

How Russia/EEU economic relations with the EU are reflected in the gas trade

Simon Pirani, Senior Visiting Research Fellow, Oxford Institute for Energy Studies
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This talk will look at the way in which economic relations between Russia and the Eurasian Economic Union (EEU)¹ on one hand, and the EU on the other, are reflected in the gas trade. It will focus mainly on the last five years, and the next five years. It will cover Russian gas exports to Europe; the decline of the Russian-Ukrainian gas trade; and gas markets within the EEU. Finally I will draw some conclusions.

Russian gas exports to Europe

Gas exports, overwhelmingly to Europe, are a vital source of revenue for the Russian budget and of support for the Russian economy. They are second in importance to oil. In 2013-16, revenues from gas exports fell by two-fifths.² This was due mainly to the fall in the prices paid for Russian gas, by more than half over that period.³ Gazprom had, at least up to around 2010, based its sales strategy on defending the relatively high oil-linked prices in its export contracts from downward pressure exerted by gas priced on European exchanges. In recent years this has changed, and in 2016-17 Gazprom compensated for the fall in the prices it was able to charge by selling much larger volumes. In both 2016 and 2017 Gazprom exported record volumes to non-CIS countries: 2017 exports were 30% higher than 2015 exports.⁴

So Gazprom's export sales have risen by volume at the very time when political tensions between Russia and European countries have risen to a peak. Over the long term, Russia is perfectly able to supply these higher volumes to the European market, and perfectly able to compete with other suppliers on price. Whether it does so or not will depend on political as well as commercial factors.⁵ Here are three reasons why Gazprom's exports to Europe may continue to grow, and three reasons why they may not.

Reasons that Gazprom's exports to Europe may continue to grow.

1. The European economy wants relatively cheap Russian gas. Alternative sources of supply by pipeline are limited, and mostly in decline. Domestic European production continues to decline, with the natural exhaustion of fields in the British North Sea and in the Netherlands; the availability of gas from Norway is close to maximum levels. The north African gas producers are increasingly using the gas they produce for their own economies. The "southern gas corridor", that could bring supplies from Azerbaijan, and possibly Turkmenistan and even Kurdistan or the East Mediterranean to Europe, has been overhyped. In 2019, 16 bcm from the Shah Deniz project in Azerbaijan will start to be exported along this route, although at least 6 bcm of that, and probably more, will go to Turkey. What remains is less than 2% of European demand. There are question marks about whether gas from Turkmenistan will ever reach Europe, and even if it could, how it could be sold in a

¹ Founded in 2015 by Russia, Armenia, Belarus, Kazakhstan and Kyrgyzstan.

² From \$52.8 bn in 2013 to \$32 bn in 2016 (my conversion from Gazprom annual reports), using the "export to the far abroad" figure stated in rubles.

³ Gazprom's average sales price to the far abroad fell from \$380.50/mcm to \$176/mcm. From annual reports

⁴ Exports to the far abroad, 242 bcm in 2017 compared to 184.4 bcm in 2015.

⁵ This argument is put in Henderson and Sharples, *Gazprom in Europe – two 'Anni Mirabiles', but can it continue?* (Oxford: OIES, March 2018).

competitive market.⁶ All this means that the most significant source of competition for Russian gas is LNG. Part of the reason for Gazprom's success in the last few years has been that insufficient supplies were available. This is now changing. Russia may be faced with a decision about the extent to which it is ready to compete with this gas on price; if it decides to, it could surely win such a competition.

2. One reason that Russia is well-placed for such competition, is that, since the mid 2000s, Gazprom made a major investment in developing gas production on the Yamal peninsula. Over the next 10-20 years, this area will replace west Siberia as the main source of Russian gas. Looking at Gazprom's finances in broad outline, the Yamal development, although not completed, is by now largely a sunk cost. That gas can be brought to the European border, and sold at prices that will always be challenging for LNG importers to meet, according to my colleagues' research.⁷

3. Gazprom has fought some sharp battles with European regulators in recent years over its sales strategy, which came into conflict with the EU's market rules, which are designed to produce a single, liquid and transparent gas market. These battles culminated in a compromise last month with the deal between Gazprom and the EU competition commissioner that ended a seven-year investigation in to abuse of market dominance. Essentially Gazprom avoided the type of fines that were levied on Google and Qualcomm by agreeing to amend its sales contracts to remove restrictions on the resale of its gas, and on free movement of gas between countries in central and eastern Europe. It also agreed that prices in its sales contracts in eastern Europe would be linked to the European gas exchanges rather than higher oil-linked prices.⁸ The point on prices is the last chapter of a much longer story: since about 2009, when the oil-linked gas prices in Gazprom's contracts have increasingly diverged from the gas market prices, Gazprom's major European customers brought commercial arbitration proceedings against Gazprom to enforce changes in the price formation mechanism. In response, Gazprom has become increasingly flexible in its pricing policy over time. While Gazprom's problems with the regulators are not over, the compromise outcome may indicate how disputes could be settled in future.

And three reasons why Gazprom exports to Europe may not grow further.

1. Politics. European governments have shown reluctance to support sanctions against anything related to the gas trade, and in the four years since the annexation of Crimea have gone to considerable lengths to exclude the gas sector from sanctions. This was also true of the US government until the additional sanctions bill passed last year, which could still be applied to aspects of the construction of the Nord Stream pipeline. Moreover, sanctions against Russia, particularly by the US and UK, have in general been stepped up, e.g. in the measures against business people judged to be associates of president Putin, amidst great political uncertainty. The example of the cold war period, when US sanctions against the Soviet "evil empire" were in place but the main gas pipelines from Siberia to central Europe were constructed, might in the past have been quoted to show that the gas business could withstand deteriorations in political relationships. I would suggest that an opposite conclusion should now be drawn. The relationships between the US, European states and Russia, particularly with respect to the conflicts in Syria and Ukraine, are now far less stable, and less

⁶ See: Simon Pirani, *Azerbaijan's gas supply squeeze and the consequences for the 'southern corridor'* (Oxford: OIES, June 2016).

⁷ Henderson and Sharples, *Gazprom in Europe*, pp. 8-16.

⁸ "Russia's Gazprom dodges fine in EU antitrust settlement", *Financial Times*, 24 May 2018.

predictable, than the relatively straightforward binary set-up of the 1980s. It is therefore possible that political measures, or politically-inspired regulation, or both, will disrupt the gas trade in a way that they did not in the 1980s.

2. Gazprom's exports to Europe are close to the point at which from a purely commercial standpoint they may be regarded as being bad for security of supply, i.e. comprising too great a proportion of some countries' total gas balances.

3. Decarbonisation. Over the longer term, gas consumption as a whole may decrease in Europe, to the extent that aspirations to decarbonise the energy system are turned into policies and those policies are implemented. This would of course affect gas from Russia along with all other sources.

Whether or not the volume of Russian exports to Europe will expand further will in my view depend on these factors.

The decline of the Russia-Ukraine gas trade

Whereas political tensions between European powers and Russia have up until now had comparatively little influence on the Russia-Europe gas trade, they have played a very big part in the decline of the Russia-Ukraine gas trade. This trade has been drastically reduced over the last five years and will continue to decline, possibly to zero, during the next five years. During the 1990s and first decade of the 2000s, Ukraine was both the main transit route for Russian gas exports to Europe, and also the largest consumer of imported Russian gas. In 2006-07, Ukraine's direct imports of Russian gas were almost twice the volume of Germany's.⁹ By 2016 they had fallen to zero, and they may stay at zero. Ukraine's role as a transit route for Russian gas has also diminished. Between 2006-07 and 2015, the volumes of gas transited to Europe via Ukraine fell by about three-eighths¹⁰ and, although they picked up in 2016-17 due to higher overall export volumes, they are likely to fall again as and when new transit diversification pipelines are completed. Moreover, the commercial relationship between Gazprom and Naftogaz Ukrainy has essentially broken down, culminating in the Stockholm arbitration case that was concluded in February.

On transit, a political and strategic decision was made in Russia in the late 1990s to diversify gas transit away from Ukraine, first of all with the construction of the Yamal-Europe pipeline through Belarus and Poland. From the mid 2000s, more resources were put into this strategy. The Russian government and Gazprom took into account both political events (the "Orange revolution") and commercial disputes (Naftogaz Ukrainy's repeated failure to pay for gas imports and use of its dominant position in transit to commercial advantage). The centrepiece of the strategy was the Nord Stream pipeline. The final investment decision was taken during the financial crisis of 2009, emphasising that this was not a decision based solely on economic factors. Once the pipeline was commissioned, it was used in preference to the Ukraine transit route and volumes on the latter fell accordingly. During the 2000s, Gazprom also proposed to further expand Nord Stream (i.e. Nord Stream II), and to construct South Stream, a major pipeline across the Black Sea that would decrease Ukrainian transit still further.

⁹ In 2006-07, Ukraine imports from Russia were 59 bcm/year, and German imports from Russia were 34.5 bcm/year.

¹⁰ Ukraine transit fell from 128.5 bcm in 2006 to 67.1 bcm in 2015, a drop of 47%.

After the removal of the Yanukovich government in February 2014, the annexation of Crimea, and the military action by Russian-supported eastern Ukrainian separatists, the Russian government's determination to press ahead with these pipelines intensified. On the European side, regulation both of offshore pipeline construction and of third party access to pipelines once they arrived in Europe (a key part of the market rules) resulted in the abandonment South Stream. It has now been resurrected in a new form, Turkish Stream, which would cross the Black Sea but end up in western Turkey. Regulatory issues have also complicated the preparations for building Nord Stream II, which could still be stopped completely, but is much more likely to be built on a delayed timetable.

If and when both Nord Stream II and Turkish Stream are built, Russian gas transit across Ukraine could fall to a very low level or to zero. Politically, Ukraine has pressed for a minimum level of transit to be maintained; the logic here is primarily to protect the transit revenue it earns. The German chancellor, Angela Merkel, has indicated that she would help to remove regulatory obstacles to Nord Stream II, but that Ukrainian transit must be preserved. The outlines of another compromise are clear. Militating against it, though, are the extremely tense political relations between Moscow and Kyiv. The immediate problem for the EU, Germany, Ukraine and Russia is to find at least a temporary arrangement that can come into force on 31 December 2019, when the current contract under which Naftogaz supplies transit services to Russia expires.

At the moment, with tempers frayed by the result of the Stockholm arbitration, European officials are trying to repeat the success they had in 2014 in bringing the Russian and Ukrainian sides together for talks that will at least preserve transit flows. If they fail, a major supply interruption of the type long that has long been feared in Europe but (aside from 2009) has never materialised, could take place.

On imports. Another result of the political hostility – or undeclared war – between Russia and Ukraine has been to hasten the demise of the direct sale of gas from Russia to Ukraine. The reduction of Russian direct sales to Ukraine started well before the Maidan events of 2013. The economic crisis of 2008-09 had a severe effect on Ukrainian industry, and gas consumption fell quite sharply from that time. The comparatively high prices of imports meant that, where gas could be substituted by coal, it was. And from 2012, that is under Yanukovich, Ukrainian companies began for the first time to import gas from non-Russian suppliers on the western border. By 2015 consumption was down so sharply, due to the military conflict and accompanying economic troubles, that Ukraine could cover its gas needs entirely with its own production and imports from the west. The actual gas molecules that make up those imports are probably all from Siberia, and have gone to central Europe and been flowed back again. But this is nonetheless a remarkable end to one of the main Russian-Ukrainian economic relationships of the post-Soviet period. It has merged with the larger decline in trade that has followed the military conflict and is now unlikely to be reversed.

Gas markets in the EEU

Russia, like many other hydrocarbons producers, has used its own gas as a subsidy for its domestic economy, specifically as cheap fuel for electricity production, industry and households. Russian gas has been used in the same way in Belarus, notwithstanding disagreements between Moscow and Minsk about the price to be paid for it. Kazakh gas has been used in the same way in Kazakhstan, together with domestically produced coal. While market reforms, especially in Russia, have reduced the scale of the state subsidy, especially to

industry, and allowed for a greater number of producers to enter the market, they have not dislodged gas from its position in the economy, as a subsidy, and they are not likely to. The rules of the EEU provide for this type of subsidy to continue across the bloc.

The main focus of gas market reforms in Russia has been to adjust the wholesale market regulation in such a way as to support higher production of gas by non-Gazprom producers. This has been a striking feature of the market in recent years, with Rosneft, Novatek and other oil companies accounting for between one fifth and one quarter of total production. They sell most of their gas to electricity companies and industry, at prices that are unregulated but that are influenced by the regulated price at which Gazprom sells to these customers. Gazprom then sells gas abroad at much higher prices, and uses part of that revenue to cross-subsidise sales to households and district heating companies at much lower prices. The government's declared aim since the mid 2000s has been to bring domestic gas prices up to the level at which Russian gas is sold in Europe, minus the additional transport costs, i.e. netback prices. Although regulated prices have gone up, the aim of netback parity has in practice been abandoned, due first to unexpected rises in European gas prices, and more recently to the devaluation of the ruble, which has widened the gap between export prices and domestic prices. In 2017, industrial customers in Russia were paying about three-quarters, and household customers less than two-thirds, of export netback levels.¹¹

As for the EEU, potentially the most significant beneficiary of the trend towards integrating energy markets is Belarus. Throughout the 2000s, a tug-of-war persisted between Moscow and Minsk over two crucial energy transactions: first, the terms on which Russian crude oil would be processed at Belarussian refineries, and, second, the price of gas imports that are consumed in Belarus, by industry, electricity producers and households, in a way similar to Russian domestic consumption. Moscow at first sought to use the principle of European netback pricing in Belarus, as it had, more vigorously, in Ukraine. But this was abandoned and prices closer to those paid by Russian consumers, plus the additional transport, were charged. The Minsk government was unsatisfied and the latest of many disputes came to a head in early 2016, when Belarus unilaterally announced that it would pay just over half the agreed price (\$73/mcm instead of \$132/mcm). A massive debt to Gazprom was accrued, and eventually Russia responded by cutting oil exports. In April 2017 a three-year deal was made providing for exports to be priced at \$127-130/mcm, and with specific reference to prices in the Yamal-Nenets autonomous okrug, where gas is produced, in the contract formula. The conclusion of this dispute put the discussion of an integrated gas market back on the agenda.¹² But the proposals indicate that pricing will remain regulated as it is in Russia, i.e. an extension of Russian market rules to the other EEU countries.

Given western sanctions against Russia, the weakening of the ruble, and the generally slow recovery of EEU economies, the prospects of rapid market reform for gas, or of significant progress towards European price levels, are minimal. It seems much more likely that the EEU reform will integrate the EEU economies more closely with the Russian form of market regulation, but that the gap between the EEU and EU gas markets will remain, as will its

¹¹ In 2017, Gazprom's average German border price was \$206.19/mcm. Export duty (30%) needs to be deducted, leaving \$144.33. The extra transit costs are probably slightly under \$50, leaving (in round numbers) \$95/mcm at the Russian border. Weighted average annual price to industry was \$72.09/mcm, to households \$60.26/mcm. The calculation for 2016 shows similar proportions.

¹² Maria Pastukhova and Kirsten Westphal, *Eurasian Economic Union integrates energy markets – EU stands aside* (Berlin: SWP Comment, January 2018).

corollary, the single export channel (currently, and showing little signs of change, Gazprom) for exports to higher-paying EU (and other “far abroad”) customers.

Conclusions

Had I given a talk about this five years ago, in mid 2013, I probably would have questioned the claims, already ubiquitous at that time, that Russia was using an “energy weapon” against Europe. I would have said that the steady flow of Russian gas to Europe – that had begun during the Cold War and been interrupted only briefly, during the 2006 and 2009 gas disputes between Russia and Ukraine – told a different story. I would have added that those supply reductions arose from a conflict between Russia and Ukraine, that Gazprom had not wanted to interrupt supply to its European customers, and that the Kremlin’s readiness to do so was about its determination to increase pressure on Kyiv, not a display of hostility to Europe. Now, I still think that such statements would have been correct in mid 2013, but that two fundamental political things have changed.

First, to state the obvious, the removal of the Yanukovich government in 2014, and the events that followed in eastern Ukraine, have changed the relationship between Russia and Ukraine for the foreseeable future. There is therefore little to no prospect that the Russia-Ukraine gas trade will be restored, and little to no prospect of halting the decline of the gas transit business, quite possibly to zero. This is part of the more general decline of trading relationships, and is self-evidently bad for both the Ukrainian and Russian economies.

Second, the political relationships between the US, Europe and Russia are now unstable in a way that they were not in the 1980s, nor in the first quarter century after the collapse of the Soviet Union. This is due only in part to Russia’s military adventures both in Ukraine and Syria, but more fundamentally to the fact that the EU has passed the peak of the trend towards centralisation, and to the decline of US hegemony, already clear under Obama, which has been made so (embarrassingly) obvious with the Trump presidency.

On the other hand, many important economic factors are basically unchanged. Russia, and arguably the EEU as a whole, continues to use raw materials’ producers traditional advantages to support the domestic economy – in this case, that means cheap gas to subsidise industry and households. Moreover, for the Russian budget and for the economy, gas export revenues remain of great importance, second only to oil (but a long way second). From Europe’s point of view, relatively cheap and accessible Russian gas imports remain a key element of the energy balance. The changes in gas markets, arising from the EU focus on market liberalisation, have forced Gazprom’s sales policies to become more competitive, which actually raises the possibility of those sales continuing at the current level or even, under some circumstances, increasing.

The Russia-Ukraine gas trade is in the process of being destroyed as a result of war and political factors, even though it is obviously economically logical for that trade to continue. This indicates how strong political factors are, and how they can supercede economic factors. I do not suggest that this is some sort of precursor of what might happen to the Russia-Europe gas trade. It is not. But shifting and uncertain political relationships are a key factor that introduces uncertainty into the future of the Russia-Europe gas trade. If it declines during the next five years this will probably be due to political, rather than economic, reasons.

simonpirani@gmail.com