

Of
course
we need
Russia,
but
never
forget
that
Russia
also
needs
us



Arild Moe

Since the events of 2001 and the continuing instability in the Middle East, energy security has regained much of the position it held in international affairs in the 1970s and '80s. But now Russian energy is seen as a solution, not a problem — witness the energy dialogues between Russia and the EU and Russia and the US.

This harmonious situation was disturbed by the gas conflict between Russia and Ukraine in early January. On expiration of existing gas export contracts to Ukraine the Russian gas company Gazprom declared that it could no longer accept the low price that had been charged and would need a significantly higher price from now on, close to the export price to Western Europe. If Ukraine would not adhere to the new conditions, Gazprom would reduce the gas volumes piped into Ukraine. Ukraine did not accept the new terms and the pressure in the pipelines fell.

Much has been speculated about the motivation for the Russian policy. Was it a Russian act of revenge after the Orange Revolution? Or was it simply, as claimed, a commercial decision — getting a fairer price for a valuable commodity?

In such a decision several agendas are probably involved, and from the outside it is impossible to be certain about the mix. But it seems clear that from Moscow, whatever the motivation, it was regarded as a purely bilateral affair. When Ukraine started to

siphon off gas in transit to Western Europe, to compensate for the drop in Russian deliveries, the spectre of a fuel supply emergency in Europe in the middle of winter was raised. The Russian side must have expected trouble for the Ukrainians. But, as we know, that is not what happened. Russia was blamed and Ukraine received a lot of sympathy for being treated unfairly by Russia.

The Russian handling of the affair was certainly heavy-handed; much less turmoil would probably have resulted from a more gradual price-revision scheme. But the reactions in Western capitals were hardly sophisticated either. It seemed as if Russia's provision of more than 25% of gas imports in the EU came as surprise to many politicians. Criticising Russia for the price hike in Ukraine also sounded a little false after the constant demands on Russia to introduce market prices domestically.

Nevertheless, the Ukrainian affair brought back the question of the reliability of Russian gas supplies. Would a new and stronger Russia misuse its energy exports for political ends? There is no doubt that Europe is dependent on Russian energy, especially natural gas. But as with the US pipeline embargo in the early 1980s, the

other side of the equation was downplayed: Russia and Gazprom depend on exports to western markets. The interdependence in the international gas trade is readily visible due to the costly and inflexible infrastructure.

Since Soviet gas exports to Europe took off in the late 1970s enormous investments have been made in pipelines for transmission of gas in this direction. Most of this infrastructure does not have any alternative usage. The latest addition to the export infrastructure — the North European Gas Pipeline — will cost some €4.5bn.

From a capacity point of view this sub-sea pipeline is not really necessary, but it will give Russia a direct connection with its main European market and at the same time reduce the leverage transit countries such as Ukraine, Belarus and Poland might have over Russia. From a West European vantage point the pipeline must be seen as another commitment to European markets, increasing security of supply by diversifying transit corridors.

Gazprom's intentions to buy the large UK gas distributor Centrica were received negatively in many circles. Introduction of special legislation to prevent a purchase was discussed as a possibility. No doubt the negative impressions from the conflict with Ukraine played an important part here.

Little was made of positive impacts of large scale Russian downstream investments — the commitment to and interest in developing the gas business. This time Russian diplomacy — or lack of it — helped augment the problem.

In late April Gazprom's president, Alexei Miller, hinted that the company would give priority to the development of other markets if aspirations downstream in European countries were blocked. President Putin reiterated the threat a few days later. Again, it seemed that the Russian side did not understand how their statements played out in the West.

The reactions were very negative, with Russia portrayed as unreliable and new calls for alternative energy supplies. Since then Russian gas diplomacy has changed and more conciliatory tones have been heard, such as when Miller appeared before the World Gas Congress on 6 June.

The increasing demand for gas in markets all over the world, and the record high capitalisation of Gazprom — some \$225bn — after its shares became freely traded may have prompted too ambitious external statements and perhaps led to an unjustified self-confidence. A sober analysis should take economic realities into account. The investments and gradual penetration of Russian gas in European markets, as well as the enormous income derived through



Gazprom president Alexei Miller: *his threat to move supplies to other markets alarmed the West, but the reality is that the West is the only credible market Russia has for a supplier whose own production is peaking*

exports — some \$15bn in 2005 — link the Russian gas industry to Europe. The notion that gas exports to Europe could be replaced by other markets in the foreseeable future is simply not credible.

In the past, now often forgotten, Gazprom has threatened to send its gas to other destinations. It happened when then Gazprom president Rem Vyakhirev was frustrated by the development of the gas directive in the EU and the prospects of a European market based on short-term contracts, depriving Russia of security of demand. But the more extreme liberalisers in Europe did not get their way either. Today there is much stronger recognition of the role of long-term buyer commitments than only seven or so years ago.

Recent announcements show, however, that Russia and Gazprom are seriously investigating other export outlets, notably the plan of building two pipelines to China which could transmit up to 80 billion cubic metres per year at an estimated construction cost of \$10bn. But it is too early to tell whether the project will be realised in full scale, since Russian aspirations of becoming a global provider of gas rest on uncertain premises.

Reference is usually made to Russia's enormous gas resources — about which there

is little doubt — but the question is whether Russia's present policy will help release these resources. Gazprom's own production is peaking, and growth in Russia's gas production is only achieved through the independents that account for some 15% of the country's output.

In reality, these companies — which include oil producers — supply gas for domestic consumption at the mercy of Gazprom. There is a growing fear that the Russian gas sector will not be able to meet demand due to lack of investment in production capacity as well as refurbishment of pipelines.

This is also a reason for concern in Europe, and deals have been made that let import countries participate directly in the development of specific fields, notably Germany and Yuzhno-Russkoye in West Siberia.

But Russia needs policies that will permit much more extensive foreign investment, as well as encouraging investment by domestic sources. Apparently, major policy changes are not on the table. In July the Duma is expected to pass a bill that will write Gazprom's export monopoly into law. The intention behind the proposal is — according to the initiator, the chairman of the Duma's energy committee — to prevent the access of foreign companies to Russia's gas fields and pipelines.

Downstream, the issue is not whether Russia will misuse a strong market position to put political pressure on importing countries, or leave the European markets if it does not get its way, but rather, the more modest and traditional question of whether a very large share of a distribution network controlled by one gas supplier is healthy for competition.

Russian ownership of downstream assets should not be treated differently than acquisitions by other producing companies. It must be up to the various importing countries and the EU to structure their energy sector in a way that secures alternative suppliers and fuel-switching possibilities, so that misuse of market power can be avoided.

The vision of mutual penetration of upstream and downstream interests and the ensuing integration and interdependence meets resistance both inside Russia and in the consuming countries.

The uproar witnessed in the first half of 2006 disturbed relations between Russia and European countries in the short term, but it may have spurred a clarification of positions and interests that will be helpful in the long term. Russia's aspirations downstream are serious — and legitimate — but so are concerns over security of supply.

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