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## GOOD GOVERNANCE AND ENERGY SECURITY IN BULGARIA

### Policy Tracker: EU and Russia's Energy Policy at the Backdrop of the South Stream Pipeline

2014

#### Overview of the EU-Russia Energy Dialogue

The present paper aims at tracking the development of the South Stream gas pipeline project from the perspectives of the EU and Russia, and in the context of the common EU external energy policy. The EU-Russia energy dialogue has become increasingly complicated since the two natural gas crises in 2006 and 2009, when the gas supply was cut for about two weeks due to a gas pricing dispute between Russia and Ukraine. Until then the energy relations between Europe and Russia have run smoothly as Gazprom had been perceived as a reliable supplier operating under long-term, oil-indexed contracts providing predictability of supplied volumes and prices. For producers such as Russia operating in a glut market, the most important goal was to preserve their market share in Europe. An eventual supply disruption would discredit suppliers and will push consumers look for more viable alternatives.

The stability of the EU-Russia gas relations were able to withstand a number of geopolitical crises and energy market shifts. The situation started changing with the rapid increase in crude oil prices following the Iraq War in 2003 and on the back of the economic

boom in developing Asia. Consuming countries in Europe became increasingly dependent on natural gas imports to satisfy their needs as domestic production in the North Sea has experienced rapid production declines. In an environment of fast economic growth, European countries found it ever harder to find substitutes to the growing amount of Russian gas supply in the overall energy consumption of the continent. Not surprisingly, the two Ukrainian gas crises became a wake-up call for Europe. At this moment, the need for a common EU energy policy became not a question of achieving more commercial efficiency and market integration, but the preservation of the security of energy supply.

The EU has attempted to counter the monopolistic market structure by drafting a common legislation aiming to integrate and liberalize European energy markets. One of the most comprehensive legislative attempts has been the Third Energy Liberalization Package aiming to 1) unbundle the ownership of the production and transmission sectors; 2) provide third-party access to at least 50% of the gas transmission capacity. This liberalization initiative is at the core of the EU argument against the commissioning of the South Stream gas pipeline as the latter had envisioned that Gazprom will have a controlling stake in the individual joint ventures in

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the countries along the pipeline and would not have provided a 50% available pipeline capacity for alternative gas sources. Although the Third Energy Liberalization Package provides the broader framework for the internal gas market integration, a lot of the relevant issues such as the definition of an entry-exit regime or formation of natural gas hubs are left to national and secondary legislation<sup>1</sup>.

More recently, the EU has initiated a more wide-reaching policy campaign amidst the military conflict in eastern Ukraine. The EU has revamped significantly its focus on energy security and has stepped up efforts to set up the European energy union. The latter faces many challenges including the enormous need of investment resources to expand regional gas links and the establishment of a common gas purchasing mechanism that takes into consideration the different ability of EU member states to pay for their gas imports. For member states like Germany, the introduction of a common EU gas purchasing mechanism could mean higher import prices, which could meet significant opposition from the German industry heavily dependent on Russian gas imports. At the same time, the Energy Union could increase the bargaining power of member states in Central and Eastern Europe, who are also the most dependent on Russian gas sources. Currently, many of them have to pay some of the highest natural gas prices as Gazprom gas meets only little competition in the region.

## Europe and Russia: clash of interests over the South Stream project

The South Stream pipeline has been in the center of a heated debate in Europe for at least the last six years. The project was initiated in 2006 as a result of the conclusion of a strategic partnership agreement

between Gazprom and Eni giving Gazprom the exclusive right to bring Russian gas directly to Italy starting from 2007. In the following 3 years, Gazprom signed a number of Intergovernmental Agreements (IGAs) with Bulgaria, Serbia, Hungary, Greece, Slovenia, Croatia and Austria. The IGAs stipulate that Gazprom owns 50% (51% in Serbia) of the joint-venture constructing the pipeline section in each of the participating countries. Yet, the European Commission (EC) has claimed that the IGAs violate key provisions of the Third Energy Liberalization Package, highlighting two major issues<sup>2</sup>:

- EU's network ownership 'unbundling' rules need to be observed, meaning that Gazprom, which is both a producer and a supplier of gas, cannot simultaneously own and operate production units and transmission networks as well as trade.
- Non-discriminatory access of third parties to the pipeline needs to be ensured. There cannot be an exclusive right for Gazprom to be the sole supplier.

In response to the violations of the Energy Package, the EC urged the South Stream partners to renegotiate the IGAs in order to achieve compliance with EU energy law. When no action was taken by the project partners, the European Commission began an infringement procedure against Bulgaria, which prompted the latter's government to suspend the project in August, 2014. Following the firm opposition of the EC to accept the project in its present form, at the beginning of December, 2014, Russia's President, Vladimir Putin, announced that the South Stream project will be cancelled. Explaining his decision, Mr. Putin named two major reasons. First of all, he claimed, the EU is hindering

<sup>1</sup> Page 5. <http://www.oxfordenergy.org/wpcms/wp-content/uploads/2013/04/NG-75.pdf>

<sup>2</sup> Stefanov, R. and Vladimirov, M. (2014). South Stream at the Crossroad of Energy Security and State Capture Risks. *Südosteuropa Mitteilungen*, vol. 05-06

the realization of the project.<sup>3</sup> Secondly, he explained that Russia still has not received permission from Bulgaria to proceed with the construction of the pipeline.<sup>4</sup> As a replacement to the South Stream, president Putin proposed the construction of an alternative gas pipeline through Turkey ending on the Turkish-Greek border. On 1st December, 2014, Alexey Miller, Chairman of the Gazprom Management Committee, and Mehmet Konuk, Chairman of the Board of Directors of BOTAS Petroleum Pipeline Corporation signed in Ankara a Memorandum of Understanding on the construction of the Turkish Stream pipeline with the same projected capacity as South Stream - 63 billion cubic meters (bcm).<sup>5</sup> The newly-introduced project will be discussed further in the later sections of this paper.

## EU energy policy in the energy security debate

Before turning to the analysis of the European position on South Stream, it is useful to add a note on energy security theory, to which the tracker will continuously refer to in relation to the EU energy policy priorities. Although there is no single definition of energy security in the academic debate, this policy tracker borrows the approach taken by Jonathan Elkind in his article "*Energy Security. Call for a Broader Agenda*". There, he defines energy security as consisting of the following components: availability, reliability, affordability and sustainability.

- **Availability** of energy refers to the country's or region's domestic endowment of energy sources and its ability to efficiently produce and distribute them on the market. The demand for energy in the EU has soared in the last decades due to the sustained economic growth of the member-states. These

developments led to largely depleting easy-to-access oil and gas reserves in the territories of the Union and are pushing exploration boundaries to: 1) ever scarcer; 2) more distant sites (farther away from existing demand centres); 3) hard-to-extract exploration (e.g., deep water, high pressure, etc.); 4) economically poorer and politically unstable areas; and 5) more restrictions like cartel agreements, environmental concerns, etc. As a result, conventional energy sources have become harder to access and costlier to develop. Europe's import dependence has increased in the last two decades and is set to grow to more than 80% in the case of oil and gas by 2035. Some MSs rely on one single Russian supplier and often on one single supply route for 80%-100% of their gas consumption. This creates the exposure risks in a market dominance situation, where price setting may not always follow a market rationale

- **Reliability** pertains to the protection of energy services from interruption. Most commonly, countries strive to enhance energy reliability through:
  - diversifying the supply sources and the supply chain;
  - stockpiling on additional storage capacity and emergency stocks;
  - reducing the demand for energy;
  - developing a redundant infrastructure; etc.

The EU has been most vulnerable to halt in natural gas deliveries from Russia via Ukraine due to regular payment disputes between Gazprom and Ukraine's Naftogaz. The result has been two consecutive supply

<sup>3</sup> <http://ria.ru/economy/20141201/1036046469.html#ixzz3Kk9FG05Z>

<sup>4</sup> <http://www.kommersant.ru/doc/2623554?isSearch=True>  
<http://ria.ru/economy/20141201/1036046112.html#ixzz3Kk9JG9gh>

<sup>5</sup> <http://www.gazprom.com/press/news/2014/december/article208505>

crises in 2006 and 2009, and potential instability of gas supplies in the next 18 months due to the political situation in Ukraine<sup>6</sup>.

- **Affordability**, as Elkind puts it, its energy that can be used.<sup>7</sup> The components he includes in the notion of affordability are low price volatility, transparent price mechanism and prices that reflect full costs.<sup>8</sup> The problem with energy affordability in the EU is unequally distributed among the different regions with the newer member-states most exposed to inability to cover the cost of utilities. Energy deprivation is also predicated upon the spatial and technical limitations associated with switching towards more affordable fuel sources in the households. High energy prices and inability of the governments to adequately compensate the energy poor has heightened the risk of civil unrest or political instability as was visible in the case of Bulgaria, Greece and Romania in 2013.
- **Sustainability**, which has the following components: low emission of pollutants, minimal addition to local/regional/global threats to environment, protection of energy systems from climate change.<sup>9</sup> This is a key element of the energy security framework for ensuring sustainable economic development for the EU in the next decades. The topic has been reinvigorated at the beginning of 2014 when the European Commission published the updated climate change strategy to 2030 envisioning the decline of CO<sub>2</sub> emissions by 40% until 2030. Climate change predisposes enhanced security risk

for the EU as frequent extreme weather events may cause transport disruption, infrastructure damage and sometimes immense human loss.

States increasingly have to face the policy dilemma of dealing both with the security and affordability of energy supply. The residents of the countries in Southeastern Europe, for example, use disproportionately high amounts of environmentally damaging coal and wood, as well as costly electricity to heat their homes, and contribute substantial portions of their income to paying their energy bills, while at the same time not being able to keep their homes adequately warm. The limited reach of certain types of networked energy infrastructures (particularly gas) means that, in addition to affordability issues, energy deprivation is also predicated upon the spatial and technical limitations associated with switching towards more affordable fuel sources in the households.

To the affordability/reliability nexus, one should add the determined strategy of many European governments, to guarantee the environmental friendliness of energy supply. While the affordability, availability and even reliability aspects can be somewhat objectively measured, the sustainability of energy supply is “possible” to only a limited extent. However, in the CEE and Black Sea regions, environmental security is often trumped by other priorities including the immediate availability of energy supply at affordable cost consistent with the stage of the country’s economic development. Paradoxically, government have to often take policy decisions that improve the overall energy security

<sup>6</sup> Jonathan Elkind, “Energy Security. Call for a Broader Agenda”, page 121. *Energy Security. Economics, Politics, Strategies, and Implications*. Editors Carlos Pascual, Jonathan Elkind. Brookings Institution Press, Washington D.C. 2010, page 122

<sup>7</sup> Jonathan Elkind, “Energy Security. Call for a Broader Agenda”, page 121. *Energy Security. Economics, Politics, Strategies, and Implications*. Editors

Carlos Pascual, Jonathan Elkind. Brookings Institution Press, Washington D.C. 2010, page 126

<sup>8</sup> Jonathan Elkind, “Energy Security. Call for a Broader Agenda”, page 121. *Energy Security. Economics, Politics, Strategies, and Implications*. Editors Carlos Pascual, Jonathan Elkind. Brookings Institution Press, Washington D.C. 2010, page 122

<sup>9</sup> Ibid.

position of the country but at the same time lead to environmental degradation.

## EU energy policy priorities

### Diversifications of suppliers

According to the European Energy Security Strategy, one of the main priorities of the EU is energy supply diversification. The *Communication of the Commission to the European Parliament and the Council on European Energy Security Strategy* published in May, 2014, focuses in particular on the search for new natural gas resources as the chief approach towards diversification<sup>10</sup>. As the *Security of Energy Supply background note* provides, the EU is vulnerable to external supply shocks as many of its Member States are heavily dependent on a single gas supplier, with six of them entirely dependent on Russia for their natural gas consumption.<sup>11</sup>

In this policy context, the South Stream pipeline would not have fitted the above-mentioned EU energy diversification goals as the project had aimed at delivering the same Russian gas to Europe, as before, with the only difference that it would have replaced the gas transit through Ukraine, with deliveries through Bulgaria, Serbia, Hungary and Austria. The circumvention strategy had begun already in 1999 when the Yamal-Europe pipeline crossing Belarus and Poland was commissioned. In 2003, the process continued with the start of the Blue Stream pipeline linking Russia and Turkey directly with an under-sea pipeline. The final bit came with the inauguration of the Nord Stream pipeline in 2011 allowing for a direct gas supply from Russia to Germany via the North Sea. Despite the efforts for circumventing Ukraine, the latter remains the single largest transit-country for

Russian gas transporting close to 52 % of all natural gas to the EU and the Western Balkans<sup>12</sup>.

One major reason for the low European interest in the South Stream gas pipeline project is that the EU simply does not need so much gas. In fact, in 2013 the EU-28 gas demand had decreased by 1.4 % year-on-year following even steeper declines of 10 % and 2 % in 2012 and 2011, respectively. The European gas demand is unlikely to grow much further in 2030 as increased gas consumption had been checked by the growth of the renewable energy capacity and the renewed interests of some European countries in coal. The latter is directly related to the reduction of US coal prices following the shale gas revolution that has been replacing coal use in US power plants<sup>13</sup>.

South Stream would have offered an additional 63 bcm of Russian natural gas exports to Europe, on top of the already existing gas supply contracts amounting to 178.6 bcm in 2013, according to data from Gazprom. South Stream could be logically explained only if we consider that Gazprom would redirect most of its gas exports to Europe from transiting Ukraine to this new pipeline passing under the Black Sea. However, this is unlikely to happen unless the gas supply comes at much lower prices to compete with EU's alternative sources of natural gas from Qatar and Norway. As it is showed in the table, the expectations of the gas demand in Europe had decreased. If in 2007 the expected demand for both 2015 and 2025 was 535 mtoe and 578 mtoe respectively, in 2013 issue of Outlook it had decreased notably. Thus for 2015 the prognosis both for baseline and environmental scenarios is 421 mtoe and for 2025 it varies between 455 and 478 mtoe, depending on scenario.

<sup>10</sup> European Energy Security Strategy. [http://ec.europa.eu/energy/doc/20140528\\_energy\\_security\\_communication.pdf](http://ec.europa.eu/energy/doc/20140528_energy_security_communication.pdf)

<sup>11</sup> Security of Energy Supply. [http://ec.europa.eu/energy/security\\_of\\_supply\\_en.htm](http://ec.europa.eu/energy/security_of_supply_en.htm)

<sup>12</sup> Sharples, J. / A. Judge (2014). Russian gas supplies to Europe: the likelihood, and potential impact, of an interruption in gas transit via Ukraine. European Geopolitical Forum – Energy Special Contribution

<sup>13</sup> Final Report, "Supplying the EU Natural Gas market", 2010. [http://ec.europa.eu/energy/international/studies/doc/2010\\_11\\_supplying\\_eu\\_gas\\_market.pdf](http://ec.europa.eu/energy/international/studies/doc/2010_11_supplying_eu_gas_market.pdf)

**Table 1 Different scenarios for the EU natural gas demand**

Year	2015		2025	
	Baseline scenario	Environmental scenario	Baseline scenario	Environmental scenario
2007	535 mtoe		578 mtoe	
2010	465 mtoe		495 mtoe	525 mtoe
2013	421 mtoe	421 mtoe	455 mtoe	478 mtoe

Source: European Commission and IEA

### Decreasing overall dependency on particular suppliers and fuels

Europe's import dependence has increased in the last two decades and is set to grow to more than 80 % in the case of oil and gas by 2035<sup>14</sup>. When observing the key constraints to the secure, predictable and affordable supply of energy sources in the EU, there is a supply and a demand trajectory to be explored. On the supply side, conventional energy production is becoming increasingly expensive and, in the longer term, simply unavailable. Concurrently, on the demand side, long-term consumption trends point to a continued rise, which cannot be sustainable if Europe is to follow through with its obligations for decarbonisation of the economy and the shifting of the energy supply towards renewable energy sources (RES).

The challenges to finding the best balance between cheap, clean and reliable energy supply are best exemplified in the variety of energy policy among the different EU member-states. On average in 2013, the total energy needs of the EU, in terms of gross inland consumption, were covered by the following sources: 36% oil, 23% gas, 17 % solid fuels such as coal, 12% nuclear power, 12% renewable sources such as hydropower, solar or wind energy. This mix varies

widely across countries and evolves over time as a result of their geographical conditions, such as the availability and access to natural resources, national policy choices (e.g. the decision to make use or not of nuclear power, allow shale fracking, participate in different international projects, etc.), changing financial incentives, progress in technologies, decarbonisation requirements and the development of the internal market.

In spite of differences, EU MSs have three common policy objectives:

- reducing energy costs for households and businesses (“competitiveness”),
- ensuring a reliable and uninterrupted supply of energy (“security of supply”) and
- limiting the negative environmental impact of energy production, transport and use (“sustainability”).

Two strategies aiming to relieve the structural energy dependence can be distinguished. First of all, the EU member-states are focusing on developing the indigenous European resources, which primarily include nuclear energy, renewables and, less so, unconventional gas. The accident in the Fukushima Daiichi nuclear power plant led to a fundamental shift in nuclear policy of some of the EU member-states, most notably Germany. The latter's decision to close all of its nuclear power plants by 2022 has increased the attractiveness of natural gas as a fuel of choice that is both efficient and more environmentally friendly than other non-renewable energy alternatives.

The second type of resources that can reduce EU's energy dependence on external supply is the expansion of the EU renewable energy production capacity. The EU has had extensive plans in terms of

<sup>14</sup> European Commission, “Europe 2020. A strategy for smart, sustainable and inclusive growth”,

accessed from <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2010:2020:FIN:EN:PDF>

developing renewable energy sources. As a 2011 paper by the European Commission titled “*Energy challenges and policy*” outlines, the first steps had been already taken, as Member States had enhanced the share of renewables to 13% from the European final energy consumption.<sup>15</sup> The primary aim of the renewable energy policy has been to cut CO2 emissions and reduce fossil fuels import bills.<sup>16</sup>

Third, the EU has high hopes for expanding domestic oil and gas production by developing the unconventional energy resources for partially substituting supplies from third countries. The so-called shale gas revolution is receiving much attention in the EU more recently, as European government have observed the positive effects of large-scale shale gas development in the US on boosting the US economic competitiveness. The “shale push” comes on the back of steady declines in conventional gas production, which has pushed the natural gas import dependency to 67% in 2011 and is projected to continue increasing reaching more than 80% by 2035, putting the EU in direct competition for the emerging global gas supply. Some European governments such as the UK and Poland have treated the shale gas potential as a long-term solution to the gas supply problem as shale gas exploration and development can additionally bring numerous benefits, such as support job creation and reindustrialization<sup>17</sup>. Moreover, as natural gas is considered to be environmentally friendlier than other fossil fuels in use, which could assist the EU in achieving its long-term strategy for energy decarbonization.

However, other European governments including Bulgaria, France and Germany had been much more

reluctant to start a large-scale unconventional gas exploration due to concerns by environmental groups about the associated ecological risks for water contamination. They have issued a moratorium on exploration activities, hence, disincentivizing major international oil companies in investing in unconventional energy sources in Europe. Meanwhile, the European Commission published a detailed study of Europe’s unconventional gas potential showing that shale gas exploration and production has a larger environmental footprint than extraction of conventional gas<sup>18</sup>. The main risks in this regards are surface and ground water contamination, depletion of water resources, air emissions, land take and harming biodiversity<sup>19</sup>.

Finally, the EU has employed the strategy of decreasing the overall energy demand to cut imports from third countries. This strategy has been outlined in the EU *Energy Efficiency Directive*, which aims at achieving by 2020 a 20 % increase in energy efficiency. The Directive calls for mobilizing investment in the renovation of residential and commercial building; the implementation of cross-EU measures such as fiscal incentives, information dissemination and energy efficiency standards fostering a behavioral change in the consumer<sup>20</sup>. If successful the energy efficiency strategy could have the same effect on the EU energy security as the large-scale integration of renewables in the European energy mix.

### Priority energy projects

As part of the EU energy security strategy, the European Commission has announced a list of

<sup>15</sup> Commission, “Energy challenges and policy”, page 6, [http://ec.europa.eu/europe2020/pdf/energy2\\_en.pdf](http://ec.europa.eu/europe2020/pdf/energy2_en.pdf)

<sup>16</sup> Ibid, page 6.

<sup>17</sup> Shale Gas Explained. <http://shalegas-europe.eu/shale-gas-explained/introduction-to-shale-gas/>

<sup>18</sup> European Commission. (2012). Unconventional Gas: Potential Energy Market Impacts in the European Union. JRC Scientific and Policy Reports, accessed at

[https://ec.europa.eu/jrc/sites/default/files/reqno\\_jrc70481\\_unconventional\\_gas\\_potential\\_energy\\_market\\_impacts\\_in\\_the\\_european\\_union.pdf](https://ec.europa.eu/jrc/sites/default/files/reqno_jrc70481_unconventional_gas_potential_energy_market_impacts_in_the_european_union.pdf)

<sup>19</sup> Ibid

<sup>20</sup> Energy Efficiency Directive 2012/27/EU, 315/20. <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32012L0027&from=EN>

priority energy infrastructure projects. In the natural gas sector, many of them aim at improving the interconnectedness of the existing domestic gas transmission systems. Energy diversification and improved gas system resilience and flexibility for the most critically energy dependent member-states in Central and Southeastern Europe is the basis of the EU long-term energy infrastructure policy. Enhanced cross-border exchanges will diminish the role of the single supplier in setting regional gas prices and will create the preconditions for regional gas hubs. As the gas stress tests showed in October, 2014, regional gas hubs based on diversified supply are most badly needed in Southeastern Europe and the Black Sea region. The CEE, Baltic and Black Sea regions were identified as the most severely exposed to disruptions to natural gas deliveries. It is likely that in these countries gas suppliers will have to curtail the deliveries to non-protected customers after a potential medium-term (6 month) disruption.

The Commission estimates that around EUR200 billion are necessary for the upgrade and expansion of the European energy network<sup>21</sup>. On 21 November, 2014, the European Commission reached a decision to allocate EUR 647 million to 34 key energy projects. The total budget of the energy section in the CEF mechanism amounts to EUR 5.85 billion until 2020. The priority natural gas corridor for improving the energy security of the CEE and SEE regions is the:

- **North-South gas interconnections in Central Eastern and South Eastern Europe ('NSI East Gas')**: The corridor is planned as a system of regional gas connections in the Baltic Sea region, the Adriatic and Aegean Seas and the

Black Sea and is aimed at diversifying gas supply and enhancing its security<sup>22</sup>.

- **Southern Gas Corridor**: The aim of this project is to take advantage of the giant natural gas reserves (1.3 trillion cubic meters) in the Shah Deniz field in offshore Azerbaijan. Around 16 billion cubic meter of natural gas will reach European consumers via two major pipelines, the Transanatolian Pipeline (TANAP) passing through Turkey reaching the Greek and Bulgarian borders, and the Trans-Adriatic Pipeline (TAP) crossing Greece, Albania and linking Italy via a subsea pipeline across the Adriatic Sea. The project received a major push on 28 June, 2013 when the Shah Deniz Consortium (SDC) announced its choice of the TAP pipeline for gas to be linked with TANAP in Turkey, dealing a heavy blow to the EU-Flagship Nabucco project, and effectively halting it. This choice is expected to have far reaching implications for the structure of CEE and SEE energy security in the short-and medium term. Although the quantities of potential gas deliveries from Shah Deniz are too small to directly challenge Russian gas dominance, they could tilt critical gas market balances in SEE with a multiplier effect across Central and Eastern Europe.
- **LNG options**: a further option for EU natural gas diversification is the development of new LNG terminals to link the most energy dependent European regions with the global gas market. <sup>23</sup> Using tankers instead of pipelines to transport natural gas is becoming more efficient as the LNG takes

<sup>21</sup> COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS, Long term infrastructure vision for Europe and beyond, accessed at <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52013DC0711>

<sup>22</sup> COMMISSION DELEGATED REGULATION (EU) No .../.. of 14.10.2013 amending Regulation (EU) No 347/2013 of the European Parliament and

of the Council on guidelines for trans-European energy infrastructure as regards the Union list of projects of common interest, page 15. [http://ec.europa.eu/energy/infrastructure/pci/doc/com\\_2013\\_6766\\_en.pdf](http://ec.europa.eu/energy/infrastructure/pci/doc/com_2013_6766_en.pdf)

<sup>23</sup> Pasquale de Micco, "In-Depth Analysis. The EU's Energy Security made urgent by the Crimean Crisis".



600 times less volume than the regular dry gas allowing for cheaper shipping of large quantities of gas over large distances.<sup>24</sup> In the case of Central and Southeastern Europe, LNG could serve as the energy source for the revival of the Nabucco project. The regional interconnectors, already built or planned to be built, could transport natural gas arriving on LNG tankers at different ports in the Mediterranean. This will feed into the above-mentioned North – South gas corridor, a priority project for the EC. LNG has already been playing a vital diversification role in Western Europe, where supplies from Algeria, Qatar, Norway and Egypt, among others, have increased the liquidity of trading hubs in the UK (the National Balancing Point), Hollande (Zeebrugge), etc. In addition, many of the EU member-states in Western Europe already have the necessary LNG infrastructure in place. Meanwhile, most of the regasification terminals in Western Europe are currently operating below their capacity, which means that there is significant room to expand LNG imports in the future. In general, the average rate of LNG terminal utilization in the EU for 2009 – 2011 periods was 68% in 2009, 75% in 2010 and 67% in 2011.

- **Global gas market:** European energy companies are likely to tap the global gas market, where the IEA envisions that around 105 bcm of new LNG capacity will come online by 2017<sup>25</sup>. This could lead to a rapid increase in cross-regional trade allowing for gas competition in Europe from non-traditional producers that will aim to gain a larger market share in Europe. The increased competition will no doubt lead to a reduction of prices and the gradual convergence of regional gas prices.

While the situation in the CEE and SEE regions is much different, global shifts in the European natural gas supply will inevitably lead to price cuts also in this part of Europe. Even without full physical gas market integration a coordinated use of the free capacities at LNG terminals for direct or virtual gas swaps in the region could trigger immediate diversification of gas supplies even before the completion of planned interconnectors and the physical entry of alternative gas supplies.

### Forming a common EU external energy strategy

In understanding the EU decision to reject the South Stream pipeline, one has to also evaluate the process of an EU common energy policy formation. The latter has culminated more recently with the publishing of an EU Energy Union blueprint communication on 25<sup>th</sup> February, which set out a policy framework for improving the security of energy supply, improving the energy market integration and liberalization and for improving demand response mechanisms in energy efficiency and green R&D. This policy tracker provides a timeline of the progress, starting with the Lisbon Treaty in 2007, when energy was recognized as one of the European policies and finishing with the main priorities of the current EU Energy Union initiative:

1. 2007: New Energy Policy for Europe part of the Lisbon Treaty: energy is recognized as part of the European policy framework. The Treaty wrote down that the energy policy's objectives must be met in a spirit of solidarity between Member States. The treaty encompassed the *New Energy Policy for Europe*, proposed by the European Council, aimed to solve the dilemma faced by governments of both ensuring competitive

<sup>24</sup> Shell Global. *What is LNG?* <http://www.shell.com/global/future-energy/natural-gas/liquefied-natural-gas/what-is-lng.html>

<sup>25</sup> Natural Gas Medium-Term Market Report 2012, IEA, 2012

energy pricing and a transition to a low-carbon supply. The affordability/sustainability nexus came at the backdrop of worsening relations with external producers, such as Russia. The latter, though, remained a secondary issue as most member states preferred to maintain their bilateral relations with external suppliers instead of integrating their energy policy. In fact, this was the dominant policy direction taken by national governments until the gas crisis in 2006, which for the first time since the Arab oil embargo in 1973 had put the European energy supply at risk.

2. 2009: Lisbon Treaty entering in force. Energy was introduced as an official article in the treaty but it did not provide for a significant boost to the creation of a common energy policy. The national government preserved their right to determine their energy mix, the form and level of taxation and the recovery of natural resources.
3. July, 2009: Adoption of the Third Energy Package, which includes two directives on the implementation of *Common Rules for the Internal Market in Electricity in Natural Gas and Electricity*, as well as three regulations defining 1) the conditions for access in the gas transmission networks and access to the network for cross-border exchanges in electricity; and 2) the creation of a common Agency for the Cooperation of Energy Regulators.

The evolution of the common energy market since 2009 has been dominated by the implementation of the Third Energy Package. The latter has presented significant obstacles for South Stream's legal status. In its current form, South Stream is in breach of three of the main provisions of the Package, including the unbundling, third-party

discrimination clause and the tariff structure clause.<sup>26</sup> There are three major issues that could be distinguished in regards to South Stream:

- Gazprom owns both the transmission network and the gas that will be exported;
- Gazprom has not allowed third parties non-discriminatory access of to the pipeline;
- The proposed tariff structure does not comply with European law.<sup>27</sup>

The pipeline's ownership structure violates Article 9 (1) (b) (i) of the *Gas Directive*, which states, that the *same person/persons cannot exercise control over undertaking that performs any of the functions of production or supply and over a transmission system operator or over a transmission system at the same time*.<sup>28</sup> On the issue of third party access the situation is also vague. A recent agreement has been signed between Bulgaria and Gazprom, according to which access to the pipeline would be allowed also for the third parties. However, access conditions remain unclear.<sup>29</sup> The third remark concerns the tariff structure, which should be defined by an independent authority, not by the pipeline owner(s). In its turn, Gazprom commented numerous times on these three issues, providing certain counterarguments, which will be reviewed in the second part of the present analysis.

4. 2010: Regulation №994/2010 on the security of gas supply: creates a genuine EU mechanism for rapid and coordinated management of external

<sup>26</sup> Pasquale de Micco. "Quick policy insight. Delays to South Stream benefit Ukraine".

[http://www.europarl.europa.eu/RegData/etudes/briefing\\_note/join/2013/522316/EXPO-AFET\\_SP\(2013\)522316\\_EN.pdf](http://www.europarl.europa.eu/RegData/etudes/briefing_note/join/2013/522316/EXPO-AFET_SP(2013)522316_EN.pdf)

<sup>27</sup> Ibid.

<sup>28</sup> DIRECTIVE 2009/73/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 13 July 2009 concerning common rules for the internal

market in natural gas and repealing Directive 2003/55/EC, page 106. 2009. <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009L0073&from=EN>

<sup>29</sup> Rayko Nikolov, "Legal contradictions in the South Stream project", page 7. 2014.

[http://riskmanagementlab.com/en/fileadmin/user\\_upload/documents/news/Pravnite\\_protivorechija\\_na\\_proekta\\_\\_JUzhen\\_potok\\_\\_en.pdf](http://riskmanagementlab.com/en/fileadmin/user_upload/documents/news/Pravnite_protivorechija_na_proekta__JUzhen_potok__en.pdf)

energy crises. The Regulation was passed in the aftermaths of the natural gas supply halt in the winter of 2009. It mandated that 1) all EU member states are able to satisfy the country's total gas demand during a full peak-demand day; 2) the member states establish reverse-flow capability in all cross border interconnections by 3 December, 2013. Although the EU implemented a comprehensive risk assessment of the natural gas supply and mandated the drafting of a national *preventive action and emergency plans*, some of the countries in the CEE and SEE regions have not been able to fully implement the regulation, and remain extremely vulnerable to a halt of natural gas supply.

5. 2012: Decision No 994/2012/EU of the European Parliament and of the Council of 25 October 2012 establishing an information exchange mechanism with regard to the intergovernmental agreements (IGAs) between Member States and third countries in the field of energy. Member States are obliged to communicate all IGAs to the Commission by 17 February, 2013. The Commission can also decide whether a new IGA or a planned one is compatible with EU law. Member States can also request assistance from the Commission in the negotiations of the contracts. The Decision has had a critical impact on the IGAs concluded in the framework of the South Stream project. The Commission took advantage of the new legal framework to review existing IGAs in South Stream, and ultimately undertook infringement procedures against Bulgaria and Hungary for certain contractual provisions violating the Internal Energy Market rules.
6. 2014: The European Energy Security Strategy:
  - Calls for more coordination of national energy policies in order to respond to challenges of energy security.<sup>30</sup>

- Calls for better exchange of information between Member States and the Union on long-term energy policy strategies and intergovernmental agreements with third-countries.<sup>31</sup>

#### 7. 2014/2015: A roadmap for the creation of an EU Energy Union

The most recent step towards the creation of a common European energy policy has been the drafting of a roadmap towards the creation of an EU Energy Union. The Commission's plan include the deepening of the internal energy market integration, the complete liberalization of the natural gas and power markets via the Third Energy Package, the synchronization of external energy relations, the shift towards demand-side energy solution and the continued reduction of CO<sub>2</sub> emissions. The European Commission has pledged that it will use all available measures to pressure the member-states in implementing the Third Energy Market.

In addition, the Energy Union envisions the creation of a coordination mechanism between the member-states and external energy suppliers like Gazprom. The goal is to increase the transparency of bilateral intergovernmental agreements (IGAs), which will reduce the ability of external suppliers to use export prices as leverage for gaining political influence. More transparent contractual terms will allow better market integration, especially in Central and Southeastern Europe, where countries could take advantage of excess gas capacities if they have information about negotiated prices and supply quantities. However, the ambitious Roadmap did not include the initial proposal for the creation of a common gas purchasing agency, which would have replaced the controversial bilateral agreements. Not surprisingly, at the moment, the consumers in the

<sup>30</sup> European Energy Security Strategy, page 20, [http://ec.europa.eu/energy/doc/20140528\\_energy\\_security\\_communication.pdf](http://ec.europa.eu/energy/doc/20140528_energy_security_communication.pdf)

<sup>31</sup> European Energy Security Strategy, page 20, [http://ec.europa.eu/energy/doc/20140528\\_energy\\_security\\_communication.pdf](http://ec.europa.eu/energy/doc/20140528_energy_security_communication.pdf)

region pay close to USD 100 per 1000 cubic meters more than the average gas price in Western Europe.

In the new version of the EU Energy Union, the decision for the determination of member-countries' energy mix remains a national priority. The Commission's attempt to coordinate the member-states' external energy relations through financial incentives (more energy investments in Common Projects of Interest) and through infringement procedures could be a fiasco if there is no supranational energy strategy, which will overcome the tendency by member-states to only follow their own energy interests. The increased supervision of the Commission, on the other hand, over the intergovernmental agreements could provide the member-states with more bargaining power vis-à-vis external suppliers. This will make politically-led gas projects such as South Stream harder to circumvent European energy law and will also embolden the member-states to counter state capture risks of their energy sectors from foreign state interests.

## South Stream in Russia's overall natural gas policy

There are a number of factors that shape Russia's policy on South Stream. The government views South Stream as a way to boost exports to the EU, and at the same time, enhance EU's energy security by eliminating the transit risk through Ukraine.<sup>32</sup> According to the Russian Ministry of Energy South Stream is considered "a powerful tool for diversification of supplies", thus ensuring stability for Russian exports.<sup>33</sup> At this backdrop, the announcement of the Russian president to abandon the project in the beginning of December, 2014 seemed contradictory to Gazprom's overall strategy.

<sup>32</sup> Южный Поток. Значение проекта. <http://www.south-stream.info/ru/pipeline/significance/>

<sup>33</sup> Министерство энергетики Российской Федерации. Проект «Южный Поток». [http://minenergo.gov.ru/activity/co-operation/russia\\_eu/south\\_stream/index.php](http://minenergo.gov.ru/activity/co-operation/russia_eu/south_stream/index.php)

The fact that no official cancellation order has been yet issued by the Russian side suggests that the decision may not be yet final or could be part of a strategy for convincing the South Stream partners and the European Commission to follow through with the project despite the legal contradictions with the Third Energy Package.

## South Stream - a priority project for Russia

According to Russia's *2030 Energy Strategy*, the chief focus will be the development and territorial diversification of Russia's oil and gas infrastructure.<sup>34</sup> The main projects, identified by the Energy Strategy include:

- The "East Siberia – Pacific Ocean" Pipeline ("Восточная Сибирь - Тихий океан");
- Oil systems "North" ("Север") and "South" ("Юг");
- The "Nord Stream" ("Северный поток") and "South Stream" ("Южный поток") Pipelines.<sup>35</sup>
- A multiline gas transportation system from the Yamal peninsula;
- Port and transport infrastructure for liquid hydrocarbons (oil, LNG).

Among these, South Stream and Nord Stream should be perceived as projects for the elimination of the "dangerous dependency" on the transit monopoly of Ukraine, which in 2006 and 2009 interrupted the gas supply from Russia to the European markets. Gazprom's CEO even suggested that South Stream is key to ensuring the reliability of natural gas supply to Europe.<sup>36</sup>

<sup>34</sup> Энергетическая Стратегия России на период до 2030 года. <http://minenergo.gov.ru/aboutminen/energostrategy/>

<sup>35</sup> Энергетическая Стратегия России на период до 2030 года. <http://minenergo.gov.ru/aboutminen/energostrategy/>

<sup>36</sup> <http://www.gazprom.ru/press/miller-journal/966597/>

The same justification logic was applied prior to the commissioning of the Nord Stream pipeline, which created a direct non-transit connection between Russia and Germany, and hence avoided Ukraine. Nord Stream was also the first of the major Russian export pipelines that had been struggling with the Third Energy Liberalisation Package. Although Nord Stream was inaugurated before the Gas Directive, and hence was exempted from the third-party access clause, the European Commission did not allow Gazprom to use 100% of the pipeline capacity in the related OPAL gas pipeline on German territory transmitting the natural gas arriving from Russia. The paradox, raised by Gazprom, has been that there is no obvious source of an alternative gas supply for the pipeline, making the European claim against Gazprom's use of the 100% capacity illogical.

To find a compromise, in early 2014, the German Transmission Regulating Agency (BNetzA) proposed that Gazprom may use up to 100% of the OPAL capacity but would need to launch regular auctions for half of it to allow for competitions. The decision was never implemented after the European Commission extended indefinitely its final decision on the pipeline access status in March, 2014. Gazprom responded by disregarding the Commission's pending procedure, and said in late December that it will claim 100% of the Nord Stream capacity<sup>37</sup>. Until the announcement by President Putin for the cancellation of the South Stream pipeline, the latter hoped for a similar compromise. However, amid the rising tensions in Ukraine, the EC dodged the issue while insisting that Gazprom has to first apply for derogation of the Third Energy Package before any meaningful negotiations could start.

From the Moscow point of view, South Stream would have been the final step to achieving transit security put at risk by the 2006 and 2009 gas crises. As 2/3 of

the Gazprom's gas revenue comes from European clients, gambling on Ukraine's moves every winter was too big of a risk and a good enough justification to spend USD40 billion on a new pipeline route<sup>38</sup>. South Stream seemed to have two additional goals. On the one hand, the project could be seen as a disincentive for the construction of the competing Southern Gas Corridor aiming to transport Caspian, and in the future, Middle Eastern natural gas to Central and Eastern Europe. On the other, at the time of the initial discussion of South Stream, Gazprom was trying to leverage the project to pressure the Ukrainian government to sell a majority stake in its gas transmission system. For Kiev, losing ownership of the gas pipeline network would not only have meant loss of significant transit tariffs' revenue, but would have also removed the main bargaining chip in gas relations with Russia. In a paradoxical way, the European policy-makers have often justified their opposition to South Stream on the basis of the preservation of Ukraine's sovereignty. However, according to Gazprom, Kiev has exploited EU's policy to take advantage of its key transit position placing the whole energy security of the continent at stake.

Officially, being Russia's priority energy project, South Stream has been justified by Moscow with three main foreign policy and energy security objectives:

- Creation of a Eurasian integrated transport system ensuring the security of the transit flows between Europe and Asia.
- Regional leadership in providing Eurasian energy security;
- Russia's full integration in the global energy security system;<sup>39</sup>

<sup>37</sup> OilandGasEurasia. (22.12.2014). Gazprom to Claim 100% of OPAL Capacities, Gazprom Spokesperson Says.

<sup>38</sup> The South Stream project expected value

<sup>39</sup> Энергетическая стратегия России на период до 2030 года

The importance of the South Stream pipeline in Russia's overall energy strategy also explains why Gazprom has firmly opposed the EU *Third Energy Package*. In general, the Russian company sees the *Third Energy Package* as a way to limit EU's receiving capacity of Russian gas. Gazprom's CEO has claimed that the European institutions have used the *Third Energy Package* to prevent Gazprom maximizing its gas export capacity even despite the absence of gas competition in Central and Eastern Europe.<sup>40</sup>

Gazprom's second objection concerns the unbundling clause in the Energy Package. According to senior officials in Gazprom, it can severely limit the amount of investment in new and existing pipeline infrastructure. In general, pipeline investments are not considered highly profitable and very risky, as the return on investment is stretched over a very long period and depends largely on market conditions.<sup>41</sup> Gazprom claims that the Energy Package will severely limit the ROE leading in the long-run to the decapitalisation of the natural gas sector. Additionally, unbundling could also affect the security of supply due to the fragmentation of decision-making in the European gas pipeline system. In case of unbundling, the producer would be excluded from operational and investment decisions, which would significantly decrease the security of the whole system.

Finally, Russia has maintained that South Stream will accommodate rising European demand for gas. While this could have been the case in the early planning of the project between 2006 and 2008 when EU gas consumption was increasing very rapidly and long-term demand projections were very optimistic, the situation changed in 2009 with the onset of the global economic crisis. Consumption fell and loss-making utilities turned to cheap American, imported coal to

substitute the Russian gas, oblivious of the earlier commitments to the decarbonization of energy sector. Since then, overall Russian exports to the EU have not been affected significantly due to falling domestic gas production in the EU, and we are unlikely to see a large shift in Gazprom's sales to Europe until 2030 (mostly due to long-term contracts). Yet, the EU's commitment to diversification of supply sources coupled with a sluggish economic recovery would mean that Russia's share in the EU's total gas consumption can stagnate and even decline. The latter has been confirmed also by the Energy Research Institute of the Russian Academy of Science, which foresees until 2040 European gas demand will increase only slowly.

### **Turkish Stream: bluff or a strategic shift**

As mentioned above, in the beginning of December, 2014, Gazprom and the state-owned Turkish energy company, BOTAS, signed a Memorandum of Understanding for the construction of an underwater Black Sea pipeline parallel to the existing Blue Stream pipeline and with the same entry point.<sup>42</sup> The newly-dubbed Turkish Stream would have the same pipeline capacity of 63 bcm per year, and would involve the construction of four lines. From the entry point on the Turkish Black Sea coast, Gazprom has expressed commitment to build new pipeline infrastructure linking Turkish Stream with the Bulgaria (TransBalkan Pipeline) or to a gas distribution hub on the border with Greece. Out of the 63-bcm planned capacity, 14 bcm have been earmarked for the Turkish market substituting the existing gas supply to Turkey transiting Ukraine, while the rest could be transported in reverse along the TransBalkan pipeline or via a new pipeline infrastructure built from the Greek-Turkish border<sup>43</sup>.

<sup>40</sup> <http://www.gazprom.ru/press/miller-journal/966597/>

<sup>41</sup> Пресс-конференция на тему «Экспорт и повышение надежности поставок газа в Европу», <http://www.gazprom.ru/f/posts/68/042663/gazprom-export-stenogramma.pdf>

<sup>42</sup>

<http://www.gazprom.com/press/news/2014/december/article208505/>

<sup>43</sup> <http://itar-tass.com/ekonomika/1615321>

Since the launch of the Turkish Stream project idea, Gazprom has maintained that it is up to the European consumers to construct the necessary pipeline infrastructure to connect with natural gas hub to be formed on the Greek-Turkish border as the Russian state-owned company announced plans to divert the gas transit through Ukraine to the newly-built Turkish Stream. The EU has not provided Gazprom with a definitive response. However, the Russian argument can potentially contradict the contractual obligations Gazprom has under its long-term, bilateral gas sales agreements to provide uninterrupted gas supply to its European clients. The latter will remain the dominant contractual framework between Gazprom and European companies until the later part of the 2020s. Hence, it is highly unlikely that the EU will back down on Gazprom's demands for a cross-European commitment for the construction of a new pipeline infrastructure. In the end, a wait-and-see approach was the *modus vivendi* for Europe during the development of the South Stream project. A similar strategy is likely to be adopted in the Turkish Stream talks.

In addition, it is unclear whether Turkey would be willing to follow through with a project that will further deepen its dependence on Russian gas supply (currently at around 60% of its gas consumption needs). Its energy policy up to now has been based on the conviction that energy security can be achieved only through the gas supply diversification from as many sources as available. The Turkish Stream makes sense to Ankara only in the framework of a second line on the functioning Blue Stream under the Black Sea, so that Turkey weans itself off the transit risk of importing Russian gas via the Trans-Balkan pipeline originating in Ukraine.

## Conclusion

The Gazprom-led South Stream project has been an extremely divisive issue in the EU as the member-states have expressed different, and sometimes contrasting views on the pipeline. Naturally, the EU countries, directly involved in the project had been lobbying heavily for a common EU decision to allow the start of the pipeline's construction. South Stream has created an acute disconnect between the national energy policies of member-states and the common EU policy objectives that had primarily focused on energy source diversification, improving the reliability of supply and shifting towards sustainable energy solutions including via fostering renewable energy production and fostering energy efficiency investments. The pursuit of bilateral energy relations between member-states, on the one side, and external supplier, on the other, had been predetermined by the close relations of national energy majors, which as in the case of ENI and Gazprom prefer long-term strategic partnerships. The latter encompass predictable contractual terms in terms of pricing and volumes and cooperation on large-scale infrastructure projects that reinforce the already-developed relationships.

The two natural gas crisis in 2006 and 2009 predisposed the gradual dissolution of this model as the security of supply stopped being taken for granted by the trading partners. Even before the transit disputes with Ukraine, Russia had overestimated its ability to leverage the gas dependence of European countries to dictate contractual terms (take-or-pay and oil-indexation) in an environment of rising supply of alternative natural gas sources and the rapid increase of crude oil prices that ultimately also drove gas prices up. The European Commission captured the moment to foster a common energy policy approach. Energy became an integral, albeit limited part of the Lisbon Treaty and only three later in the aftermath of the second Ukrainian gas crisis, the EU adopted a

comprehensive energy liberalization package that aimed to integrate European energy markets and create powerful bulwarks for monopolistic practices of external suppliers in Europe.

While the Energy Package is yet to be successfully implemented in all member-states, it was able to take its first victim by preventing South Stream from proceeding without ensuring a third-party access to the transmission capacity. Without being able to fill in the pipeline at 100%, for Gazprom it would have been very difficult to make the business model case for a pipeline of this magnitude. In addition, by scaling down the capacity for Russian gas transportation, South Stream would no longer have been able to circumvent Ukraine completely as a major transit route. Hence, Kyiv would have continued to exert influence on the security of gas supply to Europe at a time when the EU is looking in all directions for new supply options.

Amid the conflict in eastern Ukraine the urgency for diversification became even more acute in Brussels. While Western European member-states have made a big step forward in improving their energy security, partially due to the change of the structure of global energy markets, Central and Southeastern Europe remain both highly dependent on one source natural gas and strongly influenced by foreign state interests shifting domestic decision-making for their benefits. In this environment, the European Energy Union could become an important driver of change by designing effective tools for enforcing energy market liberalization and integration, and pushing countries to diversify their energy supply. The blueprint announced on 25 February watered down, though, the initial ambitious plan for the creation of a common gas purchasing agency coordination supply and demand decision-making. The contractual nature of energy relations remain unchanged under the pressure of large consumers, which benefit from quantity discounts and bigger bargaining power. However, maybe as with other integration initiatives, the EU works best when it goes slow. The introduction of mechanisms for oversight of intergovernmental agreements is a step in the right direction. Whether this would lead to more predictability of supply is a question of political will. As with other policy initiatives targeting the CEE and SEE regions, enforcement is the key impediment. We can be sure of one thing - Russia will do everything possible to deter a change of the status-quo.