Summary: The EU and Russia seem destined to have a long-lasting energy relationship, but they are far from finding common ground on which to develop deeper ties. Moreover, in European policy debates, Russia regularly features as a welcome distraction from the issue that Europe is actually grappling with: completing its internal market. Ironically, it is this completion that could take away some of the concerns about Russian energy dominance, in particular in Eastern Europe.

European Energy Security and the Role of Russia

by Tim Boersma

Introduction
In March 2013, the coordinators of the EU-Russia Energy Dialogue, Energy Commissioner Günther Oettinger and Russian Energy Minister Alexander Novak, signed the Roadmap for Energy Cooperation to 2050. The document acknowledges that interdependence in terms of natural gas relations is likely to remain a key feature of mutual relations in the coming decades. Both parties envisage increased production of natural gas and the development of untapped fields in Russia, Russian gas market liberalization and free access to infrastructure, predominantly oil-indexed long-term contracts serving European demands, and an open European market where any producer, including Russia, is able to sell, and consumers to buy, without artificial trade barriers or discriminating rules, at reasonable prices.¹

Unfortunately, the reality of EU-Russian energy relations is less rosy. As this policy brief discusses, the EU and Russia seem destined to have a long-lasting energy relationship, but they are far from finding common ground on which to develop deeper ties. Moreover, in European policy debates, Russia regularly features as a welcome distraction from the issue that Europe is actually grappling with: completing its internal market. Ironically, it is this completion that could take away some of the concerns about Russian energy dominance, in particular in Eastern Europe.

Europe’s Dependence on Russian Natural Gas

Energy relations between Russia (then the Soviet Union) and Western Europe go back to the 1960s, when Soviet authorities and Austrian Österreichische Mineralölverwaltung signed a long-term contract and the first natural gas flowed from behind the Iron Curtain. In the midst of the Cold War, West Germany, Italy, Finland, Sweden, and later France signed contracts with the Soviets. Contrary to common realist thinking, the Soviets did not work according to some grand scheme to assert dominance over Western Europe. Soviet officials were wary of doing business with “the capitalists,” but at the same time they were not able to produce high quality steel to build their envisaged domestic

Meanwhile, EU import dependence on natural gas has risen steadily with the decline of domestic production, to over 62 percent in 2010. Whereas almost 80 percent of those imports come from only three countries, i.e. Russia, Norway, and Algeria, the share of Russia in EU imports of natural gas has been in decline since the early 2000s, from 45.1 percent in 2003 to 31.8 percent in 2010. Companies that have profited from this development and have taken market share in Europe come from LNG-producing countries, such as Qatar, Nigeria, and Libya. It is fair to say that, albeit indirectly, large-scale extraction of natural gas from shale-rock layers (known as shale gas) in the United States substantially contributed to this development. Recent developments on the other side of the Atlantic Ocean have inspired several European countries, most notably Poland, to believe they too can develop unconventional natural gas and become independent of Russia. Nevertheless, there is no realistic scenario available in which Russian natural gas is not a dominant feature of European energy supply. The European Commission estimated in September 2012 that even if the unconventional natural gas potential in the EU were to be developed, this would only be sufficient to maintain European import dependence at around 60 percent in the future. In an energy market based on competition (and assuming that there is some form of carbon pricing to avoid the continent from being flooded with cheap coal), prices inevitably dictate that a substantial part of Europe’s natural gas comes from Russia.

There is no realistic scenario available in which Russian natural gas is not a dominant feature of European energy supply.

Winds that have Shaken the Barley

The European Union is in need of stable supplies of natural gas. At the same time, Russia requires stable sales of natural gas in the EU, for currently there is no economically viable

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2 For a detailed account of the origins of European dependence on Russian natural gas, see Per Högselius, Red Gas (Palgrave MacMillan, 2012).


alternative market for its gas in Asia. In spite of these facts, the two parties seem to be drifting apart.

While the EU struggles to complete its internal market, based on liberalization and competition, state authorities in Russia have been strengthening their grip on the hydrocarbon sector. The 2006 supply disruption sparked heated political and academic debates in Europe, which remarkably often focused on defaming Russia. Subsequent legislative documents in EU member states seemingly focused on preventing Gazprom from entering the EU market, and mutual suspicion has grown since. European companies would like to access the Russian market to develop new resources and foster competition, whereas Gazprom is interested in further developing its position in Europe’s midstream and downstream markets.

The EU has been worried about the lack of investments in untapped fields in Russia, and Russia on the other hand has expressed its concerns regarding security of demand. In the meantime, global oversupplies in 2008, amongst others fuelled by the large-scale production of shale gas in the United States, demonstrated one of the downsides of oil-indexed long term contracts: gas prices in Europe stayed substantially higher than spot-market prices in Europe (at trading hubs in northwestern Europe, e.g. British National Balancing Point and Dutch Title Transfer Facility). Consequently, large natural gas consumers (e.g. electricity generators) called upon natural gas producers to renegotiate natural gas prices. Reluctantly, these producers, notably Gazprom and Algerian Sonatrach, have agreed to renegotiate some of the existing contracts. Hub-based prices and those in long-term contracts seem to have converged since the second half of 2009.

The European Commission has reported a significant fall in the share of oil-indexed gas contracts in 2010 (from 68 percent of natural gas consumption to 59 percent in the year after), due to an increase in spot-purchased gas (27 percent of gas consumption 2009 and 37 percent in 2010).

This means that new contract structures and formulas are becoming common sense in northwestern Europe, based on year and month terms instead of long-term. However, there is strong evidence that in continental Europe, this transition cannot be expected within the next five years, if at all. Many unknowns make it difficult to predict the future of oil-indexed contracts in continental Europe, such as future supplies in general, liquefied natural gas (LNG) demand and supplies elsewhere in the world, the potential extraction of unconventional natural gas, the design of future carbon policies, and the duration of the economic downturn. This uncertainty may add to already existing doubts about urgently required investments in natural gas infrastructure in Europe, which the European Commission estimates at around €70 billion in the period up to 2020.

Many unknowns make it difficult to predict the future of oil-indexed contracts in continental Europe.

Natural Gas as a Tool to Consolidate Russian Influence in CEE Europe

Particularly in Eastern Europe, debates about energy security focus on Russia and its reliability as a supplier of natural gas. The available evidence suggests that this debate is overblown. With the exception of Romania (which produces natural gas and is by and large self-sufficient) and Hungary, natural gas only plays a marginal role as a primary energy resource in eastern European countries, since the economies of these countries have historically been built on coal and oil. In addition, and despite the claimed security threat, these states in general did not make an effort to invest in alternatives for Russian natural gas. For example, Poland could have built interconnection facilities with Denmark and Germany a long time ago to provide it with direct access to substitute natural gas from the Netherlands and Norway. Ironically, the Danes are interested in building a connection with Poland to get access to Russian natural gas, instead of getting away from it. The fact that Poland did...
not invest in alternatives suggests that the threat may not have been as large as is often portrayed. Finally, empirical evidence suggests that more often than not, Russia failed to achieve the political concessions that it sought through supply disruptions.¹⁰

On the other hand, one would ignore reality by dismissing Gazprom’s dominance in parts of Europe’s natural gas market. The multiple pricing schemes it employs for its customers may not always be market-based. Moreover, though overall EU dependence on Russian natural gas did not increase in the period from 1998 to 2008, this is not the case for all individual member states. In fact, with the introduction of Nord Stream, the asymmetry in risk exposure in Europe seems to have increased. Hence this pipeline, which runs from Russia to Germany through the Baltic Sea and was designed to bypass unreliable transit states (Ukraine and Belarus) to safeguard energy security in Europe, in fact increases the transit risk in European countries it bypasses, such as Poland and Slovakia.¹¹

**The Challenge of European Integration**

Thus an interesting paradox emerges: Europe wants diversity of supply routes to be less reliant on transit states such as Ukraine and Belarus, and Russia too wants this diversity to facilitate its EU clientele. Yet the alternatives bring new transit risks, because Europe does not address energy security exclusively at the international level, but predominantly at the national level. In this regard, the existing European regulations to safeguard security of supply make clear that in the case of crises, a three-level approach is to be respected: one turns first to the relevant natural gas undertakings and industry, then to member states at the national level, and then to European institutions.¹²

This brings us to a broader question that European member states have to deal with: who is in charge of energy policy? Both the external and internal dimensions of European energy policy currently reside mostly at the member state level. In theory, this would not be problematic per se, since there are examples of well-functioning collaborations of nationally oriented policy domains (e.g. NATO). Yet regarding energy policy, the reality is that national approaches have resulted in a splintered landscape, where transparency and predictability are lacking. Within the EU, this has resulted in a patchwork of regulatory regimes, and a laundry list of required investments in energy infrastructure that are not made. Externally, it has facilitated dominant natural gas producers to close favorable bilateral deals. Now that these have come under pressure, this adds to already existing uncertainties and mistrust.

Europe has chosen to solidify the role of natural gas as a primary energy resource, as is shown by the substantial investment and coordination ambitions that are ventilated in the proposed regulation for energy infrastructure.¹³ This is an important step toward completing the internal market and would help to reduce single-source dependence in Central and Eastern Europe. Yet it is worth noting that without sufficient domestic natural gas production, external suppliers are always central to EU ambitions. Russia has been the largest supplier of natural gas to Europe and may be expected to maintain that position. It has tremendous internal challenges to overcome, but wants the EU as a reliable purchaser of natural gas, if only because alternative scenarios are currently unrealistic.

In contrast to prevalent realist thinking, there is not much evidence to support the position that Russia is not reliable as a supplier of natural gas. EU energy security in relation to Russia is about coherent EU policy toward external

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suppliers, and moreover about the development of the European internal market, in order to provide market players with the possibility to come up with alternative scenarios in case of supply disruptions. In both these fields, the EU is currently highly fragmented, and tremendous efforts are needed to improve the status quo. In the ongoing process of European policy formation, Russia regularly features as a welcome distraction from what the actual problem is: (the lack of) European integration and supplementary internal struggles for power.

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About the Author

Tim Boersma is a dissertation candidate at the University of Groningen and a non-resident fellow at GMF. From 2011 - 2012 he was a Transatlantic Academy fellow and based in Washington, DC. His research deals with energy policy coordination, gas infrastructure and regulation, energy security issues, and unconventional gas extraction. The views expressed here are the views of the author alone and do not necessarily reflect the stance of the German Marshall Fund of the United States.

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