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THE POLISH INSTITUTE OF INTERNATIONAL AFFAIRS

NUPI Norwegian Institute of International Affairs

STRATEGIC FILE

No. 6 (69), March 2015 © PISM

The Power to Influence Europe? Russia's Grand Gas Strategy

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As most of Russia's energy exports go to the European Union, both players are strongly interdependent. For Russia, energy resources, especially gas, are viewed as a tool to project power beyond its borders. However, Russia's room for "gas manoeuvre" is constrained by its own capacities, the gas strategies of other players, and the EU's ability to project its regulatory power. As Russia's relations with Europe go beyond purely economic practices, and inevitably have geopolitical overtones, Europe should, in the short-term, try to limit the damage caused by the current application of Russian grand strategy; in the long-term, it should find out how to influence it, to its benefit.

In both economic and political terms, energy resources form the strongest link between Russia and the outside world. As most of Russia's energy exports go to the European Union, the relationship between these two players is often referred to as a situation of strong energy interdependence. Russia, providing more than 30% of gas and oil imported to the EU, is its most important supplier. In 2013 Russia exported 153.9 million tonnes of oil (66% of its total export), 139 billion cubic metres (bcm) of natural gas (70%) and 60.5 million tonnes of coal (50%) to the EU, and therefore has the structural power to influence energy policies of the union and its Member States.

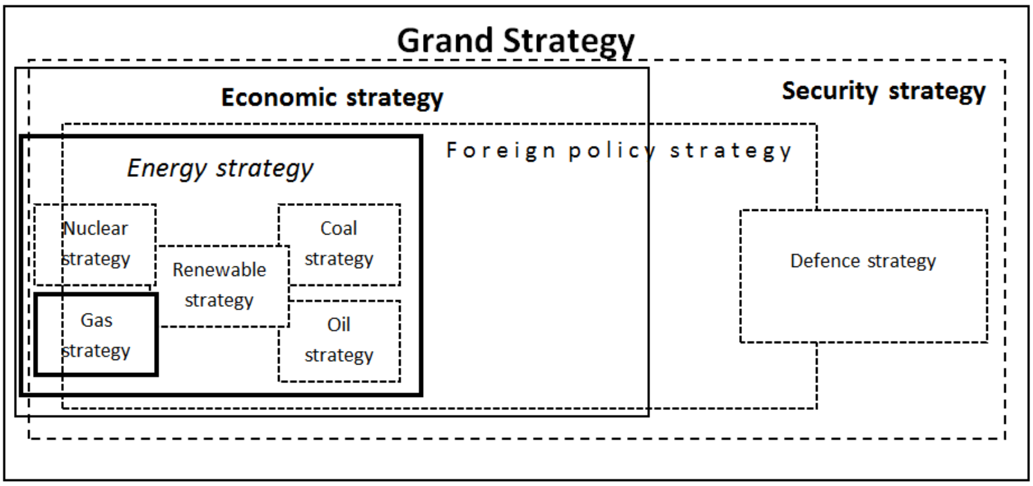
Although it is the oil sector that is the main source of revenue for the Russian state (40% of budget revenues compared with less than 10% coming from gas), the main focus of this study is on the Russian gas sector. There are several reasons for this. Firstly, the regional gas market in Europe is dominated by piped gas, and Russian gas going to Europe cannot yet be redirected to other markets due to the lack of necessary infrastructure. Secondly, and as a consequence, it is gas and not oil dependence on Russia that is viewed as the main energy security challenge that has to be addressed at both Member State and EU levels. Thirdly, what makes the situation in the gas sector in 2015 even more challenging is the fact that a relatively high share of gas supplies going from Russia to Europe still has to pass through Ukraine, which is in the state of de facto war with Russia.

As a consequence, reducing transit dependence on Ukraine, and Russia's dependence on the European gas market, are two obvious key elements of Russia's long-term gas strategy. Nevertheless, Russian strategy goes beyond the simple realisation of these two goals. This study aims to provide an understanding of the true main objectives of Russian energy policy in general, and its gas policy in particular. While some drivers of these policies are commercially legitimate, others fail to prove their economic viability.[1] In order to understand what determines Russian gas strategy, it is important to understand the gas sector's role in Russian grand strategy. Although Russia's strength lies in the fact it supplies approximately 30% of gas imported by the EU, its room for "gas manoeuvre" is constrained by its own capacities, the gas strategies of other players, and the EU's ability to project its regulatory power.[2]

The Strategic Dimension of Russian Energy Policy

According to Meghan L. O'Sullivan, national energy strategies should be interpreted in the grand strategic context because energy is the basis of economic growth, which can in turn be translated into political power.[3] She provides a definition of grand strategy as an all-encompassing concept guiding a country in its efforts to combine its instruments of national power, in order to shape the international environment and advance specific national security goals.[4] It is evident that, in the case of Russia, a self-reliant energy power having grand strategic designs and re-emerging as a classical style great power, energy resources are viewed as both a tool and a means to achieve not only economic but also security and political goals.

Figure 1. Gas strategy in a broader strategic context



The first aspect, economic and sectorial gas strategy, is thoroughly discussed in a number of documents. These include three versions of official Russian energy strategy, published in 2003,[5] 2009[6] and 2014,[7] and a document addressing specific gas issues that was signed by the Russian president in 2011.[8] We will therefore explore exclusively the grand strategic aspects of Russian gas policy towards Europe.

Russian energy resources, widely viewed as a vital strategic asset, give Russia the possibility to influence the policies (and not only energy policies) of other players who are dependent on its energy supplies. In this context, the question of resource management is a central element of any reasonable energy strategy, and allows the real intentions of an energy supplier to be determined. There are at least two sides to this

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[1] See J. Sherr, *Hard Diplomacy and Soft Coercion: Russia's Influence Abroad,* Chatham House, London, 2013 for more on this link between economic and political objectives.
[2] See A. Goldthau, N. Sitter, "A Liberal Actor in a Realist World? The Commission and the External Dimension of the Single Market for Energy," *Journal of European Public Policy*, vol. 21, no. 10, 2014, pp. 1452–1472.
[3] M.L. O'Sullivan, "The Entanglement of Energy, Grand Strategy, and International Security," in: A. Goldthau (ed.), *The Handbook of Global Energy Policy*, Wiley-Blackwell, London, 2013, pp. 30–47.
[4] *Ibidem*, p. 31.
[5] Russian Federation Ministry of Energy, *Energeticheskaya strategiya Rossii na period do 2020 goda* [Energy strategy of Russia through 2020], MinEnergo, Moscow, 2003.
[6] Russian Federation Ministry of Energy, *Energeticheskaya strategiya Rossii na period do 2030 goda* [Energy Strategy of Russia through 2030], MinEnergo, Moscow, 2009.
[7] Russian Federation Ministry of Energy, *Energeticheskaya strategiya Rossii na period do 2035 goda,* [Energy Strategy of Russia through 2035], MinEnergo, Moscow, 2014.
[8] Russian Federation Ministry of Energy, *General'naya skhema razvitiya gazovoj otrasli na period do 2030 goda*, MinEnergo, Moscow, 2008.

question. One relates to the management of energy resources available on the territory of the country in question, and the other is about the management of revenues generated by exploitation, sales and exports of energy resources. Elements of energy strategy going beyond economic practices inevitably have geopolitical overtones.

Resource Management: The Biggest Advantage or the Greatest Challenge?

Russian gas producers have long experience with gas exploration and supply, and nowadays try to cultivate an image of being predictable and stable gas suppliers, both on the world markets and internally. Russia holds one of the largest reserves, containing almost 50 trillion cubic metres of natural gas, which accounts for one-quarter of the world's reserves.[9] The Russian government has control of developments in energy sector through commanding stakes in key energy companies (for example, it holds 50.02% of Gazprom shares) and determination of the regulatory framework. It is also worth noting that the Russian gas industry did not collapse after the demise of the Soviet Union and, contrary to the oil sector, did not record a sharp decrease of production in the 1990s. Despite many difficulties at that time, Russian gas production remained at the level of 580–620 bcm per year, which placed Russia in the top global spot for both production and export. This situation changed in 2008 and 2009, when the United States, due to the shale gas revolution, became the biggest global producer of natural gas. At that time, because of the economic crisis in Europe, Russia decreased its gas production by more than 10%, but it quickly returned to the level of 600 bcm the year after the economic crisis.

According to official statements, the Russian authorities plan to increase gas extraction significantly, by developing new fields, among other measures, in order to recapture its leading position from the United States. Although 2014's short and long-term forecasts in Russian energy strategy are much more modest than those made in 2009, Russian gas production is planned to increase to the level of 739–770 bcm per year within five years, to 785–842 bcm by 2025, and to 860–936 bcm after 2034. Furthermore, the International Energy Agency (IEA) expected an increase in gas production, from more than 660 bcm per year by 2020 to more than 800 bcm after 2035.[10]

Nonetheless, these plans are difficult to realise. A key challenge in maintaining a high level of production and significant growth in forthcoming years is to replace depleted gas fields, explored since the Soviet era, with new ones. Annual production in the Nadym Pur Tazov district in Western Siberia is diminishing every year, and is expected to drop from the current 500 bcm to 333 bcm in 2035.[11] The three largest gas fields located there, Urengoy, Yamburg and Medvezhye, are already more than three-quarters depleted, and their annual decline is estimated at 25–30 bcm.

The most promising gas project is the development of new fields on the Yamal peninsula, which currently provides only a few bcm of gas, but from 2020 is projected to produce more than 100 bcm per year, and after 2035 more than 200 bcm. The second most promising fronts for gas extraction are the Eastern Siberian and Far Eastern regions, where the annual increase is estimated to rise from the current 7 bcm and 30 bcm, to 89 bcm and 94 bcm, respectively, by 2035. The third region crucial to maintaining a high level of production is the Shtokman field in the High North. However, plans to develop these deposits have been postponed. For geographical and infrastructural reasons, Yamal is to provide gas mostly to the European market, while gas from Eastern Siberia is to be exported to Asian markets. There are also some additional early-stage plans, such as the construction of an LNG plant on Yamal, and the Altai pipeline that will help Russia redirect some of the gas from Western Siberia to Asia.

These plans require huge investments, which Russian companies, despite their duty, will probably not be able to make, since according to the Russian Ministry of Energy and the IEA, they should amount to an average of $30 billion per year. In last few years Gazprom, which covers more than 70% of national extraction, rarely fulfilled this obligation. During the 2008 economic crisis, Gazprom spent only

[9] However, not all institutions collecting energy data calculate Russian deposits to be so high. While OPEC, the United States, the EIA and the Russian Ministry of Environment count them at 47–48 trillion cubic metres, the energy company BP estimates them at only 31 trillion cubic metres.
[10] Russian Federation Ministry of Energy, *Energeticheskaya strategiya Rossii na period do 2035 goda*, MinEnergo, Moscow, 2014, p. 215; IEA World Energy Outlook 2013, Paris; OECD, 2014.
[11] *Ibidem*.

$12–13 billion to this end, although between 2012 and 2014, the company invested around $35 billion annually in gas production, thanks to higher revenues caused by the high price of oil and gas at that time.[12] But this situation may change, as crude oil and natural gas prices have decreased sharply since the third quarter of 2014.

The fluctuation of oil and gas prices on the global market, combined with chronic structural problems, have also caused a severe decline in the value of such firms. Gazprom's capitalisation has dropped sharply since 2008, and has not recovered so far. According to the Financial Times ranking in June 2008, Gazprom was ranked the third biggest company in the world, with a market value of almost $345 billion. Nowadays, Gazprom's market value is the worst in its history; at the end of 2014 it was ranked 184th ($51 billion),[13] due to excessive debts, the falling value of the rouble, and poorly calculated projects such as the Nord Stream pipeline and gasification of the Sochi region for the Winter Olympics. To hide its problems, Gazprom's management decided not to publish quarterly financial reports on its website.

Revenue Management: Market Economy or Political Drive?

Russia's gas sector has the potential to generate huge revenues, allowing the current regime to embark on various ambitious programmes. Although Russia, following Norway's example, has established its own sovereign wealth fund, the combined value of which reached the level of $181.3 billion in 2014, the country's gas business culture and revenue management leave much to be desired. There are several reasons for this, but four of them seem to be crucial in the broader economic and strategic context.

Firstly, the lack of sufficient drive towards marketisation of the Russian energy market, especially the gas market.[14] Many branches of the Russian economy can only survive thanks to gas and oil rent reallocation by the Russian political class, which uses this practice to buy the support of various groups in Russian society. This political use of resource rent, draining resources from the sector and corrupting the whole economic system and parts of Russian society, makes it difficult to reform both the Russian economy at large and its energy sector more specifically.[15]

Secondly, mismanagement of contracts with external partners.[16] Although Gazprom sells only one-third of its gas abroad, this generates more than half of its income. Hence, gas exports, especially on the EU market, remain crucial for the development of the whole Russian gas sector. Yet, despite the process of price liberalisation on the European gas market, the Russian giant was determined to keep an oil-indexed price formula in its long-term gas contracts. Thanks to the high oil price on the global market between 2011 and 2014, Gazprom was able to sell relatively expensive gas to its European customers, notwithstanding the oversupply of gas on the spot markets. But this situation changed in autumn 2014, when crude oil prices dropped like a stone. From that time forward, across the board cheap oil has influenced gas prices negatively in Gazprom's oil-indexed contracts, and there is little chance to increase its income in the upcoming months

Third is the politicisation of Russian energy and the use of preferential energy prices as a form of payment to those players who do accommodate Russian strategic interests. Many post-Soviet states still receive cheap Russian gas. In 2014, Gazprom delivered gas to Belarus at an average price of $164 per thousand cubic metres, while its European partner, Germany, paid $323, and Poland was charged $379.[17] Moreover, Russia grants its closest political allies massive discounts on gas prices, which covers almost one-third of gas volumes delivered abroad, significantly diminishing Gazprom's profit potential. Amidst extremely tense relations with Ukraine, the Russian company extended the Ukrainian gas company Naftohaz a price

[12] Corporate information at www.gazprom.ru.

[13] FT Global 500, December 2014, www.ft.com.

[14] See L.P. Lunden, D. Fjærtoft, "The Impact of Domestic Gas Price Reform on Russian Gas Exports," in: J.M. Godzimirski (ed.), *Russian Energy in a Changing World: What Is the Outlook for the Hydrocarbons Superpower* Ashgate, Farnham, 2013, pp. 131–151.

[15] See C.G. Gaddy, B.W. Ickes, "Resource Rents and the Russian Economy," *Eurasian Geography and Economics*, vol. 46, no. 7, 2005, pp. 559–583; C. Gaddy, B.W. Ickes, "The Russian Economy through 2020: The Challenge of Managing Rent Addiction," in: M. Lipman, N. Petrov (eds.), *Russia in 2020: Scenarios for the Future*, Carnegie Endowment for International Peace, Washington DC, 2011, pp. 165–186; P. Sutela, *The Political Economy of Putin's Russia,* Routledge, London–New York, 2012.

[16] See J. Sherr, *Hard Diplomacy and Soft Coercion: Russia's Influence Abroad,* Chatham House, London, 2013, especially pp. 103–109.

[17] A. Kublik, "Agencja Interfax ujawniła ceny gazu Gazpromu. Polska płaci bardzo dużo," *Wyborcza.biz*, 6 March 2015, www.wyborcza.biz.

discount at the beginning of 2015 ($379 to $329 per thousand cubic metres).[18] Similar price adjustments will probably take place in the nearest future with other clients.

Fourth is the partly rational, partly irrational political drive towards diversification of routes and markets, symbolised by costly infrastructure projects, such as the Nord Stream or the now abandoned South Stream pipelines, or by the recent gas deal with China, in which Russia accepted a "lower than could be achieved" price partly due to the conflict with the West over Ukraine.[19] It is also worth noticing that Russia is aiming to diversify its markets through development of its LNG trade, and to reduce pipeline network supplies.

Politicising the country's energy resources and reinforcement of the strategic link between the country's energy sector and its grand strategy, have made many wonder whether having energy relations with Russia is safe in hard security terms. Russia, widely believed to pursue a zero sum game, is often suspected of using its energy resources to the detriment of its energy partners, and this has made many of them seek other, less risky energy solutions. In the current market situation, with new renewable and non-conventional sources of energy becoming more available, Russia may see its position on the most important and profitable European market challenged and weakened.

Relationship Management: Influence or Harsh Accommodation?

Ever since the beginning of Soviet gas trade with Europe in the early 1980s, concerns have been voiced that the USSR and then Russia could try to exploit European dependence on Russian gas for political goals, using commercial style tools of dubious nature. This is because both entities are vulnerable to interruptions of their energy trade, as gas is the basis for Europe's energy security, while Europe's demand guarantees Russian revenues. Even if the sentence of "Russia using gas as a weapon" is overused in the current geopolitical context, several arguments show that Russia is able to use its own strengths and at the same time takes advantage of European weaknesses. Such an alteration to the purely commercial logic that should be the basis of gas cooperation can suggest that Russia's energy policy indeed plays an important part in grand strategic designs.

The strong asymmetry and lack of parallelism in structures, which also function as leadership of energy sectors, characterise the EU–Russia relationship. These differences, reinforced by diverging approaches to international relations, prevent closer energy cooperation and construction of mutual trust. While discussing the Russian energy approach, it has to be underlined that there is no abstract decision making at the Kremlin. Hence it is necessary to make reference to Vladimir Putin and his entourage, eager to realise their strategic vision of Russian energy hegemony. Irrefutable vertical power, together with strong links between politics and energy through a national monopolistic gas exporter (Gazprom), give Russia a considerable advantage over the EU, composed of common institutions and 28 national governments, all subject to short electoral cycles.

As a consequence, the EU has a tendency to lead multipartite consultations aimed at preparing numerous scenarios predicting matters in the distant future, such as determination of gas strategy regarding Ukraine. Russia, in turn, is able to achieve its intended purposes under precise conditions in short periods of time, beginning for instance with gas supplies to Ukrainian territory under separatist control within three hours of Dmitry Medvedev's decision to do so. While the transparency of the EU's decision making is undoubtedly a virtue, Russia knows how to change this into a drawback. Transparency comes at a cost, and the outcome of lengthy, multi-stage negotiations between 28 Member States is widely known long before the final declaration is issued. It is therefore very convenient for Russia to take advantage of differing positions of individual Member States, and prevent implementation of a coordinated European energy policy.

In addition to this, there are national and private European energy companies in front of Gazprom, who all but act together, especially while dealing with Russia. While this approach seems legitimate in terms of open market competition, it is counterproductive for the gas relationship between the EU and Russia. Hence, a conflict of values arises, in which the liberal, consumer-oriented EU energy sector clashes with the Russian monopoly concentrated on political control of its business partners rather than win-win

[18] "Gazprom daje Kijowowi zniżkę," *Rzeczpospolita*, 5 February 2014, www.rp.pl.
[19] See interview with V. Milov at www.svoboda.org/content/transcript/25392667.html.

transactions. The impact of this asymmetrical economic relationship is clearly reflected in the persisting fragmentation of the European energy market, as well as the interpenetration of politics and business spheres. The clearest example of this EU vulnerability to Russian influence was the realisation of the Nord Stream pipeline, an undertaking that agitated EU internal politics.

Russia, belonging to the category of global and regional energy powers, seeks security of demand by all means. Russia currently exports gas to Europe through Ukraine and through Belarus, as well as directly via Nord Stream and via Blue Stream to Turkey. The scale of the volumes exported, the complexity of transport (gas has to cross numerous borders before reaching the final destination), and the nature of long-term contracts, mean that Russia looks for new market opportunities for its gas and seeks to eliminate potential competitors. This is how the idea of South Stream emerged, and made the Nabucco pipeline disappear from the EU agenda, to be replaced finally by the Turkish Stream project. This is also how Russia decided to enter the global LNG market, for the U.S. shale gas boom and merely the possibility of the US exporting gas to Europe made Russia fear the loss of its influence.

The third energy package, intended to bring major internal improvements on the EU's electricity and gas markets. also caused significant problems for Gazprom. The provisions of the directive, even though they sought to ameliorate the internal market, brought into question several pre-existing Russian practices, including long-term contracts (some of them binding until the 2030s), property rights for gas transmission pipelines and their exclusive operation, numerous re-nomination rights per day, buying separate entry/exit capacity at cross border points, and others.[20] European industrial consumers, contrarily to previous practices of bilateral long-term agreements, currently insist on gas trading through European hubs. Furthermore, the legal framework for relations with external partners is under constant evolution, which, combined with the prospects of an Energy Union, brings significant uncertainty to Russian security of demand.

It is not surprising, then, that Russia attempts to reduce the influence of European legislation on its own business. The problem is how in reality Russia does it. Russia uses suggestion, manipulation, indirect threats, and legal abuses, all in order to put pressure on the EU and its Member States. This hybrid approach consists of cultural, business, political and economic actions undertaken by Gazprom and the Russian authorities, through formal and informal channels. As a producer of gas and owner of transport pipelines, Russia has various tools to influence resource availability and its price, both positively and negatively. Its actions can range from cutting of supplies, (for example, during the 2009 Ukraine crisis), through manipulating hub prices (flooding or withholding gas), to subsidising gas prices for its best partner countries (such as the difference in gas prices between Germany and Poland). A wide range of soft tools such as media propaganda, sponsoring social movements, hiring the best lawyers, and undermining rivals' credibility is used by Russia in order to secure its position on the European market and, paradoxically, its image as a reliable, stable supplier.

Limits to Russian Influence

Even if both partners are looking for alternatives, one for its security of supply and the other for security of demand, Europe and Russia are condemned to be tied to each other for a number of years. The problem is that, despite convergence of their economic interests, geopolitical discord frustrates efforts to find a common middle ground, changing this relationship into a strategic energy charade. So far, Russian energy domination has been felt acutely in Europe, but current external factors such as shale gas development or a low oil price can turn the tide. Hence, the short-term question for Europe should not be how to break energy bonds with Russia, but how to limit the damage caused by the current application of Russian grand strategy. In the mid and long-term, Europe should however find out how to influence Russian grand strategy and turn it to its own advantage. While establishing itself as a fully-fledged, united, counterpart for Russia, the EU, for the sake of its energy security, should invest more effort in finding alternative sources of energy to make itself less dependent in energy terms on its apparently less predictable Eastern neighbour, whose actions have recently undermined the existing international security order gravely.

[20] S. Komlev, "The Third Energy Package and Its Impact on Gazprom Activities in Europe," *Natural Gas Markets*, Sub Working Group, Essen, 18 March 2011.

The GoodGov project explores how Poland and Norway can learn from each other in the crucial policy areas of security, energy and migration. This paper is one of three analyses devoted to the relations between the European Union and the key oil and gas suppliers: Russia, and Norway. The project is conducted by PISM in cooperation with the Norwegian Institute of International Affairs and the Institute of Political Studies of the Polish Academy of Sciences. The project is managed by Lidia Puka (PISM). The content editor is Roderick Parkes (PISM).

The research leading to these results has received funding from the Polish–Norwegian Research Programme operated by the National Centre for Research and Development under the Norwegian Financial Mechanism 2009–2014 in the framework of Project Contract No Pol-Nor/202499/39/2013.

norway grants

Polish-Norwegian Research Programme

Narodowe Centrum Badań i Rozwoju