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A System of Unconnected Vessels: The Gas Market in the Baltic States

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An internally integrated gas market that is independent from Russia is a permanent element of the Baltic States' energy policies. This goal in the regional dimension was to be achieved by the launch of an LNG terminal in Klaipeda, Lithuania, at the end of 2014. However, Latvia rejects the opportunity to import gas from Lithuania, and Estonia would benefit only slightly. Instead, to cooperate effectively, including in the implementation of joint infrastructure projects, all three act individually. This hinders the creation of a regional market and the EU should actively resist it.

Regional geopolitical conditions, including the Ukraine-Russia conflict, have apparently mobilized the Baltic States into regional cooperation: in January this year, Lithuania, Latvia and Estonia signed a declaration regarding security of energy supplies in which they committed themselves to the creation of a functional, integrated gas market. This perspective faces many hurdles and the Baltic States, a sort of island in the EU energy market, have acted only to a limited extent in favour of integration within the group.

Lithuania a Pioneer. Lithuania's assertive foreign policy towards Russia is reflected in its consistent implementation of energy projects, such as the launch at the end of 2014 of a floating LNG re-gasification terminal chartered from Norwegian company Hoegh. Lithuania signed a lease on it for 10 years with the possibility of renewal at a cost of approximately $690 million. The Lithuanian authorities assume that in 2015 the terminal will take in up to 1.5 bcm of fuel, which constitutes about 50% of the demand in Lithuania. The terminal's capacity is 4 bcm per year, which corresponds to 80% of the demand for gas in all of the Baltics (Lithuania, 2.7 bcm; Latvia, 1.6 bcm; Estonia, 0.7 bcm) and would provide an alternative to Russian gas.

Lithuania's motivation was to provide itself with alternative supplies, even bearing the cost of greater volatility of prices. Gas is delivered to the Klaipeda station by Statoil. Although Lithuania has managed to negotiate a price based on the UK NBP market price, it can be higher than Russian gas, especially after taking into account transportation costs. The profitability of the terminal is therefore questionable, despite plans to re-export some of the gas. This is especially true as sales opportunities have not worked out: Latvia has not shown any interest, there is no gas connection to Poland, and Russia plans to invest in its own LNG terminal in Kaliningrad. The Kaliningrad terminal would make Gazprom independent from transit through Lithuania and increase competition for the Klaipeda station. So far in 2015, despite revenue from re-gasification of up to €5.4 billion, only one-twelfth of the annual cost has been covered. In 2014, Lithuania obtained a price reduction to $370 per thousand cubic metres, in part by repeatedly appealing against the Russian company and seeking arbitration. Regardless of the economic prospects of the terminal in Klaipeda, it will be an important factor as Lithuania seeks to get a low price for gas in new negotiations with Gazprom, as the current contract ends in 2015.

Lithuania's action enhances the energy security of the state and strengthens its position as a regional leader, a role to which Lithuania is consistently striving. Lithuanian gas network operator Amber Grid is expanding the Klaipėda–Kuršėnai pipeline as part of the infrastructure connecting the Latvian gas storage facility in Inčukalns (max. capacity of 4.47 bcm, of which 2.32 bcm is used), which could be a basis for cooperation in the region. Due to the monopoly of

Latvijas Gaze (in reality, Gazprom) in access to the storage facility, Lithuania plans to build its own 0.5 bcm facility in Syderiai (Telšiai).

Because Lithuania has ambitions to become a regional gas hub, it supports transmission infrastructure projects integrating the Baltics with the networks of neighbouring EU countries: the Polish-Lithuanian GIPL gas pipeline, for which Poland's Gaz System and Lithuania's Amber Grid received EU funding (€10.6 million for preparatory work), and the Estonia-Finland Balticconnector. The launch of these projects would allow Lithuania access to the regional market and a sales potential of 25 bcm of gas per year.

Estonia on Point. Estonia, as with the other Baltic countries, until this year remained dependent on Russian gas supplies, but gas is relatively low in its energy mix (at just 9%). The electricity generation sector relies on combustion of high-carbon oil shale. Estonia has modernized its outdated infrastructure and invested in new sources based on wind power rather than gas technologies.

Despite its relatively low energy dependence, Estonia has supported regional projects. The lack of consensus among the Baltics concerning the construction of a common regional LNG terminal, which has been recommended by the European Commission, has led Estonian energy companies to begin to develop their own projects. Although Estonia's Eesti Energia in 2015 signed an agreement with Lithuania's LitGas for the purchase of 5.8 MMcm of gas from the LNG terminal in Klaipeda (in the first quarter of this year, gas imports from Lithuania accounted for 18% of overall gas consumption), it focuses on its own projects. With the three Baltic countries finding it difficult to work together, Estonia opted for cooperation with Finland. This includes finalization of a bilateral agreement between Finland's Gasum and Estonia's EG Võrguteenus Balticconector for the construction of a gas pipeline (with a capacity of 2.6 bcm per year), and an LNG terminal in each nation. For the whole region, a gas pipeline is most important, therefore the European Commission has put it on the EU priority projects list. Balticconnector will receive €5.4 million from the "Connecting Europe Facility" Fund for preparatory studies.

Latvia's False Start. The lack of progress in reform of the Latvian energy market is a major obstacle to integration of the Baltic States. This results in the persistence of Gazprom's control over the country's gas supplies and the possibility to use its infrastructure, which is important for the whole region. Initially, Latvia also intended to diminish the role of Gazprom by introducing complete ownership unbundling under the EU's third energy package. However, Latvian authorities in March 2014 delayed liberalization of the market, at least until April 2017, stipulating that they are still obliged to a 1997 agreement that guarantees exclusivity to the Russian firm.

The closed Latvian market has significantly slowed the progress of integration of the Baltics' gas sector. Gazprom's monopoly position does not allow for the use of the regional gas storage facility in Inčukalns or for the import of gas from other suppliers, including from the Lithuanian terminal in Klaipeda. While the underground storage at Inčukalns could be a guarantor of regional energy security, access to it in the coming years remains under the complete control of Latvijas Gāze, which means Gazprom. The Russian company in Latvia has the strongest influence among the Baltics and is effectively protected by the gas lobby. While Latvia's general willingness to liberalize its gas market means gas has been reduced in its energy mix (to about 30%), significant quantities are used for cogeneration of heat and electricity (the share of gas as a fuel in power plants in Latvia is 93%).

Conclusions. Despite successive political declarations by the Baltic States to create a common energy market, in practice their cooperation is illusory. The focus on their own projects with a disregard for regional projects creates doubt about their interest in rapid integration. Individual actions have clearly increased each country's independence but they have not resulted in regional consolidation. This applies to the terminal in Klaipeda, which, despite widespread expectations of immediate benefits to the region, has served primarily the interests of Lithuania. Estonia, although it is oriented as pro-integration, is carrying out its own projects, giving itself the perspective of energy independence in the form of new sources of gas. In contrast, Latvia seeks to maintain the status quo, at least indirectly succumbing to pressure from Gazprom. Meanwhile, the high costs of individual investments carry higher risk and in the long term may prove to be less profitable as they may become inadequate and inefficient with increasing competition in the region. The possible abandonment of energy cooperation in the region would petrify the Baltics' energy regimes in place and would dismiss the establishment of an effective gas market.

The different energy profiles of the Baltic States require action from the European Commission. The delays in the liberalization in Latvia have implications for the whole region, hampering even its internal integration. This gives a strong argument for the EC to be actively engaged in the process of legislative implementation and to support cooperation within regional projects due to their high capital intensity and the potential size of the market.

Poland will also play an important role in the Baltics' market integration. By 2019-2020, the construction of the Polish-Lithuanian GIPL gas pipeline, which will connect the region to the European transmission system, should be completed. Although Poland's Gaz System will bear 73% of the costs, the Baltic countries will be the direct beneficiaries; however, Poland, which is developing interconnectors with other neighbouring countries, has an opportunity to increase its position in the emerging gas market. Nevertheless, with increasing competition from LNG terminals in the Baltic Sea, where their total volume clearly increases supply, Poland should not allow further delays in the implementation of its own strategic projects.