, but the Russian monopoly might have an excessively optimistic view on its building potential and coordination skills. These risks vis-à-vis Russian promises are external. This means, that they do not concern Russian ambitions to build up new infrastructure, but rather its implementation. Gazprom might manage these projects badly, however that does not question their willingness to develop these new networks.

Fitting into the above comparison *South Stream* is not less complex than its counterparts. Stretching almost 900 km from Russia to Bulgaria, the pipeline has to be laid at the extreme depth of 2000 meters, which is at the very edge of our technological possibilities. Gazprom simply does not have the engineering skills and know-how, to work in such conditions alone. What is more, the off-shore zone has an unsettled legal status. Being undivided between the coastal states, the settlement of the Black Sea off-shore section assumes political and legal coordination with - among others - Ukraine, one of the major opponents of the project. Hardly anything has been done with regards to getting approval for the operational procedures at the EU Commission, either. Some conditions set, i.e. in the Hungarian intergovernmental agreement, do not correspond with the EU *acquis*, presupposing a longer approval process in Brussels. Even if refusal by European regulatory bodies is not very likely, serious concessions will need to be made by Gazprom in order to fit the pipeline's legal resolutions into the common *acquis*. All these risks could only be really evaluated after further feasibility studies and the start of negotiations on these particular issues. Setting deadlines in such a fluid environment appears to be a political or a tactical step. Not by chance, Moscow has already shifted the final deadline from 2013 to 2015, which, fittingly, erodes its credibility only further.

B) The real concerns regarding the *South Stream* deadlines are, however, the “internal” Russian considerations behind the project. It is not absolutely clear, to what extent Russian political circles, and - what is more important - Gazprom itself, are committed to the completion of the pipeline within the given timeframe. Critics often challenge the Russian statements on different grounds: They point to the exorbitant costs of the construction, the already existing transit capacities in Ukraine and the shaky political and strategic considerations. Pointing out any of these arguments to question the credibility of Russian plans is, however, misleading. The original initiative was based on a number of different stimuli, targets, and sometimes, even attitudes. To make a valid assessment, we have to pick out the most important considerations and analyze them in their own context.

Before this, however, one must make two important observations: First, it is certainly in the long-term Russian interest to build a new network on the given “southern” route. Russian frustration over transit issues is incredibly high. As we have witnessed in the case of the BTS oil pipeline network and the Primorsk oil terminal, all new systems would be built at minimized transit risks. Accordingly, doubts should be interpreted as skepticisms towards the communicated deadline, and not the whole project as such. At the same time, the *Nord* and *South Stream* pipelines would create an overall 118bcm additional transit capacity by 2015, almost doubling the current Russian capacity in the given direction (141.6bcm transited in 2007 through Ukraine and Belarus). Hence, even if we accept the Russian wish not to construct new pipelines through problematic transit countries, one may voice some valid concerns regarding the scale of an undertaking that could redraft the whole energy transit landscape of

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<sup>2</sup> The representative of Statoil Hydro, owner of 24 percent of the project, publicly expressed his doubts about this deadline. In: “Credit Crisis May Delay Shtokman Project” [http://www.rigzone.com/news/article.asp?a\\_id=70459](http://www.rigzone.com/news/article.asp?a_id=70459)

Eastern Europe.<sup>3</sup> Credibility is an issue of particular importance to the participating small Balkan and Central European countries, which are usually fully dependent on Ukrainian transit. Route diversification is a high priority issue for them. If *South Stream* is not ready in the given time and suffers significant delays, these countries should make different investment decisions to manage their dependence. It is the deadline that matters.

Second, it is a cheap and profitable policy for Russia to propagate its future pipeline plans in the region. In the case of Serbia, during the purchase of NIS by Gazpromneft, *South Stream* was a key argument in favor of the relatively low price. In this case, the promise of fast implementation of *South Stream* was a crucial instrument in persuading Belgrade. Actually, Moscow did not have other options, facing similar behavior from the Americans. The US also propagated *Nabucco* as an accessible mid-term option in the region without any real business commitment. Using *South Stream* as a bargaining chip, Moscow has already collected real dividends, while only making limited construction commitments. There is an obvious asymmetry between Russian profits and costs so far, and in reality, the political assurances to future transit countries only slightly increase the chances that *South Stream* may be finished by 2015.

Generally speaking, there are three main “internal” Russian considerations with regards to the *South Stream* project that are worth taking account of: (1) The construction of major new infrastructure is the easiest, if not the only way for Gazprom to get European assets; (2) Russians would like to get rid of the unreliable Ukrainian transit route; (3) Gazprom would like to preserve its control on the European markets against the rival *Nabucco* and ITGI projects.

It is important to understand that an assessment of the *South Stream* project depends very much on which of these three objectives is the strongest in influencing Gazprom’s future steps. If, for example, Gazprom were to focus primarily on acquiring new infrastructure in these countries, it could choose to almost exclusively follow its own pace of implementation. In this case, without the threat of losing an opportunity, Gazprom would not need to rush to spend a lot of money on markets, which it has, in any case, secured. At the same time, Ukrainian transit is indeed a serious headache for Gazprom. Major milestones in the development of the *South Stream* project have, so far, usually occurred in connection with the escalation of relations between Kiev and Moscow. If we were to accept this issue as the major stimulus behind Russian actions, we would create a strong logical interrelationship between *South Stream* and Ukrainian transit. In this case, an - unlikely – positive development of the latter could significantly decrease Russian willingness to move ahead with the former. Last, *South Stream*’s geographic structure is almost identical to that of the *Nabucco*-ITGI networks, both of which would rely - at least partly - on Central Asian incremental capacity, suggesting that they may be interpreted as competitive projects. It is difficult to imagine that *Nabucco*, for example, even with its estimated initial capacity of only 10bcm (and prospects for another 20bcm) would leave enough room for another pipeline. The construction of one of these networks could mean, at the very least, the postponement of the other.

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<sup>3</sup> Maximum Russian exports to Europe are projected at 200bcm in 2015. Baltic, Finnish and most of the Turkish exports go through separate pipelines, while the CIS member, Moldova, gets its demand via Ukraine. This means, that total capacity needed via Belarus and Ukraine do not exceed 170-175bcm. Calculations on the basis: *Jonathan Stern*: “The Russian Gas Balance to 2015: difficult years ahead”, in: “Russian and CIS Gas Markets and Their Impact on Europe”, *Simon Pirani (ed.)*, Oxford Institute for Energy Studies, Oxford, 2009, pp. 54-93.

## *Possible Gazprom strategies*

**“New assets” strategy.** Vertical integration and the acquiring of European assets has been a major Gazprom goal since its establishment in the early '90s. However, internal weaknesses and an unfavorable balance on the gas markets have made the achievement of these aims difficult for many years. Having consolidated its domestic situation, the Miller management could only really turn to this task around 2004-2005.

There are basically only two ways to get closer to European consumers. One way is the renegotiation of Gazprom's long-term supply contracts. Having a 20-25 year long timeframe, these contracts define almost every important aspect of the relationship between Gazprom and European companies, including price, volumes and trading points. For Gazprom, the only opportunity to change conditions in its favor easily, are the rare renegotiations of these legal frameworks. Since 2006 most European companies have extended their contracts for another 20-30 years. These include among others supplies to Germany, Austria, the Czech Republic, Italy and most of the Balkan countries. A new element of these contracts was that they allowed Gazprom into local markets. Gatekeeper companies and national champions, like ENI or OMV, guaranteed a small portion of their national markets to be supplied directly by Gazprom or by joint stock companies. Altogether, however, this was a relatively modest concession from the side of the Europeans - definitely insufficient for the Russian company - while the signing of the long-term supply documents closed the window of opportunity for Gazprom to gain further concessions for another 20-25 years.

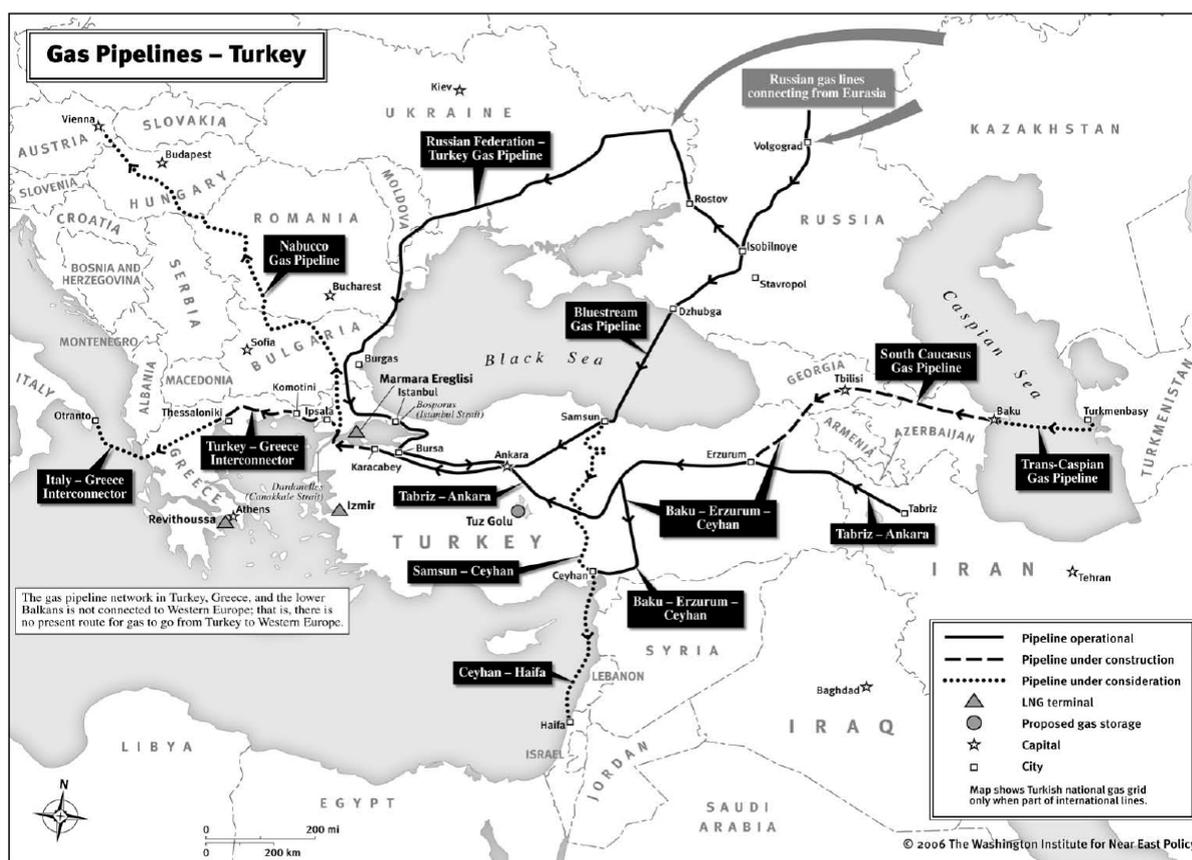
Gazprom has a bad record in taking part the privatization of existing Eastern Europe gas networks, suffering from all the impediments of its Russian monopoly status. New infrastructure, however, especially in the case of expensive storage and pipeline facilities, could be effectively built with Russian involvement. Gazprom's presence provides significant guarantees for investors with regards to questions about supply and maximal turnover. Typical existing examples for Gazprom's participation are the evolution of the company's role on the German market since 1993, *Nord Stream* asset swaps and the Austrian storage construction at Haidach. Western companies participating in joint projects can be assured of a Russian preference to use the common facility, providing maximum returns for all partners. Besides the prospect of financial gains, *South Stream* partners have another rational in letting Gazprom into their domestic markets: better security of supply. Most of these countries lack sizeable transit capacities, industrial fundamentals and funds to construct cheap storage facilities. Except for Hungary, none of the partners has decided to build storage with budgetary funds. It is always cheaper and more secure to make such decisions together with Gazprom. *South Stream* would not be feasible without clear Gazprom guarantees that it would use the new network. However, having Gazprom assets on their territory, these countries would have a better position to bargain with the Russian monopoly and secure their domestic supplies.

From the Russian point of view, constructing *South Stream*'s European on-shore section is a relatively small and favorable undertaking. The network's two branches would not cost more than €5 billion (or even much less) and Gazprom has a good chance to secure most of the construction contracts. In exchange for financing its own €2.5 billion share, Gazprom could gain direct access to, and become a dominant player in local markets. It could never buy an existing infrastructure at such a low cost. The central questions for Gazprom are the off-shore and Russian sections, which would make up the bulk of the full project costs. Formally, there is no legal connection between these elements. *South Stream* consists of six national sections without any relation to each other except a promise from Putin. In this, it is very different from *Nabucco*, where the whole pipeline is built under the umbrella of a single company and

regulatory framework. Moscow builds its network following the old logic of lines of independent national pipelines, which maximizes its room for bargaining. Logically, Gazprom might separate the implementation of each section. On-shore capacities could be easily built and supplied at the contracted 10 plus 10bcm level from the old, existing Progress system through the Ukraine. Expensive off-shore construction could be started, but delays would be, at least legally, affordable. This setup would bring about some losses due to the longer transit routes from the Ukraine to Bulgaria and then back up North,<sup>4</sup> but, in exchange, Gazprom would gain significant flexibility in *South Stream's* contractual system. If Gazprom follows this logic, the 2015 deadline is more credible with regards to the on-shore section, where the company has real commitments, than the off-shore part, where some delays are much more likely.

The implementation of the project through this scenario would improve supply security for most of the participating states. However, in order to clarify and map out the possible outcomes during the construction phase, it would be highly advisable for the small partner countries to harmonize their policies towards the project. Negotiating only with and through Moscow, and the lack of a multilateral framework, is a non-affordable luxury in such expensive and complex projects. A binding deadline in a multilateral framework is far more secure than some bilateral commitments and political promises.

**Map 1 – Gas export infrastructure to Turkey**



Source: *The Washington Institute for Near East Policy*, 2006

<sup>4</sup> Gazprom’s activity has shown some signs, hinting that it left open this scenario. Having contracted for another 20-25 years the Romanian and Bulgarian transit capacities, it seriously examines freeing up this potential by constructing a new branch of the *Blue Stream* pipeline to Turkey. The Russian monopoly still insists on the renovation and possibly expansion especially of the southern branch of the Ukrainian system.

**‘Ukrainian transit’ strategy.** Ukrainian transit (and to a lesser extent Belarus) has been the biggest challenge for Gazprom for some years. Despite all efforts of the last two decades, 70 percent of all gas exports to Western Europe still flow through this country, posing an uncomfortable dependence for the Russian leadership and causing huge financial losses for Gazprom. Decreasing both the dependence and the losses can only be achieved by consolidating the Ukrainian gas industry under Russian terms or simply excluding the country from the vertical chain. The former option has high political and prestige costs, as illustrated by the two ‘gas wars’ of 2006 and 2009, although even these costs may turn out to appear extremely relative if one considers the exorbitant price of constructing an alternative system. What is more, the Ukrainian pipeline network offers not only the cheapest transit route in technical terms, but it also disposes of a unique 34bcm storage capacity, which can hardly be substituted even in the long-term.

In previous years, Moscow tended to support the full exclusion of Ukraine from its export chain. Communicating similarly this time, it is realistic to think that the Kremlin’s true aim is to erode the Ukrainian bargaining position and by lessening its dependence through the planned construction of alternative export channels to the West. Some of this task, however, may already be achieved through the building of *Nord Stream*, where a substantial part of the capacity (maybe 20-30bcm) could be used for transit diversification purposes. The significant question in regards to Gazprom’s diversification efforts is how much alternative capacity would soften Kiev’s stance sufficiently for a deal to be reached, and when this could be achieved. In this regard, the changeable Ukrainian political situation puts Gazprom in a really difficult situation. In the 2009 contracts, Gazprom agreed to legal and financial commitments to use at least 110bcm of the Ukrainian transit capacity for another 11 years. This shows that Moscow did not really calculate considering other new transit routes becoming available in this period – although this may be just pessimistic anticipation and some sort of ‘insurance policy’ for Gazprom. What appears to be the more realistic assumption is that Moscow has not given up gaining assets in the Ukrainian system, which - if true – would create a very negative outlook for *South Stream*. The better the situation with Ukrainian transit, the smaller the pressure for Gazprom to move ahead with *South Stream*. In this light it is important to notice that despite all the brutality of Russian-Ukrainian relations, Gazprom has been progressing steadily in achieving a deal concerning transit issues. It forced Kiev to sign a Western-like supply and transit contract and succeeded in isolating Ukraine with regards to this question in the West. Moscow triumphed in its dealings with Belarus, ruling out a similar outcome in their relations with Ukraine, even in the short-term, could be a serious mistake. The 2015 *South Stream* deadline might have been a tactical move of the emerging full-fledged conflict between the two sides.

**‘Rivalry’ strategy.** The suspicion that *South Stream* is to be set up as a rival to *Nabucco* and *ITGI* is widely held among Western analysts, although it is regularly refuted by Gazprom. According to these accusations, incremental supplies of gas into the rival projects would come mainly from the same Central Asian sources and transited through the same countries. The only basic difference could be that it would be sold by one of the transit companies itself (Gazprom), further increasing its leverage on these markets. According to such analysts, Moscow’s only aim is to hinder the construction of Western pipelines and preserve its

monopoly, both on the supply and the demand side.<sup>5</sup> Moreover, controlling the trunk pipeline system on the Balkans, Gazprom could even influence Iraqi or Iranian supplies to Europe.

Gazprom's basic philosophy, concerning the gas industry, appears to strengthen the above fears. The "they, who have the pipe, have the gas" logic is present in all Gazprom investments. However, *South Stream* is planned to be built in countries that follow obligatory EU competition regulations. In those, pipeline capacities are supposed to be opened up to all suppliers. Gazprom may apply for exemptions in Brussels, but a significant part of the pipeline will still need to be offered to third parties. Even if regulations are not perfect, this means that having assets in a facility might only increase one's control over its capacities, but does not assure one's full authority. Provided that DG Competition exerts its legal power over *South Stream*, and forces the participants to respect and fully implement the Gas Directive, Gazprom will not be the only one who uses the pipeline. A working, on-line capacity and a connection to the Turkish network by 2015 would facilitate Middle Eastern and Caspian exports to Europe avoiding Gazprom's balance sheet. Gazprom might hope for imperfections in the regulatory framework, but much would depend on national and European regulatory bodies in deciding how *South Stream* would work in reality.

In this context, the "rivalry interpretation" might have some logical fundamentals, but it would not create a black-and-white situation. Actually, a relatively early completion of *South Stream* would help Europe to establish contacts with alternative suppliers. If Gazprom really wants to stop *Nabucco*, the best place to interfere is Turkey. Turkish consumption relies on Russian supplies and the country has not joined the European Energy Community yet. Having a booming gas demand, Moscow has a much bigger leverage over Ankara than over the other *Nabucco* countries. Some sort of joint management of supplies coming from the Middle East and the Caspian is a much more realistic scenario than preserving Gazprom's full capacity control over *South Stream*. Offering *South Stream* as transit channel and guaranteeing reliable supplies to Ankara, Gazprom could ask for a share of the gas transit through Turkey. Following this train of thought, the construction of *South Stream* might be thought of as a rival to competing Western projects, but it would be a mistake to characterize this as a determinative correlation. However, the "competition logic" makes the reliability of the 2015 deadline weaker, since it also assumes that the dependability of the *Nabucco* project will grow in the years to come.

### **Summary**

Having already put some question marks behind the reliability of the 2015 deadline, we must ask ourselves now, why Moscow would have put forward such an early completion date. The most likely answer could be understood as a sort of "drifting-along-effect." Equipped with numerous good arguments to build new transit corridors for the future and experiencing a strong pipeline competition in the Balkans, the Russians had to make a move. Their engagement, however, could not gather real credibility without a construction deadline. Moscow's commitment to *South Stream* was not the result of responsible pre-planning but rather a step-by-step process in which political push played a significant role. It was not a Gazprom manager, but the highest political leader of the country who made the statements about early completion. Although this may be thought of as a more credible promise, it is less reliable in reality. Politicians tend to be a bit more impatient in energy matters than the industry itself. While Gazprom managed to cancel the original 2013 deadline, it is likely that it had to fight bitterly against another completion date set before 2015. Facing a problem with the

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<sup>5</sup> Toby Vogel: "Will South Stream push EU off course?", in: European Voice, 30.04.08.  
<http://www.europeanvoice.com/article/imported/will-south-stream-push-eu-off-course-/60547.aspx>

project in Austria, disagreements about capacity allocation with ENI and significant financial constraints, the early deadline actually worsens Gazprom's bargaining position in these issues, and might turn into a headache for the company in the future. It is not going to be Putin who is responsible for any failures to implement the original plans, but Gazprom.