

The geopolitics of EU security of gas supply

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Key words: new balance of power, competition for oil and gas flows, EU energy dependence, Eu energy policy, Russia, Russian gas strategy, EU-Russia relationship, transition.

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1. Introduction

The European Commission's 'Energy for a Changing World', in which its ambitions for a clean, secure and efficient energy policy are communicated, and the recent report by the American National Petroleum Council 'Facing the Hard Truths about Energy' share the growing concern about the development of the global energy system. Meeting current and future energy needs within the constraints of climate change policies and the increasing insecurity of oil and gas supply, has not only elevated energy to the top of the political agenda in the US and Europe, but has also made energy a national priority in Asian countries, such as China, India and Japan. As a result, energy policy is no longer an issue for economy policy-makers alone, but has also become part of the trade, environment, foreign affairs and security policy agendas. At the same time, energy has also gained strategic value to oil and gas producing countries: in terms of its contribution to growth, trade, income for the government and foreign direct investments in the main consumer markets. The crucial contribution of energy to the economies of both producing and consuming countries has bestowed energy with strategic properties which play an important role in the shifting balance of power in the world. Gaining access to energy through trade, investment and technology, while further reducing energy use is part of the complex geopolitical and geo-economic positioning for power among key producing and consuming countries.

The current encounters between the EU and Russia over gas supply and demand structures are an excellent example of the role of energy in the shifting balance of power on the European/Asian continent, and the impact of this shifting balance of power on wider international energy relations. Europe is trying to reduce the strategic and structural dependence of Russian gas supplies through diversification, demand management and, in the short term, most importantly, regulatory designs that limit the market power of the near monopoly of Gazprom on the EU and its neighbouring (transit) countries. Russia is trying to use its market power to create the conditions that supports the longer term Russian energy security, economic development and an important role in the international political system. For this to be realised, Russia not only needs to secure income from (oil and) gas imports, but also companies that are willing to be part of the long term Russian energy and economic strategy. Russian energy security, both in terms of supplying the domestic market and in terms of securing export income from oil and gas, depends on realising large and complex

investment projects. These investments must underpin the ongoing important role of Russia in international oil and gas markets and the international system.

The long standing gas relationship between Europe and Russia is not only changing as a result of (supra) national ambitions, but also as result of the major political changes on the continent after the collapse of the Soviet Union. The new political and economic make-up of the EU and the countries of the former Soviet Union has prompted various transitions in the political, economic and security sphere that are uneven, inconsistent and sometimes outright conflictual. This is also reflected in the energy relations. The outcome of this transition process also has substantial geopolitical dimensions.

In this paper the focus will be on the development of energy relations on the European/Asian continent, where the tug of war between control and management of the risks and benefits over the gas value chain has been most intense as a result of divergent transition processes of both the EU, which went from 15 to 27 member states, and the states of the former Soviet Union. For both producers and consumers in these groups of countries vital interests are at stake in the outcome of the restructuring of energy relations across the continent. The shifting regional balance of power is part of the larger changes in the international system where newly emerging economic powers are increasingly asserting also their political power.

It will be argued that energy is a crucial instrument in the underlying geopolitical struggle to restructure the international system and the position that countries wish to take in that system. Europe and Russia both have to rely mainly on their soft powers to elevate their position in the region and the world.¹ The outcome of the redefinition of their relationship could play a significant role in the balance of power amid the roles that China and the United States carve out for themselves. In a multi-power world, the balance of power does not only rely on strategic strength alone but also on the others relative strengths and weaknesses. Both Russia and the US are richly endowed with fossil fuel reserves, but only Russia is a significant net exporter, while the US is a net oil and gas importer. China has substantial coal reserves but must import oil and gas, while Europe will become an even more significant net importer of fossil fuels. The US and EU offer

¹ Dmitri Trenin, *Russia's strategic choices*, Carnegie Policy Brief 50, May 2007, p.5.

large consumer markets and are still significant sources of technology and capital. China offers a large potential market and has turned into the workshop of the world. The large balance of payments surpluses in Russia and China could challenge the EU and US in their position of investors. The strategic importance of reliable and relative cheap energy in this global position game is large. The outlook for the contribution of renewables in the energy mix of the US, EU and China, although a growth sector, still pales compared to the continued importance of fossils for the energy mix. Russia's potential as an energy-rich nation is large, but much depends on the success of converting this potential into sustainable economic growth and political stability. Russia is wedged between the EU in the west and China in the east, and must find a balance between the relative strength and ambitions of both. The Putin administration is opting for a strong Russia, which can develop relations with both China and the EU on its own strength rather than weakness. Earlier attempts to seek closer relations with the EU and US have caused disappointment among Russian policymakers because its overtures were not taken seriously and perceived as signals of weakness rather than strategic positioning. With the economic and political recovery, Russia has gained strength. Energy is one of those strengths that can help Russia to regain its position as one of the world powers.

The changing relationships across the European/Asian continent have also shaped the energy relations. Russia is no longer the captive supplier of the EU. In the space of a few years, the EU is now struggling not to become a captive consumer of Russia. Moreover, the EU must compete for future Russian oil and gas supplies with countries such as China. With the restructuring of the oil and gas sector in Russia, they are dependent on the preferred merit order of investment projects in new oil and gas provinces in Russia.

The transition processes on the European/Asian continent provide ideal conditions for China and the US to manage the EU-Russia relationship. Europe provides an ideal battleground as the least politically defined among the competing powers. Europe is still predominantly an economic project that has shied away from allowing its intra-political identity to mature. Despite the far-reaching competencies of the EU institutions in economic and monetary matters, the national sovereignty in the foreign and security domain of the member states has remained intact. In this period of geopolitical and geo-economic uncertainty, the European project is suffering from a lack of cohesion on strategic issues, which fuels a re-

emphasis on securing national interests, also in energy. The diverging assessment of how best to geopolitically position the EU and the member states' diverging views on the relationship with Russia, the US and China also impacts the energy relations.

2. New market structures

The recent changes in the geopolitical and geo-economic balance of power compel us to contemplate the conditions under which oil and gas will be produced and traded in the foreseeable future, also on the European/Asian continent. Will we see a world in which oil and gas can flow freely between producers and consumers in a completely liberalised market, and where companies, operating in a level playing-field, have access to all parts of the oil-and-gas value chain? Or will we see a world in which, even more so than today, the strategic interests of sovereign states and the geopolitical balance of power will determine the oil-and-gas investment climate and trade flows. In the latter case such conditions could imply that international oil companies, as the main vehicle for achieving security of supply in an international market setting, would have to materially realign their company strategies in order to continue to gain access to upstream assets. The idea in the 1990s that international oil and gas markets would increasingly be freed from heavy handed government involvement and management and would condense its role to market regulator and tax collector has evaporated in recent years.² Instead, governments in producing countries are asserting their control and management over the energy resources and economic rents through (majority) ownership. This trend is prevalent in many of the oil and gas producing countries. In international oil companies, like in the late 1970s, early 1980s will have to decide how best to respond to these new conditions. To be sure, also consumer governments are increasing their control over the energy sector again, despite liberalisation and privatisation processes in the 1990s. They are regulating markets within the constraints of their public interests (environment and security of supply), they are breaking up the value chain by ownership unbundling, they are subsidising new energy sources and taxing the energy sector to capture the economic rents, thus setting a limited space for competitive forces to work. At the heart of

² *Study on Energy Supply and Geopolitics*, final report, January 2004, TREN/C1-06-2002, CIEP; van der Linde, C., *Energy in a Changing World*, inaugural address 22 November 2005, Clingendael Energy papers 11; Hoogeveen, F. and Perlot, W., *Tomorrow's Mores, The International System, Geopolitical Changes and Energy*, CIEP, December 2005; all available at www.clingendael.nl/ciep/publications.

all government intervention in the energy sector is the distribution of risks and benefits through the energy resource value chain in the short and the long term, often branded as security of supply and security of demand policies.

The explanation for the more interventionist energy policies around the world can be found in a paradigm shift in international oil and gas markets, from a long period of ample supplies, where production capacities around the world had grown faster than demand, to world oil and gas markets that have recently become much tighter. In the past years, demand has grown much faster than supply, and overcapacities in the oil and gas industries have disappeared. In the past, disruptions in supply, such as the one caused by 'Katrina', could easily be compensated by increasing supply elsewhere in the world. In oil, ample spare capacities in Saudi Arabia and the United Arab Emirates often helped to overcome short term supply disruptions. Since 2004, the level of spare capacity reached much lower levels than in the period 1982-2004.³ Maintenance work, political and social protests in the oil industry, acts of nature, and accidents in any of the producing countries would create immediate shortages of supply. In gas, the excitement over the increasing availability of Liquefied Natural Gas (LNG) with the unlocking of the substantial, previously stranded, reserves of the Middle East, quickly dampened when it became clear that also in this market demand would outpace supply and that the much heralded flexibility to supply markets will remain limited for some time to come.⁴

Investment levels, both in the upstream and the downstream part of the oil and gas value chain⁵, which would allow supply to catch up with growing energy demand, have been disappointing, despite the recent higher price levels. This has amplified anxieties over future security of supply. World proven oil and gas reserves are sufficient to meet demand over the next decades, and technically these reserves could be developed, but a combination of political, institutional and economic factors have prevented these investments to take place at the desired pace. Security of supply concerns are now matched by security of demand concerns on the part of the producing countries. These latter concerns are focussed on the return on investment for the national companies and the governments, control over export routes and access to markets.

³ www.EIA.doe.gov international oil section/presentations

⁴ Gas for Tomorrow, Dutch Energy Council, www.energieraad.nl, p. 54

⁵ The upstream part of the oil and gas sectors involves exploration and production, while the downstream consists of the transportation, processing and distribution segments of the industry.

In the 1990s, oil and gas import dependency mainly had economic dimensions, but increasingly, this dependency achieved geopolitical dimensions when energy also became a priority of foreign policy among the main geopolitical players in the world. In particular, the way in which China has secured oil and gas flows in recent years through predominantly bilateral government-backed deals with countries such as Iran, Venezuela and Sudan, has troubled foreign and energy policy-makers in the OECD's capitals. Also the gas crisis between Gazprom of Russia, a 50% +1 state-owned company, and the Ukraine, has alarmed policy-makers. Although, the conflict was predominantly a commercial one, and must be seen as part of the painful transition of energy trade relations among the states of the Former Soviet Union to a more market-based energy trade, many judged the refusal to deliver gas on 1 January 2006, as an act of Russian regional energy power politics. The conflict has greatly impacted the EU-Russian relations. Moreover, the concerns over gas supplies from Russia are responsible for the narrow focus in the EU on gas security instead of wider security of energy supply issues.

The renewed focus on security of supply among consumer countries in the past couple of years is understandable against the backdrop of the changed market circumstances. The fear of consumer countries is that energy will increasingly be used to leverage national producer country interests. The response of consumer countries varies. Both China and the United States are predominantly focussed on security of oil supply, while the EU is mainly focussed on the security of gas supply. In China's case, this can be easily explained by the composition of the (imported) energy mix; gas still has a very small share, while the share of imported oil is increasing rapidly. Moreover, the share of the Persian/Arabian Gulf in these growing oil flows is substantial. The growing dependency of China on this politically troubled region is an important driver for Chinese companies to develop alternative import flows from other regions, including Russia and the Caspian Sea region. The focus of the US and the EU, which are both to a varying degree substantial importers of oil and gas, is more complicated to explain. The self-imposed role of the US as 'policeman' in the energy-rich Middle East, its role in the Central Asian/Caspian Sea region, and its position with regards to Russia puts energy in the middle of its strategic and security agenda. Still, in the short and medium term, the structural dependency on oil imports is deemed more urgent than the growing dependency on gas imports and can be explained by the ability to substitute with domestic sources or not. Yet, the US is voicing its growing concerns with the EU's

dependency on Russian gas, thus hitting a raw nerve in the Baltic states and some of the East European countries. The strategic involvement of the US in central Europe and in some of the Former Soviet Union states touches upon the different strategic assessment of relations with Russia between the US and some of the larger EU member states. Due to the strong regional propensity of gas trade, the US and some West European countries are potentially in conflict over security of gas policies. This conflict could seriously divide the EU in its attempts to formulate supra-foreign and external energy policy. The diverging views on the development of strategic energy relations with Russia could increase the sense of insecurity of the Western European countries and encourage the further development of alternative supply routes from Russia, circumventing those member states that are less supportive of Russian supplies. This in turn, increases the strategic dependence on Russia of the Baltic and East European states that are no longer connected to the preferred trunk lines. For the EU security of energy security is mainly focussed on gas for two main reasons: first, the lack of foreign and security powers to play a major role in stabilising the main oil producers such that oil flows continue to be available and at a reasonable cost; and second; the continued large import dependency on pipeline gas, which structurally connects the EU and Russia for the longer term, regardless of the speed with which LNG import capacities can be developed for the European market.⁶

3. Growing energy dependency and foreign relations

The growing importance of energy diplomacy comes with the realisation that the transition to a more sustainable and less import-dependent energy future is a long and slow process, and that, in the short and medium term, energy security risks are growing.⁷ The current tight international oil and gas markets, exemplified by relatively high prices, has politicised energy relations among consumer countries and between producer and consumer countries. A new form of competition over energy has come to the fore. Evidently, it has also sharpened the fight over the allocation of economic rents among producers and consumers. The sellers market provides producer countries with more political and economic clout to set the terms

⁶ ExxonMobil Outlook 2005.

⁷ European Commission, Com (2007) 1, 10-January 2007, http://ec.europa.eu/energy/energy_policy/audiovisual_en.htm; NPC, *Facing the Hard Truth about Energy*, 18 July 2007, www.npc.com.

under which their energy can be exploited and exported. Rather than liberalising and privatising their upstream energy sectors, and become regulators rather than owners, they continue to insist on direct control through (partial) ownership to secure their economic rents and govern the domestic allocation of rents. In the mostly one product economies, the large capital flows that come with energy trade, the limited government capacity and capability to monitor the rents distribution in a private setting and the weakly developed political and social institutions, largely explain the preference for direct government control. The track record of developing countries with relying on regulation and taxation alone has been spotty because the level of sophistication that is required (checks and balances) of the political, legal and social institutions was wanting. Nepotism and other forms of (political) corruption were never far away, creating political and social instability.

In most countries of the OECD, energy markets have been liberalised and made more competitive. In the period 1985-2000, international competition for consumers allowed governments of consumer countries to re-design their markets, and they embarked on a de- and re-regulation process that reduced dominant market positions of incumbents in the downstream part of the value chain, further re-allocating economic rents to consumers and consumer government coffers. Competing for consumers made producer countries more uncertain about demand and the required investments levels, and they were reluctant to embrace private sector initiatives. For instance, the ill-fated privatisation of the Russian oil industry created all sorts of domestic political and social problems and increased the negative aspects of rent-seeking behaviour among the elites. The increasing dependence of the government budget on income from the energy industries, and the energy needs of the domestic economy were at a logger-head with the preference of the privatised firms to export energy to more lucrative foreign markets, provoked a harsh battle between the interests of the oligarchs and the political establishment. This battle was decided in favour of the Russian government when the Putin administration took control over economic restructuring and the energy industries. Given the capital flight and increasing imports, oil export growth had played an important role in sustaining growth of the Russian economy in the early 2000s.⁸ In the longer term, gas export growth must help sustain the positive balance of payments,

⁸ Rudiger Ahrendt, Sustaining Growth in a Hydrocarbon-based Economy, in: *Russia's Oil and Natural gas, Bonanza or Curse?*, M. Ellman (ed.) Anthem press, London, pp. 112-115.

further emphasising Russia as a carbon-based economy.⁹ The, admittedly, chaotic political and economic period of the 1990s ended also with a reduction in political freedoms in the country, and a renewed focus of the political and strategic interests of the state. The stated ambition of the Putin administration to both generate domestic economic growth and more social justice and to regain a more prominent position for Russia in international affairs convinced enough of the worn out Russian voters to return Putin to office a second time. In his second term, the national interest seeking approach became more prominent. Understandably, this turn of events, greatly impacted relations with Europe.

4. EU energy policy

Although the growing European long term dependence on imported oil and gas flows is generally known¹⁰, the implications and urgency of this growing import dependency was until recently not fully understood. Only when tight oil and gas markets presented themselves from 2004 onwards, and at the same time EU domestic oil and gas production began to decline, EU member state interest in managing these external energy supply relations began to appear in earnest. The eastern enlargement of the EU coincided with this renewed interest in external energy relations, in part because the energy import dependency, in particular on Russia, of the new member states was large. In 2004, the share of Russian oil in EU oil consumption was 26%, the share of Russian gas was 29% and coal were 8%¹¹, and this dependency was predicted to grow when environmental policies would begin to kick in. The growing trepidation about the potential impact on the development of the EU internal energy market by such concentrated external gas flows, and concerns about the discrepancies in EU competencies in energy policy-making, placed energy security more firmly on the EU political agenda.¹²

The growing organisational inconsistencies in the structure of the oil and gas value chain in the world, the switch to a sellers market and the political

⁹ Ibid.

¹⁰ EU Commission, Green Paper : *Towards a European strategy for the security of energy supply*, November 2001.

¹¹ SEC (2007) 12.

¹² European Commission, An Energy Policy for Europe' Com (2007) 1 final; A European Strategy for Sustainable, Competitive and Secure Energy' COM (2006) 105 final'.

changes in important producer countries has radically changed the assessment of energy security risks.¹³ Rather than solely relying on energy companies securing energy flows for the EU-market, governments realised that foreign and energy policy also had an important role to play. It is, however, in this policy space that the EU is suffering from incomplete integration. The EU is still far away from a balanced foreign and energy policy. Despite some progress, member states always preferred, both in the foreign policy as in the energy field, to largely maintain their own competence. National preferences to maintain an independent foreign and energy policy, along with increasing economic pressures by domestic business interests, continue to foreclose the possibility of creating a greater EU-wide policy space in this field.¹⁴ The resistance of, for instance, Germany and France to unbundle their gas and electricity sectors is part of their strategic assessment that a vertical and horizontal organised domestic sector is the best underpinning for their external energy policies, where the model of cooperation combines government-to-government with business-to-business.¹⁵ The competitive model the European Commission advocates is seen as model that would only work in an international market that is amply supplied¹⁶ and where multilateral or EU regulations of the market apply.¹⁷ With the resistance of Russia to accept such regulation and which rather relies on bilateral arrangements and asset swaps, the member states are further reinforced to maintain a national energy strategy. The bilateral approach is clashing increasingly with the approach of the European Commission and some member states. This was exacerbated by the enlargement of the EU with the Baltic and East European Member States, that have divergent energy mixes and are very dependent on Russian energy supplies. Their strategic re-orientation on the West combined with their

¹³ *Study on Energy Supply and Geopolitics*, final report, January 2004, TREN/C1-06-2002, CIEP, p.19/20.

¹⁴ Franco Algeri, A Weakened EU's Prospect for Global leadership, in: *The Washington Quarterly*, Winter 2006-2007, p.113/114.

¹⁵ EurActiv, Thursday 7 June 2007 EU states reject breaking up energy firms; Thomas Gomart, France's Russia Policy: Balancing Interests and Values, and Alexander Rahr, Germany and Russia: A Special relationship, both in: *The Washington Quarterly*, Spring 2007.

¹⁶ CIEP, *Contribution of Coby van der Linde, Clingendael International Energy Programme, The Hague, The Netherlands*

to the 12 September 2006 Hearing of the European Parliament on the Green Paper A European Strategy for Sustainable, Competitive and Secure Energy COM (2006) 105 final, Contribution to the session: What is missing in the green paper, p. 6/7 and 10-12.

Coby van der Linde, External Energy Policy: old fears and new dilemma's in a larger Union, in: *Europe and the Global Economy*, A. Sapir, J. Pisani-Ferry eds., Bruegel Institute, forthcoming summer 2007, p. 285

¹⁷ Catherine Locatelli and Dominique Finon, *Russian and European gas interdependence. Can Market forces balance out geopolitics?*, Working paper CIRED 07-02, February 2007, p.7.

traditional energy dependency on Russia makes the development of a common EU policy towards Russia even more complex than before.

Nevertheless, in the new international energy relations, external energy policy without a sound foreign policy is ineffective. The new EU initiatives to come to a EU-wide energy security of supply policy, does, however, not include the foreign policy and security angles that an effective policy would need in today's balance of power geopolitics.¹⁸ Europe should also review its strategic position on the competition and regulation agenda in order to strategically position the market sector in a changing international situation.¹⁹ Regulation strategy is lagging behind market and geopolitical changes and is increasingly at loggerheads with the Russian gas strategy towards the European market. European companies who are crushed between these two diverging interests, turn to their national governments for support of their investments. The EU and Russia are increasingly engaging in an action-reaction game in which the way the internal gas market project is pursued at the Commission level is clashing with the Russian domestic and export gas strategy. Cooperation has transformed into competition over who can structure the market in the European/Central Asia region. The efforts of the Putin administration to maintain the East Caspian gas flows in the realm of the Russian type of market management is, for instance, a major challenge to the Commission's designs to wriggle these flows out of the Russian's realm. The involvement of German, Italian and French companies in the three major new routes for Russian (and Caspian) gas, the North Stream, Blue Stream II, and LNG from Shtockman, however, ties major Western European companies to the Russian interests and complicates the EU approach. Moreover, the asymmetric energy security risks among the member states, and the fundamental different foreign policy interests and orientations of the various member states make it unlikely that these differences can easily be overcome, particularly, but not exclusively, with regards to Russia.²⁰ The institutional make-up of the EU and the inconsistent competencies of the Commission in energy and foreign

¹⁸ *Study on Energy Supply and Geopolitics*, final report, January 2004, TREN/C1-06-2002, CIEP; van der Linde, C., *Energy in a Changing World*, inaugural address 22 November 2005, Clingendael Energy papers 11; Hoogeveen, F. and Perlot, W., *Tomorrow's Mores, The International System, Geopolitical Changes and Energy*, CIEP, December 2005: all available at www.clingendael.nl/ciep/publications; 'An Energy Policy for Europe' Com (2007) 1 final.

¹⁹ Van der Linde, C., Correljé, A., de Jong, J., en Tönjes, C., *The paradigm change in international natural gas markets and the impact on regulation*, for the WGC2006, www.clingendael.nl/ciep/publications.

²⁰ Locatelli, Catherine, and Finan Dominique, *Russian and European gas interdependence. Can Market forces balance out geopolitics?*, Working paper CIRED 07-02, February 2007;

policy were less problematic in world seeking full economic integration than in a world where national political strategies also determine economic relations.²¹ Ironically, if the EU governments do not strategically review the restructuring of these markets, the competitive edge of European energy industry in the international field will weaken, reducing the chances of directing oil and gas flows into Europe.

The institutionalised inhibitions in the EU to co-operate in foreign and energy policy is hampering the development of a mature political and economic relationship with one of its main energy suppliers, Russia. Where in the past economic integration helped to overcome the political-strategic fears about inter-dependency, the EU is surprisingly shying away from developing such a relationship with Russia, now that Russia is recovering its strategic power. At this juncture an opportunity could easily be missed to develop stable political and economic relations with such an important and large neighbour. The vision on this relationship both in the EU and in Russia, where ideas about a future membership of the EU had floated around in the 1990s, has changed substantially since the early years of this decade. While European countries in the 1990s considerably switched their oil supplies from the Middle East to Russia, and continued to import substantial volumes of gas, the intensified economic relations were not matched at the EU level by a similar development in closer political relations. When enlargement of the EU and monetary and economic integration had been largely accomplished by 2004, diverging views on where the EU would or should go next began to surface in earnest. Some member states diverged from the joint EU strategy towards Russia by embracing their own bilateral relationships. After the completion of the 2004 enlargement, attention in the EU was refocused on relations with new neighbouring states. These new neighbouring states were largely part of the former Soviet Union. With the growing strength of Russia in the early years of this decade, these same states were subject to a renewed interest in Moscow when the Near Abroad policy was dusted off. The overlap in the EU's neighbouring countries policy and Russia's near abroad policy created a new ground for tension. Current ambiguity about both the EU's and Russia's geopolitical role and regional scope, has created divergence rather than convergence on the European continent.

²¹ Van der Linde, Coby, *External Energy Policy: old fears and new dilemmas in a larger Union*, in: *Europe and the Global Economy*, Andre Sapir, Jean Pisani-Ferry eds., forthcoming, Bruegel Institute, 2007, pp. 288-293.

5. Competing transitions on the European/Asian continent

The collapse of the Berlin Wall in the late 1980s and the break-up of the Soviet Union in the early 1990s heralded profound changes in the institutional make-up of economic and political relations on the European/Asian continent and purported a dramatic shift in the balance of power in the world. The EU²² and NATO²³ were enlarged with East European countries that had belonged to the Council of Mutual Economical Aid (Comecon)²⁴ and the Baltic States, which were part of the Soviet Union.²⁵ The Commonwealth of Independent States²⁶ is far removed from being a successor to the old power structure of the Soviet Union. From 1991 onwards, both the EU, NATO, Russia and other former Soviet Union states were in a process of digesting these profound changes. Particularly because some of the new institutional arrangements partly overlap and allow for some degree of pick and chose orientations in the foreign and security policy options. The development of EU foreign and security policy has been both stimulated and hampered by the parallel process of redefining NATO's focus.²⁷

This process of digesting change and redefinition of the nation and the accompanying national interests is uneven and increasingly more conflicting, both within institutions/groups of countries and among them when national political and economic interests. The West European member states are struggling with the integration of the new member states into the EU mores and the fact that integrating a large group such as the 2004/2006

²² New member states in 2004: Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, Slovenia, and since 2006: Rumania and Bulgaria.

²³ New NATO member states: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Rumania and Slovakia.

²⁴ Members of Comecon were: Soviet Union, Poland, East Germany, Czechoslovakia, Hungary, Rumania, Bulgaria, Cuba, and Mongolia.

²⁵ The new NATO memberships were realised before the EU East European enlargements in 2004 and 2006.

²⁶ The Commonwealth of Independent States (CIS) is a confederation, or alliance, consisting of 11 former Soviet Republics: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Ukraine, and Uzbekistan. Turkmenistan discontinued permanent membership as of August 26, 2005 and is now an associate member. The creation of CIS signaled the dissolution of the Soviet Union and, according to leaders of Russia, its purpose was to "allow a civilized divorce" between the Soviet Republics. However, many observers have seen the CIS as a tool that would allow Russia to keep its influence over the post-Soviet states. Since its formation, the member-states of CIS have signed a large number of documents concerning integration and cooperation on matters of economics, defense and foreign policy.

²⁷ John R. Schmidt, Last Alliance Standing? NATO after 9/11, in: *The Washington Quarterly*, Winter 2006-07, p.93/94; CSIS, Security Threats and Responses in Central Europe, www.csis.org, p. 6; Franco Algeri, A Weakened EU's Prospects for Global Leadership, in: *The Washington Quarterly*, Winter 2006-07, p. 110/111.

enlargement has fundamentally changed the EU itself, particularly in the political sphere. The Treaty of Maastricht had allowed to let the centrifugal forces on the European continent run free after the dramatic change in the balance of power on the continent. Ten years on, in a new geopolitical and regional environment and a weaker transatlantic alliance²⁸, the discussions about the EU constitution and a new Strategic Partnership Agreement with Russia epitomise the centripetal forces that shape today's inter-European relations. NATO's struggle to find a new purpose and the divergent views among the old NATO member states on the intervention in Iraq and how best to tackle Islamic terrorism has also left this organisation less coherent than before. The difficulty NATO has in committing their member states to contribute to the Afghanistan mission is an indication of the hesitant support of the members to NATO's new mission. The new EU and NATO member states in Eastern Europe and the Baltic (and aspiring members in the Caucasus) tend to rely less on the soft powers of the EU and the old member states and more often than not side with the US on security issues in the region. Particularly in the relation with Russia this has led to divergent foreign policy approaches and a different approach to future energy relations.²⁹ Both Belarus and the Ukraine, with their disappointing transition records, have been left in the middle between the EU and Russia. The support for further eastward enlargement of the EU is low, while the US would not want these countries, nor the countries in the Caucasus to fall in with Russia again because it would reduce the ability to develop new energy corridors outside the realm of Russia and Iran, the world's two largest gas reserves holders. The development of an energy community as part of the EU's neighbourhood policy must bridge this gap in extending the regulatory control over export pipelines. Obviously, these attempts have stimulated Russia to promote its own approach of controlling supplies and export routes and securing their market access.

Why then did the EU not forge a strategic partnership with Russia about energy and helped the Russians to restructure the CIS energy relations when the discussions in the framework of the Energy Charter ran aground? The explanation is not obvious. Clearly the influence of the US in the Eastern European sphere cannot be underestimated in its impact on European policy-making. Economically weak and politically disorganised client states such a Belarus and the Ukraine currently hold both the energy interests of

²⁸ Stefan Halper and Jonathan Clarke, *America Alone, the Neo-conservatives and the global order*, Cambridge University Press, Cambridge 2004, pp.235-237.

²⁹ Yuliya Tymoshenko, Containing Russia, in: *Foreign Affairs*, May/June 2007, p. 75.

the EU and Russia hostage. Rather than deepening the political and economic relations, we have witnessed a growing distrust between the two blocs. The explanation for the growing EU-distrust lies in the unwillingness on the part of the Russians to open up the huge reserves for foreign direct investments and the way in which the Russian government resolved its problems with the oligarchs and their companies. Just when ownership of reserves and production was so near for the western investors, the Russian government closed the door on the sale of foreign majority holdings in Russian energy companies, and instead, ruled that foreign owners could only hold minority shares. The restructuring of Gazprom and the enlargement of the ownership by the government to a 50%+1 share does, however, hold the promise of upstream investments in gas, much like the investments in Qatar and other producing countries allow. Yet, participation in the near gas monopoly of Russia and its new gas projects did not measure up to the EU's expectation that the Russian government could be persuaded to break-up the monopoly. Such a break-up would allow Russian gas to compete for the European market and would assist in realising the internal gas market in the EU. Undoubtedly, the monopolistic grip of transit countries on the pipelines and export storage facilities would have been the EU's next target.

It is likely that the position of the EU, on insisting that long term contracts and destination clauses had to be dissolved in a period when Gazprom had not been fully able to restructure its domestic sector and gas relations with the transit countries, fed the growing suspicions of Russia that it was the EU's intent to maximize the redistribution of rents towards the downstream end of the value chain, while reaping the remainder of the rent through foreign direct investments. The growing dependence of government income on oil and gas exports³⁰ necessitated the Russian government to prevent such a development. With oil and gas markets tightening and prices increasing, the Russian government acquired the means to seriously pursue its domestic and foreign ambitions and thwart the designs of the EU and others for the Russian energy sector.³¹ Energy was a part of foreign economic policy of the US and Europe and became an instrument again of national and foreign policy of Russia. The enlarged EU had triggered Russia in pursuing security of demand, which implied that some of the new gas is

³⁰ Shinichiro Tabata, Price differences, taxes and the stabilization fund, in: Micheal Ellman, *Russia's Oil and Natural Gas, Bonanza or Curse?*, Anthem Press, London, 2006, pp. 41-46.

³¹ V.V. Putin, Mineral Natural Resources in the Strategy for Development of the Russian Economy, Zapiski Gornogo Instituta 144, pp. 3-9, as translated and published by Harley Balzer, Vladimir Putin's Academic Writings, in: *Problems of Posts-Communism*, January/February 2006.

now developed for new markets in North America and Asia. Gas that was traditionally seen as destined for only one market is, partly as a result of the 'LNG-revolution', now diverted to other markets. Already, Europe has to compete for LNG flows from other gas-rich regions. Moreover, Europe is now effectively competing for new gas developments in Russia with other consuming countries because Gazprom does not have an unlimited capacity and capability to develop very many large projects all at once. The merit order of Greenfield, pipeline and downstream investments changed under the pressure of the changing strategic market outlook.

The re-emergence of Russia as a stable economy was fuelled by oil and gas and at the same time, the redefinition of the national interest from the early days of oligarch capitalism to the bureaucratic capitalism of today under Putin.³² The way in which Putin reshaped the energy sector in Russia in his second presidency mirror his ideas developed in his doctoral thesis in 1997/1998 and that were published in 1999 in a journal of the State Mining Institute in St Petersburg.³³ In his article, Putin argues that the mineral industries provide the Russian economy with a large growth potential and can create wider economic development. The state is instrumental in developing this potential. In the article he argues the importance of the creation of large financial-industrial conglomerates that can compete with Western multinationals and that can also function as the drivers of Russian domestic reforms with their stable government revenue income and foreign currency receipts.³⁴ Yet, for such a development to materialise, Russia must address the potential risks of such a strategy, namely the external vulnerability, Dutch disease and institutional shortcoming that accompany an oil and gas driven development of the economy.³⁵

The dependence on oil and gas for the re-emergence on the international stage of Russia is thus a vital driver in Russia's foreign and economic policy for the future. The challenge to replace the old mature fields in West Siberia with a new generation of fields requires a delicate balancing act between foreign market share, income flows, investment, foreign capital and knowledge and supplying the domestic market. In this balancing act, gas

³² Dmitri Trenin, Russia Redefines Itself and Its Relations with the West, in: *The Washington Quarterly*, Spring 2007, p. 95.

³³ V.V. Putin, Mineral Natural Resources in the Strategy for Development of the Russian Economy, *Zapiski Gornogo Instituta* 144, pp. 3-9, as translated and published by Harley Balzer, Vladimir Putin's Academic Writings, in: *Problems of Posts-Communism*, January/February 2006.

³⁴ *Ibid.*, p. 52.

³⁵ Rudiger Ahrendt, *op.cit.* p. 115.

supplies from independent producers and the flow of Caspian Sea gas play a crucial role to fill the domestic supply gap. And it is exactly in the sphere of access to markets and access to supplies from the Caspian Sea region that the EU (and the US) are challenging Russian domestic security of supply with their alternative pipelines routes and access regimes.³⁶ Without the necessary demand security and stable routes to the European market, the full-blown Yamal development will very likely be pushed back in the merit order to a later date because the domestic market alone cannot carry such a massive investment as long as prices in Russia remain substantially lower than world market prices. Currently exports to Europe account for 27% of Russian gas sales and 60% of Gazprom gas revenues.³⁷ Increases in the domestic gas price are foreseen in the next couple of years, bringing the viability of a Russian led development of Yamal closer. The IEA, however, keeps pushing Russia to commence on the vast Greenfield investments, perhaps hoping that foreign direct investment capital and foreign project management capacity must then be imported to realise the vast development in Yamal, but also because the level of supply to Europe will greatly impact the call on LNG markets elsewhere.³⁸ In the IEA assessment, upstream investment levels fall short of the levels needed to maintain supplies, and thus to compensate for the main fields' decline. But a full commitment to bring Yamal on stream runs counter to the other strategic ambitions of Gazprom and the Russian government as long as the mid and downstream preconditions for security of demand are not in place and Russia feels unable to properly distribute risks and benefits through the value chain.

The balancing along the value chain that is unfolding requires Russia to fill the short to medium term supply gap for the Russian market with cheaper independent and Caspian gas. This allows Gazprom to maintain its export levels to Europe. The completion of the North Stream pipeline and South Stream II open up new routes to the European market for its long term gas supplies and this frees up capacity in the main gas corridor through the Ukraine. The free capacity gives Gazprom the ability to switch routes and arbitrate between local markets, thus reducing the strategic dependence on the Ukraine, while increasing the strategic dependence of the EU and Caspian Sea suppliers on the routes stability. Moreover, the free capacity can be used or auctioned off for short term gas contracts from Russia and the

³⁶ World Gas Intelligence, *Russia's Central Asian Score*, vol. XVIII, no. 20, May 16 2007, p. 1.

³⁷ IEA, *Natural Gas Market review 2007, Security in a globalising market to 2015*, OECD/IEA, Paris, 2007, p. 130.

³⁸ *Ibid.*, p. 129 and 132.

Caspian Sea countries, offering in time a viable alternative to the EU and US supported Nabucco pipeline, while at the same time adapting to TPA-like transportation route conditions. The difference with the EU strategy is that Russia under its own strategy will have secured control over the routing and non-Russian supplies, while securing demand and reducing the risk for its own Greenfield developments. In the mean time, the Shtockman development that was recently elevated in the investment merit order, can compete for the Northwest European and American LNG market. Such a strategy helps Russia to defend her market share in the vital Northwest European gas market, while at the same time adapting to the realities of EU market developments. The fact that gasification capacity is currently outpacing liquefaction capacity, and with the inclusion of carefully selected western oil companies, will guarantee market access. While the Russian strategy seems to be shaping up, the European strategy is beginning to show some hairline cracks.

In the EU, dependence on energy imports from Russia and the subsequent policy orientations of various member states is increasingly the cause of a major fissure between some of the Eastern and Western member states. North East European member states rely for their security on the relations with the US and on their NATO membership, rather than on the soft powers of the EU, while southern East European countries seem to prefer developing their position as an alternative gas transfer lynch-pin.

The current position of the Baltic countries and Poland hampers the development of the Northwest European strategy of gas value chain integration with Russia as advocated by Germany, The Netherlands and France, in addition to increased flows from Norway and LNG. The Northeast European countries, supported to some extent in their efforts to reduce dependence on Russia by Sweden, are afraid of the continued structural dependence of Russian oil and gas supplies and fear becoming a crush zone between Russian political ambitions and North western Europe's pragmatic approach to securing gas supplies. The resistance to the North Stream or Baltic pipeline project, which allows for direct transit of gas from Russia to Germany, is strong. The Baltic states and Poland, who have been traditional transit routes for Russian oil and gas, are challenged in their position of strategic economic and political importance by the new infrastructural capacities in Russia and the Baltic Sea. Moreover, they stand to lose important (potential) flows of steady income from oil and gas in transit, when more capacity is available to by-pass these countries. In the

longer term, they face increased energy costs when the current infrastructure must be maintained by mainly local trade alone. The loss of the strategic position for Russia does make them more vulnerable, although oil and gas flows can, at a cost, be made to flow eastward in case of an emergency. The current strategy of Poland and the Baltic states is extraordinary from an energy security perspective, although a certain trepidation in re-building the relationship with Russia and Germany can be explained from its past. Rather than present themselves as reliable transit partners of Germany and Russia, and shield in the importance of Russian gas reaching the Northwest European market, they have sidelined themselves in that development.

The southern East European member states take a slightly different approach in their attempts to gain economic and political benefits from partly replacing the Ukraine and Belarus as the main transit countries for Russian and Caspian Sea oil and gas. Rather than pursue the Non-Russian-Non-Iranian corridor approach, Italy, Hungary and Bulgaria have embraced the opportunity to replace the Ukraine as the main corridor for Russian gas and support and development of the South Stream II project of Gazprom and thus strengthen their strategic position with Russia. The fact that Turkey has turned down the adoption of the 'energy acquis', which is part of the EU strategy to roll out their regulatory reach³⁹ through both the accession negotiations and the Neighbourhood policy and create a Southern European energy market, indicates the strategic nature of these initiatives and the fact that Russia has successfully convinced some countries to resist EU advances. As a result, Russia is about to develop two new prongs of gas pipeline connections to the European market that releases some pressure on the Russian-Ukrainian relationship. The Ukraine at the same time will lose some of its strategic importance and strategic hold over Russia when the new capacity is in place. Russia becomes less vulnerable to a disruption from its main income flow.

The complex context of the current energy relations between Russia and the EU is thus formed by the parallel process of introducing the internal energy market in the EU and the restructuring of energy relations among the countries of the Former Soviet Union, which were part of the old Soviet gas system. It is the dissonance between the independent logic of both processes, and the inability and ultimately unwillingness to co-ordinate these

³⁹ An external policy to serve Europe's energy interests, paper from Commission/SG/HR for the European Council, 2 June 2006.

processes that caused the current tension and distrust in the energy relations. Both processes are highly political, but ultimately also deeply about economic structures, in the sense that the combined outcome would determine the distribution of the economic rents of particularly gas among the producers and consumers. The transit countries literally are on a political-economic seesaw, and they tried to make the most of their position, while economically they experienced continuous problems in paying for their domestic gas needs. The scope of the inter-regional geopolitics of energy linked the EU, through the Ukraine and Russia, to Central Asia, where also the US and China attempted to secure their future energy relations. Thus it became part of a wider process of changing energy relations in a changing world order.

The strategy that Russia has been unfolding in Putin's second presidential term bears a large resemblance to corporate strategies in earlier periods of the oil history in governing the value chain from wellhead to market.⁴⁰ The strategy of Gazprom is a typical example of a company operating in a mature market, readying itself for a new period of investment efforts and possible expansion.⁴¹ The success of Russia's strategy to redevelop the nation resting on the oil and gas sector requires delicate juggling of domestic and regional affairs and is far from certain. The ambitions of other former Soviet Union countries, such as the countries around the Caspian Sea, China, the US and the EU, all could thwart Russia from achieving its goals, but the current tight oil and gas markets certainly help Russia to make quick strides. The warning of the International Energy Agency that international oil and gas markets would continue to be tight in the next five years⁴² certainly supports the Russian strategy with regard to Europe, and will make EU member states nervous about their options, either to accept the bilateral offers to supply their markets or to gamble on the Commission's approach to export the regulatory model to be successful.

⁴⁰ Daniel Yergin, *The Prize, The Epic Quest for Oil, Money and Power*, Simon Schuster, 1991.

⁴¹ H.W. de Jong, *Dynamische markttheorie*, Stenfert Kroese, Leiden, 1985.

⁴² IEA, Oil Market Outlook, July 2007; and for comments FT July 10, 2007.

6. Conclusions

The combined process of deepening integration and the enlargement with the Baltic and East European countries has changed the political and economic dynamics of the EU. The ability to construct a coherent EU energy policy was already weak among the 'old' six, nine, twelve and lastly fifteen member states due to the different resource base and energy mixes, but also in the degree of 'Atlantic' or continental foreign policy approach.⁴³ Some member states have a long history of neutrality. In the wake of the fall of the Berlin Wall and the collapse of the Soviet Union, the current 27 member states all thought they could unite under the economic banner of the EU. However, the deepening process, which included among other things the single currency, the internal energy market and cooperation on domestic law and order issues, also made the EU much more political in nature. In the early 1990s, changes in the international political and economic system were heralded as an important breakthrough for the proponents of globalization. The expectation in both the US and Western Europe was of a rapid integration of the global economy. There was a surprisingly optimistic view that globalization of the economy would be followed by a positive shift to more effective legal, institutional and political structures that would contribute to equity and growth.⁴⁴ Oil and gas producing countries were themselves expected to make the transition to globalization. Membership of the World Trade Organization (WTO) and foreign direct investments (FDI) were an important tool in facilitating this integration.

It is important to understand that this globalization scenario contained implicit and explicit risk management strategies. It greatly limited political risks by forcing nations to operate as if market forces were the primary ones determining supply and demand. It further envisioned a major shift in global values. Environmentalism, democratic movements, and a stigma of illegitimacy attached to the use of force were seen as more or less inevitable outcomes of economic globalization.⁴⁵ The Lisbon agenda and the European constitution were to epitomise these moves into that market

⁴³ Rene Lefeber and Coby van der Linde, *Europese Integratie vergt een energie(k) beleid*, in: *SEW* (6), June 1987.

⁴⁴ *Study on Energy Supply and Geopolitics*, final report, January 2004, TREN/C1-06-2002, CIEP; van der Linde, C., *Energy in a Changing World*, inaugural address 22 November 2005, Clingendael Energy papers 11; Hoozeveld, F. and Perlot, W., *Tomorrow's Mores, The International System, Geopolitical Changes and Energy*, CIEP, December 2005: all available at www.clingendael.nl/ciep/publications.

⁴⁵ See Giddens, A., *The Consequences of Modernity* (Stanford, CA: Stanford University Press, 1990), pp. 151-164.

based world. It is clear now that the globalisation process has become far more political and national interest driven than anticipated.

In many capitals in the European Union the consequences of the geopolitical changes are being assessed and how these might affect their national energy and foreign policies. National interests do not necessarily add up to EU interests, because the energy mix in the various member states is still different, and the risks to security of supply are asymmetrical. Moreover, the European energy and foreign policies are not supported by balanced competencies. This is also the fault of the member states. The most far-reaching competencies are in the field of the internal market and competition, whereas the competencies in the fields of security of supply and foreign policy are only weakly developed. Promoting strategic energy relations will probably increasingly return to the capitals of the European member states, unless the 27 member states will find each other yet in a new strategic approach. The EU Commission Energy Package of January 2007 is desperately weak in its external energy strategy approach and is a display of its own inability to shield it's short to medium term Achilles' heel.

Given the importance of the Russian energy industries for Russia's revival on the world political and economic stage and the central role that has been assigned to these industries to help reform and develop the Russian economy, it is clear that the European proposal to embrace the EU gas market model runs counter to all aspects of the strategy of the Russian government. At the moment, a tug of war is played out in the Russian Near Abroad over gaining regulatory control over gas transportation. With Russian control over gas and oil developments in the country now firmly established, foreign investors can now be invited to participate in the Russian developments under the new terms. The invitation of Total of France and Statoil Hydro of Norway to be part of the Shtockman development underlines this development. Given the need for foreign oil companies to gain access to reserves, they are very likely to accept the new terms of investment. European governments should not be surprised when these companies will begin to debate on the Russian side of the discussion on how best to structure European-Russian gas relations, when their interests in Russian oil and gas production increases.

What are then the global implications of the current tug of war between Russia and the EU? China seems to benefit from the last struggle by Americans and Europeans to fill the Nabucco pipeline with Kazakh and Turkmen gas, when President Putin managed to negotiate a commitment

from both governments to improve flows through Russia. China's is negotiating with Turkmenistan will make a commercially viable Nabucco less likely when gas flows are committed to Russia and China. Russia will allow Turkmenistan to diversify to China because it reduces the threat of competing flows to its most lucrative market, Europe. As long as China is not prepared to pay premium prices for its gas, the market mainly holds potential for the future. The terms at which gas will flow to Europe in the future is also important to the US gas market. If Russia fails to maintain its current flows, demand for LNG will increase and will increase competition in the Atlantic basin. A strategy in which European, Russian and indirectly American interests could converge, to combine the Bluestream II development and the Nabucco pipeline as a joint project, is not on the table. The likelihood of such a move is decreasing rapidly with the American discussion of new strategies for containing Russia⁴⁶ and the recent discussion about stationing missile defence systems in Eastern Europe. The issues of the EU and Russia over the future of the European/Asian continent, and the diverging views on these issues by individual member states, can make part of Europe the crush zone in the wider international relations, where national interests do not lead to convergence but lead to diverging strategies. Energy and energy security is but one of the issues at stake. The rise of Russia from the ashes of the Soviet Union is increasingly challenging the US unilateral approach to the international system. Although the US gas security of supply is only indirectly affected by the Russian energy strategy, successful Russian control of the European gas market, alone or in conjunction with European companies, will greatly impact the development of energy relations elsewhere. The European countries are increasingly challenged to admit sides because the soft powers have so far not produced the space to play them both.

⁴⁶ See press statement of the Russian foreign minister Lavrov (on: www.mid.ru/brp_4.nsf/sps/BCFC98E7946709C0C325731D002238F5) and Foreign Affairs about an article by Lavrov that was withdrawn on July 19 2007: Statement from the editor of Foreign Affairs regarding Russian foreign minister Sergey Lavrov's withdrawal of his essay from the September/October 2007 issue on www.foreignaffairs.org. Full article of Lavrov on: www.mid.ru/brp_4.nsf/e78a48070f128a7b43256999005bcb3/8f8005f0c5ca3710c325731d0022e227?OpenDocument