

Russian Energy Interests in South-Eastern Europe

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Main energy challenges in the region

The energy dialogue between Russia and countries in South-Eastern Europe (SEE) is developing in a rather inconsistent and complicated way. On one side, there are some obvious positive aspects promoting our cooperation. Certain economic ties have remained between Russia and former socialist countries; in a number of cases there are cultural and ethnic ties that facilitate the implementation of cooperative models. On the other side, the elite of these states is burdened with different historical complexes, most actively promoting theses about the “Russian threat” in Europe. Even in Serbia, which is religiously, culturally, historically and linguistically quite close to Russia, there are quite influential forces that advocate a tough position towards Moscow. Russia and the so-called “European option”, selected by the region’s countries, are opposed to each other. In our opinion the “Europe or Russia” dilemma is false. Yet, it is obvious that the memory of the “big brother”, rather strongly, hinders cooperation between Russia and these countries that often perceive Russian investments and new projects as steps towards the reestablishment of the Soviet empire.

As a result, countries in SEE are ready for the ideas often voiced in Brussels, i.e. diversification of suppliers and reduction of energy dependence on the Russian Federation. Moreover, such dependence is especially strong in SEE. Previously this was viewed as an advantage (besides, this region is closer to Russia than France and Germany, which means cheaper gas due to the shorter distance). Now this is considered a serious political threat, since Russia remains a monopolistic supplier of energy resources. However, here comes a trite question – how quickly will Brussels be able to ensure supplies of alternative sources of hydrocarbons to the region? Moreover, some parts of Albania, southern Serbia and Kosovo need an expansion of their gas pipeline systems, while Macedonia has no gas supply infrastructure at all.

So, how should Russia’s energy policy in the region be evaluated? According to the Balkan mass media, the dominating position of Russian companies in SEE is not a coincidence, but a long-term political strategy. There is also an opinion that over the past decade Russian businesses have systematically implemented their plans, supported by Russia’s new leadership, to gain political levers through the energy sector. It is believed that Russian companies spread their influence in the region by buying existing firms and, when this approach did not work, they founded their own enterprises. This was quite an expensive process, but it was aimed at gradually broadening their influence. Meanwhile, some states in the region have already joined the EU, while others are in the process. The conclusion drawn is that Russia will use SEE as a bridgehead for a political offensive against the EU.

Besides, these countries were the most heavily affected during the January gas war between Russia and Ukraine. Old Europe has a well-developed system of gas underground storages that were used to pump substantial amounts of Russian gas in the first quarter of 2008. As a result, Germany, France, Italy and Austria were well prepared for the shutdown of gas supplies, while Eastern Europe was most affected. Consequently, countries in this region found themselves in a rather unique situation. For European bureaucracy, their plight represents Russia’s energy faithlessness. But Brussels prefers to provide only verbal assistance to them. A system of underground gas storage facilities is not being developed, and the region will not get really valid alternative sources of gas very soon, if at all. One should not forget that amid

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declining gas production in Europe the share of imported gas will be growing sharply. According to the estimates of the International Energy Agency, in 2030 the share of imported gas may rise to 85 percent of the EU gas balance. This means that *Nabucco* and other projects will mainly serve to offset the declining gas production in old Europe. Eastern Europe is necessary just as a witness of the threat of energy dependence on Russia. But this region will not get Brussels' full-fledged assistance in ensuring its energy security. This is why countries in Eastern Europe are facing a difficult dilemma: either to try to normalize cooperation with Russia or to keep demonizing it at Brussels' request, while not getting any valid alternative solutions in return.

Russian companies in South-Eastern Europe's oil and oil-refining sector:

Are things so terrible?

Active expansion of Russian businesses into Eastern Europe started with the oil industry. Russians wanted to purchase downstream assets in Europe and this was possible only in its eastern part – opportunities to buy such assets in old Europe had been minimized for political reasons much earlier. A window of opportunity was open; moreover, these countries needed money badly. Let's us consider whether the experience of cooperation in the oil industry has been positive or negative and whether Russian companies have turned out to be so frightful.

The share of Russian oil on the region's market is quite substantial. In Hungary it is 98 percent of the market, 90 percent in Bulgaria, 80 percent in Serbia and 40 percent in Greece. Besides, Russian companies own a number of oil refineries and filling stations. But this has not concerned either the population or the political elite for a long time. Expansion continued, but this was perceived quite calmly. Meanwhile, Russian corporations gained control over quite interesting assets.

The most active company in the region is LUKOIL, an absolute leader among Russian oil firms in terms of exploration of retail markets abroad.

In December 2006, ConocoPhillips sold 376 filling stations to LUKOIL. They operated under the Jet brand and were located in six countries, including 30 in Hungary and 14 in Slovakia. In late April 2008, LUKOIL bought 75 filling stations in Bulgaria and a petroleum storage depot near Sofia from Petrol Holding. The deal totaled €237m: €156.1m for the filling stations (about €2.1m per station) and €80.9m for the depot. In Bulgaria, the company has an about 74 percent share on the wholesale market of oil products. Thus, LUKOIL is in possession of 562 filling stations in Bulgaria.

LUKOIL owns an oil refinery in Burgas (Neftochim Bourgas); the Russian firm purchased its controlling stake in October 1999 for \$101m. In early 2005, the oil company increased its stake in the Burgas refinery to 93.16 percent having bought 22.05 percent of the facility, based on an offer. The refinery produces unleaded petrol, diesel fuel and petrochemical products that correspond to European quality standards. The refinery processes about 6m to 7m tons of oil per year.

Neftochim Burgas is the only oil refinery in Bulgaria. It produces about 80 percent of the automobile fuel consumed in Bulgaria; at the same time, about one third of oil products produced by Neftochim Burgas is exported.

It is important to note that the deal with LUKOIL led to growth in investments in the enterprise. The oil firm continues upgrading the refinery whose capacity is expected to rise. In 2007 an isomerization unit was put into operation at the refinery; a hydrofining unit of a 1.7m ton capacity per year currently is at the final stage of construction. Moreover, the capacity of a

catalytic cracker is being expanded to 2m tons per year. In 2011 the Burgas refinery will be able to process 10m tons, compared to the current 8.8m tons per year.

LUKOIL's share on the Romanian market is approximately 22 percent. The Russian oil company owns a chain of over 300 filling stations in this country as well as the Petrotel-LUKOIL refinery in Ploiesti with a 2.4m tons of oil capacity per year. The Russian owner has ensured investments in the enterprise. In 2007, a turbo-generator with a 25megawatt capacity was launched at the refinery; as a result, the combined capacity of the facility's heat station reached 61megawatts. The first stage of the heat station's renovation has been completed. On the whole, a renovation project envisages the construction of a boiler unit with a 245megawatt heat capacity in the second quarter of 2009 that will use oil coke as fuel.

In Montenegro's capital Podgorica, LUKOIL bought six filling stations belonging to Roksped Petrol that had actively cooperated with LUKOIL's Serbian subsidiary LUKOIL Beopetrol since 2005. The Russian oil firm paid €26.5m for the purchase, which was €4.5m per filling station. According to European standards, this was a high price because in Europe a filling station costs about €1m to €2m on average.

In Croatia, LUKOIL purchased EUROPA-MIL, nine filling stations in Zagreb and Split and five plots of land for the construction of filling stations. The average daily volume of sales at a EUROPA-MIL filling station was 11m tons of oil products, compared to 7.9m tons at a LUKOIL station on average in 2007.

In addition to filling stations, EUROPA-MIL owns an oil product railway terminal with an 8,000 cubic meter storage capacity, located near the town of Vukovar on the Danube River. (In November 2006 the company began construction of a small bio fuel producing plant with a 35,000 ton design capacity on the basis of this terminal). As a result, LUKOIL has an opportunity to sell oil products practically all over the country.

Initially the Vukovar terminal had no river transfer reloading license. To have this permit was the condition LUKOIL had put forward to EUROPA-MIL owners before the purchase. Thus, the Russian firm may use river tankers and deliver oil products along the Danube. LUKOIL owns 180 filling stations in Serbia and six in Macedonia.

It is worth mentioning that there was no serious scandal related to LUKOIL's activities. The company was not perceived as the Kremlin's instrument of influence. Although LUKOIL launched its strategy of domination on the market in 1998, few observers considered the Russian oil firm's policy to be a threat. This was probably because LUKOIL is a private company. Besides, the American concern ConocoPhillips has a 20 percent stake in it.

Meanwhile, the attitude towards companies directly controlled by the Russian government has turned out to be completely different. However, they also started actively operating in Serbia and Bosnia and Herzegovina. This concerns Zarubezhneft as well as Gazprom's subsidiary Gazprom Neft.

Zarubezhneft has marketing assets in the Republic of Srpska (part of Bosnia and Herzegovina). It owns the Bosanski Brod oil refinery with a yearly 4.2m ton capacity, the Modrica engine oil producing plant, a yearly capacity of up to 70,000 tons of engine oil, and 78 filling stations. In 2009, the Russian firm is planning to increase the number of its filling stations in the Balkans to about 150. In the future, according to the Zarubezhneft executive, Nikolay Brunich, the company will raise the number of its filling stations in the Balkans to 300 after the second phase of the Bosanski Brod oil refinery has been put into operation, it will enable the refinery to boost its refining volume from 1.2m to 4.2m tons of oil per year in 2010 / 2011.

In February 2009, Gazprom Neft finally completed the purchase of a 51 percent stake in Serbia's NIS, while in turn, Gazprom promised to lay a branch pipeline from the *South Stream* main gas pipeline through this country and to build an underground gas storage facility near Novi Sad. NIS - TNG – a division for LNG production of Naftna Industrija Srbije, an oil company engaged in oil refining and the sales of oil products as well as the production of hydrocarbon resources in Serbia and Angola. The production volume of NIS is about 1m tons of oil per year.

The company owns oil refineries in the towns of Pancevo and Novi Sad with a combined capacity of 7.3m tons per year. NIS has its own marketing network (about 500 filling stations) and it is a leading supplier of oil products on the Serbian market, producing about 85 percent of oil products consumed in the country.

The negotiations started at the end of 2007 and continued for over a year. Russia paid €400m and agreed to invest another €550m by 2012.

These deals were carried out in a much more dramatic way than LUKOIL's acquisitions. There were accusations of attempts to create a zone of Russian interests and "Moscow's energy grip" was suspected to be behind them. But there are three points that should be underlined.

The first is that such accusations provide an opportunity to bargain for more benefits from Russian companies by introducing fiscal measures. Thus, Eastern European countries start charging more from Russian firms. These countries use the 'Russian threat idea' for commercial purposes, rather than being afraid of it. For example, Gazprom Neft paid quite a high price for Serbian assets, following political bargaining.

The second point is that local companies have to compete against Russian firms entering the market and are not always able to survive. In this case they resort to political accusations. In particular, the purchase of Bosanski Brod by Zarubezhneft seriously shook the position of Croatia's INA oil firm. INA supplied most of its products to this market, but following the deal the Russian company could sell fuel at a much lower price than the Croatian firm did. As a result, INA even had to transport its fuel to Italy to destroy it at special facilities, which resulted in substantial financial losses.

The third point is the rather difficult adaptation of Russian companies to new assets; however, this is not because of political disagreements. Let's us consider the situation around Gazprom Neft and its Serbian asset.

In this case there is a collision of two management systems, which is far from politics. Frankly speaking, in the south of Europe there are quite specific labor ethics – people are used to working less intensely, while receiving quite good remuneration. Any attempt to make them work harder and more efficiently causes indignation. On the other hand, Russian top managers are used to big salaries and bonuses and, if they need to cut expenses of their enterprise, they won't do that at their own expense. It is clear that the arrival of new young managers from Gazprom Neft to Naftna Industrija Srbije, who have established quite favorable financial conditions for their work and in every possible way, demonstrate that they are the elite, consciously keeping Serbian workers at arm's length, often causes understandable indignation among the enterprise's workers. However, this conflict is not related to the use of the notorious energy weapon against Serbia.

Thus, there are often economic interests behind political explanations. Nevertheless, a negative background has already been created. As a result, any Russian acquisition causes a sharply negative reaction in the region, even if the buyer is a private company. Any deal is viewed as growth in Russia's political influence. A clear example is a purchase of a stake in Hungary's MOL by Surgutneftegas. Hungary's reaction to the deal vividly shows how our relations with South-Eastern Europe have deteriorated.

At the end of March 2009, Surgutneftegas, Russia's fourth largest oil and gas producer, signed a contract buying a 21.2 percent block of shares in Hungary's Magyar Olaj-es Gazipari Nyilvanosan Mukodo Reszvenytarsasag (MOL) from Austria's OMV Group. The deal totaled €1.4bn. Surgutneftegas is a private company, although it has a rather non-transparent shareholder structure that is much rumored about. At the same time, the company and its head Vladimir Bogdanov enjoys a certain authority in the Russian oil industry.

The contract was drawn up on March 29 and 30, 2009 at the height of a political crisis that resulted in the resignation of Hungarian PM Ferenc Gyurcsany. Gordon Bajnai, who replaced Gyurcsany, condemned this deal later. The statement Hungarian foreign minister Peter Balazs made in an interview with EurActiv Hungary is quite demonstrative in this regard: "The problem in the MOL case is that we do not know who is behind it. The Russian methods are based on Byzantine tradition, not on Protestant ethics. It is hard to negotiate with representatives of this culture".

The European parliamentarian representing Hungary, Andras Gyurk, in a written form, inquired of the European Commission whether it considered the sale of the MOL shares to Surgutneftegas to be in line with European principles of transparency.

The following commentary by an undisclosed Croatian expert was published in the Javno newspaper: "The accession of Russia's Surgutneftegas to the ownership structure of the Hungarian oil company MOL is the culmination of a decade-long attempt by Russian companies to conquer the markets of South-Eastern Europe. They already play a dominant role in many markets, but they failed to do so in Hungary and Croatia. Now having acquired a stake in MOL and thus entering the ownership structure of Croatia's INA, the Russian firm is preparing the ground to gain control over the energy markets of South-Eastern Europe, from Slovenia to Bulgaria. The domination on these markets is one of Russia's long-term strategic goals; so, growth in political pressure by Moscow on the Hungarian and Croatian governments can be expected in the near future".

As a result, Surgutneftegas became a major shareholder in MOL, but it has not managed the company yet. Surgutneftegas was even accused of insidious plans to spoil the construction of *Nabucco*, which is a rather disputable statement – MOL assets are not enough to ruin this project. Surgutneftegas was refused registration in the shareholder register; as a result, the company was not allowed to participate in the shareholders' meeting on April 23.

Gas projects: diversification of supplies won't settle all energy problems in the region

The gas topic is even more politicized, and following the January gas war between Russia and Ukraine that mostly hit countries in the southeast of Europe, it is rather dramatic and is actively discussed. Many politicians in the region rushed to draw a conclusion: it is necessary to decrease dependence on Russia at all costs. Meanwhile, it will be rather difficult to do this. It is enough to study the following statistics:

Gas supplies from Russia (bn cu m):

	2007	2008		2007	2008
Hungary	7.5 (share is 70%)	8.9	Serbia	2.1	2.2
Romania	4.5 (share is 20-25%)	4.2	Croatia	1.1	1.2
Bulgaria	2.8 (94%)	2.9	Slovenia	0.6 (50%)	0.6
Greece	3.1 (80%)	2.8	Bosnia and Herzegovina	0.3	0.3
Macedonia	0.1	0.1			

The volume is not so large, compared to Western Europe. But the dependence on Russia is quite substantial. This is why countries in this region eagerly support calls for diversification of supplies, counting especially on the *Nabucco* project. But the countries of South-Eastern Europe often forget that they are mostly part of Europe and this is why the problem of the gas balance should be applied to whole of Europe, not separately to its southern, eastern, northern or western parts, and this is the main problem: First and foremost, the declining gas production in Europe.

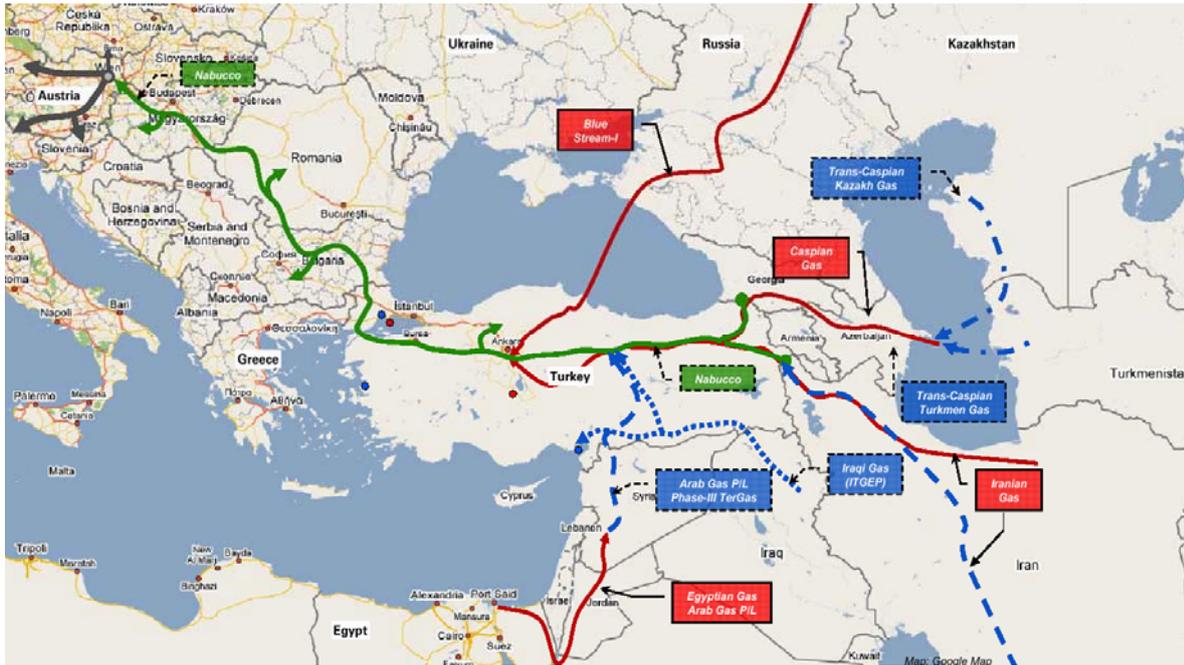
This means *Nabucco* will neither save Europe from Russian gas nor will it cover the reduction in the EU's own gas output. So far, the EU gas balance is not in danger. The share of imported gas in the forthcoming 20 years in the EU has already been mentioned above. This means the task has not been correctly defined. Europe urgently needs to seek additional, but not alternative sources of supply. The objective should be new gas, not diversification. Whereas these seem to be one and the same thing, in reality, from a political point of view, these are absolutely different approaches. The first approach means that Europe's main task is to get rid of dependence on Russia. The second approach means that the enemy is not Russia, but a growing deficit of gas. This is why the task is not to reduce consumption of Russian gas, but to find opportunities to get gas from other countries, since Russian gas alone will not satisfy the EU demand for this fuel. Besides, dependence on Russian gas is highly exaggerated: Russia's share of the European gas market has rarely exceeded 25 percent; in the first quarter of 2009, Russia was even outpaced by Norway. However, nobody in the EU has complained about the Norwegian threat.

Energy efficiency and the development of renewable sources of energy have been especially popular ideas in Europe over the past year; these ideas are reflected in the 20-20-20 concept. On the whole, the direction is correct. However, these grandiose prospects of new kinds of energy strongly resemble plans for building communism in the USSR by a particular year. The 20-20-20 strategy is unrealistic, given the envisaged period. This implies that the demand for gas will be quite high in Europe.

Indeed, this is the main problem in *Nabucco*. Even if this gas pipeline is built, it will not solve the problems of providing Europe with gas. Its capacity is too small – just 31bn cubic meters. All the other issues the Russian side highlights are, in fact, secondary, though they are sound. These are issues related to a resource base, security of transit and the inevitably growing role of Turkey, which is unlikely to satisfy all countries in the south of Europe.

According to plan, the first line of *Nabucco* will deliver gas from Azerbaijan (about 7bn to 8bn cu m per year), Iraq (7bn to 8bn) and Egypt (about 1bn to 2bn). However, even if the second phase of the Shakh Deniz deposit in Azerbaijan is launched at its full capacity and Baku finally refuses to sell large amounts of gas to Gazprom, Azerbaijan is unlikely to fill *Nabucco*'s first line independently. Therefore, *Nabucco* shareholders will depend too much on Iraq, and this is too risky because, as nobody has a long-term understanding of developments in Iraq and whether the level of political stability in this country will be sufficient to secure the gas pipeline's operation. In the long-term perspective it will be necessary to negotiate with Iran, but it is hard to foresee developments in this state.

Nabucco and Southern Corridor



Source: Nabucco Gas pipeline GmbH

Russia suggests another project – *South Stream* - viewed as *Nabucco*'s competitor given the EU's position in this regard. This situation is most dangerous: Europe is at the verge of gas deficit and in such a situation any gas pipeline would be useful. Instead, however, *South Stream* and *Nabucco* are opposed to each other, yet competition between them can hardly be called sound. As a result, each project is aimed against a competitor, rather than promoting its own advantages. Unfortunately, this concerns Russia's policy too; however, such developments only increase the energy risks for Europe.

Moreover, in Eastern Europe there is a paradoxical situation. *South Stream* and *Nabucco* have been competing for transit routes; and some countries have realized that they have a good opportunity to obtain concessions from both projects. As a result, the interests of separate countries are prevailing over common European interests.

South Stream



Source: Gazprom

To date, Eastern European nations have been trying to put pressure on Russia through *Nabucco*. However, this situation may be reversed later. In particular, Bulgaria's new PM Boiko Borisov, leader of the GERB party that won the latest elections, spoke about a need to suspend negotiations with Russia on the *South Stream* project. He made the statement, despite the fact that the Bulgarian president Georgi Purvanov had signed an agreement on participation in *South Stream* in June 2007, which was ratified by the parliament in July 2008. Moreover, Russia has opted for the Bulgarian option, over Turkey and Romania, which would provide Bulgaria with the possibility of earning over €300m on transit fees annually.

It is quite possible that this is merely 'blackmail', which will, however, require additional efforts on the Russian side to ensure the loyalty of Bulgaria's new leadership. The situation with Serbia is similar. Srbijagas' general director, Dušan Bajatović, declared his country would participate in *Nabucco* if a corresponding proposal is forthcoming, despite the fact that Belgrade is still perceived in Moscow as Russia's ally in the Balkans and Serbia is expected to be the major beneficiary (proportionally to its size and population) from the implementation of the *South Stream* project.

The logic of Bulgaria and Serbia is quite simple – they realize that Russian premier Vladimir Putin is already involved in the south European gas pipelines straggle and wants to win at any cost. Under such conditions, a transit country can really gain funds or benefits by bargaining with the Russian PM. However, for Russia and Gazprom, the policy of fulfilling the task at any cost may turn out to be dangerously expensive. What is very important for Putin is to show he has achieved the goal and has done things his way. This situation is fraught with mistakes, and Europe, for the same reasons, will lose, not benefit. Considering the predicted gas shortage it is important to implement the maximum number of realistic projects. Moreover, laying a pipeline is a long and expensive procedure.

Besides, Putin could respond to blackmail by changing the route of *South Stream*. On August 6, Putin signed a protocol on cooperation in the gas sector with Turkey, according to which Turkey allows Russia to conduct surveying within the framework of the *South Stream* project in its territorial waters. This could imply that in the future Russia may return to the idea of *Blue Stream-2*. *South Stream*, in fact, replaced *Blue Stream-2* some time ago and now the opposite may happen. However, this is unlikely to be beneficial for either Russia or the countries in South-Eastern Europe.

Main conclusions

Russia is interested in strengthening its presence in the energy sector of South-Eastern Europe. However, this should not be considered as a threat to Europe or a politically motivated step. The largest supplier and the largest consumer should drop mutual political accusations and start more active economic cooperation as soon as possible. Russia and the countries in South-Eastern Europe have positive experience of direct investments in oil refining projects, but over the past few months any move, even by private Russian companies, is given a political interpretation. Such an approach could block growth in capital investments in the region's energy sector, which will badly affect countries in the southeast of Europe.

In turn Russia should focus on improving the transparency of its business. This mainly concerns the gas industry and there have been several scandals in the region related to the system of gas sales. In particular, in late October 2008, the issue was raised about the operations of an intermediary in gas deals between Russia and Yugoslavia. Yugorosgaz, controlled by Gazprom, received an annual fee totaling €35m (a 5 percent of the total volume of supplies) and resulted in resignation of Srbijagas head Sasha Ilic.

Later, Gazprom and Serbia agreed on a number of additional documents within the framework of an intergovernmental agreement on cooperation in the energy sector. The sides agreed that Srbijagas would increase its stake in the Yugorosgaz Joint Venture from 25 percent to 49 percent and Gazprom would retain 51 percent.

Bulgaria is concerned about another intermediary - Overgas Holding Inc. This is a joint venture of Gazprom and Overgas Holding AD, established in 1995 on a parity basis. Gazprom's stake is 50 percent; Overgas Holding AD - 50 percent. The company is engaged in the construction and maintenance of transit and main gas pipelines in Bulgaria and participates in the sales of gas to that country. Bulgaria has raised the question of removing the agent, but Gazprom has insisted on retaining it to date.

It appears that the institution of intermediaries will gradually disappear in the future, which should increase trust between parties. An optimal strategy would be for Russia to improve the transparency of its business in Europe, while the Europeans decrease the level of political exploitation of this topic. I believe the most reasonable way to bring common sense back into cooperation between Russia and South-Eastern Europe is the economization of our energy dialogue. This is why the mistakes made at present could be extremely expensive for all concerned.