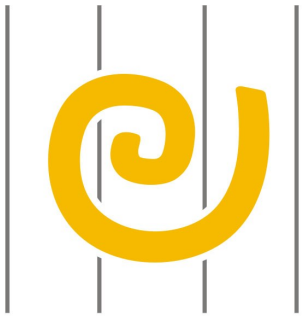

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# ENERPO Journal

December 2013
Volume 2
Issue 3

The *ENERPO Journal* was established in 2013 and is published by the Energy Politics in Eurasia (ENERPO) program at European University at St. Petersburg. The goal of *ENERPO Journal* is to bring exposure to the ENERPO program and to shed light on the latest developments in the oil, gas, and renewables industries in a way befitting both expert and casual readership. Contributing authors are primarily students and faculty with the occasional outside expert writer.

*Workshop Series* is a program hosted by European University in which leading energy professionals are invited to present on a specific aspect of their work. These professionals include energy think-tank experts, policy makers, representatives from major energy companies, and ranking members of international organizations. *Workshop Review* is a subsection of *ENERPO Journal* where students relay the content of these presentations and provide commentary.

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# Greenpeace in the Russian Arctic: Environment vs. Oil Drilling

*—Koen Van Delft and Katherine Bennett*

On September 18, 2013, Greenpeace International sailed into the Pechora Sea in the Arctic under the Dutch flag on the Arctic Sunshine to protest the Russian oil giant, Gazprom Neft's Prirazlomnaya oil rig. Greenpeace aims to stop the world's first oil from being produced in these ice-filled Arctic waters. In fact, they want to end Arctic oil drilling altogether. Soon after this stunt, the activists were detained by the Russian government and became the international sensation known as the Arctic 30. Russian authorities detained the activists for over two months after much international media buzz. This series of events begs the questions, why did Greenpeace target the Prirazlomnaya oilrig and why does Russia and its largest oil and gas company, Gazprom have such a stake in Arctic energy?

***The majority of Russian oil production so far has come from the brown fields in western Siberia; however, these fields are declining and Russia needs to explore new fields to compensate for the lower extraction rate.***

There are believed to be 20% of the world's undiscovered oil and gas in the Arctic. Specifically, it is estimated that the Arctic holds about 90 billion barrels of oil and 47.2 trillion cubic meters of gas, equivalent to 13% and 30% of the world's undiscovered oil and gas. According to the United States Geological Survey of 2008, due to climate change and the melting process of the Arctic ice caps, the plentiful reserves are becoming more accessible. The severity of the Arctic climate, including freezing temperatures, ice, wind and darkness, create a financially and technologically burdensome task. Greenpeace has successfully captured the world's attention and brought new light to the issue of Russian Arctic oil and gas extraction.

**Why does Russia need the Arctic?**

Russia lays claim to about 60% of the Arctic's oil and gas reserves, or 350 BOE (barrels of oil equivalent), according to Ernst and Young. BP's *Statistical Review of World Energy* claims this is much more than the oil reserves of Saudi Arabia and the gas reserves of Qatar taken together. Russia has a number of reasons to explore the region. The majority of Russian oil production so far has come from the brown fields in western Siberia; however, these fields are declining and Russia needs to explore new fields to compensate for the lower extraction rate. There are currently three targeted possibilities: Eastern Siberia, unconventional oil and the Arctic Ocean. The Russian territory of the Arctic Ocean is said to contain 350 BOE, whereas the Eastern Siberian region holds 4.7 billion barrels (0.75×109 m3) of oil according to a 2007 EIA report.

The offshore Arctic fields are important not only to Gazprom, but also to the Russian state. According to the Energy Strategy of Russia 2030, one of the state's main goals is to achieve regional energy security through measures including "regional strategic initiatives of the state and energy business" namely underdeveloped regions such as Eastern Siberia, Far East Yamal Peninsula, and the Arctic. Notably, the Arctic is cited in the formal strategy as an important component of the Russian oil and gas future, solidifying its importance to the Russian state.

Russia and its companies are looking to the Arctic Ocean to maintain their output of about 10 million barrels of oil a day. The New York Times stated that

without Arctic drilling, Russia's oil production is projected to decline by about 1 million barrels a day by 2020. Gazprom's serious interest in the region stems from its desire to secure energy relations with the developing Asian market. China looks to Russia as one source of oil and gas for its growing economy. So far, Russia has been eager to sell its hydrocarbons to China, and now China is looking to invest in the expensive Russian offshore projects, thereby creating benefits for both countries. China also seeks to strengthen its ability to access Arctic resource bases, including hydrocarbons in Russia.


*Greenpeace's Arctic Sunrise Ship*

***Gazprom Neft Shelf's chief, Gennady Lubin, stated that the "possibility of accidents is extremely low" and if there is an accident, [Gazprom is] fully prepared.***

Foreign investment, as well as foreign demand, is a crucial element of Russian Arctic development. According to Russian law, only Gazprom and Rosneft are able to produce oil and gas in the offshore Arctic and they both rely on the technology and financing of International Oil Companies.

**Why did Greenpeace choose to protest the Prirazlomnaya oil rig?**

Greenpeace is a nonprofit organization that aims to preserve the global environment. In 1971, Quakers, pacifists, ecologists and journalists founded Greenpeace in an attempt to end nuclear testing in the Alaskan Arctic Ocean. Their mission statement succinctly reflects their purpose as "an independent campaigning organization, which uses non-violent, creative confrontation to expose global environmental problems, and to force the solutions which are essential to a green and peaceful future." The organization believes activism is the best was to capture an audience. The Arctic Sunrise has been used for many diverse missions, including missions that did not directly target companies or governments. In 2009, the ship spent many months working around the coast of Greenland and Arctic sea ice, documenting the effects of climate change on the region.

Greenpeace pays special attention to the Arctic; they organize Arctic concerns under the umbrella of climate change. Its members believe that the world is on the brink of runaway climate change. In order to achieve its stated mission, Greenpeace resorts to attention-seeking behavior that alerts the rest of the world of their bottom line: the environment must benefit. The independently funded Canadian organization argues that the Arctic region is one of the most fragile regions on our planet and is in desperate need of more protection. In this delicate region, it is the issue of global warming causing the polar ice cap to melt that needs to be addressed. Not only does this have negative effects for the Arctic peoples and wildlife, it also has negative effects for the rest of the planet. As the white ice cap is replaced with dark seas, sunlight is less and less reflected in space, resulting in more warming of the planet. Another environmental concern is the release of methane - a

greenhouse gas - contained in the permafrost areas caused by the melting of arctic ice. Greenpeace argues that this accelerates the global warming process.


***Prirazlomnaya Oil Platform. Source: Gazprom.com***

The Arctic's environment poses serious difficulties to exploring and drilling for oil. Ice, darkness and other challenges make drilling in this region much more difficult than land exploration. Renowned companies such as Shell have delayed their exploration due to unexpected difficulties. Gazprom expects no difficulties and is confident it can safely explore the region. Greenpeace argues that Russia is not a role model of environmental safety and should not explore this fragile region.

Amidst the media attention of the Greenpeace activism in the Pechora Sea that often focuses on the Arctic 30 and the subsequent geopolitical implications of their actions, Greenpeace's exact opposition boils down to a few factors: symbolism, safety and environmental hazards, namely oil spills. The NGO targeted this oilrig because it claims in its Gazprom media briefing in September 2013 that "the Prirazlomnaya platform is really only the start of Gazprom's Arctic ambitions." They see calling attention to the first Russian oil rig as a symbolic gesture to influence oil drilling in the Russian Arctic.

Secondly, Greenpeace contests Gazprom's claim that the Prirazlomnaya platform is prepared for the harsh arctic conditions: "The drill site is only ice free 110 days every year and temperatures of -50°C are not uncommon. In truth, the Prirazlomnaya is about as far from the idea of an ultra-modern drilling unit as it is possible to imagine. It has been cobbled together from rusting pieces of old rigs and dragged, with construction uncompleted, into position in the Pechora Sea by tugs. This means Gazprom is using out-of-date equipment to drill in one of the most extreme environments anywhere on the planet." Gazprom denies that it is using out-of-date equipment. In an October 2013 interview published on Gazprom Neft Shelf's website, the subsidiary's executive director, Gennady Lubin, implored that the Prirazalmonaya rig is "a new facility."

***According to Greenpeace, Russia is responsible for half of the world's oil spills, which amounts to roughly 30 million barrels of annual inland petroleum leak.***

In the same interview, Lubin stated that the "possibility of accidents is extremely low" and if there is an accident, they are fully prepared. Greenpeace points out that Gazprom's plan to develop the Prirazlomnoye oil field poses a crucial problem in that the local rescue services are incapable of cleaning up large oil spills - the nearest rescue infrastructure is located in Murmansk, a thousand kilometers away from the drilling site. The decision to start the oil drilling by the Prirazlomnaya platform is contrary to the Russian president's commitment to ensure the environmental safety of projects focusing on the prospecting, producing and transporting of hydrocarbons on the continental shelf of the Russian Federation, Greenpeace's September media briefing further claims.

Finally, Greenpeace targeted the Prirazlomnaya oil rig in the Pechora Sea because of the dangerous ramifi-

cations of an oil spill, allegedly the number one concern of the NGO. Greenpeace's Ben Ayliffe wrote in a September 2013 blog post on Greenpeace's website that "the near-impossibility of cleaning up an Arctic oil spill is well-documented. The Pew Environment Group recently examined oil spill response plans for operations in the Arctic and warned that the oil industry is 'not prepared for the Arctic, the spill plans are thoroughly inadequate' adding that Arctic spill plans 'underestimate the probability and consequences of catastrophic blowouts.' Analysis from the World Wildlife Fund found that industry proposals for assessing the risks of a spill in the Arctic were inaccurate, describing it as 'imagineering, not engineering.'" Furthermore, Greenpeace states the "Arctic Sunrise is in the Arctic to expose and protect against the reckless oil rush unfolding there". According to Greenpeace, Russia is responsible for half of the world's oil spills, which amounts to roughly 30 million barrels of annual inland petroleum leak. There is doubt that any country in the world possesses sufficient technology and equipment to clean up large oil spills in the freezing seas. Greenpeace claims that both Gazprom and Rosneft are the worst Russian environmental polluters and claims that the Russian state and these companies together hid the truth about oil spills and other environmental damage to Russian land, rivers and oceans.


The main reason for Gazprom and its wholly owned subsidiary, Gazprom Neft Shelf, to be present in the Arctic region stems from the state's energy strategy. According to the subsidiary's website, "Russia is currently carrying out a set of state programs aimed at strengthening the country's energy security, enhancing its socio-economic potential, developing northern remote regions, and ensuring high-technology production." It is specifically stated in the Fundamentals of Russian Policy in the Arctic Region for the period up to 2020 that the Arctic Ocean and its adjacent territories need to be developed to ensure national energy security up to 2020.

**Was Greenpeace successful in achieving its goals?**

Since Greenpeace's mission statement is to expose global environmental issues to the public, then in the case of the Arctic 30, it achieved a great victory. However, if the goal of stopping Arctic drilling altogether is most important, then they might have only delayed production by a few days. Following the activism of the Arctic 30, a lot of media attention was directed at the Russian legal system and mistreatment of the activists, which at first glance does not benefit the environment. However, since Greenpeace is receiving such intense international support, this can only benefit the organization and thus its environmental causes. Further, Greenpeace has long accused Russia of being dishonest environmental abusers, and the case of the Arctic 30 provides tinder for that fire. Even though Greenpeace has not succeeded and perhaps never will succeed in stopping all Arctic oil drilling, it garnered a victory for its organization and with the support of the public, will forge ahead with mixed environmental and geopolitical goals.◆

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# Five Years on from the 2009 Gas Dispute: Are Russia and Ukraine any Closer to a Stable Arrangement?

*—Jack D. Sharples*

Another winter is upon us, and once again, observers are left shaking their heads as another potential Russia-Ukraine gas dispute appears to have been narrowly averted. As we approach the fifth anniversary of the much-publicised Russia-Ukraine gas dispute of January 2009, it is time to take stock and ask ourselves; what can we learn from developments over the past five years? Can we identify any trends that will shape developments over the next five years? This article will begin from the January 2009 dispute and its legacy, before examining the developments of the last five years in Russia-Ukraine gas relations. The events of the last three months are then considered separately, before conclusions are drawn about what we might expect from Russia-Ukraine gas relations over the next five years.

**Starting point: A brief overview of the January 2009 Russia-Ukraine gas dispute**

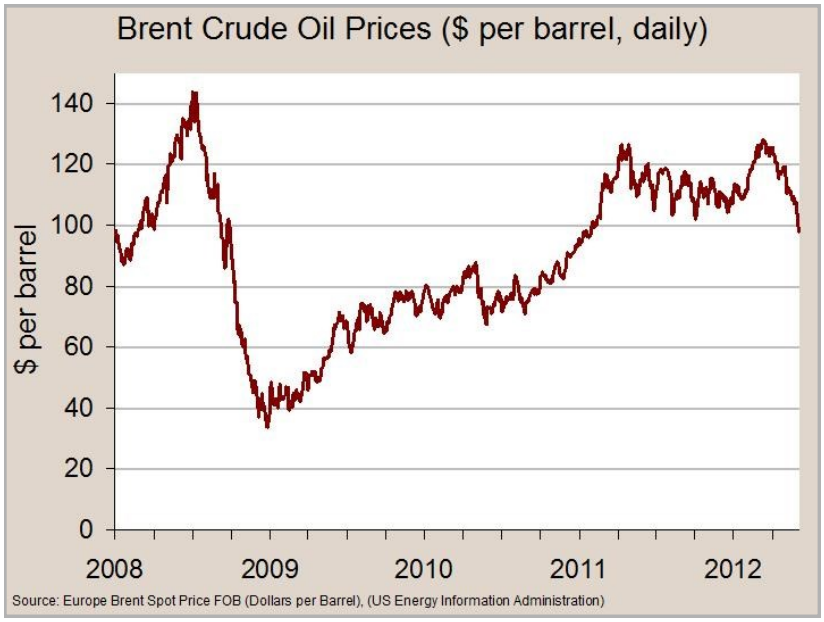
In December 2008, across swathes of Europe, snow covered the ground and temperatures remained stubbornly below freezing. As people across the continent celebrated Christmas and prepared for New Year's Eve, gas supply negotiations between Russia's monopoly gas exporter, Gazprom, and Ukraine's wholesale gas importer, Naftogaz, reached a frantic climax, with no little help from their respective governments. Despite months of negotiations, the two sides had failed to conclude a new contract for the supply of Russian gas to Ukraine.

These developments were critical for European energy security. In 2008, Russia had supplied the European Union with 144 bcm of natural gas (Gazprom, 2013), 38 percent of EU gas imports and 23 percent of total EU gas consumption (Eurostat, 2013). However, this dependence on Russian gas supplies was not evenly spread: While western European states were less dependent on Russia than the EU average, Central and Eastern Europe was particularly vulnerable. Bulgaria, Estonia, Finland, Latvia, Lithuania, Slovakia, and non-EU member Serbia relied on Russia for 100 percent of their gas imports. Austria, Czech Republic, Greece, Hungary, Poland, and non-EU member Croatia all relied on Russia for at least 70 percent of their gas imports (BP, 2009: 30). That same year, Ukraine transited 117 bcm of Russian gas to Europe (Naftogaz, 21013). Transit via Ukraine therefore accounted for 81 percent of Russia's gas exports to the EU, and all of Russia's gas exports to Austria, the Czech Republic, Slovakia, Serbia, Croatia, Bulgaria, Romania, and Greece (Entsog, 2013). Ukraine itself was Russia's largest single export customer, importing 52 bcm of Russian gas in 2008, with those imports accounting for more than three-quarters of Ukraine's 67 bcm annual consumption (IEA, 2012: II.9, II.17).

***Transit via Ukraine accounted for 81 percent of Russia's gas exports to the EU, and all of Russia's gas exports to Austria, the Czech Republic, Slovakia, Serbia, Croatia, Bulgaria, Romania, and Greece.***

At midnight on the 31st of December 2008, Gazprom's gas supply contract with Naftogaz expired. The following morning, Gazprom shut down gas deliveries to Ukraine, but continued to pump gas into the system for delivery to Europe. However, European importers began reporting reduced delivery volumes. Gazprom accused Naftogaz of stealing the gas, while Naftogaz accused Gazprom of reducing the input volume and failing to provide enough gas to main-

tain sufficient pressure in the pipeline system. On the 7th of January, Russian gas supplies to Europe via Ukraine stopped completely. They remained suspended for the next two weeks. Finally, on the 19th of January, the heads of Gazprom and Naftogaz, in the presence of the Russian Prime Minister, Vladimir Putin, and the Ukrainian Prime Minister, Yulia Timoshenko, signed a new 10-year gas supply and transit contract. The following day, gas supplies to, and via, Ukraine were restored. Naftogaz committed itself to purchasing 40 bcm of gas in 2009 and 52 bcm of gas every year for the remainder of the contract, with an 80 percent take-or-pay provision giving a minimum purchase of 42 bcm. Given that Ukraine's gas imports in 2008 were exactly 52 bcm, this meant unless Ukraine's gas consumption rose or gas production fell dramatically, virtually all of Ukraine's gas imports would be sourced from Russia for the next decade. Crucially, Naftogaz agreed to pay oil-indexed 'European' prices, which, according to Pirani, Stern, and Yafimava, (2009: 26) appeared to be 'netted back' from a European border price of $495 per thousand cubic metres.




**Developments in Russia-Ukraine gas relations 2009-2013**

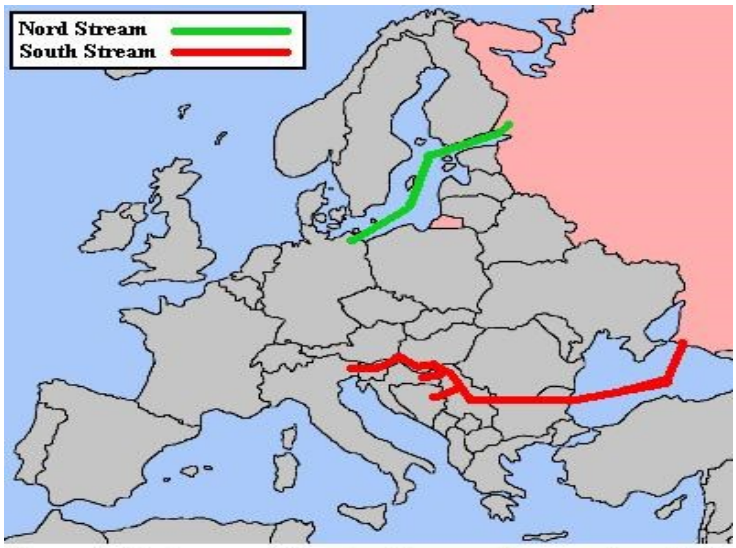
Just over a year later, in April 2010, the new Ukrainian President, Viktor Yanukovych, held a meeting with his Russian counterpart, Dmitrii Medvedev, and representatives of Gazprom and Naftogaz, in the city of Kharkiv, Eastern Ukraine. Yanukovych had been president for a month, having beaten the former prime minister, and 'Orange' candidate, Yulia Tymoshenko, in a recent presidential election. Over the previous year, oil prices had rebounded from their nadir of $40 a barrel in December 2008 to $84 a barrel in April 2010 (Energy Information Administration [EIA], 2013 – See graph), dragging oil-indexed gas prices upwards with them. This led to vociferous complaints from the Ukrainian government that it had been forced to sign a patently unfair contract, and repeated requests for gas price discounts. The election of Yanukovych prompted a thaw in Russia-Ukraine relations, opening up the possibility of renegotiating at least some aspects of the contract. At the meeting, the participants signed the 'Kharkiv Accords' (also known as the 'Gas-for-Fleet' deal). In exchange for extending the lease on the Sevastopol naval base to Russia's Black Sea Fleet, the Russian government agreed to suspend customs duties on gas exports to Ukraine up to the value of $100 per thousand cubic metres, with the discount passed on to Naftogaz.

***The 'carrot' of this offer [to transfer ownership to Gazprom] was backed by the 'stick' of the threat to reduce gas transit via Ukraine to nothing, rendering the GTS worthless.***

The next two years were characterised by several attempts by Gazprom to gain control over Ukraine's Gas Transportation System (GTS), in a bid to in-

crease the security of gas transit via Ukraine. Gazprom offered further gas price discounts and investment for upgrading the system. The 'carrot' of this offer was backed by the 'stick' of the threat to reduce gas transit via Ukraine to nothing, rendering the GTS worthless. Such a reduction in Ukrainian gas transit would be achieved by the construction of two new export pipelines for the delivery of Russian gas to Europe that would bypass Ukraine: Nord Stream and South Stream. The proposed combined capacity of Nord Stream (55 bcm) and South Stream (63 bcm) would be 118 bcm – just above the amount of Russian gas transited via Ukraine in 2008 – a coincidence not lost on many observers, especially in Ukraine.

Nord Stream, which delivers gas directly from Vyborg (Russia) to Greifswald (Germany) under the Baltic Sea (see map), was constructed between




*Source: Author's own work based on Gazprom data accurate as of 11th December 2013*

April 2010 and October 2012 (Nord Stream AG, 2013). However, the construction of Nord Stream failed to convince the Ukrainian government to give up control over the country's GTS, and they rejected Russian proposals for a joint venture to manage the system. Gazprom then tried to pressure the Ukrainian government with plans for South Stream that would circumvent Ukraine with gas deliveries to South-East Europe under the Black Sea through Turkish territorial waters (see map of route), but to no avail. Finally, in the last three months of 2012, final investment decisions were taken for the Serbian, Hungarian, Slovenian, Bulgarian, and offshore (Black Sea) sections of South Stream, while Gazprom also symbolically began construction of the onshore Russian section of the pipeline (South Stream Transport AG, 2013). From 2010 onwards, the Russian government also repeatedly promised gas price discounts if Ukraine joined the Russian-led Customs Union of Russia, Belarus, and Kazakhstan, which came into force in July 2010 (Radio Free Europe/Radio Liberty [RFE/RL], 2010). Again, the Ukrainian government rejected Russia's advances, preferring to initial an Association Agreement with the EU in March 2012 and a Deep and Comprehensive Free Trade Agreement (DCFTA) in July 2012, with the initialling of such documents a precursor to their formal signature and application (European Union External Action Service, 2012).

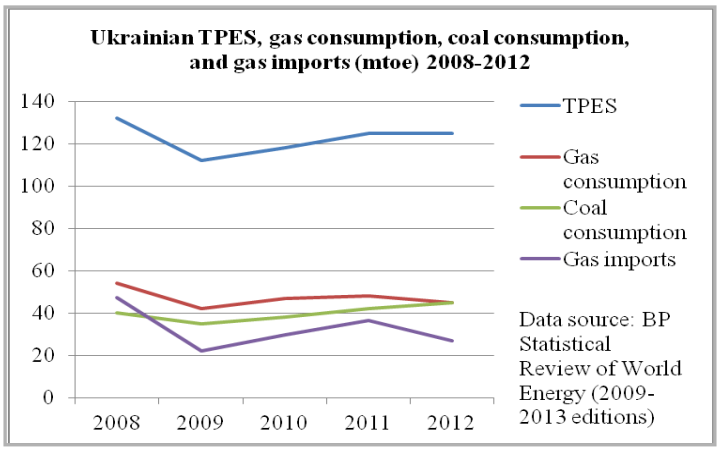
***In H1 2013 Ukraine had fallen to the fifth-largest importer of Russian gas, behind Germany, Italy, Turkey, and Belarus.***

Whilst Gazprom was building pipelines and the Russian government was pressing for closer relations with Ukraine, the Ukrainian government was actively seeking to reduce its dependence on Russian gas imports. This would be achieved by a combination of reduced gas consumption, short-term increased coal consumption, a medium-term diversification of gas imports, and a long-term increase in domestic gas production.

Ukrainian gas consumption fell from 60-67 bcm in 2008 to 47-50 bcm in 2009, rose again to 52-56 bcm

and 54-56 bcm in 2010 and 2011 respectively, before falling again to 50 bcm in 2012 (BP, 2013: 23; IEA, 2012: II.9). This reduction was achieved partly due to increased coal consumption, which grew by almost a third during this period, from 35.1 million tonnes of oil equivalent (mtoe) in 2009 to 44.6 mtoe in 2012 (BP, 2013: 33), as domestic coal replaced imported gas in Ukraine's power stations. However, the impact of economic recession in 2009-10 on Ukraine's industrial output and total primary energy supply (TPES) cannot be ignored: Total primary energy consumption in Ukraine fell from 132 mtoe in 2008 to 112 mtoe in 2009, and recovered to 125 mtoe in 2011 and 2012 (BP, 2013: 40). Between 2008 and 2012, the share of natural gas in Ukraine's TPES fell from 40 percent to 36 percent, while the share of coal rose from 30 percent to 36 percent (BP, 2010: 41). Ukraine's reduced gas consumption had a significant impact on Ukraine's gas import volumes. In 2008, Ukraine was the world's largest importer of Russian gas, with Naftogaz importing 52 bcm from Gazprom (IEA, 2012: II.17). By 2012, Ukrainian gas imports had fallen to 29.8 bcm (BP, 2013: 28). In H1 2013, Ukrainian imports of Russian gas were down to 9.67 bcm (a 39 percent year-on-year reduction) (Khrennikova, 2013), suggesting total imports of 18 bcm in 2013. This meant that in H1 2013 Ukraine had fallen to the fifth-largest importer of Russian gas, behind Germany, Italy, Turkey, and Belarus (Khrennikova, 2013; Prime-Tass, 2013).

***In January 2013, Royal Dutch Shell signed a production sharing agreement (PSA) for the Yuzivska shale gas field in Eastern Ukraine.***




In the medium term, the Ukrainian government hopes to diversify its gas imports by increasing the amount of gas the country imports from Europe. In May 2012, Naftogaz signed a gas supply agreement with RWE (Germany) for the supply of up to 5 bcm in 2013. Small volumes of imports from Poland began in November 2012, which were then augmented by supplies from Hungary from March 2013. Yet between January and November 2013, Ukraine imported just 1.9 bcm from Europe, significantly below the 7 bcm import capacity from Poland and Hungary (Interfax Energy, 2013). The operator of Ukraine's GTS, Ukrtransgaz (a subsidiary of Naftogaz) also began talks with Slovakia's pipeline operator, Eustream, about the possibility of reversing the flow of one of the pipelines that crosses the Slovak-Ukrainian border, giving a further 10 bcm of potential import capacity (Bor, 2013).

In the long term, the Ukrainian government is pinning its hopes on the development of shale gas and offshore conventional gas production in Ukraine with the participation of international energy companies. In January 2013, Royal Dutch Shell signed a production sharing agreement (PSA) for the Yuzivska shale gas field in Eastern Ukraine. This was followed by Chevron signing a PSA for the Olesska field in Western Ukraine. The Ukrainian government also hopes to sign a PSA with Exxon-Mobil before the end of 2013 for the development of a conventional offshore

gas field in the Black Sea. According to the Financial Times, "Eduard Stavytsky, the country's energy minister, has said that if the two shale projects and offshore ExxonMobil project worked out as hoped, they could together produce 20 bcm annually within 10 years. That would double current production and potentially enable Ukrainian production to completely meet its gradually falling domestic demand" (Buckley, 2013).

As the winter heating season began in October 2013, the stage was set: Gazprom was diversifying its export routes away from Ukraine, and the Ukrainian government was working to reduce Ukraine's dependence on Russian gas imports. The question was, would this lead to a calming of the previously turbulent Russian-Ukrainian gas relationship?

**Developments in Recent Months**

Observers did not have to wait long for their answer. At the end of October, Russian television broadcast a meeting between the Chief Executive of Gazprom, Alexei Miller, and the Russian Prime Minister, Dmitrii Medvedev. In that meeting, Miller complained that Naftogaz had failed to pay a bill of $882m for its August gas imports, and suggested that, in the terms of the existing Gazprom-Naftogaz gas supply contract, Naftogaz should now face the penalty of switching to a schedule of pre-payments (RIA Novosti, 2013a). Naftogaz responded by suspending its imports of Russian gas for several days between the 9th and 15th of November (Ukrinform, 2013a), prompting fears that Naftogaz was using up gas from its storage, which would later be needed to ensure uninterrupted gas transit during the depths of winter (Interfax Ukraine, 2013a).

***Ukrainian Prime Minister Azarov requested 20bn Euros in financial aid in return for signing the Association Agreement to help restructure the Ukrainian economy.***

Then, at the end of November, the Ukrainian President, Viktor Yanukovych, failed to formally sign Ukraine's Association Agreement with the European Union at the EU Eastern Partnership Summit in Vilnius. This move triggered speculation that the Ukrainian government had been under political and economic pressure from Russia not to sign the agreement, which would have closed off any possibility of Ukraine joining the Customs Union. One component of such 'economic pressure' would certainly have been a combination of Ukraine's dependence on Russian gas imports, Naftogaz's outstanding debts to Gazprom, and Ukraine's currently parlous economic situation. President Yanukovych has claimed that Ukraine needs $20bn a year until 2017 from the EU to modernise Ukraine's economy and reorient it towards Europe, whilst referring to the EU offer of 610m Euros in macro-financial assistance 'humiliating'. Meanwhile, Ukraine's Prime Minister, Mykola Azarov, requested 20bn Euros in financial aid in return for signing the Association Agreement, to help restructure the Ukrainian economy (Zinets, 2013). Yanukovych's failure to sign the Association Agreement,

*Protests in Kiev, December 2013. Source: http://news.kievukraine.info*

and rumours of Ukrainian accession to the Russian-led Customs Union instead, also prompted massive public protests in Kiev that remain ongoing as of the 11th of December. There remains the possibility that, under the threat of 'losing' Ukraine to the EU, Russia could yet offer gas price discounts and debt restructuring without demanding that Ukraine join the Customs Union, which would surely trigger further protests and bring further pressure to bear on Yanukovych and his government.

***Even if South Stream is built at only half capacity (31.5 bcm) and Nord Stream can only operate at two-thirds capacity (37.5 bcm), the Russian need for gas transit via Ukraine will not amount to much more than 25 bcm per year.***

Several days after Yanukovych failed to sign the Association Agreement with the EU, reports emerged that Ukrainian officials had also failed to attend the signing of an agreement for the import of gas to Ukraine from Slovakia, scheduled for the 5th of November (Norman, 2013). However, this was subsequently denied by Ukrtransgaz (Ukrinform, 2013b), while the Ukrainian Energy and Coal Industry Minister, Eduard Stavytsky, told reporters in Beijing on the 5th of December that "We plan to [sign it] when we get back, next week" (Interfax Ukraine, 2013b). Yet by the 11th of December, the agreement had still not been signed. Also on the 5th of December, Gazprom's Chief Executive, Alexei Miller, made an official statement contradicting claims made by Naftogaz 24 hours earlier that a deal had been reached on the payment of Naftogaz's outstanding debts to Gazprom. Miller confirmed that Naftogaz now owed Gazprom $2bn in unpaid gas bills for August, October and November. Although the Chief Executive of Naftogaz, Yevhen Bakulin, had acknowledged the debt and claimed that an agreement had been reached for Naftogaz to wait until the New Year to settle its debts for gas imported between October and December, Miller announced that while talks remained ongoing, nothing had yet been agreed (RIA Novosti, 2013b). Therefore, although Gazprom and Naftogaz have a supply and transit contract that will take them through the winter period (unlike in the winters of 2005-06 and 2008-09), the major issues of Naftogaz's debt to Gazprom and the amount of gas that Naftogaz holds in storage will ensure that this winter remains a nervous one for European states dependent on Russian gas supplies and Ukrainian gas transit.

**Conclusions and outlook for the future**

Over the five years since the January 2009 Russia-Ukraine gas dispute, both sides have worked to reduce their dependence on one another. With EU demand for Russian gas relatively stagnant, it is not expected that Russia will export much more than 150 bcm per year to the EU for at least the medium term. Thanks to the construction of Nord Stream, Gazprom currently has access to 105-110 bcm of capacity for exporting gas to the EU, plus 142 bcm via Ukraine (Naftogaz, 2013). Nord Stream is currently operating at approximately half capacity, having delivered 21 bcm between January and November 2013, while regulatory difficulties in Germany are currently limiting Nord Stream's capacity to 37.5 bcm (Reuters, 2013). Even if South Stream is built at only half capacity (31.5 bcm) and Nord Stream can only operate at two-thirds capacity (37.5 bcm), the Russian need for gas transit via Ukraine will not amount to much more than 25 bcm per year. For comparison, the transit of Russian gas to Europe via Ukraine amounted to 70 bcm in January-October 2013 and is expected to reach approximately 85 bcm for the whole of 2013 (Interfax Ukraine, 2013c). In light of Ukraine's current financial difficulties, the loss of transit revenue due to declining transit volumes would represent a painful blow to an already fragile

Ukrainian economy.

***...It is quite possible for Gazprom to offer gas more cheaply to Ukraine than European suppliers operating on the basis of European spot prices.***

From the Ukrainian perspective, if Ukrainian gas demand stabilises at around 50-55 bcm, much will depend on the volume of imports from Europe and domestic production increases. However, European imports are not expected to exceed 10 bcm for the foreseeable future, while current domestic production would need to increase from 20 bcm to 40 bcm to entirely displace Russian gas imports. A more likely scenario is the limited development of shale and offshore gas production, perhaps to 10 bcm, and a reduction of Russian gas imports to around 15 bcm by 2018. However, the costs of developing new gas production is unlikely to render shale gas and offshore gas production significantly cheaper over the next five years. Furthermore, Russian gas prices on the German border over the first ten months of 2013 ($11.27) began to converge with spot prices at the UK National Balancing Point (NBP) ($10.33) (Shiryaevskaya, 2013). If the 'netback' reduced costs of transportation, and Ukraine's $100 discount agreed in Kharkiv in April 2010 are taken into account, it is quite possible for Gazprom to offer gas more cheaply to Ukraine than European suppliers operating on the basis of European spot prices. For Ukraine in 2018, diversified gas supplies may be more secure, but they won't necessarily be significantly cheaper.

By the end of 2018, it is entirely possible that Russia and Ukraine will have significantly reduced their mutual gas dependency. Ukrainian transit may account for around 17 percent of Russia's gas exports to the EU, while Russian gas supplies may account for 27 percent of Ukrainian gas consumption – a sizeable reduction from figures of 81 percent and 78 percent respectively in 2008. Late 2018 could also see negotiations for the renewal of the Gazprom-Naftogaz gas supply and transit contract, which is due to expire in January 2019. It will be during these negotiations that the effects of reduced interdependency will become clear: Will such reduced interdependency be sufficient to break the cycle of mutual recriminations over the price charged for gas by Gazprom to Naftogaz and the repeated accumulation of debts to Gazprom by Naftogaz? Only if it is accompanied by a more transparent contractual and pricing system, and increased payment discipline by Ukrainian gas consumers that purchase their gas from Naftogaz, which would give Naftogaz the ability to meet its payment commitments to Gazprom. Furthermore, these commercial conditions will undoubtedly be influenced by the future decisions of the Ukrainian government regarding integration with its two most important neighbours, Russia and the EU. ◆

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VOLUME 2 ISSUE 3 2013

# Why is South Stream Being Built? It's Not Just Geopolitics

*—Nicholas Watt*

Almost exactly one year ago in the southern Russian city of Anapa, Vladimir Putin, in an auditorium filled with energy company executives and high-ranking international government officials, launched construction of the South Stream pipeline. Projected onto a giant screen directly behind the Russian president was live footage of the welding of the first two pipes of the project that will cost about $20 billion. South Stream will carry Russian gas under the Black Sea, through Bulgaria and Serbia, and on up through central Europe. Though this launch ceremony was more symbolic than anything, now - a year later - is an appropriate time to revisit the reasons this costly project was set in motion. South Stream is often portrayed only as a means by which Russia can enhance its geopolitical position. This interpretation is provocative and attracts readers, but is over-simplistic because it overlooks the pipeline's economic basis. Gazprom's economic rationale behind this costly pipeline may not be compelling, but it is logical. This article strives to illustrate this logic.

Some may understand South Stream as some kind of political bludgeon that Putin will be able to wield over Yanukovych's head whenever the Ukrainian president acts out of line. While it is true that South Stream will run contrary to Ukrainian national interests, its primary purpose is to sell Russian gas to Europe – a novel but important point given the hysteria surrounding the protests in Ukraine. Currently, about 50% of all of Russia's gas travels through a pipeline system controlled by Ukrtransgaz, a Ukrainian state-owned Naftogaz subsidiary, before it reaches European customers. South Stream will bypass Ukraine, and if running at full capacity, could, in principle, decrease this figure to zero, thereby depriving the former Soviet region of significant transit revenue and a key geopolitical lever over Russia. At the time of the infamous 2009 gas crisis, 80% of European-bound gas went through the Ukrainian controlled system, highlighting the importance of a good (and if not good, then workable) relationship between Russia and Ukraine.

***Gazprom's economic rationale behind South Stream may not be compelling, but it is logical.***

This importance is amplified when you consider the kinds of gas contracts Russia's Gazprom has with its European customers west of Ukraine. If you take, for example, the gas supply contract between Gazprom and Poland's PGNiG, the gas delivery point is not at the border between Russia and Ukraine, but at the border of Ukraine and Poland. What this means is that if Ukraine chooses to disrupt the flow of gas to Poland, then Russia's Gazprom is legally liable. Continued transit of Russian gas through Ukraine, therefore, relies in large part on trust between the leaderships of the two countries.

Such a delicate trust is untenable when the stakes are so high; Russian gas sales provide significant revenue to the Russian state - roughly 7% of the state budget. Ukrainian control over the transit of much of this lucrative commodity poses a serious risk and the Russian state will do what it can to protect these sales and reduce that risk. South Stream should not be seen as the optimal choice of doing so, however. Another cheaper and more reasonable option would have been for Gazprom to take over the Ukrainian transit system. Negotiations over Russian acquisition of this system have been underway since the 1990s – long before discussion of South Stream, which was conceived in 2007. Ukraine is and has been understandably reluctant to part with what may be its most valuable economic asset and its most val-

uable geopolitical lever over Russia. Once South Stream comes online, however, the value of Ukraine's system will be greatly diminished.

***Part of successfully selling gas to a particular region is making sure that others do not do so before you. South Stream has served this purpose by beating out the initial Nabucco project.***

Russia acted quickly to mitigate the risk following the 2009 crisis, and as Ukrainian transit pipeline negotiations bore little fruit, South Stream gained momentum. As the crisis was the most significant impetus for this new momentum, understanding the 2009 crisis is key to understanding South Stream. The gas cutoff is often perceived as Putin punishing Ukraine for its western leanings, such as supporting Georgia in the 2008 war or adopting more pro-NATO and -EU stances on issues. The economic reasons are sometimes forgotten or added only as a side note. On the eve of the crisis, no supply contract had been signed to provide Russian gas to Ukrainian markets, and this gas was cut off. Russian gas to European markets *through* Ukraine continued for a few days, until Russia stopped all flow, accusing Ukraine of stealing some of this gas meant for Europe. Naftogaz's consistently delinquent gas bills, which by the time leading up to the cutoff amounted to $2 billion outstanding, for already below market-priced gas could explain much of Russia's uncompromising attitude.

Just because South Stream is hostile to Ukrainian interests does not mean that it is being implemented with the specifically designed purpose to hurt Ukraine. A $20 billion investment for the sake of punishment does not make sense. South Stream is being built to sell gas to southeastern Europe. For all of the natural gas that Russia has, it has not been very successful at selling it, except in Europe - the primary export destination for Russian gas since the late 1960s. Russia is painfully behind other countries in LNG development, a method of transport that would give Russia greater market options, and Gazprom's negotiations with China have been embarrassingly slow and fruitless. Selling piped gas to European markets is Gazprom's bread-and-butter and South Stream's construction keeps with this trend.

Part of successfully selling gas to a particular region is making sure that others do not do so before you. South Stream has served this purpose as well by beating out the initial Nabucco project, which was conceived in 2002 and had the support of both the EU and the US. From 2007, when South Stream was conceived, until the summer of 2013, when Nabucco West lost out to the TAP pipeline, Nabucco and South Stream were competing for roughly the same southeastern European markets. The coexistence of

***Putin launching South Stream at the 2012 welding ceremony. Source: sptimes.com***

two huge pipelines feeding roughly the same markets was a financial impossibility, and as South Stream progressed forward, support for Nabucco waned as the EU-sponsored pipeline struggled to find suppliers and its investors were unwilling to take on the financial risk of supporting what would have been a redundant pipeline.

Another question is not about risk or competition, but about numbers. South Stream's 63 bcm capacity eclipses demand for the markets it is slated to supply. One trunk, instead of four, would be roughly 16 bcm and would more closely reflect regional demand. Alexander Medvedev, chief of Gazprom Export, at an investors meeting in 2012, admitted the possibility of sizing the project down a line or two. The official figure of 63 bcm may stay there just because it will be easier to size down later by delaying construction of one line than to start at a lower negotiating point and scaling up. Additionally, a 63 bcm pipeline may have been more effective in squashing Nabucco than a 15 bcm or 30 bcm pipeline would have been.

***One can be reasonably confident that South Stream will be realized in one form or another with Forbes 2013 world's most powerful man in Vladimir Putin serving as its biggest cheerleader.***

There is much legal uncertainty surrounding South Stream at the moment. There are two provisions of a 2009 piece of EU legislation called the Third Energy Package that particularly threaten Gazprom's business model: "ownership unbundling" – that transmission and supply be controlled by separate entities – and "third party access" – that other gas suppliers be given access to pipeline infrastructure. Just last week, the European Commission ordered all of Gazprom's bilateral deals with EU member countries regarding South Stream to be redone; Gazprom has no intention of following this order. The European Commission will continue to battle to make sure that South Stream fits into the framework of the Third Energy Package and Gazprom will continue to resist. One can be reasonably confident, however, that South Stream will be realized in one form or another with Forbes 2013 world's most powerful man in Vladimir Putin serving as its biggest cheerleader.

South Stream should be viewed primarily in the context of Russia's natural gas strategy of maximizing export revenue for both the present and the future. Whether or not this strategy is being executed successfully is debatable. Indeed, South Stream has been maligned as too big, too expensive, too politically charged, and too technically difficult to be justified. The sorry state of current Russian-Ukrainian relations has played a central role in causing Russia to favor construction of this controversial pipeline over the pursuit of a compromise with Ukraine that could have seen continued or even increased transit of Russian gas through Ukraine on mutually acceptable terms. As Ukrainian leadership is flirting with signing an Associated Agreement deal with the EU, it remains to be seen what gas concessions Russia is willing to give up to sway its western neighbor. Perhaps, we will see Ukraine paying a lower gas price if the country continues to reject the Association Agreement, but cancellation of South Stream is likely off the negotiation table. Vladimir Putin has already thrown too much weight behind the project to back down and unless something drastically changes with Russian-Ukrainian relations, the risk that South Stream was designed to reduce will still be present. ◆

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# Black Gold, Economic Flowering, and Ethnic Tensions – Hydrocarbon Exploration and Export in Northern Iraq

*—Andrea Seffens*

Cradled between distant mountain ranges and vast oil fields, a fresh capital hums like a young Dubai, as students and businessmen stroll about modern buildings built with the revenues brought by the black gold that rests beneath Kurdish Iraq. Growing oil profits and increased international investment in the region have facilitated a renaissance for Iraq's Kurdish population following the American ousting of Saddam Hussein, yet Baghdad and the capital of the autonomous Kurdish regional government (KRG) Erbil continue their rocky relationship. After the Baathists waged a genocidal campaign in the 1980's and left over 100,000 Kurds dead, the Kurds wanted to maximize the distance between themselves and Baghdad. The United States, committed to the territorial integrity of Iraq rejected proposals for Kurdish independence, and instead crafted a power sharing agreement that carved out a self-governing government within Iraq. The Sunni Kurds are weary of subsidizing a violent and economically underperforming Shi'ite based regime in Baghdad. Tensions between Erbil and Baghdad have multiplied, leading to confrontations over exploration, import, and export rights over oil found in Northern Iraq. The power sharing agreement remained steady for a decade, but new flows of foreign investment into the KRG's oil and gas sector have allowed Kurdish frustration to vent. Control over the sizable oil and gas reserves in Kurdish Iraq is quickly becoming a flashpoint between a Kurdish population set on autonomy and statehood and a central government desperately trying to contain smoldering domestic discontent.

Disagreements over exploration and production agreements with foreign firms have caused conflict between the KRG and Baghdad. The Kurds claim that the Iraqi constitution allows autonomous regions (thus the KRG controlled area) to develop and produce from new fields, in joint ventures with other gas or oil firms. The "Oil and Gas Law of the Kurdistan Region – Iraq" confirms that the public Kurdish Exploration and Production Company may "enter into joint ventures and similar contractual arrangements, whether in the Region, in other parts of Iraq or abroad." Baghdad maintains that it is illegal for foreign firms to unilaterally engage the regional government in exploration and production agreements. The central government claims the oil revenue should be distributed nationally, despite its location in the Kurdish region.

***In 2012 Iraqi and North Iraqi crude production averaged over 3 million barrels per day; despite fluctuation in production capacity due to disagreements with Baghdad, the KRG is on track to produce about 400,000 barrels per day by the end of 2013.***

**Who Controls the Oil?**

The oil fields of northern Iraq are significant – in some places it all but oozes forth from the ground. Iraq is home to the fifth largest proven oil reserves in the world, roughly 141 billion barrels as of January 1, 2013. The nation has surpassed fellow OPEC member Iran as the second largest producer within OPEC at the close of 2012, because Iran's largest Asian customers have cut their imports while the U.S and Europe tighten energy sanctions. The KRG governed area holds around 17% of Iraqi oil reserves near Kirkuk, Mosul, and Khanaqin. The International Energy Agency has estimated Kurdish Iraq holds around 4

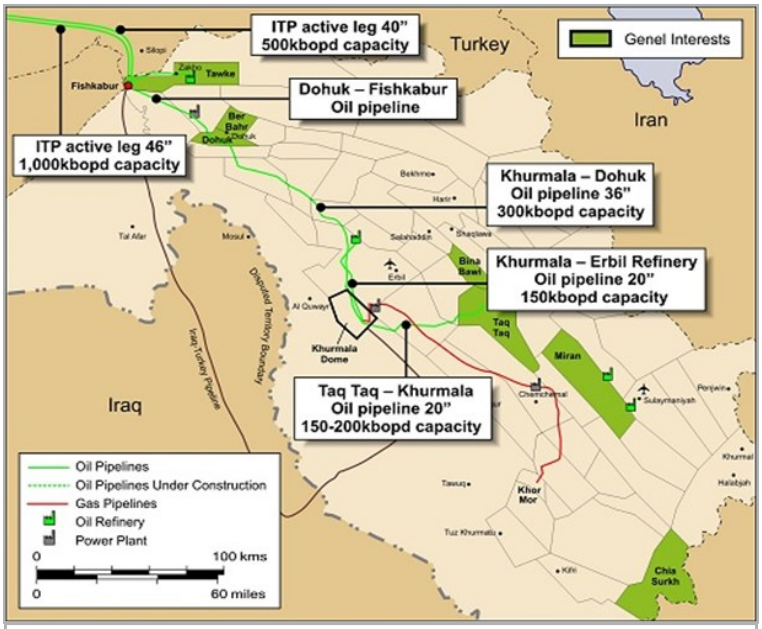
billion barrels of proven reserves.

Due to the large oil reserves, the KRG is cultivating a blossoming relationship with neighboring Turkey. The construction of a new pipeline that would transport Kurdish-Iraqi oil to Turkey is set to come online this year. The Dohuk-Fishkhabour pipeline would run straight from the KRG area to Fishkabour, an Iraqi town within three miles of the Turkish border. It will likely connect to the Kirkuk-Ceyhan pipeline terminating in the Turkish energy port Ceyhan, though whether the new pipeline will connect on Kurdish or Turkish soil is unclear. This pipeline will offer up greater market access for Kurdish Iraq. The attractiveness for foreign firms to explore and produce in Kurdish Iraq is rapidly growing due to the region's relative security and plentiful reserves, particularly when compared to the rest of the war-trampled country.

In 2012 Iraqi and North Iraqi crude production averaged over 3 million barrels per day; despite fluctuation in production capacity due to disagreements with Baghdad, the KRG is on track to produce about 400,000 barrels per day by the end of 2013. The Kurdish region of Northern Iraq produces crude oil through production sharing agreements with international companies, eschewing the state owned model favored by Baghdad. All official oil exports, Baghdad claims, must go through the Iraq-Turkey pipeline terminating in the ports at Ceyhan, Turkey or Basra, southeastern Iraqi port on the Persian Gulf (see map). The contents of the pipeline belong to the State Owned Marketing Association, SOMA, and thus to Baghdad rather than Erbil.

**Unresolved Legal Issues**

Baghdad is downplaying the KRG's growing economic power, vehemently stating that the oil and gas exploration contracts the KRG has signed with foreign firms are illegal because they have not involved Baghdad, and thus is laying the groundwork for companies to question the legality of their agreements with the KRG. The latest case is the Dana Gas suit against the KRG. Pearl Petroleum, a company owned by Dana, Crescent Petroleum (listed with Abu-Dhabi and based out of The United Arab Emirates), Austria's OMV, and the Hungarian oil and gas group MOL, is demanding clarification from the government's Ministry of Natural Resources regarding its contract with the KRG. Baghdad argues that the KRG cannot unilaterally sign exploration production agreements with foreign companies; such agreements must meet Baghdad's approval. Pearl Consortium wants to know how much money they are owed for work already carried out, and their legal status to further develop and market gas fields, Khor More and Chemchmal. Pearl Consortium has invested over $1 billion in the North Iraqi fields so far. ExxonMobil, Chevron, and Total have contracted with the KRG, but in doing so risk their contracts in the Baghdad controlled south.




*Hydrocarbon operations in Kurdistan region of Iraq. Source: genelenergy.com*

This unresolved legal environment makes investing in exploration and production in KRG-controlled Iraq risky, particularly to firms with projects in Baghdad-

controlled southern Iraq. Baghdad could potentially threaten the southern projects if firms exploring and developing in Kurdish Iraq refuse to side with the capital. Turkish firms like Genel and major international oil company ExxonMobil are continuing to explore and produce crude oil in the KRG region, but they do so risking Baghdad's ire. Baghdad has prohibited private Turkish planes from flying into KRG air space in response to Turkey's progress on energy deals with the KRG. On November 29, Baghdad made good on its ban and turned back a private Turkish plane from KRG airspace. Baghdad can also threaten the legality of business deals foreign international oil companies (IOCs) sign with the KRG, because Baghdad demands that all such business agreements must involve the central government. If Baghdad refuses to settle and accept the agreements between the KRG and foreign IOCs as legitimate, then the IOCs are risking their hydrocarbon operations, as the central government could take measures that would worsen the business environment and scare off investors.

**Turkey Plays a Key Role**

While the central government could threaten IOC projects in the south, the KRG tempts these companies with significant resources and a stable working environment. Kurdish Iraq has been a relatively safe and prosperous region for its five million Kurdish residents. Unlike the rest of the country, terrorist attacks and bombings are relatively rare. Compared to Baghdad, the KRG is the preferable of the two governments in terms of doing business due to the region's relatively safe environment. Baghdad's preferred pipeline, terminating in Ceyhan, is frequently the target of terrorist attacks. The pipeline has been bombed over thirty of times since February of this year. In August, Attackers blew up a section of the pipeline near Hadhar in Nineveh Province, whilst a complementary bomb knocked out a section near Fatha, between Kirkurk and Baiji. The flow of oil was halted for several days. Baghdad cannot defend its major oil artery to Turkey while Kurdish Iraq has witnessed comparably few attacks, and none have honed in on its energy infrastructure. If Ankara cannot trust Baghdad to protect the energy infrastructure its firms invest in (joint-venture or otherwise), while Kurdish Iraq can, the incentive to continue to explore and invest in the rest of Iraq drops dramatically in light of hydrocarbon rich and stable Kurdish Iraq. Baghdad may thus fear losing Turkish business – a doubly harsh blow as Iraqi oil exports continue to drop.

***If Ankara cannot trust Baghdad to protect the energy infrastructure its firms invest in (joint-venture or otherwise), while Kurdish Iraq can, the incentive to continue to explore and invest in the rest of Iraq drops dramatically in light of hydrocarbon rich and stable Kurdish Iraq.***

Kurdish Iraq's potential for significant oil revenues contrast sharply with Iraq's persistent infrastructure issues dating back to the Iran-Iraq war in the 1980's. Northern Iraq holds massive oil reserves. Estimated oil reserves clock in at 45 billion barrels. Though less than a third of Iraq's total, it is almost double that of the USA. Iraq's electricity demand has increased by 400% over the past decade, the majority of plants operating off of crude oil or natural gas. When crude deliveries are delayed, the workflow of the power plants suffers. Fifty foreign firms are operating in Kurdish Iraq, accelerating growth of production capacity. These firms have spent over $20 billion to improve the oil sector. An executive at Genel, a British-Turkish oil firm that is a the largest oil producer in the area, confidently predicted that production will reach 1 million barrels per day by 2015, and quite

possibly 2 million barrels per day by 2020.

This rapidly improving partnership between Turkish energy companies and Northern Iraq threatens Baghdad. The KRG continues to sign deals with Turkish and other energy companies without the central government's approval, which lessens Baghdad's political hold over Northern Iraq. The KRG's pipeline deals with Turkish firm, Genel, have emboldened Kurdish aspirations for political and economic autonomy. With such economic autonomy, why should Kurdish Iraq continue to seek permission from Baghdad to move forward with new business developments such as oil and gas pipelines?

*Though Kurds in Iraq may desire a formally independent state, policy makers within the KRG recognize that to demand formal independence could endanger their lifeblood – oil and gas production. Kurdish Iraq seems content as an autonomous region operating within Iraq.*

Baghdad may fear complete removal from the KRG's business deals and would not want to lose its percentage of Kurdish oil fields. Baghdad's economy continues to lag, and so it depends on Kurdish Iraq's oil revenue to maintain its tenuous control over the rest of the country. In accordance with the Iraqi Constitution and KRG law, revenue would go first to Baghdad who would return 17% of the hydrocarbon revenue to the KRG and redistribute the rest among Iraqi provinces to head off another civil war. Baghdad has claimed that the KRG is keeping about two-thirds of the oil revenues. The KRG claims that under the current schema, it is receiving 12% rather than the 17% it is entitled to.

The rise in Northern Iraq's energy fortunes and the associated warming of KRG – Ankara relations cause anxiety for Baghdad. If the Kurdish oil and gas fields are developed in a successful, timely manner, and in conjunction with foreign IOC's, there is a chance that Turkey may view Northern Iraq as the better business partner.

**Conclusion**

Disputes over the production of oil in Kurdish Iraq continue to flare between Baghdad and the KRG, but it is not a zero sum game. Though Kurds in Iraq may desire a formally independent state, policy makers within the KRG recognize that to demand formal independence could endanger their lifeblood – oil and gas production. Kurdish Iraq seems content as an autonomous region operating within Iraq.

The two governments have reached a tenuous truce regarding Genel's infrastructure development and oil revenue with the KRG, but the overarching issue of resource control remains a work in progress. The Kurdish pipeline will carry oil from Dohuk to an Iraqi town on the Turkish border, Fishkabur, where it will connect to the Turkey-Iraq pipeline. Baghdad will recognize the KRG's deal with Genel, while in this case the KRG gives due respect to Baghdad by connecting the Kurdish pipeline to the federally controlled Turkey-Iraq one at the Turkish-Iraqi border. This combines pipeline safety while technically transporting Kurdish oil through a portion of Baghdad's pipeline. Yet Baghdad remains furious with Ankara for progressing with the KRG on oil exploration and development. The Iraqi capital claims that Kurdish oil independence will fan the splintering of Iraq. Ankara, in response to Baghdad's unrest, has pushed for a tripartite agreement in which Turkey, Iraq, and the KRG are all involved in the sale of Kurdish-Iraqi gas to Turkey. The central government remains wary of an agreement that gives the KRG an equal standing with Baghdad, lest they cede more control to Erbil.

Hydrocarbon wealth provides prosperity and grow-

ing autonomy to the Kurdish region of Iraq, yet that same blessing complicates relations with the Iraqi capital. The KRG has created a stable environment where energy firms need not fear terrorist attacks destroying energy infrastructure. These firms can peaceably explore and produce from the significant Kurdish Iraq oil field. But they can only do so if Baghdad can comes to an agreement with the KRG and foreign firms regarding the KRG's economic autonomy. Foreign companies have caught the scent of Northern Iraq's black gold, and are hungry to explore it – but a question remains; will the entire country or simply Kurdish Iraq benefit from plumbing Northern Iraq's hydrocarbon wealth? ◆

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# Workshop Review: Vladimir Milov—Greater Role of State in Russian Energy is Not Good For Russia

*—Tsvetalin Radev and Koen van Delft*

"The behavior displayed by the state was surprising; they unannounced a big U-turn and regained control over the industry, with re-nationalizing assets, and increasing its role in regulation, planning, and investments. This almost immediately led to diminishing hopes for higher share of FDI in the energy sector. The government has reinstated itself as the National Champion." Such was the opening given by current Russian opposition leader and former deputy energy minister of the Russian Federation Vladimir Milov. Milov, who heads the Russian political party, Democratic Choice, continued his presentation at European University's Golden Hall on November 6 with sharp and knowledgeable criticism of decision-making in Russia's energy industry. Speaking without the aid of notes or a powerpoint presentation behind him, Milov said that discussing Russian energy issues was easy for him. Milov's background is that of a Russian energy specialist - he was a vocal advocate of privatization and liberal economics when he served as deputy energy minister in the early 2000s. He has been left disillusioned with the state-dominated path Russia's energy policy has taken following his departure from the Russian government.

"The first sign of the new course that Putin was taking was his statement in February 2003 that he is against the idea of market restructuring and unbundling of Gazprom. This was also the year that marked the first takeover of private companies with the acquisition of Severnayaneft by Rosneft. It has been a decade since this U-turn in energy policy was announced and it is time to evaluate the ultimate results. We should bear in mind that Russian energy industry is in totally different shape than it was 10 years ago. Today there are two main challenges that were not present a decade ago; the shift from a brown field era to green field era, and the higher level of competition on international markets. Most of the new green fields are located in very remote, difficult areas, particularly in the Pacific and Arctic offshore area where Russian companies have virtually no experience and the investments are significantly higher. Thus, these green fields present a two-folded challenge: technology and investment."

Milov underlines that previous decision makers were wrong in interpreting the outcome of global markets and energy prices, "the prospects and gas dependence on Russian exports, which was particularly exciting for some policy makers in this country, vanished. What we see is more competition, more opportunities for traditionally energy dependent countries to actually escape their energy dependence. We need to evaluate the implications for the Russian sector."

***"The privatization of the coal industry is considered a huge success, but nevertheless, is not promoted as one since it undermines the logic of re-nationalization and increased of state control."***

Milov highlighted the catastrophic loss of the European market. Further, he reiterated that Gazprom has lost a third of its supply to Europe compared to the peak year 2008. Milov expects that Gazprom will never reach those numbers again. It is often claimed by Gazprom that the problem lies with the economic crisis, however, Milov points out that competitors - Qatar and Norway - have gained market share. Russia has completely lost markets such as Belgium and Croatia since they have been heavily investing in LNG terminals. At the same time, the EU is increasing internal interconnectedness to lower Gazprom's

grip on the market. Milov further elaborates on the financial contribution to the state budget and points to higher proceeds from private companies than from those owned by the state. This argument is based on the amount paid to their shareholders is $2/$3 per barrel annually (oil equivalent), while Rosneft and Gazprom pay only $1 or less per barrel. Furthermore 75% of Rosneft and 11% of Gazprom are owned not by the Russian Government but by a 'shady' intermediary, Rosneftegaz, which until this year was exempt from paying dividends to the state budget. According to Milov, the acquisition of energy companies by the state did not bring the expected additional revenues and most state-owned companies are not able to develop offshore green fields on their own.

As Russia's market share in Europe is eroding, Russia faces increased competition in Central Asia, Milov points out. "A decade ago Russia was the only country that was buying gas from Turkmenistan. Currently, Russia is outpaced not only by China but also by Iran. Furthermore, Turkmenistan signed an agreement to supply 30 bcm of gas to China in 2006. This was just three weeks after Putin had signed the same agreement for 30 bcm to China. The major difference between Russia and Turkmenistan is that Turkmen gas is already flowing for four years to China while negotiations between Russia and China are ongoing."

The two main sectors that experienced privatization are the coal and oil sectors. The gas sector did not go through the same process and was not privatized to the same extent, and as a result, Milov argues, has been less successful. "The privatization of the coal industry is considered a huge success, but nevertheless, is not promoted as one since it undermines the logic of re-nationalization and increased of state control. In the privatization process the coal industry was restructured and labor productivity doubled in just ten years. In 1997 Russia became a net exporter of coal for the first time. Russia emerged as a major player in the international coal markets. This clearly shows the benefits of bringing private investments and increased competition."

Milov sees the privatization period of the oil industry as its most effective: "The privatization of the oil sector led to average growth rate of 8,4% in the Russian oil industry for the period 2000-2004. The private companies were also able to increase well productivity of their fields has increased by about one third. After the re-nationalization in 2005, the average oil output was only slightly above 1%. This is actually the price we paid for re-nationalization." Gazprom, from Milov's point of view, continuously denies the market trend towards more competitive environment driven by the shale gas revolution in the US.

Milov's analysis is that the current role of the state in the energy sector is significantly hindering Russia's prospects of retaining and developing its position in the energy business.

Following Milov's roughly hour-long monologue, he opened the floor to questions. The following is a transcription of the Q&A session and has been edited for length and clarity.

**Question and Answer Session:**

*Question: Recently, the Russian government passed a law to liberalize LNG export. This would seem to encourage competition, but the bill's wording explicitly states the goal is to minimize competition. To what extent is this kind of liberalization good for the Russian gas industry?*

I wish there were more liberalization, but it is a good step in the right direction. The presence of Russian companies in the global LNG market is important. It is very clear that private companies have achieved the best breakthroughs. So far, only private companies have been able to successfully develop new fields and produce gas through LNG. An exam-

ple is the Novatek Yamal LNG project that has no formal connection with the government. This is one more proof of the theory that if private investors are allowed to do this, then more LNG facilities will be brought about in Russia, which is the ultimate goal. We have had problems with competition between Russians at the international markets before. When oil export was liberalized all at once in the 1990s, there were some instances of price dampening. The same thing happened in the coal industry. With LNG projects, however, the production costs are so high that the companies will not be able to compete on prices, except for maybe a few dollars per thousand cubic meters. So, we would not see a huge price differential that would result from competition. These projects would be so costly that investors would be unwilling to bring the price down and the government would get its fair share in tax revenue. In order to make the Russian LNG market more competitive on a global scale, all export restrictions should be lifted. Liberalization is needed regardless of the upstream license or contract a certain company has. Additionally, there should be no government interference in the market, which would only serve to hinder the development.

***Market forces rather than regulators drive Europe's need for more [gas] suppliers and the accompanying diversification.***

*Question: With regard to the ongoing anti-competition investigation against Gazprom, do you think it will provide an incentive for Gazprom to change its strategy in eastern Europe? What kind of impact will it have? And do you think that it will speed up the deal of the century with China?*

I do take this investigation very seriously and I believe Mr. Putin and Gazprom do as well. Just to give an illustration: after the EU opened the investigation, Putin issued a decree that prohibited Gazprom from giving certain information to the EU. This was very helpful for Gazprom, as they could now turn the EU Commission and say "we would love to give you the papers but the presidential decree forbids us." The investigation is not the biggest threat to Gazprom in the European gas market. The main challenges for Gazprom in the European market are connected to market (liberalization) developments, such as the spread of gas storage capacity and LNG terminals from western to eastern Europe, including LNG projects in former Gazprom strongholds. These projects, even more than all the regulation put in place by Brussels, give Europe a stronger negotiation power vis a vis Gazprom. The competition regulatory committee, investigating Gazprom anti competition case, is strong and adequate, however the changes in European gas markets are the result of market forces rather than regulators. These regulators have only played a supplementary or marginal role in this regard. Market forces rather than regulators drive Europe's need for more suppliers and the accompanying diversification. This has changed the fundamental situation and brings choice to European consumers.

*Question: It is my understanding that the role of Gazprom is to bring socio-economic benefits for Russia. However, if the gas market is liberalized, who is going to fulfill the role to gasify remote areas in, for instance, the eastern Russian regions?*

The gas in the far eastern Russian regions is sometimes more expensive for consumers based on netback prices than in regions of certain European countries. To illustrate this, ten years ago the people in the far eastern regions wanted to replace coal with gas from Sakhalin due to lower prices. Now, the price of gas has increased and these people want coal back, it is simply cheaper for them. A colleague and I calculated that if Gazprom had been unbundled into 5 or 6 companies, these companies would have

required $80 or $90 per thousand cubic meters to make a decent market based profit and invest in the future development of their networks and companies. Most consumers now pay $110, therefore Gazprom is not at all helping these remote locations. They are not subsidizing these regions. I think Russia has already bypassed the competitive price threshold and no single company is selling gas without profit margin. Some people argue that this export monopoly is justified since Gazprom is a big donor of the Russian budget. However it is not at all a big donor. Roughly 45% of income of the government comes from oil and gas, but only 5% comes from Gazprom and the other 40% comes from oil. If this is compared to the different outputs of these industries, Gazprom alone is bigger than the total Russian oil industry.

***Gazprom heavily underpays to the government's budget but at the same time asks domestic consumers to pay more and more.***

This clearly shows that Gazprom pays far less tax and therefore contributes far less even though it is by itself bigger than the complete oil industry. In 2004 when there was a big increase in taxation, on the mostly private oil industry, the gas industry was untouchable and is still mostly untouchable. The mineral-extraction tax on gas is about $30 per thousand cubic meters, whereas for oil it's $130 per metric ton. This is a huge gap. Gazprom heavily underpays to the government's budget but at the same time asks domestic consumers to pay more and more. A third important issue is that all streams - Bluestream and Nordstream - receive tax exemptions from the state. Bluestream gas that is transported to Turkey is completely free of tax. This gas is completely exempt from export duties even though export duties are the main streams of revenue for the government.

*Question: Some people believe that Russia should stay in control of these resources. What do you think is more important, high control or high profits?*

The issue is that the general Russian population tends to favor control because they assume that it eventually leads to benefits for the state. However, this is not at all the case. So far, the control over companies has not led to increased profits. If we look at the taxes paid by private companies and state controlled companies, we can see that private companies contribute far more to the budget. For example, Lukoil is paying far more taxes than Gazprom even though they are 5 or 6 times smaller. The problem with state-owned companies is that the bureaucracy in Russia is not capable of dealing with new and complex projects. The division of labor should be that companies explore their fields, make their profits, pay their taxes, and then they are free to spend their profits. This is the best way to increase state revenue. Since the public is unaware of the real situation, we fight to tell people that the country gains more from private industry than from the state controlled companies. This public perception comes from a lack of knowledge of facts.

*Question: What is your opinion on Turkey? In terms of its oil and gas dependence on Russia and possible diversification to northern Iraq, Turkmenistan etc. Do you think Russia views Turkey as a threat or is Turkey not enough of a transit state to threaten Russia?*

Turkey is significantly improving Gazprom's balance sheet. The rest of Europe is lowering its gas purchases and Turkey is the only country that is rapidly increasing its purchases. However, the Russian state does not profit from these sales since the gas is not taxed with export duties. If it were taxed, Gazprom would probably not be able to sell profitably to Turkey. Some people argue that Gazprom should start operating on the now open Turkish market and establish a presence before someone else will. But

what is the benefit for the state if no taxes are paid? Taxation is the ultimate interest of the Russian federation. This national treasure should work for the benefit of the Russian state and people. It is not Gazprom who owns the gas; it is Russia's gas and should therefore bring something to the state. Another aspect is the relation between Russia and Turkey. Turkey wants to promote itself as a transit hub for multiple sources. Geographically, Turkey is one of the few options for countries that want to bypass Russia to Europe. Russia has been jealous of the fact that Turkey buys Azeri gas and resells it to Europe. Russia is taking two steps to limit Turkey's power as a transit state without openly contesting their actions. First, Russia is trying to please Turkey to outplay the other countries that want to sell gas to Turkey, thereby making it harder for these sellers. Second, Russia is trying to pressure European consumers to make them go away from the temptation to buy non-Russian gas. Russia tries to keep countries reliant on Russian gas. Additionally, Russia believes that the Trans-Caspian pipeline will not be operational soon. The relations between Azerbaijan and Turkey are still too difficult to make this pipeline work. It is more of a dream and therefore Gazprom and Russia are not too worried. From Russia's viewpoint, Turkey remains a major transit competitor to Gazprom. Turkey maintains a very solid and independent approach to things and I don't think Gazprom has much leverage to change that.

***When the first concepts of the reform were drafted in the year 2000, we had no clue that Gazprom would not only remain a state monopoly, but would start buying electricity companies. This was a nightmare.***

*Question: You have discussed the success of liberalization of the coal market. What are your ideas on the electricity market?*

The liberalization of the electricity market is not as successful as that of the coal market. In April 2003, right in the middle of the developments in electricity reform in Russia, a colleague and I wrote a memo to two government officials working on the reform, warning about one major issue: the need for a sufficient amount of independent market players interested in competing. If we would have been able to achieve a market structure that could have ensured a sufficient number of independent players - privately owned and interested in competing with each other - then the whole electricity reform could have had a positive effect. If the ownership of generation was going to be more cartel-type with a very limited number of players, somehow connected - particularly to the state - then it could turn out to be a disaster. The liberalization and lack of competition could result in growing electricity prices and lack of private investment in upgrading capital scope of generation companies. Unfortunately, we see that this scenario has happened and I think there are two major things that contributed to that; one, the general pattern of development in the Russian energy sector and economy that was not envisioned at that time. When the first concepts of the reform were drafted, in the year 2000, we had no clue that Gazprom would not only remain a state monopoly, but would start buying electricity companies. This was a nightmare. If we had been told, then we would have spent all our time trying to prevent this from happening. It is a very unfortunate development for a competitive power market when fuel companies start to interfere and become integrated with power companies because fuel supplies can then be used as leverage to influence competitors - something Gazprom is currently doing. We also had no idea that the government would stay involved at this level. The government retains more than 50% control over hydro generation. What is also important is that there was

hope for more (international) investors such as Yukos, but many are, in fact, leaving. We hope for more Russian and international players. So we don't have clean foreign investors, there is no competition; most is in the hands of state. Large business groups are effectively acting as a cartel and are in control of price. The second factor negatively influencing the outcome was a state official in charge of selling the state-owned parts to private investors, only interested in the price and not in who got to own the assets. Thereby, he created a situation in which a few rich people and companies could buy everything. He thought that Russians would remember him for the money he brought in, rather than for the contribution to market development. This greatly and negatively contributed to the non-competitive situation in the electricity market.

***Before the pricing war was launched with Ukraine in 2007, they had sold 54 bcm to Ukraine, in the past couple of years it was around 30 bcm. In the first half of this year (2013), they sold just 9 bcm to Ukraine, which may lead to just 20 bcm for the year.***

*Question: It seems that the liberalization of LNG exports is put in place as a punishment for Gazprom. How much of the market share does Gazprom have to lose before the Russian government will give the export license to someone else or create a situation where limited competition is allowed?*

The fact that Gazprom is losing market share in the European market is, of course, not good. There are a number of reasons for these losses; Russian decision makers still have the opinion that they can dictate the market. Therefore they do not consider the needs of their consumers. Gazprom is basically an Soviet enterprise - it was never reformed. It was just a bunch of guys from St. Petersburg with nice suits and ties. There is an old Soviet joke about a deputy director of a Soviet enterprise in marketing and sales, who once called his department and said, "Guys, you have to congratulate me, I got rid of all our clients so you do not have to do anything in the office and still receive the same salary." The reason I use that joke is that I switched on Russia 24 channel and literally almost dropped my cup of coffee because I heard the woman host say the following text: "Yesterday, the board of directors of Gazprom was deciding on the strategy in Europe. Whether to sell more gas volumes at a discount or less gas at higher price. They chose to sell less gas at higher price." This was considered to be a good practice since it did not matter anyway, Russian gas had to be bought by Europe. This can be clearly illustrated in the case of Ukraine. Before the pricing war was launched with Ukraine in 2007, they had sold 54 bcm to Ukraine, in the past couple of years it was around 30 bcm. In the first half of this year (2013), they sold just 9 bcm to Ukraine, which may lead to just 20 bcm for the year. This is what happens when you push this strategy. However, there is no concern among top decision makers, unfortunately. With regard to the LNG market, you are right when you say that Putin understands that Russia is outdated. He has been brainwashed with the idea that we need more pipes and more streams. When he takes a look at the international gas market, he can't deny the growth of LNG. Putin's worries come more from the fact that Russia is not present in that part of the market rather than from a lack of overall strategy. The LNG market shows Putin's position. There is no real competition. Rather, it is systemic bargaining among influential people within Putin's inner circle - people he cannot refuse their share. At the same time, he lacks an obvious plan/strategy for the development of LNG projects. If he does not interfere, he is trying to maneu-

ver between clans and parties. These clans have grown in the last year and it has gotten harder and harder for him to maneuver. When he does interfere, it means he has a strategy.

*Question: What is the biggest misperception of the Russian people with regard to their government?*

The real problem is information blockade, lack of awareness of the real situation. Our party wants to increase competition and clarity for voters everywhere. The Russian people are very interested in learning the real information; our party educates and explains how everything really works in society and business. It is difficult for Russian people to receive unbiased information due to state control over most information channels. For example, due to the distorted information flow to normal people, they think they would die without Gazprom. They are completely unaware of the real situation - that Gazprom is not paying much in taxes. Most people believe that the increases in government spending, which went up significantly, are due to increases in social spending. However, it is not. It is due to subsidization of companies close to and aligned with the government. Spending on so-called national economy was 1.7 trillion rubles. It is the biggest growing expenditure of the Russian government in past years.

At the same time it is very difficult for our political party to go to people directly, as this is very costly and time consuming. In general, the opposition parties in Russia struggle to raise funds. Our party is built on grassroots movements and we don't rush. We have started from the bottom of society. Thereby we can educate the normal people and help them in their daily life. We do not (yet) aim for presidency.

*Question: You have been arguing against state controlled and vertically integrated companies. However, there are success stories of vertically integrated companies that bring benefits to their country. What makes other countries, such as Norway, different? Is Russia suffering from a resource curse?*

I have a different vision on resource curse. In my opinion, it is possible to develop a country only with resources, look at Australia and Brazil; it is not necessarily a curse. There can only be one conclusion with regard to the efficiency of state controlled companies; there are efficient state controlled companies. However, these companies are a small minority compared to more profitable non-state controlled companies in the oil and gas sector. As a general rule, an effective state company might exist, but in most cases it is still an exception. It can be debated what efficient state controlled companies are; these debates mostly go on within the home country. If a state is in control, there is sometimes the perception that it is inefficient and paying too little in taxes.

*Question: How is the quality of Gazprom Public Relations?*

The public relations of Gazprom are something special, and not always adequate for the situation. We now see the aftertaste of the vision of ten years ago. The idea, as explained by top management, was that importing countries would become more dependent. This is still present and results in snubbing behavior. The signal sent from the top is that Gazprom is cool and the rest in EU is not. Europe is not as dependent as it was it previous decades, therefore the Russian attitude has to change. The result should be a more equal participation and thinking towards the European market. The people that work in the public relations branch in Brussels know what top management thinks and they carry out what is given to them. Bad PR is a consequence of this behavior. ◆

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