

IV. Energy Security in Mogherini's Strategy: Conclusions for Russia

A Global Strategy on Foreign and Security Policy of the European Union issued in June 2016 reflects comprehensive understanding of security that is traditional for the EU. Among other aspects of security, the document particularly highlights the issues of energy

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security.¹⁵ In order to assess the effect of GS on relations between Russia and the EU in the energy sector we shall first address the situation in Russia and provide a general overview of the contemporary state of its energy sector and particular features of the energy policy. The second section analyses basic trends of the EU energy policy. Finally, the closing section reveals how the priorities of GS in the energy policy may influence EU-Russia relations and affect Russia's interests.

Russia

Russian energy sector has found itself in the «perfect storm» in the past two years – it has confronted a number of economic (global, regional and national) and political challenges (external and, to a lesser degree, domestic). The key external challenges have economic character – these are the stagnation of demand in the global market, higher competition on the part of particular traditional and new producers of hydrocarbons and sharp drop in prices in 2014-2016. The fact that the new state of the market is a long trend was grasped by the Russian government only in the beginning of 2016.

Besides that, the development of the energy sector is still held back by the inefficient regulatory environment: these are the basic «afflictions» of the Russian economy (corruption, monopolization, etc.) and the specificity of the government's policy in the energy sector (tax treatment, «hands-on management», combination of market and non-market regulation). «Low cost» oil and gas fields, developed during the Soviet period, have been depleting; maintenance of recovery rates in the foreseeable future will demand the launch of extraction at the deposits which are difficult to access and expensive to exploit.

¹⁵ European Union (2016) Shared Vision, Common Action: A Stronger Europe. A Global Strategy for the European Union's Foreign and Security Policy. June 2016. P. 22-23

Sanctions imposed by the West in connection with the Ukrainian crisis have not caused major problems for functioning of the energy sector in the short- and mid-term perspective. However, the continuous ban on acquisition of technologies may substantially limit productive capacities (the Arctic Region, deep-water fields, shale oil) in the long-term, because Russian companies do not have proper technologies, equipment and specialists.

Among the most effective measures, the ruble devaluation should be mentioned.

Despite these and other adverse factors, the Russian energy sector has retained stability; to a considerable degree, this was

due to the competent actions taken by the Russian government. Among the most effective measures, the ruble devaluation should be mentioned. Since most of the revenues of oil companies are dollar-denominated and most of their expenditures go in rubles, the devaluation made it possible to soften the consequences of the drop in prices of hydrocarbons. Stable performance of oil companies was also maintained by tax benefits.

The reduction of investments and freezing of several major upstream projects was a response to the crisis at the corporate level. Yet, for the time being, this has not produced any direct negative effect on the development of energy sector, because the level of production in the mid-term perspective is restricted by the sinking demand. The size of idle production capacities in the gas sector is particularly big. By tradition, the first thing to be reduced is the amount of exploration drilling, but, with the prices at nearly \$30 per barrel, many oil companies have planned a reduction in the production drilling.¹⁶

The crisis in the past few years has boosted government intervention in the oil and gas business. It is the state-owned companies that become chief beneficiaries of the support arrangements. Government management of the key energy companies is aimed to control financial flows; besides this, government management in the gas industry is necessary for the supply of gas to the depressed regions and, generally, for maintaining low domestic gas prices,¹⁷ as well as for using Gazprom's export earnings to finance social expenses.

¹⁶ Analytical Centre (2016) under the Government of the Russian Federation. Neftedobycha: na grani snizheniya? [Oil production: on the verge of decline?] Energeticheskii byulleten, No. 32, January 2016

¹⁷ For these reasons, and due to devaluation, Gazprom is not getting profit in the domestic market in 2016, for the first time since 2008.

The trend for partnership with Western energy companies, noticeable before 2014, is now broken.¹⁸ Western companies were compelled to abide by the sanctions regime, while Russian companies were looking for more reliable partners in the East. But despite the abundance of plans, the «turn to the East» has not yet yielded tangible results in the energy sector.

It is difficult to forecast the future of long-term adaptation of Russian energy sector to the new situation in global markets.

Actions, taken by the Russian government, ensured the sector stable functioning during the crisis; for now, there is

no factors that could endanger this stability in the mid-term. At the same time, the policy of Russian authorities and actions by the Russian companies were mainly retroactive. It is difficult to forecast the future of long-term adaptation of Russian energy sector to the new situation in global markets or predict whether or not institutional reforms will be taken in the sphere of energy production.

At the European dimension Russian energy sector companies are facing increasing difficulties of economic, regulatory and political nature: the sinking market of oil and gas; increasing competition with the Middle East and African suppliers; need to adopt business model and especially construction and management schemes of gas pipelines to comply with the Third Energy Package; anti-trust proceedings against Gazprom; customers' desire to revise the linkage between oil and gas pricing; politicization of energy issues, and related desire to reduce dependence on Russian hydrocarbons and dislike of Russian pipeline projects.

During the past years Gazprom has adapted itself to the new realities of the European market. Granting of discounts, partial revision of long-term contracts, account of spot prices when pricing long-term contracts, retroactive compensation of «extra» payments to consumers – all this has allowed to preserve its share in the European gas market. But the increase of supply is not on the agenda, although Gazprom has substantial free capacities.

Thanks to the devaluation of ruble, the breakeven rate in deliveries of oil and gas to the EU market was substantially reduced. For example, the price of \$30-50 per barrel is quite acceptable for Russian oil producers, especially for the oil

¹⁸ Several major projects have been suspended between ROSNEFT, on the one hand, and EXXON, ENI, STATOIL, BP, on the other, as well as between LUKOIL & TOTAL and between GAZPROMNEFT & SHELL.

recovered from old fields. Besides, the availability of infrastructure built in the Soviet time, which was cost recovered a long time ago, also favors Russian companies. Russian hydrocarbons can withstand the price competition. Moreover, in order to keep the market share, it is possible to copy the practice of aggressive sales employed by Saudi Arabia. Yet, there is no significant degree of readiness of Russian energy companies to initiate a new round of price wars.

In the present-day conditions of economic stagnation and extremely scarce access to capital markets, Russia is more than ever interested in the inflow of foreign currency from the export of hydrocarbons and, respectively, in the stability of transit. This imperative, coupled with the available negative experience of dealings with the Ukrainian authorities, underlies all attempts to build bypass pipelines. However, Moscow, forced to act in the complicated political circumstances and to take into account diverging and shifting interests of numerous state and corporate actors, often improvised in promoting bypass pipelines.

The infrastructural unity of the EU energy market is insufficient to provide a merger of the national energy markets into a common market.

Two goals underline Russia's long-term export strategy: maintenance of the 30% share in the

European market and increase of supply to the East. Supply to Asia will not reach the level comparable to the supply to Europe even in the long-term perspective. That compels Russia to be particularly concerned with the political and regulatory changes in the European market.

European Union

A totally new feature of the EU energy sector is the fact that technical progress and consistent energy efficiency policy allows the EU to proceed with the economic growth with virtually stable energy consumption. Coupled with the economic crisis of 2008-2009 and the following stagnation, this has brought about a substantial reduction in energy consumption: gross domestic energy consumption in the EU today is at the 1995 level, gas consumption – at the 2000 level and oil consumption stagnates at the level of late 1990s.

This trend is not a part of the external economic policy, nevertheless, the reduced consumption helps to compensate the decline of hydrocarbons production. Due to this, the demand for imported hydrocarbons in the EU either stagnates or grows at by far smaller rates than was expected earlier. Alongside the appearance of new

suppliers, this has created a major excess of supply over demand in the EU energy market. It is already clear that the market will be unbalanced until at least the first half of the 2020s. This enables the consumers to run the show.

In light of the new opportunity, the European Union is purposefully changing the legislative and regulatory environment both in its domestic market and in its relations with foreign suppliers (the Third Energy Package, increasing competition in the market, promotion of spot trading in gas, etc.). The results of the EU energy market liberalization are quite controversial: a lot has been done, but the attainment of the goals is yet a long distance away. The legislative and regulative environment of the energy market is still extremely heterogeneous and unable to secure the desired level of competition. Significant success in establishing a competitive regime has been scored only in Great Britain, the Nordic countries and, to a lesser extent, in the central part of Western Europe.

The infrastructural unity of the EU energy market is insufficient to provide a merger of the national energy markets into a common EU market. The strategic goal of infrastructure development has changed: previously this was done in order to stimulate competition, while now the aim is to provide the security of energy supply, to enable a manoeuvre of the physical supply of energy and reverse flows. This has accelerated the implementation of a number of projects that deteriorate negotiating positions of Russian energy suppliers (for example, the North-South Gas Corridor in the CEE countries).

Today, instead of a single competitive EU energy market, there exists a cluster of national/regional oligopoly markets, which are not very strongly linked together, and the competition environment is maintained not only by the market forces but by the increasing state regulation. Political aspirations for a continuous liberalization of the energy markets are very high. These reforms have not been intentionally spearheaded against Russia, but they objectively run counter to the interests of the Kremlin and Gazprom, because the goal of these reforms is to perpetuate the allocation of risks, commitments and pricing methods to the advantage of consumers. In the existent «consumer market», it is extremely difficult for suppliers to oppose these actions taken by the EU.

In the early 2010s the EU became quite active in the field of external energy policy, i.e. precisely in upholding the interests of European energy consumers in their relations with the supply countries. This dimension of energy policy is most politicized and securitized, because Brussels cannot regulate it by means of its own law-making and, in fact, has no authority to negotiate with external actors.

For instance, S. Haghighi is compelled to admit that even after the Treaty of Lisbon entered into force the security of energy supply at the external level predominantly remains in the competence of member states.¹⁹ Likewise, Russian experts have concluded that the European Union, although in possession of a substantial internal competence in energy matters, is incapable of carrying out external energy relations and conclude international energy treaties with third countries either on its own or jointly with its member states.²⁰

Consequently, the European Commission external energy policy was focused on the implementation of three strategies.

1. Export of energy acquis to third countries, for example, in the format of the Energy Community (for Russia, this strategy yielded effect only in the field of energy efficiency and, to a lesser extent, in the renewable energy development and climate).

2. Use of internal laws on the functioning of energy markets in order to influence foreign suppliers. The most well-known example is the application of the Third Energy Package rules to pipelines projects that are only partially situated on the territory of the EU and the blunt refusal to discuss the special status of transcontinental pipelines. European Commission's anti-trust proceedings vs Gazprom, launched in September 2012, are a part of this strategy.

Besides, a mechanism for information exchange on bilateral inter-governmental agreements of the EU member states with third countries was introduced in 2012. While relying on the information received from member states, the Commission is taking measures to coordinate the activities of the EU countries. Among other things, it identifies best practices and develops model provisions for future agreements. One of the elements of the incipient Energy Union is the currently discussed modification of this mechanism. Yet, the European Commission is unlikely to get the right to veto the signing of new inter-governmental agreements between EU member states and third countries. Besides, it is doubtful that the information exchange mechanism would cover commercial contracts.²¹

¹⁹ Haghighi S.S. (2008) Energy security and the division of competences between the European Community and its member states. *European Law Journal*. 2008. Vol. 14. No. 4. P. 478.

²⁰ Seliverstov S.S., Gudkov I.V. (2014). *Energeticheskoe pravo Evropeiskogo soyuza* [Energy law of the European Union]. Moscow: Aspekt Press, p. 29.

²¹ Kaveshnikov N. (2015) Proekt energeticheskogo soyuza ES v kontekste otnoshenii mezhdu Rossiei i Evropeiskim soyuzom [The Energy Union project of the European Union in the context of EU-Russia relations]. *Vestnik MGU. Seriya 25: Mezhdunarodnye otnosheniya i mirovaya politika*. no. 2. S. 73-95.

3. Foreign policy activities, which often stem from geopolitical considerations, for example, the attempts to set up various energy alliances and the support for politically motivated pipeline projects.²²

The Commission already has some experience in rendering support to the EU countries when conducting bilateral negotiations on energy matters. Besides this, the Commission acted as a negotiator on behalf of the EU on several occasions. In 2014–2015, the Commission successfully acted as a go-between in the energy dispute between Russia and Ukraine and made tangible contribution in supporting Ukrainian transit and safeguarding energy security of the EU.

In import diversification, EU concentrated main efforts on the access to oil and gas resources in Central Asia and to gas in the Gulf. But, except the Trans-Anatolian Gas Pipeline (TANAP), most of these projects still remain a dead letter, because of poor cost recovery and regional instability.

The European Union has scored more success in promoting the imports of liquefied natural gas (LNG). Yet, LNG is usually more expensive than the pipeline gas, and, therefore, in the past few years LNG terminals in the EU were used only to one third of their capacity.

The EU approach to various pipeline projects reveal its deliberate eagerness to limit the volume of energy resources supplied from Russia.

Actually having no formal authority in the sphere of external energy policy, Brussels

has already repeatedly demonstrated its political significance and skill in using the available limited range of policy instruments. The policy of supply diversification and the EU approach to various pipeline projects reveal its deliberate eagerness to limit the volume of energy resources (primarily of natural gas) supplied from Russia, even to the detriment of the economic logic.

Global Strategy

GS touches upon the issues of energy security in greater detail than the 2006 European Commission Communication «Europe in the World»²³ and the 2008

²² Kaveshnikov N. (2014) The issue of energy security in relations between Russia and the European Union. *European Security*. 2010. Vol. 19. No. 4. P. 585–605; Buchan D. (2011) Expanding the European dimension in energy policy. Oxford Institute for Energy Studies.

²³ European Commission (2006) Communication. Europe in the World — Some Practical Proposals for Greater Coherence, Effectiveness and Visibility. COM (2006) 278, 8.6.2006.

Report on Implementation of the European Security Strategy.²⁴ General ideology behind GS is based on the ideas of European Energy Security Strategy,²⁵ but there are new points resulting from the document's foreign policy nature and desire to take into account economic and political developments of the last years.

The EU concept of energy security is historically based on the desire to achieve three goals: secure, affordable and sustainable energy. The EU politicians talk about the need to balance these goals, but it is practically impossible to achieve.²⁶ As a result, the EU energy policy is a history of vacillations; Brussels assigns priority either to the first goal of the energy triad or to the second or to the third.

GS reaffirms the priorities laid down a year ago in the Energy Union project:²⁷ first and foremost, the security of supply, then cheap energy and after that sustainable energy. A point of comparison – in 2006 the EU's main objective in the energy policy was formulated as follows: «minimum level of overall EU energy mix to come from secure and low-carbon energy sources».²⁸ The words «climate» and «greenhouse gases» are missing in the energy security section of the Strategy, while all its wordings are focused on ensuring security of the energy supply.

It is worth noting that the threat of interruption of energy supply from Russia, which caused a lot of concern in 2014, is not deeply felt nowadays. Obviously, the EU has realized that today Russia has the greatest interest ever in currency revenues from the exports of hydrocarbons.

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The EU no longer regards the policy of «exporting» energy acquis as a priority and has generally abandoned the

bundling between energy issues and the transformation of energy supplying countries. In 2006, there was a goal to spread the rules of the EU internal energy market via the Energy Community.²⁹ In 2008, «good governance and the rule of

²⁴ European Union (2008) Report on the Implementation of the European Security Strategy. Providing Security in a Changing World. S407/08, 11 December 2008.

²⁵ European Commission (2014) Communication. European Energy Security Strategy. COM (2014) 330, 28.05.2014.

²⁶ Kaveshnikov N. (2015) «Nevozmozhnaya triada» energobezопасnosti Evropeiskogo soyuza [The «Impossible Triad» of the EU Energy Security] Mezhdunarodnye protsessy, no. 4, 2015, s. 74-85.

²⁷ European Commission (2015) European Union Package. COM (2015) 80, 25.02.2015

²⁸ European Commission (2006) Communication. Europe in the World — Some Practical Proposals for Greater Coherence, Effectiveness and Visibility. COM (2006) 278, 8.6.2006, p. 5

²⁹ European Commission (2006) Communication. Europe in the World — Some Practical Proposals for Greater Coherence, Effectiveness and Visibility. COM (2006) 278, 8.6.2006, p. 5

law» in the energy supplying countries were listed alongside the measures to maintain energy security, like diversification of the energy mix, sources of supply and transit routes.³⁰ There is no such wording in GS; the national interests and pragmatism have prevailed in the energy issues.

According to GS, the main area of the EU activity is the diversification of supplies, something that is achievable only by means of new infrastructure projects. Being perfectly aware of the limited nature of available instruments, the Strategy just notes that the EU has to «support the establishment of an infrastructure». Such support may go in a variety of forms, but it can be effective only if infrastructure projects are attractive for the investors. However, very few pipelines projects discussed in Europe are economically sound.

GS regards security of supply as a minimum dependence on Russia.

Besides everything else, the EU policy for establishing preferences for particular sources and routes of energy supply can be qualified as politically motivated discrimination against other infrastructure projects. «The introduction of regulatory and financial preferences suggested by the Commission for these projects means that other projects, even if attractive for the market, resource-backed and economically efficient, may end up facing the worst position».³¹

It is obvious that within the framework of political discussion of recent years GS regards security of supply as a minimum dependence on Russia. It is typical that the text underlines the need for diversification of supply in the gas sector. Such an approach taken by EU politicians and by particular member states is extremely disadvantageous for Russia and limits the potential of commercial cooperation.

GS underscores the EU's continuous unfriendly stand on Russian projects of new pipelines: they will get neither priority status nor exemptions from the regulatory regime envisaged by the Third Energy Package. This obviously ensues from the formulation that «new infrastructure must be fully compliant with applicable EU law, including the Third Energy Package». It is also evident that the European Commission will continue its attempts to ensure transparency of the agreements, concluded by individual member states with third countries, and improvement of the information exchange mechanism on inter-governmental agreements.

³⁰ European Union (2008) Report on the Implementation of the European Security Strategy. Providing Security in a Changing World. S407/08, 11 December 2008, p. 5.

³¹ Gudkov I. (2011). Novaya Energeticheskaya strategiya i Infrastrukturnyi paket Evropeiskogo Soyuzha. [New Energy strategy and Infrastructure package of the European Union] Vsya Evropa.ru, no. 53.

Opposition to implementation of the South Stream and Nord Stream-2 projects, refusal to grant special treatment to the South Stream within the framework of the Third Energy Package – these are the examples of political and geopolitical considerations taking the upper hand over economic interests. There is a paradox: the EU encourages European energy companies to invest in pipelines, alternative to the Russian ones, but business is reluctant to invest in economically questionable schemes. At the same time, Gazprom is ready to invest its own assets in the new pipelines and, moreover, to invest without having contracts for gas supply, but Brussels hinders implementation of these projects at the political ground.

GS repeats the traditional dictum on «diversification of energy sources, routes and suppliers». This testifies to the permanent resentment regarding Gazprom's export monopoly. For Moscow, the gas export monopoly is the cornerstone of gas strategy; obviously, Brussels is well aware of this. The positions, taken by the two parties, reflect the fundamental difference in their views regarding market organization.

There are some positive sides of GS for Russia.

Still, there are some positive sides of GS for Russia. For example, there is no mentioning of a gas consumers' cartel. This idea has been actively supported by politicians from several East European countries. However, the European Commission takes a cautious stand on this matter. In its opinion, the mechanism for demand aggregation is possible only on a voluntary basis and in «compatibility with EU legislation and trade law».³² It shall not become a regular practice for doing business but, instead, it may be used only «during a crisis and where Member States are dependent on a single supplier».³³ The idea of a consumer pool proved too extravagant and failed to attract broad support in the European Union.

From the viewpoint of Russian energy producers, the main idea of the document is that *the Strategy deliberately does not include any points on cooperation with Russia in the energy field*. This runs counter to previous EU documents. For example, the European Commission Communication on the security of energy supply and international cooperation dedicated a special section to Russia. In particular, the document stated the existence of the common objective: «increased convergence of the two energy markets, recognizing that the Russian Federation

³² European Commission (2014) Communication. European Energy Security Strategy. COM (2014) 330, 28.05.2014. p. 19.

³³ European Commission (2015) European Union Package. COM (2015) 80, 25.02.2015, p. 6.

can optimize socio-economic benefits from its energy exports, and the EU can enhance competitiveness in its energy market».³⁴ GS in the «Energy Security» section does not mention Russia at all. Moreover, the Strategy does not mention energy in the list of areas, in which the EU is interested in selective cooperation with Russia.³⁵

Commercial contacts will continue. But one can draw the conclusion that *Brussels is not interested in a political and regulatory dialog with Moscow*. It seems that the EU leaders believe that Moscow will be compelled to accept the changes in rules of commercial interaction, which the EU implements within the framework of energy markets liberalization and more active application of competition rules in the energy area. Developments of recent years have given Brussels some ground for such a conclusion: involuntary adaptation of Gazprom to the rules of the Third Energy Package, partial revision of contracts under the pressure of European consumers, Gazprom's attempts to make an amicable settlement in the EU's anti-trust proceedings, difficulties in the implementation of the South Stream and Nord Stream-2.

Excess of supply over demand in the EU market allows the consumers to impose their rules. The European Union acts as a game changer that is trying to extend internal rules of the «consumer market» to the regulatory regime of international deals. Russia's attempts to protect the traditional rules of the «seller market»³⁶ are not producing visible success.

³⁴ European Commission (2011) Communication on security of energy supply and international cooperation. "The EU Energy Policy: Engaging with Partners beyond Our Borders". COM (2011) 539, 7.9.2011.

³⁵ European Union (2016) Shared Vision, Common Action: A Stronger Europe. A Global Strategy for the European Union's Foreign and Security Policy. June 2016. P. 33.

³⁶ Kaveshnikov N. (2010) The issue of energy security in relations between Russia and the European Union. *European Security*. 2010. Vol. 19. No. 4. P. 586.