

## **Chapter 9**

Title **The Ukrainian Crisis and the Aggravation of EU-Russia Relations: Consequences for Energy Geopolitics in the Danube Region**

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# The Ukrainian Crisis and the Aggravation of EU-Russia Relations: Consequences for Energy Geopolitics in the Danube Region

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**Introduction.** The Ukrainian crisis in 2014 has been a turning point for the **Ukrainian EU-Russia relations.** After the annexation of Crimea and the **Shadow Over** active Russian involvement in the separatist revolt in Eastern Ukraine, the EU (together with the USA) imposed mild **EU-Russia** economic sanctions on Russia. As a response, Moscow put a one-year ban on the import of certain agricultural products, food and raw materials from countries that had sanctioned **Relations** Russia.

The Russian export of energy resources have not been touched by the sanctions. Two years after the annexation of Crimea, the EU is still taking the lion's share of the Russian oil and natural gas export. Nevertheless, the deterioration of the EU-Russia relations has already influenced the Gazprom's plans for future market expansion in South-Eastern Europe and Central Europe, respectively in the Danube Region.

This paper focuses on the geopolitics of gas deliveries in the Danube Region in the light of the Ukrainian crisis. The reasons for the failure of the South Stream project are going to be explained, as well as the prospects of the new pipeline proposed by Russia, the Turkish Stream, to become a new route for Russian gas deliveries to the countries in the Danube Region.

The Danube Region is the zone where the Russian ambitions to strengthen the Gazprom's positions on the European gas market collide with the intentions of the EU to diversify

its gas supplies. The main pipelines through which Russia exports gas to Europe were built as early as the time of the Cold War. After the dissolution of the USSR, a considerable part of the Soviet gas-transporting network remained on the territories of Ukraine and Belarus, which made the Russian gas export dependent on the fluctuation of Moscow's relations with Kiev and Minsk.

In order to guarantee the secure deliveries to the EU, Russia decided to build two new undersea routes for the Russian gas to go around Ukraine, Byelorussia and Poland. These are the North Stream (operational since 2011) and the South Stream.

**The South Stream story - geopolitics as a creator and destroyer of a gas pipeline** The South Stream project was announced in 2006. The provisioned capacity of this pipeline was 63 bcm/y. The company, in which Gazprom and the Italian ENI participated with equal shares, meant to build the underwater part of the South Stream pipeline was registered in January 2008. In 2011 Gazprom succeeded to introduce new shareholders, the German company Wintershall Holding and the French EDF, to the project with 15% each, so the ENI share decreased to 20%. In the countries through which territories the South Stream was planned to pass, joint ventures between Gazprom and local companies were established, where Gazprom usually holds 50% of the shares (Stern, 2015).

Initially the pipeline was intended to start from Russia and cross the Black Sea to get out to land in Bulgaria, where it was to branch in two destinations: to North-West toward Austria and Southward to Greece, and to reach South Italy via the Adriatic Sea. Later on, the southern branch of South Stream (Bulgaria-Greece-Italy) disappeared from the official website of the project.

The serious problems with South Stream began after March 2011 when the EU's so-called Third Energy Package came into force. It consists of two directives and three regulations, and

is based on the idea of the demonopolization of the gas and electric energy markets of the EU states. The Third Energy Package made obligatory the separation between the owners of the gas and the owners of the gas-transporting network, it also strictly required the gas pipelines' operators to secure third parties a free access to them.

However, the Gazprom's project did not comply with those requirements. The Russian company had intention to reserve the whole planned South Stream capacity of 63 bcm a year for itself, and thus, to have the long-term dominating position on the South-East and Central European markets guaranteed.

One of the results of the Ukrainian crisis was the European Commission's full freezing of the negotiations on the South Stream project. This freezing came as part of the economic sanctions against Russia as South Stream officially was not on the list of the sanction measures against Moscow.

Russia was desperately but comparatively successful in trying to secure the support of the governments of the states through which territories South Stream is meant to pass, i.e. Bulgaria, Serbia, Hungary and Austria. The big business in the Balkan countries also supported this pipeline because the realization of the project means that private companies can receive good contracts for construction works and material supply.

But the reality was that in 2014 the fate of the project was in the hands of the European Commission. At the beginning of December 2014 during his official state visit to Turkey, Russian President Vladimir Putin announced that Russia would stop the construction of the South Stream gas pipeline. "If Europe does not want to carry out [South Stream], then it will not be carried out," Putin said. "It would be ridiculous for us to invest hundreds of millions of dollars constructing a project, bringing it to Bulgaria's borders and having to drop it from there on" (Financial Times, 2014).

Why has South Stream failed? First, the South Stream project proved to be unworkable because it did not meet the requirements of the EU energy legislation.

The second factor to contribute to the project failure is closely related to the first one – the Ukrainian crisis aggravated the relations between Moscow and Brussels and was decisive in strengthening the Commission's firm intention not to exempt the South Stream project from the energy regulation of the EU. Moreover, without such exemption, the gas pipeline could not have been profitable, as it would have operated with half of its capacity.

Putin's rejection of South Stream meant that the Russian president did not believe that the Ukrainian crisis would be settled soon, and therefore, in the near future the relations between Russia and the EU were expected to remain strained. Hence, Brussels' barrier put in front of the South Stream project would not be removed.

Certain economic factors also worked for the abandonment of South Stream. The constant increase of the prognosticated price of South Stream was one of them. That price was originally meant to be \$10 billion but increased to reach \$30-40 billion. Part of it was to cover the corruption component, always present in all major projects of Gazprom.

As for Gazprom, as well as for the remaining participants in the different sections of South Stream, a serious problem impeded obtaining the finances necessary for the realization of the project. One of the main objectives of the Western sanctions against Moscow was to bar the Russian companies from cheap financing coming from the European capital markets. Besides, after 2015 Gazprom had to spend tens of billions of dollars for the fulfillment of the already concluded contract with China for the development of new gas fields in East Siberia and the building of a trunk gas pipeline to China.

In the circumstances of severe credit shortage, internal struggle between the economic lobbies in the Kremlin flared

up. It is known that the interests of the two state energy giants Rosneft and Gazprom are in opposition to each other. Both Rosneft and Gazprom aspire for state financing and in order to get it they offer different visions for the economic expansion of their country. By the end of 2015, it was visible that Rosneft's lobby prevailed. That cannot be a surprise if we keep in mind the fact that Russia earns four times more money from the export of oil and oil products than from the export of gas.

A serious shadow of doubt over the economic feasibility of the South Stream project was thrown also by the world's oil and energy market trend that started in the second half of 2014 and is still going on. The oil price went sharply down, and the export prices of the Russian gas were bound to those of the oil. For Gazprom the decreasing gas consumption in the European Union countries has been even more alarming. Between 2010 and 2014 it fell by 23% - from 502 bcm to 387 bcm.

*Table 1. Production and consumption of natural gas in the EU, 2007-2014 (in bcm)*

	2007	2008	2009	2010	2011	2012	2013	2014
Production	190,2	192,1	174,7	178	157	148	146,6	132,3
Consumption	486,9	496,2	464,6	502	451,8	445	437,9	386,9

*Source: BP Statistical Review of World Energy; <http://www.bp.com/content/dam/bp/pdf/energy-economics/statistical-review-2015/bp-statistical-review-of-world-energy-2015-full-report.pdf>*

South Stream was a project prompted by a geopolitical reason, which was Russia's desire to export its gas without passing through Ukraine. At the end of 2014 that project failed because of another geopolitical reason, the aggravated relations between the EU and Russia after the annexation of Crimea in 2014.

**Turkish Stream** – On the same day Russian President Putin renounced the South Stream project, he concurrently announced another big project – the Turkish Stream. This is a gas pipeline meant to replace the South Stream and to connect Russia directly with the European part of Turkey via the Black Sea. According to the initial plan, Turkish Stream capacity was to be the same as that of South Stream - 63 bcm per year.

**Gazprom's subsequent attempt to seize the European gas stronghold** According to the Turkish Stream execution timetable, the intergovernmental agreement had to be signed in the second trimester of 2015, and by December 2016 the pipeline should be operational. There was an important point here: this was the term for laying only the first of the lines of the pipeline network which is meant to transport 16 bcm annually, destined not for the EU but for the Turkish market.

From December 2014, one of the main question which analyzers have tried to answer is whether the construction of Turkish Stream is realistic. The reply depends on the answer to the question that who is going to buy this 63 bcm gas which Russia intends to deliver via Turkish Stream. In 2014 Turkey received about 27 bcm Russian gas; the forecast for 2015 was that the delivery volume would increase to reach 30 bcm. Presently, about half of these deliveries coming from Gazprom pass through the Blue Stream pipeline (a direct pipeline connection between Russia and the Asian part of Turkey), and the other half follows the route through Ukraine, Romania and Bulgaria. This means that the quantity planned to go through the first line of Turkish Stream can, in fact, be taken by the Turkish market. Another point to consider is that the bigger part of the Russian supplier's contract for gas transit through Bulgaria expires by 2030, and in case of suspending its term, the "ship or pay" clause comes into force. However, as Turkish Stream, like South Stream, is also a geopolitical project, the necessity to pay penalties would hardly stop Russia from redirecting its deliveries to Turkey via the new route.

The main problem is what Gazprom will do with the remaining 47 bcm gas which will be stranded at the Turkish-Greek border if Turkish Stream would become fully operational. Building a new transportation infrastructure toward the countries in direct proximity to the Turkish-Greek border will not be too expensive. But even put together, Greece, Bulgaria, Macedonia and Albania use less than 6 bcm Russian gas yearly. Obviously, they cannot take in the enormous quantities supplied by Turkish Stream. That is why Gazprom's goal will be to direct the Turkish Stream gas through Greece, Macedonia and Serbia toward Central Europe (the so-called Tesla pipeline), or through Greece and the Adriatic Sea toward Italy. However, having learned its lesson from the failure of South Stream, Gazprom would not take upon itself the construction of new pipelines passing through EU states. That has to be undertaken by local companies not interested in geopolitics but only in making profits. In the course of the next few years, though, the construction of major gas pipelines will become more and more insecure as investment in the gradual liberalization of the European energy market will direct more and more customers toward the spot market of natural gas.

In June 2015, Russia and Greece signed a deal to create a joint enterprise for the construction of the extension of the Turkish Stream pipeline across Greek territory. This new pipeline will have a capacity of 47 bcm/y and should be financed by Russians (RT, 2015).

Still, for the time being, Russia does not have an inter-governmental agreement about Turkish Stream with Turkey. The construction of the pipeline did not start. Moreover, several operations related to the construction were cancelled. Gazprom broke the contracts with contractors, cancelled the tenders, and changed the work plans to expand infrastructure by wasting money and time. (Trend.az, 2015)

In the autumn of 2015, after Russian bombings of the Syrian opposition's forces had begun, relations between Moscow and Ankara aggravated. In October, Turkish state-owned pipeline company Botash filed a case for international arbitration to seek a price discount for Russian gas supplies (Farchy, 2015). This step will delay Russia and Turkey reaching agreement with regard of Turkish Stream even more.

So, without an agreement with Turkey, the Greek extension of Turkish Stream is impossible. But even if this extension is going to be build, it will be a pipeline to nowhere because the Macedonian prime minister has already declared that Macedonia can participate in this gas pipeline project only if the European Commission is not against it (Novinite.com, 2015).

It is important to point out that all West Balkan countries are members of the (European) Energy Community – an organization created in 2006, which includes the EU states as well as the West Balkan states, Moldova and Ukraine. This organization's objective is to extend the single European gas and electricity market out of the EU's borders. With their recent accession to the European Energy Community, the West Balkan states undertook the obligation to introduce completely the regulations of the Third Energy Package, though with some delay, by the middle of 2017 (Energy Community website, 2015). In addition, Serbia has started negotiations for accession to the EU and the Republic of Macedonia has a status of candidate for membership. The influence of Brussels over the Western Balkan countries' energy policy is obvious. For example, in September 2014 the European Commission sent letters to Serbia, Bosnia and Macedonia in order to remind that "South Stream, as any other major infrastructure project in Europe, may only be developed and operated fully in line with EU law" (Rettman, 2014).

If Turkish Stream is built, it will be with one pipeline only, i.e., it will only have a quarter of its originally planned capac-

ity. Thus, Gazprom will be able to justify, at least to some extent, the \$4.7 billion expenses made for South Stream, which was spent for conductive pipelines and compressor stations on Russian territory, as well as for ordered and paid pipes meant for the undersea part of the pipeline. These investments in the infrastructure on Russian territory can be used for Turkish Stream. Besides, the new project will save face for Putin as well as to reduce the impression made by the unquestionable defeat suffered in the geopolitical struggle for South Stream.

**Nord Stream-2, OPAL and the gas market in Central Europe** After the South Stream project failed, and the negotiations on Turkish Stream reached a dead-end, Gazprom decided to have a change of approach for achieving its strategic goal: going around Ukraine. In June 2015, a new project, Nord Stream-2, was announced. It is meant to transport 55 bcm of gas per year directly from Russia to Germany. Nord Stream-2 is planned to run in parallel with the already existing Nord Stream-1. As partners in this project, Gazprom drew well-established European companies of good reputation from Germany, France, the UK and Austria.

On the 5<sup>th</sup> of September 2015, Gazprom and its partners, namely, E.ON, BASF/Wintershall, OMV, Royal Dutch Shell and Engie agreed on percentages for each one for this route. Thus, Gazprom will lead the project with a 51% share, whilst the rest of the participants will get 10%, and French Engie receives 9% (Natural Gas Europe, 2015).

Nord Stream-2 provoked strong negative reaction from Ukraine, Poland and Slovakia. These countries could lose substantial part of the Russian transit gas. Most probably, the European Commission is going to be the main ally of Ukraine and the Central European countries in their desire to prevent the construction of the Nord Stream-2 pipeline.

In the beginning of November 2015, the European Commission's Vice-President, Maros Sefcovic spoke with German

Vice-Chancellor Sigmar Gabriel to voice the Commission's concerns about whether the Nord Stream-2 project breaches EU rules. Sefcovic noted that as only about half of the existing pipeline capacity between Russia and Europe was being utilised, there were questions about why more was needed. "As we showed for previous projects like South Stream, for the European Commission it's very clear that such projects must respect European law," told Sefcovic (Jancarikova, 2015).

All in all, it looks most likely that the European Commission will offer strong resistance to the Nord Stream-2 project. If Brussels fails to prevent the construction of this gas pipeline, it could make difficult making use of the Nord Stream land extensions, so that a bigger part of the new transport system would remain empty. An example of a similar scenario is the OPAL gas pipeline, which is a land extension of Nord Stream-1.

The OPAL gas pipeline has an annual capacity of 36 bcm per year and runs along Germany's eastern border, linking the Nord Stream pipeline to the Czech Republic. At present, Gazprom is permitted to use only 50% of the existing capacity as, under the rules of the Third Energy Package, the Russian company is required by the European Commission to reserve up to 50% of the OPAL gas pipeline's capacities for gas transportation by independent suppliers. Despite the approval by Germany, Gazprom failed to get the European Commission's blessing to increase the exemption for OPAL to 100 percent.

At the beginning of 2014 the European Commission and Gazprom agreed to a deal where Gazprom would auction OPAL's unreserved capacity under Europe's natural gas capacity auction mechanism and be allowed to bid for the capacity itself, effectively granting Gazprom 100 percent of the capacity. The European Commission had a deadline of 10 March 2014 to finalize the decision. Then, after Rus-

sia annexed Crimea, the European Commission delayed its decision, and on 23 December 2014, halted proceedings altogether (Stratfor, 2015).

In the course of the last several years, many gas interconnectors were built in the Central European countries, making possible for the gas to flow freely from one country to another, as well as in west-east direction. Since Ukraine came into a serious confrontation with Russia, it began importing gas through the pipeline interconnectors with its Western neighbours: Slovakia, Hungary and Poland. No doubt, the bigger part of that gas is of Russian origin, but Russia has no control over it anymore as the interconnectors have made reverse supplies to Ukraine possible.

By the end of 2015, Poland and Lithuania already had LNG terminals at their disposal and so the whole East-European region has turned less dependent on Gazprom.

The Hungarian transmission company FGSZ has likewise been constructing new pipelines and reverse flows to Croatia, Romania, Ukraine and Slovakia. In June 2011, a 6.9 bcm/year capacity pipeline between Hungary and Croatia was completed; in April 2013, Hungary completed the reverse flow on a pipeline to Ukraine (with a capacity of 6.1 bcm/year); in February 2014, the first stage of a bidirectional pipeline between Arad and Szeged in Romania was completed; while in July 2015, a new pipeline connecting Slovakia and Hungary was also completed – this pipeline has a capacity of 4.5 bcm/year from Slovakia to Hungary and 1.8 bcm/year in reverse. The FGSZ is also planning new connections to Slovenia and Austria, both of which will be bidirectional and should be completed by 2017 (Harrison, 2015). All these developments mean radical transformation in gas geopolitics in the Danube region.

**Conclusions. The European Commission as the new key player in energy geopolitics in the Danube region** Major international gas pipelines are built for three main reasons: financial, geopolitical and for corruption. The first case is clear – profits from a gas pipeline are expected to exceed its construction and exploitation costs in 10-15 or no more than 20 years, meaning that it is built to be profitable. It is more difficult to evaluate the geopolitical motivation for building major gas pipelines. When talking, in particular, of South Stream and Turkish Stream, it becomes visible that Russia wants to safeguard its geoeconomic and geopolitical positions in South-East Europe, regardless of the fact that from financial point of view both projects may turn loss making. The most difficult to make out is the corruption motive for building gas pipelines. It can be observed predominantly in the projects of state companies, like those of Gazprom. Apparently, when building activities at large scale are under way, the top management of state companies and controlled political leadership can obtain big commissions. The combination of geopolitical and corruption motives is an answer to the question why sometimes economically illogical major gas transporting networks are built.

In conclusion, as positive steps to decrease the dependence on Russian gas (building of new interconnectors, LNG terminals, storage facilities, shale gas exploration, etc.) are difficult, expensive and time consuming, in the light of the Ukrainian crisis, the EU has chosen to prevent Russian ambitions to dominate the European gas market through freezing the South Stream project.

The most significant tendency in European energy geopolitics in the second decade of the 21<sup>st</sup> century has been the appearance and recognition of the European Commission as a new key player. The EU supports and encourages the projects of the South Corridor, but it has also blocked South Stream. The EU's Third Energy Package took its first steps through two main cases: the OPAL gas pipeline in Germany

and South Stream in the Balkans. In both cases the EU was a winner in arguments with Gazprom.

Until March 2014, the main goal of Russia was to sell as much energy resources to the European market as possible. After the annexation of Crimea, Russia has had a broader geopolitical agenda in the Danube Region. Moscow is looking for the weak points of the European Union in order to break the consensus over the sanctions that the EU has imposed on Russia. Gas geopolitics is a part of a bigger confrontation that arose from the Ukrainian crisis. In addition, while in the struggle against the sanctions Russia has some chances to obtain the support of one or more European countries, in the field of gas geopolitics Moscow has no chances, because it faces the European Commission itself and not separate countries in the region.

## Maps

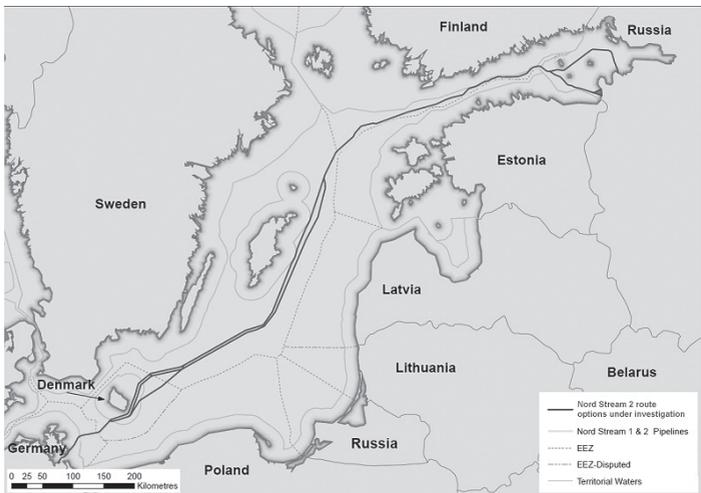
Map 1. Turkish Stream pipeline



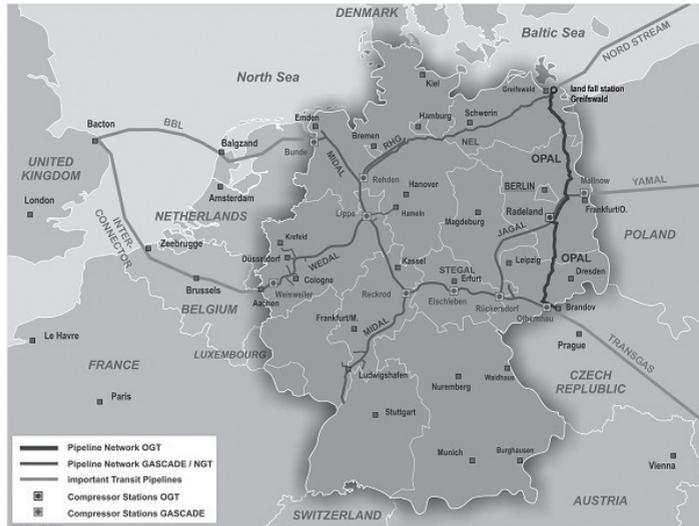
Map 2. Tesla pipeline



Map 3. Nord Stream-2 pipeline



Map 4. OPAL pipeline



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