

Energy Codependency

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During Vladimir Putin's first two terms as president of Russia from 1999 to 2008, oil prices rose from below \$20 to over \$140 per barrel. In many respects, this enabled the domestic and foreign policies that he pursued, including in the oil and gas industry where private ownership was restricted and the sector recentralized in the hands of the state and state companies. Today, Russia is more of a petro-state than the Soviet Union ever was, with oil and gas contributing more than a quarter of GDP, half of federal budget revenue, and two-thirds of the country's export earnings.

The same will not be true during Putin's third term as president from 2012 to 2018 as oil prices dropped below \$90 per barrel from historic highs of above \$100 for the last four years. For the energy industry, high prices eventually result in conservation, substitution, and new supply. The American shale gas and tight oil revolution is a classic example of the development of new supply. Even if this is a cyclical decline, oil prices are unlikely to return to the growth rate of the previous decade.

To maintain Russia's currently high oil and gas production and export levels on which its economy depends, large-scale and long-term investments are needed in exploration and development in frontier areas beyond Russia's traditional producing regions, such as in East Siberia and the Arctic offshore, and in costly infrastructure to bring new production from

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remote areas to markets in Russia or abroad. Majority state-owned Rosneft and Gazprom, or favored companies such as Novatek, needed Western energy partners to underwrite these investments and provide technical and management expertise. Western economic sanctions therefore come at a critical time for its oil and gas industry in response to Russia's aggression against Ukraine. Financial sanctions restrict access to capital for Russian energy companies. Sanctions against investments in frontier exploration in the Arctic offshore and shale oil have stalled or halted projects with major international oil companies.

The often-heard narrative that Europe is heavily dependent on Russian energy sources is true for some European countries yet Europe receives overall about 30 percent of its oil and gas imports from Russia. The less understood dynamic is that Russia is even more reliant on Europe as the market for 80 percent of its total oil and gas exports. While much has been made of Russia's recent energy mega-deals with China, diversification of Russia's export markets to Asia will take a decade or longer, if ever, to reach a level comparable to its exports to Europe. As global energy prices soften and global demand stagnates, Russia needs Europe

more than ever as the primary destination of its oil and gas exports.

The other narrative is Russia's use of its oil and gas supplies as a tool of statecraft. In reality, Moscow has little room for maneuver. Europe will continue to import oil and gas from Russia; Russia cannot shift its oil and gas exports to Asia in the near term. Therefore, this boils down to the economic terms of energy trade, whether Europe and Russia are politically willing to lessen their degree of mutual dependence, and whether both sides are willing to bear the higher cost of supply diversification by shipping or receiving oil and gas over greater distances utilizing expensive new infrastructure.

Here natural gas matters a lot more than oil. As a globally traded commodity with ease of transportation, oil supply is much more flexible than gas supply, which is tied to fixed infrastructure and longer-term contracts in regionalized markets. In other words, Russia's oil pays the rent (at a ratio of 4 to 1, more valuable than gas), whereas gas is more about power politics—both domestic and foreign—as well as revenue generation and distribution.

For the third time in less than a decade, Europe is again faced with the possible interruption of Russian gas transiting Ukraine that, following the development of the Nord Stream pipeline, represents today around 15 percent of Europe's total gas supply. Each occasion was triggered by significant political developments in Ukraine that were perceived by Putin as affecting Russia's interests: the Orange Revolution (preceding the gas cutoff in 2006), the internal power struggle between President Yushchenko and Prime Minister Tymoshenko (the longer 2009 gas cutoff), and now the Euromaidan and the departure of former Ukrainian President Yanukovich (leading to the current standoff on gas supply). Each cutoff occurred during the winter months.

Neither Russia nor Ukraine can afford another gas crisis. Ukraine has yet to implement any

fundamental reform of its dysfunctional and corrupt energy system. Reform requires political will on the part of Ukrainian leaders even under the most difficult conditions of war/insurrection and economic collapse and great patience by the Ukrainian people to accept increases in energy prices in order to improve energy efficiency and increase domestic production. Ukraine will require extensive financial assistance from international financial institutions and Western countries for the next five to ten years with strict reform conditionality.

As lower oil prices and Western sanctions exact a toll on Russia, Moscow will likely continue to see Ukraine as an undependable transit partner for its energy and to focus on completing its plan to bypass Ukraine entirely by constructing the South Stream gas pipeline system under the Black Sea and through the Balkans.

What role does Europe play as it enters potentially its third energy crisis with Russia? The European Union must decide to observe its own stated rules as outlined in the Third Energy Package and EU competition policies. After years of investigation of Gazprom's business practices in Europe, the "statement of objections" (or formal charge sheet) was poised to be released in May 2014. The matter is still pending. Europe must also decide whether and how to use its leverage to determine the terms of the gas trade with Russia. While creating a future EU "Energy Union" may be an important step, the EU must first implement its own rules rather than continually seek exemptions without reducing its energy vulnerabilities.

The best solution for all sides is for Russia and Ukraine to reach a six-month interim agreement, which is currently under discussion, on the gas debt that Ukraine owes Russia and on the gas price Russia will charge Ukraine. Continued brinkmanship between Russia and Ukraine on gas negotiations has only led to bad outcomes for all parties, including Europe. ►