

help from one of their number go unanswered. But they have in the past. Such a clause might have been useful during the 1973–4 Arab oil boycott, which was particularly directed at the Netherlands, as well as the US, for being pro-Israeli. At that time, countries such as Belgium, joined to the Dutch through the Benelux organization as well as the European Community, gave way to Arab pressure not to pass on oil to their Dutch neighbours. Yet it is likely that policy on energy security will evolve – even more than other aspects of EU energy policy have – in response to necessity and events rather than to treaty wording. The question therefore is whether the Georgian conflict of summer 2008 and the gas cut-off of early 2009 mark the point at which the EU got serious about diversifying energy imports away from Russia.

## CHAPTER 9

### MANAGING RELATIONS WITH RUSSIA

*The president stated he learnt that in Europe Russian gas is resold at three times the export price charged by Gazprom... 'Why is Gazprom supplying so cheaply, and, even more importantly, where is the price difference going, where is the money?' exclaimed Putin with indignation.*

Report in *Kommersant* 21 November 2001 on Putin's meeting with Gazprom leadership.

*Russia's energy policy follows a tight script, it has a sense of strategic purpose. There is, in principle, nothing that stops us, the Europeans, from matching their determination with our own discipline.*

Javier Solana, High Representative for common foreign and security policy, February 2008.

Russia is the EU's most important, but also most difficult, energy partner. It provides nearly half (42 percent in 2005) of the Union's gas imports, a third (32 percent) of oil imports, a quarter (24 percent) of coal imports, and almost all of its enriched uranium fuel imports. Especially in gas, this dependence may grow for the obvious reason that Russia has the world's largest gas reserves and is still the main outlet for gas from central Asia. Moreover, the only outside electricity link that the EU's three Baltic states have is to the Russian grid.

Relations with Russia have not grown any easier as a result of the mass entry into the EU in 2004 of central and East European states, many of whom still carry a strong anti-Russian animus from their days as forced members of Soviet institutions and alliances like the Warsaw Pact and Comecon.

They evidently thought they would find greater energy security in EU membership than they did. As smaller states, too, these countries place a higher value on the Union speaking with one voice in its energy foreign policy, provided it is a tough voice. For instance, in September 2007 the European Parliament

approved a report, written by the Polish chairman of its foreign affairs committee, Jacek Saryusz-Wolski. It called for a stronger and more collective 'common European energy policy, covering security of supply, transit, and investment related to energy security', and for the naming of 'a High Official for Foreign Energy Policy' to coordinate such a policy.

This *ostpolitik* of the EU's new members has brought them into disagreement inside the EU with the larger and older member states which have tended over the years to cut their own energy deals, or pursue their own political lines, with Moscow. But it is probably a mistake to think, as many in America as well as in Europe do, that the differing approaches of EU member states towards Moscow stem largely from their differing energy reliance on Russia. According to this widely held theory, energy actually determines the various EU views of Russia, ranging from the East Europeans' desperation to rid themselves of near total dependence on Russia to some bigger west European states' reluctance to offend Moscow in any way that could jeopardize their sizeable and lucrative bilateral energy trade and investment links with Russia.

Important people believe this. Successive US administrations have voiced concern that its European allies risk, by becoming too dependent on Russia for energy, exposing themselves to political leverage from Moscow. This is why the US has sought to raise the energy security issue in NATO, and why the EU has to endure a certain amount of 'diplomatic back-seat driving' from Washington on the matter of energy security. (In recent years the State Department has put a series of senior officials in charge of 'Caspian regional energy diplomacy'. An early part of this mission related to US energy security – building the Baku–Tbilisi–Ceyhan oil pipeline to take Caspian oil to the Mediterranean and the world market, thereby influencing the world oil price that affects the US, like any other oil importer. But the rest of this State Department mission relates to trying to introduce into Europe Caspian gas that would have no impact whatever on North America's regional gas market. The US aim is to encourage energy diversification for both Caspian energy producers and European importers, especially in Central Europe.)

In fact, Germany's desire for a smooth relationship with Russia is based as much on the memory of the terrible damage the two countries did to each other in the Second World War, as on a historic symbiosis of Russian raw materials feeding German industry. France's cultivation of Russia goes back to General de Gaulle's foreign policy and earlier, predating any French import of Russian gas. Andris Piebalgs, the EU energy commissioner and himself a Latvian, believes that 'energy is sometimes being used as an excuse to hide' political reasons for taking different approaches to Moscow.<sup>1</sup>

Indeed, such is the multiplicity of political factors in relations with Russia that one observer claims to be able to divide EU states into five categories according to their attitude towards Russia.<sup>2</sup> These are 'the Trojan horses' (Cyprus and Greece); the 'Strategic Partners' (France, Germany, Italy, Spain); the 'Friendly Pragmatists' (Austria, Belgium, Bulgaria, Finland, Hungary, Luxembourg, Malta, Portugal, Slovakia and Slovenia); the 'Frosty Pragmatists' (Czech Republic, Denmark, Estonia, Ireland, Latvia, the Netherlands, Romania, Sweden, and the UK); and the 'New Cold Warriors' (Lithuania and Poland). Energy is not the common dividing line between these groups.

All this led to Peter Mandelson to say, when EU trade commissioner, that 'no other country reveals our differences as does Russia.'<sup>3</sup> Differences over Russia are internally very disruptive within the EU. The way that member states diverge in their political reactions to Russia is not totally unlike the way their currencies used to diverge in reaction to the gyrating movements of the US dollar; Germany's D-mark was always firmer against the dollar relative to other EU currencies (just as, some would say, Germany's political response to Russia is always softer). The response to monetary gyrations was to create a common currency. Nothing so mechanistic is possible in creating a common policy towards Russia. But a unified approach on energy

1 Interview with Argus Media Group, September 2008.

2 Mark Leonard and Nicu Popescu, European Council on Foreign Relations, 2007

3 Peter Mandelson, speech in Bologna, 20 April 2007.

would be an important building block towards a common foreign policy. And as a step to that it is important to look beyond perceptions to some realities.

### **Russian realities**

In certain ways, Russia has become a more difficult energy partner than when it was the Soviet Union. For Western Europe, the politics of dealing with the Soviet Union were relatively simple. The Cold war, although it had its thaws and chills, kept these relations in a relatively steady state. Moreover, west Europeans knew where they were with the Soviets, who were clearly the enemy. But they were not beyond the pale when it came to energy. The first supplies of Soviet gas came to Austria (then neutral) in 1968, and two years later West Germany's Ruhrgas signed its first long term contract for Siberian gas. Such was the confidence that west Europeans had come to have in Moscow as a supplier by the early 1980s that they were willing to defy the attempt by their major ally, US president Ronald Reagan, to curtail their dependence on Soviet gas.

But the collapse of the Soviet Union ushered in a more confusing era for Russia's neighbours (as well for Russians themselves). Russia went first, under Boris Yeltsin, through a very pro-western phase. During this phase it entered the fold of the democracies, was admitted to the Group of Eight, and subscribed to high-minded organizations such as the Council of Europe with its stress on democracy and human rights. But just as west Europeans started to feel they had acquired a perfect right, through organizations like the Council of Europe, to comment on Russia's political imperfections such as its brutal subjugation of Chechnya, Russia itself began to bridle at such 'interference' as the president it elected in 2000, Vladimir Putin, pledged to restore law, order and his country's fallen prestige.

Vladimir Milov, president of the Institute of Energy Policy in Moscow and an outspoken critic of Mr Putin's, charted this policy's effect in the energy field when he spoke to the European Parliament in February 2007. After 2003, according

to Mr Milov, government policy moved away from privatizations towards greater interference in the economy and energy sector and arbitrary use of the state's regulatory powers to advance the position of state-controlled 'national champion' companies. The most spectacular example of this was the deliberate destruction of the Yukos group of Mikhail Khodorkovsky, whom Mr Putin considered a political challenger; he ended up in a Siberian jail for tax evasion. Whether or not Yukos or Mr Khodorkovsky were guilty of tax evasion, they were never given a chance to redeem themselves. Whenever Yukos appeared to come near paying a demand for back-tax, the authorities would hit it with a larger demand and/or freeze its bank accounts. The resulting dismemberment of Yukos provided a convenient occasion to bolster the assets of state-controlled Gazprom and Rosneft. The latter became the largest oil company, giving back to the state (which had never relinquished ownership of the gas industry) direct control of around 30 percent of the country's oil production.

Somewhat subtler but no less firm methods were used to squeeze some western majors out of upstream positions they had acquired in days when Russia was more receptive to foreign capital. Mr Putin particularly disliked what in June 2007 he described as the 'colonial' nature of production sharing arrangements (PSAs) that a few of the western majors had negotiated in Russia during the Yeltsin decade of the 1990s. His 'colonial' reference related to the fact that traditionally, PSAs, a form of financial ring-fencing to protect a project from arbitrary political or fiscal interference, were used in developing countries that might be considered unstable. At all events, the authorities used Royal Dutch Shell's alleged environmental shortcomings as a means of getting it to cede to Gazprom its predominant position in one of the PSAs on the island of Sakhalin off the Russian Pacific coast. It is unclear whether the Kremlin had any hand in causing the major problems that BP has had with its Russian partners in their TNK-BP joint venture, but Gazprom has had official support in moves to prise certain Russian gas assets away from the UK oil major. At the same time, Russia has passed more restrictive legislation on future foreign participation in strategic oil and gas fields.

Yet, as Mr Milov commented, 'Russian companies wish to buy energy assets in Europe freely.' It was, he noted, 'a strange concept of reciprocity'. It is mainly Gazprom that would like to buy direct sales companies in the EU, in the somewhat misguided belief that it has been missing out on enormous profit margins by using middlemen in the EU market. After meeting distribution costs and taxes, these profits margins are probably not very great. Nonetheless, as the quotation from Mr Putin at the start of this chapter makes clear, the gas company has come under pressure from its state owner to increase its profit and presence in the EU market.

But the main question marks about Russia's reliability as an energy partner have not arisen out of doubt about its attitude to contract sanctity – oil producers around the world have been renegotiating contracts as the oil price rose – but about Russia's ability to ensure continuous delivery. For, in contrast to the Soviet era, Russia no longer controls the transit routes for its energy exports.

Russia has always been the most land-locked of the world's big energy exporters. Though the world's largest country, its fossil fuels deposits have generally been far from the sea. This did not matter when Russia was still the Soviet Union, because all the transit routes – Ukraine and Belarus – as well as other oil/gas provinces – Azerbaijan, Kazakhstan and Turkmenistan – were also Soviet republics. Once the Soviet Union split up, transit was bound to become more complicated as Gazprom began to phase out subsidized prices to Soviet republics that were drifting out of Moscow's political orbit. Two incidents particularly spooked the EU. The first was Gazprom's cut-off of gas to Ukraine from 1–4 January 2006 as the result of a price dispute with Kiev. Then, exactly a year later, came an oil tariff row between Russia and Belarus that occurred in the context of a similar gas pricing dispute between the two countries. Any lingering doubts about the shakiness of post-Soviet transit arrangements for Russian gas to the EU were dispelled in January 2009 when Gazprom stopped all gas to and through Ukraine for two weeks.

These were just the sort of post-Soviet energy transport difficulties that the Energy Charter Treaty, referred to in the previous chapter, was supposed to deal with. Russia signed, but

unfortunately never ratified, this treaty, which therefore is not binding on Moscow.

For the Kremlin and the Duma had come to view the ECT as an unfair treaty foisted on Russia in its pre-Putin decade of weakness. Their reluctance to ratify was only reinforced by the attempt in 2000 to start negotiations on a supplementary Transit Protocol, creating an international legal regime for energy transit across multiple borders with enforceable dispute settlement. Gazprom claimed that the protocol was a deadly threat to its interests, even though the protocol stops short of the EU practice of requiring mandatory third party access to pipelines. In reality, as Jonathan Stern has put it, Gazprom's dilemma with the Transit Protocol has been that 'while it would effectively provide international sanctions against any transit violations by Ukraine and Belarus, it would also open the door to uncontrolled transit [across Russia] of Central Asian gas to Europe'.<sup>4</sup>

Yet the obstructionism was not all on the Russian side. The European Commission played its part in sabotaging Russia's adherence to the protocol. Russian negotiators wanted any quarrel involving transit across an individual EU state, as any other party to the protocol, to be taken to mutually agreed international arbitration. But the Commission insisted that any dispute involving the territory of an EU member state must go to the European Court of Justice in Luxembourg. Naturally the Russians did not regard the EU court as a totally impartial referee.

If energy were not a vital commodity, one could imagine relying on the passage of time for EU and Russian negotiators to see sense, and for both the transit countries and the new members of the EU to get over their 'post-Soviet traumatic stress syndrome'. On this analysis, EU-Russian energy relations would eventually settle down as Moscow 'market-izes' its relations with Kiev and Minsk, and as Poland and other new EU states become less paranoid about Russia. But since both sides have viewed energy as a vital commodity, they were weighing, at least before the Russian – Georgian conflict, the following steps to improve the situation or change its parameters.

<sup>4</sup> Jonathan Stern, *The Future of Russian Gas and Gazprom*, OIES, Oxford, 2005, p.138.

### Improving the status quo

Some powerful people in the energy business argue this is the only option. One such is Paolo Scaroni, chief executive of Italy's Eni group. As quoted at the start of the previous chapter, he complained to the World Energy Congress in autumn 2007 that Europe had 'sleepwalked' into being 'very reliant on a small number of gas suppliers', partly because Brussels 'concentrated all its efforts into fine-tuning the internal gas market, without grappling with the growing external threats'. Yet, in the next breath, the Eni chief went on to argue that 'under these circumstances [of dependence], it makes sense for the EU to build and safeguard good and cooperative relationships with its main suppliers, and in particular with Russia, with which it has geographical, historical and cultural links deepened by decades of mutually profitable trading.'

But safeguarding, let alone improving, this relationship is increasingly difficult. There was a steady deterioration in the EU-Russia political relationship during Mr Putin's second presidential term. Most EU governments, including Chancellor Merkel's government in Germany, have criticised Mr Putin's oppression of his opponents and his orchestration of the selection and election of a successor. Any hopes of EU-Russian relations improving with the advent of President Dmitri Medvedev were dashed by the Russian-Georgian conflict. This growing divide at the political level contrasts sharply with the cosiness between some of the big energy companies on both sides.

A dramatic sign of this dichotomy came in the autumn 2006 round of contract renegotiation, in which Germany's Eon, Gaz de France, Italy's Eni, Austria's OMV all extended their long term purchasing contracts with Gazprom for no less than 30 years, until 2035-6. At the same time, Gazprom has not been shy about its desire to advance into the European downstream with direct sales to European consumers. In return it says it is willing to give European companies a stake in developing the Russian upstream.

Both sides say they would like reciprocity, but mean different things by it. For the Russians, and for the bigger EU energy companies, negotiated asset swapping – upstream positions for EU firms in Russia and downstream access for Gazprom in the

EU – constitutes a perfectly satisfactory form of reciprocity. The asset-swapping formula was set out by Andrei Denisov, first deputy foreign minister, at a conference in November 2007. 'The capital assets [in Russian oil and gas] should be controlled by national corporations which should be getting their shares in supply and transport companies abroad in exchange for relevant minority shares in these assets.' For their part, the EU authorities want a legal framework conferring the same kind of automatic access that Russian companies, like all companies, have to the EU's single market. In fact, EU authorities – in Brussels and in national capitals – do not at present have the same ability to control Russian investment in their downstream that Moscow has in controlling European investment in its upstream.

So the European Commission has – in the context of its internal energy market restructuring (see earlier chapters) – come up with a proposal designed to give it some negotiating leverage on Moscow. The Commission has proposed a ban on any non-EU company taking majority control of any EU energy network, unless the home government of the buyer has an agreement with Brussels allowing such a purchase.

The aim of this clause, dubbed 'the Gazprom clause', is to prevent non-EU companies circumventing any new EU rules on the unbundling of energy networks by, for instance, a Russian financial fund with hidden links to Gazprom buying a gas pipeline in the EU. This is a safeguard to ensure equality of treatment so that Gazprom could not just snap up any networks that EU gas supply companies might be forced to sell. It has been denounced in Russia as an attempt 'to dictate to Russia the way in which it should regulate the operation of its energy companies in its domestic market.'<sup>5</sup> This is not so. The Commission was not trying to force Gazprom to get out of the gas supply business in Russia, any more than it was forcing Gazprom to buy EU networks. All Brussels was saying was that the EU should have the means to check Gazprom followed whatever new network unbundling regime that EU gas supply companies will have to

5 Sergei Yastrzhembsky, (former Kremlin adviser on EU relations) Pipelines, *Politics and Power*, Centre for European Reform, 2008, p. 37.

obey. However, it is true that the legislation – which does not mention Gazprom by name and ostensibly applies to all non-EU companies – was drafted with Gazprom very much in mind. Indeed Commission president Jose Manuel Barroso said publicly, when the proposals were announced in January 2007, that the aim of ‘the Gazprom clause’ was to give EU negotiators some leverage in order to obtain a more equal form of reciprocity in a new round of EU-Russia talks.

In July 2008, the EU and Russia started negotiations aimed at replacing their 1997 Partnership and Cooperation Agreement (which ran its intended ten years, but continues thereafter in effect unless discontinued by either party or replaced by a new accord). The idea was to reach a broader agreement, with substantial provisions on energy. Because of the Georgia conflict the EU briefly suspended the negotiations.

These negotiations will be lengthy and tough. EU states have a long laundry list of political issues on which they, probably unrealistically, want concessions from a Russian government that is relatively happy with the status quo in EU-Russian relations. But, to its own disadvantage, Moscow has contributed to the EU desire for change. The proposed restrictions on foreign investment in the Russian oil and gas upstream, and Gazprom’s push to expand in the EU downstream, have both had the effect of making Russia’s version of reciprocity look lop-sided to Europeans.

### **Diversifying energy routes**

Part of the security question mark hanging over Russia’s gas exports to Europe stems from its inability to arrive at smooth post-Soviet commercial arrangements along its traditional transit routes through Ukraine, Belarus and the Baltic states. So, if the routes are the problem, why not change the routes? This is what Russia is doing – proposing new undersea gas pipelines and overland oil pipelines to deliver energy more directly to most EU customers.

Any strategy that multiplies alternative pipeline routes increases reliability of delivery and so energy security for the

European customer. This is why many of the big EU energy companies, and, to an extent, the European Commission, have become willing accomplices in this Russian plan of new pipelines to sidestep old problems. But this is not altruism on Russia’s part. Multiple alternatives also increase Russia’s bargaining power over its traditional transit partner countries.

Gazprom has long thought strategically in developing alternative pipelines. In bringing Siberian gas to Europe, it has supplemented the main trunk route through Ukraine–Slovakia–Czech Republic with another pipeline through Belarus to Poland. Not content with being able to play Ukraine and Belarus off against each other, Gazprom is now proposing alternatives to both.

The biggest and most controversial project is the North European Gas Pipeline, otherwise known as Nord Stream. This would take gas, up to 55bcm a year, from the St Petersburg area through the Baltic to northern Germany. This project is made up of Gazprom (51 percent), Eon and BASF (20 percent each) and Gasunie of the Netherlands (9 percent); through the latter’s participation Gazprom has also acquired a 9 percent stake in the BBL interconnector to the UK.

Nord Stream has stirred particular controversy in Poland. For Warsaw, the only thing worse than having Russian gas crossing Polish territory (and thereby maintaining dependence on a politically unwelcome source) is not having Russian gas crossing Polish territory (and Gazprom having another means to get gas to its richest markets in Germany and points west). In 2006, before he became Poland’s foreign minister, Radek Sikorski, likened the basic Gazprom–German deal underlying Nord Stream to the Ribbentrop–Molotov pact of 1939 (which allowed for the Nazis to invade Poland without fear of drawing the Soviets in against them). But there are also environmental worries raised by states around the Baltic, and by the European Parliament, about running a big double pipeline through an area of sea in which German chemical weapons were dumped towards the end of the Second World War.

Since diversity of energy route, as well as source, is a guiding principle of energy security, the European Commission has endorsed Nord Stream as ‘project of European interest’. Asked whether he should be supporting a project that bypassed

an EU transit state, Poland, EU energy commissioner Andris Piebalgs justified his stance by pointing out that it also bypassed Belarus.<sup>6</sup>

As a sort of mirror image to Nord Stream, Gazprom and Italy's Eni have announced the South Stream project to take gas across the Black Sea to Bulgaria, whence it would go either north through the Balkans to Hungary and Austria or across the Adriatic to Italy or both. South Stream would duplicate existing and planned pipelines that pass through Turkey – the existing Blue Stream from Russia across the Black Sea to Turkey; the new Interconnector Greece–Italy (IGI) that pipes gas from Turkey; and the Nabucco project to take gas from the Caspian region to Central Europe. So apart from reflecting Gazprom's general expansionism, Italy's rising anxiety about its geographic position as last-in-line for Russian gas, and doubts about Nabucco, another purpose of South Stream may be to bypass Turkey for fear it may become too greedy a middleman (see below).

Russia is planning a third transit avoidance pipeline, this time for oil, to bypass Belarus. It will take 1m barrels a day of oil and oil products from western Russia, near the Belarus border, 1,200 Km north to the Russian Baltic port of Primorsk. This project known as Baltic Pipeline System-2 was started shortly after Russia's energy tax dispute with Belarus in January 2007. But it will also have implications for the Baltic states which, while hankering for less dependence on Russian energy in the long run, have come to rely on the fees they get for allowing the Russians to transport oil to ports like Ventspils in Latvia and Tallinn in Estonia. At the same time, Russia has cut off pipeline supplies to Lithuania's Mazeikiu refinery (after it was sold to a Polish, rather than Russian, buyer) on the ground that the pipeline is too corroded; so Lithuania now imports the same Russian oil by sea, and at a higher price.

It is up to Russia to decide how it wants to export its energy. But its strategy of export route diversification has consequences for foreign partners and customers. Transit countries will find it harder to resist Russian pressure on them to charge lower transport fees. The impact on final customers may be double-

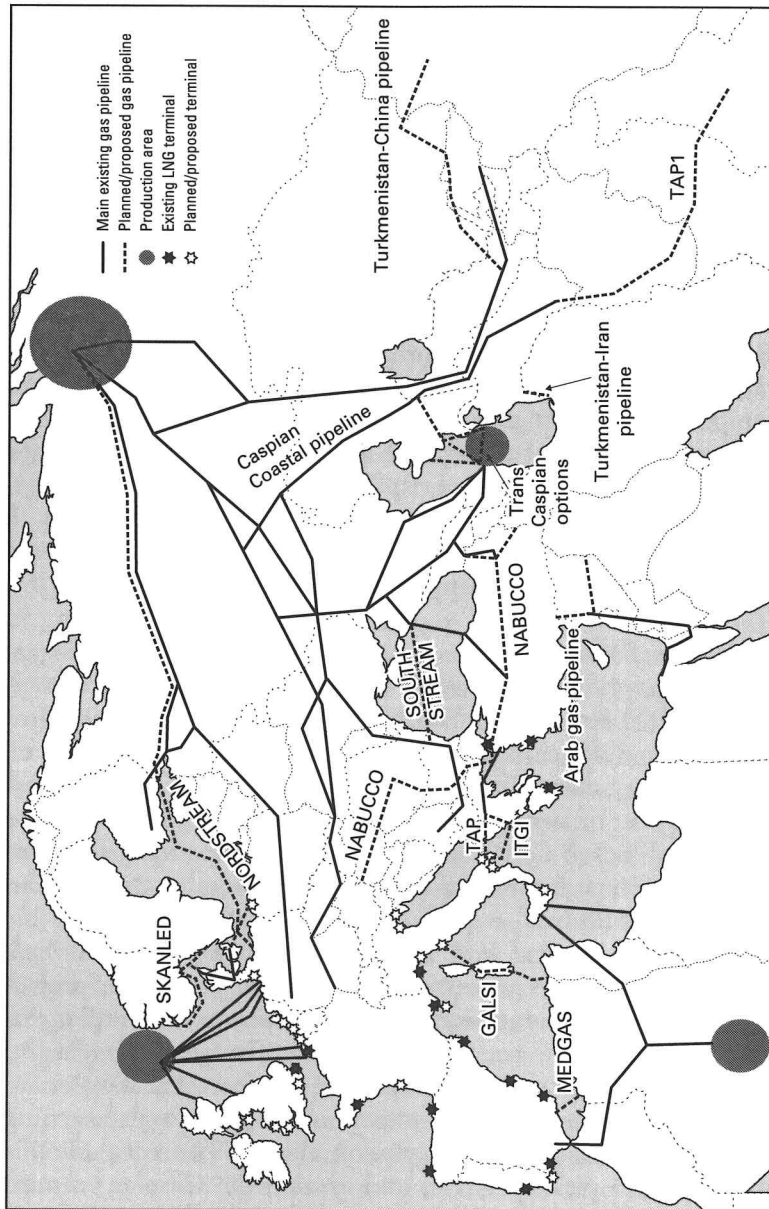
edged. On the one hand, most final customers in the EU (though not Poland) can have more certainty about Russia's gas getting through to them. On the other hand, Russia could draw more of other countries' gas into its widening net of export pipelines. Russia has made it very clear its determination to remain the main geographical export outlet for central Asian gas. One motive for Gazprom building Blue Stream across the Black Sea, from southern Russia to Turkey, may have been to lessen Turkey's desire to buy non-Russian gas directly from the Caspian and central Asia. Yet South Stream might one day provide a Russian-controlled conduit for central Asian gas. All this could increase the dominance of Russia's gas market position, and the temptation to abuse that dominance by perhaps raising prices. It is therefore eminently sensible for the EU to make efforts not to avoid, but to supplement, Russia as an energy supplier.

### **Diversifying energy supply**

Europe is far better placed to do this than most other gas-importing regions of the world. It has  $\frac{2}{3}$  of world's gas reserves within 3,000 Km of it, or  $\frac{3}{4}$  of such reserves within 4,000 Km. This latter distance is a bit beyond the current outer limit of pipeline economics, but there is always ship-borne LNG for most EU states on or near a sea. However for others, especially the more land-locked Central European states, hope for diversification could come from developing a gas corridor to the Caspian and the Middle East.

The main scheme here is the Nabucco pipeline. The gas company executives who met in Vienna to create the project gave it this exotic name, simply because that was the Verdi opera they had all been to see the night before. (In fanciful hindsight, an opera about Israelites yearning to escape their Babylonian captivity could be seen as a metaphor for Europeans yearning to escape Russia's energy grip on them). The idea of this pipeline is to pick up gas in and around the Caspian, central Asia, Iraq, the Middle East as far east as Iran and as far south as Egypt, and to take it across Turkey up through the Balkans to Hungary and Austria. Running the project is a consortium

<sup>6</sup> Interview with Argus Media, September 2008.



**Map 1:** Main Gas Pipeline Projects to Europe up to 2015

Source: International Energy Agency Gas Market Review 2008, p.58.

headed by Austria's OMV oil and gas company, with the four national gas companies from the other four countries along the pipeline route – Hungary, Romania, Bulgaria and Turkey – plus Germany's RWE. To underline its importance as the core of the EU diversification strategy, the European Commission appointed a special coordinator, the former Dutch foreign minister, Jozias van Aartsen, to help with the pipeline diplomacy involved.

However, two big question marks hang over Nabucco. One is where will the gas come from. Azerbaijan's Shah Deniz gas field in the southern Caspian Sea, which is already pumping gas to Turkey in a pipeline that parallels the Baku–Ceyhan oil pipeline, may be sufficient to get it started. But Nabucco will definitely need gas from other neighbouring sources. The most obvious place to look is Turkmenistan which has very big onshore gas reserves. So far it only exports to Russia (though shortly also to China), and the Russian government and Gazprom are keen to keep it that way. Russia has substantially benefited in the past from buying Turkmen gas cheap and selling it on dear to the Ukraine and Europe. In his May 2007 meeting with his fellow presidents of Kazakhstan and Turkmenistan, Vladimir Putin effectively persuaded these two countries to continue to funnel their gas through Russia. The Russian leader initialled an agreement whereby Turkmenistan would sell Russia an extra 30bcm a year. To do this, Gazprom had to agree to raise its price for Turkmen gas from \$100 thousand cubic metres (a price that was earlier agreed to hold till 2009) to \$130 during the first half of 2008 and \$150 in the second half of 2008.

Under its new leader, Turkmenistan is potentially more open to the west. Yet in vying for its gas, EU leaders can hardly compete with single-minded Russian gas diplomacy for Turkmen gas. European commissioners not only cannot sign gas contracts; they are also under internal political pressure to protest about Turkmen human rights abuses. In that cause, the European Parliament has frozen negotiations for a formal EU agreement with Turkmenistan.

Turkmenistan says that it plans to quadruple gas production to 250bcm a year by 2030. But for the time being, it looks unlikely to have much to spare for Nabucco, after increased shipments to Russia and new ones to China. A big gas find in



Turkmenistan's offshore Caspian zone would greatly increase the economic rationale of piping the gas across the rest of the Caspian to Azerbaijan and thence to Turkey and on, via Nabucco. Even so the politics of doing this have been worsened by the events in Georgia. Speaking two months after the conflict, Mr Piebalgs was in no doubt about this. 'Russia has a huge interest in energy resources in this region. It is ready to buy all the gas from Turkmenistan, not to mention Kazakhstan, and to pay a good price.' The EU commissioner did not rule out central Asian states sending energy to Europe 'because diversification is important for these countries'. But he concluded that 'if I were in their place, I would be very cautious to take decisions that could complicate their relations with Russia.'<sup>7</sup>

The other doubt hanging over Nabucco is whether it can get reasonable transit terms from Turkey. For there are some worrying signs that Turkey could, in terms of rapaciousness for transit fees, become the Ukraine of the south. Some Turks see their country as constituting 'the fourth artery of Europe's energy supply after Russia, Algeria, and Norway' because of its ability to carry gas from many sources in central Asia, the Middle East and North Africa.<sup>8</sup> The phrase fourth artery is mirrored exactly in the European Commission's tendency to talk of Turkey as the 4th Gas Corridor. The bracketing of Turkey, a transit country, with three actual originators of gas is disturbing, and fuels fears that Turkey wants to be an arbitrageur – like Ukraine with Russian gas, or Russia with Turkmen gas – buying gas from the east cheap and selling it on to the west dear.

For precisely this reason, the European Commission has been keen to entice Turkey to join its Energy Community. Essentially, this community is a vehicle for extending the EU's existing legislation, or 'acquis' in the Brussels jargon, to neighbouring countries. The Energy Community rationalizes the transit issue that so bedevilled the Energy Charter Treaty out of existence. Once inside the Energy Community a country is part of a

single (energy) market in which the concept of transit across a third country does not exist. Nor would, say, Turkey, once in the Energy Community be allowed to have dual pricing of energy by, for instance, raising the transmission price for exports and subsidizing down the domestic price. Inside the Energy Community, Turkey would have to charge the same cost-related fee to let gas traverse its territory as any state inside the EU with gas pipelines crossing it.

It remains unclear whether Turkey will sign up to the energy part of an EU that it may never actually join. If Ankara did sign up, then Commission officials have suggested that Turkey should be offered energy security guarantees, in the same way that some Balkan countries were provided with electricity from the EU under an 'energy for democracy' programme. Whether such energy security guarantees would be credible for a country the size of Turkey is another matter. It is inherently odd for the EU to offer such guarantees when it, the EU, is more a 'consumer' than 'producer' of energy security. On the other hand, financial guarantees backed by the EU budget or European Investment Bank loans to countries reorienting their energy production and transport infrastructure towards Europe might be conceivable.

Outside the energy sector, the EU has been very successful in exporting its laws, rules, norms and standards to other countries, especially to those neighbours with a real prospect of joining the Union eventually. But, where energy is involved and where there is doubt over a country like Turkey ever joining the EU, these 'policy exports' will have to be accompanied with something tangible like cash. That is the view of Mr van Aartsen, in his role as EU coordinator for the Caspian–Middle East–Gas Route. 'Some infrastructure projects are of such great importance that we should realistically expect some form of public subsidy for their realization', he wrote in June 2008. 'I would put Nabucco, or an equivalent route, in that category.'<sup>9</sup> That hope, however, was voiced before the general financial crisis of autumn 2008.

7 Ibid.

8 Senior Turkish diplomat, quoted by John Roberts, in 'The Black Sea and European Energy Security', in *Southeast and European Black Sea Studies*, 2006, June, Vol. 6: 2, p. 216.

### Future perspectives

The EU has every interest in preventing deterioration in the mutually beneficial energy relationship that some of its member states have had with Russia for over 40 years. But part of the difficulty is that Europe and Russia are two energy markets moving in opposite directions. The European Commission is trying to create another seismic shift of liberalization in the EU market, and nothing would suit Brussels or indeed European consumers better than to have Gazprom broken up into five or six gas companies all competing to export to Europe. Instead, Europe faces one huge vertically integrated monopoly in gas, and consolidation of the Russian state's ownership and control in oil.

Only in electricity is there parallel movement in the same direction. The privatization and unbundling of Russia's UES electricity system, carried out by its CEO, Anatoly Chubais, the one significant holdover from the Yeltsin years, matches what has been done in much of the EU. German, French and Italian companies have been encouraged to invest in electricity generation in the UES system. When faced with EU complaints about reciprocity and the lack of investment opportunities in upstream Russian gas, the Russian authorities can correctly point to the welcome they have given to foreign investors in their power sector.

Nonetheless, Russia has not lived up to the St Petersburg principles of 'Global Energy Security'. Vladimir Putin made these the hallmark of his year, 2006, as president of the Group of Eight industrialized countries. The St. Petersburg declaration on energy security included such principles as:

- *'transparent, equitable, stable and effective legal and regulatory frameworks, including the obligation to uphold contracts, to generate sufficient sustainable investments upstream and downstream'.*
- *diversification of energy supply and demand, energy sources, geographical and sectoral market, transportation routes and means of transport'*<sup>10</sup>

9 'European Union: The Energy Issue', *Financial Times* Business publications, June 2008, p. 54.

10 Declaration of the Group of Eight, St Petersburg, June 2006.

But within months of sponsoring this charter of economic liberalism and rule of law, Mr Putin was busy forcing companies out of their 'colonial' contracts and enshrining in law Gazprom's de facto monopoly on gas exports. The move of Dimitri Medvedev from chairman of Gazprom to president of the country in 2008 further reinforced the identity of Gazprom with the state.

What can the EU do? It can hope one day to negotiate a better legal framework on energy trade and investment with Russia, as well as for warmer political relations. But it takes two to achieve such results, while there are unilateral steps the EU can take to improve its own energy security. In the short term, it can, inside the EU, improve gas storage, create gas-sharing arrangements and fill in the missing links between national energy grids. In the medium term, the EU can take the St Petersburg declaration to heart and begin to diversify energy sources and routes. Nabucco would not have to be fully built, merely underway, for Europe to feel some of the easing of commercial terms that could come from diversification. Most important but over a longer time frame, it can carry out its low-carbon revolution to reduce Europe's dependence on fossil fuel imports, from Russia and everywhere.

Energy commissioner Piebalgs produced the following projections in autumn 2008 to show this could be possible. If the oil price were a relatively low \$60 a barrel, keeping gas prices low and demand up, and in the absence of the Brussels renewable energy and climate change package, EU gas imports would rise 50 percent from around 300bcm to 450bcm by 2020. In the absence of new climate change policies but a \$100 oil price, gas imports would fall to 380bcm. But gas imports could actually fall below today's levels, to 280bcm in 2020 – if, in addition to a \$100 oil price, Brussels' new energy and climate change package all worked as planned. This is a very big assumption. Is it realistic or heroic?

11 Interview with Argus Media, September 2008.