Commission on Security and Cooperation in Europe

Hearing on Energy Security in the OSCE Region

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THE EU-RUSSIA NATURAL GAS RELATIONSHIP

Challenges and Policy Responses

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Mr. Chairman, Mr. Co-Chairman, members of the Commission, I would like to thank you for your invitation to participate in this hearing today. I am honored by this invitation and I hope my remarks are of some value to the Commission's important work.

Today I want to offer my perspective on the issues related to the energy relationship, especially the trade in natural gas, between Russia and the European Union. These views are strictly mine and should not be taken as reflecting those of any institution.

1. The dominant view: Europe's rising dependence on Russian gas carries serious energy security and geopolitical risks

Over the past five years and especially after the gas crisis between Russia and Ukraine in January 2006, the European Union has frequently been described as being under threat because of its large and rising dependence on energy imports from Russia, especially its dependence on Russian natural gas. The dominant view is that with this important trade relationship come serious and increasing supply security risks. Beyond that, there is a growing perception that this gas relationship is limiting European countries' freedom to define and implement their foreign policy towards Russia, and that the Russian government is using energy to advance its own economic and foreign policy interests in Europe, including by playing European countries against one another.

The growing uneasiness in Europe and in Western countries in general about the political dynamics in Russia and in Russian foreign policy – uneasiness which, I believe, is entirely justified – is turning into uneasiness about the energy relationship itself. Russia is becoming a country which is quite different from the country we would like it to be, that is undeniable. But does it mean that the risks associated with our commercial energy relationship with Russia are higher and can only grow? Does it mean that our energy security can only be sustained by aiming at energy independence from Russia, or at least a lower degree of dependence?

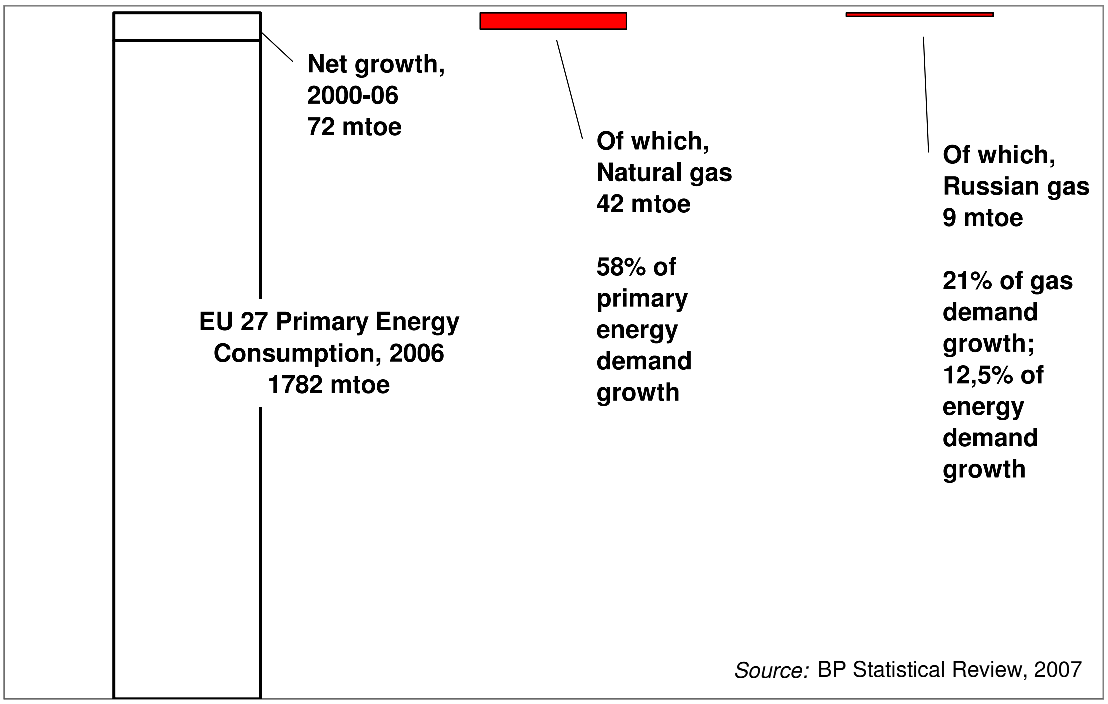
Our gas relationship with Russia raises real issues and I will try to describe them, and also what could be done to tackle them. But "dependence on Russian gas" is not a useful concept to think about these issues. If anything, framing the problem in terms of "dependence" plays in the hands of Russia and encourages the Russian government to try and politicize further the commercial energy relationship. The risks associated with our gas trade with Russia can and should be analyzed independently from our judgement about the evolution of Russia as a country, or the evolution of Mr. Putin's foreign and domestic policies.

2. A large but stagnating commercial gas relationship

In 2006, the EU 27 imported 128 billion cubic meters (bcm) of natural gas from Russia. This is a very large commercial energy relationship. (By comparison, the US imported just under 100 bcm of gas from Canada that same year.) Imports from Russia amount to 41% of the EU27 gas imports (32% for EU15), or 26.5% of gas consumption (22% for EU15). Russian gas clearly covers an important share of our energy needs.

But this trade relationship is not growing significantly. Between 2000 and 2006, the share of Russia in the EU27 gas imports has declined by 10 percentage points (51% to 41%). As a share of gas consumption, it has remained stable at just under 27%.

Between 2000-2006, gas imports from Russia have grown by 10 bcm (6 bcm for EU15). It amounts to 21% of the rise in EU gas consumption, and 12.5% of the rise in primary energy consumption (see graph below). In other words around 80% of incremental gas (and 88% of incremental energy) consumed in the EU27 since 2000 has not been Russian gas. Arguably, this is not a situation which is well described by the phrase "rising dependence".



3. Supply disruption risk

The first of the two serious issues that Europe faces is the risk of disruption in the flow of gas from Russia to the EU consumers. This can happen for a number of reasons, from harsh climate in Siberia to an accident in the Russian transport system or in a transit country, to a commercial or political dispute between Russia and a customer, or between Russia and one of the countries through which the gas transits.

What can be done?

- First, European countries should create a single, integrated, competitive gas markets in order to substantially increase the level of "fungibility" in the European gas system. In a well-functioning market, a disruption of supply to one of the European countries should trigger spontaneous re-allocation of the physically available gas, as well as a rise in price. Currently this can not be the case. A fully integrated European gas market would also allow any molecule which reaches Europe (say, a LNG cargo unloaded in Spain) to be commercialized anywhere in Europe, thereby alleviating the problem of dependence of some countries on specific import facilities. Some countries (among them France, Germany, Italy) are strongly resisting the Commission's push towards a fully integrated and competitive European gas market, partly to protect the markets of their big national companies. If these countries are serious about gas security, this will have to change.

- The EU could also review its options in terms of strategic gas storage. The Commission made some proposals a few years ago which were not accepted by member governments. It should be noted that European strategic stocks would only be effective as a gas security instrument if there were an integrated and competitive European gas market.
- It is possible to increase the short-term price elasticity of gas demand by mandating gas-fired power generation plants to maintain stocks of petroleum products on which they could run if their gas contracts had to be interrupted during an emergency.
- Another, probably relatively costly option is to mandate LNG operators to maintain spare regasification capacities so that the market can source incremental cargoes on the open market if supplies from Russia became temporarily unavailable.

4. The scarcity risk: how to hedge against Russia's inability and/or unwillingness to sell more gas to Europe in the future?

The second risk that we face is the "scarcity risk". In a sense, it is the risk that we will not be able to become "dependent" enough because Russia will not be able, or will not be willing, to increase its supply to Europe.

Such a scenario is much more likely to happen than a scenario where Europe would be flooded by cheap Russian gas and its dependence would grow significantly. This is the case for reasons linked both to the political economy of Russia's gas industry (strong domestic gas demand, political difficulty to raise domestic gas prices towards market levels, lack of strategic and operational autonomy of Gazprom) and to the political economy of the EU-Russia gas relationship (declining mutual confidence, diverging visions regarding the principles and institutions that should structure the gas relationship and the European gas market itself).

The main impact of a restrictive Russian gas policy (or other constraints on the expansion of Russian exports to Europe) would be higher gas price, either directly if there is a free market for gas in Europe, or indirectly as Europe (but also potentially China) would be prepared to pay more for LNG and other fuels. Beyond this economic impact, one can imagine a scenario where Russia's restrictive gas policy is meant at extracting geopolitical benefits, not only monopoly rents. This possibility is an important driver behind the perceptions of rising energy security risks associated with the EU-Russia gas relationship. It should be noted that this scenario is highly relevant to China (a potential big importer of Eastern Siberian Russian gas). Beyond that, a sustained restrictive gas policy from Russia, especially if it is accompanied by a restrictive oil supply policy, could help maintain structural tensions on global energy markets.

Let me briefly describe what could be done to hedge against these risks.

- The main policy goal that should be pursued is to maximize competition against Russian gas. The more restrictive the Russian gas policy will be, the more competing options there will be against Russian gas; it should be (and to some extent it has been in the recent past) a clear policy goal to encourage the development of these competing options.
- Europe's integration into the international market for LNG is already a reality but is still progressing rapidly. Direct gas imports from Central Asia are another source of non-Russian gas to Europe. Governments should work towards removing barriers to the development of this new trade route. The United States has worked quite effectively towards this goal through a very active "pipeline diplomacy" in Central Asia and the Caucasus; to the maximum extent possible, these efforts should be systematically coordinated with the EU.
- As the natural gas market is globalising, dealing with the risk of a sustained restrictive Russian gas policy also means facilitating the development of gas trade links which have nothing to do with Europe. For example, gas exports from Central Asia to China are a positive development and, to extent possible, should be encouraged to increase further if the parties think it is in their interest. Iranian gas is also potentially very important in checking the implicit or explicit monopoly power of Russia. Technically, Iranian gas can be marketed in Europe by pipeline but is more likely to be exported as LNG to markets in Asia and Europe. There are serious uncertainties as to whether Iran could become a credible supplier of gas to the world market; both history and the current negotiating process with European and other companies would lead to caution, if not skepticism. But it is clear that if Iranian gas should remain stranded for geopolitical reasons that would clearly reinforce Russia's position.
- Maximizing competition against Russian gas also means continuing public support for alternative electricity generation technology, especially low-carbon coal. Scarcity on the natural gas market means coal is back as the fuel of choice in Europe and the US (and remains so in China and India). This cannot be reconciled with the objective to de-carbonize energy supply unless technologies of low-carbon coal (through carbon capture and storage) become commercially available.
- Finally, the possibility that we will have to face a sustained restrictive Russian gas policy is one more incentive for the US and Europe to develop strategic energy

partnerships with China and India. Such partnerships should have both technical and political dimensions. Building a common vision of energy security with these big emerging countries should be a priority if we want to avoid over-politicization of the global energy markets in the coming years and decades. This could mean reforming the International Energy Agency to accommodate these key energy consuming countries.

5. Concluding thoughts

You asked me to reflect on how we can reduce the risk of conflict over energy supply. Conflicts over energy supply in the OSCE region (or in the world for that matter) are neither likely nor inevitable. For them to become even less likely, we have to work towards a situation where no country can be credibly threatened of supply disruption for political reasons; and where no country has to accept the politicization of the commercial energy trade that Russia is implicitly proposing to its actual and potential customers. We do not have to accept this "offer" and should not. Politicization of energy trade is a dangerous route to go down to. Provided we implement the policies that will help Europe hedge against the risks that emerge from our gas relationship with Russia (and this will not come free), we can live comfortably with this relationship. If the Russian government wants it to flourish as a commercial relationship, it will. If Russia demands that the gas relationship becomes the axis around which its political relationship with Europe revolves, then Russian gas will become less and less acceptable and the relationship will stagnate, if not decline.