

## **The Prospects of Cooperation between South East Europe and Russia in Ensuring the Long-term Energy Security of the Continent**

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2009 – the crisis year – brought about crucial changes in the established and seemingly successful picture of the oil market. The New Year “gas war” between Russia and Ukraine consolidated bad tradition, demonstrating the vulnerability of the present structure of the oil and gas market once again. There were no winners, everyone suffered: the supplier, the transporter and the consumers. Conclusions and assessments of the conflict, and its consequences, are, generally, diametrically opposed. This was reflected in the subsequent actions and statements of the players in the market. It seems generally considered that on the ‘gas front’ Russia is leading a war “against all”. This confrontation is not new; but if earlier it could be considered as “debatable”, now resentment towards the actions and positions of Moscow are reaching a kind of hysteria. Such a political context, alongside some recent events, certainly has an influence on the future of the energy security in Europe, especially considering dramatic changes in the oil and gas markets.

### ***New Energy Order***

One of the symptoms of the global energy crisis is the acknowledgement that the true test for world energy is expected after the crisis ends. Nowadays, to foresee the realities of the post-crisis era and to prepare for the new paradigms of the world energy market, the revision of established views and strategies takes place in Russia. From the 1970s the overall strategy of the energy market was based on the idea of continuous consumption growth. However, the present crisis demonstrated a reverse tendency, and not only over the next few years, but long-term and for many markets. The markets have faced a fast and wide-scale decrease in the demand for fuel and energy. As this analysis shows, the U-turn in previously existing global tendencies had been threatening long before the crisis. This crisis became a potent catalyst revealing deeper causes behind a new order in the energy market.

It should be admitted that the policy of developed countries in the field of energy supply and the development of alternative energy resources is gradually beginning to bring results. The reduced participation on power-consuming industries in the economy, the steady improvements of standards of power efficiency, amid continuous economic stagnation, have already led to a decrease in absolute volumes of demand. It is important to note that in member countries of the Organization for Economic Cooperation and Development (OECD) a new energy efficiency standards have been introduced on a normative level. Normative controls are in force even at the lowest energy sources, where the competitiveness of alternative energy sources is not an issue. As a result, the energy capacity of the economy decreases, and in the foreseeable future, the growth of demand will also decrease for energy resources in OECD countries. Therefore, Barack Obama’s Energy Plan and the European Program “20-20-20”, even if only partially fulfilled, will lead to stagnation of demands for oil and gas in the US and Europe in the mid-term. Added to this, the dominant concept in developed countries of energy security and aspiration towards diversification of import sources, and moreover, growth of domestic production, it is almost inevitable that volumes of import of oil and gas imported into

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developed countries after the crisis will be noticeably lower than it was predicted during the last years.

### ***Crisis and Gazprom***

At the beginning of this year, Russian gas monopolist Gazprom fully felt the decrease in demand on the main markets: minus 20.8 percent within four months and substantial decrease in export. The main reason for this fall is a decrease in demand, both inside the country, by 3.7 percent in February, and, more seriously abroad. Although Gazprom's forecast foresaw a decrease in supply to Europe by only 5 percent per year, the data for first months of the year do not give grounds for much optimism. And neither does the gas consumption growth data from Europe.

Moreover, if we consider the predicted fall of gas prices from the average US \$400 for a thousand cubic meters last year to \$210-230 in the middle of this year, then the financial perspectives of the Russian monopoly are not bright. At present, Gazprom officially expects a reduction of income from Europe of about \$29bln.

However, it is in such a framework of decreasing demand that a paradoxical strengthening of interdependency in gas supplies between Europe and Russia is taking place. In mid-August this year, the International Energy Agency (IEA) published recent data on the consumption of gas in the EU for May: in the 1st quarter there was a 5 percent decrease, compared to 2008, then, according to the results for January-May, the decrease was already 8.5 percent (while in May it was 14 percent decrease in demand - 31.1bln cubic meters). At the same time, this decrease in consumption has helped Gazprom to re-establish its share of the European market: according to the IEA data, in the 1st quarter it was only 16 percent (compared to 23 percent the year before), and in May it was already 32 percent.

In Gazprom, confidence is high that nothing really dramatic is happening. The company will increase its export in the next six months: the Europeans will refill gas storages, and will remember the main principle of Gazprom's contracts – “take or pay”. In short, according to the official Gazprom forecast, based on this year's results, export will decrease by 10.5 percent to 142,3bln m<sup>3</sup> for Europe and Turkey, compared to 2008.

### ***Gazprom is being pushed out from Europe***

Lately, adverse changes in the geographical structure of European gas imports have taken place for Russian gas producers. In January, the insufficient delivery of Russian fuel was compensated with increased import from Norway, Algeria and Libya. The level of additional supplies from competitors was not too substantial: the suspension of Ukrainian transit was met by the European importers who filled up underground gas storages stations “to the top”. More to the point, this very fact was accepted in Brussels with delight as a result of the diversification policy, while for Gazprom, even such a temporary decrease of share on the market, can hardly be desirable under the present conditions.

According to one of the leading experts of the Russian gas industry, the Vice President of the State Duma and the President of Russian Gas Society, Valery Yazev, at present “consistent efforts are being made to push Russia and Gazprom out of Europe”. The statement was given at a press-conference on 21 April this year.

Fears of excessive dependence from the politicized Russian monopolist are, indeed, voiced in the European Union. However, objective processes of the crisis period are obvious in the Brussels' interpretation, supporting the drive of Europeans to diversify their sources of supply in the name of energy security.

In general, the frequency of reference and the intensity of discussion on the topic of energy security in Europe can, probably, only be compared with the topic of the global financial crisis and its consequences. Considering the general situation in the economy – decrease in demand and plummeting prices of fuel – such great attention is puzzling. It is quite obvious that Brussels tackles two tasks: drawing attention away from the real problems of the crisis and not always successful attempts to overcome them, while laying the foundation for a future, when demand and prices for energy resources will rise and the positions of suppliers (including Russia) will objectively strengthen.

### ***Southern Europe Political Gas Pipeline Projects***

Growing controversies between Russia and the countries consuming its fuel can be noticed not only in the political or legal spheres, but also in the design of particular gas supply projects. Issues, such as pipe laying and fuel transit conditions, have practically overshadowed earlier problems to which we had become accustomed, such as disarmament or deployment of rockets. New geopolitical games and pipelines involve more and more participants, propose more and more projects and, paradoxically enough, often overshadow and devalue the only objective purpose – securing energy for the development of the economy.

Such a conclusion is obvious when one analyzes the behavior of the participants. The Europeans, in their almost maniacal commitment to diversification of sources, try to impose their own rules on Gazprom, which is blatantly not interested and considers discriminating. Attempts to push out the Russian supplier, which provides a quarter of EU imports, are obvious, and where is energy security here?

The *Nabucco* pipeline project is usually presented as a serious threat to the Russian export. Supposedly, it will transit Iranian and Turkmen gas to Europe through Asia Minor. This way the European Union intends to decrease energy dependence on Russia. According to independent experts, *Southern Stream* and *Nabucco* do not just compete with each other, but are mutually exclusive because, in the future, EU gas needs, as mentioned above, will be significantly lower than expected levels of supply.

The official point of view of the Russian authorities is that two pipeline projects in the South of Europe are not competitors. At the beginning of July, Vice-Premier Igor Sechin, who supervises the Russian fuel-energy complex, said: “The more opportunities for gas supply provided for consumers, the better”. This opinion concurs with the position of European countries, which are ready to support both projects. At the same time, the accelerating race to see which of the projects will be launched sooner, not only does not correspond with such a restrained position, but damages the normal procedures of preparation, regarding precise calculations of effectiveness and competitiveness.

Seeing these projects as competitors and consequent suggestions to abandon *Southern Stream* are absolutely inappropriate; there will be no negative fallout for Gazprom if *Nabucco* is launched. Furthermore, it is tactically important for Gazprom to continue to pressure key countries in relation to *South Stream*. In this case, it can obtain several advantages: on the one hand, it can speed up construction, and, on the other, paradoxically enough, be included as a beneficiary of the *Nabucco* project. By gaining access to *Nabucco*, Gazprom can only

strengthen its presence in Caspian-Central Asian region and on the European market (see below).

Presumably, the *South Stream* pipeline will be laid on the floor of the Black Sea from Novorossiysk to the Bulgarian port Varna. Its two branches will then cross the Balkan Peninsula to Italy and Austria, though their exact routes are not yet confirmed. According to the plans, the pipeline should be in service by 2013. The capacity of the pipeline should be 63 billion cubic meters per year. The total amount of investments is assessed at €25 billion.

A Memorandum of understanding on the implementation of the project between the Italian company ENI and Gazprom was signed on 23 June 2007 in Rome. On 8 January 2008 Bulgaria joined the project; on 21 January the Government of Serbia and Gazprom signed a set of agreements, which includes Serbia's participation in the project. On 28 February Russia and Hungary signed an Agreement on cooperation on implementation of the Project. Finally, on 29 April Greece joined the project. At present, an agreement with Slovenia is in the negotiation process, while an intergovernmental agreement with Austria is expected to be signed.

Other countries may join the project, but their participation would include only an over-ground network of pipelines. The portion that will transit the Black Sea will belong to Gazprom and Italian ENI in equal shares.

The *Nabucco* project envisions a transfer of gas to Europe bypassing Russia – through Azerbaijan, Georgia, Turkey, Bulgaria, Hungary, Romania and Austria. Therefore, it should become a continuation of the existing Baku-Tbilisi-Erzurum pipeline. Construction of the new pipeline is set for 2010, and should be operational by 2014. The capacity will be 31bln cubic meters and the cost of construction €8bln.

Two events in July-August 2009 put further strain on the political controversy surrounding the two projects. On 13 July in Ankara an intergovernmental agreement on the *Nabucco* project was signed by the leaders of the Governments of Turkey, Austria and Hungary and by the Ministers of Energy of Bulgaria and Romania. Significantly, the ceremony was attended only by potential transit countries, but not by suppliers. Uzbekistan, Kazakhstan, Turkmenistan and, most importantly, Iran have not accepted any formal commitments regarding *Nabucco*. Moreover, at the end of June Gazprom signed an agreement with the State Oil Company of Azerbaijan on the purchase of Azerbaijani gas, after which Baku cannot objectively be considered as a serious participant in the *Nabucco* project. Gas from Azerbaijan and its Shakh-Deniz deposit was to become a source for the first stage of *Nabucco* (10bln cubic meters).

Lately, Turkmenistan has been named as the main potential supplier. Turkmenistan, taking advantage of a suspiciously well-timed explosion on the pipeline, has been talking about reconsidering its gas policy. President Gurbanguly Berdymuhamedov supported the *Nabucco* pipeline, which will create new routes of gas supply. “The question of the sovereign right to choose the energy resource supply route is directly related to defining prices”, said Berdymuhamedov. This should be read as: Ashgabat is ready to sell its gas to the highest bidder. If Gazprom does not buy gas at the price that suits Turkmenistan, then Ashgabat is willing to reconsider schemes and conditions of supply to the West. Alternative directions of supply will be Europe, though the pipeline *Nabucco*, China and Iran.

It is unlikely that Moscow will agree with Ashgabat's participation in launching *Nabucco*. For the time being, Turkmenistan has nowhere to go with its gas. The limited opening of supply to Iran can not solve the problem and is limited by issues of price. Nevertheless, in August this year, the sides agreed on the construction of supplemental reserve services and increase of Iranian purchase of Turkmen fuel from 8bln to 20bln cubic meters per year. The launch of a pipeline to China in the foreseeable future is unlikely due to lack of

finances and resources, as well as the absence of a price formula. This state of affairs will last for at least two to three years. Formally, this pipeline was planned to be initiated next year, but a substantial gas flow can not be expected earlier than 2012-2013.

In reality, Turkmenistan's threats to reconsider gas policy or its attempts to play the European card are, unlikely, to bother the Kremlin significantly. First of all, supplying *Nabucco* with the Turkmen gas in the forthcoming decade seems to be impossible. To start building a pipeline, the legal status of the Caspian Sea and its floor needs to be defined, a process involving the Caspian states (Russia, Iran, Azerbaijan, Kazakhstan and Turkmenistan), which has already failed for many years. Any attempt at laying pipes across the Caspian Sea, which ignores the interests of other countries, may provoke a harsh reaction – especially from Iran, which would not exclude a forceful response to such attempts. Moreover, Moscow too does not exclude the possibility of using force to strengthen its influence on the Caspian Sea. As indicated in the “Strategy of the National Security of the Russian Federation until 2020”, the struggle for the Caspian resources may bring an “imbalance of forces located on the borders of the RF”. In such a situation, according to the Strategy, Russia must strengthen its military presence in the region. For this purpose Russia and Iran can simply block the process of defining the legal status of the Caspian Sea. Recently, a consensus of interests of Moscow and Tehran has also gained a practical dimension: at the beginning of August, for the first time, they conducted joint maneuvers with around 30 vessels on the Caspian Sea.

Furthermore, Turkmenistan does not have infrastructure to transport its energy sources from the Western deposits to the shores of the Caspian Sea. Attempts to build this infrastructure, financed by Russia, did not succeed and European business is not ready for make large investments in Turkmenistan as it is not convinced by this country's resources.

Another important event that influenced the balance of power in the gas pipeline confrontation was a visit paid by the Russian Prime Minister Vladimir Putin to Turkey and new agreements signed. According to these, Gazprom obtained permission to conduct seismic and ecological explorations in the exclusive economic zone of Turkey, as well as preliminary consent for construction of the *South Stream* pipeline. Turkey's support significantly strengthened the *South Stream* position. At the same time, construction of the pipeline through Turkish waters offers a choice of routes between Romania and Bulgaria, which had not been favorable towards the Russian projects.

However, the destiny of the *South Stream* project is still not apparent, despite the commitment underlined whenever possible by Russian representatives.

According to preliminary estimates, the cost of *Nabucco* will be €8bln, and that of *South Stream*, with the capacity of 63bln cubic meters, will be €5bln. However, since the visit of Vladimir Putin to Ankara, Turkey has started bargaining for a number of concessions, which, should they be accepted by Russia, would lead indirectly to increasing the cost of *South Stream*.

According to the forecasts of the Ministry of Finance, Ministry for Economic Development and Trade and Gazprom itself, with falling prices and demands, revenue from exports in 2009 may plummet even by \$29bln, compared to 2008. According to some estimates, pure debt exceeds \$47bln at the moment. Moreover, the gas pipeline program does not correspond to the decreasing demand in gas and its diminishing production in Russia. In 2008, the total volume of Russian gas exported was 158.4bln cubic meters with the spare volumes in the pipes exceeding 37bln cubic meters or 19 percent of nominal capacity. Let us remember that in the first quarter of 2009 supplies to Europe went down by 50 percent, and officially planned volume of Gazprom's European sales proceeds reduction was about \$29bln. Therefore, prospects for the new infrastructure project are not brilliant.

The weakening of political support for *South Stream* in the EU, alongside the Gazprom's financial difficulties, can seriously slow down the implementation of the project. Therefore, it is no accident that in his speech at the Gas Summit in Sofia, the Minister of Energy of the Russian Federation, Sergei Shmatko, spoke of postponing the launching date until 2015.

In the meantime, Gazprom has revived discussion of the project *Blue Stream 2* - an expansion of existing pipelines targeting the markets of Israel, Lebanon and the entire region. It should not be ruled out that other options are available to secure a stable gas market other than through Southern Europe. The world economic crisis may bring changes into seemingly rigid and consolidated political structures.

The idea of including the Russian Federation into *Nabucco* is not an exception. Moreover, Gazprom has been invited to participate in that project as a supplier more than once. On signing the agreement, the Prime-Minister of Turkey, Recep Tayyip Erdogan, expressed his hope for the participation of Russia, as well as Iran, in the implementation of *Nabucco*: "We support Iran's participation in the project, should circumstances so allow, and we also hope for Russia's inclusion". Furthermore, Richard Morningstar made an eloquent confession: "We want Russia to participate in the project as a partner, and we can submit a proposal to supply gas within the *Nabucco* project".

One of the possible scenarios is the merger of all hypothetical southern pipelines into one project under the conditional title *Southern Corridor* and although, all sides obviously intend to defend their own proposals, this option should not be entirely ruled out.

The prospect of filling *Nabucco* with Russian gas has always provided opportunities for delicate political games, interesting moves and exchanges and, possibly, commercial benefits. Analyzing the expansion of the *Blue Stream 2* pipeline, one must pay attention to its intersection with *Nabucco* near Ankara. Opportunities become apparent for the continuation of the *Blue Stream* southwards, to Syria and Israel, for instance. Intersection with the European pipeline could become a weighty argument in Gazprom's favor when competing for export volumes of Azerbaijani gas. It could also be possible to rely on European support in delicate negotiations with Turkey on conditions of transit (not resale) of Russian gas.

In this option there is also an opportunity to cut Iran out of European market by substituting Iranian gas with Russian gas (or Central Asian). To direct the fuel of potential competitor to the East has always been an important geopolitical goal of Gazprom. It is no chance that Moscow has always supported not only the project *Peace* - the pipeline Iran-Pakistan-Iran, but was also ready to participate in such an exotic initiative, such as the Trans-afghan pipeline which would also direct Turkmen gas towards the east.

Vladimir Putin's visit to Ankara demonstrated a certain flexibility in Moscow's policy. As an additional bonus for permission to construct *South Stream*, Turkey obtained preliminary consent from Russia to consider the possibility of participating in the oil pipeline project *Samsun - Ceyhan*. More than once Turkey has invited Russia to participate in this project, which would connect the Black Sea port Samsun and the Mediterranean port Ceyhan and allow oil transport avoiding the Bosphorus and Dardanelle straits on the Black Sea. The operators of the project are the Turkish holding Calic Energy and the Italian ENI. Russia's decision on possible participation in this project will in no way reduce the interests of the Russian companies in the implementation of the *Burges - Alexandropoulos* project supplying Russian oil to Europe. Therefore, Russia, as well as Turkey, may become participants of two, practically competing, projects - potential benefit winning over political preferences.

### *The issue of “reliability of supply”*

The European Union presents its idea of diversification of supplies almost exclusively as a means to increase energy security, since Russia, allegedly, is not a reliable supplier, and Europe’s overdependence on Moscow threatens this security. In more “down-to-earth” versions, this idea goes along with European skepticism about Russia’s ability to provide enough fuel for the growing needs of the EU economy.

Over the last year, however, this topic has been somewhat muted. Firstly, because of the crisis, energy consumption in Europe has decreased, significantly effecting Gazprom’s exports. This cost the company not only a 20 percent decline in production, but also reduced purchase from Central Asia and from Russia’s “independent” gas producers.

However, there are also long-term prospects whereby Russia should not expect an increase of gas demand from Europe. Forecasts of gas consumption in Europe are constantly decreasing. Within the last decade demand estimates for 2020 have been reduced by 180bln cubic meters, and forecasts for import volumes have decreased by 135bln cubic meters. The main reason is a new energy policy in EU countries, aiming at increased energy efficiency in economy and the development of alternative sources of energy. Although many in Europe view these plans as not being very realistic, unclear perspectives becomes real and not a mythical threat to energy security. Since the investment cycle in the field of energy is long and there is a need for appropriate transport infrastructure, decision should be made in the present, alongside limited budgets and extremely uncertain external conditions.

Not surprisingly, this uncertainty of demand assessment and unwillingness to consider guarantying the “security of the supplier” irritates Moscow. “The New Energy Strategy of the EU”, published in November 2008, which targets a decrease of specific demand in energy resources by 20 percent and a respective decrease of gas import, provoked a very clear reaction in Moscow: “Europe must decide whether or not Europeans need a gas pipeline from Russia in the proposed volumes. If not, then we will not construct the pipeline, and will build plants for gas liquefaction and sell it on the world markets”, said Vladimir Putin after negotiations with the Prime-Minister of Finland Matti Vanhanen, and thereby introducing a new discussion on gas export development models.

Therefore, in the contemporary debate, a legitimate question is not whether or not Russia can fill all existing and planned pipelines, but whether Europe is an adequate market in volume and reliability for Russian gas and to what extent the high expenses, which Russia should incur for ensuring a gas supply to the EU, are justified.

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The stability of Russian gas transit through the territory of Ukraine continues to cause concern for European consumers and also for the supplier – Gazprom. As during the last winter, the countries of the South-Eastern Europe, which do not have alternative sources of gas supply to the transit stream that goes through the Ukrainian territory, are in a high risk zone. Indeed, all Moscow’s efforts to organize alternative routs of fuel supply to Southern Europe are aimed at avoiding transit risks and guarantying supply of energy to the consumers. Extreme, often hysterical, politicization of these, mainly technical and financial problems, causes irritability and misunderstanding in Russia, and negatively influences the stability of the markets and prices.

Today, because of the crisis we have a “seller’s market” that causes attempts to pressure Russia – the seller of the fossil fuels. But this situation is temporary: the inevitable recovery from the crisis and the inevitable increase in demand and prices, will reverse the situation.

Europe is not the only market, and the crisis, quite possibly, has given an opportunity and even dictated the necessity to break the monopsony in oil and gas export, by means of market development and the development of the LNG sector. In a number of cases, behind the loud-mouthed statements of the perspective suppliers – Turkmenistan, Iran, Azerbaijan and others, as well as advocates from the camp of European consumers, there are neither any real resources nor short-term solutions for development and transportation.