

## With or Without South Stream ? Russia's energy strategy between the European Union and Turkey



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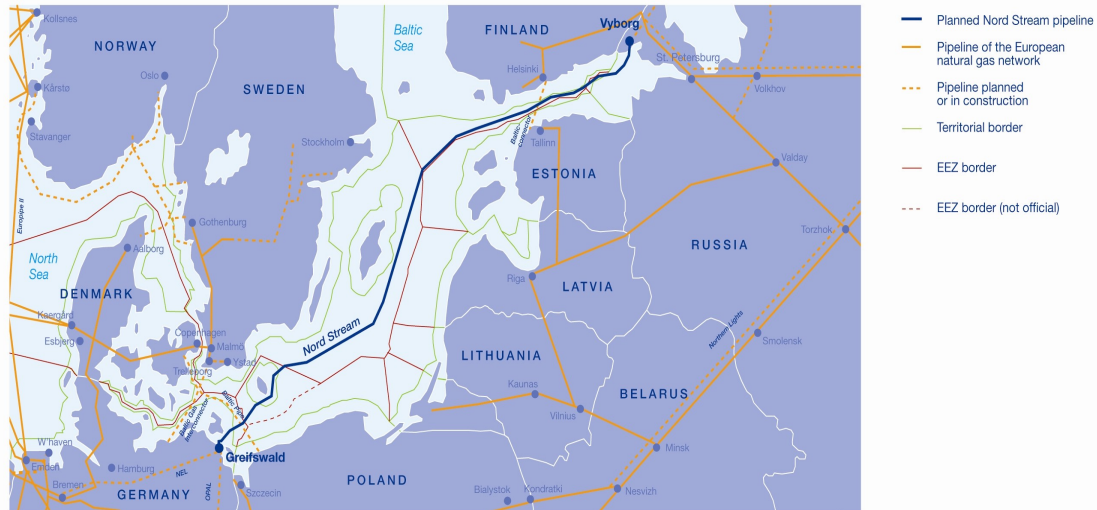
**O**n paper, Russia's energy strategy could not be better. It is theoretically perfect. Connecting directly the huge Russian gas reserves to European Union's markets, both in North and South, bypassing thus potentially unreliable transit countries, especially Ukraine and the Baltic States, appears to be a major geopolitical coup. It does not only reinforce European Union members' dependency on Russian supplies, but it also significantly increases Russia's bargaining levers with its closest neighbouring "satellites" (Belarus and Ukraine) and partners (Turkey), while building strategic economic ties with major energy European companies.

### A too perfect picture

Already relatively well-advanced, the North Stream Project is covering 1220 km through the Baltic Sea between northern Russia and Germany, expected to deliver 55 billion cubic meters (BCM) annually. Half of that volume is set to be available in 2011 at Bovanenkovskoye on Yamal, the other half coming in addition after 2013. The total cost of the pipe is estimated to be less than €8 billions. Dominated by the Russian Gas giant Gazprom, that holds 51 percent of the shares, the consortium also includes Germany's E.ON Ruhrgas and BASF/Wintershall with 20 percent each and Netherlands Gasunie with 9 percent. The French company GDF is also said to be in talks with Gazprom to secure long-term supply contracts, but not necessarily to buy stakes.

Launched in June 2007 jointly by Gazprom and the Italian company ENI, The South Stream Project is at an earlier stage of implementation. Laid on the seabed of the Black Sea, the pipe is to start from the Krasnodar Krai in Russia, near to the Blue Stream, and reach Bulgaria. Then the project divides into two overland routes: one to the Greek Adriatic coast for subsequent prolongation on the seabed to Italy, running some 1000 km; the other one to Serbia, Hungary and Austria, with various planned outlets, in Romania, North Italia and/or Slovenia, i.e. more than 1300 km in total. Firstly proposed to bring around 30 BCM per year, Gazprom officials have recently declared that the annual output would rather be 47 and more probably 63 BCM after 2015 (1). Russia in that case tacitly counts on Turkmen gas, which it would re-export, defeating thus any European rival projects, notably Nabucco. It proves indeed to be easier to make Central Asian gas transiting through Russia than under the Caspian Sea or by swaps in Iran. Overall costs of that project are quite high, between €19 and 24 billions, but many variable components, gas price among others, can still move, reducing the bill. Gazprom has, for example, calculated its investment potential on the basis of conservative prices, keeping thus now

certain flexibility (2). Russians and Italians only are supervising the whole project : on January 18, 2008, South Stream AG, a special purpose company was registered in Switzerland, incorporated by Gazprom and Eni on a parity basis.



Source: North Stream AG. <http://www.nord-stream.com/en/the-pipeline/pipeline-route/route-details.html>



Source: South Stream AG. <http://south-stream.info/index.php?id=3&L=1>

However, behind this coherent picture of Russia finally ensuring almost half of future European gas consumption within a decade (3), some fault lines are emerging. Russia’s energy strategy does not seem as clear and effectively-built as it appears in a first reading. The new-shown complexity is not entirely linked to the recent financial crisis and the subsequent drop in oil and gas prices to more normal levels. Most analysts recognize that Gazprom’s financial results for 2009 will be largely comparable to those in 2007, 2008 being indeed a particularly successful year, for the Russian giant on one hand but for all major energy companies too. Besides, even if Gazprom is highly indebted, as soon as it looks for additional investment funds, it would have no difficulties to find them, either from the Russian budget or from foreign banks (4). It would be a mistake to think that Gazprom could face any financial shortcomings. Russia’s and Gazprom’s real energy strategy is rather related to Russian world ambitions, as a superpower almost equal to the US and keeping its role and importance among the growing Asian powers, China and India. Relations to Europe should not be overestimated to

understand Russia's moves and priorities, regarding energy matters in particular. In those cases, South Stream appears to be a quite eloquent example. To achieve some regional objectives, it does not necessarily require that the pipeline exists materially. If it does, it is better, but if not, Russia would yet have managed to preserve or to advance otherwise its interests. There are strong signs, putting in doubt the South Stream Project, which must be taken into consideration.

## The illusion South Stream

It is true that the South Stream Project still remains at a very initial stage. Most of strategic and political decisions, regarding the final route and the work agenda, have still to be made. Significantly, the feasibility Study will only be ready for the second semester of 2010 (5). Therefore, there are too many accumulated contradictory trends against the project. There is an initial dilemma on the most advantageous route for example. Should the pipe go across the entire Ukraine's exclusive economic zone (EEZ), which is the shortest way, or should Gazprom give head to the other but longer option across the Turkish seabed, which would increase a bit more the first cost estimate? So it appears a first doubt on the South Stream relevance: is it worth spending so much money to avoid Ukraine but not its EEZ and even spending more, adding technical difficulties (greater depths) to go through the Turkish EEZ? But actually there are far more substantial constraints.

### **Gazprom's work principle**

It has been once again stated by CEO Alexey Miller to the Annual General Shareholders Meeting last June that "Gazprom operates "from the market" (6). No gas will be produced until it is sold... Instead of relying on demand forecasts that are not supported by purchasing contracts, Gazprom has used a balanced method to always invest in production and gas transportation in the exact amounts required to implement its already signed contracts. As a consequence, the company has a sufficient production capacities margin that avoids any excess". It clearly means that as long as some Balkan States and several EU member states, such as Austria, Slovakia, Hungary or Italy, would not have signed long-term supply contracts with Gazprom, the South Stream pipeline will not be built. But such high needs in Europe do not seem to occur in the near future. Gazprom itself has just decided, in accordance with the above work principle, to delay "the commissioning of the Bovanenkovskoye field's first launch complex until 2012" (7). Besides, in the same speech, Alexey Miller has declared that the investment decision for the Stockman condensate field will not intervene before the end of 2010. Gazprom's anticipation and calculations on European demand for imported gas apparently proved to be too ambitious and optimistic, at least until the second part of the decade. That's why, it is quite unlikely that those countries, primarily concerned by South Stream, will conclude long-term contracts with Russia in the coming years. The gas volumes, already earmarked for North Stream and flowing through Ukraine, would be largely sufficient until 2015. Those European countries would also prefer to wait a bit more and see if Nabucco is materializing. If only Italy and several balkan countries sign some agreements, those would not be important enough to justify the high costs of South Stream.

### **No reliable supplies anymore from Turkmenistan**

If, contrary to most of serious analyses, European gas consumption raise unexpectedly before 2015, making so South Stream more urgent, Russia and Gazprom had been counted so far on Turkmen resources, which would replace non-produced (yet) Russian ones. But that option also becomes less and less plausible. On 9 April, an explosion struck the old Central Asia-Tsentr-4 pipeline that connects Turkmenistan to Russia. Immediately both countries have rejected the blame for the blast on each other, Turkmenistan saying that Gazprom ordered to decrease by 90% the gas deliveries, causing a technical problem and Russia replying that Turkmen official should have better monitored this aging pipeline system. Actually, whoever is responsible of that crisis, relations between Turkmenistan and Russia have been deteriorating for months. Firstly, in March, Turkmen President Berdymukhamedov

in Moscow reported the signing of an East-West trans-Turkmen pipeline construction agreement. That new pipe is supposed to plug into the existing Caspian Coastal Pipeline, carrying Central Asian gas via Kazakhstan to Russia, which is due for full reconstruction and capacity expansion, according to a tripartite intergovernmental agreement signed in May 2007. That last project by the way has disappeared in the limbo of the post-soviet administrative ineffectiveness. Then, secondly, shortly after the explosion, Gazprom has cancelled a previous accord (concluded in March 2009) to buy up 50 additional BCM of Turkmen gas annually at \$340 per BCM. That move has angered the Turkmen authorities. In that context and on the contrary, the pipeline rupture has satisfied many in Russia, since the agreement to pay "European price" for Central Asian gas has been considered unanimously as a mistake, when those price in Europe are effectively falling. Of course, Turkmenistan would anyway need to sell parts of its gas to Russia, but both countries would have before to review some strategic points of their relations, notably the price changing levels and the capacity of the old pipeline system to carry those necessarily growing gas volumes.

### **South Stream's weak incentives**

The South Stream contractual framework, supposed to build a "South Stream Community", according to Gazprom (8), is far from being as structured as the ambitious project developments require to. All together, the South Stream pipeline includes Russia's, Bulgaria's, Serbia's, Slovenia's, Italy's, Hungary's, Austria's and Romania's governments, as well as some of their major energy companies. So far, Russia and Gazprom, as leading managers, have only established binding and prospective agreements with the Italian ENI, as the other leading partner (Memorandum of Understanding in June 2007, South Stream AG in January 2008), with Greece (intergovernmental agreement, completed by a detailed document to constitute a joint-venture with Greek energy companies) and with Serbia (intergovernmental agreement, completed by a detailed document to constitute a joint venture with Srbijagas). In addition, during those signing ceremonies in Sochi on May 15 2009, Gazprom and ENI have also inked an Implementation agreement that sets the terms for Gazprom's acquisition of a 51% stake in OOO SeverEnergiya, the first Russian-Italian company. Significantly, that new-built company is set to conduct exploration activities in Western-Siberia fields and is absolutely not directly related to the South Stream Project. Regarding the other important countries, namely Bulgaria, Hungary and Austria, the contractual frames are partly achieved, only. In Austria, if relations between Gazprom and the energy company OMV have been strong for decades, Austrian government is still reluctant to sign even an intergovernmental agreement with Russia (9). For Bulgaria, it exists both an intergovernmental agreement (January 2008) and a cooperation agreement signed with the Bulgarian Energy Holding EAD, but this last document is only limited to parties interaction for the preparation of the feasibility study. In Hungary, authorities have accepted to take part into the project (intergovernmental agreement in February 2008) but Gazprom could only associate with the Hungary's Development Bank (March 2009) to conduct all studies and works of the South Stream local section. Lastly with Slovenia and Romania, Gazprom has begun talks without any results so far. That's right however that the project is still at its starting point, but Gazprom's shortcomings in Bulgaria, Hungary and Austria let think that Russia fails to convince of the reality and perspectives of its plan. It may so not be exaggerated to ask whether Russian authorities themselves believe in that project.

## Russian realities beyond

Looking at all the public relations operations that Gazprom and the Russian government are initiating in Berlin, in Paris and towards the European Union, it sounds as if the South Stream Project is suffering no uncertainty. It should yet not be considered in itself. It appears to be more a mean than an end. Russia aims at gaining a world position, which largely overcomes any European Union related moves. Relations with Europe are indeed an essential part of this "superpower" ambition but not the only one. The South Stream Project, in that perspective, is set to serve both, i.e. firstly, that's right,

to strengthen Russia's European position, secondly, in a less obvious way, to maintain a kind of regional supremacy, compared to rising China and Turkey.

### **To make Gazprom a normal European economic actor**

Opening the European markets to Russian companies and to Gazprom in particular has been probably one of the main objectives of Russia's authorities since the beginning of the decade. Considering the substantial Russian comparative advantages in energy matters, that sector has been at the forefront of Kremlin's economic external strategy. Today, thanks to the North Stream Project which is already on tracks, Russia has considerably reinforced its ties with Germany and Gazprom is determined to become one of the main energy players in the northern European markets, in a position comparable to its North Stream partners, E.ON Ruhrgas and BASF/Wintershall, at least for all the supplies aspects (and not the distribution for the moment). South Stream is serving a parallel strategy in the South, towards Italy. Moscow needs to maintain alive its privileged partnership with Roma and to a lesser extent with Athens. Without mobilizing projects, relations between both partners could loosen. Those cooperation perspectives, opened by the South Stream Project, allow the Russians to negotiate plenty of others energy-related deals, which especially increase Gazprom's positions and interests in European southern markets. In particular, the Balkans objective should not be underestimated. Russia and Gazprom clearly look at them, hoping to make Serbia their Trojan horse. In Moscow moreover, regarding South Stream future markets, Balkans seem to be part of the plans (10). Once again, what really matters in that project is not the pipeline in itself, but the possibilities, it opens. If indeed eventually, South Stream is built, gains might be even bigger. If it is not, the Russian company would have taken benefits anyway and advance its positions.

### **To keep most of Central Asian energy resources under control**

Since the fall of the Soviet Union, it became a truism to refer to the high stakes new Great Game going on in Central Asia between Russia, the US and some newcomers, such as China or Iran, all supposedly struggling for the control of the abundant oil and gas resources. Of course, there was a kind of competition but after almost 20 years, reality proved to be slightly different. The US is only partly concerned or very indirectly involved. US presences in Afghanistan, Uzbekistan and Kirghizstan have little to see with oil and gas resources (11). It seems more accurate to inquire a tripartite only rivalry between China, Russia and the European Union. So far, Russia had an indisputable advantage. Most of Kazakh oil flows through its territory and Russia has a purchase option on future Kazakh gas production and exports. Regarding Turkmenistan, until 2009 Gazprom took at least 80 percent of country's total annual gas exports at the Turkmen border (averaging some 45 billion cubic meters, out of some 50 to 55 BCM produced annually by Turkmenistan during the past years). Additional acquisitions for 50 BCM annually had even been contracted at European "market" prices, Russia wanting so to secure those Turkmen volumes. The South Stream Project justified those Russian commitments, giving in the same time a European perspective for the Turkmen gas. Russians argued that, for Turkmenistan, selling directly gas to the Europeans would prove to be far more complicated than making it transiting through Russia with an official minimum profit for the "transit" country. Without sufficient gas resources available, the European Nabucco Project became so economically unviable. That move would also considerably limit the possibility for the Chinese to enhance their first contracted supply volumes.

The European Union and China, since the beginning of the decade have shown a growing interest in those resources. During the recent past months, they got indeed more and more willing in their diplomatic contacts to offer alternatives export options to the Turkmen authorities. They have even obtained certain successes in 2009. For the first time in April, a European company, the German RWE, has been authorized to prospect and develop an offshore gas field in the Turkmenistan's Caspian Shelf. The two parties have even signed a long-term agreement for gas deliveries. In June, a Chinese governmental delegation visiting Ashgabat reiterated its commitment to buy at least 30 BCM of Turkmen gas for a 30-year period, starting on January 2010. That delegation has even negotiated 10 BCM more, to be developed onshore under licence by CNPC, the Chinese national company. Engulfed in a very difficult negotiation to pressure Turkmen authorities (as seen above) to either

reduce their delivery volumes or the price, Russia and Gazprom have obviously lost their monopoly on those resources, but they still keep a predominant position. In the nearest future, Turkmenistan should be able to fulfil all its contracts commitments (10 BCM for the EU, 40 for China and around 45 for Russia). In the mid-term however, Moscow has to secure new Turkmen-produced volumes as much as possible, and avoid thus that China's intake grows at their expense. But experiencing strong difficulties to renegotiate with Turkmenistan, Russian authorities have quickly turned to Azerbaijan to try to compensate with Azeri gas. But, during his quick and urgent visit to Baku on 29 June 2009, President Medvedev only managed to ensure the acquisition of 0.500 BCM from the State Oil Company of Azerbaijan (SOCAR) beginning on January 1, 2010. This represents of course nothing but, as Alexey Miller said after the deal with the Azerbaijani, "Well begun is half done" (12). Russia is now looking for any gas purchase opportunities anywhere.

### **To operate a strategic rapprochement with Turkey**

Russia and Turkey have maintained close relationships for years, including, but not only, on energy issues. The Blue Stream pipeline, under the Black Sea between the Krasnodar Krai and Samsun, was completed in 2003 and has been working so far, carrying between 10 and 15 BCM of gas annually. Recurrent quarrels about prices and volumes stopped additional projects, such as the Blue Stream II. This second trunk, supposed to bring 16 other BCM was shortly discussed but dropped in 2007 in favour of South Stream, whose first *raison d'être* was to bypass as much as possible non-European countries and directly reach the southern EU. Today, objectively, considering the afferent difficulties to South Stream, it is in Russia's primary interests to review their position, reinforce their ties with Turkey, notably on energy matters, and reinstate the Blue Stream II idea. Indeed, that route to Turkey is cheaper and technically easier; its implementation would be faster, compared to the Nabucco pipeline for example. Russia thus would have a comparative advantage on Europe. The Blue Stream II also opens the way to the Israeli market for Russian gas. At several occasions, Gazprom has already expressed an interest in it (13). Lastly, if anyway, because of the strongly deteriorated relations with Ukraine, South Stream is to be built on Turkish EEZ, Russia should rather directly link Turkey and then separate the routes, one towards Europe, the other one to Israel. That strategy appears especially relevant as in Turkey strong political, academic and economic lobbying groups are pushing in that direction (14).

Russia comes back progressively to the Blue Stream II option. Russian high authorities have already begun to re-discuss it with their Turkish counterparts. In March 2009, Alexey Miller concluded a preliminary agreement with Turkey's governmental representatives; in Sochi in May, Prime Minister Vladimir Putin promised to the new Turkish Energy Minister, Taner Yildiz to re-launch the prospects on that issue. The South Stream Pipeline, which has not disappeared yet of course, could then serve as a bargaining tool, Russia asking significative Turkish concessions in exchange for their "abandon" of the South Stream strategic priority. That kind of instrumentalization is of course absolutely not calculated. Russia did not set up the South Stream Project purportedly, thinking to those different objectives with Turkey or about Central Asian resources and European markets. This project simply offers larger space for negotiation. That's a specifically Russian tactic to multiply declarations and initiatives on paper and afterwards give them up against some concrete political benefits.

### **Conclusion: Russia, the EU and the Prisoner's dilemma**

The EU and Russia have been opposing each other on those supply routes, South Stream or Nabucco, the Russian choice or the European energy independence, for the past two years. The South Stream Project does not appear as certain as Russia is claiming to. But in any case, whether that route would exist or not, Russia would manage to gain some advantages. Sooner or later however, Moscow would have to make a final and definitive decision. Probably, if indeed South

Stream is bound to fail, the best option then should be to cooperate and find common interests with the European Union. Otherwise, as shown in this revised model of Prisoner's dilemma, both countries would loose a lot and Russia even more, considering that South Stream either would cost a lot, or would never bring the expected results or might even never be implemented.

**The EU and Russia / Nabucco against South Stream**

	European Union	Nabucco	/
Russia			
South Stream	-15	- 10	- 20
/	-20	+ 20	0

*Table reading. There are two options for each country: either it builds its project or it does nothing. To do nothing or to build its project in second (whereas the other's project is already working) is considered equal in that presentation. The countries have to make a rational choice without knowing what is the other's decision. Figures do not represent any statistical calculation. They only give a range of loss and gains.*

Based on this double hypothesis of simultaneity of choice and rationality, it appears that the EU and Russia should better build their own Project pipeline, whatever the other chooses. But the table also says that acting unilaterally both entities would fail to achieve the best outcome. Theoretically, the EU and Russia should do nothing...or nothing alone, without consulting each other. In that sense, Turkey is to play an important pivotal role. To make the maximum of gains, the EU and Russia have to cooperate, and this cooperation, obviously, should not include any other state but Turkey.

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- (1) Speech Alexey Miller, CEO of Gazprom, to the Annual General Shareholders Meeting, June 26, 2009, Moscow. Addendum to the Memorandum of Understanding between ENI and Gazprom, 15 May 2009, Sochi.
- (2) Vladimir Khandokin, Head of the Logistics and Gas Purchasing Department, Gazprom Export, "Meeting Europe's Growing Energy Demand: North Stream and South Stream", *Blue Fuel Gazprom Export Global Newsletter*, June 2009, Vol.2, Issue 2.
- (3) According to concordant sources (Eurogas, European Commission, Russian forecasts), EU gas consumption in 2020 should reach 500 BCM, 250 BCM being supposedly provided by Russia.
- (4) Author's interview in Moscow: energy expert, April 2009.
- (5) Author's interview, Gazprom, International Media Relations Division, May 2009.
- (6) Alexey Miller, *op. Cit.* Author's interview, Gazprom, International Medias Division, *ibid.*
- (7) Alexey Miller, *ibid.*
- (8) *Blue Fuel Gazprom Export Global Newsletter*, June 2009, Vol.2, Issue 2.
- (9) An accord is said to be in preparation for the end of the summer.
- (10) Author's observation, Duma's Parliamentary Meeting between Just Russia and the European Socialist Party, April 2009. Author's interview, Duma Deputy, Moscow, April 2009.
- (11) The most important reserves lay indeed in Turkmenistan and Kazakhstan.
- (12) Oleg Mityayev, "Gazprom is losing Europe", *RIA Novosti*, 30 June 2009.
- (13) Author's interview, Gazprom, International Media Relations Division, May 2009.
- (14) Among others: Necdet Pamiir, Board Member, World Energy Council Turkish National Committee, "Turkey's Energy Challenge", *Blue Fuel Gazprom Export Global Newsletter*, June 2009, Vol.2, Issue 2.