

# Bringing Energy Security to East Central Europe

Regional Cooperation Is the Key

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# BRINGING ENERGY SECURITY TO EAST CENTRAL EUROPE REGIONAL COOPERATION IS THE KEY

*Keith C. Smith*

## Summary

The energy security challenges that for the past two decades have confronted the countries of Central and Southeastern Europe (CSEE) continued into 2010. The European Union still lacks an effective common energy policy or even a common energy market. The divisions between the interests of the older and newer EU members persist. The financial interests of the large European multinational energy companies dominate Europe's reactions to Russian oil and gas export policies. Moscow's pursuit of a "divide-and-conquer" policy toward Europe has not diminished. It continues to increase Russian leverage over the foreign and commercial policies of several EU member states. Gazprom is able to charge the poorer Baltic states higher natural gas prices than it does Germany and Italy, in part due to the weaker bargaining position of the CSEE states. Progress continues to be made by Gazprom in winning acceptance in Europe for both of its flagship pipeline projects: Nord Stream and South Stream, although there are a few indications that South Stream's supporters may want to merge the project with the Nabucco pipeline. Any merger of the two projects, however, would likely result in Gazprom taking a strong blocking position on any Nabucco board. In any case, the long pursued Nabucco gas and Odessa-Brody oil pipeline projects, counted on to bring non-Russian energy supplies to Europe, remain bogged down as a result of supply uncertainties and effective counter steps on the part of Russia.

The recent elections in Ukraine will likely result in increased Russian control over that country's gas transmission system and return much of the gas trading regime to nontransparent intermediary companies. The same Ukrainian political figures who set up the past regime of murky intermediaries have regained their posts in the new Yanukovich government.

Nevertheless, some positive steps are in the works. The newer member states are presently pushing harder within the European Union for financing help for energy infrastructure projects that would bring a measure of security in the event of future disruptions in gas and oil supplies from Russia. There is a wider consensus in Europe that more gas and electricity interconnectors should be built and that national storage requirements for natural gas should be ramped up significantly. Receiving plants for liquefied natural gas (LNG) are likely to be completed in the next few years in Poland and Croatia, with one possible in the Baltic states. There are more energy cooperation discussions taking place between Central European governments, private

energy companies, and CSEE representatives on the European Commission and within the European Parliament. The European Union is now more willing to fund electricity and gas interconnectors in the EU area. There is likely to be continued price moderation in natural gas purchases as a result of increasing supplies in the future from LNG and unconventional gas. In short, the prospects for regional energy security are becoming somewhat more favorable for most of Central and Southeastern Europe than at any time in the past decade. The results from the February 24 energy security meeting in Budapest, if followed through, could greatly improve the situation in the region.

## Lessons from the Gas Crisis of 2009

The January 2009 cutoff of natural gas supplies from Russia to the Ukrainian pipeline system woke many West Europeans to the energy vulnerability of the countries of East Central Europe. Even some of the original members of the European Union have since appeared determined to improve their preparedness for energy shocks that could again confront Europe in the years ahead. Natural gas and oil supply disruptions by Russia have occurred on a fairly regular basis since 1990, but they did not elicit sufficient concern and an effective response until recently by the leadership of the European Union or by the larger member states. As long as Russian gas cutoffs did not adversely affect Western Europe, there was an unwillingness by the older member states to acknowledge that Russia had for the past 20 years been using its energy resources to coerce neighboring states into adopting “acceptable” political and economic policies. The length and breadth of the gas disruption in January 2009 exposed the fallacy of the widespread belief in Western Europe that Russia could always be counted on as a “reliable supplier of energy.”

With the January 2009 disruption, Bulgaria, Romania, the Slovak Republic, and Italy, in addition to the Baltic states, Poland, and Hungary, were severely affected by gas shortages in the middle of a cold winter. During the Russia-Ukraine dispute of 2006, most of these countries had escaped relatively unscathed as a result of the short four-day duration of the disruption. In the 2009 disruption, however, even Germany felt obliged to share its stored stocks of gas with neighboring countries hardest hit by the cutoff. Unfortunately, the response in most of Western Europe was to blame equally the governments of Ukraine and Russia. This view ignored the fact that the Kremlin had devised an energy regime with Ukraine that guaranteed periodic crises. This was accomplished, in part, by Moscow requiring annual renegotiations of their bilateral energy agreement at the highest political level. Price was related more to the two countries’ political relationship than to normal supply and demand factors. Nevertheless, the January 2009 crisis finally did get the attention at last of the European Commission and officials charged with promoting a greater measure of energy security within the entire union.

The initial 2009 response of the European Commission was to call for a substantial increase in funding for electricity and gas interconnectors and to require member states to institute increases in their natural gas storage. These two measures, while not representing a comprehensive approach to the supply problem, did offer the prospect of some relief in the long term to countries

that would be most affected by any future crisis. The commission initially proposed a €5-billion spending program for interconnectors and storage but eventually settled on a €3.5-billion assistance package. However, to the surprise and consternation of those countries who had suffered the most damaging economic effects of the cutoff, over 75 percent of the EU funding went to those countries least affected, including Spain, France, and Germany. When questioned about this discrepancy, one central banker from a wealthier EU member state remarked to this author that “those who fund the EU budget should benefit the most.” Not a reassuring endorsement of EU solidarity!

In a more positive vein, however, the European Commission announced in early March 2010 that it would fund a second-stage package of pipeline and interconnector projects. The €2.3-billion effort will again concentrate on the entire EU market, but it also includes partial funding for a two-direction gas interconnector between Germany and Poland and one between Poland and the Czech Republic. In addition, it includes some modest funding for gas transmission lines along the “southern corridor.” The European Union has signaled its support for considering the White Stream project that could take gas from Azerbaijan through Georgia to Romania. If constructed, Bulgaria would also be a major beneficiary.

Before the Directorate-General for Energy and Transport (DG-TREN) was divided into two offices, EC president Manuel Barroso directed DG-TREN to authorize a study by an outside organization to examine the energy exposure of all member states to supply disruptions, with an emphasis on the newer member states in the Baltic region (Poland, Estonia, Latvia, and Lithuania). The report was completed at the end of 2009 and recommended more funding for interconnectors and a feasibility study for LNG receiving plants and nuclear reactors. There has been no indication yet that additional structural adjustment funding or money from other EU sources will be made available to implement the recommendations of the outside consultants. By itself, however, the commissioning of the study was a welcome sign that more must be done to bring greater energy security supply to the “energy islands” of East Central Europe. It should be noted that Russia has expressed an interest in building new nuclear plants and used-fuel storage facilities in the Baltic states and in other Russia-dependent states. These proposals by Moscow may simply be intended to delay or kill projects that would weaken Russia’s export dominance.

## Still No Sign of a Common EU Energy Policy

Those member states with close energy ties to Russia (Germany, Italy, Austria, and France), remain opposed to an EU energy policy that would limit in any way their national energy firms. Nor are they willing to assign any blame regarding disruptions to the aggressive energy policies of the Kremlin. The last Russia-Ukraine crisis has also not yet resulted in significant implementation of the European Union’s policy of unbundling energy supply from its distribution. Faster action on this front would bring increased competition and transparency on the part of companies importing oil and gas into the EU market. This would also limit Moscow’s aggressive drive to control more of the downstream energy market within EU countries. There



appears to be little interest within the European Commission to press for reciprocity by Russia in terms of foreign ownership of energy facilities or production fields. NATO continues to be blocked from implementing a Polish proposal to study the effects of Russian energy policies on member states, primarily due to resistance on the part of Germany.

With Russia's 2009 formal withdrawal from the Energy Charter Treaty, it became more difficult for EU states to start antitrust proceedings against Transneft or Gazprom regarding their monopoly behavior within the EU area. This does not, however, prevent the European Commission or any individual state from bringing a complaint regarding any activities of those companies within the EU common market that occurred before Russia's formal withdrawal from the treaty. Nor does it preclude a suit being brought against the two companies for any antitrust violation under Article 82 of the EC Treaty. Their monopoly roles are a flagrant violation of the European Union's antitrust and anticompetition policies. Under Russian law, these two Russian companies are designated respectively as the monopoly exporters of all oil and gas, including that which is destined for EU markets. Yet the European Commission seems to find it easier politically to go after Western firms than to deal with Transneft and Gazprom, whose import policies have a far greater impact on the European consumer than Western computer manufacturers. However, the new European Parliament elected in late 2009 is led by a Polish member, who is more likely to support the creation of a coalition of member states with enough influence to force the commission into adopting more robust action that would reduce the CSEE countries exposure to Russian economic coercion.

In mid-March 2010, the European Parliament was debating rules that would mandate increases in gas storage in member states in order to limit in the future the shortages that occurred in 2006 and 2009. However, as this paper went to press, there was still no final bill or indication that the commission would carry out the parliament's wishes.

A majority of the EC members who stepped down from their posts in 2009 had ignored the overwhelmingly approved September 2007 report of the parliament. This resolution called for a common EU energy strategy and stronger EU action to support those countries faced with energy blackmail. It is not yet clear if the new commission, which includes several new members, will be more proactive in supporting CSEE security. Questions were raised about whether the European Union would support Central European energy security interests when on March 2, 2010, Guenther Oettinger, the new commissioner for energy, announced that he and the commission would support the construction of the South Stream pipeline, Russia's rival project to Nabucco. This statement caused concern in those countries that have worked long and hard to develop non-Russian energy pipelines. It is still unclear whether this is a political move on the part of the European Union to calm Russian concerns, while at the same time working quietly to promote non-Russian pipeline projects.

While Oettinger has been widely quoted as backing South Stream, he has also mentioned that the European Union might help fund the White Stream project. There will not be enough gas supply or demand to fill, or even finance, all of the pipeline proposals that would carry Russian or

Central Asian gas to Europe. It is impossible to know at this point, whether the European Union's statement is an attempt to apply leverage on the Turks and Azeris to induce them to stop bickering and move ahead with Nabucco. It is difficult to believe that the European Union will actually shift its backing from Nabucco to South Stream, even in the face of the more Russia-friendly policies of the West Europeans. The new energy commissioner appears to be more supportive of EU energy security projects in CSEE countries than was his predecessor.

## Nontransparent Companies and Nontransparent Governments

As long as the large EU member states resist confronting Russia on energy issues and continue to strike their own energy deals with the Kremlin, the smaller states will continue to feel compelled, as a result of the need to guarantee supplies, also to reach bilateral deals with Gazprom, particularly if the venture is strongly backed by Russia's leaders. There is no EU requirement for advance notice to other member states before a major deal is finalized. This creates an atmosphere in which the more aggressive and nimble Kremlin leadership can maneuver quietly behind the scenes to play various EU member states off against each other. The carrot for cooperation with Moscow is often the promise of a pipeline route through the country or, as in the case of Serbia, an appeal to "Slavic solidarity," including support for that country's positions on foreign policy issues.

The absence of a common EU policy makes it easier for the former intelligence officers in Russia's energy companies to strike nontransparent deals with individual leaders in some of the smaller EU states. Of course, it is difficult for outsiders to detect which of these supply or pipeline agreements are the result of commercial considerations and which result from under the table exchanges between the Kremlin and the ruling political party. Even in the absence of any indication of corruption, the agreement between Russia and Hungary in 2008 over the South Stream pipeline deal is hard to explain, particularly when MOL, Hungary's own national energy company, strongly opposed it. The agreement between the new Croatian government and Gazprom threatens to further isolate Central Europe from alternative supplies of oil and gas. This is also a deal that defies easy explanation.

The European Commission, however, could require more commercial transparency in any energy agreement with a nonmember state. This alone would instill a measure of confidence into the system and at the same time diminish the temptation to use unnecessary and/or murky business intermediaries in supply contracts. Both Hungary and Poland found themselves short of natural gas in the winter of 2009/2010 as a result of a Ukraine-Russia agreement to eliminate the use of a questionable intermediary company as the supplier of 3 billion cubic meters of gas to each country. The two countries then had to scramble in the middle of winter to reach new agreements for additional supplies with Gazprom, the original provider of the gas, only adding to the bargaining leverage of the Russian side. One should question why the two countries agreed to put their faith in a company (RosUkrEnergo) that was already under attack in the European press for

its lack of transparency. Nor is there a compelling explanation for the firm's existence in the first place.

It should also be noted that since the European Union announced its support in 2008 for its Eastern Partnership initiative, Moscow has been increasingly resistant to Europe's encroachment into what the Russians claim to be their rightful sphere of influence. There now appears little likelihood of an early agreement for a new EU-Russia partnership agreement in spite of German and French support. Russian president Dmitry Medvedev's call for a new European security architecture is partly a reaction to NATO enlargement over the past 10 years but also a result of EU efforts to draw Belarus, Moldova, Ukraine, and Georgia closer to Europe, thereby creating a zone of stability between the European Union and Russia. Russian prime minister Vladimir Putin's distancing of Russia from membership in the World Trade Organization and his country's formal withdrawal from the Energy Charter Treaty, both occurring in 2009, also make it more difficult to draw Russia into a rules-based system regarding energy sales and distribution.

In the past decade, changes of government in East Central Europe often resulted in a more accommodating stance toward Moscow's energy strategy. This occurred after the elections of new governments in Slovakia, Hungary, and Croatia. In each case, parties more susceptible to increased influence by Gazprom and its supporters in Moscow assumed leadership positions. Although not a member of the European Union, Ukraine's change of government and even the relative power of its various oligarchs have had a direct impact on the reliability, price, and marketing of supplies of natural gas imported from Russia, thereby affecting downstream states. The countries that are most affected by Ukraine's vulnerabilities are the newer and poorer EU member states of East Central Europe. The recent election of Viktor Yanukovich as president of Ukraine does not auger well for an energy policy more independent of Russia. In fact, if Yanukovich fulfills his campaign promise of "internationalizing" the major Ukrainian gas pipeline system, the move will increase Russia's lock on the supply of gas from eastern suppliers into Europe.

## Political Impact of Outside Policies

The recent publication of Russia's National Security Strategy, and the explanatory statements of Foreign Minister Sergey Lavrov, made it clear that the Kremlin will continue to pursue a policy of maximizing its political and economic influence, particularly in Central and Southeastern Europe, the Caucasus, and Central Asia, even if it requires the use of coercion to achieve its objectives. The August 2008 war with Georgia was intended by the Kremlin as a warning to other neighbors that any move toward greater cooperation/integration with the West, and especially with NATO, would be resisted more vigorously than in the past. NATO is again termed a danger to Russia in the military doctrine of February 2010, and Moscow appears to be reemphasizing its 1990s era "red line" in terms of maintaining its "privileged role" in the affairs of former Soviet states. The failure of France or the European Commission to insist on Russian compliance with

the August 2008 cease-fire agreement, adds to concern in CSEE countries and greater self-confidence within the Kremlin in dealing with the larger EU member states.

In addition, one should not underestimate the political influence of Gazprom in Europe, even as the company faces a serious decline in its overseas profits, a substantial reduction in net value, and weaker control over Central Asian production. The company continues to spend large sums hiring public relations and other firms to defend its positions in Brussels, Berlin, Washington, Paris, Vienna, and London, with EU and German officials being the major target audience. Former EU employees have found highly compensated positions within Gazprom, as have former heads of government, the most prominent being Gerhard Schroeder, former chancellor of Germany. Some European think tanks are now accepting funding directly or indirectly from Gazprom, leading many to question the objectivity of their commentary on energy issues. This has meant that even those who have turned down offers of Gazprom financing sometimes have a difficult time demonstrating that they remain independent of Russian financing and influence.

Within CSEE countries, there is now substantial unease as a result of firm indications from Western Europe that the wealthier members intend to respect Russia's red line policy when it comes to greater NATO cooperation with Georgia or Ukraine, or even on issues involving European security cooperation designed to reassure the more vulnerable CSEE states. The agreement by France to sell four highly sophisticated Mistral warships to Russia is creating anxiety throughout much of the region. This again demonstrates graphically the lack of respect for CSEE security concerns on the part of the larger EU member states, with the exception of the United Kingdom. Although some of the smaller countries may react by cutting separate energy and political deals with Moscow, the more advanced CSEE countries in the region—such as Poland, Slovakia, the Czech Republic, and Hungary (after this spring's elections)—appear to be accelerating their efforts to coordinate security, including energy security, policies within the region. Their chances of succeeding in pulling together the energy interests of very different CSEE states may have improved as a result of greater national self-confidence, in addition to a realization that the European Union and NATO's priorities no longer focus on the security interests of the newer member states.

Compounding a feeling of insecurity in the CSEE region is concern that the "reset" policy of the Barack Obama administration will be pursued at their expense, particularly with indications coming from Washington that Iran sanctions and a new Start Treaty are at the top of the political agenda with Russia. There is also some unease that U.S. policy declarations of "neutrality" regarding the competing gas proposals for pipelines from Central Asia may signal that South Stream is just as favored as Nabucco by the United States. This is already drawing anxious questioning from several Central European governments.

The recent election of Victor Yanukovich in Ukraine also brings in a government likely to be more sympathetic to Moscow's desire to control the primary natural gas pipelines to Europe. It may also work to preserve Ukraine as a country where Russian energy companies will exercise ownership control over oil refineries, electricity, and gas distribution systems, as well as the

exploitation of new oil and gas production. Western firms will find it even more difficult to get a foothold in Ukraine's energy sector. The country will likely remain off limits to the use of new U.S. technology to explore Ukraine's substantial potential for unconventional gas production. Increased Russian influence in Ukraine will complicate EU and CSEE efforts to draw Kyiv into a system of greater regional energy cooperation—one that is more independent of monopoly supplies from Russian pipelines. There is a widespread perception in Central Europe that Moscow's primary goal in the region is to limit Europe's influence in Ukraine and to maintain the impression in the West that Ukraine is a failed state with poor prospects for eventual EU membership.

## Polish and Hungarian Leadership at Core of Regional Cooperation

Poland is the largest EU member in Central Europe. Its representatives in the European Parliament have taken a leadership role in advocating robust policies that would bring greater energy security to the entire union. The September 2007 parliamentary declaration on energy security was the most comprehensive statement to come out of the European Union regarding the need for concrete measures to deal with energy security and Europe's energy relationship with Russia. That document was authored by Jacek Sarusz-Wolski, then-chairman of the External Affairs Committee of the parliament. Jerzy Buzek, the current president of the parliament, is also a strong supporter of a common European energy market and the financing of infrastructure projects that would increase Eastern and Central European security. Other Polish members of parliament have played prominent roles in questioning the security value to Europe of Nord Stream. They have pushed harder than West European members for alternative pipeline projects that increase, rather than decrease CSEE energy security (such as the Amber or Yamal II pipelines). Polish governments, irrespective of party affiliation, have also promoted regional pipeline and electricity interconnectors. The Polish state has maintained control of its energy sector since 1990 and has successfully countered several efforts by Russian companies to buy into Polish energy facilities.

Recently, Polish energy specialists have given more active support to building interconnectors with Germany, the Czech Republic, Lithuania, and Slovakia. One Polish energy specialist has proposed that the Nabucco pipeline be redesigned to operate in two directions, so that any surplus of unconventional or conventional gas from future development in the Baltic basin would be available to ship to markets in Southern Europe, including the Balkans. The LNG plant to be built soon near Szczecin is designed to include gas storage facilities that could also supply the Czech and Slovak Republics in case of further gas pipeline disruptions from Russia/Ukraine.

Energy politics in Hungary have been somewhat more complicated. The Social Democratic government of Ferenc Gyurcsany provided support to Russia's South Stream project and permitted highly nontransparent Eastern energy companies to use Budapest as their base for regional operations. The government was, however, somewhat divided on energy policy since the

Foreign Ministry supported the work of Ambassador Mihaly Bayer, a special envoy to promote the Nabucco pipeline project. In early 2009, Hungary, hosted an international gathering of Central Asian gas producers and European consuming states in Budapest designed to generate greater regional collaboration in order to move the Nabucco project forward. Unfortunately, the meeting was marked by a lack of visible support for Nabucco by representatives of the European Commission and of large EU member states such as Germany.

Nevertheless, the current Hungarian prime minister, Gordon Bajnai, held a summit of the Visegrad countries (Hungary, Poland, Slovakia, and the Czech Republic) on February 24, 2010, and together with representatives of 10 other countries signed a joint declaration calling for a secure energy supply to be made a priority of the CSEE states. Particularly interesting was Bajnai's call for the establishment of a natural gas "supply triangle." The triangle would consist of the future LNG terminal in Poland, the LNG terminal planned for the Croatian island of Krk, with the Nabucco pipeline as the third leg. Although the Nabucco project is still far from certain, the conference declaration and the triad proposal appears to represent a significant shift toward greater Central European energy cooperation by the Hungarian state. (More regarding the conference outcome below.)

Hungary is fortunate in having MOL (the Hungarian Oil Company), the most dynamic integrated oil and gas company in Central Europe. With its effective leadership, it has bought key energy facilities in Slovakia, Croatia, and the Czech Republic. More significant is MOL's success in countering or neutralizing the effects of hostile takeovers by Austria's OMV energy company and Russian companies, most recently Surgetneftgaz. The Hungarians are convinced that the Austrian government worked closely with Gazprom during OMV's unsuccessful 2008 attempt to buy out MOL in a hostile bid. Hungarian suspicion of OMV appeared to be borne out when in 2009 OMV sold its 22 percent share in MOL to the highly nontransparent Surgetneftgaz, a company with particularly close ties to the Kremlin. The OMV sale created greater difficulties for those energy officials attempting to build a system that would provide a substantial degree of Central European energy independence.

In addition, MOL has had to counter Russian efforts to lure Croatia into a deal that would effectively cut off Central Europe from oil and gas pipelines that would bring North African and Middle East supplies into the region. This would have the effect of eliminating competition with Russia's Gazprom and Transneft. By reaching nontransparent agreements with Russia, Croatia jeopardizes its support within the European Union, particularly by Poland and Hungary, for early EU membership. The threat to energy supply diversity posed by the Croatian negotiations has not yet resulted in visible opposition by the European Commission's Directorate-General for Competition. MOL has proposed a New European Transmission System (NETS) that would tie together the gas transmission systems of Central and Southeastern Europe by using the framework of the European Union's own energy market unification goals.

## Baltic Cooperation: Slow but Steady Progress toward Regional Integration

The “energy island” countries of Estonia, Latvia, and Lithuania are nearly 100 percent dependent on Russia for oil and gas imports, reflecting the legacy energy policies of the former Soviet Union. The three Baltic states have been a prime target for Russian energy supply disruptions for the past 20 years. An oil cutoff was used by Moscow in 1990 in an attempt to stifle the region’s new independence movements. In 1992, in a futile effort to keep the Russian officer corps stationed in Estonia and Latvia, energy supplies were again shut off in the middle of an especially cold winter. Oil shipments to Lithuania were disrupted nine times between 1997 and 1999 in an attempt to influence negotiations over ownership of an oil refinery. Russian oil shipments through the Druzsba pipeline have now been permanently stopped to Latvia and Lithuania (both EU member states) as a result of these two countries’ unwillingness to sell their pipelines, oil ports, and refineries to Russian companies cheaply (or at no cost). Gazprom has succeeded in gaining control of the natural gas companies of all three Baltic states and ownership of power plants in Latvia and Lithuania.

Surprisingly, few Western Europeans are aware of the extensive use by Moscow of energy coercion in the Baltic states, even though more than 25 politically motivated disruptions have occurred in the past 20 years. These tactics by the Kremlin have been widely documented but have attracted little attention in Germany, France, Italy, or Austria—Moscow’s closest energy partners in Europe. Requirements imposed on the three Baltic states as a condition for EU membership, such as the premature closing of the nuclear power stations in Lithuania, have made it certain and unavoidable that in the short term the three countries will be more, rather than less, dependent on energy supplies from Russia.

Since the mid-1990s, there have been numerous meetings among officials of the Baltic states in an attempt to adopt a coordinated response to Russian pressure and a strategy for enlisting more support from Western Europe. In addition, a Baltic States Energy Forum is held each year in one of the capitals with representatives from the United States joining officials of the three governments. The goal of the forum is to draw up realistic proposals for greater regional energy cooperation and diversity of energy import sources. Although there have been repeated meetings at the governmental and nongovernmental level, progress toward greater regional energy cooperation has been slow.

Nevertheless, there has been development toward establishing a common electricity market that would cover the three Baltic states. Lithuania has even introduced an electricity exchange, in which 43 percent of the country’s domestic electricity use is now traded. Electricity exchanges in the other two countries would advance considerably the prospects for a real common Baltic market for energy. With the help of Sweden and Finland, construction of a Baltic-wide power grid is under way, linking the three Baltic states’ electricity systems with those of Poland and the two Nordic countries. Estlink I, the first electricity interconnector between Estonia and Finland

(350 megawatts) was completed in 2007, and a second line (Estlink II) with a capacity of 650 megawatts will likely be completed in 2013–2014. In times of need, the three Baltic states will in the future be able to draw on excess electricity from Finland, particularly when Finland’s two newest nuclear power plants go on stream in the next few years. Another significant development has been the signing in early February 2010 of a deal between Estonia and the Norway-based regional electricity bourse called Nord Pool, with the aim of creating a single Nordic and Baltic power market by 2013. The latest agreement allows Nord Pool to expand its connections with Latvia and Lithuania. Until February, the Baltic–Nord Pool agreement provided only for electricity ties with Estonia and that through Estlink I.

The European Union has approved funding of a large capacity electricity interconnector between Lithuania and Sweden, and the governments of Latvia and Estonia have agreed to the arrangement. It also appears as if the long talked about “power bridge” between Poland and Lithuania will be constructed in the next five years. All of these interconnectors are designed to work in two directions. Nevertheless, there is some uncertainty whether a new nuclear power station will ever be constructed in Lithuania to replace the two reactors that were shut down, the last at the end of 2009. The Baltic states have been discussing for the past five years the common use of power from a new Lithuanian nuclear reactor. The project’s delays, however, only add to the energy insecurity in the region. Russia’s announcement that it will construct a nuclear power reactor in the small Russian enclave of Kaliningrad and sell excess electricity to neighboring states appears to be an attempt to weaken support for constructing a new Lithuanian reactor.

Within the Baltic states there is growing interest in importing LNG in order to compete with Russia’s present gas monopoly. There is the inevitable competition among the three countries regarding where to establish an LNG gasification plant. Lithuania seems to have taken the lead over Latvia, by securing funding in 2008 from the U.S. Trade and Development Agency for an \$800,000 feasibility study for a plant located on the country’s Baltic west coast. One Polish energy planner, however, voiced a preference for a plant in Latvia, arguing that an LNG receiving plant located at the port of Ventspils could serve to ship the piped gas more easily to the three Baltic markets.

In any case, with the Baltic economies only slowly emerging from a deep recession, it is difficult to see how a proposed LNG plant could secure the necessary financing in the near term. One Latvian businessman has discussed with Qatar the possibility of that country financing an LNG port with the guarantee that the three countries would take enough gas to make the venture profitable. It would be very difficult, however, to persuade the three governments to agree to this formula—and to overcome the inevitable opposition of Gazprom, which at present controls the gas distribution systems in the region. Surprisingly, the Latvian branch of Russia’s Itera is supporting the idea of building an LNG plant in Latvia. Since Itera relies on Gazprom for its product, this may simply be an attempt by Gazprom to control any possible competition or to discredit the deal.



Another plan, with better prospects, is the attempt to reach an agreement among the three countries on the construction underground of additional gas storage facilities. Currently, the largest underground storage facility is in Latvia and is controlled by Gazprom. The firm uses gas imported in the summer to supply the St. Petersburg area during periods of peak demand in the winter. A new and larger Baltic-wide storage facility, including a revised financing formula, would have to be agreed upon by the three governments in order to construct new facilities. This project is already receiving funding for a feasibility study by the European Union, and it might receive construction funding as part of the European Union's next energy facilities funding package. Latvia is the only Baltic state that appears to have enough underground cavern space for constructing new storage facilities, although Lithuania is financing a new geological survey that will examine possible storage sites in that country. In any case, the region is under pressure by the European Union to increase significantly its gas storage capacity; in itself, this is a positive step.

One roadblock that has defied resolution for the past 15 years is the demarcation of the sea boundary between Latvia and Lithuania. An intergovernmental agreement has been signed between the two states and has been approved by the Lithuanian parliament; however, its prospects for passage in the Latvian parliament are not good. This is a serious setback, since there is good reason to believe that profitable quantities of oil and gas lie offshore in almost the entire Baltic Sea basin. The Chevron Company of the United States was ready to begin exploratory drilling in the disputed zone in the late 1990s but pulled up stakes after it became apparent that the two countries were far from reaching a sea boundary agreement. Even the possibility of significant tax revenues has not been enough incentive to break the legal and political logjam. Meanwhile, Russian companies have already been drilling off Kaliningrad, and while the results have not been made public, it is reasonable to assume that significant amounts of gas and oil will be found there. Polish seismic work in the Baltic basin just west of the Kaliningrad offshore economic zone indicates that there are reasonable prospects for commercial exploitation of some oil and larger quantities of gas. Therefore, the failure of the Latvian government to ratify the most recent treaty is a major disappointment to those hoping for some relief from the tight grip that Gazprom has over the gas markets of Latvia and Lithuania.

Lithuania proposed in November 2009, at the NATO Industrial Planning Committee, the establishment of a NATO Energy Security Center of Excellence, with a possible location at a university in Kaunas, Lithuania. Although the Lithuanian side has been floating the idea for over a year, it has not been able to gather enough support from other member states. It is difficult to ascertain how much opposition is coming from countries like Germany that oppose any NATO role in energy security. In order to move ahead, the proposal would require a strong push from the United States and several other key NATO members.

## Possible Breakthrough in Budapest: Regional Cooperation at Last?

As mentioned above, this year's February 24 meeting in Budapest involved the prime ministers of 11 CSEE countries representing more than 100 million people. Representatives of the European Union and United States attended as observers. This was the first time that an independently organized meeting brought together so many of the region's leaders to discuss energy security. The motivation for the conference and its remarkable attendance at such a high level stemmed from the growing realization that the European Union and other regional institutions are either incapable or unwilling to support the security interests of Europe's newest democracies. It seemed ironic and contradictory that a conference with the understated goal of reducing the region's energy dependency on Russia took place one week before support for Russia's South Stream project was announced by the new EU energy commissioner.

The conference participants unanimously called for stronger measures to deal with supply disruptions, especially the diversification of supplies from Central Asian and Persian Gulf shippers, and for pipelines to the region that would bypass Russia. The clear emphasis was on natural gas supplies. They pledged to support greater harmonization of energy diversification projects, including the construction of LNG ports, new electricity and gas interconnectors, new gas storage facilities, and more EU support for region-wide energy projects. Even more important, the group supported the formation of a unified internal gas market for the European Union and also for moving the contractual gas delivery points to the European Union's external borders in the future. While this will meet resistance from the large EU states, and most certainly from Gazprom, there is now clear support building within the CSEE countries for the European Union to live up to its goal of becoming a real common market—especially for such vital supplies as oil, gas, and electricity.

The summit endorsed the Hungarian proposal mentioned earlier that would create north-south pipelines for the delivery of natural gas originating from the future LNG receiving plants in Poland and Croatia and from the planned Nabucco pipeline. These lines would link the Baltic coast with the Adriatic and Black Seas, with branch lines going to several supply-vulnerable countries, particularly those in the Balkan region. Significantly, the summit agreed to the creation of intergovernmental working groups at the expert level and to hold regular meetings on energy security at the prime minister level.

The conference was a clear breakthrough in that it took a major initiative outside of the office of the EC commissioner for Energy and the Directorate-General for Energy. Both bodies are presently blocked from taking more aggressive action on energy security as a result of opposition by the large Western European governments. The large states tend to be tied closely to their national companies' projects within Russia and to the prospect of short-term profits from pipeline projects that benefit from sales to Russia of European steel and power units, irrespective of whether the projects result in higher energy costs to the European consumer.

## East Central Europe's Own Roadblocks to Greater Cooperation and the Road Ahead

Much of the blame for a lack of greater CSEE cooperation can be laid at the feet of the large EU member states who seek closer energy ties with Russia and also from the lack of support from the European Commission, which has so far hindered regional cooperation. Nevertheless, by far the biggest obstacle to collaboration and more effective resistance to Russian pressure is the lack of sufficient reform within the CSEE countries. Their vulnerability to energy coercion and questionable agreements with Russian leaders in large measure stem from the lack of transparency in the governments themselves. In addition, there are regulatory, licensing, and taxation issues that have to be tackled by each of the region's governments, in order to effectively implement the funding programs approved by the European Commission. Investment laws have to be adopted in order to attract foreign energy investors—those who follow the best business practices and who bring the most innovative technology into the country. They need to attract foreign firms who intend to stay involved in the long term and not act as future sales agents for nontransparent firms representing Russian interests.

The situation, however, may now be moving in a more positive direction. The intergovernmental group that was announced at the February 24 Budapest energy summit could be put together quickly and should include the best energy policy specialists from each of the 11 participating states. The group should be given broad authority by each government to implement the best practices in developing domestic and cross-border projects. Total transparency should be required of the group in order to prevent nontransparent or corrupt local business interests from overriding the need for regional energy security. Openness is also needed in order to combat efforts by supplier nations from subverting the goal of greater regional cooperation. It will be a difficult task to harmonize totally the energy activities of 11 nations, but a high degree of combined action should be possible, particularly if it has strong political support from member governments and is allowed to reach out to international banks and development institutions for technical and financial advice.

Effective use of this intergovernmental group would likely increase the region's influence within the European Commission's Directorate-General for Energy and with the commissioner for energy. Strong and effective support from member governments could persuade Russia's closest energy backers in the European Union (Germany, France, Italy, and Austria) to pay greater attention to investment opportunities and even to the energy security needs of the region. Most importantly, the kind of cooperation envisioned at Budapest would increase the weight of the CSEE countries on a wide range of energy security issues, including the formation of a common energy market and the enforcement of competition and antitrust laws that are now openly flouted by several of the larger states.

An intergovernmental commission, however, cannot resolve many of the most important impediments to regional cooperation. Under international law, two countries cannot link together

their energy transmission systems without a formal state-to-state agreement. Several countries that want to build gas interconnectors with EU funding have not yet reached agreements with their neighbors. Even Hungary and Romania, which plan to tie part of their pipeline systems together, do not yet have the required intergovernmental agreement. A lack of agreement has caused some delay in completing the interconnector. This is one area in which a nudge from the Directorate-General for Energy could help move things along.

All EU members are already subject to the rules contained in the Energy Charter Treaty. And yet, several member states have taken no action to force their domestic firms to open their pipelines as “common carriers” so that multiple companies would have access to spare capacity. Doing so would increase competition and efficiency and ultimately lower prices for the consumer. Unfortunately, several of the larger EU members, such as France and Germany, have resisted both unbundling and a common carrier system, but this should not prevent the CSEE countries from moving ahead on their own.

A stable regulatory and licensing system that covers pipelines, LNG facilities, and nuclear plants, as well as pricing and environmental concerns, is also a must. The challenge is to devise a regulatory system that encourages, rather than stifles, competition and that is transparent without tying projects up with endless political conflict. The United Kingdom’s energy regulatory system is a good model for the new democracies, as is the U.S. Federal Energy Regulatory Commission, although the United State has a separate agency for oil and nuclear plants. Both countries appear to strike a reasonable balance between promoting open energy markets and being able to protect the interests of the consumer. Governments should provide a regulatory framework and not try to “manage” the market. All of the countries must avoid the temptation to regulate consumer prices to the benefit of either producer or consumer groups, rather than have them reflect the real market price of the final product.

Although for political reasons many governments are reluctant to publicize negotiations with non-EU or non-European energy suppliers, the European Union has so far refused to require greater transparency. The CSEE states could take on this challenge. It would prevent the smaller and more economically vulnerable countries from being played off against each other by phantom promises of future riches made by supplier states, such as Russia. The history of Russian negotiations with CSEE states regarding participation in the South Stream project and possible benefits to individual countries is a good example of why greater transparency is needed in bilateral discussion involving energy deals. The shrouded negotiation between Croatia and Russia regarding the Druzhba pipeline and the pipeline from the Krk Island LNG facility is a good case in point. Both pipelines are controlled by a Croatian company that is independent of Hungary’s MOL.

The unspoken goal of Gazprom appears to be one of shutting off competition to Russian oil and South Stream gas by limiting shipments to Central Europe through Adriatic ports. After Gazprom’s takeover of the key NIS oil refinery in Serbia, a Croatia-Russia deal would pose a significant danger to CSEE energy security. Although the Croatians deny that they are “breaking

ranks” with their CSEE neighbors on energy security, they have agreed to Russian suggestions that they support the South Stream pipeline in return for possible economic benefits, such as insuring that the pipeline would pass through Croatia to the gas storage terminals in eastern Austria. Even if South Stream never materializes (a good possibility), Russia will still be in a strong position through its control of Croatia’s pipelines from the Adriatic.

The Croatians are not the only CSEE country to sign up for South Stream while at the same time declaring their support for Nabucco. Austria, Hungary, and Bulgaria have agreed to participate in both pipelines. There is not sufficient gas demand for both pipelines, and it may appear prudent for governments to hedge their bets on which pipeline (assuming one of them is built) can demonstrate that it will be constructed and be the first to bring new gas supplies. Not only are there supply questions regarding Nabucco, but in addition, Turkey’s demands for effective control of the gas and its touchy relationship with Azerbaijan has stalled the project. At the same time, Russia’s South Stream project shows even fewer signs that it can supply the necessary gas volumes. South Stream’s reported \$26-billion construction costs make one question whether the project is only being put forward in order to kill off Nabucco. Only Italy appears to claim that it is a serious proposal to supply the region with new gas supplies. Russia also sees South Stream as a means of putting pressure on Ukraine to turn its pipeline system over to Gazprom.

Recently, Russia and Turkey have floated the idea of Gazprom becoming part of the Nabucco project, with Russian gas from the Blue Stream or a possible new Russia-Turkey pipeline contributing a large share of the gas. The difficulty with such an option is that Russia has never been content to play a minority role in any of its pipeline deals. It should be assumed that even if Gazprom were to take a minority and non-blocking share of Nabucco ownership at the beginning, it would, within a short time, start applying pressure on other partners to sell their shares to Gazprom, until it acquired a majority, or at least a blocking position in the consortium.

## Unconventional Gas: A Known Unknown in CSEE Energy Security

In the past year considerable attention has been lavished on the “unconventional gas revolution” in the United States and the possible implications for Europe of new technologies for extracting shale or tight gas. While domestic gas consumption in the United States is increasingly being met by unconventional gas production, exploration of the technology’s potential in Europe is only now quietly and slowly getting under way. No major production well has been brought on stream yet in Europe utilizing the new technology. A joint drilling project in Hungary’s Mako Field involving Exxon, MOL, and Falcon Energy failed in its first attempt to find gas, instead encountering too much water. Although Exxon has since pulled out of the project, MOL and Falcon are convinced that the field does contain commercial quantities of recoverable gas and are determined to re-drill a well in the region. Poland, however, is receiving the most attention from U.S. multinational energy companies regarding possible unconventional gas production. The country has leased exploration blocks to Exxon, Conoco, Chevron, and Marathon, and at least

two small U.S. companies are also in partnership arrangements with European firms in exploration ventures.

The first exploration well in Poland is due to be started in April 2010 by Conoco, with Exxon planning on drilling its first well in early 2011. Although the geology in Poland looks quite promising for commercial unconventional gas finds, no one knows how much recoverable gas will be found and whether the price of bringing it on stream will make it competitive with Russian supplies or future LNG shipments from Qatar. Some Poles firmly believe that for national security reasons, any domestic gas production should be utilized as long as the price differential is not greater than a few dollars per thousand cubic feet from that charged by Gazprom or the Qataris. In any case, as the technology migrates from the United States to Europe, and CSEE countries establish incentives and a regulatory framework for unconventional gas production, this new potential source of gas is bound to draw considerable attention from governments and local firms alike. The degree to which this technology is utilized in the region over the short term may depend on the success of the U.S. companies in Poland. Bulgaria and Romania are also countries where there may be significant quantities of unconventional gas, and again, success in Poland would likely guarantee that companies would look more closely at the geology and business opportunities in those two states.

Gazprom, as should be expected, is already lobbying against the exploration and development of unconventional gas in Europe in order to dampen competition with its own exports. Gazprom export director Alexander Medvedev is already publicly warning Europeans of possible serious environmental dangers of drilling for shale or tight gas and alleging that there is increasing public resistance among the American public. Gazprom may use its considerable influence in Brussels in order to secure EU environmental laws or regulations that will delay or kill efforts to use the new technology in Europe, particularly in those CSEE countries now more vulnerable to Gazprom monopoly pressure.

## Recommendations

- The 11 states should organize a strong follow-up to the February 24 Budapest conference by having each of the 11 representatives appoint a high-level official to represent them on the Intergovernmental Commission. Provide the commission with a technical panel of experts that is empowered to advise on measures that will increase regional energy security.
- The 11 states should set up an independent office in Brussels that would assist the group in pushing through energy security recommendations in the European Parliament and in the European Council and European Commission. The combined political weight of the 11 countries would increase the likelihood of receiving a greater share of the European Union's funding of energy projects, such as interconnectors, storage facilities, and pipeline proposals, thereby bringing forward the goal of achieving real supply diversification.
- The same group should also support an EU requirement for full discussion and disclosure of commission positions on pipeline proposals such as Nord Stream, South Stream, Yamal II,

Amber, White Stream, and other southern corridor proposals. They should demand that the European Union fund an independent calculation of the costs and benefits of each project.

- The CSEE members of the European Union should also push for quicker enforcement by Directorate-General for Competition (DG-COMP) of the regulations on energy unbundling and for greater enforcement of the Energy Charter Treaty, particularly any action that took place before Russia's formal withdrawal from the treaty in 2009. This would require increasing the institutional capacity of the DG-COMP.
- CSEE members of the European Union should demand EC enforcement of the competition and anti-trust rules of the Lisbon Treaty (i.e., the consolidated EU Treaty) in all cross-border deals between individual member states and foreign entities, including Gazprom and Transneft.
- CSEE members should demand the right for the European Union to immediately investigate the causes, irrespective of where they occur, of any disruptions in energy supply to a member state on the part of a nonmember importer. The investigation should be transparent and include representatives of those states directly affected by the disruption.
- CSEE members should support the Lithuanian proposal for a Center of Excellence in Energy Security, whether or not it operates under the aegis of NATO or the European Union. The center could act as a technical arm that would provide expert and independent advice to governments regarding the costs and benefits of various energy proposals. It could also engage in small research and development projects regarding energy efficiency and alternative energy.

## About the Author

**Keith C. Smith** is currently a senior associate in the CSIS New European Democracies Project. He retired from the U.S. Department of State in 2000, where his career focused primarily on European affairs. From 1997 to 2000, he was U.S. ambassador to Lithuania, with additional posts in Europe, including Hungary (twice), Norway, and Estonia. In addition to several other State Department assignments, he most recently served as director of policy for Europe and senior adviser to the deputy secretary of state for support of East European Democracies (SEED Program). From 2000 to the present, Smith has been a consultant to several energy companies and has lectured on Russia-Europe energy issues in the United States, Poland, Belgium, Norway, United Kingdom, Germany, Czech Republic, Estonia, and Lithuania. He has been interviewed by the *New York Times*, *Wall Street Journal*, *Los Angeles Times*, *Economist*, *Financial Times*, and several European papers. His articles have been published by the *International Herald Tribune*, *Georgetown Journal of International Affairs*, Center for European Policy Studies, and Norwegian Atlantic Committee. He has appeared on BBC World, CNN, and CSNBC. His most recent CSIS publications include *Russia-Europe Energy Relations: Implications for U.S. Policy* (March 2010) and *Russia and European Energy Security: Divide and Dominate* (October 2008).



