

Energy Security and Russia-EU Cooperation

Spanning huge territories of Eurasia, Russia was always a complementary economic space to the core European community, both as a readily available pool of resources and high-quality products and as a vast market for European goods and services. And our ancestors used to successfully capitalize on these opportunities for centuries. Despite certain drawbacks occurring from time to time, in general up to this point commercial relations between Russia and Europe had been developing quite well.

Energy supplies from Russia to other European countries is an important part of this relationship. On one hand, these supplies had reached record highs last year, almost 400 million metric tons of oil equivalent of hydrocarbons, or almost one-third of oil & gas consumption in the enlarged EU, comprising 25 countries. On the other hand, Europe is by far the largest market for Russian energy. Moreover, new commercial plans and projects targeted to further increases of energy supplies from Russia to Europe are being discussed. These will necessarily enhance the extent of mutual cooperation and interdependence.

To provide for stable development of this key relationship the Russia-EU Energy Dialogue has been launched several years ago. The idea was to make medium and long-term forecasts of the demand dynamics in Europe and correspondingly to work out the plan of the development of oil and gas fields in Russia and neighboring countries, provide for appropriate capital investment and create the necessary infrastructural capacity.

But at present, this energy dialogue, to a large extent, stands idle. The energy chapter of the 'Road Map for the Common Economic Space', approved a year ago at the EU-Russia summit in Moscow, incorporates a list of general statements which hardly clarify where Russia and EU are going in the sphere of energy relations. Regularly published 'progress reports' on energy dialogue refer now to quite a narrow circle of specific activities, like TACIS-sponsored energy efficiency projects in certain Russian cities. These 'tactical' projects are indeed important, but much

less productive in absence of mutual understanding of political strategy of the 'bigger' dialogue.

That is very sad, because Russian and European politicians together can and, actually, should contribute a lot to help establish a reliable, mutually respectful and environmentally friendly common energy space in Eurasia. It requires political action, which is simply not discussed today.

All that feeds fertile ground for mutual tensions and concerns, which are growing. Europeans are now worried about the reliability of energy supplies from Russia, which has never been a concern even during the Cold War. In turn, Russians suspect that some politicians in Europe would like to artificially bias the European market against Russian energy supplies and legally block Russian corporates' direct investments in European energy industry.

In addition to that, newly appeared transit problems lead to discussion of alternative infrastructure projects, which too often are grossly inefficient on strictly economic criteria. But countries make decisions to build them to avoid, often imaginary, 'geopolitical' risks of the XVIII century nature. In other words, nowadays politicians tend to consider energy a destructive weapon rather than productive economic resource.

One can easily derive the overall price of mutual mistrust adding up extra costs of such projects. Since these are, as a rule, government-sponsored projects, the costs are to be borne mainly by the taxpayers. But anyway nobody dares today to discuss possible policy alternatives associated with cooperative solutions and as a result the idea of long-term international energy cooperation as such is being dangerously discredited. That is certainly not the right way to build a sustainable energy relationship.

It seems that it is high time now to carefully review past experiences, learn from them, and, in a sense, 'turn the page' and take new steps in order to build a better common energy future.

Of course, there are some objective constraints for development of mutual energy relations – general cooling of relations, uncertainties with regard to the extension of the Russia-EU Partnership and Cooperation Agreement after 2007, the inherently different paths of development of

energy markets in EU and Russia. But there are also certain subjective factors and both parties are to blame that they did not manage to provide for sustainable dialogue.

I will start with my assessment of slips on the European side of this political equation and then turn to the Russian side.

Sometimes, a ‘one-way street’ approach in energy relations with Russia was being embraced in Europe, ignoring any concerns by Russia, even quite reasonable and legitimate ones. Speaking of the specific limitations of the European approach to energy dialogue, I would highlight the most important ones.

As you in Brussels admit yourself, like in the recent Green Paper (March 2006), Europe has yet to build fully competitive internal energy market. It is important that as processes of liberalization and integration of the European gas and electricity markets proceed, Russia is given a first-hand and accurate information about developments in this area. Moreover, as Russia is not disinterested in the subject, it might be helpful if it becomes an observer in the process of working out of the common European energy policy. I do not think it will be a breach of sovereignty – at the end of the day it is in the EU interest that its main supplier is aware what is going on. It will help to remove certain sources of mistrust and to better understand the goals and logics of European policymakers.

Will the liberalization and integration of the European gas and electricity markets be completed any time soon? What will be the rules? Will there be a single European regulator? Unless we have these answers, Russian companies will be forced to give priority to bilateral relationships with European countries and national companies. This seriously devalues energy dialogue with the European Union and puts it behind bilateral relationships with potential serious drawbacks, like in the infamous North European pipeline case.

‘Diversification of energy supply’ is an example of the issue that was never properly explained to the Russian side. It had appeared on the scene as a political goal long before current problems began to emerge. As everyone knows, there are now EU countries 100% dependent on Russian energy (like Finland) and the effort needed there to diversify is

huge and wasteful. Therefore Russian experts have fears that the goal of diversification is to try to minimize energy supplies from Russia to the maximum possible extent, which may lead to serious loss of traditional Russian export markets.

Normally, diversification is a good instrument of supply and demand risk management. Europe needs to minimize the risks of energy dependence as much as Russia needs to minimize its risks of nearly 100% oil & gas exports dependence on the European markets. But diversification policy should be predictable and transparent to the trade partners otherwise it might become an expensive blackmailing tool only.

I would also allow myself to mention that European approach to the international legal regime on energy transit and trade, incorporated in the Energy Charter process, was not very helpful to the development of the relations in this sphere. I am specifically talking about the article 20 of the Transit Protocol, the EU's 'regional clause', which had actually set up an official legal exemption from the Transit Protocol to the EU member countries, and completely devalued the Transit Protocol and Energy Charter process itself, discrediting the Energy Charter Treaty and leaving it to be a document regulating only the regime of transit outside the EU territory. As a result, the Energy Charter is now a source of endless wrangling between the countries and is basically void.

Unfortunately, my country, Russia, on its part, has not achieved much in developing its own internal and external energy policy, moreover, lately this policy significantly deteriorated and caused several new problems and concerns.

First. The reforms of the domestic energy markets in Russia, particularly electricity and gas markets, are not moving forward. My Government in 2000 had started the work on these reforms in order to make Russian electricity and gas markets more transparent, efficient, open to private and international investment and free from the burden of regulatory risks. If only these reforms had proceeded successfully, by now Russian and European energy markets would have been moving towards similar economic models, opening up and providing compatible and clear market rules, market-based and competitive environment, reliable supplies, better opportunity for investment.

This type of picture can be seen on an example of the Russian oil sector, which, to a large extent, was liberalized and privatized during the last decade, and during the recent years had delivered impressive examples of growth, efficiency and satisfying market demand. Russian private oil companies have significantly improved corporate governance, introduced environment-friendly technologies, actively enter international cooperation and make direct investments abroad.

However, Russian electricity and gas sectors largely remain unreformed. Gas reform was banned, and power sector reform does not demonstrate any progress. Gazprom's active acquisition of the generating electricity assets contradicts the initial reform plan and adds to overall Soviet-type centralization and monopolization. This means that the Russian electricity and gas markets will yet remain vertically integrated, under state control and regulation, for an uncertain, but definitely a long period of time.

At the same time, liberalization and deregulation of the European electricity and gas markets is slowly, but still moving forward. This means that, unfortunately, our energy markets are moving in opposite directions rather than converge.

Second. Recent trends of the Russian policy towards foreign, not excluding European, investment are quite worrying. The so-called access to strategic sectors became a serious impediment for realization of investment plans by foreign energy companies. Some restrictions that are really defined by national strategic interest can be tolerated and are not unknown in other places, but in any case such restrictions should be imposed in a transparent, clear and legislative manner. Unfortunately, what we see is exactly the reverse.

Of course, economic nationalism is a dangerous disease and it would be much easier to struggle with it if others abstain from it. Corresponding reactions we are able to already observe and without any doubt will observe repeatedly in the future.

But the lack of direct foreign investment is much more risky for Russia since it badly needs capital to be invested in the national energy sector to support development, extraction and production of its vast

resources. It is evident for industry experts that only urgent action can help to avoid sharp decline of output of the natural gas in the nearest future.

Third. Mutual trust in energy area had been severely damaged by the crises in relations between Russia and energy transit countries, which had led to gas supply disruptions from Russia to Belarus in January 2004 and to Ukraine in January 2006, resulting in subsequent gas supply disruptions to European customers. Because the relations between Russia and transit countries are still not settled on a long-term solid contractual basis, and, unfortunately, tend to be seriously affected by politics, possible disruptions of energy supply from Russia to Europe are quite likely in the future as well.

Last but not least. The loss of political will and direction of reforms, chaotic domestic policy actions and aggressive foreign stance by the state-owned energy companies – all these phenomena are not coincident or accidental. The problems I have touched upon concerning Russia's energy policy are clearly associated with the recent undemocratic trends of the development of the country. Under this scenario numerous problems look unavoidable.

Almost all the essential characteristic features of modern democratic state have in fact disappeared in Russia within short period of time. Separation of powers has been effectively demolished and replaced by the so-called 'Vertical of Power' which is based on the false idea that all the meaningful social and political processes must be kept under control by the state. The Government and the Parliament cannot function any longer without daily instructions. The judiciary is increasingly servile. Independent central TV does not exist any more. Moreover, the state and state-owned companies increase its grip over the electronic and printed media. Abolition of the elections of regional governors and the corresponding destruction of the municipal level of power add to the systemic management crisis.

What concerns me much, that a lot of people both in Russia and here in the West are prepared to tolerate these trends in order to provide for steady flow of business development or even to extract some exclusive opportunities.

Moreover, as I know, some foreign companies agree to be involved in the murky dealings they cannot afford even to touch at home. I have heard many times a very characteristic phrase: “Business is business”. And it is especially true when energy prices are that high.

I would not explore long that this ‘short-sighted realism’ is a deep mistake. Foreign companies or investors which today face unexpected tax or administrative claims already know that even protection from their national authorities does not give them full guarantee against arbitrary action in Russia.

Violent and show-case demolition of Yukos, the biggest private oil company in the country, and everyday expansion of non-transparent entities in the energy sphere deteriorated the business climate and evidently reduced efficiency of the sector. As opposed to Western publicly owned companies, the Russian ones are not accountable at all and often drive the government decision-making rather than vice versa. It becomes another source of ill-based policies.

Because of all that, building of the common Russia-EU reasonable win-win energy strategy currently seems next to impossible. Nevertheless, I would like to speculate a bit on the subject of what can be realistically done in the medium term provided Russia gets back to a path of normal democratic and market development. Anyway we are to prepare ourselves to the next stages of the dialogue and start the necessary technical and political work.

A simple suggestion is that, following the lessons from past mistakes, Russia and EU would start to seek the solutions of the very severe mutual energy challenges on a mutually respectful and beneficial basis.

The plan appears to be quite clear.

First of all the real sharp edges of mutual energy relations should be brought back to the EU-Russia energy dialogue. In any event, we will not be able to hide behind the ‘small step approach’ and very general statements for long.

Russia and EU need a more frank dialogue on the issue of energy supply diversification. Aside from ‘supply diversification’ ideas, we need to focus on the guarantees of stability of supply of the basic

volumes of energy from Russia to Europe as a critical source of energy supplies for Central, Eastern and Southern European countries. Russian and EU commitments on such guarantees would be critical.

Both Russia and Europe need the development of the new mutually beneficial international legal framework to support fair and non-discriminatory regime of supplies and transit of energy resources to European markets from Russia. Such framework may appear in the form of an Eurasian energy supply stability pact, the signatories of which may not only be Russia and EU, but also Central Asian and Caucasian, Mediterranean and Balkan countries, Turkey, Ukraine, Belarus and Moldova.

In its turn, European Union needs to widely explain and clarify its energy policies in order to avoid misinterpretations and irrational fears of supply source diversification and market liberalization inside Russia. It will be fair if the EU also abandons the 'one-way street' approach and double standards in energy relations with Russia and other countries.

Russia needs to radically improve the climate for international investment in its energy sectors, make specific decisions on terms and conditions of liberalization and deregulation of its energy markets, to renounce barriers or at least clearly set the conditions for foreign investors' involvement in the energy sector. Much more favorable environment for integration of the Russian and EU energy markets will be achieved along these lines.

Russia and Europe also need to develop a joint energy investment support regime, in order to promote European direct investments in Russian energy production and transportation sectors and Russian direct investments in the European downstream energy sector. This will help to meet the growing investment needs of the Russian oil, gas and electricity production sectors, and establish a much more integrated, safe and balanced energy space between Russia and Europe, and remove dangerous barriers to investment that are rapidly being erected now on both sides.

Strategic solution for Russia and Europe in their energy relations lies in the direction of deeper market integration, mutual direct investments, establishment of common market structures and rules. Such an approach

will make all parties interested in stability, reliability and efficiency of markets and energy security of supply.

If we do follow these principles, that would only lead Russia and Europe to better energy security and mutual economic development benefits. It's not too late, but we must act now to ensure that such security and economic benefits will be achieved in the future.

History keeps a long record of mutually beneficial development of relations between peoples of Russia and other European nations in many spheres of life. This story is being written now by Russia and the European Union and I believe there exist all the conditions to put these relations on a sounder basis. It is our common current interest and common future we need to build together.

Thank you for your attention.