



Energy institutional and organisational changes in EU and Russia: Revisiting gas relations

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HIGHLIGHTS

- ▶ In this study, we analyse the evolution of EU–Russia gas relation since the 1990s.
- ▶ The problems of defining new gas relations between the EU and Russia stem from a clash of values.
- ▶ The problem: Russia's rejection of the EU's power to enact rules for the gas industries and markets.
- ▶ For the EU and its gas companies, access to Russia's hydrocarbon resources is a key question.
- ▶ For Gazprom, the question is whether it can define flexible strategies on the European gas market.

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ABSTRACT

This article tries to shed light on why gas relations between the EU and Russia, which were previously stable, have deteriorated since the introduction of institutional changes in the two regions. After identifying the areas of divergence in the context of European gas market liberalization, we then attempt to examine them in the context of the differing approaches to structuring this sector. The model of vertically unbundled network industries promoted by the EU is no longer the one that Russia intends to implement in its gas sector, despite the big changes taking place in its domestic market. All this is happening in a context where the economic stakes are very high. For the EU and its gas companies, access to Russia's hydrocarbon resources is a key question. For Gazprom, the question is whether or not it can define strategies that are flexible enough to adapt to the changing conditions in the European gas market.

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1. Introduction

Gas security and economic risks are particularly important issues in the relations between the EU and Russia. Gas relations between Russia and the EU are characterized by strong interdependence, which is recognized in the *Roadmap of the EU–Russia Energy cooperation to 2050*. But the dialogue on energy matters initiated in 2000 at the Paris summit has been plagued by persistent lack of understanding between the two parties, making it difficult for them to reach agreement on a new energy partnership. The literature most often focuses on differences rather than on the importance of shared interests (Van Der Meulen, 2009). Essentially, as far as the European side of the debate is concerned, it is a matter of ensuring the security of the EU's supply of fossil fuels. Russia's response to this concern over security is the “guarantee of gas demand” in the long term because it needs to

make heavy investments to expand its export capacity. The contractual relations based on long-term contracts during the 1970s and 1980s led to relative stability in energy trade between the two regions. But since the mid-1990s, this trade has been destabilized by two “institutional shocks” that appear to have caused more conflict than cooperation. The process of opening up the EU's gas industries to competition and the desire to create a single gas market led to an in-depth reorganization of the sector. In this context, the EU intends to redefine the way in which it manages its relations with its main suppliers by attempting to impose a model based on competition, unbundling of network industries and privatization. The collapse of the Soviet Union and Russia's desire to create a “market economy” were initially in line with this approach. But perhaps it is not sufficient in the new era.

The differences of opinion seem to lie in rules and standards that are based on values and beliefs which, according to the neoinstitutionalist approach developed by North et al. (2010), reflect two different social orders. Market institutions operating in two different contexts cannot have the same effectiveness and efficiency. The question as to whether the international standards

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generated by the EU through the Energy Charter are consistent with Russia's institutional environment is thus a key one. The Russian state's growing role in the hydrocarbons industry, exerted through various state-controlled companies, through the imposition of tougher conditions of access to resources but also through the introduction of some form of competition, can be seen as an attempt to introduce an organizational model more in keeping with the country's institutional environment. An approach based on the preferential use of state instruments conflicts with the multilateralism and principles of competition of the EU, which advocates market opening, unbundling and even the privatization of the gas sector. The EU's normative power is thus in contradiction with the institutional environment of the Russian energy sector. In this context, it is unlikely that standards based on international rules and institutions could alone be used to structure energy relations between the EU and Russia. Russia's withdrawal in 2009 from the process to ratify the Energy Charter Treaty illustrates this point and undoubtedly marked the end of the EU's attempts to stabilize its energy relations with this country through the sole means of a legally binding multilateral framework (Cameron, 2010).

However, the various reforms that were introduced produced new market players, such as the Russian company Gazprom, which has attempted to present itself as a company able to define a certain number of strategies in its main export market – the EU – more specifically in cooperation with European gas companies. Thus, on the fringes of the changes taking place in the European gas market, European and Russian companies may share new kinds of common interests.

The aim of this article is to try to shed light on why gas relations between the EU and Russia, which were previously stable, have deteriorated since the introduction of institutional changes in the two regions (Section 1). After identifying the areas of divergence in the context of European gas market liberalization (Section 2), we then attempt to examine them in the context of the differing approaches to structuring this sector (Section 3). In this kind of context, without prejudging other positive developments in global cooperation, we can nevertheless seek to determine the reasons for this persistent preoccupation with security in future gas relations between the two parties. This debate is important at a time when the EU is trying to define a comprehensive strategy for its external relations in energy in order to manage the security of its energy supply (European Commission, 2011a).

2. Quantitative and qualitative changes in UE–Russia gas relations

Since the end of the 1960s, gas trading relations between the EU and Russia have been characterized by interdependence based on the reciprocal interests of each party: the EU is Russia's main export market while Russia is the EU's main external supply source. Two major periods can be distinguished. The period from the 1970s until the mid-1990s was relatively stable as far as contractual relations were concerned, while since the start of the 2000s relations have been more turbulent, marked by tension and conflicts, in particular at the time of the natural gas transit disputes with Ukraine.

2.1. Gas interdependence between the EU and Russia

The strong interdependence in gas relations between the EU and Russia can be clearly illustrated by a few figures: 40% of the EU's natural gas imports come from Russia. The EU has estimated that its total gas imports could represent 84% of its consumption

Table 1

Dependence of some EU countries on Russian gas in 2011.

Sources: Gazprom, Annual Report 2011, Moscow; BP Energy Statistical Review, 2011.

Countries	Volume Bcm	Gazprom's market share (/gas imports), %
Germany	34.1	36.7
Austria	5.4	51.0
Bulgaria	2.5	100.0
Estonia	0.7	100.0
Finland	4.2	100.0
France	8.5	18.2
Greece	2.9	78.9
Italy	17.1	24.6
Latvia	1.2	100.0
Lithuania	3.2	100.0
Hungary	6.3	85.0
Poland	10.3	86.1
Czech Rep	8.2	57.5
Romania	3.2	100.0
UK	12.9	26.6
Outside EU: Turkey	26.0	56.2

by 2030, compared with 57% in 2007, which would make it considerably more vulnerable to supply risks (European Commission, 2007).

Gazprom exported 157 Bcm of gas to Europe and Asia in 2011. However, the dependence of each state on gas imports from Russia varies according to their internal gas resources, energy policy (energy mix) and their strategies to diversify supply sources. The Central European and Baltic countries are characterized by a strong path dependence, a consequence of trade relations forged by the former Soviet Union and the former COMECON (Council for Mutual Economic Assistance) which grouped together the countries with centrally planned economies of Central and Eastern Europe. Consequently, the dependence of these countries on Russia is above 70% (cf. Table 1), but in terms of volumes imported (and revenue), Germany, France, Italy and the UK are the key markets in Russia's strategy. For a long time, Russia's gas policy has made extensive use of this segmentation of the European markets.

Similarly Europe, with 70.8% of Russia's total exports, represents a vital market for Gazprom, and one that is profitable, especially when compared with its domestic market, which is dominated by low government-regulated natural gas prices. Russia's domestic natural gas prices are still based on a pricing system introduced at the end of the 1990s to encourage consumers to use gas instead of oil and coal. They are as low as a quarter of the price charged on the European export market (Jensen, 2010). The recent increases in domestic tariffs (more than 20% in 2010 compared with 2009¹) are not yet sufficient to make up for existing differences. The same is true of sales to CIS countries, formerly based on a cost-plus approach and therefore much less profitable than sales to the EU, dominated by the netback principle (Konopliianik, 2010).

The EU is destined to remain Gazprom's main export market for some time to come, despite its desire to diversify to Asia. In Russia's long-term energy strategy published in 2010 Asia is forecast to represent 20% of gas exports in 2030 (Ministry of Energy of the Russian Federation, 2010)². A far-reaching diversification policy can only be envisaged for the long term, given the

¹ Price rises and market reform in Russia, a long and winding road. *Gas matters*, June 2011.

² In 2010 Russia signed an agreement in principle with China for the export of 30 Gm³ of natural gas starting in 2015. But the thorny question of price has yet to be settled. (Gazprom's slow boat to China, *Petroleum Economist*, Nov. 2010.

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