

Europe's Chance to Face Up to Russia's Energy Bullying

Written by Camilla Hagelund
Thursday, 18 June 2009 00:00

The Russian economy, largely based on its oil and gas industry, has been hard hit by the current economic crisis. Gazprom's revenue on the European market is expected to shrink to \$40bn from \$73bn in 2008, and production to drop by 10-15% this year – a production level likely to last four to five years owing to lack of future investments in production facilities. Petroleum Argus also recently reported, citing an undisclosed Gazprom source, that Gazprom's investment program will be reduced by more than 50% to RUB400bn this year. Simultaneously, export prices have dropped to around half the record level of the last quarter of 2008. Despite this slump, the Putin regime and Russian oil and gas companies – the regime's extended arm – are continuing an aggressive strategy towards the European market – what could even be called a crisis-exploiting strategy. In April Gazprom in cooperation with Credit Suisse issued Euro-bonds worth \$2.25bn; a move that enhances the number of European stakeholders with a distinct interest in Gazprom's success. Concurrently, with Gaz de France's apparent readiness to join in, the Nord Stream pipeline project might be facing a critical breakthrough that could lead the Swedes to drop their procrastination on the project, which is destined to increase Russian political leverage in Europe. Nord Stream, however, also requires permission from Finland, which continues to withhold authorization perhaps reflecting the Finnish objection to Russian restrictions on timber trade.

Other aspects of this strategy are seen in Ukraine, Azerbaijan, Turkey and Hungary. Kiev and Brussels in March brokered a deal in which the EU will finance the modernization of Ukraine's pipeline infrastructure, which transports 80% of Russian gas exports to Europe. The Kremlin considers this to be a hostile move which is why Gazprom threatened Ukraine with fines for buying less gas in the first quarter of 2008 than agreed – a step Gazprom had hitherto repudiated. As a consequence of this agreement, and the EU's recently adopted Third Energy Packet, which enables European energy companies to buy Russian gas at the Russia-Ukraine border, the Ukrainian pipeline system could come under control of European firms; this situation would not only lessen Russian political clout but pose a financial threat to Russian gas companies as the transit fees paid are likely to almost double. Such developments led President Medvedev to suggest scrapping the Energy Charter, which Russia has signed but not ratified and thus does not feel bound to, in favor of a new structure for energy security in which producers and consumers jointly supervise the maintenance of pipeline infrastructure in third countries. This scenario is aimed at undermining the role of transit countries such as Ukraine and Poland. Medvedev is unlikely to succeed with this proposal; it remains unclear, however, if Russia will play a role in the upgrade of the Ukrainian gas pipeline system. With the Ukrainian economy in serious trouble, Prime Minister Yulia Tymoschenko recently invited Russia to participate in the modernization work in exchange for Gazprom forgoing its right to levy a fine upon her country. Gazprom and the Kremlin upheld strong pressure on Ukraine until Naftogaz on June 5 managed to pay Gazprom \$657m, including \$500m for gas placed in underground storage. How the Russians responds to this remains to be seen.

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Also, in Azerbaijan Gazprom has been making inroads. In late March Gazprom and SOCAR, the Azeri state oil company, signed a memorandum of understanding to start negotiations on exporting Azeri gas through Russia from January 2010. No doubt this – in part – reflects Gazprom's interest in spoiling the Nabucco project by drawing on Azeri gas reserves. However, it is unlikely to mean Azeri deflection from the Nabucco project. The issued joint memorandum is vaguely worded implying that Azerbaijan is perhaps using the negotiations in order to pressure its European partners into firmly committing to the Nabucco project. With the recent progress in negotiations on the Nabucco project it is increasingly unlikely that Azerbaijan would choose the Russian alternative. President Aliyev is intent on securing a transit agreement rather than the delivery-at-frontier (DAF) agreement Moscow is offering; an outcome far more likely with transit via Turkey who has, nevertheless, also been insisting on DAF.

Meanwhile, Gazprom and Turkey reached a preliminary agreement on constructing a second branch of the Blue Stream pipeline. As Turkey's gas market is saturated, the construction of a second Blue Stream trunk-line would be for export, possibly to Israel or Southern Europe – a region also targeted by the Nabucco project. Thus clearly, Gazprom is exploiting the current risk-averse environment to blatantly challenge the realization of Nabucco. On May 15 Bulgaria, Greece, Italy, Serbia and Russia signed a deal on the South Stream pipeline, which designates 2015 as the year in which the pipeline will become operational, and sets the end of this year as deadline for a final decision on the pipeline's route. Furthermore, it was announced that the capacity of South Stream will be expanded from 31bcm to 63bcm. Since South Stream is a project aimed at debilitating the Southern Corridor, this can be seen as a decisive moment for European energy security. Though the Nabucco project, the quintessential branch of the Southern Corridor, has seen progress recently there are still severe obstacles to realization, namely uncertainty regarding both financing and supplies. These obstacles are well illustrated by the recent postponement of production from phase two of the Azeri Shah Deniz gas field, which is designated for the Nabucco pipeline, and underlines the necessity of a firm European response.

The perhaps most aggressive Russian move this Spring was, however, not made by Gazprom but by Surgut Neftegaz when the company acquired Austrian OMV's 21.2% stake in Hungary's MOL oil and gas company under nebulous circumstances, making Surgut the single largest shareholder in MOL. Whereas the Hungarian government has signed on to the South Stream project – directly aimed at undermining Nabucco – MOL has stayed loyal to the Nabucco project; a stance which the Russians might seek to reverse. Surgut Neftegaz has a commercial interest in MOL's refining capacities, which are considered the most efficient in Central Europe. Yet, with MOL being a partner in the Nabucco project and in a LNG project on the Croatian Adriatic coast – both projects aimed at lessening European energy dependence on Russia – the bargain has strategic implications allowing Russia influence into European decision making on energy security. It seems particularly disturbing that Russians are gaining a say in MOL's initiative for enhancing Central European energy security the New Europe Transmissions System (NETS), which is intended as a mechanism for sharing gas supplies in case of

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emergencies by creating a single regional market. In other words, an initiative aimed at counteracting consequences of Russian actions, such as the cut-off of January 2009, will now come under Russian influence. Russia is effectively jumping past transit countries into the heart of Europe thereby increasing its leverage over these very transit countries, particularly Ukraine.

Surgut Neftegaz is – even measured against Russian standards – an opaque business with an obscure shareholding structure. Putin is believed to be the major shareholder owning, directly or indirectly, a 37% stake in the business. The company is also headed by a longtime confidant of Putin's, Vladimir Bogdanov. The transaction followed OMV's unsuccessful attempt at a hostile takeover of MOL in 2008. Already then, OMV was rumored to be fronting for a Russian takeover attempt. Brussels and Budapest – as well as MOL – were kept in the dark until OMV and Surgut publicized their deal. As late as a week before the transaction was revealed, on March 23, OMV CEO Wolfgang Rutenstorfer declared that OMV had no current plans of selling its stake in MOL, though it was likely to do so eventually. It can only be speculated what happened in between but it appears that the price paid by Surgut – €1.4bn, twice the market price – exactly covers the costs held by OMV for buying and holding the shares in MOL; a fact supporting the suspicion that OMV was fronting for a Russian takeover attempt.

Surgut's long term intentions are unclear. It is assumed that the company will be tied up with Rosneft – a story supported by Bogdanov's recent nomination to sit on Rosneft's board. Another rumor has it that Surgut will in time resell its shares to either Rosneft, Lukoil or Gazpromneft, which are all in financially weak positions at the moment. Such a resale could double the Russian voting power in MOL. Surgut Neftegaz is estimated to have cash reserves of \$20bn. These reserves, along with its new stake in MOL, put the company in a good position for future takeover attempts. As demonstrated with the recent deal, Surgut can – unlike companies accountable to their shareholders – easily overpay for shares. Furthermore, Surgut can with its cash reserves tempt the Hungarian government with recapitalizing the country's energy sector; the company can rely on Putin supporting their agenda through foreign policy. MOL is dependent on Russian oil supplies from the Druzhba pipeline, which could be critical if a takeover battle emerges as Russia has been known to cut off supplies through Druzhba.

Another ongoing offensive towards the Hungarian energy sector underscores this point. In late April Emfesz KMT – the second largest gas distributor in Hungary, controlling 20% of the market – announced that it would cease importing gas from RosUkrEnergo in favor of RosGas AG. Less than ten days later, Emfesz was bought by RosGas, which is believed to be within Gazprom's network of interests but has an unintelligible ownership structure. The company has so far failed to provide information on this matter to the Hungarian Energy Office, which has nevertheless approved of the sale. According to Global Witness, the agency shows no sign of withdrawing such approval in the case that RosGas does not present the required information on deadline. Furthermore, Rosgas is believed to be the future target of takeover by Bulgarian

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Overgas. The latter, likewise, has an opaque ownership structure, and is thought to be a proxy of Gazprom. Thus, Russian leverage over the Hungarian energy sector is only set to increase.

While pursuing an aggressive strategy towards Europe, Russia seems to be losing ground in Central Asia. This highlights how the crisis-exploiting strategy pursued by Russia is untenable. Putin, and Russian oil and gas companies, are seeking to recreate a situation of excessively expensive energy. At the same time, it is questionable whether Gazprom is able to follow through on its many present commitments. With Gazprom's own production set to shrink and stay at a lower level for years to come, losing access to the gas reserves in Central Asia would effectively undermine the strategy.

The pipeline blast on the Davletbat-Dariyalyk pipeline (CAC-4) near the Turkmen-Uzbek border is a pertinent example of the troubled state in Russian-Turkmen relations. With the explosion, virtually no gas is flowing from Turkmenistan to Russia, as the only other pipeline route – the western branch of the Central-Asia Centre (CAC) pipeline – carries only 2bcm/y. In 2007 Kazakhstan, Russia and Turkmenistan agreed on the re-construction of the western branch, the Caspian Coastal Pipeline (CCP). However, since then construction has been postponed (though Kazakhstan recently ratified the agreement), and Ashgabat has sought other bidders for the construction as Turkmen President Berdimukhamedov doubts Gazprom's ability to get the job done.

The explosion followed a somewhat unsuccessful meeting in Moscow between Berdimukhamedov and Medvedev at which the two failed to agree on the construction of an East-West pipeline across Turkmenistan. This partly reflects Moscow's fear that the Trans-Caspian pipeline project will resurface in which case Gazprom investment into the East-West pipeline would damage the company by facilitating easier export of gas from eastern Turkmenistan to Europe, circumventing Russia.

The blame game following the explosion has seen the Kremlin remain silent while Russian experts attribute the explosion to a combination of worn-out Soviet-era infrastructure and Turkmen negligence. The Turkmen authorities on the other hand blame Gazpromexport for decreasing the amount of gas drawn from the pipeline without warning to the Turkmen authorities, thereby causing the explosion. Whatever the cause, gas has stopped flowing and repairs – anticipated to take two-three days – have not begun while the blame game continues. Both sides could be speculating that the spat will position them better in upcoming price negotiations, which will settle the price paid by Russia for Turkmen gas from 2010. Clearly, it reflects Gazprom's position in that it has become less dependent on Turkmen gas owing to declining demand, and in which the current "European" price it pays for Turkmen gas is hurting

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the company's bottom-line. Indeed, Gazprom is attempting to bully Turkmenistan into accepting a lower gas price on with the deputy chief executive, Valery Gobulev, on June 2nd threatening to buy less gas off Turkmenistan unless a lower price is agreed on.

Turkmenistan, on the other hand, is using the row to signal to the West that it is not a Russian satellite state, and that the country will be open to countervailing proposals from the West. As recent as the first week of June, a high-level Turkmen delegation led by Foreign Minister Rashid Meredov visited Brussels. While Gazprom might find it difficult to finance an upgrade of Turkmen infrastructure, Turkmenistan certainly does not have the funds to do so itself. In that sense, the cessation of gas supply probably suits both sides well.

In mid-April Turkmenistan and the German Rheinisch-Westfälische Elektrizitätswerk AG (RWE) signed an agreement to have RWE develop the Turkmen offshore gas field, Bloc 23; included in the agreement was the objective of RWE eventually exporting Turkmen natural gas. This deal could prove a breakthrough for the Nabucco project; however, the subsequent summit on the Southern Corridor in Prague on May 7 did not see Turkmenistan, nor Kazakhstan or Uzbekistan, sign on to the project. This highlights the precarious situation Central Asian states are in. Continuing on the case of Turkmenistan, the country is hugely dependent on stable relations with Russia and Gazprom to fill the state coffers. This income could, in principle, be supplanted by the EU but a definite, unmistakable and long-term commitment from Europe is requisite for the Turkmens to make such a risky policy shift. Considering further, that the prospect of exporting via a Southern Corridor continues to be some years away, the possibility of Turkmenistan returning to Moscow's flock is great.

Nevertheless, at present Europe would be well-advised to beef up its relations with the Central Asian states, particularly Turkmenistan, in an effort to break the Russian stronghold on the European energy market. The financial crisis, and the resulting cracks in the Russian strategy, call for urgent European action – now is the time, so to speak. The EU must, concurrently, commit strongly and unequivocally to the Nabucco project in order to achieve the tantalizing prospect of bringing both Azerbaijan and Turkmenistan firmly onside thereby securing the Southern Corridor. Given both countries' present signaling for Western engagement, the chance to lessen dependence on Russia certainly exists.

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An earlier and abridged version appeared on www.henryjacksonsociety.org on 15 April 2009.