



## Russian gas and European energy security

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I've been struggling for two weeks with the article in the Economist about Russian gas ([A bear at the throat](#)) as it takes legitimate (if often poorly informed) worries about Russia's sometimes blustering behavior on the energy markets to peddle the usual insane crap that market liberalisation is the only solution to promote energy security (I'll get to why I think it is insane below).

But two days ago, I spoke at a [debate on Gazprom](#) at IFRI, a French think tank. That conference was organised after the publication of two quite different articles about Gazprom:

[Gazprom as a Predictable Partner. Another Reading of the Russian-Ukrainian and Russian-Belarusian Energy Crises](#) by *Jérôme Guillet*

[Gazprom, the Fastest Way to Energy Suicide](#) by *Christophe-Alexandre Paillard*

The titles give a hint that the papers start from pretty different positions - as you can see in the executive summaries of each that I am posting below. Before jumping in, I'll flag that I am identified as an Oil Drum contributing editor in the paper, so the good name of the site is slowly spreading around...

The recent crises over oil & gas deliveries from Russia to Ukraine and Belarus have triggered alarm and virulent criticism in the West. This article describes how these conflicts are in fact not very different from those that took place in the early 1990s and reflect behind-the-scene conflicts between powerful factions inside the Kremlin and in Ukraine rather than the exercise of an "energy weapon." In the context of a European energy policy driven by Britain's panic at becoming a gas importer and by the ideological zeal to liberalize, the West should worry less about the exercise of a purported aggressive geopolitical strategy and more about Putin's lack thereof, and his inability to control his warring lieutenants. Above all, the West should stop considering that Russia owes Europe any gas beyond its contractual obligations, which it fulfills with alacrity.

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Russia is an unavoidable actor in world energy geopolitics. It is also the biggest energy partner of a European Union (EU) that is becoming ever more dependent on outside sources for its energy needs. However, the future of Russia's largest company-Gazprom-and the development of its future production capacities are at the center of a complex financial and political game dominated by numerous uncertainties, including

Gazprom's actual reserves, its ability to invest in exploration and production, and its very capacity to develop production. Indeed, back in state hands, Russian gas and oil companies-Gazprom included-do not appear to be in a position to meet their future production commitments. Gazprom's ability to honor its contracts with gas companies in the EU is in fact already the subject of numerous interrogations.

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But the most interesting thing, in fact, is that both in our papers, and during the debate, we ended up agreeing on many, if not most, things, the most important of which being:

- European energy policy is inexistant and what passes for policy (the liberalisation of markets) is indeed considered insane by all;
- Russian behavior is driven to a large extent by the personal strategies and interests of a few individuals at the very top. There is no overarching geopolitical plan, but a lot of political infighting and short term asset-grabbing strategies. That may be even more worrying in itself than purposeful strategies to use the "energy weapon", but the motivations are different. It is true however that the global energy situation allows Russia to be a lot more assertive, or even brutal, on the international stage, and there's little that can be done about that;
- there is indeed a lot of uncertainty of what medium and long term production of gas in Russia will be - because of the decline of its existing "workhorses" (the huge fields that current provide most of its production) and the lack of incentives for Gazprom and/or its managers to invest in upstram assets. There are more or less optimistic views on this, but the question definitely exists for all - and brings us back to the lack of European strategy in the face of uncertainty.

The unanimous conclusion is that Europe can actually do something: it controls its own demand, and should focus its efforts on that.

That would mean, for instance, having an energy policy that does not encourage almost exclusively the construction of gas-fired power plants... And yet that's exactly what liberalisation does, as I explained in [in this article in the Financial Times](#), by making it easier to invest in generation assets that are cheap to finance - i.e. those with lower upfront investment costs and higher running (fuel) costs like gas-fired and coal-fired plants.

Of course, that is a topic that is conspicuously absent from the Economist's article, which must sadly be presumed to better reflect the state of mind of our political and business leaders about European energy and Russian gas than the papers of academics or inlookers.

That article focuses on two things, which will not come as a surprise, despite their inherent contradiction:

- Europe must take a tougher, more united, line against Russia
- Europe must break up its cartelised market and open up to real competition in order to provide alternatives to Russian gas;

You can stop here for now; I add below some comments on various offensive bits of the article in the Economist.

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[A bear at the throat](#)

*The European Union is belatedly grasping the riskiness of its dependence on Russian gas, but it is disunited and short of ideas for how to reduce it*

Again, right from the first sentence, boiling blood. It is not the "European Union" that has decided to be worried about its dependence on Russian gas, it is the UK government, nudged by Cheney & co in Washington. France, Germany and Italy, as well as the Central European new members, who are the main importers of Russian gas in the EU, have long been aware of the the significance of importing large volumes of gas from Russia while being completely or mostly dependent on imported gas for domestic needs, and have managed the issue accordingly. Those Central Europeans that are wary of Russia are happy to use the issue to get the rest of Europe to worry more about Russia, but, in practice, as they are the first to be served on the pipelines, it is impossible to cut them and not the rest of the EU, so the risk for them is actually no worse than it is for France or Germany. Even better, they can 'force' solidarity by simply turning the taps.

Thus, as usual for the Economist, "disunited" just means that not all Europeans are on the US line (inspired by hawks around Cheney and helped by Condoleeza Rice's apparent nostalgia for the Soviets), as channelled by the Blair government (and the Poles all too happy to pile in on anything that can be used to bash Russia).

RUSSIA'S president, Vladimir Putin, must be feeling smug. His strategy of using the country's vast natural resources to restore the greatness lost after the break-up of the Soviet Union seems to be paying off. If power is measured by the fear instilled in others—as many Russians believe—he is certainly winning.

"As many Russians believe"?? Or as the gang in Washington has proven is the only rule they ever follow? Bluster, threats, unilateral action, the odd bombing or occupation of countries, blatant disrespect for the domestic laws of vassals, encirclement by bases, etc... Anybody that refuses to let American oil majors invest in their country declared an enemy and treated as such? Fearmongering at home and attempts at brutish dominance outside have been the trademark tools of the Bush administration. That the Russians respond in kind, especially when they have a strong bargaining position, is hardly surprising nor shocking, if unpleasant from our perspective.

And yet, in this case, to fear him is *our* choice, because gas trade is a fundamentally bilateral endeavour: the interdependence is mutual, structurally created by expensive infrastructure which hard to replace and impossible to divert to other uses - and codified in long term contracts that reflect the need for each party that the other side perform its obligations for a very long time.

The EU has few ideas for how to deal with its chief energy supplier. "We know we should do something about Russia, but we don't know what," one Brussels official says. "In the EU we negotiate on the rules, whereas Russia wants to do deals."

Heh, guess what: the EU does not set the rules for what it does not control. Russia's position is a lot more realistic: the two blocs can only do bilateral deals. But that's a market for you: you only enter into deals that are favorable to you, right? We should never forget this: the Russians have no obligations to sell us any of their gas, only to deliver when they contracted to do so - and they will only contract if it is of any benefit for them. Being bound by EU rules might be beneficial for

them, but that's not, as of today, how they see the future of Russia, and there's little we can do about that. Threatening noises are not going to help, there.

Yet dependence cuts both ways. Europe may depend on Russia for half its gas imports, but Russia is dependent on Europe for the bulk of its export revenues. Repeated threats by the Kremlin to divert the flow of gas to China mean little without pipelines that it would take many years to build. Switching off gas to Europe will never make commercial sense for Gazprom. The fear in some EU countries is that commercial interests may one day become secondary to political ones.

A rare moment of sanity in that article (even if it suggests that the disputes with Ukraine and Belarus were about political issues rather than commercial ones, something I vigorously contest and debunked extensively in my text above). And yet the Economist continues to encourage the fearmongering and the strategy of alienating the Russians politically, by refusing to take their point of view into consideration, by blatantly provoking them with the missiles in Central Europe, and generally treating them as dangerous neighbors.

If all this is not worrying enough, there is another, more immediate source of concern for the EU: that Russia may be physically unable to produce enough gas to satisfy demand. Even worse than being dependent on a company like Gazprom may be to be dependent on a Gazprom that is short of gas.

The output of Gazprom's three super-giant fields, which account for three-quarters of its production, is declining at a rate of some 6-7% a year. Output from a new gas field brought on stream in 2001 has already peaked. Last year, Gazprom decided to develop a massive field in the Yamal peninsula—frozen and barren Arctic land—but that will take years. Meanwhile, Russia's domestic demand for gas is growing by more than 2% a year. For all its swagger, Russia is short of gas, a problem that is already affecting its electricity-generation capacity. This does not reflect any lack of reserves—Russia has the world's biggest—but rather a longstanding failure to invest enough in their development.

Gazprom has argued that it will invest in new fields only if it can pre-sell the output to Europe. Instead it has been spending lavishly on pipelines and downstream assets.

This reflects the pessimistic view on the long term prospects for Russian exports to Europe, in that the Russians are not doing what they should to deliver all the gas that will be needed (of course, the underlying assumption is that such need itself is not even open for discussion - we need the gas, dammit!). It does reflect an interested agenda as, again, the view that underpins this is that the Russians are really too corrupt to take care of that important business, and they should let "serious" people (like Shell or BP) take care of it.

It also reflects a fundamental ignorance of the structure of the gas business, where the downstream transport infrastructure is the single most important bit of it (being both the most expensive and the most complex, politically and commercially, to set up). Thus blaming Gazprom for investing in export pipelines - and even in distribution capacity at the end of the chain - is like criticizing an icecream merchant for investing in refrigeration capacity...

And it ignores both the way Gazprom behaves (it has always sought to export as much gas as it could), and the point that Gazprom has been repeatedly making (the upfront investments needed

to increase production require predictable future flows and thus long term contracts). So far, Gazprom has always produced enough to ensure that it can both export and supply the vital domestic needs. There is no compelling argument yet to say that this will no longer be the case, other than the self-interested lobbying of the Western energy majors and their shareholders. On the other hand, as has been discussed on the Oil Drum (for instance [here](#)), there is some doubt on the long term availability of reserves, but that's not the point made by the Economist, which focuses on investment capacity in the medium term (an argument also used for the oil side, to blame the national oil companies and avoid the "peak oil" debate).

Vladimir Milov, the head of the Institute of Energy Policy in Moscow, says that the links between Gazprom and its European counterparts amount to a cartel between wholesale buyers and sellers. The losers in this game are European consumers who are forced to pay gas prices that are several times higher than the wholesale price which their national companies pay to Gazprom.

Considering that gas prices are linked, for very obvious reasons, to oil prices (oil products being the simplest substitute to gas for many of its uses), wholesale prices are what they are. The issue here seems unrelated to Gazprom, in that the Economist lambasts "national companies" (read: the evil French government) for making money off domestic customers. But hey, blame Gazprom anyway.

The best way to increase the EU's energy security would be for it to liberalise its own market and unbundle its national utilities. This would cut profit margins in gas distribution, and thereby reduce Gazprom's appetite for European domestic assets.

I thought the problem was the domination of national markets by former incumbents? Surely Gazprom coming into these markets would provide more competition and lower prices? But in any case, while I understand how that might lower prices for consumers, I fail to see how it would impact in any way wholesale prices, and thus Gazprom's willingness or not to sell us gas.

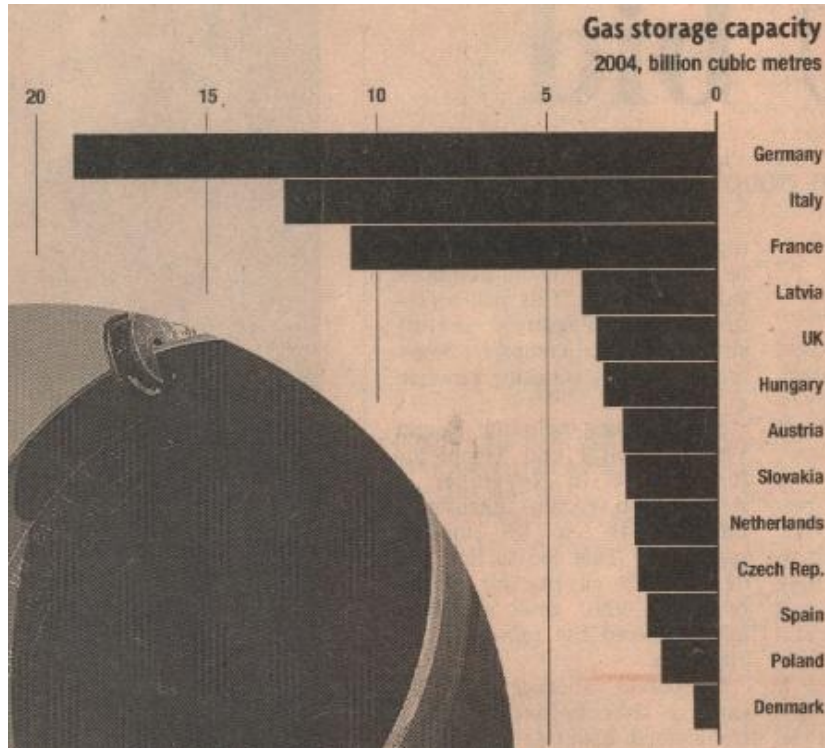
The European Commission has been urging EU members to break up their vertically integrated energy companies, but France and Germany are resisting. The problem, says the commission, is that national governments do not understand the link between liberalisation and greater energy security.

Or maybe they actually understand it, because they've been working on security for the past 40 years? Liberalisation can help those that did not make the effort to set up long term contracts, diversify sources, build storage capacity to freeride on those that did. No wonder the careful planners are a bit wary of seeing their insouciant neighbors, who have spent the past 30 years scoffing at their prudence while sitting on the North Sea treasure, now claiming their "solidarity" now that the treasure (which they did not share for the greater good of European energy security) is gone.



Répartition des approvisionnements par origine géographique

*Origin of natural gas, France. Source: Gaz de France*



*Source: Financial Times*

Europe is also talking of building more LNG terminals that can be stocked by other suppliers.(...) But LNG is expensive, and generally involves inflexible long-term sales contracts. Moreover, the IEA's projections assume that the Europeans overcome their squeamishness about building ugly LNG terminals. Equally improbably, they assume that Russia will not find some way to impede the emergence of rival exporters.

Another unguarded moment of clarity: LNG requires inflexible long term contracts, *just like pipelines...* It is usually touted as the way to bring spot markets to gas by the most breathless enthusiasts...but in fact it creates almost the same kind of highly interdependent relationships as pipelines. Arbitrage will take place to some extent (by diverting a cargo from one destination to another, when profitable), but will remain a small part of the business.

But the comment about Gazprom being able to "impede the emergence of rival exporters" somehow attributes a lot of power to Gazprom. Or is it an unwilling acknowledgement that Gazprom dominates the European gas market because its gas is, you know,... cheaper? That it's more competitive than alternatives? Hmm... Of course - that's why we hate them for sitting on

Russia's ability to cause harm to itself and to others in the cause of proving its greatness should never be underestimated.

Yeah, stupid Russians. Better to blame them rather than ourselves for our inability to even consider burning less of the stuff.



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