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I.S. Ivanov, Corresponding Member, RAS, Dr. of History; **A.V. Kortunov**, Ph.D. in History

Authors:

V. Likhachev, Ph.D. in Technical Sciences; **K. Westphal**

Drafting and copy editing:

I.N. Timofeev, Ph.D. in Political Science; **T.A. Makhmutov**, Ph.D. in Political Science;

N.S. Evtikhevich, Ph.D. in Political Science; **A.V. Ponomareva**; **R.V. Maika**

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Restoration and further development of the energy dialogue between Russia and the EU will require the sides to search for compromises and a balance of interests. This is not a simple task, fresh ideas, flexibility and the rejection of stereotypes are crucial. The report provides recommendations for renewing the dialogue. The report is published in the frameworks of the joint project of Russian International Affairs Council (RIAC) and the Robert Bosch Center at the German Council on Foreign Relations (DGAP) that aims to address the question of where we stand and to propose ways of rebuilding Russia–EU relations.

The views and opinions of authors expressed herein do not necessarily state or reflect those of RIAC.

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Opportunities for Russian–EU energy cooperation

Vladimir
Likhachev

Russian–EU relations in the gas sector: ups and downs

For several decades now, Russia (the successor to the USSR) has been a natural partner for Europe in the energy sector, supplying natural gas, oil, petroleum products, coal, electricity and nuclear fuel to countries in the region. Advanced energy infrastructure has been established, technical regulations have been coordinated and mechanisms for trade operations have been developed in order to provide sustainable supplies on the European continent. Energy companies from Russia and Europe have extensive experience working together, including as part of joint projects. European companies are full-fledged players on the energy markets of Russia. Supplies of energy resources from Russia to the EU have continued to increase over the last two years following a brief slump. More specifically, PJSC Gazprom reported that gas exports to Europe were up 8% in 2015 compared with the previous year,¹ and gas exports surpassed the 2015 level over the first eleven months of 2016 alone.²

The period prior to 2014 was marked by the active development of EU–Russian relations in the energy sector. The Russia–EU Energy Dialogue format was launched in 2000³. After two incidents involving stoppages in gas supplies in 2006 and 2009 due to gas-related disputes between Russia and Ukraine, an “early warning mechanism” was established with the aim of preventing further disruptions in supplies of gas, oil and electricity and to ensure operational communications between the parties in the event of incidents or accidents. Two years later, the EU–Russia Gas Advisory Council held its first meeting in October 2011. Finally, the European Commission and the Russian Government in March 2013 agreed on the Roadmap for EU–Russia Energy Cooperation until 2050.⁴ It seemed that progress had clearly been made and that there was a strong foundation for the further development of mutually beneficial and, moreover, strategic cooperation.

However, during this same period an anti-monopoly investigation was launched against Gazprom, the EU refused to take into account Russia’s opinion when adopting the Third Energy Package (TEP), Russia’s proposal

Vladimir Likhachev, Ph.D. in Technical Sciences, Deputy Director of the Energy Research Institute of the Russian Academy of Sciences, Deputy Director of the Energy Institute of the National Research University Higher School of Economic

¹ PJSC Gazprom Annual Report. Multipolar Energy. 2015.

URL: <http://www.gazprom.com//posts/56/116176/gazprom-annual-report-2015-en.pdf>

² Record gas exports will not help Gazprom to increase its revenue // *Vedomosti*, January 2017.

URL: <https://www.vedomosti.ru/business/articles/2017/01/10/672284-eksport-gazpromu-viruchku> (in Russian)

³ The EU and Russia agreed on an early warning mechanism in the energy sector, *Deutsche Welle*, November 2009.

URL: <http://www.dw.com/ru/ес-и-россия-договорились-о-механизме-раннего-предупреждения-в-энергетике/a-4897498> (in Russian)

⁴ Official website of the Ministry of Energy of the Russian Federation. URL: https://russiaeu.ru/sites/default/files/user/Roadmap%20Russia-EU%20Energy%20Cooperation%20until%202050_Rus.pdf

to implement the South Stream project was rejected and discussions about the feasibility of building the Nord Stream-2 gas pipeline took a turn for the worse.

A conflict had been brewing for several years and 2014 proved to be the breaking point. As a result, Russian–EU relations were basically cut off for political reasons. The situation was exacerbated by political contradictions. Both sides and their “partners” found themselves in an ideological deadlock with some of them appearing perplexed and others trying to use the situation to their advantage.

Despite declarations by the parties about the need to restore relations due to a mutual interest in expanding Russian–EU energy cooperation, official representatives only have contacts at the level of working meetings in order to resolve operational issues. The introduction of visa restrictions, sanctions and countersanctions because of the situation around Crimea and the armed conflict in eastern Ukraine only served to exacerbate and aggravate the situation.

It seems the time when both parties were discussing the establishment of common energy markets “from Lisbon to Vladivostok” had passed for good and there are fundamental reasons for this. The primary reason was the principled unwillingness of the parties to establish common European integration projects involving Russia. In the energy sector, this was manifested by Russia searching for opportunities to develop energy exports to the East and conclude agreements on supplies of energy resources to China, above all. Meanwhile, the EU is considering fields in North Africa, the Middle East and countries in the Caspian region as alternatives to energy supplies from Russia, particularly with respect to gas. Both parties view the geographic diversification of energy trade and energy cooperation as a means for strengthening their energy security, however in actuality this leads to increased risks for both sides and fewer opportunities for cooperation with one another.

The situation with Russian–EU relations in the energy sector is further exacerbated because of the need to take into account the interests of “third parties”, i.e. countries that directly or indirectly influence decision-making in Russian–EU energy cooperation such as Ukraine, Baltic states, Poland and, until recently, the United States.

Thus, the controversial and politicized interpretation of matters concerning energy cooperation and energy security by both parties is making the conflict even worse.

EU policy in the energy sector and Russia’s interests

Russian companies face restrictions in their activities on European energy markets and factor in heightened risks in relations with their European partners as part of their programmes. This is evident in the gas sector above all else.

In recent years, the European Commission has committed to establishing a common European energy market and boosting energy security while viewing supplies from Russia, particularly natural gas as well as electricity, as the primary threat.

The desire among Europeans to reduce their dependence on Russian gas and the tension with respect to Gazprom that appeared following the transit crises in 2006 and 2009 increased dramatically with the political escalation in Ukraine, which led to the adoption in 2014–2015 of a number of new EU policy documents that contained clearly negative signals for Russian–EU relations in the gas sector. The situation was made even more dramatic by an unprecedented drop in demand for gas – by 116 billion cubic metres (–20%) from 2010 to 2014, although things recovered slightly in 2015 and 2016⁵ – along with the obvious and extreme degree of uncertainty for all market participants with respect to prospects for utilising gas even with a planning horizon not exceeding ten years.

As a result, Russian–EU relations in the gas sector have now shifted from a strategic partnership to ordinary commercial cooperation that is further aggravated by serious political disagreements. However, it should be noted that the Russian–EU gas business demonstrated its best results in 2015 compared with previous years, when Russia's share reached an all-time high of 30% of total gas consumption in the region, and this trend has carried over to 2016.⁶ An obvious gap remains between the goals set by the European Commission, which aim to contain Russia as much as possible in the energy sector in general and in the gas sector in particular, and the actual economic practice of European consumers.

The liberalization of the European energy market with pervasive changes in its previous approaches as well as the legal framework and regulatory practice has prompted Russia to gradually alter its export strategy, and in the future Russia will have to make considerable efforts to adapt to the new institutional environment. Against the backdrop of the traditional accusations against the leadership of Russia and PJSC Gazprom concerning the use of natural gas as a political weapon, an increasingly obvious political component is also being seen at the core of the European Commission's decisions, which on the whole creates special operating conditions for the Russian side that are not always close to being purely market-based in nature.

According to Russian experts' opinion⁷, in recent years, the European Commission has adopted a number of regulatory documents that directly or indirectly affect relations with Russia in this area.

⁵ Commodities overview. Bloomberg. URL: <https://www.bloomberg.com/markets/commodities>

⁶ Ibid.

⁷ The EU gas market: the era of reform. INEI RAS / HSE. 2016. URL: https://www.eriras.ru/files/gazovyy_rynok_es_-_epokha_reform.pdf (in Russian)

In May 2014, the European Commission presented a new European Energy Security Strategy⁸ in which matters concerning the future development of European energy are tied to an analysis of the energy independence of individual nations. It places particular emphasis on gas supplies from Russia and countries where such supplies make up more than half of total natural gas imports.

In addition to short-term measures that aim to strengthen energy security (increasing the capacity of underground gas storage facilities, infrastructural development, including reverse flows, reducing energy consumption and switching to alternative fuels), the new strategy proposes a number of long-term measures:

- Increasing energy efficiency, primarily for the building and industry sectors, which account for 40% and 25% of overall European energy consumption, respectively.
- Increasing the production of energy resources in the EU (including alternative energy, the extraction of fossil fuels and civilian nuclear energy) and the diversification of supplier countries and supply routes.
- The development of competition on the internal EU energy market and the construction of interconnectors to promptly redirect flows in the event of their disruption or another need.
- The presentation of a “single voice” in the energy policy, including European Commission member nations providing information about proposed or signed agreements with third parties that are capable of influencing EU energy security.

Strengthening cooperative mechanisms and bridging infrastructural restrictions, including coordination between EU countries on the use of underground gas storage facilities, the development of reverse flows and reducing risks both at the regional as well as the European levels.

The results of stress tests published by the European Commission involving the complete stoppage of Russian gas supplies or its transit via Ukraine for a period ranging from one to six months reveal the vulnerability of gas supplies to European nations. A stoppage in the transit of Russian gas via Ukrainian territory would require Bulgaria, Hungary, Bosnia and Herzegovina, Macedonia, Serbia, Finland and the Baltic countries to reduce gas consumption by 20–60%, and Poland, Romania and Greece by 10%. The maximum monthly reduction in supplies could total 100% for Bulgaria, Finland, Bosnia and Herzegovina, and Macedonia, 73% for Estonia, 64% for Serbia, 59% for Lithuania, 35% for Hungary, 31% for Romania and 28% for Poland.⁹

Essentially, the European energy security strategy proposed by the European Commission as supported by the stress test results, is preparing

⁸ European Energy Security Strategy. COM (2014) 330 final. Brussels. May 28, 2014.

⁹ *Ibid.*

the European community to ensure their economies function under risk conditions, including the full or partial stoppage of Russian gas supplies, while offering a detailed set of short-term and long-term measures for their compensation.

On 25 February 2015, the European Commission published a document concerning the establishment of the European Energy Union, which envisages the development of a consolidated position for all EU countries on energy-related matters, including relations with third countries.¹⁰ The strategy's key provisions fully fit in with the course of the European energy policy and cover the following main areas:

- the security of supplies, which entails reducing energy dependence on countries that are not part of the EU through the more efficient use of its own energy resources and the diversification of outside supply sources;
- the development of an internal energy market with its own free energy flows without any technical or regulatory barriers, which should ultimately ensure an optimal price level, and also fully realizing the potential of renewable energy resources;
- improving energy efficiency with the ability to reduce harmful effects on the environment and demand for the import of energy resources;
- reducing harmful emissions (achieving a 40% reduction in emissions by 2040 versus 1990), revising the European system for harmful emissions trading and increased investments in renewable energy;
- research and innovations in energy that promote technological leadership in alternative energy and reduce energy consumption.

The Energy Union strategy is the most significant EU initiative in the energy sector since the Third Energy Package. It incorporates the European Commission's desire to obtain a substantial portion of sovereign powers from EU nations in order to pursue the union's external energy policy. It cites Algeria, Turkey, Azerbaijan, Turkmenistan, Middle Eastern countries, Africa, Norway, the United States and Canada as countries with which strategic cooperation should be developed with particular emphasis on cooperation with Ukraine.

The only mention of Russia in this document stresses that under favourable conditions relations in the energy sector may be revised subject to market transparency, fair competition and mutual benefits.¹¹

The establishment of the Energy Union is designed to help the EU "find a unified voice during negotiations with third countries".¹² The European

¹⁰ Roadmap to the Energy Union. Annex 1 to Framework Strategy for a Resilient Energy Union with a Forward-Looking Climate Change Policy. COM/2015/080 final. February 25, 2015.
URL: <http://www.eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2015%3A80%3AFIN>

¹¹ Ibid.

¹² Ibid.

Commission proposes considering options for collective gas purchases during crises, which is particularly important for countries that depend on a single supplier (Baltic states and Eastern Europe). Poland had previously insisted on the ability to have collective agreements for gas purchases, but in a more radical form.

It is noteworthy that the Energy Union Roadmap along with the initiative to strengthen the Energy Community and the signing of a memorandum on strategic partnership with Ukraine entailed the signing of a trilateral memorandum on the construction of the Trans-Caspian gas pipeline between Turkmenistan and Azerbaijan (with subsequent export to Europe) back in 2015, however later this deadline was later pushed back to 2016.¹³

The documents provided by the European Commission during an extensive tour by the Energy Union's leadership of all European countries in 2015-2016 describing the benefits of unification for each nation elaborates on the focus of this initiation as regards the gas market. Almost each of these brief analyses starts with an emphasis on the given country's dependence on gas imports from Russia and the proposed measures for overcoming such dependence within the framework of the Energy Union.

In November 2015, the European Commission published a package of documents in which the primary was the State of the EU Energy Union¹⁴ and a number of reports that track significant processes for the functioning of the Energy Union and their status as of late 2015.

The EU has recently taken the following specific measures to implement its policy in the gas sector:

Throughout 2015, the new LNG terminal in Klaipeda (Lithuania)¹⁵ ensured the diversification of gas supplies in the Baltic region for the first time. The region's isolation will be definitively eliminated by an interconnector between Poland and Lithuania on which an agreement has been reached. The importance of an interconnector between Hungary and Slovakia with reverse ability along with similar capacity on the border with Ukraine is also noted.

A gas group for Central and Southeast Europe coordinated a list of priority projects whose implementation would grant the region access to at least three sources of gas. An Energy Infrastructure Forum established by the European Commission also started working with the first meeting held on 9-10 November 2015.

The European Commission is actively working with member nations to eliminate regulatory barriers in the cross-border trade of gas and electricity and the full implementation of the TEP provisions. The intensifica-

¹³ Updated Roadmap of the Energy Union. Annex to COM(2015) 572. November 11, 2015.
 URL: <http://www.eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM%3A2015%3A80%3AFIN>

¹⁴ Ibid.

¹⁵ The terminal in Klaipeda – counted and shed tears // Vesti, March 2015. URL: <http://www.vestifinance.ru/articles/55095>

tion of the European Commission's market design initiative¹⁶ specifies the framework for the further development of the regulatory process in order to integrate energy markets.

Commenting on companies' plans to build new networks that would connect Russia and Germany under the Baltic Sea, the European Commission stresses that the third and fourth phases of the Nord Stream (Nord Stream-2) will not provide access to a new source of gas and will serve only as another route from Russia, while only half of the existing capacity is currently being utilized. This project should fully comply with European laws, and the European Commission reserves the right to conduct a relevant assessment of the project.

As part of the establishment of the Energy Union, the European Commission in February 2016 presented a package for the security of energy supplies that aims to ensure the EU's inclusion in transitioning global energy to low-carbon development and also boost its readiness for possible disruptions in energy supplies.

In February 2016, the European Commission adopted a new version of Regulation 994/2010 on the security of gas supplies¹⁷ in order to ensure that all EU member nations introduce the appropriate mechanisms to manage negative factors resulting from a sharp decrease or disruptions in gas supplies as well as factors causing sharp growth in demand for gas supplies. The principles of solidarity among neighbouring countries for joint gas supplies to protected categories of consumers (households, medical institutions, social services, etc.) in the event of serious crises were cited as one of the primary measures for achieving these goals. Such an approach reflects the transition from the national to the regional level for ensuring the security of energy supplies.

In addition to the tasks identified for risk assessment and preparing preventive plans and action plans in crises and joint actions, EU member nations should adopt decisions to ensure bi-directional gas flows at each cross-border station with the participation of all countries that are interested in transportation via this corridor.

In addition, EU oil and gas companies must automatically inform their national regulators and union structures about all contractual conditions that are significant for ensuring the security of supplies from the time such contracts are concluded or amended.

It is noteworthy that the final version of the document only mentions the mechanism for joint gas purchases as a possibility but does not prescribe specific measures for its implementation. This approach can be considered as compromise between the desire of some eastern EU nations to

¹⁶ Consultations on a new Energy Market Design.
URL: <http://ec.europa.eu/energy/en/consultations/public-consultation-new-energy-market-design>

¹⁷ REGULATION (EU) No 994/2010 concerning measures to safeguard security of gas supply and repealing Council Directive 2004/67/EC. October 20, 2010.

introduce such a mechanism and the position of other countries and market participants who believe it is a non-market and uncompetitive mechanism (Eurogas and EFET among others).

In this regard, there is particular importance in the position of the most influential European player – Germany, which also stresses that this mechanism runs counter to the liberalization of gas markets. In general, the German Government points out the level of integration among countries should vary for different sectors of the economy. In particular, the full-fledged introduction of a common energy market is necessary, but when it concerns the energy structure of an individual country, the country must freely decide what to choose based on its own actual capabilities. On the other hand, Germany has yet to determine what market components should be regulated in a centralized manner and which ones at the regional (national) level.

The legal and strategic documents in question adopted by the European Commission in 2014–2016 constitute the coherent development of a legal trend for establish a single open and competitive gas market as specified in the Third Energy Package. In addition, the documents consolidate the fully obvious and persistent desire among Europeans to diversify gas supply capabilities and methods for its flows.

The TEP regulation granting third parties free access to existing gas infrastructure, which makes it difficult to implement major projects with Russian involvement, offers a somewhat positive signal. Russia now has the right to act in the spirit of the TEP, citing the responsibility of European gas transportation system (GTS) operators to establish new capacity to meet demand.¹⁸ According to Article 13.2 of Gas Directive 2009/73, “each transmission system operator shall build sufficient cross-border capacity to integrate European transmission infrastructure accommodating all economically reasonable and technically feasible demands for capacity and taking into account security of gas supply”.¹⁹ In other words, European network operators must finance and build new transportation capacity in accordance with the current and future market demand.

The TEP requirement granting third parties free access to infrastructure facilities, which had been a serious obstacle in relations between the two sides, ultimately proved to be an area where a compromise is possible. The Russian side revised its traditional approaches with partners and desire to advance as far as possible up the gas chain on the European market as part of its vertical integration strategy (which was logical as part of the previous regulatory and market rules) in favour of a more pragmatic approach under the new conditions with responsi-

¹⁸ PJSC "Gazprom" Interim Consolidated IFRS Financial Statement (unaudited), Moscow, September 2016.
URL: <http://www.gazprom.ru/ff/posts/36/607118/gazprom-ifrs-3q2016-ru.pdf> (in Russian)

¹⁹ Energy Community. Directive 2009/73/EC of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC. URL: https://www.energycommunity.org/portal/page/portal/ENC_HOME/DOCS/2938030/0633975AD7837B9CE053C92FA8C06338.PDF

bility, including financial responsibility, for gas deliveries to end users throughout the EU being shifted to European operators. However, it is debatable whether EU consumers will benefit from ensuring compliance with legislative requirements. In addition, the issue of whether operators will be able to introduce the necessary capacity in a timely manner remains unclear.

Starting from September 2015, PJSC Gazprom has introduced the practice of holding gas auctions in St Petersburg for EU consumers. September 2016 marked the third round of such auctions²⁰. Gas that has a change in owner at the exit point from the Russian GTS can then be pumped under the conditions of third party access to the European system (including OPAL). The further development of trade mechanisms when selling Russian gas on a short- and medium-term basis cannot be ruled out, either. Such approaches may form the basis for ensuring the operability of such projects as Nord Stream-2.

The basic requirement of the TEP on separating the network component in the structure of vertically integrated oil companies has forced PJSC Gazprom to give up many of its network assets: stakes in the Baltic companies Lietuvos Dujos, Amber Grid, Eesti Gaas, Interconnector (UK) and Gasum (Finland). Of the remaining assets, the most significant ones include Cascade Gastransport (Germany, 49.98%) and EuRoPol Gaz (Poland, 48%) in which Russia owns less than 50% of shares.²¹ In addition, the Gazprom Group along with its European partners are building, operating and leasing gas storage facilities in Germany, Serbia, the Netherlands and the Czech Republic.

The traditional production chain for the delivery of Russian gas was ruptured as a result of selling assets and altering the approaches to the regulation of the transportation component in the EU, which made it essential to revise the mechanisms for delivering gas to consumers. Given the length of the route, the crossing of multiple borders as well as the new conditions for access to gas transportation facilities when it is impossible to buy 100% of the necessary facilities, this division could be the reason for so-called “contractual non-compliance” with an increased risk of discrepancies in various contracts in terms of volume, dates or other conditions. In this regard, it is necessary to take into account the changes in operating and technical rules on the European market, where Gazprom now primarily serves as a shipper, while retaining its responsibility to meet contractual terms.

Also note that under pressure from European consumers and based on the market situation, the Russian company has revised the conditions of long-term contracts on numerous occasions, both as regards pricing

²⁰ The third gas auction of Gazprom Export was successfully completed // Gazprom Export, September 2016.
URL: <http://www.gazpromexport.ru/presscenter/press/1865>

²¹ Financial Statement PJSC “Gazprom” for 2016 and last years.
URL: <http://www.gazprom.ru/f/posts/36/607118/gazprom-ifs-3q2016-ru.pdf> (in Russian)

terms as well as the formula for pricing, the take-or-pay level, gas make-up²² and other indicators.

Thus, the practical implementation of the EU's TEP, which was adopted to develop liberalization processes on the European gas market, has created several key challenges for Russia:

- the trend of the increased short-term nature of the market, which significantly complicates long-term planning for the entire gas business and alters the system of existing relations with consumers;
- difficulties with the use of existing infrastructure by PJSC Gazprom and major problems when implementing new large-scale projects;
- high risks for PJSC Gazprom in meeting its contractual obligations due to contradictions in integrating the Russian gas supply system into the new concept of the European gas market.

Russia's strategy with respect to the European energy market

Russia has always viewed the European market as a priority in the energy sector. Russia is interested in sustainable demand for its energy resources, ensuring the economic efficiency of Russian energy companies, attracting investment as well as acquiring advanced technologies and experience. For its part, Russia tries to provide guarantees for the stability and reliability of supplies, flexibility in pricing for the energy resources it offers and technological interaction with European energy systems.

At present, the Russian government and PJSC Gazprom are aggressively trying to resolve the problem of reducing transit risks, above all those related to the situation in Ukraine. Approximately 40% of the Russian gas exported to Europe currently passes through Ukraine. The sides have a long history of strained relations in the gas sector due to Ukraine's debt, the siphoning of gas from the main gas pipelines and the failure to observe agreements on the use of gas from underground gas storage facilities, among other things. The gas agreements concluded by Russia and Ukraine in 2009, which Russia does not want to extend according to declarations by the Russian government and PJSC Gazprom, are set to expire on 2 January 2020.²³ PJSC Gazprom expects to either fully eliminate the volume of Russian gas transited through Ukrainian territory or to minimize it at the very least. PJSC Gazprom CEO Alexey Miller said in June 2016 that if a new contract is reached, Ukraine can expect to transit no more than 10-15 billion cubic metres of Russian gas per year starting from 2020.²⁴ In order to resolve this

²² Make-up gas. Risk glossary. URL: <http://www.risk.net/definition/make-gas>

²³ Turkish stream will be built without discussion with the European Union // Vneshneekonomicheskie Svyazi. URL: <http://www.eer.ru/a/article/u123213/13-04-2015/29517>

²⁴ Reduction of transit through Ukraine will save Gazprom 1.6 billion dollars // Lenta, June 2016. URL: https://www.lenta.ru/news/2016/06/16/no_gas_in_ukraine

problem, PJSC Gazprom is taking active steps to implement the Nord Stream-2 and the Turkish Stream projects. The situation surrounding these projects has resulted in PJSC Gazprom apparently having to implement them on its own.

Russian companies working in other areas besides the gas sector are also experiencing the difficulties associated with developing their activities in Europe, for example Rosatom when promoting projects to build nuclear power plants in Central and Eastern European countries.

The growing mutual mistrust and its interpretation as heightened risks for the Russian energy business and Russian interests in Europe has resulted in Russia giving an increasingly negative assessment of its abilities as an exporting country recently when forming its long-term plans for the development of its fuel and energy sector on the European energy market, which was previously regarded as a key market in Russia's energy strategy.

In particular, the latest forecast prepared by the Analytical Centre under the Russian government jointly with the Energy Research Institute of the Russian Academy of Sciences in November 2016²⁵ projects that a reduction in Russian oil supplies to Europe after 2020 can be expected under all scenarios, above all due to the decline in demand for petroleum products and for raw crude as a consequence. In this case, Russia's share of the European petroleum feedstock market would decrease from 33% in 2015 to 20-23% in 2040. In addition to reduced demand on the European oil market, Russian companies will face fierce competition with suppliers from regions of the Middle East, Africa and even South and Central America that traditionally send large volumes of oil to the North American market, which will almost completely stop importing resources from other regions by 2040. A decrease in supplies of Russian petroleum products is also expected to take place.

Gas exports, both based on existing long-term contracts as well as part of spot trading, could make it possible to preserve the volume of exports from Russia to the European market, however there is no reason to expect a significant increase in export volumes in this direction in the period prior to 2040 given both the geopolitical situation as well as sluggish European demand. A reduction in Russian gas exports to Europe is inevitable if a number of conditions materialize.

In addition, a sharp decline in the volume of Russian coal exported to the European market is also expected.

Thus, Russia currently believes that the volume of Russian energy resources exported to Europe will decline significantly over the next 20-25 years, which cannot help but cause concern, and Russia will be unable to

²⁵ Global and Russian Energy Development Forecast 2016 // Analytical Centre under the Russian Government. Energy Research Institute of the Russian Academy of Sciences.
URL: <http://www.ac.gov.ru/files/publication/a/10585.pdf> (in Russian).

compensate for these losses without a forced increase in exports to the East or South.

A promising platform for the development of energy cooperation: the EU–EAEU format

Active work has been carried out in recent years to establish the Eurasian Economic Union (EAEU). It should be noted that the experience gained by the EU was actively utilized during the establishment of the EAEU with adaptation to the special features of former Soviet states. Particularly close attention was paid to studying the EU's experience in forming common energy markets.

In particular, when developing the concept for the formation of a common electricity market, the EAEU took into account the experience of establishing and regulating the internal EU electricity market.²⁶ EAEU countries agreed that national electricity markets need to be preserved, however coordinated centralized electricity trading will be organized in a similar fashion to the European market. As regards the regulation of the common electricity market, unlike the EU, EAEU countries went their own way and opted not to establish supranational regulatory authorities with a view towards resolving any issues that arise in the functioning of the market through interaction among national ministries, system operators and other infrastructure organizations.

The EAEU bases its programmes for the establishment of common electricity, natural gas, oil and petroleum product markets on the following principles: the development of competition, ensuring market pricing for energy resources, the absence of technical, administrative and other obstacles with respect to the trade of energy resources, the development of transport infrastructure as well as ensuring non-discriminatory conditions for the businesses of member nations in common energy resource markets.²⁷

The EAEU plans to approve the programme for the establishment of a common electricity market by the end of this year and the programmes for gas, oil and petroleum product markets by 1 January 2018.

The development of fair competition by ensuring equal access to the common markets and energy transportation systems based on the non-discriminatory and transparent distribution of the capacity (technical capabilities) available in these systems among market participants is crucial to the formation of common markets and requires the adoption of unified rules for access to oil, gas and electricity infrastructure as well as rules for mutual trade.

²⁶ The concept of forming the common electric power market of the EAES. Materials of the Eurasian Economic Commission. URL: <http://www.eurasiancommission.org/ru/act/energetikaiinfr/energ/Pages/Koncepciya.aspx>

²⁷ The common gas market of the union. EEU. Comments. URL: <http://www.eurasiancommission.org/ru/act/energetikaiinfr/energ/Pages/%d0%9e%d0%b1%d1%89%d0%b8%d0%b9%20%d1%80%d1%8b%d0%bd%d0%be%d0%ba%20%d0%b3%d0%b0%d0%b7%d0%b0%20%d0%a1%d0%be%d1%8e%d0%b7%d0%b0.aspx>

In accordance with the EAEU Treaty, EAEU member nations²⁸ are developing long-term mutually beneficial cooperation in the energy sector and pursuing a coordinated energy policy. At the same time, the EAEU Treaty does not envisage provisions concerning a common foreign policy with respect to third countries.

However, in order to promote the energy security of EAEU member nations and strengthen their positions on global oil and petroleum product markets, the parties agreed on the following in the approved concept for the formation of common EAEU oil and petroleum product markets:

- to promote the implementation of major cross-border investment projects in the oil sector;
- to promote the more effective positioning of the oil industries of member nations, the use of global value chains from oil production to the refining and sale of oil and petroleum products and an increase in the volume of oil and petroleum products transited from third countries via the territory of member nations;
- to form infrastructural, financial, economic, technical and technological conditions to expand the involvement of businesses from member nations in the international trade of oil and petroleum products.

As for the gas market, the corresponding concept notes the parties' intentions to hold consultations on matters concerning the transportation and supply of gas to third countries based on delivery destinations in which member nations compete or may potentially compete with one another.

The concepts do not envisage the establishment of a single network of export-based oil and gas pipelines. It seems premature now to speak about the establishment of such a network since the formation of common gas, oil and petroleum product markets above all aims to satisfy the internal demand of EAEU member nations for fuel and energy resources.

However, as previously noted, the concept for the formation of common oil and petroleum product markets envisages the transit and transportation of oil and petroleum products, including for export from EAEU territory, as well as promoting the development of transport infrastructure within the framework of joint activities.

Based on the foregoing, it seems that the goal of preparing prerequisites for cooperation in the energy sector among the EU and EAEU as two regional organizations is a relevant one, particularly given the general trend of expanding the EAEU's international cooperation. As a first step, it would seem appropriate to establish preliminary contacts in the form of a dialogue and consultations.

²⁸ Eurasian Economic Union / Treaty on the Eurasian Economic Union.
 URL: <https://www.docs.eaeunion.org/Pages/DisplayDocument.aspx?s=bef9c798-3978-42f3-9ef2-d0fb3d53b75f&w=632c7868-4ee2-4b21-bc64-1995328e6ef3&l=540294ae-c3c9-4511-9bf8-aaf5d6e0d169&EntityID=3610>

Conclusions and suggestions

It is obvious that the current situation does not meet the interests of European nations or Russia. Interestingly enough, that this is understood by the representatives of expert community as well as business representatives from both sides. It is essential to overcome the grievances that have accumulated and restore mutual trust in the political sphere and consequently at the governmental level.

In order to resolve this difficult problem, it seems appropriate to discuss the following actions.

Consider the feasibility of cooperation improvement in the least controversial and least politicized (“non-contentious”) areas that are also regarded as strategic priorities both in the EU as well as in Russia:

- sustainable development and issues concerning climate and environmental protection;
- improving energy efficiency and developing alternative and renewable energy sources;
- developing new energy technologies and new materials;
- training and re-training engineering and management personnel.

Successful cooperation in these areas will help to improve the atmosphere and ensure a positive perception of problems at the level of representatives of the government authorities, business and society;

Discuss the scope of major and strategically important investment programmes that are attractive to Russian and European business and supported by the government authorities and society with mutual guarantees to protect the investments of the cooperating parties;

Separate discussions concerning sensitive and contentious issues (gas problems, problems with Russia’s involvement in European nuclear energy) into separate “cases” and resume a discussion of these issues at various decision-making levels;

Start preparing for an energy dialogue between the EU and EAEU, thereby expanding the range of participants and creating a balanced foundation for an energy dialogue between the two integration associations;

Resume information exchanges and a discussion of matters concerning the long-term energy development strategies of Russia and the EU, including by formulating possible areas for the development of joint programmes and projects.

It is clear that the restoration and further development of the energy dialogue between Russia and the EU will require the sides to search for compromises and a balance of interests. This is not a simple task and will require new forms of interaction to be resolved. Fresh ideas, flexibility and the rejection of stereotypes are crucial.

The “Energy Order” and Russia–EU Relations

Kirsten
Westphal

State of the Relationship

Over the last ten years, EU–Russia energy relations have been subjected to fundamental changes that have even had disruptive effects on a corporate, commercial, economic and political level.

The major changes to these relations are:

- The EU’s enlargement in 2004 and its subsequent approach to energy security, Russia and the common neighborhood;
- Reinforcement provided by the 2006 and 2009 Russia–Ukraine gas supply and transit disputes;
- The EU’s 2007 integrated energy and climate policy and the IPCC report, followed by COP21 and the Paris Agreement in 2015;
- The “era of plenty” and the (re)turn to a buyer’s market since 2009;
- The 2009 Third Energy Market Package and internal market developments.

This list of events prior to the crisis in and over Ukraine explains why energy relations became more complicated and subjected to misunderstanding and misperceptions leading up to 2014. In sum, EU–Russia energy relations are therefore less resilient to external shocks.

Following the crisis over Ukraine, a rapid deterioration of EU–Russia relations and the imposition of sanctions and counter-sanctions became apparent.¹ EU–Russia energy relations have been further and profoundly affected by mutual distrust, disappointment and increasing security concerns. This has effects beyond energy cooperation, as energy relations – especially natural gas trade – played an important role for cooperation and rapprochement during and after the Cold War. Thus, conflicts in energy–business relations can result in negative spillovers on the political situation and security on the continent. The outcome can be sketched as follows:

The energy order of the Eurasian continent is becoming increasingly fragmented. It is characterized by competitive regionalism in a multipolar world with overlapping or competing regional integration projects, deepening regulatory, legal, political (and technical) fault lines across wider regions.²⁹

Kirsten Westphal, Senior Research Fellow, Stiftung Wissenschaft und Politik (SWP)

²⁹ Øverland I., Schol E., Westphal K., Yafimava K. Energy Security and the OSCE. The Case for Energy Risk Mitigation and Connectivity. SWP Comments 2016/C 26, May 2016.

Long-standing guiding paradigms have eroded and are now even openly questioned – even in Germany. The political framing of paradigms such as mutual independence and rapprochement as a function of economic cooperation has completely changed.

A long-term vision for EU–Russia energy cooperation has vanished. Uncertainty about, and unpredictability of demand add to the complicated political environment. The Paris Agreement and national climate plans have repercussions for producers of fossil fuels.

The coincidence of the gas glut (due to shale revolution, LNG turning to the EU and stagnating demand in the EU) with the implementation of the Third Energy Market Package has resulted in a grand transformation of European gas markets with effects upon commercial transactions, contracts, companies and price structures.

EU–Russia energy relations is a story of increasing institutional mismatches. Positive effects from the bilateral energy relationships on other policy areas can hardly be expected. Yet negative spill-overs to the foreign, economic and security realm have to be avoided.

Principles and Norms – a “Grand Transformation” on Many Levels

Implementation of the Third Energy Market Package and Reinforcement

The EU Internal Market Packages³⁰ were intended to establish a liberalized, competitive, well-functioning and integrated EU gas market. This created a new energy order characterized by third-party access, unbundling and market opening. Change was induced by the EU. The reinforcement and implementation was in many cases (yet not in all) driven to reduce Gazprom’s market power (often perceived as a synonym for Russian power).

With the Third Energy Market Package, the EU unilaterally changed the legal framework and implemented a new regulatory regime affecting cross-border/trans- regional trade and the gas grid. Nevertheless, the integrated gas infrastructure and long- term contracts still persist.

The decade-long balance had been shaken up and the need for adaptation was raising both uncertainty and transactions costs. Cooperation between the Soviet Union/Russia and Western Europe was built upon: 1) complementary economic structures and interests; 2) an integrated gas infrastructure; 3) matching market structures and 4) corresponding business models. The business model of oil-indexed long-term contracts with take-or-pay volumes allowed the two parties to balance the price and quantity risks – in other words, the producer bore the price risk, while the importer bore the risk of failing to sell the full quantity. The con-

³⁰ Directive 1998 (Directive 98/30/EC), the Internal Market Package 2003 (Directive 2003/55/EC) and 2009 (2009/73/EC).

tracts included provisions for adapting prices to changing market conditions at regular intervals. The market and contract structures, as well as the business model, were designed to serve both ends of the pipeline and provided the basis for long-term stable relations. In the 1990s and early 2000s, bilateral Germany-Russia gas relations were dominated by the paradigm of ‘interdependence,’ which translated into a business model of ever-closer alliances along the entire transnational natural gas value chain. Demarcation at the border was blurred. These asset swaps and *quid pro quo* deals were in line with the Russian idea of “interdependence.”

After 2009, the coincidence of new gas volumes arriving on EU shores reinforced and paved the way for the implementation of the Third Energy Market Package.

However, the degree of implementation of the Third Energy Market Package differs widely throughout the EU; markets in the West tend to be more liberalized, while those in the East tend toward renationalization and state-driven energy policies.

New Business Strategies and Silent Adaptation

The coincidence of gas glut and internal market reforms described above had drastic effects on both commercial relations and price formulas. These effects can be summarized as follows:

- EU “incumbents” unbundled. In Germany in particular the gas industry became highly competitive and liberalized;
- Independent Transmission System Operators were created;
- Uncertainty about actors’ behavior has increased on both sides;
- The number of arbitration cases grew unprecedentedly between Gazprom and importers (discounts, revision of take-or-pay volumes, price formulas adapted);
- Spot-market-based transactions and gas-to-gas competition took off, while oil price linkage lost ground;
- Gazprom went successfully mid- and downstream within the EU;
- A silent adaptation to the EU’s regulation by Gazprom continues to take place within the EU, but not beyond it (even in the neighborhood);
- Long-term contracts continue to lock in a major share of EU demand, but uncertainty about future trade deals is rising (as contracts expire in the future).

DG Competition launched a number of antitrust probes in the energy sector. Gazprom also became a target with regards to destination clauses, third-party access and ‘unfair pricing’ in September 2012. A settlement was achieved in March 2017 and it can be seen as a step towards making Gazprom play according to the EU market rules.

Principles and Guiding Paradigms under Review in the EU

The EU Member States are split on the topic of an integrated energy and climate policy – and over the topic of Russia. The EU Commission aims to create an Energy Union – which would grant Brussels a more political role – and the EU Parliament has taken a strong stance on the matter.

The geopolitical crisis has not resulted in an energy supply crisis. Gazprom’s attempt to obstruct reverse flows into Ukraine proved unsuccessful in winter 2014/2015. Explanations and narratives differ throughout the EU: In Western Europe, the narrative of Russian reliability as a gas supplier prevailed in the past and the idea of rationality still persists today. Mistrust and diversification play a major role in the discourse of the eastern EU member states, where interdependence is questioned.

Shaping a Post-Paris World – Antagonism Instead of Common Interests

Russia and the EU have lost a common, long-term vision of a mutually beneficial, sustainable, integrated energy market within a pan-European energy space. This was envisaged in the EU–Russia Energy Cooperation Roadmap as the strategic target for 2050.³¹ The EU has embarked on an ambitious decarbonization policy that prioritizes

energy efficiency and low carbon fuels in a long-term perspective. This policy does not match with Russian interests to maintain the sizeable export of hydrocarbons to the EU. Climate issues are not a high priority on the Russian political agenda and natural gas has yet to be identified as a transitional solution to decarbonization. However, gas remains one of the most important pillars of Russian energy export policy and continues to be perceived throughout the EU as a problem directly connected to imports of Russian gas.

A Fragmented Order Taking Shape

International cooperation and dialogue is no longer guided by the vision of a “European House” spanning from Lisbon to Vladivostok. While Russia shows a preference for bilateralism, the EU embodies a fatigue for multilateral engagement.

Telling here is the fate of the Energy Charter Treaty, the only international treaty governing trade, transit and investment. Because of its investor-state dispute settlement mechanism, Norway and the U.S. never ratified respectively signed the treaty. Russia signed but never ratified the treaty. Over the course of a decade, the parties negotiated a transit protocol. In 2009, Russia withdrew from the provisional application and Italy exited. Russia no longer supports the modernization of the Energy Charter Process and its policy on consolidation, expansion

³¹ Adopted and issued in 2013 in the frame of the EU–Russia Energy Dialogue.

and outreach that resulted in the International Energy Charter in 2015. Russia has not signed the International Energy Charter, which could serve as a very soft “Code of Conduct.”

On the wider Eurasian landmass, a proliferation of market and political orders, as well as competitive regional groupings can be observed (the EU and Energy Community/Eurasian Economic Union, as well as the Energy Club of the Shanghai Cooperation Organisation). These different political and market orders have the potential to deepen fragmentation and cause disputes when different legal, regulatory and contractual spaces overlap and are potentially in conflict, or when entities fall outside existing regulatory and contractual spaces. Institutional and regulatory fault lines and incompatibilities may result in commercial and/or technical disputes, which could have a negative impact on broader security issues.

Renewing Dialogue and Mechanisms – The Need for a “Code of Conduct” for Energy Relations

“Business as usual” is not a forgone development. Since the crisis in and over Ukraine, energy relations have remained highly politically charged and the geopolitical paradigm has prevailed. Yet compartmentalization of the energy relationship seems reasonable. As an indispensable channel for dialogue and interest-balancing, energy relations should reflect and be driven exclusively by economic rationality, commercial logic and innovation – in other words, by a pragmatic approach. The globalization of oil and especially gas markets as well as the shift of the demand center to Asia-Pacific offers a new environment for both the EU and Russia. This will most likely result in a gradual diversification of both sides. This may help provide a more relaxed basis for bilateral energy trade, but it is also important that existing energy ties be preserved and that change is managed.

Dialogues have to be restarted in order to solve outstanding issues – especially dialogues that promote a common “idea” for the future. A minimum set of rules (“Code of Conduct”) is required in an “infrastructured energy space” across different regional orders that are promoted by the EU, but also by the Eurasian Economic Union. A minimum set of rules is required for cross-border trade along energy corridors to define technical standards, clarify roles of actors and facilitate exchange and dialogue. Therefore, existing mechanisms should be exploited and revitalized in the OSCE and UNECE. The formation of energy programs in the Eurasian Economic Union provides an opportunity. Exchange on practical, technical and regulatory issues between the EU and the Eurasian Economic Union is also promising – most notably on the level of an Advisory Energy Forum to share experiences, in the conducting of regulatory and technical dialogue and in the inclusion of neighboring countries.

Russian International Affairs Council

Russian International Affairs Council (RIAC) is a non-profit international relations think-tank on a mission to provide policy recommendations for all of the Russian organizations involved in external affairs.

RIAC engages experts, statesmen and entrepreneurs in public discussions with an end to increase the efficiency of Russian foreign policy.

Along with research and analysis, the Russian Council is involved in educational activities to create a solid network of young global affairs and diplomacy experts. RIAC is a player on the second-track and public diplomacy arena, contributing the Russian view to international debate on the pending issues of global development.

Members of RIAC are the thought leaders of Russia's foreign affairs community – among them diplomats, businessmen, scholars, public leaders and journalists.

President of RIAC Igor Ivanov, Corresponding Member of the Russian Academy of Sciences, served as Minister of Foreign Affairs of the Russian Federation from 1998 to 2004 and Secretary of the Security Council from 2004 to 2007.

Director General of RIAC is Andrey Kortunov. From 1995 to 1997, Dr. Kortunov was Deputy Director of the Institute for US and Canadian Studies.

Russian International Affairs Council
Robert Bosch Center at The German Council for Foreign Relations

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RUSSIAN INTERNATIONAL AFFAIRS COUNCIL (RIAC)
1, B. Yakimanka street, 119180, Moscow, Russia
Tel.: +7 (495) 225 6283
Fax: +7 (495) 225 6284
E-mail: welcome@russiancouncil.ru
www.russiancouncil.ru