

# Russian gas price reform and the EU–Russia gas relationship: Incentives, consequences and European security of supply

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## Abstract

In order to provide a comprehensive picture on the relationship between Russia and the EU, the focus should be on both the external energy relationship as well as Russia's internal organization. This paper sets out to do this by combining both strands of research in order to arrive at recommendations for Europe on the way to adjust its energy policy towards Russia. The emphasis is on whether or not Russia should impose unified gas pricing. Main conclusions are that the perceived advantages of unified Russian gas pricing to Russia as well as Europe are in fact overstated and that EU security of supply might worsen under unified gas prices. Three policy recommendations are that EU policy should (1) more explicitly acknowledge the interdependence between Russia and Europe; (2) not push Russia towards unified gas pricing; and (3) not take for granted any increase in Russian exports flowing to Europe.

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## 1. Introduction

There has been renewed interest in the issue of European gas import dependence following the gas struggle between Russia and Ukraine (and to a lesser extent Moldova) during the last week of 2005 and the beginning of 2006. At New Year's Day, following a disagreement concerning subsidized gas prices paid by Ukraine for Russian gas, Gazprom decided to reduce gas supply to this country. The Ukrainian pipeline system, however, is pivotal in supplying gas to Europe and consequences for Europe's gas supply security were quick to follow: from January 1–3, Gazprom's gas supply to France decreased by 25–30%; supply to Austria decreased by 33%; and Italy received approximately 25% less gas than normal (Stern, 2006a). These developments have increased the awareness of the risk being too dependent on a single supplier. Moreover, anxieties are magnified by fears of the gas row being politically motivated and, therefore, that Russia's energy

weapon could be deployed against Europe too (Washington Post, 2006; The Guardian, 2006). These problems, among others, have resulted in a growing body of research on the EU–Russia gas relationship. One strand focuses on the interdependence between the two of them and concludes that the current EU–Russia relationship should be amended (Ivanov, 2003; Monaghan and Montanaro-Jankovski, 2006; CEC, 2006). The fact that the EU and Russia are to some extent interdependent has been well established in the literature. When we consider the European reactions to the gas struggle, however, this understanding does not appear to be established equivalently in policy circles. Section 2 will discuss this issue by introducing the concept of security of supply and will claim that the interdependence is in practice too often overlooked. However, in order to provide a comprehensive picture, Russia's internal policy should be reckoned with also. This is because an important reason for Russia's dependence on Europe is its dual gas-pricing policy in which low revenues from internal gas supplies are subsidized by much higher European gas prices. This brings us to a second strand of research that focuses on

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Russia's domestic gas policy (IEA, 2002; Ahrend and Tompson, 2004, 2005; OECD, 2004; Stern, 2005). We will confine ourselves to Russia's gas-pricing policy (Selivanova, 2004, Tarr and Thomson, 2004; Dudek et al., 2006). Dual gas pricing provided a natural gas subsidy to the Russian economy. In Russia's WTO accession negotiations, some WTO members, among them Europe, argued that dual pricing acted as a trade barrier by providing unfair advantages to Russian energy-intensive companies and, therefore, that gas prices should be unified. Section 3 discusses Russia's dual gas-pricing policy and elaborates on the implications for domestic Russian gas prices of unified gas pricing. By combining both strands of research mentioned above, this paper sets out to provide recommendations for Europe on the way in which to adapt its relationship with Russia. To this end, Section 4 analyses whether Russia's incentives point in the direction of unified gas pricing; Section 5 analyzes the European case. Neither one will have sufficient incentives to want to introduce unified Russian gas pricing. From a EU perspective, unified gas pricing could in fact even be disadvantageous as it might worsen Europe's security of supply. Section 6 concludes by providing a number of policy recommendations to EU policy makers.

## 2. Security of supply

Security of supply can broadly be divided into two parts: system security—the extent to which consumers can be guaranteed, within foreseeable circumstances, of gas supply—and quantity security—guaranteeing an adequate supply of gas now as well as in the future. This comprises not only gas volumes, but also price and diversification of gas supplies. The emphasis in this paper is on quantity security, particularly Europe's dependence on Russian gas. This import dependence creates three risks: source dependence, transit dependence, and facility dependence (Stern, 2002). The gas struggle between Russia and Ukraine and European responses to it indicate an emphasis on source and transit dependence (Chichester, 2006). This paper will take the same focus. We start with transit dependence. Because most pipeline gas transits several countries before reaching its destination, transit issues are very important with respect to European gas supply. Russian exports account for 38% of EU imports and 26%<sup>1</sup> of EU consumption. These Russian gas supplies to Europe transit at least one country with Ukraine being by far the most important with around 80% of Russian gas supply to Europe transiting Ukraine in 2004 (Stern, 2005). Interruption of Ukrainian transit flows would, therefore, seriously harm Europe. Transit risks also pertain to Russia. The relationship between Russia and Ukraine illustrates Rus-

sia's interests in this regard. Both Russia and Ukraine could interrupt Russian gas transiting Ukraine.

If Russia decreases its gas flow to Ukraine and consequently hurts those European customers who depend on Ukrainian transit, Russia's reputation as a reliable supplier will be damaged. Though Russia will possess a considerable amount of market power in the future, a damaged reputation will nevertheless be harmful to them since it urges Europe to focus on alternatives such as nuclear energy or LNG at an increasing speed. This is illustrated by reactions from Brussels regarding the gas struggle emphasizing the need for a more coordinated and cohesive European policy on security of supply measures and for Europe to become less dependent on Russian gas by focusing on alternative suppliers (Piebalgs, 2006). Also, from a longer-term perspective, a damaged reputation could have similarly negative consequences to Russia's relationship with other demand centres such as China, India or the USA (see Section 5).

If, on the other hand, a decreased gas flow to Europe would be attributable to the Ukrainians, the ultimate consequences would not change much. After all, the security of Russian gas flows to Europe would still be damaged resulting in similar reactions from Europe—and the other demand centres—as mentioned above. The risk of transit-induced interruptions has been acknowledged by Russia: a main reason for constructing the Blue Stream Pipeline to Turkey, the Baltic Pipeline through the Baltic Sea to Germany, and the Yamal-Europe Pipeline through Belarus to Poland has been to minimize transit risks by circumventing potentially difficult transit states. Minimizing transit risks is thus an importance policy objective for both Europe and Russia; as a result, emphasizing only Europe's costs of unreliable transit is a much too narrow view on the subject.

It is accepted in academic circles that source dependence creates a degree of interdependence between Russia and Europe (Ivanov, 2003). However, in spite of the fact that the launch of the EU–Russia Energy Dialogue actually acknowledges Russia and Europe being interdependent (EU–Russia Energy Dialogue, 2006), in practice this observation is still too often underrated or overlooked. The above-mentioned European reactions to the gas struggle, emphasizing that Europe should not depend too much on Russian gas since Russia may abuse its dominant position, illustrate this. Russia's interest in supplying Europe has hardly ever been mentioned. Although Russia has been a reliable supplier thus far, from a user's political viewpoint, some uneasiness with large import dependence is in fact understandable. However, it should not be forgotten what the alternative is: diversification of supplies to another major gas supplier such as Qatar, Algeria or Iran, does not necessarily decrease fears of a producer state using energy as a political weapon. Second and more important, if we consider that Russia is also to some extent dependent on Europe, some of the uneasiness regarding source dependence should vanish. A main reason for

<sup>1</sup>These import dependence figures should be treated with caution. Given the large differences between member states, figures like these have very limited value concerning the dependence of a specific member state.

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