

A Common Energy Market in the Eurasian Economic Union

Implications for the European Union and Energy Relations with Russia

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To the east of the European Union a regional energy market is taking shape under the auspices of the Eurasian Economic Union (EEU). Even if the interests of the participating states diverge and the ultimate shape of the market remains unclear, the development is likely to be substantial. On the one hand, it threatens to deepen the fragmentation of energy markets in Europe and Asia, on the other the process could generate new opportunities for cooperation and larger spheres of integration. It is thus worth exploring at this early stage the extent to which the emerging energy market is compatible with the European Union and the European Energy Community. It is especially important to track the effects in the common neighbourhood, above all Ukraine, in order to avoid renewed geopolitical disruption.

The Eurasian Economic Union was established on 1 January 2015, after Belarus, Kazakhstan and Russia signed the founding treaty in 2014. Kyrgyzstan and Armenia have since also joined. The concrete proposals for a common energy market developed in 2015 are more detailed and concrete than any other post-Soviet initiative; stability in the energy sector is essential for the economic prosperity of the EEU member-states. In terms of geographical area, this would represent one of the world's largest energy markets, strategically located between Europe and Asia and comprising a population of about 182 million. The affected countries together account for 14.6 percent of the world's oil

production and 17.3 percent of natural gas production – although this is almost exclusively Russia's (Kazakhstan contributes 1.9 percent and 0.6 percent respectively).

The EEU's decision-making process is complex. Its institutions include the Eurasian Economic Commission (EEC) and the Supreme Eurasian Economic Council, composed of the heads of state of the member countries. While the Commission is responsible for routine questions, fundamental decisions about sensitive and strategic resources such as energy are taken by the Economic Council. There is no clear legislative mechanism. Although the EEC is the Union's legislative organ, the Council also possesses the power to issue regulations

and decrees, and to point the work of the Commission in the “right” direction. The EEU also has a Eurasian Intergovernmental Council (composed of the prime ministers of the member-states) and the Court of the Eurasian Economic Union.

Partly owing to the asymmetrical power relations between the EEU members, the process is dominated by intergovernmental and bilateral negotiations. Armenia, Belarus, Kazakhstan and Kyrgyzstan together contribute less than 15 percent of the Union’s joint GDP, and represent almost 20 percent of its population. Russia is geographically, demographically, economically and militarily far larger and more powerful than all the other members, and correspondingly funds almost 80 percent of the EEU integration process. Under the EEU’s founding treaty all decisions at the highest level must be reached by consensus under “one country, one vote”. Belarus and Kazakhstan, however, have repeatedly complained of Russia exploiting its dominant position.

A common energy market in the EEU would have a significant influence not only on its own member-states, but also on the European Union, on the Energy Community (which exports the energy-related *Acquis Communautaire* to the EU neighbourhood and to which the Balkan states, Moldova and Ukraine also belong), and on the common neighbourhood in the Black Sea and Caspian regions. The market would also reverberate on China’s Silk Road initiative. Any revival of the old vision of a shared economic space from Lisbon to Vladivostok is now – if at all – only conceivable under these new premises. Decisively, Russia is pursuing the Eurasian integration project – against the backdrop of the Ukraine conflict – primarily for political motives, in order to consolidate its status as the leading power in Eurasia and to preserve its own influence in the region.

Concepts for the Energy Market

The EEC’s energy market concepts were prepared by its legislative body, the Collegium,

and the concept for the electricity market was approved on 8 May 2015 by the Supreme Eurasian Economic Council. The Collegium approved the gas and oil market concepts in December 2015 and they are due to be confirmed by the Economic Council by the first quarter of 2016.

The common electricity market is due to be realised by 2019, while the concepts for oil and gas are to be implemented in stages by 2024 and 2025 respectively. Progress on integrating energy markets will require the successive dismantling of infrastructure, commercial and regulatory barriers.

The concepts are based on existing (partly Soviet-era) infrastructure and on agreements dating from 2010, signed in the context of the customs union. The only new elements in the concept for the electricity sector are the introduction of a trading platform at the international level and the commitment to grant all EEU states non-discriminatory access to national transmission grids. Tariffs for EEU-wide long-distance transmission are not to exceed those at national level. These objectives are also relevant for third countries, because a quasi EEU-wide grid could contribute not only to the development of an electricity market within the region, but also to its transit potential.

An agreement on the methodology for preparing indicative balances for oil and gas products in the EEU was drafted in May 2015 and approved by the EEC at the end of September, also on the basis of agreements from 2010. The harmonisation and exchange of indicative balances is regarded as a precondition for barrier-free access to transport infrastructure and cross-border trade. But creating a common market will ultimately require much more incisive reforms with respect to privatisation, competition, unbundling and price liberalisation, as well as effective, independent regulation. It must be remembered that the member states of the EEU differ greatly in their progress on implementing reforms.

According to the concepts for the common EEU energy market published in 2015,

the member-states' obligations under international treaties, the particularities of national markets and the laws of the individual states will be taken into account. Priority will be granted to provision for national markets.

In terms of the oil market the central question – alongside the creation of joint infrastructure – is the pricing method for crude oil and oil products. Market prices are to apply to crude oil and oil products, while tariffs for pipeline transport will be subject to national regulation. But the pricing question is still a matter of controversy. In Russia the tax reform will gradually bring domestic oil prices into line with export prices; in the internal markets of other EEU member-states, on the other hand, no such trend is discernible. These sensitive points are therefore only vaguely mentioned in the concept. Price formation is to be based on market mechanisms and fair competition, but will take national conditions into consideration. There are also differences over gas pricing, which under the gas agreement of 2010 was actually supposed to have been brought into line with the market price by 1 January 2015.

Another point of dispute is the harmonisation of quality standards and norms for crude oil and oil products. Belarus and Kazakhstan regard this as necessary, while Russia believes it to be unrealistic.

Furthermore all technical and administrative trade barriers are to be dismantled, while commercial exchange and physical infrastructure are to be expanded. Market mechanisms are given preference, and the principle of non-discrimination of economic entities of the member states applies in the common market. Favourable conditions for investment are also to be created. Indicative balances of consumption, production and transmission are to be harmonised and shared.

Many of the same elements recur in the concept for the natural gas market, for example with respect to uniform standards of quality and norms (for calorific value, sulphur content etc.). But unlike for the oil

market, no concrete implementation timetable is specified. Instead the schedule until 2020 lists common standards as a priority, together with harmonisation of the relevant legislation. Under the objectives for a common gas market the concept also names non-discrimination, fair competition and a transition to market mechanisms, as well as a commitment to improve the conditions for investment in the gas transport system and to provide access to transport capacities in the EEU in a non-discriminatory and transparent manner. Not least, the concept also proposes establishing an exchange of information about consumption, pricing and transport capacities. For free capacity this is to be in place by 2020.

The pricing mechanism is described in quite some detail in the concept for the gas market, which proposes a voluntary commitment to achieve market-based gas prices. By 1 January 2025 a decision is to be reached on setting prices in the EEU on a netback basis, meaning net of the costs associated with bringing it to market.

From the international perspective it is significant that the extant market concepts principally concern oil and gas trading *within* the EEU and not with third states. Bilaterally agreed conditions are to continue to govern trade with other countries. It is also noteworthy that the EEU members intend to investigate whether their gas exports compete with one another.

In summary, it can be said that the decisive details have yet to be negotiated and implemented. The example of the European Union demonstrates how convoluted and difficult such processes can be. Despite great ambitions on paper, conflicts are predestined in the EEU because far-reaching differences are becoming apparent in the inter-governmental negotiations. The strongest driver to date has been Moscow's geopolitical interest; in other words the Kremlin dictated the pace and direction.

Asymmetry of Interests

The existence of (in some cases diametrically) opposing interests between EEU member-states hampers the creation of a common energy market. These result from an asymmetrical energy trade and the different starting situations of the involved states.

In the oil sector, resource-rich Russia and Kazakhstan are interested above all in modernising their refineries and petrochemical industries in order to boost value added. The oil sector tax reform initiated by Moscow in spring 2015 shifts the financial burden from the export tax to the extraction tax and was conceived as such a stimulus. But these incentives are currently subverted by the falling oil price, the devaluation of the rouble and the Western sanctions over Ukraine. In order to generate hard currency, Russia is exporting crude oil at post-Soviet record levels. These developments cross-cut the interests of Belarus, whose economy is heavily dependent on refining and exporting Russian crude. Belarus needs access to cheap oil if it is to preserve its strong refinery sector and processing industry. While Moscow wants a pricing mechanism that takes into account the specifics of the national markets, Minsk argues for a uniform oil price no higher than that determined by the international agencies, minus the transport and transit costs and customs duties incurred in export to third countries. Kazakhstan for its part insists that pricing be left to the market and occur under conditions of fair competition.

Minsk also hopes that the common market will provide access to cheap and reliable supplies of natural gas from Russia. Given that more than 90 percent of Belarusian electricity is generated using Russian gas, the gas price is a top priority for Minsk in the talks on a common energy policy. In this connection Belarus explicitly demands that a common oil and gas market be developed before the common electricity market is tackled – throwing a spanner into the ongoing negotiations over the latter.

Electricity trading between Russia and the other EEU members is restricted to exports to Belarus and Kazakhstan (with respectively 9.7 and 11.7 percent of total Russian electricity exports). However, because Belarus, Russia, the Kaliningrad enclave and the three Baltic states share a power ring (BRELL), the Baltic states are synchronously connected with the Russian and integrated post-Soviet UPS/IPS grid. The UPS/IPS grid is also connected to Finland via a high-voltage D.C. line. Only small amounts of electricity are exchanged between Kazakhstan and Kyrgyzstan, while Armenia is not connected to the other EEU member-states at all.

The trade in oil and gas between resource-rich Kazakhstan and Russia and the other EEU members is very unbalanced and represents only a tiny fraction of total exports. Kyrgyzstan for example receives no more than 0.001 percent of Russian oil exports.

Trade between Russia and Belarus represents an exception, with a much higher export volume than to the other EEU states. In 2014 it amounted to 23.3 million tonnes of crude and 20.3 billion cubic metres of natural gas (representing 10.4 percent and 9.5 percent of Russian entire oil and gas exports). The two neighbours are linked by cross-border value chains. On the one hand 90 percent of the electricity supply for Belarusian industry is generated from Russian gas. On the other, Belarusian refineries process almost exclusively Russian crude with the products largely also re-exported to Russia.

At the same time businesses are very closely linked, giving grounds to expect an intensification of trade relations between the EEU member-states. Russian businesses dominate, even if the current slump in the oil price has shrunk their financial leeway. The Russian state-owned Gazprom has subsidiaries in all the member-states of the Union. In Belarus it is involved in the onward transport of Russian natural gas via the Yamal-Europe Pipeline, through its subsidiary Transgas. In Kyrgyzstan it possesses

exclusive rights to explore and exploit domestic gas fields until 2028 and has taken over the state-owned Kyrgysgas. In the Armenian gas sector Gazprom possesses a monopoly via a subsidiary. In Kazakhstan Gazprom operates a joint venture (KazRosGas) and runs joint gas and oil exploration projects with the Kazakh energy company KazMunaiGaz and with Rosneft and Lukoil.

The Russian electricity utility Inter RAO UES also controls Ekibastus power station in northern Kazakhstan (output 1 GW) and the Armenian Razdanskaya thermal power station (1.1 GW).

There are joint projects in the nuclear sector too. Rosatom (Russia) and Belarus have agreed to build a nuclear power station (2.4 GW) and negotiations on another are under way with Kazakhstan.

Electricity Market as the Driver?

Electricity market integration is the project with the most ambitious timeframe. And the electricity market could function as the starting shot for the EEU's common energy market, because despite the critical position held by Belarus the negotiations are already well advanced.

However, an integrated market can hardly be created without privatisation, competition, unbundling of vertically integrated companies, and an independent regulator. And here the starting points diverge enormously. With 223 GW of installed capacity Russia possesses considerable surplus, with significantly ageing plant. Kazakhstan has 16.9 GW installed, Belarus 8.3 GW, Kyrgyzstan 2.6 GW and Armenia 2.1 GW. In Belarus the electricity market is under complete state control through a single vertically integrated company, while Russia's is largely run by (part-)privatised companies. The Russian wholesale market is liberalised and there is a capacity market. Today consumer prices remain regulated only in a few regions. The Kazakh market is similar to the Russian, but with a different mechanism for consumer pricing. There are also considerable regional differences within the

country, whose three electricity regions are only weakly connected to one another. A capacity market is to be established in 2016. Although the Kyrgyz electricity market is partially liberalised, it remains dominated by an open joint-stock company, in which the state holds a majority stake.

In principle electricity market integration can follow one of three models: a common market (the most far-reaching option), a common trading platform, or the linkage of national markets. In view of the differences between the EEU member-states and their unwillingness to restructure their national electricity markets, the common electricity market has been modelled on the European Union's electricity market for continental Europe. This model retains the national markets, which operate in parallel to a common market on which companies can trade both bilaterally and through a centralised auction platform. An electricity exchange would be a new element for cross-border electricity trading in the EEU, whereas bilateral trading is already well-established. While the capacity of the cross-border transmission lines would permit trading of about 30 GWh annually, just 6.5 GWh were actually traded in 2014. Russia's exports are in fact declining, and now represent less than 4 percent of total generation. Imports are less than 1 percent of total consumption.

Since Soviet times today's EEU members have been connected by a shared transmission grid. But this network needs to be further expanded and above all comprehensively modernised.

Implications for the European Union and the Energy Community

Alongside the open question of how quickly and incisively a common market will in fact emerge in the EEU, the question of what internal reforms will be initiated in the process is also important. This affects above all the monopoly on pipeline transport, but also that on exports and imports. This is of interest to Europe in relation to diversified gas imports from Russian non-

Gazprom and Central Asian producers, and also in relation to electricity trading.

In the 1990s the transit of Central Asian gas through Russian pipelines was a sticking point in the Energy Charter process, because Gazprom wished to protect its monopoly on transport and exports. Attempts by the Russian firms Rosneft and Novatek to gradually break open that monopoly failed again at the end of 2015. It is therefore hard to imagine the EEU integration process producing any change there. Circumstances within Russia could, however, lead to reforms. On the one hand Moscow shows great interest in expanding the area of integration; on the other, economic pressure is increasing as a result of sanctions, falling commodity prices and the slide of the rouble. Any reform moves in Russia could also present the European Union with a new situation, for example if other Russian gas companies would supply e.g. via the Nord Stream pipeline.

Despite the crisis over Ukraine, there are thus good reasons to approach the EEU process constructively. From the European perspective the question is to what extent one can encourage a positive market-led development from the outside. In the current complex political situation any active attempt by the European Union to exert influence is likely to be counterproductive.

A more promising option is cooperation at the technical, operational and regulatory (working) levels. Looking ahead, it is important to avoid fragmentation in the Euro-Asian energy market and to ensure compatibility. This is especially relevant at the boundaries of the different energy spaces and for countries located in-between that belong neither to the EEU nor to the European Energy Community. Creating a common energy market for the EEU could build new bridges – or create deeper rifts in Europe.

In Europe it is widely assumed that the EEU is a project aiming to isolate its members from the European Union and establish a political coalition under Russian leadership. But within the EEU both inte-

gration processes are in fact regarded as complementary at expert and working level. It is emphasised that closer cooperation with institutions of and in the European Union is essential and would offer advantages to both sides. Both in expanding an EEU-wide energy grid and in modernising the energy market, it is noted that the Eurasian Economic Union will be heavily reliant on foreign investment, know-how and technology transfer. Thereby it is emphasised that the cooperation must be based on shared economic interests; different political values of the European Union and EEU member-states should not be made into a problem.

The fact that the European continental electricity market was taken as the model for the EEU's common electricity market leads to discussion of the potential of a common economic area with the European Union entering the domestic Russian discourse. Here there are obvious similarities with the vision "From Lisbon to Vladivostok" propagated by Vladimir Putin in 2010.

The representatives of the EEC Collegium responsible for energy and infrastructure are seeking dialogue with European actors in the energy field. The chair of the EEC is Viktor Khristenko, who long led the Russian end of the EU-Russia Dialogue. European institutions visited by members of the Collegium include the independent Council of European Energy Regulators (CEER), marketplaces for energy and related products such as EEX, ICE and ICE ENDEX, the European Network of Transmission System Operators (ENTSO-E) and the European technical coordination centre for system security CORESO.

Apparently purely technical and commercial processes have potentially major impacts on the interfaces between different markets. They can deepen demarcation lines and exacerbate geopolitical conflicts. Although little strategic attention is generally devoted to the electricity sector, it is precisely here that important long-term changes are emerging in the Black Sea, Caspian and Baltic regions. The Baltic Energy

Market Interconnection Plan (BEMIP) proposed synchronising the Baltic States with the European continental network. Estonia, Latvia and Lithuania are still part of the Soviet-era power ring (BRELL), and otherwise only connected to the Scandinavian Nord Pool electricity market via high-voltage D.C. lines. But talks about de-synchronisation with Belarus and Russia were suspended in 2014 after a study showed that keeping the existing system made better economic sense. Electricity market integration in the EEU context could create a whole new dynamic here, for example in connection with the planned nuclear power station in Kaliningrad, which will be looking to sell electricity to the European Union. On the other hand, a de-synchronisation forced through for geopolitical reasons would create a great need for investment in network connectivity in Belarus and Russia and could lead to new political turmoil.

The implications of developments in the Black Sea region are even more far-reaching. Synchronising Turkey with the European continental network in 2014/2015 was a crucial step. A feasibility study has shown that Romania, Moldova and Ukraine could also be connected to the European continental network if that was politically desirable. It would be technically possible, but expensive. If that meant disconnecting Crimea and the separatists in eastern Ukraine, it could write the military front lines into the grid architecture and de facto cement existing demarcation lines. This presents the European Union with a dilemma, as various sides in the conflict have without doubt used energy supplies as a means of hybrid warfare. Moves that might create greater security and flexibility for one side would leave others out on a limb. A tricky situation could also arise in the Caucasus, where Georgia is a candidate for the Energy Community, while South Ossetia, Abkhazia and Armenia are being drawn into the orbit of the EEU.

Recommendations

The European Union should follow the development of an EEU-wide energy market very closely, as the process is strategically important for at least two reasons. Firstly, a fragmentation of the energy markets in Europe should be avoided, as it would create new conflict lines and commercial disputes. Secondly, the European Union possesses a manifest interest in free and liberalised trade. The EEU's increasingly close cooperation with China could shift the region's orientation from Europe to Asia and establish mercantilist trading patterns. China and Russia are discussing the possibility of integrating the EEU into the Silk Road Economic Belt, and China is specifically channelling long-term funding into infrastructure projects in the region.

From this perspective it would seem advisable to seek dialogue at an early stage. The European Union should respond to the EEU and to China's Silk Road initiative with integrative proposals seeking shared technical standards and norms, compatible trading forums, and a joint codex for energy trading, investment and transit.

A realistic perspective is helpful here, because both integration processes – the EEU's and the Silk Road initiative alike – are driven by tangible economic interests. The European Union's "DNA" is different of course; it is rooted in general, commonly shared values and norms (such as solidarity). Even if the EEU and the European Union are not dissimilar on paper, their respective dynamics differ significantly.

At the same time, the European Union must possess an interest in compatible norms, standards and rules. At the working and technical levels, despite geopolitical troubles, there are good grounds for offering the EEU cooperation in developing and implementing its common energy market. The repercussions at the boundaries of the energy spaces and on the common neighbourhood could otherwise be (even more) consequential.

First and foremost, cooperation at working level – for example concerning high

voltage grids, experiences in unequal power generation and regional distribution, mechanisms of cross-border trading, network planning and IT security – could contribute to ensuring compatibility between the European Union and the EEU, and at least not drifting further apart at the technical, commercial and regulatory levels. Should direct cooperation between EU institutions and EEU continue to be difficult, the Energy Community could also become involved. But ultimately a plurilateral dialogue between Europe and Asia needs to be expanded and intensified at multiple levels: through existing institutions such as the International Energy Charter process, but also via new mechanisms in the UN Economic Commission for Europe (UNECE) and the OSCE. The lack of mechanisms and forums is a problem.

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Further reading

Alexander Gusev
Kirsten Westphal
*Russian Energy Policies Revisited.
Assessing the Impact of the Crisis
in Ukraine on Russian Energy
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Implications for German and
EU Energy Policies*
SWP Research Paper 8/2015