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Policy Brief

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In Brief: Europe's dependence on Russian gas has raised security concerns, especially in response to Russia's aggression against Ukraine. But this threat is overestimated. The truth is that the EU market, a large market with relatively high prices, is very important for Gazprom. What is more, Europe's regulatory apparatus is well-equipped to deal with market power and discriminatory pricing, which is at the core of the real problem Russian gas poses to Europe.

Making necessary infrastructure investments to connect still-partitioned national gas markets, completing the single market for energy in order to enhance resilience against external shocks, and further empowering the Commission — the EU's competition watchdog — to comprehensively govern the EU energy market will alleviate the valid security concerns and force Russia to play by European rules. This needs to take priority in the proposed Energy Union. Because the EU is much better at regulatory politics than at playing geopolitics, it should push the former and abstain from the latter, particularly in the case of Russian gas.

Addressing the Russian Energy Challenge: Why Regulation Trumps Geopolitics

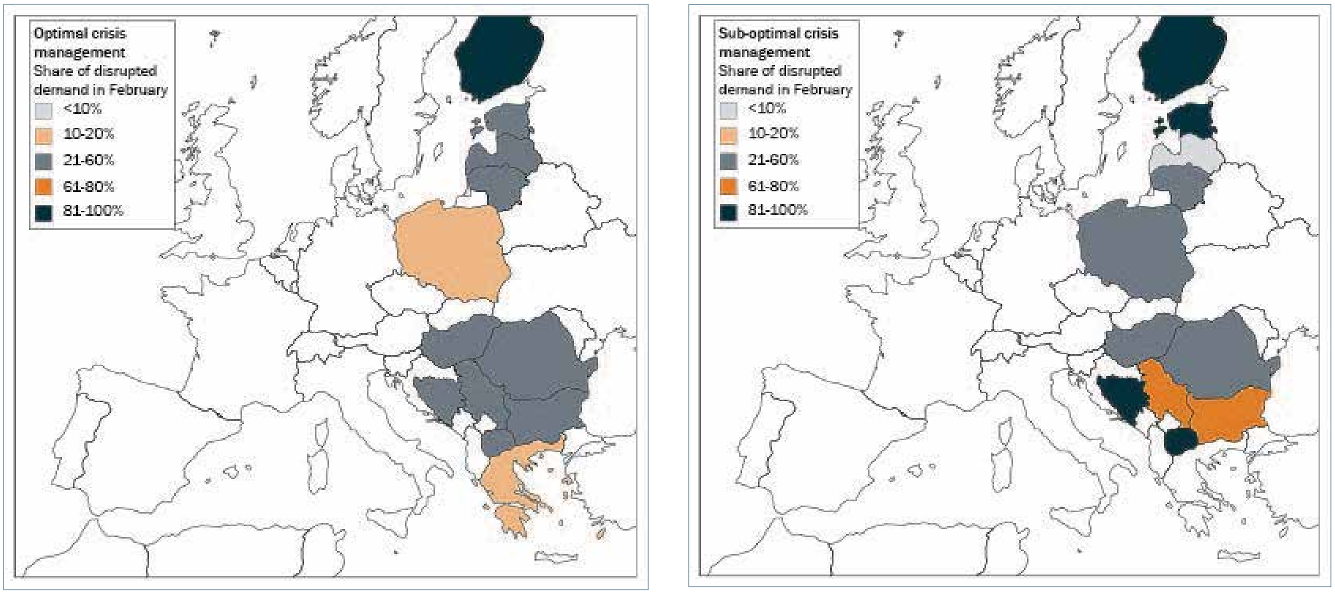
by Andreas Goldthau

Energy Geopolitics are Back in Europe

In European capitals, an increasingly assertive Russia has triggered renewed concerns related to the security of EU gas supplies. EU leaders have vivid memories of January 2009 when Russian gas supplies were cut for 13 days, affecting a total of 16 EU member states. Clearly, the ongoing Ukraine crisis has further politicized Russian energy trade with Europe, and added a geopolitical dimension to already strained Eurasian gas relations. In short, European energy has re-emerged as a prominent security concern, both in the EU and in the United States. The heightened security concerns have led many to suggest a "muscular" energy policy toward Russian gas that looks to replace Russian gas with alternate sources, including liquefied natural gas (LNG). However, such plans are unrealistic and ignore Europe's advantages. Instead of looking to replace Russian energy in Europe, the EU needs to use its regulatory power to turn the tables. If the EU makes the right kind of progress on the common energy market, then it will dictate the rules to Russia.

To be sure, Russian gas has never been just another commodity; if it had been seen that way this changed in 2006, when Russia stopped gas deliveries through

Figure 1: Six-month Russian gas supply disruption scenario, cooperative and non-cooperative



Source: ENTSOG

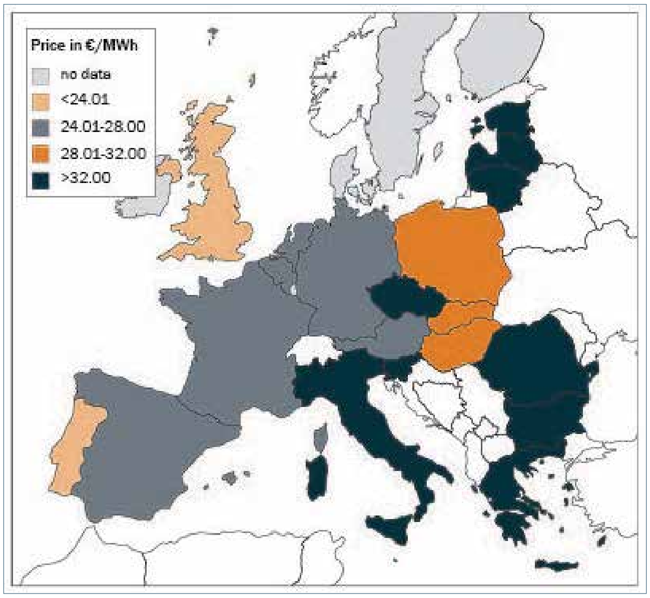
Ukraine for the first time. Russian gas presents a challenge for the EU in two ways: supply and divisive pricing.

Gazprom provides about 30 percent of EU gas supplies, and up to 100 percent of gas consumption of eastern EU member states Bulgaria, Estonia, or Slovakia. A series of stress tests conducted in the fall of 2014 highlighted a persistent European vulnerability to Russian gas supply disruptions. In the absence of solidarity mechanisms, a short term cut-off would seriously affect Eastern European countries such as Poland and the Baltics, but also Finland. Western Europe, including Germany and Italy, remains exposed to serious medium-term supply risks, too. Even in a cooperative scenario, some countries remain heavily affected (see Figure 1).

What is more, Moscow has in the past used discriminatory pricing strategies across countries (for price differentials, see Figure 2) and played "divide and rule" tactics by incentivizing individual governments into lucrative energy deals. That way, in the past the Kremlin had also lured Budapest and Sofia, but also Western capitals such as Rome to connect to Moscow-sponsored pipelines such as South Stream, which rivaled projects the EU backed as part of a "Southern Gas Corridor" to bring non-Russian energy sources into Europe.

Arguably, the events of 2014 have not only pushed energy even higher up on transatlantic foreign policy agenda, but have also further securitized energy policy more generally. While Brussels and Washington have for some years promoted alternative supplies of gas to the EU, energy has now emerged as the most prominent subject for strategizing on how to deal with the Kremlin's increasingly assertive foreign policy. Energy, therefore, has become both a tool for Western foreign policy toward Russia and an end thereof. This marks a new level in EU external energy affairs. For the first time, the West is making deliberate use of Russia's dependence on energy revenues to try to induce Moscow to change course. The Russian energy sector, providing for some 50 percent of state income, was a prime target of Western sanctions on Russia. While the oil sector became the key target, Russia's gas industry has started to be affected too. As the EU-28

Figure 2: Wholesale EU gas prices, 2012



Source: European Commission

demonstrated on June 17, 2015, they are committed to keeping sanctions going until at least early 2016.

Moreover, the EU's energy policy agenda has seen some important shifts. The proposed Energy Union seemingly prioritizes "energy security, solidarity, and trust" over other policy objectives such as enhancing research and development in energy. Further, in the context of the Energy Union debate, suggestions have been made that the EU set up common purchase vehicles for dealing with external supplies, thus making use of the collective purchasing power the EU's 400 cubic meters (bcm) gas market, the world's largest in terms of imports.[1] This, effectively, amount to a mercantilist turn in foreign energy policy thinking, aimed at using market power for non-market related policy goals. Finally, voices have been raised suggesting that the EU eventually 'wean itself of Russian gas in order to "end Russia's energy stranglehold,"[2] hence limiting exposure to the perceived security threat coming with Russian supplies. The aim of diversifying import sources would therefore give way to the goal of fully diversifying away from Gazprom gas.

Cutting Russian Gas out of the European Energy Market is Hardly Feasible

While proposals pertaining to a more "muscular" approach to European external energy affairs have gained traction in high-level policy debates, they in fact face a harsh reality check, including legal frameworks, physical limitations, and economic imperatives.

To start with, replacing Russian gas in Europe's import portfolio will be a demanding task against the backdrop of existing long-term contracts with Russia that hardwire more than 100 bcm into the European import portfolio far into the 2020s.[3] Moreover, maturing European gas fields imply there are growing import needs even with flat or falling demand going forward. Norway's production is already near its limits, Dutch supplies are capped by law, and U.K. production is in decline, while production from shale gas should not be expected to reach more than token quantities before the mid-2020s, if then.[4] Moreover, new pipelines from alternative suppliers have long lead times, and the prospects of additional gas from Northern Africa and the Caspian stretch far into the future, which add to turmoil in Libya and limited supply options for the "Southern Corridor" beyond Azerbaijan. Though much debated, post-sanction gas prospects in Iran remain a long shot at best, as do Eastern Mediterranean supplies, not least due to difficult business environments, required investment needs, and infrastructure bottlenecks. In the short and medium term, alternative supplies would therefore predominantly have to come from LNG. With currently around 200 bcm of available European LNG regasification capacity, the problem here obviously does not lie in

1 Tusk, Donald. 2014. "A united Europe can end Russia's energy stranglehold." *Financial Times*, April 21.

2 Ibid.

3 Dickel, Ralf, Elham Hassanzadeh, James Henderson, Anouk Honoré, Laura El-Katiri, Simon Pirani, Howard Rogers, Jonathan Stern, and Katja Yafimava. 2014. "Reducing European Dependence on Russian Gas: Distinguishing Natural Gas Security from Geopolitics." Oxford Institute for Energy Studies Paper NG 92.

4 Bradshaw, Mike, Gavin Bridge, Stefan Bouzarovski, Jim Watson, and Joseph Dutton. 2014. "The UK's Global Gas Challenge," London: UKERC.

a lack of ability to absorb more LNG volumes, although there are infrastructure constraints between markets (e.g., insufficient pipeline volume from Spain to France). Available capacity would certainly be sufficient to replace the roughly 140 bcm of gas that Gazprom sent westwards in 2014. The fact that European regasification terminals presently run at only one-fifth or less of their capacity clearly indicate that LNG exporters have preferred higher-priced Asian markets to European ones.

This, in turn, points to a significant pricing challenge coming with replacing Russian gas with "-162°C cargos" from Qatar, Algeria, or Australia and potentially the United States going forward. To be sure, LNG will be a significantly more attractive supply option for Europe than it has been in the past, thanks to a narrowing spread between Atlantic Basin and Pacific Basin gas prices. LNG prices into Japan, which had hovered around $15 per million British Thermal Units (MMBTU) by mid-2014 still, have come down to $7 by mid-2015, effectively matching the British national balancing point (NBP) spot marker and German prices for Russian pipeline gas. With global liquefaction capacity expanding significantly at present, Asian prices may fall and stimulate additional European imports, as would U.S. LNG exports ramping by 2016 (though arguably some LNG trains might not go online in the new pricing environment). The soft oil market will further depress oil-indexed price levels of Russian gas (which still make up for some 50 percent of contracted volumes), with the typical time lag of about half a year. This represents an improvement for the European supply outlook. Still, Russia has demonstrated that it is willing to defend European market share at the expense of higher price levels. Gazprom has come to revisit several long term contracts in the aftermath of the 2009 price drop, has offered more attractive deals to countries that had invested in LNG facilities, such as Lithuania, and increasingly priced its gas against the NBP marker. It clearly is in the position — and determined — to undercut LNG from the United States or elsewhere if strategically necessary. Against the backdrop

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of a still ailing economy and the competitive edge low energy prices have given to the U.S. industry, European consumers will remain reluctant to pay a significant "security premium" for LNG over Russian supplies.

To be sure, EU countries could support supply diversification by way of mandated regulation. Effectively, this amounts to obliging consumers to take gas volumes in the shape of LNG regardless of whether cheaper (piped gas) alternatives are available; and it means that molecules from, say, Qatar, are given preference over others — the ones originating from Siberia. However, this option not only comes with costs for consumers, as Poland had to learn when facing a significant price premium for its LNG contract with Qatargas, it also faces clear legal limits, as heavy-handed regulation of this sort would effectively amount to a return to the public utility model of old. This would be incompatible with current EU law and effectively undo more than 20 years of EU energy sector reform. The same also holds true with a view to the idea of pooling purchasing power, be it on a country or EU level. A state-sanctioned monopsony would run counter to the free market principle underpinning European legislation.

Finally, the EU could also consider replacing Russian gas with other sources, in the shape of fuel switching. While there are limits in the short term, there clearly is potential in replacing gas with oil for heating households, or in fostering domestically available resources in electricity production — an option that would presumably find notable support in Eastern European countries. Depending on the estimates, Russian gas could thus partially give way to Polish hard coal or Bulgarian lignite. (Germany fostering renewables indeed replaces gas, although rather unwillingly as the intention was to target coal instead, in addition to nuclear.) This move, however, means trading climate for security goals. Not only would this move put the emission and decarbonization targets the EU has agreed on in serious question, up to 2030 and beyond. It would also endanger the EU's traditional leadership role in the UN climate negotiations. Climate policy represents one of the few policy areas where the EU exerts true leadership and where it has a track record of successfully shaping global policy. It is, therefore, the one area where the EU can hardly afford to lose its standing and impact, notably against the backdrop of rising Asian economies and a looming shift in global negotiating power.

The Way Forward: Regulation, Internal Market, and Infrastructure

In light of all this, an EU energy policy strategy to replace Russian gas is costly and would compromise other key policy objectives. Instead, the EU should rely on its attractiveness as an export destination for Russian gas and cope with a high import ratio through market mechanisms. For this, it should use its elaborate regulatory toolbox and complete both the internal market for energy and crucial infrastructure to render the European gas (and electricity) grid robust against external shocks.

Europe will be the one market that Gazprom cannot turn its back on. Russia's Eastern Strategy, and its attempts to pivot to Asian markets, so far remain a loss-making exercise. Despite its immense value, the much-acclaimed 30-year $400 billion deal on 38 bcm of annual gas deliveries struck between Russia and China in May 2014 seems unlikely to be a profit-generating endeavor for Moscow. Gazprom's domestic Russian market — where the company sells two-thirds of overall output — remains hardly profitable either. By contrast, the European market remains the company's cash cow, and accounts for the majority of the $73 billion in revenues that Gazprom makes in gas exports.[5] European sales are crucial to fund new upstream projects in Eastern Siberia, to push the China pivot, and to put in place related infrastructure. This is why Moscow is pushing hard to make Turkish Stream, a 32 bcm project partially replacing the failed South Stream link and aimed at circumventing Ukraine as a transit country, a reality. The recent move to double the capacity of Nord Stream, the 55 bcm pipeline connecting Russia's Vyborg with Germany's Greifswald, drives the point home that Europe is the one market Gazprom cannot let go of.

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It is their market's crucial importance that hands the Europeans a powerful means to deal with the Russia challenge: market regulation. Indeed, the EU has put in place a comprehensive legal framework that defines the level playing field for domestic and foreign companies, and has developed a sophisticated regulatory apparatus to govern the internal market, including in the energy sector. The European Commission, the EU's executive, oversees the functioning of the internal market and has a set of sharp legal instruments at its disposal, including competition policy and anti-trust measures. A set of independent regulators ensure market operation at national levels and are represented through the Agency for the Cooperation of Energy Regulators (ACER), their joint agency, in Brussels. Three consecutive "Energy Packages" have injected competition into formerly monopolistic structures, have liberalized national energy markets, and have empowered the Commission to take on violations against competition rules, now also in the gas sector. This gives the EU a formidable

5 EIA. 2014. "Today in energy: Oil and natural gas sales accounted for 68% of Russia's total export revenues in 2013." July 23.

toolbox to deal with Gazprom's market dominance, its discriminatory pricing practices, and Moscow's notorious pipeline politics.

This approach, in fact, has already started to yield success. The Russian-sponsored South Stream pipeline was brought to a halt not by politicians but by regulators, Brussels-based bureaucrats who enforced EU law pertaining to unbundling gas sales from transport, making Bulgaria and other countries that backed the project eventually change course. Likewise, the EU anti-trust case against Gazprom that European Commissioner for Competition Margrethe Vestager is determined to push forward will likely force the

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monopolist to fundamentally alter its business model in Europe. In short, rather than aiming at curbing Russian gas imports, Europeans should make sure that if they buy Gazprom's molecules, the latter does not come complete with Moscow's political agenda. The completion of the internal market is a precondition for this, competition policy represents the tool, and the Commission is the watchdog waving the big regulatory stick if required. As the anti-trust cases against IT-giants Microsoft and Google have demonstrated, the Commission has the power to take on dominant market players; this power derives from a sizeable market and its mandate to safeguard it.

To be sure, the EU energy market is still incomplete, and competition tools often prove weak. This is vividly demonstrated by numerous pending investigations by the Commission against EU member states for not fully transposing the 2009 Third Energy Package into national law, by infringement procedures particularly against Southeastern European countries such as Bulgaria and Romania, and by persisting national resistance against opening up markets for competition. Moreover, markets in the region remain poorly integrated and physically connected, and as a result trading of natural gas at hubs with multiple buyers and suppliers such as Zeebrugge in Belgium dominates the north but gas-on-gas competition remains limited in the south and in Eastern Europe with hub activity staying at low levels. Reacting to this, the Commission has identified high priority "projects of common interest" in energy infrastructure, which will receive funding from the EU. It has also set up the Central East South Europe Gas Connectivity (CESEC) high-level group, which will work toward establishing a regional roadmap for infrastructure priorities, in order to give each country access to at least three different sources of gas. National energy agendas, still, all-too-often trump common European energy goals, as epitomized by the fact that some EU members backed Russia's South Stream pipeline despite its clear inconsistency with EU norms.

Europe's energy security therefore hinges on fostering internal market reforms, strengthening intra-European gas infrastructure and creating a fungible common gas market to which external suppliers such as Russia are invited to "come and play," but play according to EU competition rules. The EU should also support pipelines from alternative sources, including the Caspian. This is not only for geopolitical purposes but also because of the public goods characteristics of infrastructure: the "market" alone will not put them in place. As a corollary, completing the single market requires strengthening the hand of EU regulatory authorities to end the tug of war between national governments and Brussels resulting from split competencies. On one hand, this means empowering the EU Commission as the bloc's energy watchdog, so that it can fully enforce EU law vis-á-vis external suppliers but also individual member states should they chose to violate common market principles, and inject transparency into the market by way of vetting bilateral contracts. On the other hand it is regulatory agencies such as ACER and the EU level network of Transmission System Operators that will resume a crucial role in deepening the market, overseeing its smooth operation, and managing physical gas flows.

In short, the EU is well positioned to take the edge off Russia's "energy weapon" by way of internal market regulation.[6] This is, eventually, what the planned Energy Union should do. The EU is good at regulatory politics but not at playing geopolitics. It should push the former and generally abstain from the latter, particularly in the case of Russian gas. Rather than giving in to anti-market reflexes and further securitizing energy policy, EU leaders should seize the momentum and push the Energy Union with a view to completing the internal market project and to further empowering the EU Commission as its competition watchdog. The current momentum may prove enough for those governments who have been resisting giving up protecting their national companies' rents and domestic regulatory power. It is the EU's genuine strength in playing regulatory politics that will allow it to effectively respond to the challenge presented by Russian energy geopolitics. The energy infrastructure that is necessary to create a fungible pan-European gas market will need to be pushed by EU level funds, notably the Juncker investment plan and the Connecting Europe Facility. The governance structure of the Energy Union, finally, should be informed by the principle of transparency and build on established processes such as peer review. This will ensure key elements, such as interconnection targets, will be made a reality. A completed internal market in energy that is coupled with robust regulatory governance on the EU level will come with increased resilience against supply shocks. As a corollary, there will be no more room for Russia or any other external supplier to divide and rule. And the single voice in energy, often called for by security analysts and EU politicians, will eventually materialize — in the shape of EU decisions, communications, and recommendations.

6 Goldthau, Andreas, and Nick Sitter. 2015. "Soft Power with a Hard Edge: EU Policy Tools and Energy Security." *Review of International Political Economy*, 22 (5), 941-965.

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