Russian gas exports to Europe: unravelling the misconceptions

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Russian gas exports to Europe, and Soviet exports before them, have been controversial since they started, in the late 1960s. As the largest single component of European gas supply, they are the subject of ongoing security and geopolitical controversies. However, much of the commentary on these controversies is subject to misconceptions which, in the 2010s, have been compounded by growing regulatory complexities, particularly in relation to pipeline infrastructure.

Volume issues

One important misconception is the idea that the majority of European countries have become increasingly dependent on Russian gas. Russian exports to Europe exceeded 100 bcm in virtually every year in the 1990s; they rose to more than 160 bcm/year in the mid-2000s and fell below that level only in the late 2000s, before recovering to

pre-recession levels in 2013. *(Data in this article refers to all gas sold in Europe as reported by the Gazprom Group and includes the Baltic countries in Europe.)*

However, all of the increase in volumes has been in (to use Cold War terminology) western Europe; not only did central and east European countries import less Russian gas in 2013 than they did 10 years previously, but the 2013 figure was also less than that seen in the early 1990s. Much of the 'west' European increase stems from the inclusion of two countries – Turkey which imported relatively small quantities of Russian gas prior to 2000, and the UK which had imported none. Turkish volumes increased to 27 bcm in 2013, making the country Gazprom's second largest European customer after Germany where volumes had plateaued over the previous decade, only increasing significantly in 2013 (back to 2004 levels). The UK is recorded as receiving 17 bcm of Russian gas in 2013, but it is unlikely that any Siberian molecules were physically delivered (rather this was, most likely, gas of varied origin acquired and resold by Gazprom's UK-based marketing subsidiary). Aside from these countries, only Italy and Poland imported significantly more Russian gas in 2013 than they did a decade earlier.

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Also misleading is the generalization that Europe is dependent on Russia for 26–30 per cent of its gas demand. The figure changes from year to year – 2013 was a record year for Russian exports, while European demand levels remained depressed. Countries such as Spain and Portugal import no Russian gas, while the Baltic countries and many in central and south-eastern Europe are completely dependent.

Commercial and price issues

Another misleading designation relating to Russian gas exports is that their motivation is overwhelmingly 'political'. While there are undoubtedly political motivations, recent history suggests that their principal motivation – certainly in Europe – is commercial and aimed at revenue maximization. When recession hit Europe in 2008 and energy demand collapsed (coinciding with a gas supply glut and increasing competition) Gazprom resisted changing the price basis of its contracts from the traditional oil linkage to hub prices. The result was a fall in Russian gas exports, substantial and protracted renegotiation of the majority of its long-term contracts, and international arbitration with many of its major European customers. At the beginning of 2013, Gazprom's prices in the competitive markets of north-west Europe came into line with hub prices, resulting in an increase in exports of more than 20 bcm compared with the previous year. To summarize the period 2008–13, Gazprom resisted lowering its export prices for four years and lost market share as a result; once it accepted lower prices it regained market share. This was an overwhelmingly commercial – rather than a political – decision.

However this is not the end of the price story. In 2012, the EU Competition authorities opened proceedings against Gazprom to investigate anti-competitive practices relating to exports to eight central and east European countries (where Gazprom has a monopoly or an overwhelmingly dominant market position). By early 2014, all issues had been resolved with the exception of pricing, where Gazprom was apparently refusing to agree to give up oil-linked prices. If the two sides fail to reach agreement, the Commission will issue a Statement of Objections which the Russian government will probably appeal to the European Court of Justice.

Transit issues and transit avoidance pipelines

Far more problematic during the entire post-Soviet period has been the question of transit of Russian gas to Europe across western CIS countries, particularly via Ukraine. There have been periodic transit crises – linked to lack of payment by Ukraine for Russian gas, and disagreements over pricing – of which the most recent have been 2006 and 2009. The 2009 crisis, when no Russian gas was delivered to Europe across Ukraine for two weeks in winter, was the most serious European gas security crisis; some south-east European countries suffered a humanitarian emergency. Ukraine's reputation as a reliable transit state was destroyed and Gazprom suffered huge reputational and financial damage. In mid-2014, in the aftermath of the Ukrainian political crisis and the Russian annexation of Crimea, Europe was on alert for another interruption of deliveries. On 16 June 2014 Gazprom cut supplies to Ukraine following a breakdown of negotiations over debts and prices brokered by the European Commission; its exports to Europe continued in full into early August.

Transit conflicts seriously affected Gazprom's export strategy: it resolved to end non-payments and unauthorized offtakes, but finding its existing instruments ineffective, it intensified the development of alternative export pipelines – Yamal Europe, Blue Stream, Nord Stream, and South Stream. Gazprom built the Yamal–Europe pipeline (across Belarus and Poland to the eastern border of Germany) to lessen its dependence on Ukraine and to demonstrate that,

unless it changed its behaviour, Ukraine would lose lucrative transit business. However, not only did this have little impact on Ukrainian policy, but periodic Belarusian transit crises caused Moscow to conclude that diversifying transit between Ukraine and Belarus was insufficient to solve its problems, and that export pipelines avoiding both of these countries were required. The Nord Stream consortium (Gazprom, E.ON, Wintershall, Gasunie, and GDF Suez) built two pipelines (each with a capacity of 27.5 bcm) to transport Russian gas from the St Petersburg region to northern Germany across the Baltic Sea; the first line started to operate in November 2011, followed by the second line a year later. The Blue Stream consortium (consisting of Gazprom and ENI) built a pipeline across the Black Sea to Turkey, which went into operation in 2003. The South Stream consortium (consisting of Gazprom, ENI, Wintershall, and EDF) intends to build four pipelines (each with a capacity of around 15.5 bcm) to transport Russian gas to Bulgaria across the Black Sea); the first pipeline is scheduled to go into operation in late 2015.

Regulatory issues

The major advantage of such pipelines for Gazprom, is that they deliver gas directly to Europe. Yet this gas still has to be transported across multiple borders and over long distances inside Europe before it reaches contractual delivery points, the geographical location of which goes far beyond the Russian border. Such transportation is governed by the EU Third Energy Package (TEP) adopted in 2011. This mandates regulated third-party access (TPA) to pipeline capacity based on published tariffs (or their methodologies) approved by national regulatory authorities (NRAs), unbundling of transmission assets, and certification of transmission system operators (TSOs) – unless an exemption is granted by an NRA and approved by the European Commission (EC). Although transit avoidance pipelines potentially establish a transit-free geography of Russian gas exports to Europe, thus resolving a problem of insecure transit, they face another big problem of complying with the changing regulatory environment both in respect of existing and new pipeline capacity.

Until mid-2014 Gazprom has been unable to utilize the full capacity of the onshore extensions of the Nord Stream pipelines – OPAL and NEL. Although the German regulator granted an exemption allowing Gazprom to use 100 per cent of OPAL, the EC has capped it at 50 per cent, following which Gazprom and the EC negotiated for more than a year, and reached a solution allowing Gazprom to utilize 100 per cent of capacity unless wanted by a third party. The EC was expected to approve the exemption by March 2014 but delayed the decision, citing technical issues and linking it to the worsening EU–Russia relationship over Ukraine.

Given its negative experience with OPAL, Gazprom did not apply for an exemption for South Stream pipelines but based the project solely on a set of intergovernmental agreements signed with host countries. The EC deemed these agreements in breach of the TEP and called for their re-negotiation or renouncing, otherwise threatening infringement procedures against member states concerned. The EC's willingness to resolve the South Stream regulatory issues with Russia bilaterally has waned following the latter's annexation of Crimea, and also following Russia's request for consultations under the WTO – which alleges the TEP is discriminatory. Unless a mutually acceptable regulatory solution for South Stream is found, the supply security of south-eastern European countries will remain at risk, as Gazprom might be prevented from using sufficient capacity in South Stream if Ukrainian transit is partly or completely halted.

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Reduction of Russian gas to Europe, or phasing out gas in European energy balances?

Despite a great deal of European and American hand-wringing, following Russian annexation of Crimea, there is very little likelihood of any *substantial* reduction of European imports of Russian gas over the next decade. The contractual situation alone, quite aside from the lack of alternative non-Russian supplies, prevents this from happening. The main immediate question is whether the Ukrainian transit pipelines will continue to be used to transport Russian gas, and if not whether the EU authorities will permit Gazprom to use the full capacity of Nord Stream and South Stream (if and when it is built) to fulfil its contracts with European customers. If not, the European Union may find itself in the position of accusing Russia of being an insecure supplier, while preventing Gazprom from supplying through pipelines which have been built for this exact purpose. The longer term question is whether Europe will be able to reduce its dependence on Russian gas, or whether the lack of realistic alternative sources will either mean more reliance on Russian gas, or phasing the fuel out of the energy balances of individual countries.

This article uses data and summarizes arguments in Chapters 3 and 4 of The Russian Gas Matrix: how markets are driving change *(eds. Henderson and Pirani, OIES/OUP, 2014).*