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GAZPROM'S NEXT WAR: COULD THE EU BE THE CHOSEN TARGET?

By Pavel K. Baev, 15 January 2009

Nothing is resolved in the Russian-Ukrainian gas quarrel but it has already acquired distinct features of a farce. European monitors cannot establish whether the pipelines are blocked because of Russia's deliberate manipulations with, or Ukraine's incompetence in operating the complex system of pumping stations. The subject of disagreements between *Gazprom* and *Naftogaz* appears strikingly miniscule in comparison with the scale of damage that all parties to the conflict continue to suffer. Prime Minister Vladimir Putin, who positions himself as the master-mind and micro-manager of the 'business dispute', is apparently enjoying every opportunity to demonstrate ineptitude of his Ukrainian 'colleagues'. It is too early for assessing the consequences but one lesson looms large for the European gas consumers: More problems of this sort are in the making.

The EU bureaucracy, slow as it is, cannot miss this lesson and is predictably gearing up its discussions about reducing the dependency upon Russia through diversification. *Gazprom*, however, does not seem to be worried even if potentially it stands to lose a considerable share of its pivotal market. This cavalier attitude can partly be explained by the great distortions to political decision-making caused by the exploding economic crisis. Ukraine, for that matter, is definitely past worry about its reputation as a transit country as it looks into a very real prospect of bankruptcy and must convince the reluctant Europeans that they have to come to rescue.

Forging a common energy strategy was a hugely complicated task for the EU in the best of times, and as the member-states are adopting individual 'stimulus packages' it becomes all but impossible. Putin has made sure that Germany, the absolutely central country on his mental map, is not affected by the gas blockade, so *Gazprom* counts on the proverbial 'common denominator' in the EU position on this conflict to be very low indeed.

There are, however, deeper reasons for Moscow's readiness to take the toughest possible line in the conflict with Ukraine, and they concern mid-term prospects for the EU energy market. The goals of 20% reduction in total energy consumption and 20% increase in the use of renewable sources by 2020 approved by the EU last December were interpreted by *Gazprom* as a triumph of wishful thinking and political correctness over expert analysis. Maybe Russia's experience in increasing energy efficiency (which has not increased at all) is not that informative, but there is little evidence to disprove its assessments that the EU cannot: a) shift from gas back to coal since the environmental lobby would sabotage any 'clean coal' project; b) develop any meaningful alternative sources since their costs have become prohibitive in the times of cheap oil; and c) agree on any proposal for building nuclear power plants.

This firm conviction that Europe has no alternative to natural gas in its energy balance goes hand in hand with the belief that the plans for diversifying sources of gas, circulating around Brussels and Washington, would remain harmless fantasies. Indeed, Norway has no potential for increasing production, Algeria neither (and permanent civil war is a risk factor), Qatar is oriented towards China and other Asian markets, and Iran – which could potentially saturate the market – remains ‘un-investible’. Putin has put great effort into making sure that Turkmenistan would export the bulk of its gas northwards, and even if the Pri-Caspian pipeline is slow in materializing, the Trans-Caspian one is effectively blocked, so many ardent advocates of the *Nabucco* project cannot invent a resource base for it.

Moscow could be over-confident in its outlook for *Gazprom*’s unshakable dominance on the European market, but the halt of deliveries has revealed an asymmetry in the long-existing inter-dependency: many EU member-states are very vulnerable to interruptions in gas flow, while Russia has reserves to compensate for delays in money flow. This position of strength established in the ‘skirmish’ with Ukraine makes it possible for *Gazprom* to plan for the next ‘gas war’: Challenging the EU about the gas prices. The current formula for calculating it on the basis of oil prices was established back in the 1980s, and it determines that *Gazprom*’s revenues since the second half of this year would shrink to merely a third from the peak in the last quarter of 2008. This behemoth of a company cannot exist on such a thin diet, so Putin needs to convince Germany and every other European consumer that the ‘era of cheap gas’ is indeed over.

The EU has lost three years since Miller’s first experimental turn of the valve contemplating various unfeasible propositions from *Nabucco* to wind-farms – but there are still two plans on which it could move reasonably fast: Constructing new storage facilities that would contain gas reserves for 3-4 months and building connections between isolated distribution systems in order to create an all-European gas network. That would not automatically advance liberalization of the gas market, about which such national ‘champions’ as *Gaz de France* or E.ON remain less than enthusiastic, but it would deny *Gazprom* the ability to put painful pressure on particular targets.

Setting the Moscow summit, Putin radiates confidence that Russia is set to win this round of gas confrontation but despite his self-proclaimed pragmatism, he has drifted far from touch with the reality of such elusive political matters as trust, respect or partnership. No price can be put on them, unlike on a thousand cubic meters of gas, and it is up to the EU quiet bureaucrats, over-worked commissioners and rotating presidents to prove that Putin has lost these credentials – and his business is treated accordingly.

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