



Transcript

Challenges in Russia- EU Energy Cooperation

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This is the text of a speech delivered in St Petersburg at a conference organised by the St Petersburg State University of Economics and Finance, 'Energetika XXI: Economy, Policy, Ecology', sponsored by Gazprom (general partner), Lukoil and Integra.

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James Sherr¹:

George Clemenceau famously remarked that war is too serious a matter to be left to generals. At a conference sponsored by Gazprom, I will not be so tactless as to say that energy policy is too serious a matter to be left to energy companies. But it is too serious to be left to any one profession or domain of expertise. Energy and energy security are multi-faceted and multi-dimensional issues. Yet in both Russia and the European Union, there are far too few people able to connect these dimensions in a reasoned and knowledgeable way. We need ten times as many such people if we are to avoid serious problems in future. Each of us has a responsibility to acquire a minimum degree of literacy in the core disciplines that define the subject. Experts in politics or geopolitics must make the intellectual investment necessary to understand the energy business as a business – and understand that even in a perfect world, a gas supplier's definition of energy security will be different from that of a gas consumer. Economists as well as planners and decision-makers in the energy sector must maturely accept that their business will advance and threaten political interests whether they have such interests or not.

Before going further, allow me to clear up one misconception. No informed person in the West believes that Gazprom pursues political objectives. But no one except a simpleton or a casuist will pretend that the Russian state does not use energy for political as well as economic ends. Gazprom expects the Russian state to secure the political conditions that allow it to realise its business objectives. The Russian state expects Russia's 'mighty energy sector' to provide the financial resources and economic power needed to pursue its political and geopolitical objectives.²

Today, everyone knows that Russia and the European Union have an interdependent energy relationship. But a lot of comfortable nonsense is said about it. Throughout history, interdependent relationships have been unhappy and characterised by mistrust. It is different from Cold War mistrust. For the most part, the Cold War military relationship was balanced, but it was not

¹ This is the text of a speech delivered in St Petersburg at a conference organised by the St Petersburg State University of Economics and Finance 'Energetika XXI: Economy, Policy, Ecology', sponsored by Gazprom (general partner), Lukoil and Integra. Certain alterations essential to the translation from spoken to written word have been made.

² According to the *Energy Strategy of Russia to 2020*, Russia's 'mighty energy sector' is 'an instrument for the conduct of internal and external policy' and that 'the role of the country in world energy markets to a large extent determines its geopolitical influence'. *Energeticheskaya strategiya rossii na period do 2020* (Government of the Russian Federation, 28 August 2003, No 1234-g).

interdependent. Today's energy relationship is interdependent, but it is not balanced. Russia has energy strategies which, with greater or lesser success, are implemented in practice: the 'Energy Strategy to 2020' that I just referred to and the 'Energy Strategy of Russia for the Year 2030' that was the subject of Aleksey Gromov's presentation.³ The EU has a common trade policy and a common fisheries policy, but it does not have a common energy policy. To be sure, the European Commission has tried to formulate a common policy.⁴ But in this domain, competence resides for the most part in member states. And despite the fact that the Commission has some prerogatives, the business of monitoring and regulating the activity of non-EU entities in our energy markets - and the business of law enforcement - is dependent upon the adequacy of national institutions. In several new member states of the EU, we are obliged to talk about the inadequacy of these institutions. And this is known to, indeed exploited by, many of the Russian energy entities that seek access to our energy infrastructure and markets. This, to put it mildly, creates a level of apprehension and tension. So does the inadequacy of institutions in the Russian Federation itself, where the absence of firm traditions of property rights, judicial integrity and sanctity of contract leave Western as well as Russian companies vulnerable and often hostage to rivalry between financial and economic groups close to the state.

This apprehension naturally reinforces a deeper concern that others in this conference are almost certain to talk about: the impending imbalance between demand and supply (only temporarily alleviated by the financial crisis) and the fear that we might find ourselves dependent on what Russian authorities do or fail to do to address the problem. These tensions and apprehensions have led the European Commission to call for 'diversity with regard to source, supplier, transport route and transport method'⁵ But I believe we need to think about 'dependency' and 'diversity' with more discrimination than we often do.

- The EU as a whole does not suffer from excessive dependency on Russia, at least not today. In 2007, natural gas accounted for 24 percent of EU energy consumption, and Russian deliveries accounted for 29 percent of that. Some EU member states suffer

³ Aleksey I. Gromov (Institute of Energy Strategy), presentation at this conference: 'Approaches, Priorities and Reference Points of Energy Strategy of Russia for the Year 2030'

⁴ See for example, 'Communication from the Commission to the European Council and the European Parliament: 'An Energy Policy for Europe' (SEC(2007) 12) (Brussels 10 January, 2007 COM(2007) 1 final), p 3.

⁵ *Ibid.*

from undue dependency on other countries and regions. When Italy increases its supply of Russian gas, it is not 'deepening its dependency upon Russia', it is diminishing a dependency on North Africa. In other words, it is diversifying supply.

- Nevertheless, a number of member states are excessively dependent upon Russian gas, not to say oil, and it is right that we regard this a problem for the EU as a whole. Yet it is eminently possible to *reduce* dependency on Russia—by modernisation, conservation and efficiency; by building interconnectors to distribute gas surpluses; by investing in storage and other infrastructure—without indulging in visionary projects to *bypass* Russia. And these home-grown efforts might prove more sustainable and less hazardous than efforts that are politically more adventurous.
- For a whole host of reasons, the EU will also need to change its energy mix and develop new sources: nuclear power, LNG, newer coal-burning technologies, renewables and improved gas extraction techniques. The financial crisis expands the grace period required to shift direction in this way. Whether we meet our targets or not, these efforts will gradually acquire momentum, so that pre-2008 levels of growth are no longer accompanied by pre-2008 levels of anxiety about dependency on any single supplier. Russia will remain a prominent factor in our markets, but the trajectory to dominance looks less likely than it did even a short time ago, and Russia will have to accept this.
- But how important are new suppliers? What benefits are they likely to bring? What risks? Western specialists worry about diseconomies in Russia's energy sector and consumption—and rightly so, because Russia consumes as much oil and gas per year as the UK, Italy, Japan and India combined. Yet compared to Iran's energy sector, Russia's is a model of efficiency and good management. Even if political problems subside, will Iran be a reliable supplier? Will Turkmenistan? No one should minimise the problems that have arisen between Russia and Turkmenistan. But it is fancifully Eurocentric to assume that Ashgabat will, in defiance of both Iran and Russia, build a direct connection to Europe via a Trans-Caspian pipeline, instead of emphasising

Indian, Pakistani and especially Chinese energy markets as a way of counter-balancing Russia's influence.⁶

Concentrating the EU's efforts on the construction of elaborate pipeline projects bypassing Russia is less likely to produce a strategic solution than a strategic diversion.⁷ The strategic problem is to make interdependence with Russia work. That, as I have said, requires the EU to develop resources, capacity and cohesion. But it also requires the EU and Russia to overcome two obstacles.

The first of these concerns rules of the game. When Russian energy entities seek to expand their presence in our markets in accordance with EU laws, regulations and norms, there is nothing wrong with this even if, in some places, their presence is disliked. But when they use intelligence methods to exploit vulnerabilities, influence politicians, eliminate competitors or deceive partners, then they will encounter resentment and resistance. Despite well known divisions inside the EU, that resistance is likely to grow rather than diminish. So will questions about transparency. At one level, transparency is the ability to know what decisions are taken, where they are taken, by whom they are taken and why. But at another level, it is simply the ability to know who people are and who they represent. As a case in point, pay a visit to the website of the Public Limited Company, StatoilHydro. There you will see the entire structure of corporate governance, share ownership, membership of the Executive Committee and Board of Directors, Articles of Association, the mechanisms designed to insulate the company from political pressure, inventories, budgets, statements of profits and loss—and on all of these subjects, you will find links to other links that can keep you on the site for a month. Now pay a visit to the websites of some of the leading private Russian entities that operate in our markets and compare what you see there.⁸

The second is Ukraine. We all understand the economic facts, as well as the contractual problems and payment issues that lie ahead. But we need to face up to the political facts: the interests, ambitions, passions and phobias that make it impossible for any serious commercial dispute between Ukraine and

⁶ Its western ambitions could well take the form of a transit route across Iran, which would not displease Turkey, but would be deeply problematic for the EU as well as the United States.

⁷ In this conclusion, I share the view of my former colleague, Andrew Monaghan, *Russia & the Security of Europe's Energy Supplies: Security in Diversity?* (Shrivenham UK: Conflict Studies Research Centre, UK Defence Academy, Special Series 07/01, January 2007)

⁸ No doubt I should have added, but failed to add a point I have made elsewhere: 'To Russia's mega-economic actors, 'markets' exist wherever money-commodity relations exist, however unbalanced, inequitable or monopolistic they are. But from the perspective of the European Commission, monopoly is the antithesis of markets, which, in principle, mean choice for buyer and seller'.

Russia to remain a commercial dispute. Until these political facts change, Ukraine and Russia will not be able to manage their energy problems on their own. These problems are also the EU's problems, because 80 percent of the gas we import from the former USSR reaches us via Ukraine, and a high percentage will continue to do so even if, many years from now, Nord Stream and South Stream are built.

If we wish to avoid a replay of the crises of 2006 and 2008, we need to redefine this relationship. One way of doing so would be for the EU take delivery of Russian gas on the eastern rather than the western border of Ukraine and pay Ukraine an EU transit rate to deliver this gas to the European consumer. This step might create the conditions needed to:

- institutionalise the EU's participation and presence in a relationship characterised by mistrust, chicanery and reckless behaviour; transform the bilateral relationship into a trilateral relationship;
- provide Ukraine with finance for modernising, rationalising and expanding an opaque and convoluted energy system, damaging to its own energy efficiency, tax revenue and the development of indigenous energy resources through internal and foreign investment;
- provide properly motivated Ukrainians with the leverage they need to oppose the trans-national interests that benefit from today's malign status quo—in other words, shift the balance of incentives;
- ensure that bilateral Russia-Ukraine gas contracts conform to market conditions and international best practice;
- strengthen Ukraine's confidence that EU-Russia partnership will not be built at its expense.
- strengthen Russia's confidence that Ukraine will fulfil its contractual obligations and be a predictable partner;

Russia will not secure EU support, let alone trust, in this trilateral relationship if its aims are different from these. The EU will not secure greater influence in this relationship if it is not willing to assume greater responsibility. These are the preconditions, along with agreed rules of the game, for transforming an

unbalanced interdependence into a mutually beneficial one. Until we fulfil them, we will have difficulty looking at problems and solutions on their merits. Once we fulfil them, we might find that the obstacles to North Stream diminish, the case for South Stream recedes and the Nabucco project dies of natural causes. But we should have no illusions. We will have no partnership worthy of the term without a degree of sobriety and wisdom from Russia—and a degree of foresight and moral fibre from the EU—that so far has been absent. Until these qualities are present, we will find ourselves subjected to more instability in energy markets and more political turbulence in Europe.