

4. IMPORTANT FACTORS, TERMS AND INFRASTRUCTURAL PROJECTS

4.1 Russia and SEE – relations and perceptions

As was shown in the chapter devoted to methodology, energy policy is normally exercised along a continuum whose outermost poles are defined by two approaches: the state-guided and market-guided. Put simply, while the market-oriented approach does not allow for the misuse of natural resources, in the state-guided approach these resources are subordinated to the state's needs and serve as a tool to achieve particular policy goals. The perception is widespread that Russia follows the strategic approach, and that Gazprom's strategy is driven by government directives that may be politically rather than economically motivated. This perception often dominates the debate, especially in the CEE and SEE countries¹⁴. Russia's handling of energy resources is particularly sensitive for states that depend on Russian supplies, including most states in the region the author has examined, where Russia is the major or even the sole supplier of natural gas. An additional factor is Russia's strong opposition to the expansion of Western economic, political, and security organizations that came with the dissolution of the Eastern Bloc and the fall of communism at the end of the 1980s. The Russians wished for these countries to remain neutral and serve as a kind of 'bumper region' (as was suggested for Central Europe), but this did not come to pass; membership in Western organizations was more attractive to the former communist states. The path to transition for states in the SEE, though, was far less straightforward than that followed CE. And Russia took a stronger hand in the region than it did in the CE, partly because of geograph-

¹⁴ See the literature review.

ical proximity and, in some cases, due to cultural ties.¹⁵ The bottom line is that it became a generally accepted notion that Russia might use its energy resources in a coercive manner to steer development in this region.

4.2 Importance of energy exports for Russian economy

Although the supply of Russian energy resources is vital to its customers, one must not neglect the fact that the Russian economy is in turn vitally dependent on natural resource exports, and that energy commodities make up a great share of these exports. Although natural resources had always been a significant part of Russian exports, they came to play an even bigger role after the year 2000. In the decade between 2000 and 2010, oil exports rose by 70 % and natural gas by 15 %, driven primarily by greater demand and rising oil prices. During this same period, they rose to account for more than 20 % of Russian GDP. On top of this, between 1996 and 2012 the share of fuel exports (oil & gas) in Russia's total exports rose to almost 70 % (Henderson & Pirani, 2014, p. 6; Covi, 2013, pp. 8–9). From this perspective, it is no wonder that the Russian government pays great attention to developments in the energy markets, since they know any changes there may substantially impact the country's economy. With the principal energy companies in the state's possession, the government theoretically has the tools to influence state energy policy and to use these companies to achieve its goals, political or economic. Producers, though, dependent upon exports as they are, need to proceed carefully so as not to aggravate their customers, since any decline in energy sales could have major consequences for the producer's economy. Failure to do so could lead to accusations that energy is being misused to further state goals, seriously affecting future sales and harming the economy.

¹⁵ Greece is a special case here. It has a history of somewhat special, rather friendly relations with Russia and can hardly be omitted from the research because of its geographic location.

4.3 Important factors in relations between Russia and Europe

In discussing concerns over Russia's potential misuse of his position as a key energy supplier, it is imperative to note the changes that have taken place in the relationship between Russia and Europe over the past several years. Since Vladimir Putin has assumed the office of president, the Russian government has implemented measures to increase government involvement in various elements of the administrative apparatus, including that involved with the energy sector. Over the past 15 years, several steps have been taken to help restore state control over the most important parts of the energy sector. Within the past decade, several disputes have also arisen in Europe in which Russian energy sources played an important role. But the bottom line is that all these events aroused concerns only from states that are dependent on Russian energy.

4.3.1 Accusations of misusing energy supplies and history of supply curtailments

A large number of states have accused Russia of using energy supplies as a foreign policy tool, best known among them likely being Ukraine. Aside from the supply disruptions that eventually did take place, there have been a series of threatened supply cuts that never came to pass. Although they caused no actual damage, they remain important in terms of how Russia's energy policy is perceived. Moldova, Serbia, and Bosnia and Herzegovina have all experienced the threat of supply cuts; in Bosnia and Herzegovina's case, they remained threats only; in Serbia, the threats became reality; and in Moldova, gas supplies were tied to the country's foreign policy discourse (see the relevant chapters).

4.3.2 Crisis in Ukraine

Ukraine is probably the focal point of the current poor state of relations between Russia and the West. It is also the example most commonly used to demonstrate the role played by energy supplies in Russian foreign policy. Without delving deeper into this individual case (which is not the subject of this research), there is no doubt that energy supplies,

specifically natural gas, played an important role in the crisis, since it has been a major source of dispute between Ukraine and Russia over the past decade, and was a facilitating factor in the crisis.

4.4 Specifics of natural gas utilization in SEE

Although the utilization of natural gas as an energy source varies among the countries of the SEE region, its importance must be recognized. Its importance is determined by several factors described below.

4.4.1 Structure of economies

The states under scrutiny are characterized by the pronounced role played by the industrial sector in their overall economic output. This economic structure was considerably influenced by the Soviet model and its use of central planning, which focused on industrial production and post-war reconstruction. Because of this, the economies of the former communist states in SEE (as well as those in CE, including the Czech Republic) are highly energy-intensive (i.e. a relatively large amount of energy is needed for one unit of production) (Ürge-Vorsatz, Miladinova, & Paizs, 2005). As natural gas is often used in the industrial sector, it becomes a crucial factor in industrial production and one on which a supply curtailment might have a severe impact, both on the industry itself and subsequently on the whole economy. A similar impact might be felt on households and heating systems, ordinarily another leading consumer of natural gas.

4.4.2 Underdevelopment of the natural gas sector

Compared to Western Europe, states in the SEE have far sparser natural gas infrastructure, hindering the development of natural gas and preventing its higher utilization. In most cases these states rely on a single pipeline, which brings gas from a single supplier (Russia). This often makes them dependent on a single supply route in addition to a single source of supply. From the energy security perspective, this makes these states extremely vulnerable to supply curtailments. Natural gas may not play a crucial role in the overall energy mix in these states, but outages and supply cuts do pose a serious threat to industry as well as to

heating and households, the sectors that are usually the two biggest natural gas consumers. Also, as these countries are among the poorest in Europe, the sector suffers from underfinancing, which further hinders development. The situation thus amounts to a vicious circle—underfinancing and low utilization hinder development, which leads to a lack of incentives and inadequate consumption for investing in the sector.

4.5 The preconditions for misusing natural gas as leverage

The natural gas sector possesses specific features that make it well-suited to misuse as a pressure tool. These features are embedded in its very physical makeup as well as in the historical development of the sector. Natural gas, unlike, for instance, oil, cannot simply be loaded on a truck, train, or ocean-going vessel and shipped almost anywhere. Because of its gaseous nature, it must be contained within a sealed space, and this applies to both shipping and storage. The most suitable way to ship natural gas is thus to send it via pipeline. However, because it is extremely costly to build a pipeline to transport gas from the (usually remote) areas where it is extracted, suppliers usually take measures to offset their high construction costs. These have resulted in the establishment of long-term relationships between supplier and customer that provide the supplier with the certainty needed to assure the economics of the project as a whole. It is for these purposes that long-term contracts with take-or-pay conditions (securing a stable flow of funds) were introduced, as were a prohibition on gas resales and the linking of gas prices to those of oil (see next subsection). These measures naturally gave suppliers the upper hand, allowing them to manipulate prices according to their needs. Moreover, such moves effectively blocked the evolution of a truly functional natural gas market. Instead, the sector has taken on the structure of a series of isolated islands bound to individual supply routes and suppliers.

In any case, the combination of dependency on a single supplier (or even a single supply route) and the lack of other sources¹⁶ of sup-

¹⁶ In recent years, transport of liquefied natural gas (LNG) over long distances (typically overseas) has been changing the situation and influencing the partitioned

ply, combined with the importance of natural gas for vital subsectors (mainly industry and housing—see below), make supply into a perfect tool of leverage, should the pertinent actor decide to employ it as such.

4.6 Changes to the environment due to EU Internal energy market rules¹⁷

With the introduction of the so-called Third Liberalization Package into the natural gas sector in 2009, the European Commission tightened the rules for the Internal Energy Market, including those that affect natural gas trading (EUR-Lex, 2009). The Package was not directed specifically against Gazprom but targeted more broadly market incumbents that had dominated the market in the past; nevertheless, Gazprom felt particularly in jeopardy.¹⁸ For years, Gazprom relied on specific principles to cement its control over the market and potentially also to provide the company with power to exert pressure on its customers. These principles included long-term contracts, destination clauses and a prohibition on reselling gas, the linkage (indexation) of gas prices to oil prices¹⁹ and control over transit infrastructure (Jirušek, et al., 2015, pp. 384–388). By these measures, Gazprom was able to secure a long-term relationship between itself as supplier and its customers by keeping the market partitioned.

In introducing measures aimed at improving market flexibility and liquidity, the European Commission challenged those principles that had served for years to maintain Gazprom's stable position. The changes

world market. However, the construction of needed facilities (i.e. liquefaction and regasification facilities) and transport, along with generally missing infrastructure, make LNG a rather unviable choice for most SEE countries.

¹⁷ This subsection is based on a subchapter of a study published in November 2015, co-edited by the author. See (Jirušek, et al., 2015, pp. 377–397)

¹⁸ The frustration could be felt as well on the level of Gazprom's main shareholder, the Russian government, as demonstrated by Vladimir Putin at the EU-Russia summit in December 2012 (Euractiv.com, 2012c).

¹⁹ Indexation was introduced when oil was used as a substitute for natural gas (Jirušek, et al., 2015, p. 386).

that undermine Gazprom's position the most are the ownership unbundling principle, the third party access principle, and the prohibition of destination clauses. The first principle prohibits any entity from acting as producer and/or supplier and infrastructure owner at the same time. This principle is based on the assumption that such a setup may prevent fair competition and eventually harm the consumer. Therefore, division according to certain legally permitted schemes is required. The second principle requires that equal entry to the market should be available to anyone who wishes to enter, and no one should be prohibited from doing so by being exempted from using certain infrastructure. Lastly, the third principle rests on the assumption that no one should be told what they cannot do with gas purchased, e.g. reselling it to other entities (i.e. states). In essence, these rules were imposed to ensure fair competition in the natural gas market (Jirušek, et al., 2015, pp. 382–388; Talus, 2011). As for the long-term contracts, they are not prohibited as such, but are under increased control by the European Commission (ibid., 201, p. 385; Talus, 2011). On a similar note, the European Commission cited oil-indexing as one of the causes of unfair pricing²⁰.

These rules are in place within the EU's Internal Energy Market, and any state wishing to join the market must subscribe to them, as well. Here, the Energy Community serves as the main platform within which member states approximate to the Internal Energy Market and gradually implement the main IEM principles. All countries under examination thus have either already subjected themselves to the rules as EU members, subscribed to these rules as members of the Energy Community, or are in the process of doing so.

It is fair to point out that Gazprom was not alone in utilizing these traditional gas marketing tools. They were also used by other suppliers, basically to offset the cost of infrastructure and to secure a certain level of stability and economic viability in the market²¹. In the same way, as

noted above the EU legislation was not aimed exclusively at Gazprom but rather adopted as a systematic change to harmonize the playing field within the Internal energy market. In the region under examination, however, where Gazprom has held a prime position, the predominant impact of the new rules has definitely fallen on the Russian gas giant. Essentially, Gazprom's position has changed in that it is no longer the creator of the environment. Rather, the company is now subject to rules imposed by a superior authority—the European Commission—which is now in charge of the market, at least in countries where the abovementioned liberalization principles are in place (Jirušek, et al., 2015, pp. 384–388).

4.7 Energy Community

In examining the Southeastern European region, one must appreciate the role played by the Energy Community, an intergovernmental organization established in 2005 to bring together the countries of the European Union and the Balkan and Black Sea regions. The main aim of the Energy Community is to facilitate the membership of non-EU states in the region in the EU's Internal energy market (Energy Community, 2016a). The organization also collects information on the energy sectors of individual countries within the region and issues reports on whether the requirements of the Internal energy market have been met.

4.8 Concept of energy security

Since the book frequently operates with the term “energy security”, the basic definition must be made. The author uses the definition of the United Nations Development Programme, which defines energy security as “(...) *the continuous availability of energy in varied forms, in sufficient quantities, and at reasonable prices (...)*” (United Nations Development Programme). This definition encompasses all spheres of energy security that this book operates with – stability of supplies (addressing the issue of supply curtailment), sufficiency (addressing the issue of sufficiency respecting a country's needs), and prices (addressing the issue of overpricing).

²⁰ The questioning was based on accusations that Gazprom misused its position with the group of Central and Eastern European states (Jirušek, et al., 2015, pp. 384–388).

²¹ In fact, these measures were used by virtually all major suppliers in Europe, as well as in other markets (e.g. the United States).