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The EU-Russia Centre cooperated with the OGE (Oil, Gas & Energy Law Intelligence) Journal in preparing a special issue on EU-Russia Energy relations. This special issue publishes papers from distinguished authors which cover a number of key areas:

- The ECT and Investment Arbitration
- Energy Relations between EU and Russia
- Implications of EU Energy Law and Policy on Russia and Gazprom
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This EU-Russia Centre Review contains selected papers from the Journal. A full list of contents is listed overleaf.
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EU-Russia Energy Relations: Common Goals and Concerns

by
Andris Piebalgs

Energy Commissioner, European Commission

The European Union and Russia are important strategic partners. Russia is Europe's third biggest trade partner and Russian supplies of oil and gas assemble a large percentage of its export to Europe. The EU and Russia cooperate on a number of challenges, both on international and local level and share a great deal of common interests and concerns. The relationship is one of interdependence not dependence, which means that Russia needs us as much as we need Russia. This offers both sides powerful motivation to put our energy relations on a predictable and concrete basis. We want to develop and further strengthen our relations with Russia based on the principles of reciprocity and transparency.

Russia is indeed the most important energy supplier to the European Union and European companies are its key foreign investors and it is in our mutual interest to continue this trend. Russia has the world's largest known natural gas reserves and its oil and gas deliveries represent more than 25% of the EU's consumption. What's more, sales of Russian raw materials to the EU contribute to over 40% of its federal budget and the EU represents almost 80% of cumulative foreign investments in Russia. This clearly shows our interdependence and creates a common ground for future cooperation.

Although the EU has to diversify its energy sources and suppliers, the share of Russian gas and oil in the EU market will remain high in the next 20–25 years due to the geographical closeness of Russia to the EU, the existing transport infrastructure and the energy cooperation based on long-term agreements. In this respect, the EU is working together with Russia towards diversification of delivery routes of gas to Europe, creation of new pipelines, development of new gas storages and LNG facilities. Both sides strongly support the cooperation of the EU and Russian oil and gas companies on such projects as Stockman gas field, Burgas–Alexandropoulos oil pipeline and the Nord Stream gas pipeline.

The partnership between Russia and the EU represents an important component of stable mutual relations. The Partnership and Cooperation Agreement (PCA) concluded in 1994 between Russia and the EU indicated a few cooperation areas in the energy sector. Since then both parties are working together inter alia in order to improve the security of energy supply, to develop management and regulation of the energy sector, to promote energy saving and energy efficiency, to modernise energy infrastructure and to limit the environmental impact of energy production. What's more one of the main objectives of the PCA is investment and trade promotion as well as the development of harmonious economic relations between the parties.
Today we are negotiating a new agreement with Russia, whose main purpose is to create a transparent and predictable relationship. The agreement could also be a great reflection of the importance of the energy sector in EU–Russia relations. Therefore I believe that the agreement should inter alia address such important issues as security of energy supply and sustainability and reliability of the production, distribution and transportation.

We are also cooperating in the framework of the EU–Russia Energy Dialogue, launched at the EU–Russia Summit in Paris in October 2000. Its main objective is to promote trust and transparency in the EU–Russia energy relations, evaluate trade barriers and obstacles to energy investments and market development. The dialogue is a real potential for further development from which both sides could benefit, therefore it is important to further deepen this cooperation.

One of the main challenges faced by the EU is the security of energy supply and by Russia the security of demand. Since the recent gas crisis that occurred between Russia and Ukraine at the beginning of 2009, security of supply has even more become a critical issue. The conflict has had a negative impact on the image of both Ukraine and Russia.

Whatever we think about the origins of the conflict, it is very important that the dialogue between Russia and the EU continues. I believe that Europe as well as Russia cannot afford another disruption of supply. Therefore the EU, Russia and Ukraine must cooperate in order to ensure uninterrupted and guaranteed supply and transit of Russian gas to the European consumers in the long term perspective. The European Union needs to ensure that the existing energy infrastructure is optimised and fully utilised. Consequently it is crucial to have an open dialogue with Russia and Ukraine as well as with other interested parties about upgrading existing infrastructure.

I believe that in the light of the recent crisis we need to put in place a conflict resolution system that facilitates governments’ and industry’s search for a swift solution to the dispute, before any harmful action is taken. A first step towards this could be an enhanced Early Warning Mechanism and a legally binding resolution mechanism, in order to avoid any repetition of the recent crisis.

Improving energy efficiency in all sectors of economy and increasing the share of renewable energies’ use is also an important part of the EU and Russia cooperation. Russia has an enormous potential for cost-effective reduction of greenhouse gas emissions. In 2008 Russia and the European Union have made a considerable effort in the area of primary energy saving and renewable energy. The cooperation concentrates mainly on further development of the legislative, institutional and financial framework in the field of energy efficiency. There is a large untapped potential in the field of energy efficiency, energy savings and renewable energy in the EU as well as in Russia that still remains to be realised. What’s more, the EU and Russia are currently developing the EU–Russia Energy Efficiency initiative which goal is inter alia to reduce the impact of the environment by introducing new energy efficient and environmentally
clean technologies and renewable sources of energy. The initiative is also promoting usage of the Kyoto protocol mechanism to improve the energy and efficiency indicators.

To conclude, I would like to underline the fact that with regard to energy cooperation, Russia and Europe do share a great amount of common goals and concerns. The EU and Russia have joint interests in building a long-term strategic energy partnership. Such cooperation could provide confidence, security and predictability in the long term to both sides. This and the greater transparency in energy relations with Russia will pave the way for the necessary long-term investments on both sides in the transport infrastructure and the construction of new facilities including upstream ones. Therefore the transition from the basic trade in energy to a wider cooperation based on joint investments is crucial for the future of energy supply to Europe. Russia is a very important European partner and considering the existing interdependence in the energy sphere it will remain so in the next decades.
EU-Russia Energy Dialogue at the Origins of the European Foreign Energy Policy

by

Mr. Ferran Tarradellas Espuny

Spokesperson for Commissioner Piebalgs

INTRODUCTION

Russia is the world’s largest producer and exporter of natural gas and together with Saudi Arabia also the largest producer and exporter of oil. Russia controls more than 20% of the world’s known gas reserves and 5% of proven oil reserves. Energy products represent more than 60% of Russia’s overall exports to the EU, equal to more than €60 billion annually (60% of Russia’s oil exports and 50% of gas exports go to the EU). The Russian Federation is also the EU’s most important single supplier of energy products. Over a quarter of gas and oil consumed in the EU originates in Russia.

A significant share of Russia’s economic growth in recent years can be attributed to increased production and exports of energy products, supported by high world prices and recently favourable terms. The share of the energy sector of the Russian economy as a whole has already grown to approximately 25%, approaching levels of some of OPEC countries. The Russian economy, including the federal budget, continues to be largely dependent on the export of hydrocarbons.

At the same time, Russia is the EU’s most important single supplier of energy products, already supplying about 25% of the EU's total oil consumption and about 25% of overall natural gas consumption. The trade is also of immense importance to Russia, accounting for over 60% of exports and about 25% of government revenues. Russian energy supplies to the EU are expected to grow further in the future, though there are concerns about "supply gaps", notably for gas, because of insufficient investment.

These figures illustrate the importance that from both side of the border, the sector of energy has in the bilateral energy relations. It is not by chance that in the bilateral relations of the two neighbours energy got a special treatment. On the occasion of the sixth EU-Russia Summit (30th October 2000, Paris), it was agreed to institute an Energy Dialogue on a regular basis between the EU and Russia to enable progress to be made in the definition and arrangements for a EU-Russia Energy Partnership.

OBJECTIVES AND FUNCTIONING OF THE EU – RUSSIA ENERGY DIALOGUE

Objectives

The overall objective of the energy partnership was to enhance the energy security of the European continent by binding Russia and the EU into a closer relationship in which all issues of mutual
concern in the energy sector can be addressed while, at the same time, ensuring that the policies of opening and integrating energy markets are pursued. With the strong mutual dependency and common interest in the energy sector, this was clearly a key area of EU-Russia relations.

In a first face the energy dialogue aimed at improving the investment opportunities in Russia's energy sector in order to upgrade and expand the energy production and transportation infrastructure as well as improve its environmental impact, to encourage the ongoing opening up of energy markets, to facilitate the market penetration of more environmentally friendly technologies and energy resources, and to promote energy efficiency and energy savings.

The dialogue was a novelty in the way the Commission was dealing with International energy relations. Actually, the Green Paper on Energy Policy of 2000\(^1\), probably the first strategic paper on energy policy in the history of the European Union, developed the idea of the dialogues, which had to follow later on with other key countries.

The Green Paper already made clear that the political and economic influence of Europe had to use in order to ensure flexible and reliable external supply conditions. "The European Union must establish an ongoing dialogue with producer countries and not only in response to major movements on the market. This will lead to greater transparency on the market and obtain stable prices. It is important to be aware of the expectations of several producer countries regarding political developments in the Middle East. Such dialogue must facilitate the improvement of pricing mechanisms, the conclusion of agreements and the use of reserve stocks for mutual benefit."

The idea of the mutual benefit was key to the structure of the idea of the dialogue. For instance the green paper mentioned that the dialogue "should be extended to all matters of common interest, in particular protection of the environment (flexibility mechanisms) and technology transfer". The European Union was prepared to mobilise European technical assistance to facilitate European investments in transport and production in the energy sector (oil, natural gas and electricity), study legal framework for investments in the energy sector, questions relating to taxation or a guarantee mechanism for investments.

However, initially the dialogue was seen as step towards a more ambitions energy cooperation within the framework of a co-operation and partnership agreement between the European Union and Russia. This idea has been retaken in the current negotiations for the next PCA.

**Other energy dialogues**

The idea of the energy dialogue with Russia has been the basis for the development of similar processes with other key players in the European Union. For instance in a similar basis there is a permanent dialogue with Norway (06/07/2005) and with the OPEC (09/06/2005) or Brazil\(^2\)

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\(^1\) Green Paper – "Towards a European strategy for the security of energy supply"; COM/2000/0769 final
(05/07/2007). With other countries the approach has been the signature of Memorandums of Understanding as the founding stone of a closer energy co-operation. This is the case of Ukraine (01/12/2005), Azerbaijan (07/11/2006), Kazakhstan (04/12/2006), Turkmenistan (25/05/2008), and there are negotiations to sign a similar MoU with Algeria.

It cannot be considered as exaggerated that the success of the bilateral Energy Dialogue EU-Russia has set the tone for the way that the EU is conducting the bilateral co-operation in the field of energy, and the tendency is to exploit this line even further.

As a matter of fact, so was recognised in the 2006’s Green Paper - A European Strategy for Sustainable, Competitive and Secure Energy, which marked the European Energy Strategy under the Barroso's Commission.

"The EU and its energy partners are interdependent. This is reflected at bilateral and regional level in a number of specific EU energy dialogues with a number of producer and transit countries. Equally, energy issues are a growing feature of the EU’s political dialogues with other major energy consumers (such as the US, China and India), including through multilateral fora like the G8. These dialogues should be set within the common vision offered by the Review."8.

However, immediately it stated that in the case of Russia, "our most important energy supplier, it was necessary to move forward towards a real partnership in the framework of the next PCA.

"The EU has an established pattern of relations with major international energy suppliers including OPEC and the Gulf Cooperation Council. A new initiative is particularly opportune with regard to Russia, the EU’s most important energy supplier. The EU, as Russia’s largest energy buyer, is an essential and equal partner in this relationship. The development of a common external energy policy should mark a step change in this energy partnership at both Community and national level. A true partnership would offer security and predictability for both sides, paving the way for the necessary long-term investments in new capacity. It would also mean fair and reciprocal access to markets and infrastructure including in particular third party access to pipelines. Work should start on an energy initiative based on these principles.

Subsequently the results could be integrated into the framework of EU-Russia relations due to replace the current EU-Russia Partnership and Cooperation agreement in 2007. In addition, efforts

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4 http://ec.europa.eu/energy/international/international_cooperation/doc/mou_azerbaijan_en.pdf
5 http://ec.europa.eu/energy/international/international_cooperation/doc/mou_kazakshtan_en.pdf
6 http://ec.europa.eu/energy/international/international_cooperation/doc/mou_turkmenistan.pdf
7 SEC(2006) 317
8 "Green Paper – A European Strategy for Sustainable, Competitive and Secure Energy" (pg. 15)
should be intensified in the G8 to secure rapid ratification by Russia of the Energy Charter Treaty and conclusion of the negotiations on the Transit Protocol⁹.

As we will see, the question of the Energy Charter and the Transit Protocol will be discussed once an over again along the different meetings of the dialogue.

**Functioning**

The functioning of the EU-Russia energy dialogue is based on several working levels.

**The Permanent Partnership Council (PPC)**, comprising the Russian Minister responsible for Energy, the Energy Commissioner, and the Minister responsible for Energy from the current Presidency and the next Presidency. It is up to the EU Presidency to convey an Energy PPC.

The last ministerial meeting of the EU-Russia Permanent Partnership Council on Energy (PPC) was held in Paris on 8th October 2008 in the presence of Jean-Louis Borloo, State Minister of Ecology, Energy, Sustainable Development and Spatial Planning, Andris Piebalgs, European Commissioner for Energy, Serguey Shmatko, Energy Minister of the Russian Federation, and Martin Riman, Minister of Industry and Trade of the Czech Republic.

Actually this is just the third time that a PPC is convened in the almost 9 years of energy dialogue.

The Finnish Presidency conveyed the previous in December 2006. And the upcoming Czech Presidency has already expressed its interest in having one the first half of next year.

**The Coordinators**

At the political level, regular contacts are maintained by the *Coordinators of the Energy Dialogue*, Commissioner Piebalgs and Minister Shmatko. Initially the Coordinators of the dialogue were the Director General of DG TREN, François Lamoureux (endorsed by President Prodi) and the Russian Energy Minister Viktor Khristenko. The Coordinators normally meet twice per year. At working level, regular contacts are maintained between Commission and Russian Ministry of Energy officials.

**Working groups**

At technical level, the dialogue is structured in working groups, which have been evolving with the time.

Following the last PPC in December 2008, it was agreed to restructure the *Energy Dialogue Joint Thematic Groups* (until then Investments, Infrastructure, Trade and Energy efficiency) into

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⁹ Ibidem

The Thematic Groups involve experts nominated by the Member States and Russia, from the European industrial federations (IFIs) and from the Commission. Organisational work in each Thematic Group is handled by a Secretariat, which consists of representatives of the European Commission's Directorate-General of Energy and Transport and of the Ministry of Industry and Energy of the Russian Federation. The groups are co-chaired by a EU Member State and a Russian official, with the Commission (DG TREN) ensuring the Secretariat.

In addition, the EU-Russia Industrialists Round Table often covers energy issues and typically meets back-to-back with other Dialogue events.

**Priorities of the four thematic groups**

- The Group on Energy Strategies, Forecasts and Scenarios\(^\text{10}\) has been set up to exchange views on the EU and Russian strategies, policies and forecasts in the energy field, to develop bilateral energy information systems. The first meeting of the Working group took place on 26th September 2007 in Moscow, the second on 22nd May 2008 in Brussels.

- This group has a Subgroup on Energy Economics, very much focused on the balancing between gas demand and production capacity, the so-called, energy gap.

- The Group on Market Developments\(^\text{11}\) aims at promoting trust and transparency in the EU-Russia energy relationship through exchange of information on current and planned legal, regulatory and policy developments impacting energy markets, trade and investment in the EU and Russia. It also promotes increased security and predictability of energy markets in the supply, demand and transit sectors, especially through its contribution to the Early Warning Mechanism, that I will explain later on. The first meeting of the Working group took place on 18th September 2007 in Moscow, the second on 20th May 2008 in Brussels.

- A Subgroup on Investments was established and is focusing mainly on barriers to investments and enhancement of the investment climate. A Subgroup on Infrastructure is currently establishing its work programme.

- The work of the Group on Energy Efficiency\(^\text{12}\) is focused on exchange of information on legislative and regulatory frameworks, sharing the experiences and knowledge, and cooperation


on concrete projects in the field of energy efficiency and energy savings, gas flaring, renewable energy sources. The first meeting of the Working group took place on 27th September 2007 in Moscow and the second took place on 11th April 2008 in Brussels.

Progress achieved under the Energy Dialogue

The Dialogue continues to be a valuable tool for enhancing EU-Russian energy relations providing that there is commitment on all sides - the Russian government, Commission, EU Member States and industry and that the Dialogue has the political impetus provided by energy PPCs. The practical results of the dialogue are reflected in the so-called "Progress Reports, which are normally adopted in the PPCs or in the meeting of the Coordinators of the dialogue (normally the reports are signed by them).

Progress reports

Currently there have been 9 progress reports\(^\text{13}\), the last of which I would like to comment further on. The progress reports allows having an overview of the job realised by the thematic working groups, and the participants in the dialogue, including Russian governmental bodies, the Commission and EU Member states, International Financial Institutions such as the EIB and EBRD, and a wide variety of EU and Russian energy companies. The Progress reports also set the working program for the coming year.

Main elements of the energy dialogue

One of the most positive elements of the energy dialogue was that it identifies the issues that were going to be of mutual concern and work on common approaches to address those issues.

It is therefore not surprising that the thematic groups before the modifications of 2008 were based in the questions of investment, infrastructures, trade and energy efficiency. There was an element that has been always present in the bilateral energy dialogue in which both, Russia and the Commission have shown that joint work can lead to concrete results. I would like to underline some of the main elements addressed in the framework of the dialogue.

Investments

The question of investments has always been one of the key elements from the European side.

The need for substantial investments in the Russian energy sector and noted in some of the progress reports, including the joint examination of barriers to investment in order to encourage Russia to address them in a practical manner. Rapid recent growth in Russian oil and gas exports has been largely the result of a return to full use of the existing infrastructures within Russia

\(^{13}\) http://ec.europa.eu/energy/international/bilateral_cooperation/russia/progress_reports_en.htm
following the reduction in domestic demand in the 1990s. However, with growing domestic energy demand within Russia combined with a continuing demand on the world market in general and in the European in particular, there is now a very pressing need for investments into the Russian energy sector. These strategic investments over the next ten years will need to be at a financial scale, technological complexity and with a risk factor far outweighing all those of the past decade.

In the conclusions of the 9th progress report, the Energy Strategies and forecasts group identified possible scenarios of demand and production and the possibility of the existence of a possible "gap" between demand and production. According to EU's baseline scenario the annual gas demand of gas between 2005 and 2030 was expected to grow from 500 billion cubic meters (bcm) to 575 bcm. With most of the European fields in decline, most of this consumption would have to be imported. Russia forecast for natural gas exports to Europe, including CIS countries in 2030 was estimated in between 210 and 225 bcm per year, but Russia made it clear that "the guaranteed volume of Russian gas exports would depend on the contracted demand for Russian gas on the side of European consumers".\textsuperscript{14} It is clear that both parties are looking for security (of supply on the EU side and demand from the Russian side) and that clear understanding of what demand and supply will be in the future is of the utmost importance. In this sense the existence of the Energy Strategies and Forecast group has proven its added value.

**Markets**

The creation of a working group focused on markets indicates the importance that this issue on the bilateral dialogue. In fact one of the reasons for this interest was the proposal in September 2007 of the third package of measures for the liberalisation of the European Internal Market for Energy\textsuperscript{15}. The package raised concern in the Russian side for the inclusion of safeguards to ensure that in the event that companies from third countries wished to acquire a significant interest or even control over a EU network, they will have to demonstrably and unequivocally comply with the same unbundling requirements as EU companies. The so called "third country clause" was seen as a limitation of future investments of Russian companies in the European market.

From the European side the Federal Law "On procedures regulating foreign investment in sectors of the economy having strategic importance for state defence and security", was also a cause of concern, particularly for the future of European investments on energy sector.\textsuperscript{16} In this sense the dialogue has proven useful in order to have a clear interchange of visions and to avoid many misunderstandings from both sides. Certainly the development and the implementation of both laws will make necessary a further interchange of information.

\textsuperscript{14} EU-Russia energy dialogue, 9th Progress Report (pg. 3)  
\url{http://ec.europa.eu/energy/international/bilateral_cooperation/russia/doc/reports/progress9_en.pdf}  
\textsuperscript{15} \url{http://ec.europa.eu/energy/gas_electricity/third_legislative_package_en.htm}  
\textsuperscript{16} An interesting article addressing this issue. "Genesis of Economic Nationalism in Russia" by professor Kari Liuhto. Electronic Publications of Pan-European Institute 3/2008. ISSN 1795-5076. \url{http://www.tse.fi/pei}
Both parties agree that "a favourable climate for investments in the development of the energy sector will be mutually beneficial for both sides". In this sense, in the conclusions of the 9th progress report both parties "positively view the process of liberalisation of the power sector in Russia. (...) It represents a significant step forward in the creation of compatible energy markets between the EU and Russia". This cooperation of course, needed the technical compatibility of the Russian IPS/UPS power network system with the European counterpart, the UCTE. The "feasibility study" on the possible synchronisation of both systems has been one of the main outcomes of the bilateral energy dialogue. Actually the final conclusions of the study were presented in the last PPC. The main conclusion of the study was that while a long-term solution (synchronous interconnection) was technically possible, in the short-term direct current links could be identified between the countries of the interface.

**Infrastructures**

Bearing in mind the foreseen growth in EU energy demand, the importance of upgrading and enhancing existing energy infrastructures and promoting the development of new infrastructures has been one of the main topics of discussion. The dialogue served as a forum for studying the obstacles to the optimal utilisation of the existing oil transportation infrastructure and identifying key new projects.

The two parties approved the proposals that further work should concentrate, inter alia, on:

- Avoiding that costly infrastructure is underused; to that effect, undertake further joint analysis of the existing oil transportation infrastructure, the need for upgrades and new projects to address, in particular, the issue of congestion in the Bosphorus, and the need to address interruptions of supply in the Druzhba (LT) and Ventspils (LV) oil pipelines.
- Examination of the obstacles of the optimal utilisation of the existing oil-loading terminals in the Baltic and Black Sea regions.
- The harmonisation of existing standards and regulations for pipeline systems, and the possibility for joint action (joint inspections, mutual assistance) for accident prevention and rapid response to accidents.
- Addressing the issue of gas flaring and encouraging the more efficient use of gas within Russia.
- The options for practical co-operation in investment projects to extend and modernise the Russian electricity infrastructure and the possible use of the Kyoto flexible mechanisms for fostering the construction of new, more efficient, thermal power plants and for modernising existing plants.

But the parties also identified joint projects of mutual interest that have to move forward. The Conclusions of the 9th progress report identified particularly three:

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17 EU-Russia energy dialogue, 9th Progress Report (pg. 5)
18 EU-Russia energy dialogue, 9th Progress Report (pg. 4)
The development of the Shtokman gas deposit

The construction of Burgas – Alexandroupolis oil pipeline

The implementation of the joint natural gas transportation project, including North Stream and others."

The formula used by the conclusions of the progress report ("and others") indicates the different priority that Russia and the EU give to the South Stream project that some media consider to be a competitor to the European led pipeline "Nabucco".

It is important to mention that the European Commission has never opposed publicly the development of South Stream (in which ENI and other European companies have expressed their interest in participating), but it does not consider it to be a priority.

**Energy efficiency**

Energy efficiency has been on the main elements of the dialogue since its very beginning. The Commission has identified energy efficiency as the main priority of European energy policy.

One of the three famous 20-20-20 objectives of the Energy and Climate action plan is precisely the 20% energy savings by 2020. The first paper presented by the Commission in its new Energy Strategy was precisely the Energy Efficiency Action Plan (November 2006)\(^\text{20}\).

The interest of energy efficiency is share by both parts for different reasons. First of all there is the common objective of Climate Change prevention. Experts (IEA, for instance) recognise that one of the main ways to achieve CO2 reduction is improving energy efficiency and energy savings. In the case of Russia, there is a big interest to decouple economic growth with energy demand, which has put the supply system for both gas and electricity under certain pressure.

There is of course the question of security of gas supply, since a reduction of demand in the European side would mitigate the rapid depletion of European gas fields, and on the Russian side would reduce the tensions in gas production capacity of growing external and internal demand.

Finally, there is a big interest from both sides to reduce the amount of gas flared in the Russian oil producing facilities, in order to reduce CO2 emissions and increase gas production. Russia is currently flaring more than 24 bcm of gas per year (around 26% of the associated gas coming from oil dwells). Both parties agreed in increasing efficient use of associated bas in Russia from 74% in 2008 and 90.8% in 2010.

\(^{19}\) Idem.


The Thematic group on Energy Efficiency has been one of the most actives, with wide exchange of information between both sides, and with concrete projects, with the idea to move towards a EU-Russia Energy Efficiency Initiative. Three events were organised in the framework of the EU-Russia Thematic Group on Energy Efficiency on 28 and 29 February 2008 in Moscow:

– Joint Meeting of the EU-Russia Thematic Group on Energy Efficiency and the EU-Russia Climate Change Subgroup.
– Presentation of the EU Climate Change and Energy package to the public and the mass media of Russia (Joint presentation of DG ENV and DG TREN).

EU–Russia consultations on legislation on energy efficiency and support for the use of renewable energy sources.

The meeting of the Thematic Group took place on 11 April 2008 in Brussels. Implementation of the EU – Russia Energy Efficiency Action plan and the Action programme for 2008 and 2009 was discussed. Russian side gave presentations on latest developments on gas flaring reduction in Russia and on concrete proposals for EU - Russia cooperation projects. EU side presented the EU standardisation system and the ODYSSEE project (energy efficiency and CO2 indicators). The common agreement was that the EU – Russia Energy Efficiency Action Plan, adopted in 2006, has been fully implemented.

Important areas of cooperation in the Action plan 2008 and 2009 will be:

– Legislation consultations on energy efficiency and on support for the use of renewable energy sources, including the draft laws and draft sub laws;
– Joint projects on energy efficiency, renewable energy, and the use of associated petrol gas, cooperation at the federal level as well as the regional level;
– Exchange of information on promotion of investments in energy efficiency, energy savings (including gas-flaring reduction) and renewable energy. Sharing of experience and promotion of practical cooperation on energy efficiency statistics, indicators, standardisation and certification, investments in energy efficiency, energy savings and renewable energy (workshops, seminars).

In 2008 and 2009 the work of the Thematic Group will be supported by the following EU – funded projects:

– TACIS project on renewable energy and rehabilitation of small scale hydropower plants (€ 2 Mio, started in September 2007, will support the federal government and the regions of Astrakhan, Krasnodar and Nizhniy Novgorod);
– TACIS project on the reduction of GHG emissions in Russian regions (€ 3 Mio, the call for tender closed on 7 April 2008);

EU-Russia energy dialogue, 9th Progress Report (pg. 6).
Northern Dimension Environment Partnership projects under preparation on rehabilitation of
district heating in Kaliningrad (€ 7.3 Mio, in cooperation with the EBRD), Murmansk (€ 5 Mio, in
cooperaition with the Nordic Investment bank) and in Novgorod (€ 2 Mio for improvements to
the city’s wastewater, solid waste and district heating utilities, in cooperation with the NIB as well)

A €2.8 million EU-funded project on energy efficiency in Arkhangelsk, Astrakhan and Kaliningrad
regions was successfully completed in December 2007. Currently the two parties are discussing
possibilities to organise follow-up seminars in other regions of Russia in order to disseminate the
experience and the results of this project (particularly on elaboration of energy balance and
capacity building on investments in energy efficiency).

Early Warning Mechanism

An Early Warning Mechanism (EWM) was agreed in principle in May 2007 at the EU-Russia Summit
(Samara; confirmed at Mafra Summit). EWM is based on procedures for the Parties to receive and
exchange analytical information regarding potential problems and ways of resolving them. The
mechanism utilises existing modalities of cooperation in the framework of the Thematic Group on

In 2008 steps were taken to make the decision operational, notably by the appointment of
designated officials (Vice minister Yanovski on Russian side, Christian Cleutinx for the
commission); the agreement in Terms of Reference for Energy Market Developments' Group to
include evaluation of short term problems related to EWM and trade issues; the agreement to
include evaluation of middle and long-term problems - technical, commercial, and political for oil
and gas supply and demand in Terms of Reference for the Energy Strategies Group.

In the Conclusions of the last PPC, the parties agreed to consider the possibility of associating
energy transit countries to the EWM "in order to ensure the stability of existing transport networks
and foster international cooperation in construction of new transit capacity"22. There is in
preparation a seminar to advance in the development of the EWM.

CONCLUSION

The EU and Russia have expressed satisfaction about fruitful and continued cooperation under the
Energy Dialogue as it provides the appropriate framework for frank and objective exchanges on
issues of common interest in the field of energy cooperation. They praised active participation of a
wide range of experts, from the Commission, EU Member States, Russia, European and Russian
energy companies and IFI's. The continuation of the Dialogue represents an interest shared by both
sides.

22 Idem (Pg. 8)
The structure of the dialogue, in different levels (PPC, Coordinators, Working Groups and Early Warning Mechanism) has created an structure that allow for regular contacts at technical and political level, which allow to scale up decision making process when necessary. At the same time the existing of technical working groups has allowed for clear progress in concrete projects, like the UPS/IPS – UCTE interconnection study or the energy efficiency projects.

**Future of the dialogue**

In the last PPC both sides agreed on the idea to set up a High Level Group to steer the Energy Dialogue and expressed the need to elaborate further on a concrete set up.

The Russian side expressed the wish to expand the scope of the Energy Dialogue, to strengthen its high level steering and increase the frequency of meetings. It also expressed the wish that the Energy Dialogue becomes a platform for support to contacts between EU and Russian companies and plays an educational role. The Russians side also expressed the wish that the Energy Dialogue focuses more on investment conditions in Russia.

The EU and Russia agreed on the need to strengthen the Early Warning Mechanism and to invite transit countries to participate. The EU suggested to create a core group while the Czechs underlined that further development of the Early Warning Mechanism would be a priority for their Presidency.
The Politics of EU-Russia Energy Relations

by

Dr Fraser Cameron

Director, EU-Russia Centre

INTRODUCTION

There are few subjects as controversial and emotive as the energy relationship between the EU and Russia. On the one side, there are those who argue that the nearly 500 million EU consumers are very fortunate to have Russia as a huge energy provider as its neighbour. On the other side, there are those who argue this is a curse as it allows Russia to ‘blackmail’ European countries by threatening to turn off oil and gas supplies or by offering lucrative deals to European companies in an effort to ‘divide and rule’ the EU. Oil and gas are Russia’s biggest exports to the EU, and Russia is the EU’s biggest energy supplier. The EU is also the biggest investor in Russia’s energy sector. Russian gas accounts for a quarter of total EU consumption, and 80 per cent of this comes through Ukraine. For some EU countries the dependency is 100 per cent. But overall Russia only provides less than 7% of the EU’s energy needs. In terms of energy type, oil accounts for 37% of EU energy consumption, natural gas 24%, solid fuels 18%, nuclear power 14% and renewables 7%. It is thus important to maintain a sense of proportion when discussing EU-Russian energy relations. Russia needs the EU market as much as the EU needs Russian gas.

The EU-Russia energy relationship does not take place in a vacuum. It must be viewed against the wider backdrop of the geopolitical relationship between the West and Russia and the growing concerns about energy security that have propelled the subject to the top of the EU’s foreign policy agenda. The US sometimes pursues different approaches than the EU towards Russia and often seeks NATO support for its views. The US, for example, has a long history, dating back to the 1970s, of opposing closer energy links between the EU and Russia. Most EU members are also members of NATO but they sometimes speak with a different voice in each institution. Some EU member states even want NATO to play an enhanced role in energy security. The new US secretary of state, Hilary Clinton, has announced plans to appoint a personal representative for energy security amid reports that Washington is concerned about Europe’s over-reliance on Russian energy.

In recent years there has been a steady deterioration in relations between Russia and the West. Russia was vehemently opposed to NATO bombing Serbia and the West’s recognition of Kosovo. Moscow suspended the conventional forces in Europe (CFE) treaty, criticised the US planned missile deployment in Poland and the Czech Republic, and above all has tried to prevent Ukraine and Georgia joining NATO. The August 2008 conflict in Georgia led to Russian recognition of South Ossetia and Abkhazia, a move opposed by the EU and US. The Georgian conflict also raised concerns about the stability of pipeline routes in the Caucasus. There have also been disputes between the EU and Russia over human rights and trade issues. For several months Poland and
Lithuania help up the start of negotiations on a new EU-Russia agreement, demonstrating the lack of an agreed EU attitude towards Russia. These disagreements were also on display at the 2009 Munich security conference when the presidents of France and Estonia took very different positions on how to deal with Russia. At the same venue, the new US vice president, Joe Biden, said that it was time ‘to press the reset button’ with Russia and stated that the Obama administration was prepared to discuss all issues with Moscow.

This lack of an agreed EU policy towards Russia is a major complicating factor in the EU’s ability to negotiate with Russia. For some member states. Russia is the major security threat and the Georgia conflict should be regarded as a final wake-up call. For others, Russia is an essential partner in tackling global security threats such as Iran and the proliferation of WMD. The current relationship is based on the 1997 partnership and cooperation agreement (PCA) which both sides agree should be updated. But because of divisions within the EU it has been a long and difficult process just to start the negotiations. There is little doubt that energy cooperation will be at the centre of this new agreement which will likely take 12-24 months to negotiate and a similar timeframe to ratify. Although energy will be a key issue, it will not be easy to secure a deal given that the EU has no common energy policy and the two sides are starting from very different positions.

The splits in the EU are especially evident when it comes to the energy sphere where there is considerable difference in the dependency of EU member states on Russia. While some of the new member states such as Latvia and Bulgaria are almost completely dependent on Russian energy supplies, others such as Spain and Ireland receive no energy from Russia. But all member states were united in their condemnation of the most recent gas crisis involving Russia and Ukraine. This crisis affected millions of EU citizens and provoked yet another round of criticism and soul-searching. EU envoys shuttled between Brussels Kiev-Moscow but were baffled by the complete lack of transparency in the energy relationship between Russia and Ukraine. The EU and Russia have had an energy dialogue since 2000 but it has failed to head off a number of gas disputes affecting the EU. After the 2006 crisis, an early warning mechanism was established to ensure predictable supplies. But in the latest crisis the mechanism was simply ignored. EU leaders denounced the latest shutdown as ‘unacceptable’ and urged an acceleration of diversification of supplies.

British Prime Minister, Gordon Brown, said it was unacceptable that any nation should exert ‘an energy stranglehold over Europe.’ German Chancellor, Angela Merkel, urged the EU to support three new major gas pipeline projects (North Stream, South Stream and Nabucco - see annex). In a letter to European Commission president, Jose Manuel Barroso, she also called on the EU to press for European energy companies investing in Russia’s highly monopolistic gas sector to be given full rights. The negotiations on a new partnership agreement between the EU and Russia should also aim ‘to give our energy suppliers operating in Russia the legal security needed for extraction and production at gas fields.’ Merkel also stated that that interruption of supplies had ‘inflicted substantial economic damage on the EU and must not be allowed to recur.’
During his visit to Moscow, with nine fellow Commissioners, on 6 February 2009, President Barrosso also emphasised the damage that had been done as a result of the Russia Ukraine gas crisis and made it clear that it would take several years of sticking to its promises before Russia could be judged a reliable supplier again. He pressed Russia to ratify the Energy Charter and conclude negotiations to join the WTO as soon as possible. President Medvedev said that Russia might be ready to join the Energy Charter if it were reworked to take account of Russian concerns. Certainly the EU will wish to include in any new agreement bilateral rules for trade and investment, legal arrangements for conflict resolution, and closer cooperation on environmental issues. These issues will also be to the fore at the next EU-Russia summit on 19-20 May in Russia.

Russia has also used the crisis with Ukraine to emphasise the urgency of proceeding with both North Stream and South Stream. But these projects are highly controversial. Poland and the Baltic States accuse Russia and Germany of doing a deal behind their backs. Some of the Nordic countries are worried at the environmental aspects of a gas pipeline in the Baltic Sea. Some critics also argue that South Stream would compete with the EU backed Nabucco project that would bring Caspian gas via Turkey to the EU.

It is easier to talk about diversification of gas supplies than to take concrete action. The EU already receives gas from a number of different suppliers including Norway, Algeria, Nigeria and Qatar. But with the exception of Norway there are few stable areas from which to import gas. A much bigger problem is whether Russia can fulfil its contractual obligations to supply Europe with gas over the next decade. The neglect of investment in Russian energy infrastructure is now causing major problems.

Meanwhile the EU is struggling to agree on the principles for a common energy policy. The European Commission has given a lead in proposing measures to complete the internal energy market, reduce the consumption of energy and to diversify supplies. This debate will also be affected by the global economic crisis and the Copenhagen climate change review conference scheduled for the autumn of 2009. Seeking cooperation with Russia on climate change would be a useful way of broadening the dialogue into a win-win situation.

RUSSIAN ENERGY POLICY

Russia, with over 10% of global energy exports, is an energy superpower. But without renewed investment in infrastructure this superpower status will be in jeopardy. Russia already has to import gas from Turkmenistan to meet its needs. There are different forms of control of energy resources in Russia but the trend is towards greater state interference. While the coal industry in Russia is largely privatised; electricity is a mix of state and private control; oil is mainly state controlled and gas completely state controlled. Gazprom and Rosneft are essentially arms of Russia Inc.
On assuming the presidency, Vladimir Putin was quick to recognise the importance of energy as a political tool arguing that it was energy which ‘to a large extent determines the country’s place in geopolitics.’ According to the Russian Federation’s ‘Energy Strategy of Russia to 2020’ (August 2003), the energy sector was ‘an instrument for the conduct of internal and external policy’ and that ‘the role of the country in world energy markets to a large extent determines its geopolitical influence’. Putin quickly mastered the politics, economics and even the technical details of the energy industry. He also made it clear, by breaking up the respected Yukos oil company and imprisoning its chief executive, Mikhail Khodorkovsky, that he would allow no one to challenge his authority. A case brought by Yukos shareholders is due to be heard in the European Court of Human Rights this year with over 30 billion dollars in damages being sought. The continuing controversy over the Yukos case is major source of concern to those in the Kremlin.

By nationalising the oil and gas sectors, Putin also contributed to the relative decline in Russian energy output. These problems were hidden to some extent by the high price of oil in recent years, a trend that gave Russia the illusion of being a major economic power. For most of his tenure as president, Putin was able to profit from rocketing oil prices. But Putin failed to fulfil his own stated aim of diversifying the economy and now Russia is paying the price. Falling world energy prices have led to a slump in economic growth, rising unemployment, capital flight and a run on the rouble. But these developments have not so far changed Russia’s refusal to ratify the Energy Charter or the Transit Protocol. Russia wants access to EU markets for its energy companies but is not prepared to allow reciprocal arrangements for EU companies.

A number of leading Russian experts such as Vladimir Milov have expressed concern about trends in Russia’s energy policy. He argues that the Kremlin has unfounded optimism about the long-term benefits of energy led growth and has not taken into account vulnerability to price fluctuations. The move towards increased concentration and state control has also diverted focus from urgently needed reforms in the energy sector. The Kremlin’s policy has brought short-term prosperity and the appearance of success at the expense of Russia’s real long-term interests.

This appearance of success makes it exceedingly difficult for the EU to speak to Russia with authority, let alone persuade it that its approach needs adjustment. There are also very different views on what constitutes a market and on regulatory frameworks. To the Kremlin, markets exist even if they are monopolistic. But in EU eyes, monopoly is the antithesis of markets. To Russia, energy security is guaranteed by a strong vertical control the energy sector from extraction to the point of sale. From the EU’s perspective, it is guaranteed by an impartial and effective regulatory framework and by diversity with regard to source, supply, transport and sales.

The increasing state control of the energy sector in Russia has resulted in a delay to much needed reforms and investment. According to the International Energy Agency, Russia will not be able to meet either foreign or domestic demand without major restructuring, massive new investment and market liberalisation. But such investment is not taking place and in the oil sector the picture is no more encouraging. Gazprom has preferred to seek new downstream acquisitions abroad rather
than investing in domestic infrastructure. It is now searching for capital investment in Europe and the US.

Putin has always been ready to use energy as a political weapon abroad. The close historical, business and cultural ties between Russian and many CIS countries provide Moscow with many opportunities to influence the political and economic direction of its neighbours. Russia, in the guise of Gazprom, uses its market power to offer discounts and deals to a range of countries. One of Moscow’s top priorities has been the promotion of two major pipeline projects (North Stream and South Stream) that would bypass Ukraine. With the Baltic Sea pipeline, Putin made deals with major German energy companies and secured the services of former German Chancellor, Gerhard Schroeder, as chief lobbyist. With the South Stream project, Putin made deals with Austria, Bulgaria and Greece, as well as Turkmenistan, with the aim of sabotaging the EU-preferred Nabucco pipeline. The North Steam and South Stream projects would also undermine Ukraine’s domination of pipelines to Europe, one of the biggest obstacles to Russian domination of the European gas market.

UKRAINE

EU-Russian energy policy cannot be discussed without reference to Ukraine as over 80% of the gas that the EU imports from Russia comes via Ukraine. Putin has always been keen to ensure that Ukraine remained in Russia’s orbit and hence the gas disputes between Russia and Ukraine have been as much about politics as money. Moscow had been suspicious of the direction in which Ukraine was heading ever since the Orange revolution. A neuralgic point was Ukraine’s wish to join NATO and Moscow was determined to demonstrate to Kiev that it could make life very uncomfortable if it continued to pursue its aim of joining the Atlantic Alliance. This was one factor in the gas dispute as was Moscow’s desire to maintain political influence with certain groups in Ukraine. Another source of contention was the alleged failure of Ukraine (in the guise of RosUkrEnergo, the murky trading company with the contracts for gas deliveries) to pay back fees to Gazprom. The dispute then escalated to include the price that Ukraine should pay for Russian gas in 2009 and the fees that Ukraine charges for use of the pipelines on its territory. The EU watched this dispute with increasing anger and frustration. Eventually Prime Ministers Putin and Tymoshenko signed a deal that is due to run for ten years and should eliminate the annual disputes. But many experts doubt whether this agreement will hold. Furthermore, the reputations of both Russia and Ukraine suffered a major setback as a result of the protracted crisis and their apparent indifference to European consumers.

Relations between the EU and Ukraine have been characterised by mutual misunderstandings. Ukraine cannot understand why it should not be recognised by the EU as a potential member state and is critical of Brussels for paying so much attention to Russia. The EU, suffering from enlargement fatigue, is not ready to give Ukraine a signal until Kiev demonstrates that it can fulfill its current contractual relations and embark on much needed reforms, including in the energy sector. The internal political disputes that have been a main feature of recent years have also not contributed to a positive image of Ukraine in the EU.
EU POLICY

The latest crisis has been a wake-up call for the EU. In 2007 the Commission published its policy paper ‘An Energy Policy for Europe’ and in 2008 a Strategic Energy Review. Both documents were endorsed by the Council but little concrete action has occurred. The Commission has long championed the principles of market liberalisation and produced proposals for ‘unbundling’ that would loosen the grip of national energy companies. The Commission has also indirectly warned Gazprom that it would be subject to competition policy within the EU and would not be allowed to move into downstream activities. But little action has been taken by the major member states, especially the key states France and Germany, to implement the Commission’s proposals. While there was much talk of solidarity in the latest crisis the EU was unable to supply the member states most affected due to lack of connections. The objective of constructing more interconnections between national gas markets has been there for years. A new initiative to link South East European gas markets (NETS) might now move forward as this region was the worst affected by crisis.

In late January, the Hungarians hosted a 'Nabucco summit' for consortium members and potential suppliers for this planned pipeline through Turkey and the Balkans. The project was given a boost by a Commission pledge of financial support and increased EU efforts to sign a deal for gas from Azerbaijan. At their spring summit in March 2009, EU leaders will continue their discussions on the Commission’s strategic energy review with the Czech Presidency pressing for action on liberalisation and interconnections.

Another idea gaining ground is to involve Russia, the world’s third largest emitter of CO2, in the upcoming climate change negotiations. Advancing cooperation on climate change could broaden cooperation on the energy agenda and shift its sole focus from oil and gas. There are a number of factors that could motivate Russia to move in a more climate-friendly direction. One is that Russia will be one of the first and greatest victims of climate change affecting the Arctic as well as river supplies in the south of Russia. Secondly, there is a huge loss of energy in Russia due to inefficient factories and badly insulated buildings. A concerted energy efficiency initiative, where the EU supplies technology and know-how, could help small and medium EU enterprises as well as Russian households and Russian energy exports. Thirdly, there is tremendous potential for all kinds of renewable energy sources in Russia. Finally, the EU could encourage Russia to join its emissions trading market. Broadening the EU-Russia energy debate’s exclusive focus on pipelines to include the issue of climate change might even change the terms of the debate and put its geopolitical element into perspective. Oil and gas have become instruments of Russia’s foreign policy as much as of its economic strategy. A stronger focus on green technologies could depoliticise the energy dialogue between both sides in a healthy way.
CONCLUSION

EU-Russia energy relations are likely to remain an area of political tension for some time. The future trajectory of Russia is impossible to determine. It projects a combination of overweening confidence and congenital insecurity. In the eyes of some new member states, Russia is an aggressive power ready to use all its assets to secure control of its neighbourhood. But one can also argue that the bigger danger is Russian weakness. Russia is a country characterised by stark demographic imbalances, decaying infrastructure, dysfunctional governance and chronic underinvestment. It is this combination of ambition and vulnerability which makes partnership with Russia so difficult.

The EU needs to get Russia back into proportion, including its position as a major energy supplier. The credit crunch has hit Russia harder than other emerging economies with Gazprom losing more than two-thirds of its market capitalisation since May. With oil prices down from a peak of $147 a barrel in July 2008 to below $40 in February 2009, the heavily oil-and-gas dependent Russian economy is highly vulnerable, especially since Russia needs Western technology to boost its energy extraction. Furthermore, concerns about state meddling in business, widespread corruption and shortcomings in the rule of law have contributed to its failure to diversify away from hydrocarbons and minerals.

In the medium term, the EU and Russia are condemned to be partners in the energy field. There is simply no alternative supplier for the EU and the EU is the most lucrative market for Russia (Gazprom gets nearly 70% of its profits from sales to the EU). Talk of alternative pipelines to China is just talk. Until the recent crises, Russia was a reliable supplier of energy to Europe for decades – even at the height of the Cold War. The current elite in the Kremlin is unlikely to take measures that would harm the steady income they receive from EU sales. But there is now increasing doubt about Russia’s reliability, even in quarters normally sympathetic to Russian concerns. How these developments will play out in the EU-Russia negotiations for a new partnership agreement is an open question. The EU member states do not have a good track record in being able to speak to Russia with one voice, especially on energy issues. But if they fail to do so then Russia will continue its successful policy of divide and rule. The ball is very much in the EU’s court.
Annex: Pipelines supplying the EU

NABUCCO - Nabucco is a 7.9 billion euro project to transport gas from Turkey to Austria through Bulgaria, Romania, and Hungary. Construction of the 3,300-km (2,050 mile) pipeline is scheduled to start in 2011 and first deliveries are expected in 2014 with an initial annual capacity of 8-10 bcm. It could transport up to 31 bcm of gas a year from Central Asia and the Middle East to Europe by 2020, reducing dependency on Russian gas, and may be used to bring Iranian gas to Europe. Austrian oil and gas group OMV heads the consortium which includes Hungary's MOL, Turkey's Botas, Bulgaria's Bulgargaz, Romania's Transgaz, and German utility RWE.

AMBO - The 900-km AMBO Trans-Balkan Oil Pipeline is planned to transport Caspian or Russian oil from Bulgaria's Burgas via Macedonia to the Albanian Adriatic sea port of Vlores. AMBO, the Albanian Macedonian Bulgarian Oil Corp. plans to commission the pipeline in 2011 and to transport crude of 750,000 barrels/day or around 40 million tonnes/year.

TRANS ADRIA (TAP) - The 520 km pipeline will transport gas via Greece and Albania across the Adriatic Sea to southern Italy from 2012. TAP is a 50/50 joint venture between Swiss EGL and Norway's StatoilHydro and is expected to cost about 1.5 billion euros to build. It will initially have a capacity of 10 billion cubic metres (bcm) a year but could be expanded to bring up to 20 bcm/year of gas from the Caspian Sea and Middle East regions into Europe.

MEDGAZ - The 210 km deepwater pipeline, of which construction started in March 2008, will carry up to 8 bcm/year of Algerian gas to Spain when it opens in mid-2009. The project is being built by Algerian state gas company Sonatrach and a consortium of Spanish and French companies to help diversify European supplies and cut dependence on Russia.

GALSI - The Galsi gas pipeline could bring up to 10 bcm/year of Algerian gas to Italy through Sardinia when it opens in 2012. Major shareholders include state-run Algerian gas company Sonatrach, Italian power generator Edison and utility Enel.

PAN-EUROPEAN OIL PIPELINE (PEOP) - Due to start operating in 2012, will connect the Romanian port of Constanta with Trieste in Italy, via Serbia, Croatia and Slovenia. The 1,400 km long pipeline, worth between $2 billion and $3.5 billion, will supply refineries in northern Italy and central Europe with crude from the Caspian. It will have an annual capacity of 1.2-1.8 million barrels per day (bpd).

BAKU-TBILISI-CEYHAN PIPELINE - The $4 billion BP-led pipeline was opened in June 2006. Its capacity is one million bpd of Azeri crude. It ran 1,770 km to Turkey's Ceyhan port in 2008. It is the first pipeline to carry large volumes of crude from the Caspian without going through Russia.

CASPIAN PIPELINE CONSORTIUM (CPC) - Connects Kazakhstan's Caspian Sea oil deposits with Russia's Black Sea port of Novorossiisk. Although the 1,510-km CPC pipeline transverses Russia and was developed in conjunction with the Russian government, it was the first to give the
Caspian Sea region and Kazakhstan a viable alternative to the Russian dominated northern export routes. Its shareholders plan to double CPC's annual capacity from 33 million tonnes by 2013.

**DRUZHBA PIPELINE** - Russia's Druzhba (Friendship) oil pipeline starts in Russia's Samara and ends in the northern Adriatic port of Omisalj in Croatia, connecting Germany, Poland, Hungary, Slovakia and the Czech Republic. It has a planned capacity of over 2 million bpd, of which some 1.4-1.6 million bpd go directly to consumers in the European Union and the rest stays in Belarus. The Druzhba splits into two legs with the bigger northern leg going to Poland and Germany and the southern leg supplying Slovakia, Hungary and the Czech Republic. One fifth of German supplies arrive via the Druzhba pipeline. Supplies were cut several times in the past years.

**YAMAL-EUROPE PIPELINE** - The pipeline, which runs from the Yamal peninsula in Russia's Arctic north to Frankfurt on Oder on the Polish-German border, carries Russian gas for over 4,000 km (2,485 miles). Its capacity is 32.3 bcm a year.

**BALTIC SEA PIPELINE** - The 7.4 billion euro gas pipeline would run 1,200 km from Vyborg in Russia to Greifswald in Germany under the Baltic sea. The Nord Stream, majority owned by Russian gas monopoly Gazprom, is building the pipeline with Germany's BASF and E.ON and Dutch company Gasunie and has plans to build two parallel gas pipeline legs of 750 miles (1,200 km) each, the first by 2011 and the second by 2012. Total annual capacity will be 55 bcm.

**BALKAN OIL PIPELINE** - The 279 km oil pipeline, with an estimated cost of 1 billion euros, will run between the Bulgarian Black Sea port of Burgas and the Greek Aegean Sea port of Alexandroupolis. Construction is planned to start in 2009 and the pipeline could come onstream in 2011. Russian oil producers Rosneft, Gazprom and crude oil pipeline monopoly Transneft will share 51 percent of the pipeline. Greece and Bulgaria will share the remaining 49 percent. It will have capacity of 35 million tonnes per year with a potential to expand to 50 million tonnes.

**CZECH-BELGIUM PIPELINE** - Germany's RWE plans to invest 1 billion euros to build a natural gas pipeline from the Czech Republic to Belgium, to transport 5 bcm Russian natural gas a year after it starts operation in 2011. *

**CASPIAN GAS PIPELINE** - Russia, Turkmenistan and Kazakhstan have agreed plans for a new natural gas pipeline around the Caspian Sea to deliver up to 20 bcm of gas per year by 2009-2010. Critics say the deal tightens Russia's grip on gas exports from the region, while Moscow says it would create additional routes to the European Union.

**BALTIC PIPELINE EXPANSION** - Russia has approved expansion of the Baltic Pipeline System, which will allow Russian oil exports to bypass Belarus and by running to Ust-Luga near Russia's Baltic Sea port of Primorsk. Russian pipeline monopoly Transneft suggested building a pipeline to Primorsk after a row with Belarus that disrupted oil exports flowing to Europe. The new pipeline which could cost around $4 billion will have a capacity of one million bpd. *
HUNGARY GAS PIPELINE - Hungary's MOL plans to build a 100-km expansion of its gas pipeline towards Ukraine by 2010 at a cost of 48 billion forints ($290 million). The pipeline will help meet Hungary's rising domestic gas needs. MOL and Romania's Transgas also plan to connect their networks via a new 109 km pipeline to be built by 2010 between Hungary's Szeged and Romania's Arad.

SOUTH STREAM PIPELINE - Gazprom and Italian oil firm Eni plan to build a 10 billion euro pipeline, seen as a rival to Nabucco, to take Russian gas under the Black Sea to south-eastern Europe, avoiding Ukraine with which Russia has had pricing debates. Russia has already secured Bulgarian, Hungarian and Greek participation in the project and has won the right to route South Stream through its ally Serbia.
2009 Gas Conflict and Its Consequences for European Energy Security

by

By Michael Gonchar, Vitalii Martyniuk and Olena Prystayko

INTRODUCTION

In December 2008 – January 2009, Europe experienced an “unprecedented energy crisis” that resulted in a 20% cut of the EU’s gas supply for two weeks in the middle of the winter. Deliveries to Europe had never been halted by Russia since the gas transit system was built in the Soviet times in 1970s. Relationships between the EU and Ukraine, the EU and Russia and Ukraine and Russia, taken separately, are far from being easy. Their interconnection and interdependence complicate the whole issue and impact the general European affairs. The second gas crisis between Russia and Ukraine in December 2008 – January 2009 had a drastic impact on the relationship in the triangle and led to mutual confrontation – “EU vs. Ukraine vs. Russia”.

Many see the crisis as continuation of Russia’s use of energy as leverage to influence decision-making in its neighbourhood and the EU. At the same time, if Russia is to blame for unleashing the crisis, internal political fight in Ukraine and overall difficulties in Ukraine-Russian relations, intentionally or not, facilitated the crisis and contributed to its severity. The EU’s continuing “neutrality” in the Russian – Ukrainian gas relations, despite the 2005-2006 gas crisis, was taken by Russia as a “policy of pacification” that also was one of the factors conducive to the crisis of 2009.

This paper outlines the general background of the crisis, reviews economic and political considerations of the sides prior to and during the crisis. The main questions to be answered here include: whether the conflict was unexpected, what the origins of the dispute were and why it became so severe, what lessons and problems the crisis revealed, and whether the sides found a solution that will be able to provide and sustain a stable energy supply-transit-consuming chain in Europe. The authors sum up with some conclusions and recommendations intended to ensure the stability of the European energy security.

RUSSIA: ENERGY AND FINANCIAL BACKGROUND PRIOR TO THE CRISIS

It is important to note from the beginning that this unprecedented gas supply cut for customers by the monopoly supplier took place against the background of existence of a legal mechanism for

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23 Michael Gonchar, Vitalii Martyniuk, Centre for Global Studies «Strategy XXI», Kyiv; Olena Prystayko, research fellow, EU-Russia Centre, Brussels.

settlement of conflicts with the transit country at the Arbitration Institute of the Stockholm Chamber of Commerce. It was initially specified in the contract between Naftogaz of Ukraine NJSC and RosUkrEnergo company (RUE). Probably, this conflict was the only practicable option to escape a complex situation, despite the threat of fight back involving serious damage and financial losses for Russia.

The analysis of past events shows two main non-articulated and carefully hidden backgrounds of the events in the gas relations among Russia – Ukraine – European Union in January, 2009.

– The need to “sweep under the carpet” of an external business conflict the corporative problem of current gas deficit for simultaneous satisfaction of the domestic demand and export commitments during the peak of consumption due to low temperatures of this season. A fragment from Gazprom’s official presentation at an international conference on the energy security of the EU and Slovakia in Bratislava on October 27, 2008, sets it clear: “Consider also that Gazprom’s long-term contracts are structured so that the company is subject to severe penalties and fines if it does not meet its obligations to ship gas under those contracts.” Therefore, it may be suggested that Gazprom tried to escape a situation fraught with serious financial losses against the background of the deteriorating situation with overall corporate finance.

– The factor of Gazprom’s shortage of energy and financial resources. Russia has the largest gas reserves in the world – that is a proven fact staying out of dispute. But for several years now, a strong downfall in gas production is observed at the main gas fields – Urengoy, Yamburg, Medvezhye, Nadyr and Pur-Tazovskoye. The downfall is the hardest at the two former gas fields, together accounting for 2/3 of Gazprom’s production. There is also a considerable underrun in the development of new gas fields on the Yamal peninsula and Shtokmanovskoye field on the shelf of the Barents Sea, where field production was to begin yet in mid-1990s. Authors of one of the drafts of the new Russian Energy Strategy through 2030 especially emphasised the importance of Yamal and Shtokmanovskoye for gas production: “In the conditions of gas production downfall at the main gas fields... without development of gas deposits on the Yamal peninsula, the country won’t be able to provide itself with this energy source and balance its demands in the fuel and energy sector.” Therefore, kind of a «scissors effect» appears – a growing gap between extracted and replenished gas reserves.

Table 1. «Dynamics of gas extraction and growth of reserves of “Gazprom” in the current decade»

<table>
<thead>
<tr>
<th>Year</th>
<th>Volume of extraction (V), billions m³</th>
<th>Growth of reserves (G), billions m³</th>
<th>G/V, %</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>523.2</td>
<td>81.70</td>
<td>15.6</td>
</tr>
<tr>
<td>2001</td>
<td>512.0</td>
<td>162.2</td>
<td>31.7</td>
</tr>
<tr>
<td>2002</td>
<td>521.9</td>
<td>514.4</td>
<td>98.5</td>
</tr>
<tr>
<td>2003</td>
<td>540.2</td>
<td>426.8</td>
<td>79.0</td>
</tr>
<tr>
<td>2004</td>
<td>545.1</td>
<td>378.1</td>
<td>69.4</td>
</tr>
<tr>
<td>2005</td>
<td>547.9</td>
<td>583.4</td>
<td>106.5</td>
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<tr>
<td>2006</td>
<td>556.0</td>
<td>590.9</td>
<td>106.3</td>
</tr>
<tr>
<td>2007</td>
<td>548.6</td>
<td>592.1</td>
<td>107.9</td>
</tr>
<tr>
<td>2008</td>
<td>-</td>
<td>-</td>
<td>109.5*</td>
</tr>
</tbody>
</table>


*For 2008 – preliminary information from Gazprom.

I. Estimate of the current deficit of resources of Gazprom during the consumption peak in the period of January 1-20, 2009

Russian Prime Minister V.Putin said in the midpoint of the gas conflict: «Gazprom had to stop operation of over 100 wells...»27. In view of the problems of Russian gas production described above, that statement could be interpreted as shutting more than 100 low-pressure gas wells that could not produce necessary gas yield.

According to the official annual report for 2007, production facilities of the Gazprom Group include 6,640 gas extraction wells with the total annual production volume of 548.6 bcm28. Therefore, we can calculate the average gas yield of one well - 0.082620 bcm, or 82.620 million cubic meters, a year. If we make recalculation for above mentioned 100 wells, it gives ~8.3 bcm of current gas deficit (annualised). If we compare it with the annual production level, it is rather a small figure, but

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27 Gazprom lost $800 million because of cutoff of supplies through Ukraine, RIA Novosti, Economy (Jan. 11, 2009)
28 Annual Report of Gazprom OJSC for 2007 (Moscow: Gazprom, 2008), pp.37, 40
if we compare it with export volumes, it seems to be significant. This volume is comparable with total annual exports to 5 Balkan states – Bulgaria, Greece, Serbia, Bosnia, Croatia (8.6 bcm in 2007), or Hungary (8.8), or Great Britain (8.7).

The volume of gas accumulated during the period of stoppage of export to the EU can be estimated, if we take last years’ daily average transit volume through Ukraine to Europe as a unit of account. It made 388 million cubic meters. During 13 days of cut supply (07-20 January), it totals 5.04 bcm. Regarding daily average supply volumes to Ukraine, it will make 160 mcm. Proceeding from 19 days (01-20 January) of stoppage in deliveries, it means 3.04 bcm. Altogether, the total amount of shortfall in deliveries, or «saved» gas, made ~8.1 bcm.

Therefore, it is approximately equal to the volume of the above-calculated deficit that came up due to the shutdown of 100 wells. **We dare conclude that the 20-day «gas break» in deliveries to Ukraine and the EU allowed Gazprom to pass the winter consumption peak, while hiding the emerging deficit behind the «problem of gas transit through Ukraine»**. Therefore, the suggestion of problems with current deficit of resourced is indirectly confirmed.

The suggestion of emergence of the gas deficit during the peak of consumption is also confirmed by Russian independent experts. In 2008, B.Nemtsov and V.Milov, speaking on the situation with gas deliveries during two previous years, noted: “In January – February, 2006, serious tension was felt with gas exports. According to media reports, on January 18, 2006, «Gazprom» voluntarily decreased the volume of gas transit through the Ukrainian territory to Europe from 390 to 350 million cubic meters daily because of gas deficit. The same day «Gazprom» informed the Italian partner, ENI concern, about its inability to guarantee full volume of gas deliveries because of extreme cold, whereupon Serbia (by 25%), Croatia (by 6-10%) and Hungary (by 20%) consecutively reported limitation of gas supply by «Gazprom».**29**

It is clear that it will also appear in the future, during peaks of consumer demand for gas. In this context it should be mentioned that the gas crisis in the beginning of January, 2006, also took place during the peak period of the extremely cold winter in Europe and Russia. Two winters of 2007 and 2008 were, on the contrary, very warm, that is why the problem did not arise.

**II. Next to critical financial standing of Gazprom** caused by debts and price downfall on the main market in the EU. It prompted a confrontational course towards Ukraine with the aim to maximise gas prices and to increase returns, to partially make up for the loss of profits on the EU market. According to an estimate by East European Gas Analyses (USA), Gazprom gas earnings in 2009 will make nearly $72 billion – $30 billion less than in 2008. Earnings from export to the EU and Turkey will fall by 40-45% due to simultaneous price and gas demanddownfalls. Earnings will go down also on Russia’s domestic market, where V.Putin’s government had decided to suspend bringing

the internal gas prices to the market level. The only market where earnings are to increase is that of the CIS. According to estimates, it may increase by 15-20%\textsuperscript{30}.

Ukraine with its 50 bcm of yearly imports is the place for a significant increase in earnings. Thus, a potential conflict with Ukraine using its political instability could have brought a maximum effect for Gazprom’s purposes.

RUSSIA: POLITICAL AND ECONOMIC CONSIDERATIONS BEHIND UNLEASHING THE CRISIS

Unleashing the crisis, Russia was guided by demonstrated and non-articulated political and economic considerations. The psychological background of the Russian-Ukrainian relations also played a role. The major considerations were as follows.

\textit{Articulated political and economic considerations:}

− Defamation of Ukraine as a transit state that could not ensure stability, reliability and safety of transit, as well as payments for consumed gas.

− Control over the Ukrainian gas transporting system (GTS) and the Ukrainian gas storage facilities (UGSF) (an agreement of privatisation or establishment of a gas transportation consortium based on the Russian variant) or an attempt to solve the problem through creation of more severe conditions for operation of Naftogaz of Ukraine NJSC, which could lead to its bankruptcy. \textit{One should keep in mind that the Russian Energy Strategy officially proclaimed the goal “to strengthen its presence on internal energy markets of foreign states, joint ownership of distribution networks of energy sources and energy infrastructure facilities in those countries”}\textsuperscript{31}.

− Pressure on the EU in order to impose a new regime on the Ukrainian GTS, with creation of a management and ownership consortium.

− Pressure on the EU to support Russian plans of building alternative transit routes bypassing Ukraine, namely, the South and Nord Streams, using its lobbyist potential in some EU member states. The RosUkrEnergo scheme is already “cloned” by Gazprom in Nord and South Stream projects, as well as in the development of Shtokmanovskoye field (just as in case of RUE, offices of development companies are registered in Zug canton, Switzerland).

\textit{Russia was also pursuing non-articulated goals:}

− Another attempt to influence the internal political situation in Ukraine, especially in the light of the forthcoming presidential elections of 2010. The “gas provocation” could have prompted a political conflict between the East and West Ukraine. It was expected that in case of full cut of gas supply (for internal consumption and for transit to the EU), Ukraine will not be able to transfer gas from the main UGSF located in the Western part of the country to the main industrial centres in the Eastern

\textsuperscript{30} M. Korchemkin, “Till the end of 2009 the average price on Gazprom’s export in Europe will drop down $180 per 1000 cm”, \textit{East European Gas Analysis} (Jan. 4, 2009), p. 1

\textsuperscript{31} Energy strategy of Russia through 2020 (Moscow: May 2003), p. 45
part of the country, and they will be cut off from gas. This could have provoked social unrest in Eastern and Southern Ukraine. *It was not accidental that during that period Russian mass media published articles on the subject of «territorial changes» in the CIS and statements by some Russian politicians like: «Russian State Duma deputy Konstantin Zatulin excepts that Russia «in due time will give a sign» to South and Eastern regions of Ukraine for affiliation with Russia»*.32

- The second probing of the EU and NATO after the conflict in South Caucasus, taking into account the change of the US administration and loyalty to Russia on the part of the leadership of some European countries (Germany, Italy, the Netherlands).

- Private interests of the Russian officials connected with33:

III. the intension to keep or transform private incomes generated through RUE intermediary (under long-term contract till 2028) in Zug canton (Switzerland) from the Central Asian gas trade scheme, if it manages to get favourable gas prices in Turkmenistan and Uzbekistan;

IV. to politically tie Ukrainian leaders to Russia with corruption channels of the RUE scheme, to provide conditions for non-transparent preferences for Russian business buying up industrial assets in Ukraine. Registration of RUE in Zug canton means that its activity can not be controlled by any competent bodies of Ukraine, Russia, or the EU. Money could be sent to accounts of various individuals and front persons by a decision of the management body34,

V. traditional desire of Ukrainian politicians, irrespective to political parties, to get access to financial flows of gas production and gas trade in Ukraine and between Ukraine and Russia.

Finally, RUE found itself «overboard», as soon as the difference between the selling price on the EU market and the purchasing price in Central Asia appeared to be unattractive (in 2008, before the oil price downfall, it was super profitable: gas purchasing price - $130 (I half of the year) and $150 (II half year), selling price in the EU – over $500). Furthermore, a great deal of negative information about RUE made Russia and Gazprom to distance themselves from non-transparent schemes, as it happened in 2004 with its predecessor, Eural Trans Gas.

This lead to dissatisfaction with RUE intermediary, which actually made possible its elimination from the gas trade between Ukraine and Russia, recorded in the gas and transit agreements of January 19, 2009, as the legal basis to solve the crisis.

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32  “Zatulin: Russia will give a sign to the South-Eastern part of Ukraine to join in appropriate time”, “Korrespondent” (Jan.12, 2009), p. 1
34  Andrey Miseuluk, Kyiv, BBC Russian (Jul. 26, 2004)
UKRAINE: ALLEGATIONS VS REALITY

As well as in the previous cases, the recent gas crisis involved allegations of Ukraine siphoning gas and subsidising the Ukrainian economy with “cheap” gas prices. We will try to address those stereotypes:

− **Subsidising the Ukrainian economy with cheap gas prices:** «Since the collapse of the Soviet Union and till now Russia has been subsiding countries of the former Soviet Union through low market prices on gas. The amount of those subsidies is made up of the difference between the European gas price and the market price, set by Gazprom for customers in those countries» - this is a fragment from the above-mentioned Gazprom's presentation, illustrating subsidy assistance of the Russian monopoly to the Ukrainian economy due to lower gas prices. The amount of subsidies for Ukraine, according to Gazprom’s official information, made $34.23 billion in 1994-2007\(^{35}\). The fact that this figure is actually a manipulation is confirmed by another figure mentioned by V.Putin in the heat of the gas crisis – $47 billion. In fact, those circumstances were highly profitable for Russia, as it enjoyed counter-subsidies – low transit costs and rates of gas storage in UGSF. For example, even the current rate of gas storage makes 4% of the average European level (estimate by Eastern Europe Gas Analyses, USA)\(^{36}\).

− **Gas siphoning:** This allegation lies in the propaganda domain and largely has an emotional character. The history of the Ukrainian-Russian gas relations knows no case of legal acknowledgement of this statement by international judicial authorities. Moreover, there has been only one failed case when Gazprom officially went to court to establish a fact of «theft» in legal proceedings. It was case №185/2000 at the International Commerce Common Court of Arbitration at the Chamber of Commerce and Industry of Russia, in Gazprom’s suit against Naftogaz of Ukraine NJSC in connection with alleged unsanctioned siphoning of gas on the territory of Ukraine. On May 30, 2001, the Court dismissed the suit arguing that the contract between Naftogas and Gazprom had a clause regulating consumption of gas in excess of contracted volumes, and the issue could not be legally termed as unsanctioned siphoning.

During the current gas crisis Gazprom, using the bugaboo of gas «theft» on the territory of Ukraine, tried to present the situation with the use of process gas, performed by the automated system of gas pipeline control automatically, as the fact of confirmation of the theft. It was not confirmed by the monitoring group. And after signing the contracts, the Russian side reiterated that it had no claims to the Ukrainian party.

At the same time, it would also be incorrect to completely release Ukraine from the fault if not for the unleashing, then for wilful or unwilled incitement to the crisis. Ukraine’s behaviour prior to and during the crisis was guided by a number of factors, including fear of high energy prices, especially in the circumstances of the recent drastic fall in the Ukrainian industry, and poor financial

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performance of Naftogaz of Ukraine that was unable to pay debts to RUE till the last date - December 30, 2008. Besides, the Ukrainian position before and during the crisis is to be viewed through the prism of internal political “mortal combat” and long-term existence of non-market and non-transparent schemes in the Russia-Ukrainian gas trade. Access to the schemes gave political forces shadow revenues used, in particular, for financial support of their political fight: “the energy sector has served successive rounds of leaders as a political trophy and tool”\(^{37}\).

Therefore, handling corruption and internal political stability is the key not only for the future of the country but for its role in the European energy security, which might remain very important.

**PROSPECTS OF GAS TRANSIT VIA UKRAINE**

The transit role of Ukraine’s GTS is defined not only by pipeline routes through the Ukrainian territory. Underground gas storages with the total volume of 32 bcm are important. They have a special role for the security of deliveries during the peak winter months, when the EU consumes more gas. Interconnections and convertibility of Ukrainian pipelines ensure uninterrupted transit of gas in case of breakdowns or other accidents. Other transit routes referred to by Gazprom as bypassing Ukraine (Yamal – Europe, Blue Stream, Nord Stream, South Stream) do not have such parameters. A breakdown on one of those routes automatically results in supply cut.

For example, in 2007, two serious technical accidents occurred on the Urengoy-Pomary-Uzhhorod pipeline in Ukraine. The repair process took less than 2 weeks in both cases. However, gas supply to the EU was not stopped at all. Two other parallel pipelines, Progress and Soyuz, were used instead of the damaged pipeline. There is a contrary example: on September 2-3, 2008, Russia announced the need of technical maintenance of the Yamal – Europe pipeline bypassing Ukraine through Belarus. Gas deliveries to Poland and Germany through Belarus were temporary stopped\(^{38}\).

As for transit volumes, the transit to the EU via Ukraine did not decrease considerably after the Yamal – Europe gas pipeline was put in operation in 2005 (see Table below).

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\(^{38}\) “Moscow reassures Europe: supplies through the Yamal – Europe gas pipeline will be stopped only for 30 hours”, NewsRu, Economic news (Sep. 2, 2008), p. 1.
Table 3  «Volumes of gas transit via Ukraine’s GTS»

<table>
<thead>
<tr>
<th>Year</th>
<th>Total transit</th>
<th>Transit to the EU+ *</th>
<th>Transit to the CIS</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>124.4</td>
<td>105.3</td>
<td>19.1</td>
</tr>
<tr>
<td>2002</td>
<td>121.4</td>
<td>106.1</td>
<td>15.3</td>
</tr>
<tr>
<td>2003</td>
<td>129.2</td>
<td>112.4</td>
<td>16.8</td>
</tr>
<tr>
<td>2004</td>
<td>137.1</td>
<td>120.4</td>
<td>16.7</td>
</tr>
<tr>
<td>2005</td>
<td>136.4</td>
<td>121.5</td>
<td>14.9</td>
</tr>
<tr>
<td>2006</td>
<td>128.5</td>
<td>113.8</td>
<td>14.7</td>
</tr>
<tr>
<td>2007</td>
<td>115.2</td>
<td>112.1</td>
<td>3.7**</td>
</tr>
<tr>
<td>2008</td>
<td>119.6</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Note: * EU+ means the EU member-states + Turkey; ** - only transit to Moldova (the transit route from Russia to Russia through Ukraine does not work after the bypassing gas pipeline Sokhranovka – Oktiabrskaia was built)

Ukraine’s GTS with its underground gas storages alone can guarantee stable gas deliveries to the EU, even if the Nord Stream and South Stream projects are implemented without such storages. The Ukrainian gas storage capacities close to the EU borders (Slovakia) are able to ensure reliability of deliveries from the East to the West, if Ukraine is integrated in the European Energy Community.

The EU-Ukraine Joint Declaration on the modernisation of Ukraine’s gas transit system, signed in Brussels on March 23, 2009, may be welcomed\(^{39}\). The Ukrainian Government declared its readiness to take serious steps to ensure transparency and openness at modernisation of the transit system and the gas market. The EU with the help of international financial institutions is to provide necessary funds for modernisation. The Declaration is beyond doubt a positive step towards enhancing security of the gas supply and transit in Europe.

Only three scenarios can ruin the efficiency of energy transit through the Ukrainian territory:

- "Crisis of production" – collapse of production in Russia (existing gas fields in Western Siberia are empty, Yamal and Stokmanovskoye projects do not run, as in 1990s);
- "Recession of import" – the EU refuses to increase gas import from Russia and even decreases it;

\(^{39}\) Joint Declaration of the Joint EU-Ukraine International Investment Conference on the Modernisation of Ukraine’s Gas Transit System, Brussels, 23 March, 2009:
“More pipelines than gas resources” – Russia has more gas pipelines than gas resources to fill them after the Nord Stream and South Stream pipelines are built together with Germany and Italy; gas production in Siberia decreases.

Even if the Nord Stream and South Stream pipelines are built, gas consumption in the EU increases and Russia is able to meet the demand, Ukraine will retain its role as a transit link.

**GAS CRISIS AS A “MIRROR” OF ENERGY VULNERABILITY OF THE EU**

Since the first serious gas conflict between Ukraine and Russia at the junction of 2005-2006, the European Union has stably taken a “neutral stand” towards the Russian – Ukrainian gas relations, although those relations had and continue to have direct influence on the energy security of the Community. Such behaviour was taken by Russia as a “policy of pacification” and even silent consent and contributed to the emergence of a serious conflict in the beginning of 2009. The EU indeed afforded too long tolerance and non-interference into obviously non-market and non-transparent gas trade between its major supplier and the transit state.

Lack of a united position in the energy relations with Russia. Too strong impact of bilateral relations, which allowed Russia to pursue the “divide-and-rule” policy. Besides, the crisis clearly showed how little the EU had done to build an internal energy market, despite long-term talks about its need. The absence of a functioning market and poor interaction made that crisis so devastating for the EU, especially its South-Eastern members and candidate states.

Although it was a purely commercial dispute from the initial statements, very soon it became evident that the conflict could not be solved without political interference. Given the absence of an effective European Energy Policy, the EU had scanty means to influence the situation. This demonstrates the first vulnerability of the EU: failure to oppose a supplier that uses commercial means to attain political goals. The situation is caused, first of all, by the absence of direct energy agreements, at least some framework agreements, between the European Communities and Russia. Today, all gas supplies are determined by Gazprom’s agreements with individual energy companies of the member states.

The second vulnerability is that Russia as a major supplier of oil and gas for the EU, as is mentioned in the Second Strategic Energy Review, has no official agreement with the EU which could give the EU any levers against Russia. Russia signed but did not ratify the Energy Charter Treaty. This fact helps Russia avoid international and bilateral responsibility for actions like the latest gas crisis of 2009. In the light of that crisis Russia, manipulating data of Ukraine’s fulfilment of its gas obligations, cast doubt on the validity of the Energy Charter as such.

Last year, the European Union and Russia started negotiating a new agreement on strategic partnership. The Russian authorities are decisively opposing the intentions of the EU to include bilaterally binding energy provisions in the new agreement. Russia also insisted on elimination of gas and oil from export rate commitments within the framework of the possible future Free Trade
Agreement with the EU. It was officially declared by Russia during the visit of the European Commissioner for Trade Peter Mandelson to Moscow on February 13-14, 2008. The difficulties between the EU and Russia in negotiation of the energy issues of the future Free Trade Area are mentioned in the Second Strategic Energy Review40.

The third vulnerability ensues from the different energy interests of the EU member states undermining the European solidarity. During the gas conflict, the EU tried to demonstrate cohesion and spoke in one voice on behalf of the Czech Presidency and the European Commission. The EU made a lot for soonest resumption of gas supply from Russia through Ukraine to the member states. At the same time, Bulgaria’s call for greater solidarity in the EU was not accidental. The Bulgarian Prime Minister Sergei Stanishev said that he counted on the European solidarity, which was not reciprocal for the time being41. There are several reasons for this. First, West European countries are less dependent than East European that suffered the most. Second, there are differences in the volumes of consumption of different kinds of energy, in the shares of renewable energies, in the structure and openness of energy markets, as well as in geographic proximity to energy resources. Third, the Russian pressure is not that strong in Western Europe. Hence, it is important for the leaders of those countries to understand problems faced by newly admitted Member States neighbouring Russia. Forth, the EU member states differ by the level of economic and energy cooperation with Russia.

Diversification of the energy interests of the EU has recently become more apparent in the attitudes to the Nord Stream project. The Baltic States and Poland, historically dependent on Russia’s energy, actively oppose that gas pipeline and suggest that it should run not on the Baltic Sea bed but across their territories. Meanwhile, Germany, Russia’s main partner in the Project, says that it is not a German but a European one. The Minister of State at the Federal Foreign Office of Germany Gernot Erler said at the IFRI energy conference "The External Energy Policy of the European Union" (31 January – 1 February 2008, Brussels): “It is a European, not a German project that many EU member states will be able to profit from; already today, French, Dutch, British, Danish and German companies have ordered big quantities of gas which will be delivered by the Nord Stream pipeline”42. However, Gernot Erler said nothing about the absence of those quantities of gas and problems with the development of new gas fields to fill the pipeline.

The forth vulnerability is that the level of cooperation between European energy companies and Russian ones is different. This concerns, for example, close cooperation of German companies EON-Ruhrgas and BASF and Italian company Eni with Gazprom. The same stands true for the French company Gaz de France, Danish company DONG Energy and Bulgarian Bulgargaz. Besides, gas supply to the suffered Member States is controlled either by companies with the Russian

41 “Sergei Stanishev: It is unacceptable that entire Europe becomes a hostage of the gas dispute between Russia and Ukraine”, Council of Ministers of Bulgaria, Leading News, Sofia (Jan. 14, 2009)
capital or lead European corporations that have close ties with Gazprom, such as ENI and EON-Ruhrgas, or companies that had no serious problems with gas deliveries for their national consumers, such as GDF Suez. Russia skilfully uses European internal competition and, manipulating different propositions for one or another company, tries to disunite their actions and win support for the Russian interests and projects. That is why during the gas conflict the European companies did not make enough efforts for immediate resumptions of gas supply from Russia.

The absence of a real domestic energy market, especially in the gas sector, is one of the reasons for the EU energy imbalance. It is the fifth vulnerability for the EU. The gas market is absent in the European space, and there is no common approach to gas pricing.

**Table. 2. Gas prices in the European Union**

<table>
<thead>
<tr>
<th></th>
<th>For households</th>
<th>For industrial consumers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>European Union</strong></td>
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<td></td>
</tr>
<tr>
<td>(EU-27)</td>
<td>318.9</td>
<td>376.9</td>
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<tr>
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<tr>
<td>Czech Republic</td>
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<td>317.7</td>
</tr>
<tr>
<td>Denmark</td>
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<td>497.1</td>
</tr>
<tr>
<td>Germany</td>
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</tr>
<tr>
<td>Estonia</td>
<td>147.7</td>
<td>148.1</td>
</tr>
<tr>
<td>Ireland</td>
<td>331.7</td>
<td>415.3</td>
</tr>
<tr>
<td>Spain</td>
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<tr>
<td>France</td>
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<td>407.4</td>
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<td>Italy</td>
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<td>Latvia</td>
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<td>521.3</td>
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<td>Slovenia</td>
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<td>Slovakia</td>
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<td>343.7</td>
</tr>
<tr>
<td>Finland</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sweden</td>
<td>441.7</td>
<td>557.8</td>
</tr>
<tr>
<td>Great Britain</td>
<td>260.4</td>
<td>295.5</td>
</tr>
</tbody>
</table>
Note: Gas prices in Euro for 1000 cm including transport expenses but without taxes, on the 1st of January. Source: Eurostat

The absence of a common pricing policy enables Russian Gazprom to sign gas contracts separately with each European state or, more precisely, with each energy company of a separate national market, by proposing different conditions. This prompts European states to build separate gas relations with Russia, not coherently with other Europeans, and helps Russia use the gas pricing policy for its benefit.

The sixth vulnerability lies in the absence of a Trans-European gas transport network. The gas pipeline system of the EU mainly runs from the East to the West, especially in the Central and East European states. Due to the absence of gas links between the EU states, the EU is tightly bound to gas needles coming from the Russian Federation (Figure 1).

Figure 1. Eastern gas pipelines of the EU  
Source: Jamestown Foundation

The Nord Stream and South Stream projects proposed by Russia just help strengthening the EU dependence on Russian supplies and divert financial resources of the EU from the energy infrastructure development. Those resources could be used to build a system of gas links.

The Second Strategic Energy Review and the “energy – climate” package envisage enhancement of the energy infrastructure, especially the Trans-European energy transport network, and closing gaps.
in it. Special attention should be paid to links between the EU member states and especially to support for remote states and connection of European networks with producing facilities. The European Commission has already announced allocation €5 billion from the EU budget for implementation of infrastructure projects, including €3.5 billion planed for the EU energy security. However, the most suffered states will receive less: Bulgaria - €25 million for the Bulgaria – Greece pipeline, Slovakia - €25 million to connect its energy infrastructure with Hungary’s networks, the Czech Republic - €25 million for building additional gas storages. At the same time, Poland will receive €80 million to build own LNG terminals, €250 million to build underground storages for energy wasted in the result of gas emission. Such states as France, Germany, Great Britain and Spain will also receive at least €100 million for implementation of regional projects to develop gas and electricity networks.

The above-mentioned vulnerabilities may be viewed as factors that might hamper prevention of crises like the latest one in the future, when this is advantageous for the monopoly supplier of energy resources. For this reason, the EU should concentrate on the removal of vulnerabilities and get a greater stake in the guarantee of Russian gas supply via Ukraine’s territory instead of keeping away from that process. In fact, Ukraine is and will remain the largest gas transit corridor between Russia and the EU for the nearest future.

RESOLUTION OF THE CRISIS AND ITS CONSEQUENCES

On January 19, 2009, Ukraine and Russia concluded an agreement to end the dispute, the heads of Gazprom and Naftogaz of Ukraine NJSC signed a contract of supply and transit, both covering the ten years period of 2009-2019. Positive outcomes of the agreements include introduction of the fixed European price, high for Ukraine though, which will bring more understanding to the relations, elimination of the intermediate trader (RUE) and introduction of the formula for transit rate evaluation.

All this makes the Ukraine-Russian gas trade more transparent and market-like. But there are doubts if that this completely eliminates the grounds of the crisis. Naftogaz of Ukraine may find it difficult to make monthly payments as required by Articles 4 and 5 of the supply contract, which requires monthly payment for 100% of delivered gas by the 7th day of the month following the month of delivery at the price of 80% of the ‘European price’ in 2009 and 100% from 2010. Political conditions that might have been made for the Ukrainian side are unknown, which, in view

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of the forthcoming presidential elections in Ukraine, make the reached agreements vulnerable. Therefore, security of energy supply and transit to the EU remains unstable.

The immediate consequences of the crisis include:

− Damaged reputation of Russia and Ukraine: large, perhaps irreparable damage to the Russian reputation as a reliable energy supplier.

− Heavy financial damage for Gazprom that lost around €1.5-2 billion of revenues due to cut sales, plus possible damages caused by penalties from the European customers.

− Heavy losses for Ukraine’s reputation in the EU and their mutual trust. This is especially damaging in the light of the prospects of Ukraine’s further integration in the EU including: development of the Eastern Partnership, conclusion of the Association Agreement and absence of clear prospects for Ukraine to become a member of the EU in the long run.

− Serious lack of trust in the triangle, which is repairable but could take a long period of time.

− Demonstrated necessity for the EU to step up and speed up its efforts for creation of the internal energy market in order to minimise its dependence on external suppliers.

− Imperative of more EU efforts in looking for diversification opportunities, both in terms of the transit states and suppliers.

In a broader context, the crisis has revealed:

− Reliability of Russia as a supplier and Ukraine as a transit state, as well as reliability of the current EU’s energy supply and transit networks, were questioned.

− Insecure character of the contractual framework of the Ukraine-Russian relations and the extreme vulnerability of the state leaders to political and personal factors.

− Need for greater EU involvement in energy trade relations between the EU’s main energy suppliers and transit states.

− Lack of the political leverage of the EU and its institutions, as well as technical and financial resources, to exert pressure on the sides to come to an agreement.

− The existing international energy security instruments, namely the Energy Charter Treaty and its Transit protocol, were made, by Russia’s disregard, incapable to secure uninterrupted and safe energy supply to Europe.

− Both the EU and ECT failed to prevent the occurrence of the crisis, even despite the similar situation of 2006.
PROPOSALS FOR ENHANCEMENT OF THE EUROPEAN ENERGY SECURITY

- The EU has already defended itself from the «oil weapon» by creating a system of strategic oil reserves. Now, it is time to establish a similar system in the gas sector. The energy security formula remains unchanged:

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\text{\textit{integrated infrastructure + strategic supplies + diversification = energy security}}
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\textit{Integrated infrastructure and strategic supplies:} Creation of the European gas contour (European Integrated Gas Supplying System – EIGSS) – an integrated system of gas supply to the EU, which would be technically able to provide necessary circulation of gas resources from the places of storage to the regions of deficit is one of the key elements. Underground gas storages (UGS), connected to the contour, should become the core component of EIGSS. In this context the Ukrainian system of UGS can play a basic role for EIGSS to the East of the EU, for Central European countries, the most dependent on gas supplies from the East.

\textit{Diversification:} Unfortunately, the EU has no unified approach to the handling of this problem. Recent Nabucco forum in Budapest showed this once again. Nevertheless, the EU will have to address the dilemma of the Nord Stream and South Stream projects, proposed by the Russian Federation and some member states (Germany, Holland, Italy). Even if those pipelines are built, they would help diversify the transit routes, not the supplier. The EU should, therefore, address the diversification challenge in the bulk, with a view of diversification of supply or replacement of gas with other sources of energy.

- It makes sense to consider the European Energy Transparency Initiative (EETI) to ensure transparency of the whole technological chain «Upstream – Midstream – Downstream». As for gas, mutual access of users, suppliers and transit states to information about all parts of the technological chain from the mouth of a well to a consumer must be guaranteed. The users have the right to know how much energy resources are produced and how much of them are pumped into the pipeline of a supplier for transportation, how much goes out from the transit system, how much is supplied to a consumer, as well as the prices, tariffs, idle capacities of pipelines, etc. An initiative like this would possibly become a part of the already operational Extractive Industries Transparency Initiative (EITI), initiated by Tony Blair in 2002 in Johannesburg. The issue of EITI extension to the sector of transportation is examined at the 4th EITI Global Conference in Doha (Qatar) this year.

- The EU and the USA should take joint actions in order to:
  1. convince Russia to ratify the Energy Charter Treaty. Negotiations of its transformation may start only after the ratification;
  2. break the monopoly of Russia’s gas sector;
  3. admit independent gas producers of the Russian Federation to foreign markets;
  4. make Russia to abolish provisions of the Russian legislation discriminating foreign investors in the field of hydrocarbon production on the territory of Russia.
In order to prevent recurrence of the energy crises of 2006 and 2009, the EU:

V. should not delay interference in settlement of the issue of gas transit via Ukraine. As we noted above, the recent legal settlement of the crisis is unstable and vulnerable to the political will of Russia. Further non-interference of the EU in the sector may prompt further Russia’s actions intended to undermine the stability of energy supply to the EU, as soon as Russia needs it for the achievement of political and economic goals;

VI. should not support the Russian proposal of creation of an international consortium for the management of the Ukrainian GTS. Such consortium will not diminish the EU’s dependence on gas supply from Russia. On the contrary, the consortium may result in the increase of such dependence, with diminution of the role of Ukraine as the main transit mediator and kind of a buffer between Russia and the EU;

VII. should support the European Parliament recommendation of February 2, 2009, to conclude a tripartite agreement between the EU, Russia and Ukraine on the transit of Russian gas to the EU. That agreement would provide guarantees and ensure transparency of Russian gas supply;

VIII. should step up efforts to create the internal European gas market with the rules of coordination of actions of the European energy corporations.

The EU and Ukraine should rearrange the package of proposals for implementation of the Memorandum of Cooperation in the energy sector (signed on 01.12.2005):

IX. main gas pipelines in the points of crossing the Ukrainian-Russian border must be equipped with measuring stations, in accordance with the project developed in 2005-2006 and approved by the European Commission, EBRD and EIB;

X. reformation of Ukraine’s gas sector with the help of consultants from the EU, restructuring of Naftogaz of Ukraine NJSC, passage to the scheme of transfer of the Russian gas to the European consumers on terms DAF Eastern border of Ukraine;

XI. expansion of capacities of UGS in Western Ukraine to store gas for the European consumers and their subsequent inclusion in the system of strategic gas reserves, if such will be created in the EU.

Modernisation of the Ukrainian GTS within the framework of the EU-Ukraine cooperation is very important. The Donor Conference of March 23, 2009, in Brussels indicated the willingness and ability to raise funds for that. The European Commission could also initiate creation of an operational system for on-line communication between control centres of Gazprom, Naftogaz of Ukraine and the European companies (SPP in Slovakia, PGNiG in Poland, MOL in Hungary, Transgas in Romania). The system should provide real-time information about the entrance of gas into the United Gas Supply System of Russia, movement of gas through the gas pipelines of Russia, Ukraine, Belarus and Moldova and delivery of gas to the EU territory at corresponding gas measuring stations. It will be a test of the readiness to work by the rules of transparency for all participants of the technological chain “Upstream – Midstream – Downstream”.
CONCLUSION

The overall solution of the European energy problems lies beyond the energy sector. Unless common trust, confidence and mutual assistance come back to the EU-Ukraine-Russia relations, we may witness recurrence of energy and other conflicts. For this to be the case, all the actors should take necessary actions.

Liberalisation and democratisation of the political and economic life in Russia is, probably, the key not only to the European energy security, but to the stability and steady development of the European continent. Nothing can be better for prosperous and predictable development of Europe than Russia implementing common with the EU values, principles and rules. The European Union should, first of all, restore its self-confidence and realise not its dependency, but interdependency with Russia. The current financial crisis is an excellent opportunity to remind Russia that trust and mutual confidence alone is the key for handling the crisis. The EU should, therefore, remain patient, but keep on asking unpleasant for Russia questions. The crisis is also an opportunity for the EU to demand fuller information from Russia about the actual state of affairs with the energy resources and exploration plans. The EU should assume a much more active role in legal arrangements to secure its energy supply and transit. Fighting corruption, internal political stabilisation and achievement of understanding of currently disputable issues of Ukraine’s home and foreign policy will help this country find the right place on the European continent and secure its interests between major actors that surround the country. Only through joint efforts of all the main actors, trust will be restored, and the parties will be able to look forward.