

# Competing Designs for Caspian Energy Highways

## Russia and the EU Face Reality Checks

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*Pavel K. Baev*

*International Peace Research Institute, Oslo (PRIO)*

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The profound economic disaster that began unfolding in the summer of 2008 has inevitably distorted the energy-related political perspectives developed in the United States, the European Union, and Russia during an earlier period of steadily rising oil prices. In the wider Caspian region, the crisis has interacted with three crucial developments, causing a change in direction in the fluid systems of regional finance and security. The August 2008 Russian-Georgian war did not inflict physical damage to regional pipelines, but it seriously compromised the safety of the South Caucasian route. In January 2009, the Russian-Ukrainian “gas war” revealed the risks built into the European energy system and forced the EU to revise plans for diversifying supply sources and transit routes. Finally, in January-February 2009, the sprint start of the Barack Obama administration in the United States cut short the particular petro-ideological zeal that previously characterized U.S. policy toward the overlapping regions of the Middle East, Central Asia, the Caucasus, and Russia.

Assessing the new composition of drivers, policymakers in Berlin, Paris, Brussels, and Moscow cannot have any real confidence in their positions and have to acknowledge the possibility of political breakdown caused by economic dislocation. In Russia, the two-headed “tandemocracy” was a good-weather experimental construct which now increases the probability of an elite conflict that could be aggravated by a mutiny in the disgruntled army. Meanwhile, the

EU is experiencing strong centrifugal pulls that exacerbate a fundamentally poor fit between tightly integrated economies and loosely coordinated state-centric policies. For both Russia and the EU, energy policy has appeared to constitute a way out of the doldrums, with the Caspian-Black Sea interface evolving as a key focal point.

## **The EU Agonizes Over Diversification**

In November 2008, target figures for EU energy consumption, and specifically demand in imported gas, were sharply revised downward. These new targets appeared at first a triumph of wishful “green” thinking: the Energy Security and Solidarity Action Plan containing the new targets provided few details on how exactly projected gas imports for 2020 were to be reduced from a baseline estimate of some 455 billion cubic meters (bcm), at an oil price of 60 dollars per barrel, to 340 bcm (by comparison, the 2007 level was about 300 bcm). However, with a 40 percent drop in European gas imports recorded in the first quarter of 2009 (compared with the same period in 2008), the crisis has made the “ecologically correct” guidelines appear rather more realistic. While many alternative/renewable energy sources have become prohibitively expensive, the way out of recession for the economic “powerhouses” of the EU can hardly lead back to high energy consumption.

Still, a diversification strategy in this uncertain period cannot be policy-driven but has to make practical economic sense. Wind turbines may be aesthetically appealing, but natural gas remains the source with the best combination of cost-efficiency and eco-friendliness. The EU must also acknowledge that every incremental increase in the diversification of energy sources leads to greater differences between member states. Even now, for example, Finland imports all its gas from Russia, while Sweden imports none. Even if the Nord Stream pipeline does not materialize (though it most likely will), Northern Europe already has a far greater level of energy security than Southeastern Europe, which can ill afford expensive projects in, for instance, nuclear power generation.

It is thus precisely in the southeastern corner of the EU that the strategy of diversification involves a tricky balancing act of reducing dependency upon Russia without antagonizing it. A real breakthrough in enhancing the energy security of Southeastern Europe could be achieved by delivering gas from Iran, but its vast resources remain essentially off-limit. This option hangs on the slim chance that the Obama administration will be able to talk Iran out of uranium enrichment. The alternative solution that has long appeared suitable has been the opening of a medium-size southern “energy corridor” combining small gas streams from Azerbaijan and Turkmenistan and which could be widened by the end of the next decade, assuming Iranian gas comes online. This solution was on the table of the Prague summit on the “Southern Corridor” in May 2009, but the

key potential suppliers, Kazakhstan, Turkmenistan, and Uzbekistan, refused to sign the Declaration, backed by the presidents of Azerbaijan, Georgia, and Turkey, as well as the EU Commission, setting a goal of finalizing negotiations on the Nabucco pipeline by the end of June. A sharp row between Gazprom and Turkmenistan in early April does not change the fact that Turkmen President Gurbanguly Berdymukhammedov has fairly limited space to maneuver, while Moscow remains firmly set against the development of the trans-Caspian pipeline. Without it, the imagined gas highway is reduced to a mere donkey trail.

## **Russia Goes for the Impossible**

The dynamics of expected GDP contraction in 2009 is about the same in Russia and the EU (five to seven percent), but the relative scope of decline is greater in Russia, which used to have expansion of six to seven percent, than in the EU, with its sluggish one to two percent growth. Accordingly, the pain from the decline in economic fortune is far sharper in Russia, and the dismay within its leadership also runs more deeply. Prime Minister Vladimir Putin (whose opinion is the only one that matters) was initially confident that Russia was a “rising power” and that its accumulated reserves would suffice for keeping the economy on track, not just for cushioning its fall. While the main source of revenues for the state budget was oil export, it is Gazprom with which Putin has been deeply and passionately involved. The 75 percent decline in its market capitalization was thus a personal setback that influenced the first (somewhat desperate) draft of an anti-crisis strategy.

As the recession acquired a modicum of stability, Putin has left much of the “reassurance-providing” work to President Dmitry Medvedev, entrusted macroeconomic policy to Finance Minister Aleksei Kudrin (to the disappointment of many *dirigistes*), and concentrated on energy matters. The January 2009 “gas war” with Ukraine was conducted from his office and, through a deal with Ukrainian prime minister Yulia Tymoshenko, resolved as Putin’s decisions normally are, in non-transparent and ambiguous fashion. With his trademark inability to admit mistakes, Putin expected that Ukraine’s demonstrated unreliability would secure greater support for new pipeline projects, Nord Stream in particular.

Southeastern Europe, where the impact of the “gas war” was most directly felt, is potentially of greater importance in energy geopolitics. One crucial accomplishment was the resolution of a longstanding conflict in the Caspian Pipeline Consortium that opens the way for constructing a second trunk for the Tengiz-Novorossiisk oil pipeline. Putin’s main project, however, is a gas pipeline across the Black Sea known as South Stream. He has spared no effort negotiating with leaders of Bulgaria, Hungary, and Serbia to build a coalition of interested parties. Gazprom’s key partner in this endeavor, as in the construction of Blue Stream to Turkey at the start of the decade, is the Italian ENI, which is ready to

provide technological solutions for deep underwater construction tasks.

South Stream's main problem appears to be financing. Gazprom upped its cost estimate to as high as 19-24 billion euros. In these times of tight credit, however, it is hardly possible to secure commercial loans for a quarter of this sum. Putin's word that the necessary investments will be made may be as good as the gold in the vaults of the Russian Central Bank, but a potentially more complicated problem is that the pipeline has to cross either a Turkish or Ukrainian exclusive economic zone. Neither is any more willing to grant permission for this than is Sweden for Nord Stream. What might help circumvent this obstacle is an agreement with Turkey on combining South Stream construction with the addition of a second trunk for Blue Stream. This 16 bcm-capacity pipeline has never transported more than 10 bcm of gas a year. While the Turkish market itself is saturated, Ankara is eager to acquire the standing of a "gas hub." Vague ideas about export to Israel have been floated, but the main aim is inevitably Southeastern Europe, where Russia will not necessarily try to defend its monopoly.

## **The Turkey-Ukraine Dilemma**

In the evolving Russia-EU gas intrigue, Turkey and Ukraine have been shaping up not only as two focal points but as essentially two alternatives, representing different approaches to diversification and loaded with clashing – and hidden – political agendas. Until recently, Turkey was seen in Brussels as an aspiring EU candidate that had the added value of providing a transit route for non-Russian gas; the Nabucco pipeline project was the virtual embodiment of these perceptions. Now, the view from Europe is more of Turkey as an indecently persistent gate-crasher, trying to maximize profit and political dividends from gas transit. Indeed, the Nabucco project barely survived an attempt to erase it from a list of EU priorities, and the Prague summit produced only feeble support for it in any real political terms.

Ukraine was enthusiastically embraced by the EU after the Orange Revolution. Soon afterwards, however, its self-perpetuating political chaos and desperate hopes for accession complicated the relationship. The EU was generally supportive of Ukraine in the "gas episode" of January 2006 but far less so in the "gas war" of January 2009, when it harbored doubts about the "peace deal" reached behind its back. The practical conclusion from this breakdown of the key element in the European energy supply system, however, was not a need to expand the southern corridor (as the Nabucco fan club argued) but for investing in the modernization of Ukraine's energy infrastructure.

Putin was taken by surprise and infuriated by the EU-Ukraine agreement on a 2.5 billion euro energy loan, calling it "unprofessional" and "senseless." He also canceled Russia's own promise of a 5 billion dollar stabilization loan to Ukraine. The feeling of having been outfoxed by Tymoshenko, who graciously

slipped out of the deal that terminated the “gas war,” definitely added to Putin’s irritation. However, his overreaction was quite possibly deliberate, aimed at deepening divisions inside the EU. Decisionmaking in Brussels at the moment was affected by the collapse of the Czech government, which held the rotating EU presidency. More importantly, however, the European Commission was infringing on the interests of European “energy champions,” such as E.ON or ENI, who are prepared to go to great length for the sake of their lucrative contracts with Gazprom.

In this rather peculiar twist of the gas intrigue, the EU appears to have abandoned its own doctrine of diversification and made a bet on Ukraine, going for the most cost-efficient option while simultaneously aiming to reduce Russia’s political leverage. In turn, Moscow has dropped its reservations against a Turkish energy “hub” while firmly intending to reduce Ukraine’s transit grip on its exports, so that no more than half of the 180-200 bcm of natural gas that it plans to deliver to the European market by the end of the next decade will enter the Ukrainian pipeline system.

## **Conclusions**

Energy-centered political maneuvering in the southern “flank” of the EU-Russia interface has become more fluid and intense since the Russian-Georgian war, which effectively excluded the Caucasus from the European security system. There is a clear need to prevent a new war, and a moral obligation to help Georgia is acutely felt in many European quarters. However, rearmament is a very problematic proposition which Washington appears set to enact. This high-risk security environment scares away those Western investors who still have stakes in the energy business, but it does not deter Russia from advancing mega-projects aimed primarily at reducing its transit dependency on Ukraine. A sharp decline in revenues has forced Gazprom to reduce its 2009 investment program by twenty-five percent, but Putin has not accordingly scaled back his energy ambitions. Moscow has apparently concluded that the strengthening centrifugal momentum in the EU creates an opportunity to play hardball and disrupt the efforts of the EU Commission to shape a meaningful energy strategy combining diversification with a “green” agenda. Russia’s own vulnerability to the deepening recession is far greater than Putin is ready to admit. However, exploiting this vulnerability – or Putin’s self-deception – is not a rational choice for either the EU or the United States.

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