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Beyond Co-Dependency: European Reliance on Russian Energy

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At a June 2005 meeting in Berlin on Russia's relations with Germany and Europe, Russian politician, Dmitry Rogozin, complained that Europe had developed a peculiar "oil phobia" about Russia. By this he meant that Europe perceives Russia's growing share of its energy imports as dangerous. And, in fact, Europe has both an oil and a gas "phobia" about Russia, as Russia is also the largest single supplier of gas to European markets. According to the logic of this dangerous dependency——which is an echo of the old fears about the USSR in the 1970s and 1980s—Russia will wield its oil and gas exports as a political weapon against its neighbors to exert negative influence over their policies. In this view, the oil and gas-fueled "Finlandization of Europe" is inevitable as European domestic oil and gas production declines and imports continue to rise. Indeed, this phobia has become a real issue in public discourse in several European countries, including Germany, and is starting to percolate into political circles at the European Union level in Brussels.

Comments from other prominent Russians over the last several years have encouraged this phobia—like the President of Russian oil giant, LUKOIL, Vagit Alekperov's oft-quoted April 2001 interview on the Russian oil industry's expansion in Eastern Europe. In a candid moment, Alekperov remarked, almost off-handedly, that he was "certain that Bulgaria, whose oil sector is almost entirely owned by Russian companies, will not conduct an anti-Russian foreign policy in the foreseeable future." The basic facts provide further validation. In 2004, around 42% of Europe's oil imports came from Russia and just over 43% of Europe's gas imports.[1] But Europe's Russian "oil phobia" is somewhat over-played. The fashionable obsession with "energy realpolitik" glosses over the influence of other political priorities, and more prosaic issues like commercial considerations and the functioning of international energy markets. More important perhaps, it ignores Russia's corresponding dependency on Europe as a market for Russian energy.

Individual Vulnerabilities

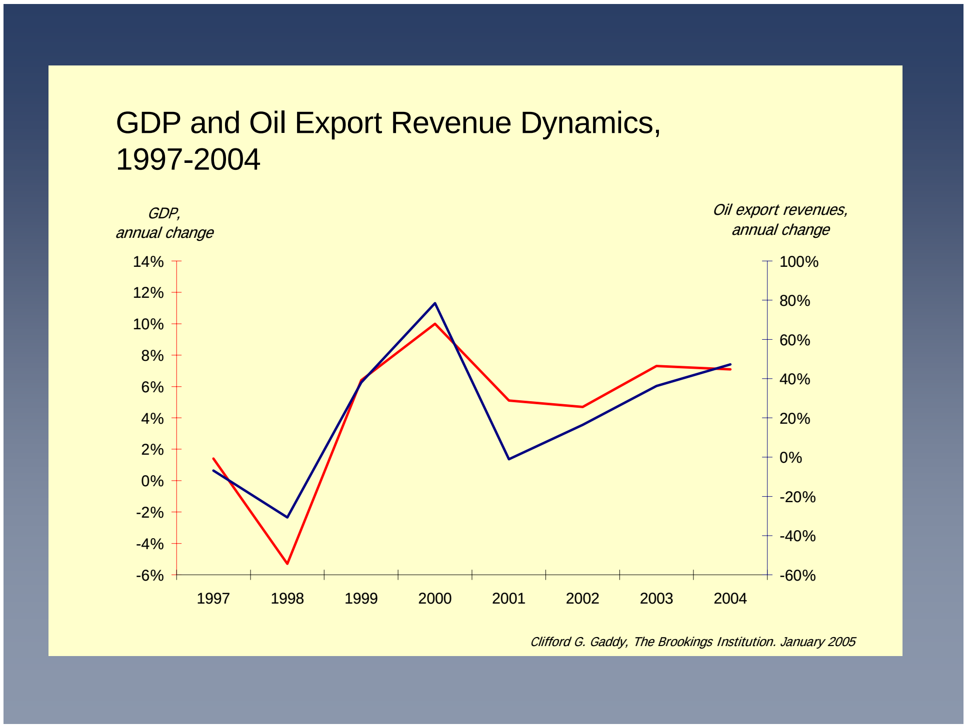
It is at the individual country level where the vulnerabilities seem acute (see map below). Not only is the eponymous Finland heavily dependent on imported energy from Russia, but new European Union entrants like Poland and the Baltic States are entirely reliant on Russian energy

[1] *BP Statistical Review of World Energy*, June 2005. These figures account for all European countries, including Turkey, not just current European Union members.

imports—especially gas. And the European Union's new neighbor, Ukraine, which is one of the primary energy transit countries from Russia to Europe gets a large portion of its oil and gas from Russia. The Baltic States and Ukraine offer classic cases of Russia using energy as a weapon. Moscow repeatedly cut off oil shipments and gas supplies to these countries in the 1990s at critical junctures during political and economic disputes. And not just small or former Soviet states are seen at risk. Germany, the European Union's biggest economy, appears particularly susceptible to Russian influence. Germany is Europe's largest natural gas consumer, and 41% of German natural gas imports came from Russia in 2004. This share is set to rise over the next decade given the increasingly close commercial relations between German energy companies and Russia's giant gas monopoly, Gazprom. Also a proposed Russian-German pipeline under the Baltic Sea (avoiding the Baltic States and Poland) has been heavily promoted by German Chancellor Gerhard Schroeder.

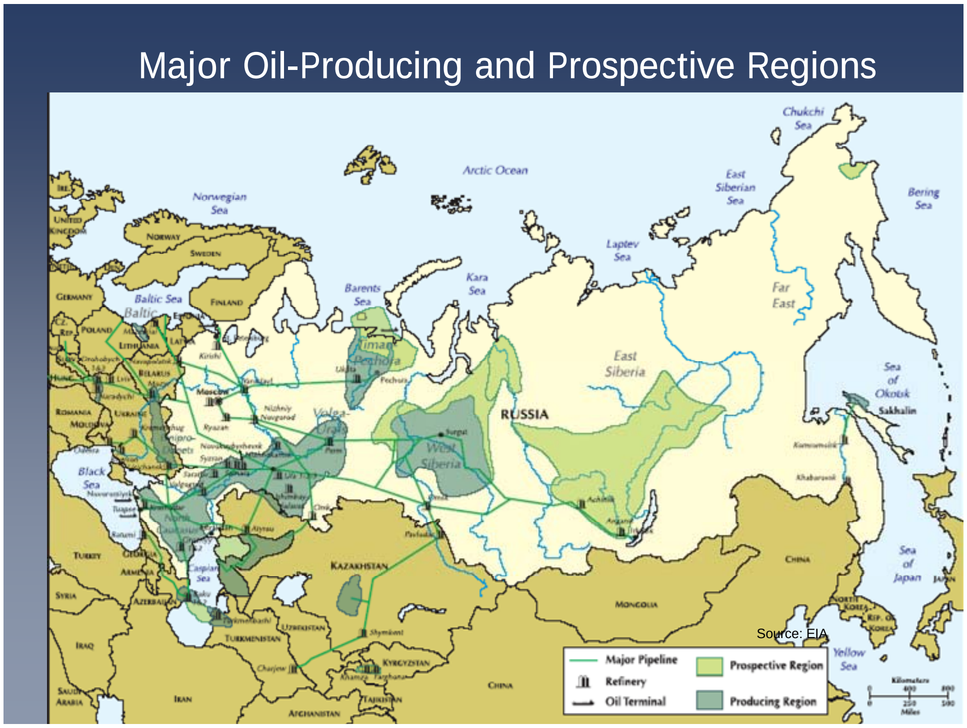
The Other Side of Dependency

But, there is another side to Europe's growing dependency on Russian energy. When it comes to Russia itself, the fact that Russia's primary interaction with European and other global markets is through oil and gas is a considerable source of weakness. Commodities dominate Russian exports, and few of its manufactured goods are internationally competitive. Russia's economic revival and gross domestic product (GDP) growth after its 1998 financial crisis can be traced directly to a combination of high energy prices, oil and gas production growth rates, rising energy export volumes, and associated revenues (as the chart below illustrates).



In short, the future of the Russian economy is now entwined with the future of the world energy market, and Russia is thus vulnerable to exogenous shocks. Indeed, as Russian economists and politicians readily admit, the Russian economy is essentially addicted to energy revenues. As a result, Russia is, itself, highly dependent on Europe as the primary consumer of its energy product, not just the other way round. In 2004, Europe was the destination for more than 80% of Russia's oil exports and essentially all of Russia's gas exports. So Europe and Russia have an interestingly codependent relationship in energy not just a one way dependency. Europe enables Russia to get its 'revenue fix'; Russia gives Europe its 'energy fix'. The Russian-German gas relationship is especially symbiotic.

For now, Europe is also the main action in energy for Russia (see maps below). International observers often get carried away by an irrational exuberance in contemplating the extent of Russia's, admittedly considerable, oil and gas assets—believing that Russia can expand exponentially into new energy markets in Asia (especially China) and the Americas, as well as Europe. But at this juncture, Russia cannot meet all the energy demand expectations projected on it. Russia still has not developed the oil or gas production in East Siberia, nor the new export infrastructure for Chinese and other markets. Production and exports remain very much oriented toward Europe; Russia's much-vaunted oil exports to China are transported by rail over huge distances from West Siberia. This method and route is only feasible with high world oil prices and because China is also prepared to pay a premium to guarantee its oil supplies.

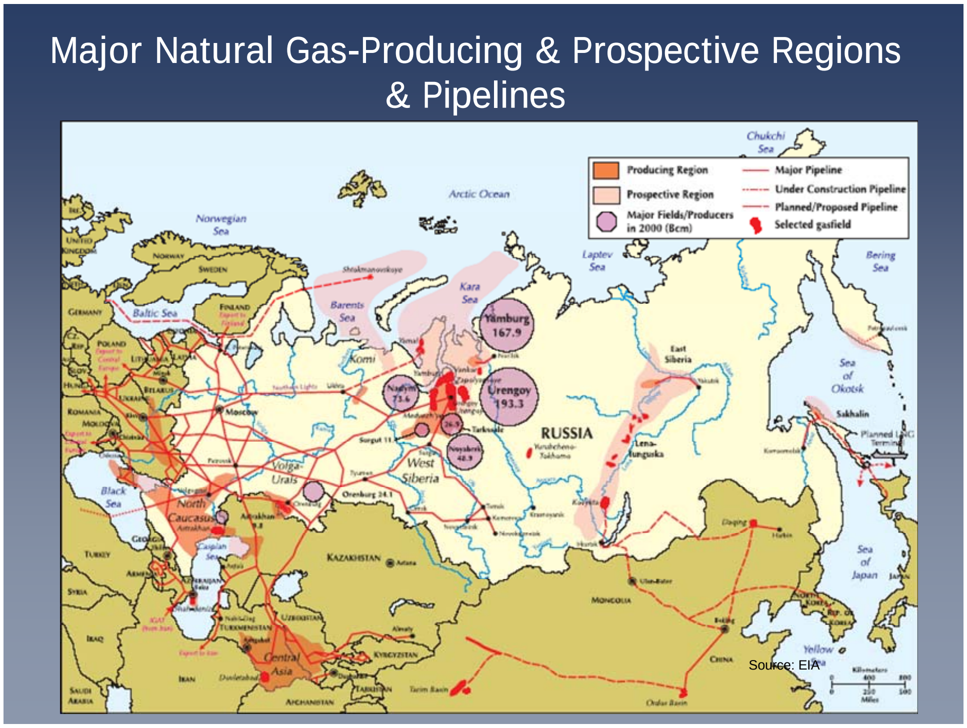


Pipelines are expensive fixed assets that can not be built overnight, and the politics that surround them often bring costly delays—like the current wrangling among Russia-China and Japan over the route of a proposed oil pipeline from East Siberia to the Russian Pacific coast. In the absence of agreement on oil and gas pipelines to Asia, other new projects like the Baltic undersea gas pipeline from Russia to Germany will tie Russia even more to its primary European consumers. And Russia is particularly vulnerable when it comes to gas.

Russia's Gas Constraints

Unless it is in the form of liquefied natural gas (LNG), gas is much more difficult to transport than oil, which can be shipped by tanker and rail in addition to being piped. Although gas markets are increasingly global (and LNG production from Sakhalin, for example, will soon enable Russia to export gas to Asia and potentially the United States), for the next few years, gas will still be primarily a regionally-traded commodity. It is dependent on the construction or existence of pipelines and on long-term contracts between producers and consumers. Here all the cards are not in the hands of the producer.

Thus, for example, Russia found itself in a bind with Turkey in 2003 after the construction of the Blue Stream gas pipeline under the Black Sea, when Turkey's economy sharply contracted after its 2001 financial crisis. With energy demand reduced, Turkey essentially found itself with too much gas on its hands at too high a price. It reneged on its long-term contract with Russia. Without an alternative consumer for Blue Stream and physically unable to redirect the gas, Russia was eventually forced to renegotiate terms. Blue Stream was a learning experience for Moscow. Russian energy producers now want to ensure that new gas contracts are concluded with reliable partners in Europe—especially Germany, which most Russians view as one of Russia's few foreign friends. Russia needs a reliable consumer just as much as European consumers need a reliable energy supplier. Furthermore, Russia wants to avoid constructing new pipelines across transit states that have a track record of making political waves for it in Europe––like the Baltic States, Ukraine, and Poland—hence Russia's interest in the direct route of the Russian-German Baltic Sea Pipeline.



Europe's Leverage with Russia

Over the long-term, as its oil and gas fields in East Siberia are developed, Russia should be able to reorient energy exports toward China and Asia. In the meantime, Europe has considerably more leverage with Russia than it realizes—especially in the gas sector. In spite of its mammoth size, Gazprom suffers from a number of structural problems, including aging and inadequate infrastructure, mounting production costs, and declining gas fields. Gazprom needs European (and particularly German) investment capital to meet its future targets for production and exports—once more an indicator of Russia's codependency. A variety of Russian politicians and analysts have all made clear in private conversations that they are very nervous about the potential consequences of German and broader European debates over the dangers of Russian energy dependency.[2]

[2] Author interviews, June 2005.

Many Russians fear that Europe will collectively turn away from Russia toward other regional piped gas suppliers and sources of LNG in the Middle East and North Africa, before Russia has been able to develop other markets for its energy. As a result, Russia has adopted a number of specific tactics to prevent energy dependency from being put on the European Union's political agenda. Moscow, for example, emphasizes bilateral and individual deals with European companies—like Germany's Eon, Ruhrgas and Wintershall, and Britain's BP—rather than larger partnerships, and encourages competition among European companies and states for access to Russian energy assets. The Russian government and Gazprom stoke fears of political or commercial retaliation if European energy majors pursue alternatives to deals with Russia. And, Gazprom promotes deals with Eastern European states to acquire gas at lower prices, which distorts European gas markets, all to avoid the risk of having concerted European pressure exerted on Moscow over energy issues.

Fixing Codependency

The fact that Europe and Russia have a codependent relationship in energy might suggest that nothing need be done, as long as the relationship is mutually beneficial. However, like many codependent relationships, this is an unhealthy one for both sides. It removes competition in European energy markets, opens the door for political manipulation, and distorts the Russian economy. The energy export revenues that have flooded Russia since 1999 have not been uniformly distributed. Industries with ties to the oil and gas sector in energy-producing regions have benefited, while those with no special relationships have not. Discrepancies in living standards across the country have increased, and the Russian government has little incentive to tackle its structural problems while it is awash with petrodollars. Increased supply competition in Europe would force more strategic thinking in Russia about the future of its energy industries as well as of the rest of the economy, and would push Moscow to find ways out of its own dangerous dependency on energy revenues, no matter how difficult that may be. The current state of codependency does need to be fixed.

Over the long-term, the ideal situation would be to create conditions in Europe where oil and gas would not be viewed as strategic assets and political tools but rather as traded commodities in completely open energy markets. In the meantime, change can be encouraged and effected precisely by raising energy issues to the political level in the European Union, to pursue as unified an approach as possible in dealing with Europe's energy needs and with Russia as a primary supplier. Some basic frameworks are already there. For example, energy is one element targeted for cooperation between the European Union and Russia, as part of the political dialogue on the four "Common Spaces" proceeding from the May 2003 St. Petersburg Summit. It is, however, only one element in the first "Common Economic Space," and Europe's energy dialogue with Russia has thus far tended to be too rhetorical and too visionary. Putting the dialogue onto a more practical plane will require focusing directly on issues like market regulation, investment protection, freedom of pipeline transit and other methods of energy transportation, dispute resolution, and the promotion of energy efficiency.

Ensuring European energy security, as well as more competitive markets, will also require a coordinated strategy between the European Commission and individual European governments to include the Europe Union's more vulnerable neighbors like Ukraine. Continued geographic diversification of oil and gas imports beyond Russia and the Middle East would be part of this strategy. The opening of the Baku-Tbilisi-Ceyhan oil pipeline in May 2005, for example, increases the prospect for new oil supplies to Europe from the Caspian Basin. And there are new gas supplies from Azerbaijan and Iran that can be piped through Turkey and Southeast Europe (a gas pipeline between Turkey and Greece was inaugurated on July 3, 2005, with an extension planned to Italy after 2006); as well as piped gas from North Africa (Algeria and Libya); and LNG from a variety of global sources that can be shipped to new European coastal terminals. The further development of alternative fuels, and energy conservation are also elements in this strategy.

In short, there are ample possibilities to reframe the debate about European energy security. And Europe's "oil phobia" about Russia can be addressed in practical ways that benefit both Europe and Russia and do not lead to unnecessary political confrontation.