

Compared to the Eurozone's public finances, European energy policy looks decidedly bright. Capacity margins are high, prices are low, even emissions have dropped of late. The EU's 'Third Package' of gas and power market reforms, which took effect in March, is set to further enhance supply security, increase competition and improve consumer choice and services. It all sounds very good, but the problem is that such 'policy hits' are grounded in weak fundamentals—not silver bullet policy making. Shale gas developments have turned LNG markets on their head, while deep seated financial frailties and economic slumps have kept fundamentals weak and growth anemic across EU27 states. That's making energy policy look good, and political populism all too easy.

But with growth showing tentative signs of recovery and climate policies still placing a premium on natural gas over coal, complacency and energy populism will come with costs. Nowhere more so than on natural gas – and the 158 billion cubic meters (bcm) of Russian supply that the EU will gobble up this year. After dipping to 2002 levels in 2009, EU gas consumption has surged by 7.2% in 2010, with most analysts expecting that by 2013, demand should have rebounded to pre-crisis levels. Increased LNG shipments to Asia have already added upward pressure on prices, and Germany's snap decision to decommission its last nuclear power plants in 2022 will sustain demand growth for the foreseeable future. The European Commission, meanwhile, has taken its eyes off the Asian ball and remains undecided how it should deal with Russia, its single largest supplier. If RWE, Germany's second largest electricity producer, and Gazprom, the world's biggest gas firm, implement their recently announced Memorandum of Understanding (MoU) and establish a joint venture to manage coal and gas plants across Germany, the UK and the Benelux countries, the EU's Third Package might well follow Germany's 2011 decision to toss nuclear power into the dustbin of history.

Thanks to European politicking, Moscow holds the energy aces. Berlin's accelerated nuclear phase out may be popular, but it is likely to add as much as 20bcm/year to German gas imports alone. The French ban on shale gas drilling is hardly going to help reduce energy dependency, while Europe's renewed commitment to democracy and good governance in its neighborhood may chime with European values, but has done little to reassure the authoritarian rulers who control alternative upstream sources in Central Asia and the Middle East that Europe is a credible energy supply bet. Any European state that follows Germany's nuclear example, emulates France's disdain for fracking, or thinks it can 'play nice' and win with suspect neighbors will simply strengthen Russia's hand.

Missing the point?

Overly dramatic? Perhaps. Conventional wisdom in Europe holds that Gazprom is in deep trouble. The main reason for this relates to cheap spot markets that have been growing in liquidity. Oil indexed gas from Russia is deemed too expensive for European consumers to bear, with independent benchmarks on Western European hubs the preferred option. Move over or lose market share is the clarion call from consumers: current price spreads clearly point towards this way of thinking between UK wholesale hub and oil-indexed Russo-German border prices. Unsurprisingly, producers have been screaming murder. In 2010 Gazprom reportedly agreed to cut oil indexation levels in some long-term contracts to 85%, but insisted that the three years exemption would not change its long-term contract system. Algeria went a little further and called for the formation of a fully fledged gas cartel. So far, it was only really Norway that took price corrections on the chin by rapidly revising contractual relations to retain its stake in European supplies. You'd think that with Gazprom on the ropes and shale gas starting to blossom beyond US shores that European capitals would not offer Russia an opportunity to

regroup. Not so. In June, the German government shocked utilities, already out of the money on oil-indexed prices and burdened with an onerous nuclear fuel tax, when it reversed the October 2010 amendment that had extend the lifespan of nuclear plants by an average of 12 years in exchange for an annual €2.3bn 'fuel rod tax'. Faced with a massive capital expenditure program, ratings downgrades and a negative outlook, RWE went cap in hand to Gazprom to offer the Russian company a major downstream stake in a rare and combustible blend of commercial and political brinkmanship.

Commercially, RWE's gamble might pay off if Gazprom's entry into the downstream game made it more amenable to price discounts that would narrow the gap between term prices and lower hub-based spreads. A more flexible Russian partner might also add pressure on E.On, RWE's main competitor in Germany, whose supply contracts expire in 2012 having voiced its preference for '100% spot'. But the fact that Alexey Miller, chairman of Gazprom, has been talking with both RWE and E.On about prospective tie-ups suggests that he is far more likely to pitch the utilities against each other rather than to make concessions. If discounts are offered, they will be given on the strict understanding that oil indexation will remain the basis of Russian supply pricing in any long term take-or-pay contract. In short, Gazprom intends to use RWE and E.On as 'sledge hammers' to crack the European spot market 'nut' before it really takes off.

That would be a shame. Spot markets can obviously play out any which way in terms of price, but moves towards independent gas benchmarks would have been in everyone's long term market interests – at least within the European context. To that extent, German politics has given Gazprom an unnecessary eleventh hour reprieve to retain European market share and a Russian 'market price'. Politicians will no doubt blame RWE for using Gazprom as collateral in its fight to overturn Berlin's nuclear ban. But they should keep in mind that the power utility has lost roughly 20% of its market capitalization since the German parliament decided to accelerate the nuclear phase out and wipe out roughly 30% of RWE's installed capacity. The policy message is thus very clear. Chancellor Merkel must rethink the nuclear turn or RWE will hand Gazprom the keys to European downstream doors. A classic double catch: RWE is using Gazprom to salvage its nuclear position, just as much as Gazprom is using RWE (and potentially E.On) to maintain its pricing policy.

Eventually something has to give. If the German government doesn't budge on nuclear, RWE might find that its brinkmanship leaves it little choice but to turn the MoU with Gazprom into a contractual commitment. In the interests of consumers, industry and tax payers, things arguably shouldn't get that far; if German courts agree that the government violated the utilities' property rights, or if Berlin comes to its senses and reinstates the October 2010 consensus that stretched the phase out until 2036, they probably won't. But as the Eurozone debt crisis has shown, German politicians can be stubborn defenders of voters' preferences, no matter the costs. And energy populism has a price. Even if Berlin keeps some nuclear generation capacity online, Germany will still have to look to gas to fill most of its gaps. This is exactly what Gazprom is banking on. Germany's nuclear window has offered the Russia a perfect opportunity to keep exports high and prices firm. If it all goes to plan, Russia will be able to feed Europe with discounted gas—on its own joint venture terms.

Russian hugs

Given the complexity of the games underway, it's impossible to say how the RWE-Gazprom MoU will or won't play out. But the simple fact that utilities are considering the comforts of a Russian bear hug has set alarm bells ringing in Brussels and beyond. And with good reason: German brinkmanship has exposed the deep rooted frailties that pervade European Energy

Policy on pricing, supply diversification and unbundling. Besides threatening a return to the oil-indexed dark ages, an RWE-Gazprom tie-up could deal the final blow to one of the few supply side measures among the EU's 2020 energy infrastructure priorities: the Nabucco pipeline. RWE has long been the driving utility force behind Nabucco, and it does not take a clairvoyant to see the 'synergies' created from a tie up would ensure RWE tucked in behind Gazprom's South Stream initiative, not to fight the Russian giant tooth and nail for strategic control of the 'Southern Corridor'. No matter how much Brussels has invested branding the likes of TAP, AGRI or ITGI as 'European' projects, it is highly unlikely that any other pipeline will see the light of day besides South Stream. Today's spread bets on South Stream and Nabucco from countries and utilities involved, displays just how little credence 'projects of European interest' have among those who understand that to be commercially viable, one, and only one, pipeline project can prevail.

This hits on a deeper European problem. Even if Nabucco were to succeed, and even if Azerbaijan were to bet on the EU, rather than Russia, Gazprom would still have a downstream say. It already controls 20% of the German gas market through linkages with BASF, Wintershall and Wingas, and looks determined to use North Stream take offs to increase its stake in the Netherlands, France and the UK. More importantly, Gazprom also holds a 50% stake in OMV's Baumgarten transmission hub that is designated to connect Nabucco to European pipelines. Last but not least, the Russian firm has ramped up storage-capacity across multiple markets including Austria, Hungary and Netherlands, with a view to expanding facilities in Serbia, France, Belgium and Britain.

This underpins why the RWE-Gazprom tie up is so crucial. Although the deal would have to overcome political opposition in Germany and to conform to the growing body of legislation that envelops the Third Energy Package, it will be hard to close the 'vertical integration' flood gates once Gazprom claims a major stake in German production and distribution. The Russian company is already talking with France's GDF-Suez (a Nord Stream partner) and Italy is no doubt on the list. As Central and Eastern European states will be left to fend for themselves, the Third Package might well be remembered as a lore of 'legal niceties'. Russo-German political and commercial realities will hold sway. As the fine print of European legislation points out, national regulators should take the 'utmost account' of the European Commission's terms and opinions. But this won't cut much ice with utilities whose profits and survival depend on swap agreements with Gazprom, or with Moscow once Gazprom has a say on downstream rents.

From regional supplier to global player

Vertical control is of course exactly what any ambitious producer state dreams of. And the bad news for Europe is that things might get worse. While the EU has been caught up in increasingly parochial squabbles over energy efficiency, renewables, smart grids and the control of transmission systems, Gazprom has turned to the East, and is reportedly close to signing a 68bcm/y deal with China. True, we've been there before. Gazprom and CNPC struck a similar gas MoU in 2006 only to see it flounder on pricing problems. But the rationale of linking one of the world's largest energy consumers to one of the world's biggest gas reserves remains as compelling as ever, and Beijing has already moved the debate on by offering prospective advanced payments of \$25-40bn in return for 30bcm/y of discounted gas.

Although Gazprom will haggle to raise the current (alleged) \$300/million cubic meters (mcm) target price, Moscow knows that it needs Chinese cash to consolidate its Eastern Gas Program and that spare funds could enable it to upgrade the integrated gas production, transportation and supply system that connects Eastern Siberia and the Far East. Gazprom also knows that while China may not be prepared to pay European gas prices, it is likely to agree to some kind

The Empire Strikes Back: European Energy and the Return of Gazprom

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of oil index link. Beijing is too cautious to buy into a buyers' market, not the least because both Sakhalin and Shtokman have been earmarked for LNG development and might produce as much as 62 million tons a year by 2030. Even before the Fukushima meltdown boosted Japanese demand, Gazprom had been discussing prospective LNG deals with the likes of South Korea, India, Vietnam, Thailand and Singapore down the line to secure market presence and market share well beyond traditional Western European hunting grounds.

There is no point in pretending that European politicians have woken up to these developments, let alone contemplated a 'doomsday' scenario in which Russia links its East Siberian reserves to the Unified Gas Supply System in a way that would allow it to switch between LNG or pipeline exports and route supplies to either the Atlantic or the Pacific basin at a mouse click. Even if the engineering and financial strains mean that Yamal will feed the EU for some time to come, Europe needs to understand that as the gravitational pull of supplies is shifting eastwards, Gazprom's—and Russia's—strategic focus will be on arbitrage not compromise.

Realignment

Gazprom's return thus highlights a number of bad moves the EU made while it was lulled by a soft gas market. Investment in storage capacity has been low, reforms to reduce pricing pressures have been meek and grid integration has been treated as a regional, if not local problem. More recently, the EU's plans for upstream diversification have been debunked by its blatant failure to project military power across the Middle East and North Africa, and Germany's decision to phase out its nuclear assets just as tighter markets were heralding the golden age of gas has been reckless at best; no matter what showings in local elections will prove, voter 'preferences' in Germany will not eclipse rising Asian demand, the energy needs of a European recovery, or potential supply side constraints as the downside risks of fracking and cracking unconventional gas become more apparent.

European posturing has not only placed supply side eggs into predominantly Russian baskets, it has also encouraged Gazprom to renew its efforts to move downstream across the European value chain. If Russia manages to cement supplies to the East and enhance internationalization strategies across North African and Central Asian markets to boot, the prospects for European energy will be incredibly bleak, and even more so when markets will tighten. Who knows, we might be truly grateful to retain an oil-indexed link by that stage to keep a lid on spiraling gas prices, and applaud those who turned a policy failure into a 'crowning success'. But like with the Eurozone debt crisis, we will still wonder whether the price to appease the German voter is worth paying.

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