EU-Russia Energy Relations: Russian Perspectives

Centre for European Studies
at the Carleton University, Canada
13 June 2013

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Overview of presentation

- Russia energy policy with emphasis on external priorities
- EU energy policy: liberalization & security of supply + external activities
- EU-Russia energy relations with emphasis on existing challenges

Energy policy of Russia

Crucial importance of energy sector for Russian economic development

30% of GDP

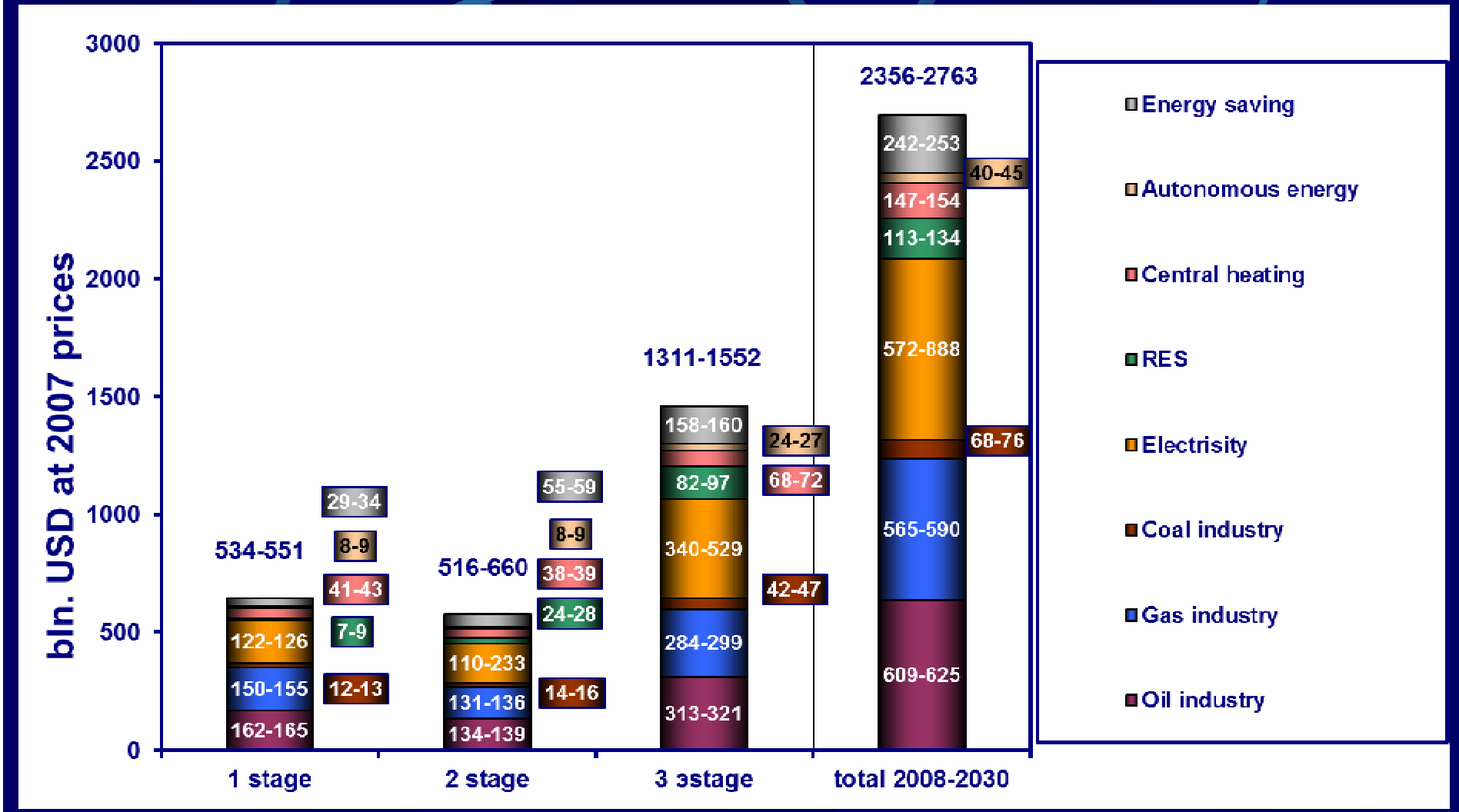
65% of export

50% of budget revenues

Russia Energy Strategy till 2030: Priorities

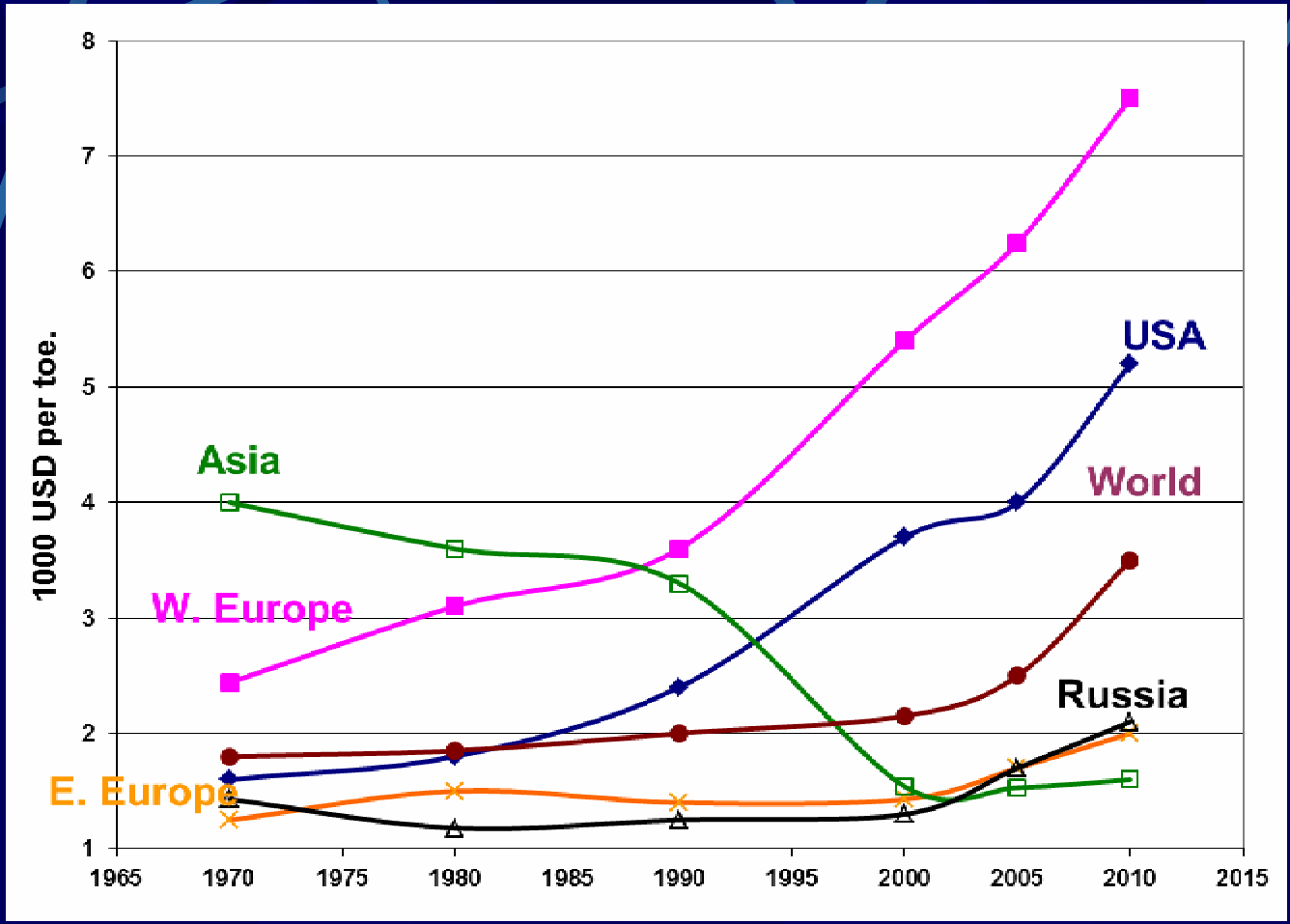
- Development of oil & gas industry in Eastern regions
- Development and diversification of energy transport infrastructure
- Development of Arctic shelf
- Development of non-fuel energy
- Energy saving

Forecast of investments demand



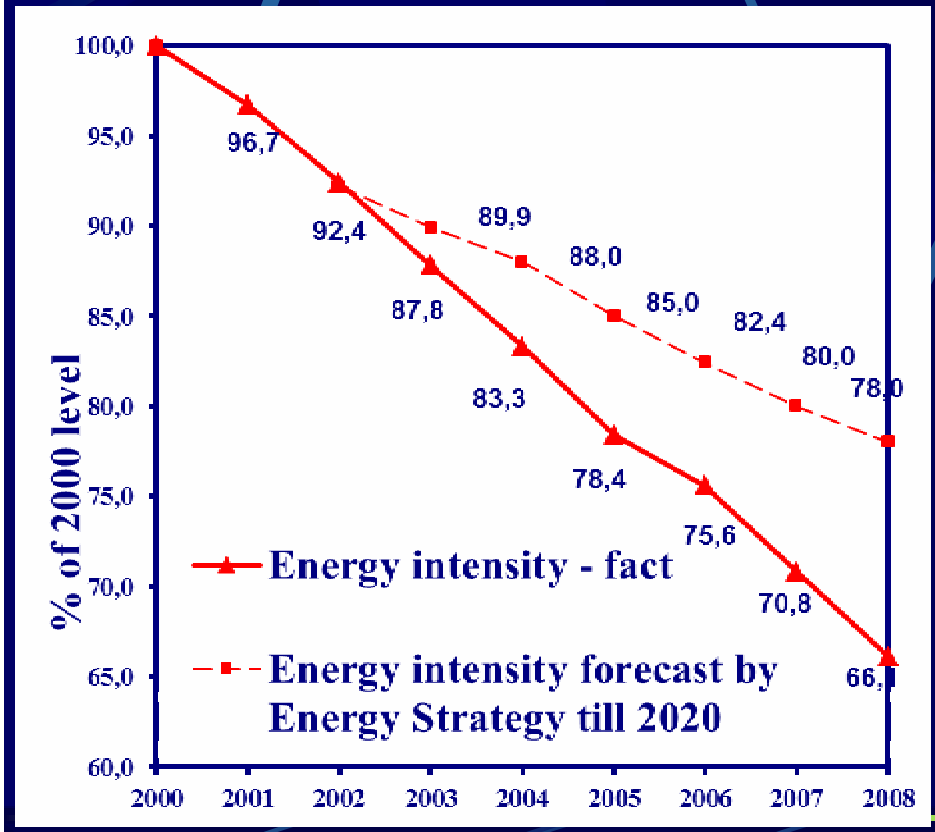
Source: Russian Energy Strategy till 2030

Energy efficiency, 1000 USD per toe

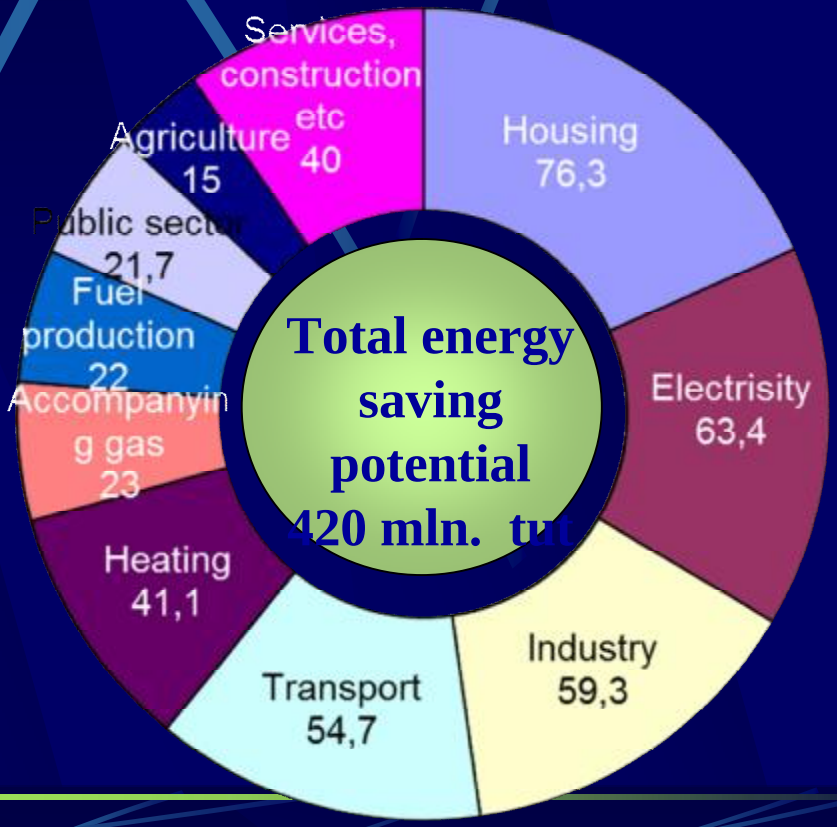


Energy efficiency in Russia

Since 2003 energy intensity decreased faster then it was predicted because of business adaptation to high energy prices



Energy saving potential, t.u.t

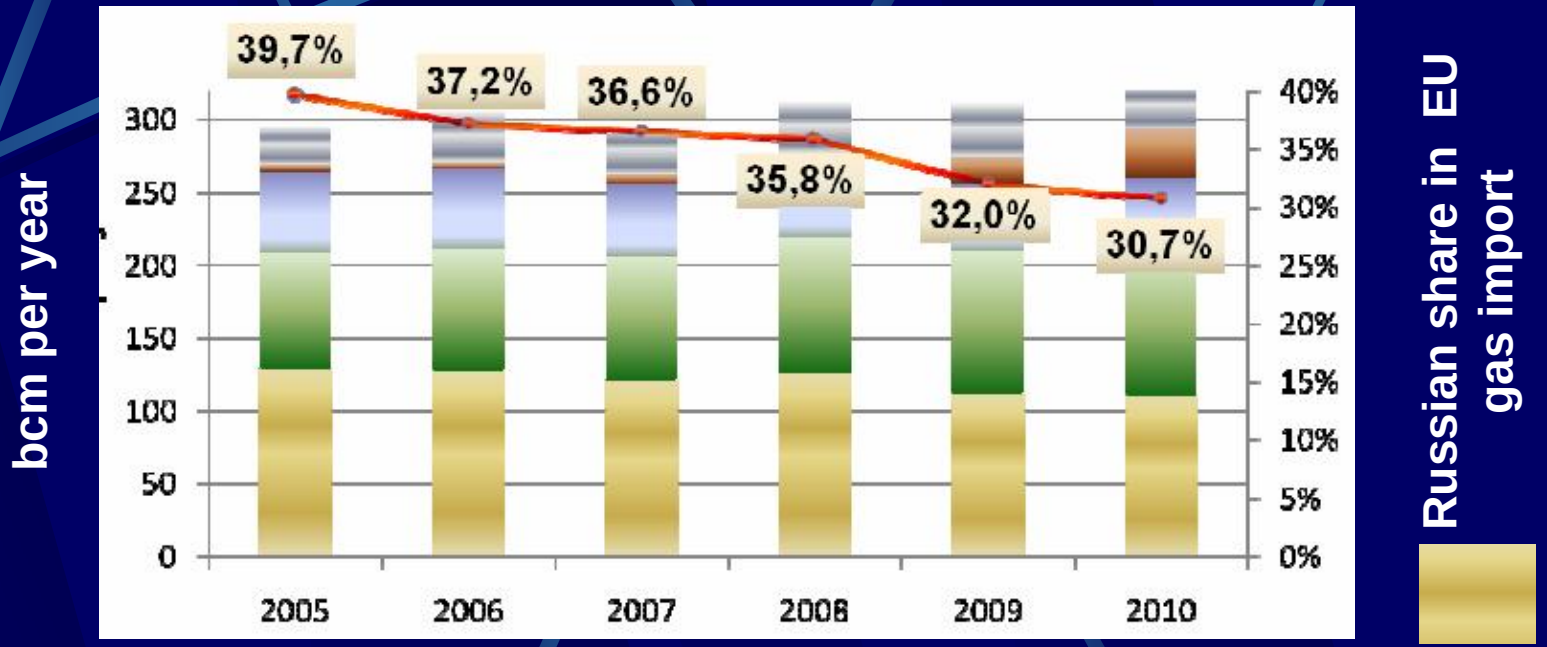


Source: IES

External priorities of Russia energy strategy

- Priority of European market with partial export diversification eastward
- Provide the stable, uninterruptible and economically affordable transit
- Preserve leading role in Central Asia
- Diversification of energy export nomenclature

Priority of European market …



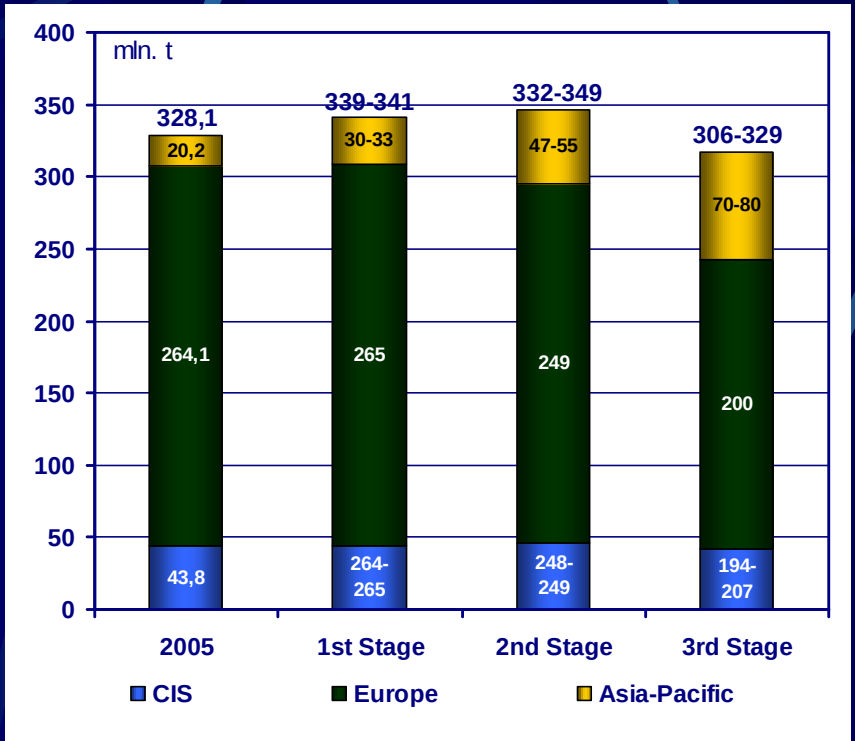
Europe is big and predictable consumer which pays adequate price

Russia strategic interests:

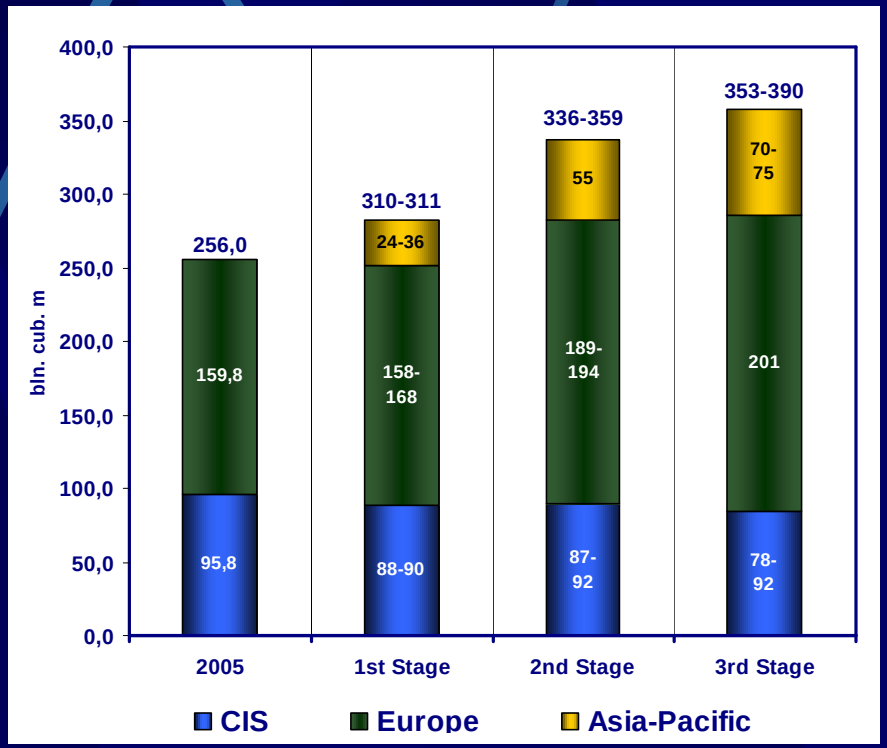
1) keep or even increase market share
2) maximize profit via access to the final consumer
3) maintain existing ‘rules of the game’

… with partial export diversification eastward

Forecast of oil & oil product export



Forecast of gas export



Source: Russian Energy Strategy till 2030

Oil pipeline
East Siberia – Pacific ocean

Provide the stable, uninterruptible and economically affordable transit

North Stream
Length – 920 + 1200 km
Capacity – 55 bcm
Shareholders – Gazprom (51%), Wintershall Holding (20%), E.ON Ruhrgas (20%), N.V. Nederlandse (9%)
In operation – 2011-2012

South Stream
Length – 2446 + 900 + ? km
Capacity – 63 bcm
Shareholders of undersea part – Gazprom (50%), Eni (20%), Wintershall (15%), EDF (15%)
In operation – 2015-2016

Preserve leading role in Central Asia

- Role of Turkmen gas in Russia energy balance
- Change of price setting mechanism for Turkmen gas in 2008-2009 on the base of linkage with price in Europe
- Possible challenge: Turkmen gas at EU market
- Enigma of Trans-Caspian pipeline – nobody wants to pay
- Gas pipeline ‘Central Asia – Center’; capacity 80 bcm
- Caspian pipeline consortium, project of its further development

Diversification of energy export nomenclature

Synchronization of Russian and EU electricity systems

Nuclear plant Belene (Bulgaria)

Liberalisation of energy markets and energy security in the EU

- 1990s approach: free movement and competition first; invisible hand of the market would provide security of supply
- But security of supply as a possible exemption from freedom principles (*Campus Oil* case)
- Later on…
  - the option of 'public service obligations' relating to security of supply (1990s Directives)
  - monitoring and reporting obligations (2003 Directives)
  - Security of Electricity and Gas Supply Directives (2006/2008)
  - Security of Gas Supply Regulation 2009 – cross border infrastructure and regulation of investments in infrastructure
  - 10 year infrastructure development plans (2009) devellopped by system operators and **state regulators** – evidence of market failure
- Conclusion: energy market legislation increasingly focuses on security of supply, trying to balance liberalization and security. But this balance is applicable only to EU market players, not for external suppliers.

EU external energy policy: activity with a shortage of competency

Restriction of EU competency:

EU energy policy ‘shall not affect a Member State’s right to determine the conditions for exploiting its energy resources, its choice between different energy sources and the general structure of its energy supply’ Article 194(2) TfEU

Long term activities

- Export of energy acquis
  - Energy Community
  - European Neighbourhood Policy
- Diversification of suppliers and supply routes
- Dialogs with key suppliers and big global consumers (Russia, Brazil, India, OPEC, USA etc.)

Recent activization of EU external energy policy

- Commission Communication ‘The EU Energy Policy: Engaging with Partners beyond Our Borders’, 07.09.2011
- Commission participates in bilateral negotiations of MSs
  - Intergovernmental agreement on Nabucco, 2009 (Austria, Bulgaria, Hungary, Romania, Turkey)
  - Russia – Poland agreement on management of the Polish part of Yamal pipeline, 2010

  Günter Oettinger: ‘EU plaid the role of advisor… we worked together to ensure the contract would be in line with EU legislation’
- 12 September 2011: the Council of Ministers gave to the Commission the mandate to negotiate Trans-Caspian pipeline – precedent decision
- Decision No 994/2012/EU of establishing an information exchange mechanism with regard to intergovernmental agreements between Member States and third countries in the field of energy (25 October 2012)

EU-Russia relations: Abundance of controversial rules

- Existing legal base:
  - ECT (still unbalanced, under modernization, Russia is outside)
  - PCA (not energy-specific, out-dated, has to be replaced)
  - Road Map 2050 agreed on March 2013 (does not set rules)
  - Bilateral treaties of MSs, for example investment treaties (variety, under question because of competence shift to Brussels)
  - WTO (rules on energy trade & transit are unclear, no case law)
- Potential legal base:
  - Private law contracts (under pressure of Eur. Commission)
  - NBA (incl. “energy chapter”, work in slow progress since 2007)
  - Convention on International Energy Security (work in slow progress since 2010)
  - Agreement on Cross-Border Energy Infrastructure (work in slow progress since 2011)
- Conclusion: Need for Mutually Agreed Set of Rules

Third Energy Package: Main regulatory challenges

- Retroactive application
  - *Lietuvos dujos* case
- Contradictions with existing EU & MSs obligations
  - ECJ case European Commission v. Republic of Slovakia
  - Ownership unbundling for transmission and TPA undermine future investments in infrastructure
  - South Stream
- Certification under Third Country Clause open door for selective approach

When law meets reality

OPAL & NEL – pipelines to link Nord Stream with German gas network

LAW

Pipelines are subject of TPA provisions of Gas Directive 2009:
-TPA
-(partial) exemption for long term contracts, about 50%

REALITY

German regulator gave OPAL & ENEL 100% exemption from TPA
Commission revised this decision and gave only 50% exemption
Pipelines are 50 % empty !!!

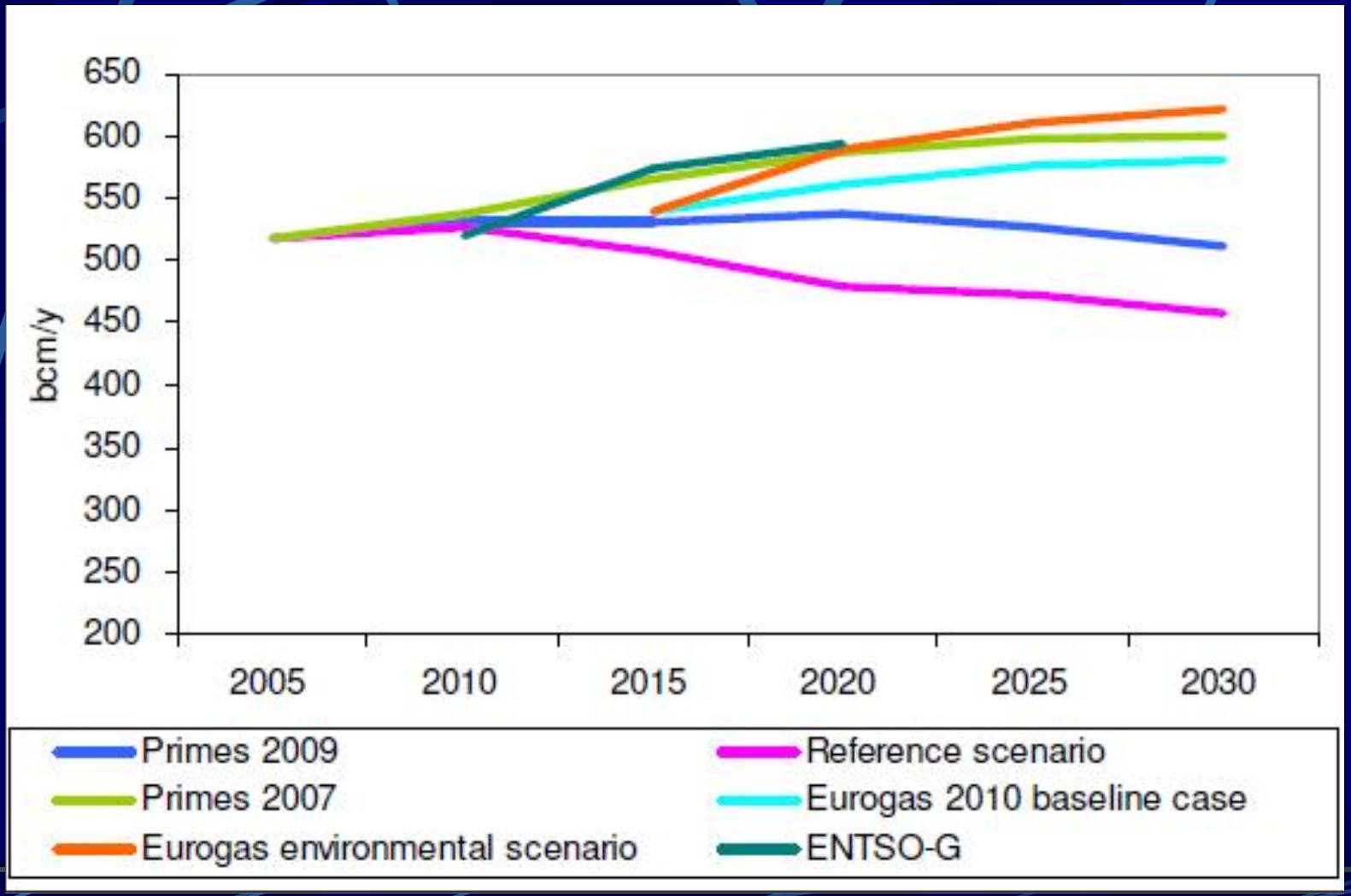
Gazprom problems:
- Sells less gas, receives less profit
- Risks not fulfill contractual obligations

Consumers problems:
- risk stay without gas (especially at the peak period)

Who wins? Brussels ideology

Fiat justitia et pereat mundus? Who is ready to be a victim?

EU gas demand in different forecasts

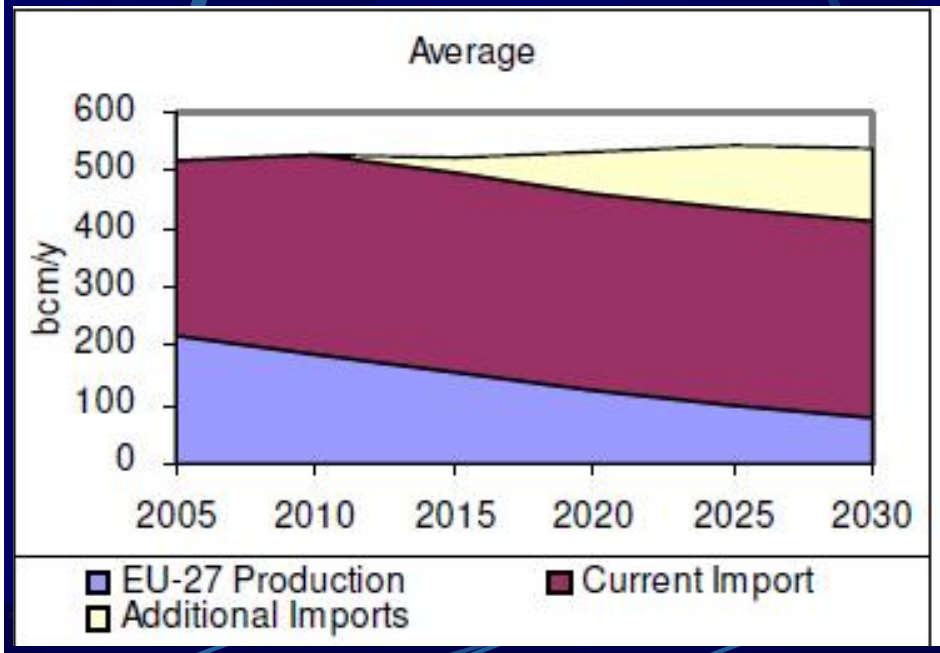


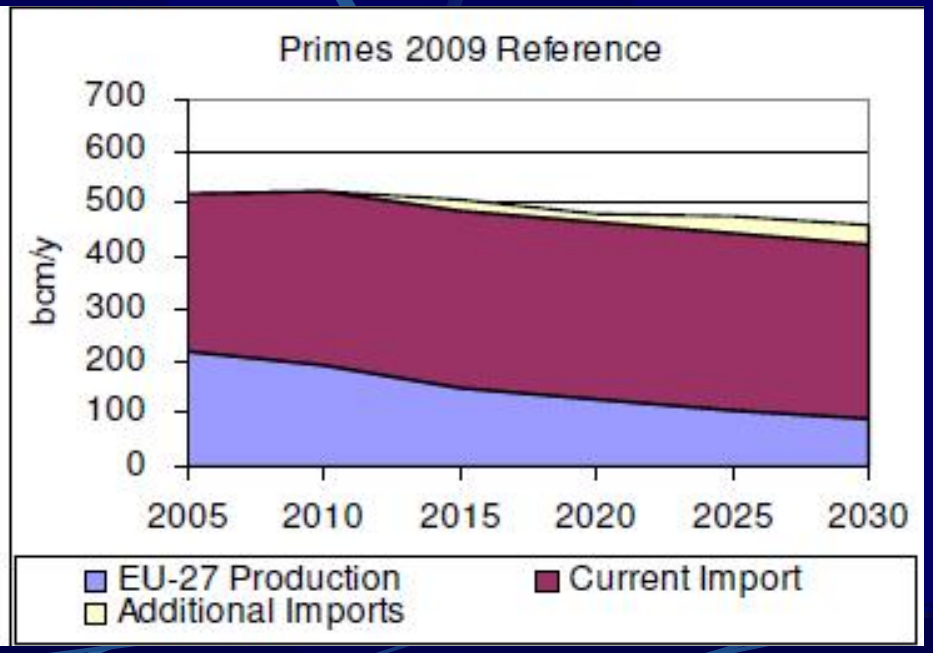
Source: DG TREN

Such uncertainty, what does it mean for suppliers?

Additional EU demand in 2030 would be more 100 bcm/y or only about 30 bcm/y?

Different realities require different strategies; but which one to choose?





Source: Mott MacDonald

Predictability of trade flows

- Why predictability is valuable for Gazprom?
  - Investment planning
  - Big supplier
  - Near to become marginal supplier
- Why predictability is valuable for European consumers?
  - Gazprom de facto is guaranty supplier in Eastern EU MSs

What is the fair price of gas?

- Consumer approach
  - Price should be low enough not to undermine economic growth
- Producer approach
  - min: income should be enough for development of energy sector
  - max: income should be high enough to redistribute “energy money” for development of other sectors and social needs

Who earns more?

Gas price, euro per gigajoule

	2009	2011
Average price of Russian gas exported to the EU	5,32	7,66
Price of gas in the EU - industrial consumers	10,8	12,07
Price of gas in the EU - domestic consumers	15,55	16,81

Income distribution of money for Russian gas sold to EU domestic consumers, 2009

Gazprom (including taxes to Russia budget)	34 %
EU energy companies	44 %
Taxes to EU member states	22 %

Source: Rosstat, Gazprom, Eurostat

Existing legal & regulatory market framework provides unfair distribution of revenues. Supplier's strategy – to reach the final consumer, but…

Does EU legislation really provides to Gazprom access to the final consumer ?

Market share of three largest companies in whole retail market (%)

	2008	2009		2008	2009
Austria	NA	80	Italy	66,5	63,4
Belgium	92,3	NA	Latvia	100	100
Bulgaria	32,5	12,9	Lithuania	100	100
Czech rep.	NA	47,4	Luxembourg	88,5	
Denmark	NA	NA	N. Ireland	NAP	86
Estonia	99	99	Poland	100	100
Finland	NA	NA	Portugal	NA	NA
France	98,5	NA	Romania	83	59,1
Germany	26,3	35,2	Slovakia	100	100
UK	72	72	Slovenia	86	82
Greece	100	100	Spain	74	71
Hungary	75	72,6	Sweden	NA	NA
Ireland	100	100	Netherlands	NA	NA

Despite all liberalization measures gas markets of EU MSs are oligopoly; level of concentration is very high. Even national newcomers hardly can bypass ‘former’ national monopolies and reach the final consumer.

New regulatory measures doesn’t provide new opportunities for external suppliers, but undermine existing security of demand.

Source: European Commission

Spot markets as a price setter?

Theory – what spot market needs to be efficient?

- Storage facilities
- Infrastructure
- Many suppliers of physical gas
- Liquidity

Reality

- Physical trade at spot markets gives only 3,5% of final consumption
- No spot markets in Eastern EU MSs
- Let's imagine spot market, for example, in Poland… with one superdominating gas supplier

Spot markets in the EU

Gas Hub	Trade volume in 2010, bln. m3	Physical trade volume in 2010, bln. m3	Churn rate, %
NBP	1237	106	11,5 %
TTF	106	31	3,4 %
NCG	84	31	2,7 %
Zeebrugge	65	13	5,0 %
GASPOOL	62	25	2,5 %
CEGH	34	11	3,1 %
PVS	43	21,5	2,0 %
PEG	28	9	3,1 %
Total	1660	249	6,7 %

Source: Skolkovo based on market operators, HEREN, IEA, Medium Term Oil&Gas Outlook 2011

Why Gazprom ‘formula gas’ is more expensive then ‘spot market’ gas?

Short term explanation:

‘spot market’ gas is additional gas; if spot market price is higher then formula price, consumer asks additional volumes from Gazprom

Long term explanation:

Gazprom not only sells gas but also provides…

- a service – flexibility (how much does it costs?)
- a long-term guaranty of supply (how much costs the risk to be without necessary volumes of gas in 10-15 years?)

Different negotiation strategies

EU:

- Agreement possible only on the basis of EU rules ("Energy Community model");

Russia:

- "Energy Community model" is not acceptable because rules shall be mutually elaborated rather than imposed by the partner
- Easier to agree with separate Member States

BUT this would preserve unclear situation with various contradicting sets of rules

Alternative options of EU-Russia energy cooperation

Simple trade

- Gazprom doesn't care about peak capacities. If peak demand like in January 2012 – please go to the spot market.
- In investment planning Gazprom takes into account minimal / low forecasts of consumption growth. What if in 10-15 years EU demand will be higher then expected?

Long term energy partnership:

- How to take into account producer's risks and how to provide fair distribution of income?

EU approach to use short term favorable situation at the market to reconfigure regulatory framework may cause serious risks in long term perspective.

How existing legal & regulatory base should be modified to answer abovementioned concerns?

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