

THE BALKANS | A GAS HUB IN EASTERN EUROPE?

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Tribune 41

May 2014



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The author | A Belgian national with a Master's degree in Electrical and Mechanical Engineering, a degree in Physics and Nuclear Chemistry and a baccalaureat in Economics from the Louvain University (Belgium), Jean-Pierre SCHAEKEN WILLEMAERS began his career as a Lecturer at the faculty of applied sciences of this University. He thereafter joined the Tracetebel and Suez-Tracetebel group. Within this group, he was Head of Trade and Marketing and a member of the Tracetebel Engineering Executive Committee. He was thereafter appointed Executive Vice President and member of the executive committee of Suez-Tracetebel EGI (Electricity and gas international), and Director of Powerfin. He was in charge of investments in Europe, Russia and the Middle East in the fields of electricity production, transmission and distribution as well as the transportation and distribution of natural gas by acquisition or project development. In this capacity, he was appointed Chairman or Director of several subsidiaries of this group in Europe and Central Asia. He was also Vice President of the Brussels Chamber of Commerce and Judge at the Brussels Commercial Court. In 2000, he founded a centre for high technology start-ups of which he is still a board member. Today, he is a board member of several industrial companies. He is Chairman of the Energy, Climate & Environment Department of the Thomas More Institute a also member of its Advisory Board.

| Introduction

Three main events, within the last decade, have been affecting the gas business in the Balkans. At first, President Putin's geopolitical strategy. One of President Putin's principal objectives is to restore some of Russia's former global power status. Ukraine is central to this strategy. Russia's violation of Ukrainian sovereignty in Crimea could be the first step in an attempt to control the entire country and, at the same time, a test to NATO's effectiveness. However, it is not just a matter of expanding its turf, but the Crimea annexation has also economic implications as, for instance, the exploitation of Crimea onshore and offshore natural resources, in particular, gas – conventional or non-conventional- depriving Ukraine of them. Russia's endeavors to control the gas routes to Europe, including the ones crossing the Balkans, and to oppose eastern European countries to exploit shale gas, are aimed at maintaining those countries dependent on Russian gas supply with, as far as possible, oil indexed long term contracts and so at securing its own gas exports.

Then, EU's position towards Russian gas routes. According to the EU legislation known as the Third Energy Package, which is still in the process of being implemented, an energy company cannot be responsible for production, distribution and sales because the EU defines that as monopoly. Such monopoly practices actually describe Russian energy companies like Gazprom. The European Commission urged Russia to adapt its gas system to EU legislation, in particular, to conform to EU unbundling and third party access to pipelines requirements. Brussels is also investigating whether Gazprom is offering fair gas tariffs. The negotiations on the "South Stream" pipeline route crossing Bulgaria, Serbia, Hungary Slovenia to Italy, are postponed pending the settlement of such legal issues. Another reason to block negotiations is Russian alleged support to Russian speaking protesters in Eastern Ukraine. In spite of the April agreement between Russia, the US and the EU, nothing has changed since then, except Austria's OMV's agreement, signed on April 29, 2014, with Gazprom to build a branch of South Stream to Austria. Would this move be the first step to save South Stream pipeline project? If the EU member states that have signed the South Stream agreement, do not comply with their obligations towards Russia, Moscow could plead the case before the International Court of Justice.

Finally, Shale gas. Natural gas is the world's fastest growing fossil fuel with consumption increasing at an average rate of 1.6%/year from 2008 to 2035¹. It has traditionally served the needs of three major types of customers: manufacturers, power generators and residents using gas for heating and cooling. A fourth one

¹ US Energy Information Administration, *International Energy Outlook 2011*, September 19, 2011.



is emerging more recently: gas powered automotive vehicles. Low natural gas prices in the US and Canada are beneficial for steelmakers, producers of chemicals, petrochemistry and fertilizers industry. For some of these users, gas is a feedstock. That is the reason why domestic shale gas deposits should be explored in the EU countries. Shale gas could also be imported from the US and Canada although not immediately at a significant scale. Indeed, existing gas terminals need to be converted from gasification to liquefaction or new such terminals should be built. On the other hand, the Obama administration should clear the way for broader natural gas exports, trading prospective benefits from gas exports off possible downsides for the US economy. "Proponents of such trade off (including the oil and gas industry) claim that exporting inexpensive shale gas will help the US trade balance, shore up energy-poor US allies and so on. Opponents counter that exports may cause domestic prices to rise, hurting consumers and some industries such as chemicals that have benefited from cheap natural gas"². Actually, the Obama administration started approving gas exports but on a case by case basis. For instance, Freeport LNG has signed preliminary 20-year contracts to sell much of export facility's capacity to Chu Bu Electric Power Co, Osaka Gas Co and BP Energy Co. Substantial imports of low-priced shale gas would lower Japan's trade deficit and put it in a better position in price negotiations for gas imports from the Middle East.

² Keith Johnson and Ben Lefebvre, "US approves expanded gas exports", *Wall Street Journal*, May 18, 2013.

| Gas routes to Europe and their impact on Balkans gas business

1 | Piped gas

Investors in gas pipelines are concerned by the political stability and reliability of the transit countries all the more so that they have learned the Ukrainian lesson. Diversification of gas routes is of the essence. This concerns piped gas from Russia and from the Caspian area over to Europe. It also means that transit through Turkey should be carefully assessed to avoid the "Ukrainian trap".

South Stream | South Stream is intended to transport Russian natural gas across the Black Sea to Bulgaria, Serbia, Hungary, Slovenia and Italy as well as to Austria and Greece, with planned branches to Croatia and Bosnia Herzegovina. For the implementation of the onshore section of the project, intergovernmental agreements have already been signed with most of the above countries. This route avoids both Ukraine and Turkey. The annual capacity of its offshore section will be up to 63 billion cm. However, while South Stream may lower the risk of gas shortages caused by problems in Ukraine, there are serious concerns that it will make the Balkans and parts of Central Europe even more reliant on Gazprom. But what are there alternatives, today, to meet rising gas demand? The rival Nabucco project championed by the EU is dead³ and it will take some time before other alternative projects take off the ground.

"Mr Oettinger froze high level political talks between the EU and Russia related to the final approval of the South Stream project. [...]. Despite the uncertainty (due to EU stance), Gazprom which holds a 50% stake in the project, is pressing ahead with construction. The group is laying pipes in Russia, Bulgaria and Serbia.

³ Nabucco West project is tackled below.

The pipeline could be operational by 2015⁴. However, it should be kept in mind that while energy has served as an effective tool for Russia to wield influence in Europe, Moscow is first and foremost concerned about maintaining revenues from energy exports that has become so crucial for Russia's own budget and economic stability. In this sense, maintaining European market share and further developing market share in Asia takes precedence, for Moscow, over political manipulation. On the other hand, hard stance towards Russia is not the position of most EU member states which are not prepared to accept the consequences of tough sanctions.

Southern Corridor Pipelines⁵ | The TANAP project is designed to transport Azeri Shah Deniz gas from the Turkish-Georgian border to Turkey's border with Europe: Komotrini. The initial capacity of this pipeline is expected to be 16 billion cm/year. About 6 billion cm of gas will be delivered to Turkey and the rest to Europe. In the future, the pipeline's capacity can be expanded to 31 billion cm/year. The intergovernmental agreement on the Tanap project has been signed in June 2012 between Turkey and Azerbaidjan which intends to hold a majority stake of 51%. Currently, the Azeri company SOCAR holds a 80% stake and Turkey 20%. BP has vowed to acquire 12% of the capital. So, following the completion of the process of BP acquisition, the shares will be distributed as follows: Socar (operator) 68%, Botas (Turkish state pipeline company) 20% and BP, 12%. "The entire project will be financed with equity and the investment cost is currently estimated at USD 10-12 billion"⁶. Tanap shareholders plan to lay the pipeline foundation in the second quarter of 2014 and to commission it in 2018.

The TAP pipeline offers capacity for gas transport for a period of 25 years from Komotrini (near the border between Turkey and Greece) to Italy through Albania and the Adriatic Sea. The European Commission has approved exemptions from regulated tariffs on both TAP initial (10 bcm/year) and expansion capacity as well as exemption from ownership unbundling for 25 years. Socar (20%), Statoil (20%), BP (20%), Fluxys (16%), Total (10%), E.ON (9%) and Axpo (5%) back the project. First delivery to Europe are expected for late 2019. TAP can facilitate gas supply to several South-Eastern European countries. It also diversifies gas supply of bigger economies.

Nabucco West | "On 2 September, Turkish Energy Minister Taner Yildiz said that the pipeline from the Turkish-Bulgarian border to Austria⁷ is still on the table and could be realized in the future [...]. His Azeri counterpart NATIG Aliyev [...] said that the projects have different goals and the choice of TAP does not exclude implementation of Nabucco [...]. For Azerbaidjan, Nabucco would help to fulfill its long-stated desire of making inroads into the Balkan market. Although TAP will deliver this through the planned Ionian-Adriatic Pipeline, an additional route would enable more widespread and reliable Azerbaidjani gas supplies across Southeastern Europe. Although the Shah Deniz consortium undoubtedly chose the most commercially viable route, there were certainly aspects of Nabucco which some of the shareholders preferred [...].The 1-2 bcm/year which Bulgaria expects to get from TAP will not, realistically, allow it to diversify away from Russian gas [...]. In the long run, TAP will not fully satisfy either Azerbaidjani rising gas output, Turkey's energy hub ambitions or Bulgaria's diversification efforts"⁸.

⁴ Selina Williams and Vanessa Moch, "Gazprom Pushes Ahead With New Pipeline, Despite Ukraine Standoff", *Wall Street Journal*, April 9, 2014.

⁵ This corridor will be based on three main pipelines: the South Caucasus Pipeline (SCP) through Azerbaidjan and Georgia, the Transanatolian Pipeline (TANAP) from Georgia to Europe border through Turkey and the TAP project across Greece, Albania to Italy.

⁶ "Tanap to be financed by Shareholder equity", *Hurriyet*, February 14, 2014.

⁷ This project of pipeline crossing Bulgaria, Romania, Hungary to Austria, rejected in favor of the TAP pipeline, could be reactivated.

⁸ Alex Jackson, *Nabucco seeks to rise again*, Natural Gas Europe, September 17, 2013.

The South Caucasian region is “a gateway to the west for Eurasia’s new energy-rich states: Azerbaijan, Kazakhstan and, potentially, Turkmenistan. Moscow is fully aware of the reverse gateway and is active in attempting to orient the region energy flows towards Russia and from there to Europe”⁹.

Other pipelines | Other pipelines are conveying gas from Russia to Europe such as the “Yamal Pipeline” to Poland and Germany via Belarus and the “North Pipe” to Germany via the Baltic Sea. However, they are not directly connected to the Balkans.

2 | Liquid Natural Gas (LNG)

The real long term threat to Russian gas supply and transportation to Europe comes less from the Caspian Sea than from the building of LNG terminals. LNG gives more flexibility for selecting gas sources and makes importers less dependent from specific suppliers. Poland and Lithuania are building such terminals on the Baltic Sea and Croatia wants to build one on the Adriatic. The Visegrad countries: Hungary, Poland, the Czech Republic and Slovakia, have been building pipeline interconnectors in part to integrate with- and take advantage of- these terminals.

The LNG comes from many different sources including Africa, the Middle East and North America. This is the reason why Russia is deeply concerned about vast shale gas discoveries in North America and potentially in Europe.

The LNG trade has been growing rapidly in the recent years and it will continue to outpace the growth of the pipeline trade in the next 20 years¹⁰. The global LNG export capacity climbed up to 379 bcm/year in mid 2012, with Qatar currently holding the largest share. The LNG market supplied one quarter of Europe’s net imports in 2011.

“In the future, at least two regasification terminals should be able to supply the market: Swinoujscie on Poland’s coast and Adria on the Croatian island of Krk. Both are part of the North-South corridor relaying the Baltic and the Adriatic via the Visegrad countries [...]. If built, the two terminals will create a real alternative [...]. Thanks to the inter-state gas connectors, the LNG ports should reinforce diversification of supplies, provide leverage for negotiations with Gazprom for its regional clients, and finally increase liquidity and competition on spot markets”¹¹.

However, large imports from the US are still some way to go. More than 20 US gas producers filed an application for building LNG terminals. But only one of them got a permit up to now. It deals with Cheniere Energy that will transform the Cameron Parish terminal, Louisiana, into a liquefaction plant. Exports could start in 2015 according to a source within the US State department.

The other projects will not materialize before 2017 or even 2018. In any case it appears that, due to the size of investments, the number of such projects will be limited.

⁹ Alexandros Peterson, Associate director of the Eurasia Energy Centre at the Atlantic Council of the United States.

¹⁰ IEA, *World Energy Outlook 2012*.

¹¹ *Central Europe’s energy security after Nabucco*, Security and Defense, Policy briefs, November 6, 2013.

| Major players in the Balkan gas market

1 | Serbia

Good relationship between Serbia and Russia is centuries old. In 2013, several agreements have been signed by Serbia: military treaty, Serbia observer at the common security treaty organization, not to speak about millions dollars injected by Russia in Serbian economy. The Serbian National Energy Company (NIS) sold (sold off?) a 51% stake to Russia for EUR 400 million.

Serbia is a major player in the South Stream project with 450 km (out of a total of about 900 km) pipeline crossing its territory and its 300 million cm underground gas storage capacity in Voivodine. As a side effect, such storage capacity is a tool to calm down autonomy pressure from that region. South Stream will secure gas supply to Serbia to meet its 2.4 billion cm consumption.

In addition to the revenues generated by the tax on the gas transit on its territory and the creation of thousands of jobs, Serbia is engaged in an economy recovery based on gas: petro-chemistry, gas fired power stations and so on. Serbia should be an energy hub in the region after commercial operation of South Stream pipeline, scheduled for 2015, thanks to, inter alia, gas connections to Croatia and Bosnia Herzegovina. In the longer term, Macedonia and, through it, Greece could be supplied from Serbia in Russian gas. From a local perspective, the underground gas storage capacity should play a major role for compensating gas supply fluctuation. If well negotiated, Serbia could obtain favorable gas prices thanks to its good relationship with Russia. Such relatively cheap gas and the important Russian investments¹² in the energy infrastructures could enable Serbia to become an important energy (gas and electricity) exporter in the region.

¹² Lukoil take over of Serbian national company JugoPetrol and acquisition of a 79% stake in fuel distribution company BeoPetrol. Gazprom oil subsidiary Gazpromneft 2008 acquisition of a 51% stake of Nafta Industrija Srbije (NIS), distributing 50% of oil in Serbia. As a counterpart, Gazprom is committed to invest in the refurbishing of Serbian refineries and in the construction of natural gas storage capacities.

A strong Serbia, supported by Russia, would increase its influence locally and reinforce its importance vis-à-vis the EU taking into account its regional weight once the South Stream Pipeline is in operation. In such a context, what about Serbia's accession to the EU? If membership negotiations are successful, would Serbia's good relationship with Russia be altered, on one hand, and what would be the impact of large Russian investments in Serbia on the other? These questions are briefly addressed, below, under the chapter "Challenges for investments in the Balkans".

2 | Croatia

Croatia faces a number of challenges to develop its gas business: the construction of the long delayed gas terminal on the northern Adriatic island of Krk to enable access of LNG to gas sources from a wide variety of countries; gas interconnections within the region to take advantage of the Azeri Shah Deniz Gas supply, and with western Europe; gas exploration and exploitation in the Adriatic.

Krk terminal | The project is being developed by LNG HRVATSKA, a 50/50 joint venture between PLINARCO, Croatian state-owned gas transmission system operator and state-owned utility group HEP. It deals with a regasification plant producing initially 5 billion cm of gas annually for an investment of EUR 600 million¹³. This project is part of a policy aiming at making Croatia an energy gateway into Central and Eastern Europe. The Croatian government is trying to convince potential partners and the European Commission that Krk is a project of common interest (PCI) for South Eastern Europe and its gas supply, thereby securing co-financing from EU's Connecting Europe Facility.

Croatian Economy minister said: "we are currently finalizing the documentation for the LNG terminal and we hope that the Commission will decide before the end of 2014 whether it will provide part of the funding for the project and if so in what manner." Hungary has shown a great interest in participating in the project. Qatar is also a potential investor. A Qatari delegation visited for the second time the small town of OMISLJ in the middle-west of Krk where the LNG terminal is to be built. Qatar would supply LNG for the Krk terminal over 25 years. Croatia is also seeking help from the MACQUARIE group LTD.

As this terminal project contributes to the diversification of gas supply and transit to Europe with respect to Ukrainian and Turkey routes and consequently to a single and Unified European Energy Market¹⁴, the Visegrad countries (Hungary, Poland, the Czech Republic and Slovakia) coupled with Romania and Bulgaria should support Croatia's attempt to achieve the PCI status (like Polish Baltic terminal at Swinoujscie). In order to enhance the flexibility of the system, reverse flow capability should be addressed.

Gas connections | Through interconnectors, Eastern European countries such as Poland, Hungary, the Czech Republic, Slovakia and Romania could be supplied in gas from the Krk terminal. This is a win-win deal. "By developing interconnections between the Polish system and the neighbouring markets, the Polish Gas Transmission Operator Gaz-System SA, has positioned itself as an integrator for the natural gas transmission in the region. This is why the company supports the construction of the North-South Gas Corridor which would be eventually supplied with gas from two new LNG terminals at Swinoujscie in the north and at Krk in the south. Within the corridor, gas will be transmitted from the north to the south, or in the reverse direction, through local transmission networks"¹⁵.

According to Commissioner Oettinger, the completion of the North-South Corridor will take 5 to 8 years. Plinarco is also involved in the IAP (Ionian-Adriatic Pipeline) project. IAP would run from FIER in Albania

¹³ Croatia's Plinarco completes concept design for Krk island LNG terminal, Power Market Review, May 27, 2013.

¹⁴ This is in line with the Energy Community of South East Europe (established between the EU and 9 contracting parties) objective to extend the EU internal energy market to South-East Europe, the Black Sea region and beyond.

¹⁵ Integrated Transmission System in Europe, Gaz-System SA, June 15, 2012.

through Montenegro and Bosnia-Herzegovina to Split in Croatia. In FIER, IAP would be connected with the planned Trans-Adriatic Pipeline (TAP).¹⁶

Offshore gas exploration | Exploration of oil and gas in the Croatian Adriatic has been a priority of the government since it took office. To prepare the grounds for the tenders, the relevant legal framework has been passed. Croatia launched its first offshore licensing round earlier in April 2014. Twenty nine blocks are on offer for international oil and gas majors interested in participating in the country's offshore explorations. Production sharing agreements offered to bidders are with a 5 year exploration phase and a 25 year production period.

Following Croatia's launch of its bidding round, Slovenia formulated in April 2, 2014, an objection to the use of geographical maps of the Adriatic Sea that unilaterally prejudice the solution of the maritime border between Slovenia and Croatia included in the tender documentation for the offshore licensing round. The documentation published in relation to Croatia's first bidding round includes the Northern Adriatic, an area subject to the unresolved Croatian-Slovenian dispute. A hearing before the Arbitral Tribunal is to be held in the spring of 2014.

With its terminal, its domestic gas storage capacities and future offshore gas, Croatia would become a regional LNG hub like Serbia for piped gas.

3 | Romania

Romania ranks third in EU shale gas reserves after Poland and France. The Romanian government has awarded several concessions to Chevron that planned to begin exploration within the end of 2013. However, demonstrations against Shale gas are delaying the program. In any case, the government is well determined to support shale gas exploration to enhance local gas production, to ensure more energy independence from Russia and to improve trade balance.

As already mentioned above, Romania could also be a gas transit country with related financial repercussions, if piped gas projects such as West Nabucco materializes. The pipe avoids Ukraine and the Black Sea and will be initially supplied with Azeri gas.

¹⁶ TAP's shareholders are Switzerland AXPO (42.5%), Norway's Statoil (42.5%) and Germany's E.ON (15%).

| Challenges for investments in the Balkans

Corruption, bureaucracy, political instability and voter fraud in the Balkan countries are a cause for concern for investors, as a rule, and, in particular, for investments in the local gas business. In spite of governments' commitment to fight corruption and reform bureaucracy, very little has been achieved so far. Between 2001 and 2010, the Balkans lost over USD 11.6 billion in illicit financial outflows to crime, corruption and tax evasion¹⁷.

As GFI research indicates, the Balkans region is losing a tremendous amount of money in illicit financial outflows each year. Illicit capital flight undermines economic development, exacerbates income inequality, fosters corruption and reduces tax revenues. Those outflows from Southeastern Europe have serious consequences not just for the Balkans, but also for Brussels and Berlin as well. According to GFI's report, Croatia and Serbia are topping the region's illicit financial outflows for the period 2001-2010 with respectively USD 15.2 billion (or 25% of GDP) and USD 51.4 (or 112% of GDP).

In the case of Croatia, such significant amount is particularly shocking, knowing that this country, as a new EU member state, is scheduled to receive EUR 13.7 billion of EU taxpayer funds during the period 2014-2020¹⁸. These indictable offences are contaminating the highest levels of power. Croatia's prime minister Milanovic sacked his finance minister over a dubious deal. He is the sixth minister to leave the government since a coalition led by Milanovic's SDP took office late in 2011 which obviously does not contribute to the country's political stability.

In Serbia, the electoral success of Aleksander Vucic on 16 March 2014, owes a great deal to his campaign against corruption which is a positive signal. But to what extent corruption cases will be really instructed? Up to now, only Miskovic is being prosecuted otherwise few cases have been seriously investigated. No sentence has been passed so far.

¹⁷ Global Financial Integrity (GFI), *Global report on illicit financial flows from developing countries*, December 2012.

¹⁸ *American and EU taxpayers continue to bankroll Croatia's corrupt networks*, Adriatic Institute, April 30, 2014.

Another potential challenge which could jeopardize gas project financing is linked with Russia's endeavor to keep its influence in, or even its control on Serbia and through it on the pipeline system crossing this country. In this context, the EU membership negotiations with Serbia could generate a conflicting situation because Russia could consider that membership talks is an interference into its sphere of influence. In such a context, Serbia is confronted with several options: discontinuing negotiations with the EU and opting for Russia because of its historical close ties with, and financial support from this country. In that case, western investors would have a minor role to play because big Russian corporates like Gazprom and Rosneft would have the lead; or proceeding with EU membership negotiations which is not without political consequences in the region; or adopting a neutral position which would prevent it from joining NATO, but would allow economic agreements with the EU as well as with the future Eurasian Economic Union (Russia, Belarus and Kazakhstan).

At any rate, the EU cannot do without discussing a mutual agreement with Russia on such issues.

The problem with negotiations with Russia is that the EU does not speak with one voice and that the member states themselves are divided between contradictory objectives. Germany is a case in point in that respect. It is divided between economic interests, geopolitical empathy for the Eastern countries and its inhibitory historical guilt. Moreover, Germany is Russia's first European trading partner. There are more German companies in Russia than from all other EU countries combined. If the Germans condemn the invasion of Crimea, they plead for soft power. A Gallup by Infratest Dimap in March 2014, indicated that 62% of them are in favor of political pressures but only 38% support economic sanctions.

Under such circumstances, what will come out in terms of increased energy independence from Russia, in particular in Eastern Europe and in the Balkans, and of gas routes, knowing that Moscow's strategy is to have a compliant Europe through control of the pipeline system?

Will the EU and its member states have the will and guts to protect their interests and to progress their strategy?

