

Europe's 28 Russian energy questions

11 April 2014

Summary:

Vladimir Putin's letter to European leaders has raised the threat of gas supply disruption in Europe and once again posed the question - how reliant should the EU be on Russian gas imports? However, in European energy security there are 28 different 'Russia questions' - one for every member state. As a result a grand European response is unlikely and there are also reasons to doubt Russia's main energy partners, Germany and Italy, will want to abandon that relationship. However, there are a range of smaller actions linked to greater interconnection, supply diversity and Europe's antitrust case against Gazprom that should be closely watched. What is less clear is what these actions will add up to and whether this will amount to a significant change in Europe's energy relationship with Russia.

In a letter to European leaders, Russian President Vladimir Putin on 10 April warned that Russia's Gazprom may ultimately be "compelled to...completely or partially cease gas deliveries" to Ukraine after Monday's failure by Ukraine's Naftogaz Ukrainy to settle over \$2.2 billion of unpaid gas bills. This has raised the threat of energy supply disruption in Europe in the coming weeks. This latest twist comes as the unrest in Ukraine has already pitched Europe's relationship with Russia back to the top of the policy agenda. Europe is once again being posed the question of how reliant it should be on Russia as a source of the gas used to generate its electricity, heat its homes and power its industry.

The reality is that there are 28 different questions - one for every member state. Dependence on Russia differs in important ways from country to country with significant implications for the ability of Europe to provide a coordinated policy response. The near total reliance in the south-eastern and

Baltic EU states means they face the Russia question most sharply, but it is Germany and Italy who have the market power to impact on the relationship.

There are serious question marks, however, around how they will choose to use that market power. Their energy relationship with Russia is deep and unpicking it would bring significant costs. Beyond the big players there is likely to be a patchwork of responses in Europe, with the emphasis on resilience, diversity of supply and reducing Gazprom's market power - not least through the European Commission's soon to report antitrust case. The question is how effective will these responses be, and what will they add up to?

28 different questions

The dispute between Naftogaz Ukrainy and Gazprom revolves around two issues. One is the unpaid debt of \$2.2bn. The other is price. Gazprom has revoked both a prior rebate on gas sales and a price reduction negotiated in

2010 as part of the Kharkov Agreement for the renewed lease of Russia's Black Sea port in the Crimea. Consequently, the price at which Ukraine buys gas will rise from \$268.50 per thousand cubic metres (tcm) to \$485 per tcm.

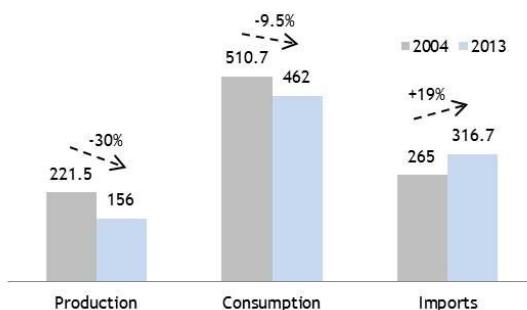


Fig 1: Selected European gas data
Source: Eurogas

Without assistance Ukraine will not be able to pay these bills. As a result Gazprom may consequently be presented with the option to trigger contract clauses to force Ukraine to pay in advance for its gas, and refuse to continue to supply Ukraine until it does. Its ability to do so without damaging the transit of gas to Europe is however limited, as we saw during a similar episode in 2009 when gas destined for Europe was diverted into the Ukrainian system after the country's own supply was halted. With just over half of Europe's imports from Russia transiting Ukraine it is clear why this turn of events has caused anxiety in Europe, and prompted a refocus on Russia as Europe's largest energy supplier.

But just how important is Russia in the broader picture of Europe's energy security? European gas consumption has fallen by 15% since 2008 - the result of the economic downturn and a surge of cheap coal imports searching for a market after the US shale gas revolution. However, European production has fallen twice as fast - almost 30% in the last decade - largely due to a rapid drop off

from the UK North Sea. As a result, Europe is more import-dependent than ever: gas imports are up by a fifth and import's share of total consumption has grown to around two-thirds from a half (Fig 1).

Until recently Russia's market share within the import mix was being eroded by rising LNG imports from Qatar and a growing share for Norway's Statoil (Fig 2). However, data for 2013 puts Russia's share - possibly as a result of price cuts in its larger markets - back up towards 40%, a level last reached in 2007 (Fig 3).

As a result of developments in Ukraine there is much discussion of the 'European' energy relationship with Russia. Despite the ambition of the Commission for a unified European approach, however, energy security threats remain primarily a national, rather than pan-European issue due to geographic factors and fragmentation in the internal energy transmission infrastructure. Consequently, both European member state dependency on Russia and their perceptions of vulnerability to disruption differ widely from country to country.

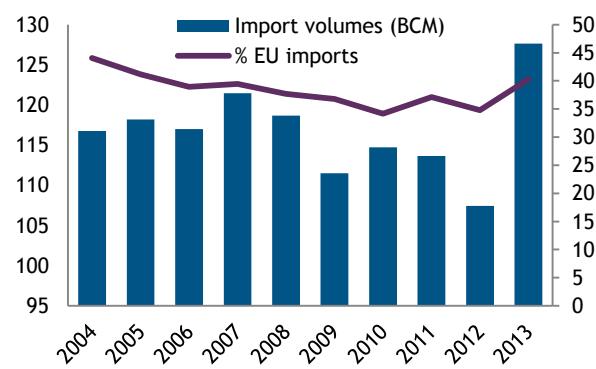


Fig 2: Russia gas imports to EU
Source: Eurogas

Whilst countries such as Slovakia and Hungary are around 80% reliant on Russian gas imports, their proximity to Austrian gas hub Baumgarten provides the security of

alternative supply. Germany receives a large import volume from Russia but its Nord Stream pipeline bypasses Ukraine. Countries such as Romania and Slovakia would be able to use their ample gas storage to see them through two to three months of disruption. The standout case is Bulgaria. The country is almost 100% dependent on Russian imports - all of which transit Ukraine - and although it has enough storage for almost two months, the rate it can withdraw stored gas would only replace two thirds the flow of Ukrainian imports.

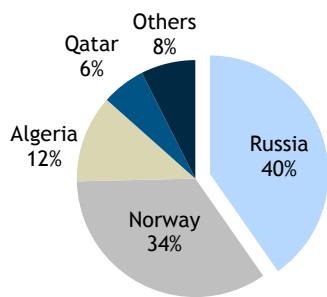


Fig 3: Origin of 2013 gas imports to EU
 Source: Eurogas

So while much of Europe is dependent on Russia, they are dependent in different ways (Fig 4). An important result is that individual member states will see the ‘problem’ of Russia - and its solution - very differently. Lithuania has for a long time sought alternatives to Russian supply and been heavily critical of Gazprom. Meanwhile Bulgarian Energy Minister Dragomir Stoenev has been actively advocating Gazprom’s proposed South Stream pipeline through the country, insisting it “should go uninterrupted because of its strategic importance for the whole of Europe.” In this context the EU will struggle to achieve a cohesive, coordinated European response.

How far will Europe go?

For those seeking a ‘big’ change in Europe’s energy reliance on Russia the spotlight will be on Germany and Italy. Simply by virtue of their size - between them they consume around 45% (50 bcm) of the EU’s total Russian imports - they have the largest potential to change the terms of the relationship. With the addition of Poland, Hungary and France these five largest consumers account for two thirds of all Russian gas entering Europe.

However, there are a number of reasons to think that neither Germany nor Italy will be in a rush to effect major changes to their energy relationship with Russia. First, because both German and Italian energy companies are tied into long term contracts for sometimes decades ahead on take-or-pay terms which will be expensive and difficult to unpick.

Second, it would also be difficult and expensive for Germany and Italy to source additional energy supply in the near future. It is estimated that extra Norwegian supplies to Germany would be limited to 10bcm - only a third of its Russian supply - and an amount which could impact on the Norwegian supply to other member states such as the UK. Italy’s nearest suppliers, Algeria and Libya, are both countries with serious security of supply issues of their own. Accessing LNG would be possible, but costly. And the restarting of German nuclear power plants seems a distant prospect in the face of strong public opposition.

Finally, alongside Germany and Italy’s deep commercial links with Russia, there is both a high level of personal engagement with the country (exemplified by former German Chancellor Gerhard Schroeder’s position on the board of Nord Stream) and the view,

strongly held by many, that trade builds strong mutual dependence.

The Commission and individual member states will be focussed on using the tools available to them to encourage diversity of supply in the long run, and taking incremental - but not unimportant - steps to improve resilience to supply disruption in the medium term. This will be coordinated where possible, but bilateral and unilateral where necessary.

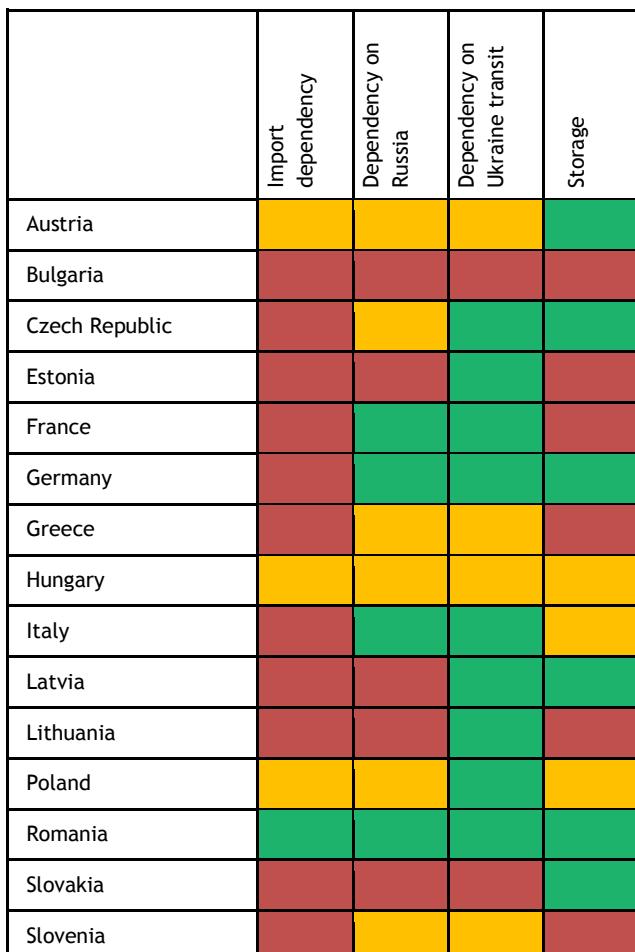


Fig 4: European energy security*

Source: Eurogas, Gas Infrastructure Europe, Global Counsel calculations. Import dependency [% total supply]: Red >80%, Yellow 80%-50%, Green <50%. Dependency on Russia [% total supply]: Red >80%, Yellow 50%-80%, Green <50%. Dependency on Ukraine transit [% total supply]: Red >80%, Yellow 50%-80%, Green <50%. Storage [no. days import substitution]: Red <30, Yellow 30-60, Green >60.

For alternative sources of supply the focus has fallen on LNG from the US and the Southern Gas Corridor from Central Asia and the Middle East. Neither is guaranteed, however, due to political, regulatory and technical obstacles in the first instance and commercial obstacles in the second. European production of shale gas could also bolster resilience, but even production in the UK - arguably the member state most advanced towards production - is unlikely before towards the end of the decade. However, energy security concerns are likely to support a continuation of the recent resurgence of coal in power generation and have added a 'security of supply' rationale to support for renewables.

The Commission has called for an acceleration of interconnection of the European grid, and isolated member states will be redoubling their efforts. This will be financed using the EU's Connecting Europe Fund, although with only €5.85 billion between 2014 and 2020 allocated for energy projects, the impact will be relatively limited. There will also be a renewed emphasis on increasing reverse flow capabilities in existing pipelines to allow more gas to move south and eastwards through Europe.

The Commission will also use its regulatory tools. It will focus on ensuring third party access is maintained on new transmission infrastructure to encourage competition and alternative supply. A leaked briefing by President Barroso suggests that the Commission will take a tough line on South Stream's application for exemption from the requirement to allow others to use the pipeline's capacity.

In addition, the European Commission's DG Competition antitrust investigation into Gazprom is likely to deliver its 'statement of objections' in May. The report is expected to

be strongly negative and support accusations of price-fixing and abuse of market power, with the possibility of both fines from the Commission and lawsuits launched by European energy companies. The investigation could uncover and put an end to Gazprom's alleged use of illegal 'destination clauses' which restrict the onward sale of gas by purchasers. If it does, this will remove what has been one of the major obstacles to greater connectivity within the European gas market.

The impact of the Ukraine gas disruption in 2009 on traded volumes of gas was modest, but perceptions of Russia are now significantly more negative, and consequently the response this time around could be more significant. At a minimum there is likely to be a patchwork of responses - a combination of regulatory pressure from the Commission and steps towards greater interconnection between national markets.

The objective will be to ensure no individual member state is left isolated in the face of possible Russian supply disruption. Europe's most isolated markets - Bulgaria, the Baltic States - require guarantees of access to relatively small volumes of gas to provide security. In addition the Commission's antitrust investigation into Gazprom could remove obstacles to the flow of gas between European markets, and limit the extent to which isolated member states can be exploited. The coming months will show whether or not Europe has the appetite to go further than this.

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