

# On the Future OF EUROPE

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## Policy Papers 8

Between Need and Dependency.  
Russian Gas in the Energy Balance  
of the Enlarged EU

Warsaw, December 2002

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[www.batory.org.pl](http://www.batory.org.pl)

**ISSN 1641-9979**

This publication is distributed free of charge.

This publication is also available in Polish and Russian.

# Introduction

The presented report is the eighth in the series of publications (policy papers), which present the position of the Polish non-governmental organisations concerning important issues for the future of Europe. Although we are keenly committed to initiating public debates in Poland, we do not wish to limit ourselves only to presenting the Polish view and the Polish interests. The target audience of our policy papers comprises both readers from the West and from the East. We attach importance to making sure that our proposals should take into account their mode of perception of the issues discussed.

The initiator of this project is the Stefan Batory Foundation. We believe that – as the non-governmental community – due to not being attached to any government institutions, and therefore not constrained by any necessity to be subordinated to the policy of the state or to the government's position towards the European Union, we have a chance to make a substantial contribution to the discussion on the future of the Union and its external policy.

We cordially thank all the persons who have contributed to the creation of this report, for their friendly helping hand and valuable comments.

*We invite you to read this paper and to participate in the discussion.  
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The European Commission's green paper "Towards a European Strategy for the Security of Energy Supply" developed in 2000 projects a significant growth in natural gas consumption in the EU in the coming decades. This will coincide with a declining share of domestic supplies because of limited local deposits. This will make the EU even more dependent on non-EU sources. Currently, imports account for 40 per cent of total gas consumption in the EU. It is expected that the figure will grow to 70 per cent in the enlarged Europe by 2020.

The latter of the three major natural gas exporters to the EU: Algeria, Norway and Russia, enjoys a unique position. Its significance is primarily attributed to the large deposits of natural gas estimated at one third of total global reserves and recognized by current EU member states (particularly by Germany, France and Italy) as strategic to both current and future supplies. Russia is already the number one supplier to the European Union of 15 states. Its significance is likely to grow exponentially upon enlargement with Central and Eastern European member states being strongly dependent on this source. Indeed, Russia could easily be said to enjoy a monopoly in the region.

The current European Union, both the European Commission and member states should think in terms of enlarged EU of 25. This approach is now noticeable as evidenced in the said green paper, which is largely contemplating the consequences of enlargement to the security of energy input supplies to the EU. However, the theoretical interest does not seem to be easily translated into specific action.

The EU dependency on Russian gas and its importance for the energy security of Europe should be viewed in two time perspectives: short and medium term (until 2020) and long term (2020-2050). In the first case, the most important task is to bring the current trade with Russia to compliance with the liberalized energy market in the EU and sort out the situation in the new member states, which are grossly dependent on Russian supplies. The time until 2004 will be of critical importance for countries, which have completed accession negotiations with the EU. This will be the time for final decisions on diversifying gas supplies to the countries in the region. New supplies, and particularly the new transport infrastructure components, would certainly help dismantle Russia's monopoly in accession countries.

In the long-term, the following will be critical: the depletion of currently available gas sources, including currently operated Russian deposits, and the emergence of new supplies in the EU market.

# *I. Short and Medium-Term Perspective*

## **1. EU-Russia Energy Dialogue.**

The EU-Russia Energy Dialogue initiated at the EU-Russia Summit in October 2000 in Paris is a natural process. Gas and oil supplies from Russia will be indispensable for EU in the coming decades to balance off the supply and demand. On the other hand, Russia is dependent on exports of energy inputs to European markets in the short to medium term. Nearly one quarter of Russia's national budget revenue is generated by the sales of gas to the EU and pre-accession countries, and almost half of the entire budget if oil and oil derivatives are included.

The mutual interdependence on energy inputs is the major ingredient of the EU relations with Russia. Hence, its political and not only economic significance. Developing the dialogue is a prerequisite to furthering good relations but conflicts of interests between the supplier – Russia, and the consumer – the European Union, will be inevitable.

The Energy Dialogue is also positive for pre-accession countries. Participation in the dialogue after access will lend these countries a stronger position vis-à-vis Russian suppliers of energy inputs, particularly Gazprom.

The pre-accession period is posing challenges. The European Commission is for the time being just informing candidate countries about the progress in developing the dialogue with Russia, whereas what is needed is some sort of consultation. This could be modeled after the recent consultations between the EU and candidate countries regarding the introduction of new regulations for Russian citizens traveling to and from Kaliningrad after the EU is enlarged to incorporate Lithuania and Poland. The decision making in the EU with respect to the Energy Dialogue with Russia with no involvement of the countries which are about to become EU members seems to be short-sighted. Because of the unique position of the sector the consequences of decisions made today will be felt in the enlarged EU over the coming decades. Any decisions which are unfavorable towards the new members may potentially spur internal arguments after the enlargement is completed.

The Energy Dialogue has revealed so far that Russia would like to keep existing contracts alive. This applies to contracts concluded with future members. Its other priority is to raise funds for investments, particularly investments in industrial infrastructure. Russia does not seem to consider allowing any major foreign capital into its gas sector today, neither extraction nor transport. This strategy is evidenced by the lack of Russian consent to the ratification of the Energy Charter, which introduces clear rules in the entire energy market of Europe and Asia (rules on extraction, trade and transit).

It could be argued that the European Commission has not been active enough in its talks with Russia. The EC does realize Russia has no choice but to continue its gas exports to the EU. However, in its negotiations the EU does seem to lean towards concerns about the security of supplies and is being less focused on the job of explaining to the Russians that they simply have to yield some concessions, particularly abandon the concept of Gazprom's monopoly. Russia will not be able to support the maintenance and extension of its gas production and transport infrastructure without EU investors. One of the Commission's key tasks now ought to be an open pressure on Russia to expediently ratify the Energy Charter. Russia ought to agree to the Production Sharing Agreement, which sets out the rules of assigning duty-free gas export quota. The new rules would remove some of the obstacles preventing foreign investors from taking interest in major gas projects in Russia.

## ***2. Common Gas Market in the EU versus Take or Pay Contracts with Gazprom***

The European Union is currently building a liberalized gas market within its territory. The single market approach is a positive development for new members which are to join the EU officially in 2004. No single country in isolation has enough bargaining power in negotiations with Gazprom. This particularly applies to the desired modification of unfavorable terms of formerly concluded "take or pay" contracts, which preclude any resale of excess gas quantities over the contracted level. The EC must at least get Russia to agree to the resale of gas within the EU single market, if not in a larger market. Both old and new member states would benefit from this. The Russian government and Gazprom appear to appreciate the inevitable consequences of gas market liberalization in the EU and are ready to give partial concessions in existing contracts.

The stress should be moved from long term "take or pay" contracts to spot gas trading. This arrangement would not preclude new long term "take or pay" contracts. However, their share in the total sales to the EU would no longer be close to 100 per cent as it is the case today. New long contracts should contain a clause ensuring a minimum level of off-take of gas purchased by customers. The quantity of gas subject to this arrangement should ensure that producers and transport companies can cover at least essential investment costs to support continued supplies to the EU. The surplus could be sold on the spot market. This would inject competition to gas imports to the EU. Percentage quota assigned to these two types of contracts could be agreed in the Energy Charter and/or in the Energy Dialogue between the EU and Russia as well as through bilateral arrangement between the EU and Norway and Algeria.

Existing "take or pay" contracts, particularly those featuring a clause banning resale of gas, mostly favor producers. The EC's statement of May 2002, confirming the need to maintain long term "take or pay", does not make any difference. First, it is vague and does not say clearly whether the EU supports the existing model of the contracts or whether it seeks to change it radically.

Strangely enough, some "take or pay" contracts in fact oblige off-takers to buy gas whether or not they actually take it and no sanctions are provided for producers who are not able to provide the contracted quantities. For example, Poland has a contract with Gazprom, which covers the supply of gas primarily through the second line of the Yamal pipeline. Currently, the construction of the second line is debated by the Russians as potentially unviable. If the second line is not developed Poland will have a problem taking the gas it will have to purchase under the contract.

## ***3. New Gas Suppliers to Central and Eastern Europe***

Alternative sources to Russia must be found for natural gas consumers in the new member states. Poland is mainly looking at Norway as a desirable supplier. New EU members from the south of Europe would benefit from North African sources. It is possible in the future that gas could be transported from Iran and Azerbaijan via Turkey.

Alternative sources are important because of the security of supplies and market competition. No regular gas market can be developed if one supplier (Gazprom) enjoys an almost monopolistic position. It is critical that pre-accession countries should ensure diversification of gas supply sources preferably before accession. Committed to the single European gas market, the EU should assist its future new members in these efforts. Notably, the gas market liberalization will coincide with the planned date of enlargement.

It is desirable that the EU take a broader view of its Central and Eastern European would-be members not as individual countries but as a group in the region which is in need of a new gas supply structure. This approach is welcome because of the common history of the countries in the region, which under communism were not able to consider any other sources than the Soviet Union.

While the EU declares its commitment to provide financial and political support to the extension and maintenance of the Russian gas transmission network it should also participate in the development of gas transmission infrastructure linking Norway and Central and Eastern Europe in the nearest future. It is desirable that the EU should commit itself to the co-funding of a gas pipeline from Norway to Central Europe. The position is expected in 2003.

The European Investment Bank, which could get involved in the construction of pipelines for Russian gas in the candidate countries according to the conclusions of the EU-Russia Energy Dialogue, should look equally favorably at the Norwegian projects. Note that the EU and EIB have played an important role in developing gas transmission lines from Algeria (Transmed and GME pipelines).

The involvement of the EU through the EIB in the development of the transmission grid for Russian gas proves the issue is political as well as economic. Hence, it is apparently relevant to look at gas pipeline projects not just in terms of economic viability. Continuity of supplies is another critical factor of great strategic importance for EU member states. The EU should develop a standard policy of supporting alternative gas supply routes to individual countries and regions in its enlarged territory.

Further, it must be emphasized that the capacity of gas transmission systems to the EU should be larger than the actual level of imports. This would safeguard the EU against unexpected shortages of gas from one of the sources. Clearly, the redundant capacity must not be too large for owners to maintain economically.

As it has been seen in the EU, the diversification of gas sources for Central and Eastern European countries will also help weaken the unsound linkages between business and politics that emerge in connection with gas imports from Russia. Some of the linkages go back to the Soviet period. Needless to say, the transparency of business dealings would be greatly enhanced in the countries which are on the EU's doorstep if these patterns were eliminated or least limited. Hence, it is in the best interest of the EU to be part of the process.

On the other hand, Gazprom has taken some interesting pro-active measures in Central and Eastern Europe. The Russian conglomerate is keen to use the period of accession negotiations for positioning in the candidate countries. Its policy can lead to a gas monopoly – being essentially a gas supplier, Gazprom is seeking to enter the transmission and distribution market in some CEE countries. For example, in the Baltic states, Estonia, Latvia and Lithuania where Gazprom has participated in the privatization of the state-owned gas sectors. Further, Gazprom was involved in the privatization of SPP, a gas monopoly in Slovakia. SPP's significance lies primarily in the fact that it owns a major pipeline transporting Russian gas to Western and Southern Europe. The Russian group also took control of the Bulgarian gas trade and transmission company, Topenergo. The European Union should verify whether Gazprom's activities in the region are in line with its energy policy and its liberalization agenda.

Gazprom is working closely with Ruhrgas in several candidate countries. Both conglomerates have paired up to win significant market positions in these countries. This is the case in three Baltic states and partly in Slovakia. The close collaboration between Gazprom and Ruhrgas reduces market entry opportunities for other operators.



## *II. Long-Term Perspective*

### ***1. Necessity to Continue the Dialogue Between the EU and Russia***

It is essential that the EU-Russia Energy Dialogue be continued in the long term. The talks are bound to evolve. Russia is likely to play not only the role of a gas producer and exporter but also of a transit country for gas coming to the EU from Central Asian republics and possibly Azerbaijan. The new situation will call for new arrangements between Russia and the EU.

Russia and some Central Asian countries proposed in early 2002 that a cartel of gas producing countries be established. Being the strongest country in such a cartel, Russia would have a major decision-making power, especially as it is the only country that owns pipelines leading to European markets.

### ***2. Threat of output decline in Russia***

Despite the existence of enormous deposits of gas in Russia, output may decline or at least its growth rate may be limited. The depletion of existing major deposits may be one reason. They should be replaced by deposits lying further north. The most important in the region are deposits in the Yamal peninsula, the Barents Sea (Shtokmanov Field) and two smaller ones in the Kars Sea. These deposits will not be easy to extract for economic reasons. They lie in the far north, where the climate is extremely harsh. Some of them are sea-bed deposits, which adds to the complexity of commercial extraction. The price of gas extracted here will be much higher than that of gas extracted in North Africa or in the Caspian Sea basin.

Russia recognizes the problem of depleting deposits. This is why it is buying cheaper gas from Central Asia to cater for its domestic consumption and exporting its own gas to the EU and candidate countries at a higher price. It can reasonably be expected that Russia will start re-exporting the gas purchased in Central Asia, which is going to be against the interests of the EU. This would mean a discrimination against Central Asian republics and making it politically and economically dependent on Russia. Attempts could be made to monopolize gas supplies to the EU through Russia, which would obviously affect the price of gas in the EU. Therefore, pressure should be exerted on Russia to agree to free transit rules developed as part of the Energy Charter.

### ***3. Gas from the Caspian Sea basin***

In the long run, Europe is likely to see large volumes of gas from Iran and some from Azerbaijan. In order to be use these sources pipelines must be built through Turkey which may become an important gas transit country for the EU. Hence, the EU's relations with Turkey will have an additional "gas" dimension.

The Turkish route is yet another opportunity to diversify gas supplies to Europe. It is essential for reasons of strategy (security of supplies) and of economy.

Gas from Iran and Azerbaijan could be available to Europe as soon as in medium term because Turkey will not be able to consume the volumes of gas it is going to receive in the coming decades. In fact, Turkey is estimated to witness a drop in its gas consumption figures by at least 10 billion cubic meters in 2010. As much as 50 billion cubic meters of gas could be transmitted through Turkey to Europe ten years later.

In the long term perspective, the Turkish route could be used for Central Asian gas. What would be necessary is the construction of the Trans-Caspian Gas Pipeline or an Iranian consent to transit Central Asian gas through its territory. The pipeline through Turkey can in the long run become the key gas supply route for southern Europe. The use of this route should not eliminate existing transit routes from the Caspian Sea through Russia. Having two transit routes would give EU member states a choice and would bring down the cost of transit. This would be beneficial both for the Caspian Sea producers and EU consumers.

#### ***4. LNG to Hypothetically Replace Gas from Russia***

The share of Russian natural gas in the future EU energy balance may be further reduced if LNG gains more gas market share in the EU. This type of fuel can be transported from the most remote sources on the Planet where no pipelines could prove viable or feasible (Qatar, Nigeria or Trinidad and Tobago). EU member states are currently importing some 30 billion cubic meters of the gas. LNG may become a more sought-after commodity as technology develops. The higher LNG market share would further boost competition.

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