Norwegian Institute of International Affairs

Policy Brief
[2 / 2016]

Nord Stream 2: policy dilemmas and the future of EU gas market

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Summary

The Nord Stream 2 (NS2) gas pipeline project is one of the most controversial issues in EU gas-related debates today. Its proponents hold that the project is driven by purely commercial considerations, while opponents label it as political and contradictory to EU goals and rules. The project has also contributed to raising several questions concerning the role of commercial actors in the shaping and realization of the EU energy policy as well as the impact on EU internal cohesion and relations with Ukraine and Russia. Realization of NS2 may boost the role of Russian gas in the European energy mix, especially in northwestern Europe; however, it could also undermine the credibility of the common EU energy policy, which aims, at least formally, at diversification of supply routes and suppliers as a joint and coordinated response to the energy-security challenges faced by the EU as a whole and by its member states. This Policy Brief sheds light on the current state of the debate on this project and examines the possible short-, mid- and long-term implications.

1. Nord Stream 2: Controversy & policy dilemmas

The Nord Stream 2 (NS2) gas pipeline project has become one of the most controversial issues in EU gas-related debates today. Its proponents – some of the biggest northwest European (NWE) gas companies supported more or less openly by governments in Berlin,[1] Paris[2] and Vienna – hold that the project is purely commercial. Its opponents – most of the Central and East European (CEE) countries, recently backed by Italy[3] – say that the project is political and contradictory to the EU goals of diversification and energy security goals. They have called for an EU-wide debate on the project,[4] as they fear greater dependency on Russian gas coming from only one direction. Indeed, the NS2 project could undermine diversification of gas supply sources, which remains a key goal of current European security of supply strategy, specifically of EU policy in the Central and Southeastern regions.[5] Its realization would make it harder to take difficult political decisions concerning relations with Russia, and could also adversely affect relations with Ukraine, as NS2 construction would both indicate a return to 'business as usual' with Russia and result in lesser EU interest in energy cooperation with Ukraine.

Proponents of NS2, for their part, are worried about the future of EU gas market. This future, and the role of specific EU gas companies, is being challenged by depressed demand, relatively high (consumer) prices and the uncertain role of gas in EU energy mix. In addition, there are supply-side problems, like falling internal production, the volatility of supplies from North Africa, and the risks entailed with imports from Russia – especially if they pass through Ukraine. As a major joint investment and long-term infrastructural connection, NS2 could help to address at least some of these worries by increasing stability of gas supplies from Russia, the biggest and potentially cheapest supplier – as well as possibly improving the image and competitiveness of gas on the EU market. Many actors view cooperation with Russia as a necessary condition for the revival of the gas sector, but NS2 could also play a political role as a possible re-opener of energy dialogue with Russia, preventing it from becoming a more profound and lasting pivot for Asia.[6] Finally, EU companies engaged in

1 See remarks by German Vice Chancellor S. Gabriel during meeting with Russia's President Putin: http://en.kremlin.ru/events/president/news/50582
2 See speculations on political backing: http://tass.ru/en/economy/832372
3 However, Italy's move seems more a tactical one, as it has already started talks with Russia on possibility of joining Nord Stream 2 by Italian companies see e.g. https://uk.finance.yahoo.com/news/saipem-gains-nord-stream-2-095200175.html
4 http://www.reuters.com/article/2015/11/27/us-ukraine-crisis-nord-stream-idUSKBN0TG0JX20151127?feedType=RSS&feedName=worldNews
5 See e.g. https://ec.europa.eu/energy/en/topics/infrastructure/central-and-south-eastern-europe-gas-connectivity on diversification and integration as key goals launched in early 2015 by EU and member states with the CESEC initiative
6 See e.g. http://www.swp-berlin.org/fileadmin/contents/products/research_papers/2015RP08_gsv_wep.pdf

the NS2 project may have their own corporate interests. Shell may wish to strengthen its leading position further (after acquiring, in early 2015, worth USD 70 billion British Gas's shares, and the significant strengthening of position on the global LNG market). Austria's OMV wants to counterbalance challenges to its position on the Central European gas market and the future of the Central European Gas Hub (CEGH), such as the collapse of the Nabucco and the South Stream projects and the fall in export of Russian gas via Ukraine. German companies might be aiming at strengthening both their own and Germany's role in the European trade and transit of gas – a role which has increased significantly since the worsening of the Russian–Ukrainian gas conflict from mid-2014.[7]

Divergent views and interests of CEE and NWE countries are to certain extent reflected in the EU approach to the issue. EU institutions have been rather sceptical regarding NS2 itself. Both the Commissioner for Climate and Energy and the Vice President for Energy Union have warned that the project will not provide for diversification of sources or routes of gas supply to the EU, and that the EU Commission will rigorously assess its conformity with EU rules.[8] Similar concerns were expressed by the European Parliament in its resolution on EU Energy Union strategy[9] and by the European Council, which in December 2015 called for any new infrastructure to comply with both EU law (third package) and Energy Union objectives.[10] At the same time there have also been calls from some key EU politicians – like German Minister of Foreign Affairs F.-W. Steinmeier[11] and EC President J.C. Juncker[12] – for rapprochement in economic and energy relations with Russia. The persistence of intra-EU differences can negatively impact the process of policymaking in the EU, as well as the consistency of EU energy policy itself and specific gas-related strategies.

Current debate on the NS2 project goes beyond energy, as questions about the desired shape of EU relations with Russia or Ukraine are also discussed. The NS2 agreement, which was signed without consultation with partners in the EU (neighbouring states, other companies, EU institutions), give rise to questions about the rules of the game when it comes to projects of strategic, pan-European significance. How should the EU proceed in such cases, especially if they fuel internal controversies? What is and should be the role of specific actors and institutions, and the relationship between commercial and political actors in shaping EU energy policy? The opinions of EU institutions about new infrastructural projects may well influence the decision-making process – but the final decisions are taken by investors who risk their money[13] and thus significantly co-shape the EU gas market and in consequence set limits on the feasibility of some EU energy-policy goals (as defined until now) and the role of the European Commission as regards project realization.

2. The new context

The idea of expanding the existing Nord Stream gas pipeline is not new:[14] what is surprising has been the re-emergence of the project in mid-2015, in the current political context.[15] NS2 is to follow the same route as the original Nord Stream, have the same capacity (55bcm) and be constructed by a similar consortium where Russia's Gazprom holds 50% of the shares, with the remainder belonging to northwest European companies (this time: German Eon & BASF, French ENGIE, Dutch Shell and Austrian OMV). These companies can get access to Russian upstream on the asset-swap basis: BASF has already finalized such agreements, while OMV is negotiating the details. Also the estimated costs – ca €8 billion – are similar. The project should be less complicated technologically and legally; and gas would be landed in the same area in Germany, for further distribution within the EU.

However, the global and EU gas market context has changed. The shale revolution, and growing volumes and decreasing prices of both LNG and piped gas, translate into oversupply and increased gas-to-gas competition. Ongoing market liberalization and integration mean greater flexibility in the European market. Within the EU, the demand for gas has been decreasing since 2008, with gas being pushed out from the EU energy mix by coal and renewables. This trend is expected to continue,[16] but due to decreasing internal production[17] and stalled developments in unconventional gas, European gas imports will keep growing. Assessing future gas needs is difficult, due to sustained uncertainties related to the final shape of European electricity/gas markets, EU energy-policy design, and implementation of 2030 goals. This negatively affects the situation for the European gas companies that have been shelving increasing numbers of gas-fired power plants and changing their strategies. They want the EU to be more clear on its gas-related goals.[18] Those factors also negatively influence the feasibility of future investments in EU internal gas infrastructure, creating a vicious circle where the lack of infrastructure hinders market flexibility, security of gas supply, as well as a (potential) revival of gas demand.

7 See http://www.osw.waw.pl/en/publikacje/analyses/2015-06-24/gazproms-call-proposals-how-many-new-gas-pipelines-to-europe
8 See e.g. http://europa.eu/rapid/press-release_SPEECH-15-5797_en.htm
9 http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P8-TA-2015-0444+0+DOC+PDF+V0//EN
10 http://www.consilium.europa.eu/en/press/press-releases/2015/12/18-euco-conclusions/
11 See http://www.ft.com/intl/cms/s/0/4ee93654-9840-11e5-9228-87e603d47bdc.html#axzz3t9OTpXZc
12 See http://www.dw.com/en/eu-commission-kremlin-confirm-juncker-letter-to-putin/a-18863225
13 http://www.ft.com/intl/cms/s/0/0028981c-ae56-11e5-b955-1a1d298b6250.html#axzz3wHZgkjKn
14 It was raised by Gazprom back in 2011, then aimed primarily at supplying UK gas market. From then and until 2014 was part of the EU's gas network development plans. See: http://www.entsog.eu/publications/tyndp/2013#ENTSOG-TEN-YEAR-NETWORK-DEVELOPMENT-PLAN-2013-2022
15 Tense EU–Russia relations, sanctions regime.
16 See IEA WEO 2015.
17 On subsequent Groningen production caps, see: http://www.reuters.com/article/2015/11/18/netherlands-gas-groningen-idUSL8N13D-1CO20151118
18 See interview with CEO of German Uniper K. Schaffer calling for an EU gas target unrelated to renewables or energy efficiency targets as a way of increasing security of demand: http://www.energypost.eu/klaus-schafer-future-ceo-uniper-eu-set-target-gas/

3. Rethinking Gazprom's strategy

The situation on the European and global gas market negatively impacts the results of Gazprom. Its exports to both the EU and the CIS decreased significantly in 2014;[19] the prices are also lower at EU gas hubs[20] and – due to low oil prices - in long-term oil-indexed contracts. In 2016 the average price of Russian gas for European consumers is expected to be at approx. USD 200 /tcm, the lowest in 11 years.[21] Also tense EU–Russia political relations resulting from the Ukraine crisis play a part: in addition to sanctions and freezing of bilateral gas consultations, the EU has intensified its attempts to diversify gas imports and decrease its dependency on Russian gas.[22]

Challenges on Gazprom's key external market come in addition to those at home, where gas demand has been decreasing since 2011, and Gazprom faces increased competition from other gas producers (mostly Rosneft and Novatek). In consequence, Gazprom's share in the domestic gas market dropped from 83.5% in 2007 to 69% in 2014.[23] The two main competitors have also been lobbying for liberalization of Russian gas exports, and in 2013 managed to achieve right for independent from Gazprom LNG sales.

In response to challenges with the EU, in 2014 Moscow intensified its attempts to diversify Russian gas export markets, especially by speeding up agreements with gas-hungry China. However, challenges linked to financing new gas pipelines to China and related upstream projects,[25] economic problems in Russia, increased competition, and lower prices on global gas markets (including LNG), combined with recently depressed Asian demand, may further postpone the opening of new markets for Russian gas – which would in any case have been feasible only in the longer term.

In consequence, the importance of EU gas market for Russian gas exports has been reaffirmed and Gazprom has had to rethink its European strategy. Gazprom seems, at least at present, to be refocusing from defence of its gas prices to defence of its market share in the EU, and has shown greater openness towards adapting to the changing market and regulatory settings in Europe. This might explain Gazprom's apparent interest in settling the antitrust case with the European Commission.[26]

Gazprom focuses on increasing its flexibility of operating on more liquid and volatile EU market. It seems more open to try new solutions in gas trade with the EU, such as selling gas via auctions[27] and increasing the role of spot prices,[28] and is paying more attention to the 'liquid' segment of EU gas market (more frequently entering gas-to-gas competition and selling more gas on European hubs). It also has been enhancing its access to EU storage and other gas infrastructure, for instance, through the recent asset-swap with BASF and the forthcoming asset-swap with OMV, as well as through building additional gas pipelines to Europe, like the proposed Turkish Stream or NS2. Gazprom's interest in the LNG market[29] marks another step in this direction.

Gazprom's partnership with northwest European gas companies is an important instrument in its policy. The Nord Stream 2 agreement also shows that, in its attempt to defend its market share, Gazprom – contrary to Norway[30] – may be ready to play quite boldly, and, despite poor EU demand forecasts, may launch large and expensive projects.

4. What does all this mean for the EU gas market?

NS2 would double capacity of the existing direct export route to Germany, and, via the German network, further to the other EU counties. The new Baltic route would be only slightly smaller than the existing Ukrainian route (110bcm vs ~142bcm/y). Additional capacity would enable Gazprom to step up the volume of its exports to the EU relatively quickly, in the case of increasing gas demand or import needs (like a further fall in EU gas production,[31] or unexpected cuts in Norway's gas exports). Moreover, it would, in the short to medium term, constitute mainly a surplus capacity, as existing capacity is not fully utilized – in 2014, available capacity for Russian gas exports to Europe and Turkey was at ~ 307bcm, while Russian gas exports amounted to less than 147bcm.

Construction of Nord Stream 2 would make Russia less dependent on transit via third countries – Ukraine (and Slovakia) but also Belarus (and Poland). Furthermore, and possibly even to a greater extent, it would increase Gazprom's possibilities for choosing optimal routes for gas supply to delivery points agreed with its EU consumers. Along with other Gazprom assets in the EU gas infrastructure,[32] NS2 would thus increase Gazprom's flexibility in operating on the EU gas market. That could in turn lead to heightened uncertainty about the level of utilization and profitability of existing transit infrastructure – in Ukraine,

19 by over 17% y/y in 2014 for the EU, and for the CIS by almost 20% – calculated on the basis of data from Gazprom's Annual Reports www.gazprom.com

20 What has been proven recently inter alia by decision of Ukrainian Naftogaz to stop gas imports from Gazprom as buying gas at EU gas hubs is cheaper: http://www.argusmedia.com/News/Article?id=1142681

21 According to Gazprom's own estimates from late 2015; see http://www.bloomberg.com/news/articles/2015-10-23/gazprom-said-to-see-its-lowest-eu-gas-price-in-11-years-in-2016

22 See e.g. European Energy Security Strategy or EU LNG and gas storage strategy (still being developed).

23 See: http://minenergo.gov.ru/activity/gas/

24 It had signed an agreement on gas exports and Russia–China pipeline construction ('Power of Siberia') and started negotiations of one other (the Altai pipeline project).

25 Details regarding gas prices or financing of Power of Siberia construction remain unclear.

26 Gazprom is said to have submitted a proposal for such a settlement, in parallel to issuing a formal response to EC allegations. See e.g. http://www.ft.com/intl/cms/s/0/16f9906a-6067-11e5-a28b-50226830d644.html#axzz3sgXQ6kGQ

27 See first auctions or reported Gazprom Export intention of auctioning gas for Baltic states supplies after contracts expiry http://www.bloomberg.com/news/articles/2015-09-10/gazprom-prefers-price-over-volume-in-first-eu-gas-auctions, http://tass.ru/en/economy/833559

28 alleged Gazprom's promise to its Nord Stream 2 consortium partners to increase sales at spot prices http://uk.reuters.com/article/uk-russia-gazprom-spot-exclusive-idUKKCN0S72FC20151013

29 See e.g. http://oilprice.com/Latest-Energy-News/World-News/Gazprom-Sees-LNG-As-Key-To-Its-Future.html

30 Norway's Minister of Petroleum and Energy has called for assurances related to EU gas demand if Norwegian companies were to build gas pipelines from Barents Sea gas fields to Europe http://www.ft.com/intl/cms/s/0/b74ad666-9526-11e5-8389-7c9ccf83dceb.html#axzz3t9OTpXZc

31 E.g. next production caps in the Netherlands see : http://uk.reuters.com/article/uk-russia-gazprom-spot-exclusive-idUKKCN0S72FC20151013

32 E.g. Gascade gas pipelines, shares in storage facilities in Latvia or Germany.

Slovakia, Belarus and Poland – adding to the problems faced today by European transmission system operators and further complicating the planning of network development (especially in the CEE countries). NS2 could also stimulate the development of specific links or interconnectors (such as onshore legs in Germany) and increase use of existing ones[33] for transmission of gas from the Nord Stream system. In consequence NS2 could co-shape infrastructure use and development in NWE but also CEE. Specifically, it could fill the existing and planned North–South Gas Corridor links in Central Europe with Russian gas, and limit the capacities available for gas from non-Russian sources.

In the context of growing liberalization of the EU gas market and the flexibility of Gazprom's supply to the EU,[34] NS2 could further increase Russian gas supplies to chosen European hubs – in Germany (NCG, GPL) or Netherlands (TTF) – at competitive prices. This could lead to an increase of Gazprom's share there, as well as its ability to influence prices. The option of swinging volumes of supply to specific hubs (in theory Gazprom would be able to send over 140bcm of gas to the German market through both NS2 and Yamal–Europe, while retaining the possibility of supply via Ukraine–Slovakia) would strengthen Gazprom's leverage on the NWE gas market. At the same time the declared intention to send substantial volumes of gas from the NS2 to Baumgarten (Central European Gas Hub),[35] combined with the ability to supply gas also via Ukraine, would allow Gazprom to at least maintain the Russian gas share on this hub and on the Central European market.

A greater share in the key European hubs, supported by relatively low gas-production costs in Russia, would allow for more effective competition with gas supplies from alternative sources.

33 as was the case of Lanzhot Czech–Slovak border point http://www.icis.com/resources/news/2014/09/23/9823215/czech-to-slovakia-natural-gas-flows-increase-after-lanzhot-capacity-expansion/?cmpid=SOC|RSS|twitter|FreeNewsFeed

34 Long-term contracts supplemented by shorter-term ones, decreasing role of transit contracts, changes in pricing, removal of destination clauses etc.

35 Supported by the possibility of obtaining substantial exemptions from EU rule of Third Party Access for Nord Stream 2 onshore German/European legs, as was the case with NEL (Nordeuropäische Erdgasleitung) and OPAL (Ostsee-Pipeline-Anbindungsleitung) gas pipelines.

The availability of potentially large volumes of cheap Russian gas could impact LNG supplies to both NWE and CEE. This could limit imports via existing infrastructure (LNG terminals in Klaipeda or Swinoujscie) and hamper the construction of new facilities aimed at greater diversification of sources (e.g. Wilhelmshaven LNG terminal). Simply the perspective of NS2 being constructed could limit the willingness of EU customers to sign longer-term LNG supply contracts. It might also influence the share of Norwegian gas in this part of Europe: in the short run, if Gazprom enters into effective price-competition on European gas hubs, and in the longer run by constituting yet another factor (together with weak EU gas demand) that would decrease the economic viability of new upstream or infrastructural investments, such as the construction of pipelines from the Arctic.

Construction of Nord Stream 2 could also strengthen the Russian–German gas partnership on several levels. It could lead to a greater share of Russian gas in the German market. Despite the currently decreasing gas consumption, the ongoing energy transformation on the one hand and the drop in EU internal gas production on the other could translate into a comeback of the 'gas as a transition fuel' policy, with increased demand for gas imports to Germany. In addition, it could contribute to greater importance of the German gas market in the EU: this could mean more gas trade on German hubs, more gas transit via Germany to other parts of the EU including the Austrian CEGH hub, and the development of German gas infrastructure (storage facilities, pipelines) needed for connecting the NS2 project to German and EU gas networks. Therefore NS2 could co-shape the development of the German gas market and infrastructure, help to raise the importance of the German and Austrian hubs (with potentially even a merger of German and Dutch hubs). Increased imports of Russian gas to Germany, together with bigger Gazprom investments in German infrastructure (existing shares in pipelines, storage and possibly new ones) and the significance of cooperation with Russia for the prosperity of the German gas sector – and the German economy in general – would in turn translate into greater German dependence on Russian gas.

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