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# Russian and caspian hydrocarbons: energy supply stakes for the European Union

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**Europe's gas supplies :  
diversification with Caspian gas  
and the "Russian risk"**

**Catherine Locatelli**

**Février 2010**



# Europe's gas supplies: diversification with Caspian gas and the "Russian risk"

Catherine Locatelli \*

February 2010

## Abstract

The issue of EU gas supply security has become more and more important in the 2000s in the context of the gas market liberalisation and the question of reliability of Russian supplier. One answer to these problems is the EU gas diversification, specifically the opening up of a fourth gas corridor to supply the EU via the "Caucasus" or "southern" route with gas from Central Asia. The feasibility of this strategy might now be called into question. The aim of this article is to examine the new strategies that could emerge in the producing countries as well as those of international oil companies, and then look at what the consequences might be as far as the EU's diversification strategy is concerned. The aim of this article is to identify some of the problems and limits for this corridor.

\* \* \*

The liberalization of EU gas industries over the last decade against a backdrop of great upheaval on the international energy markets – volatile hydrocarbon prices, rising oil nationalism, increasingly difficult access to the hydrocarbon resources of producing countries – has brought to the fore the question of EU gas supply security. Along with environmental issues, this is now one of the central themes in EU energy policy, (EU, 2006 and 2007). The paradigm of "liberalization" of network industries in the EU spurred on by the gas directives (1998, 2003) and the third energy package of 2009 is based on the assumption that there will be a multiplication of gas suppliers to create a competitive market to replace the current oligopoly, while at the same time meeting energy security objectives.

Concern for supply diversification also ties up with the more specific question of reliability of supplies and thus of gas producers. The question concerns essentially the "Russian risk" highlighted by the problems of Russian gas transit following the gas disputes between Ukraine and Russia (2006 and 2008). The risk also concerns the market power that Russia might wield over the European market as well as the geopolitical stakes (Finon, Locatelli, 2008, pp. 423-42). At the heart of the debate are the regulations that the EU is trying to promote in a liberalized context to manage its relations with its main gas suppliers. Based primarily on standards, rules and more generally the Rule of Law, these regulations are contradictory to the hydrocarbons policy developed by Russia and therefore would appear unable to provide a framework for dialogue between the EU and Russia. Russia has always favoured bilateral relations with one or two main partners in the EU, such as Germany, France and Italy. While this strategy may fit in well with the energy security strategy of the individual member states (and their gas companies), it is contrary to EU policy.

The opening up of a fourth gas corridor to supply the EU via the "Caucasus" or "southern" route can supposedly solve these two problems. The idea is for Europe to diversify its sources by obtaining gas from Central Asia while bypassing Russia, thereby reducing the EU's reliance on this country. But a great many questions might be raised regarding this option. The materialisation of the "southern corridor" will depend on certain economic factors (for

example, natural gas availability) but also on more geopolitical factors related to the major political uncertainties in the region caused by tensions stemming from the collapse of the Soviet Union and the external influence of countries such as the US, China, Turkey, even Iran. These factors could have a profound effect on the behaviour of these players, in particular as regards the strategies of the hydrocarbon producing states in the region. Implicitly, export markets other than the EU are likely to interest these producing countries, China, India or quite simply Russia. Clearly Russia's hydrocarbons policy with respect to its so-called "near abroad" as well as the EU will be of paramount importance and will determine a certain number of trade configurations in the region.

The aim of this article is to examine the EU's strategy of diversifying supplies by importing gas via the fourth corridor through the Caucasus and to identify some of the problems and limits for this corridor. For this, it is also important to analyse the extent to which EU gas supplies are exposed to the "Russian risk"

## **I –EU gas security called into question**

The EU gas dependence rate (that is the ratio of imports to consumption), under the combined effect of a rise in demand and a drop in its production (UK, Netherlands), is expected to increase significantly by 2030<sup>1</sup>, reaching 84% compared with the present 57%. It is important to note that EU gas imports come from an oligopoly of suppliers. Russia, Algeria and Norway account for 84% of the gas imported by the EU27 (IEA, 2008-a). The question of supply security is thus once again at the heart of EU energy policy (Helm, 2007). However, this concern is being addressed today in a context that has changed profoundly since the 1990s. Gas market liberalization, and more specifically the introduction of competition in network industries and the desire to create a single European gas market (EU, 2006), have considerably changed the nature of the debate.

### **1.1 Liberalization and gas security: a few of the stakes**

Since the 1970s, gas trading between EU consumer countries and the gas producing countries has been organized on the basis of long-term Take Or Pay (TOP) contracts. Thanks to various clauses in these contracts, risks related to prices and quantities have been shared between buyer and seller. In this respect, they have been an important element in safeguarding the security of EU gas supply. In a competitive liberalized framework, EU gas supply security should be achieved less and less through such contracts. The EU in particular (EU, 2007) considers such contracts to be significant barriers to the entry of potential new suppliers. They slow the development of sufficiently liquid spot markets and as such can be seen as detrimental to the competition policy promoted by the EU (Percebois, 2008, pp.33-53). It would seem difficult for the time being to come up with a precise definition of efficient long-

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<sup>1</sup> According to data published by Eurogas and reported in *Gas Matters*, EU demand for natural gas is expected to rise by 27% between 2007 (505 Gm<sup>3</sup>) and 2020 (642 Gm<sup>3</sup>). At the same time, EU gas production in 2020 will cover only 33% of its consumption compared with 59% at present. Compared with current gas import levels, Europe will have to import an additional 223 Gm<sup>3</sup>. 'Corridors of power – Europe's energy options after the 'August War', *Gas Matters*, October 2008, p. 1-7.

term contracts that could both promote long-term investment and short-term competition (Rious, 2009).

The development of short-term transactions thus has an essential role in EU gas market liberalization. In part these transactions should be structured around spot markets that are sufficiently liquid to enable a reference price to emerge by balancing supply and demand (Holz, von Hirschhausen & Kemfert, 2008). This does not mean that they cannot exist alongside TOP contracts, although the clauses of these contracts will have to be considerably more flexible, in particular where price indexation and contract duration are concerned (Percebois, 2008).

TOP contracts are concluded on a bilateral basis between consumer and producer and therefore are not conducive to the creation of a single gas market, which is needless to say central to Europe's energy policy. The policy promoted by the EU with respect to its internal energy market is thus likely to considerably change its relations with its external suppliers<sup>2</sup>.

## **1.2 The Russian risk**

Today, the energy security stakes for Europe are seen as linked to a great extent with more specific concerns over the "Russian risk". The latter is linked to the market power that Russia might exert on the European market, given the volume of its reserves<sup>3</sup>. But generally speaking, the concern over Russia is that the EU cannot conduct its gas trading relations with this country only on the basis of market principles or more generally the Rule of Law. In such a context, the EU has clearly stated its desire to escape its reliance on Russian gas and the related geopolitical risks (Finon, 2009). Certain EU states (and their gas companies) might disagree with this vision and prefer to develop bilateral relationships with Russia and Gazprom (McGowan, 2007). It is worth noting that in 2007-2008 a few big European gas companies, including E.ON, ENI GDF and OMV, renewed their long-term contracts (25 years) with the Russian gas company in spite of the EU policy (Locatelli, 2008).

### *Russia's market power*

It could be in Russia's interest to adopt an approach based on spot markets and short-term agreements at the expense of long-term contracts in order to find the best balance between prices and volumes. With a slow growth in its gas production and exports, Russia could drive spot prices upwards, a strategy that is impossible with traditional TOP contracts. Oil indexing practised in these contracts removes the ability of any player to influence prices, as well as the incentive to do so (Finon, 2008). With the European upstream gas market decidedly concentrated, D. Finon concludes that "spot markets can easily be distorted by a concentration of market power in the hands of one or more sellers or buyers" (Finon, 2008).

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<sup>2</sup> Another area where a relationship can be established between the EU's internal energy policy and its relations with outside suppliers is the question of unbundling and more specifically ownership unbundling. Numerous European gas companies have expressed their opposition to this standard, which they claim weakens their negotiating power with the gas suppliers. In fact, the gas supply companies, whether Russian or Algerian, remain organized in a monopoly (McGowan, 2007).

<sup>3</sup> Russia's proven reserves are of the order of 43 trillion cubic metres, i.e. 23.4% of world reserves (BP 2009).

Furthermore – and even if this turns out to be a longer-term strategy on account in particular of the nature of the Chinese market (Locatelli-a, 2008, pp. 246-64) and now the US market<sup>4</sup> – Russia might be tempted to put the European, American and Asian markets in competition with one another and make decisions depending on the prices on these different markets (Boussena, Locatelli, 2005, pp. 85-105). This type of strategy would affect Europe's gas supply security.

For some experts (Dasseleer, 2009), in such a context Gazprom's strategies in relation to the EU - its downstream integration in European markets and the increase in export channels to Europe (NorthStream, SouthStream, Locatelli-b, 2008) - are simply a reaffirmation of Russia's power.

### *Impossibility of managing Russian-Europe gas relations according to the Rule of Law*

As well as diversifying its gas supply sources, the EU is trying to manage its energy security and its relations with external suppliers principally by enlarging its market (Glachant, Lévêque & Ranci, 2008, pp.13-18; UE, 2008). The EU's goal is to establish a single regulatory space (standards, rules, etc.) with its suppliers (Belyi, 2009, pp. 117-127); European Council, 2006). This could be the prelude to integration of the EU and Russian energy markets (Haghighi, 2007). In this approach, extending the Rule of Law within an essentially multilateral international system is seen as a mechanism for dealing with the issue of energy security and one that would lead to the creation of a single energy market (Correljé & Van der Linde, 2006, pp. 522-43).

This approach is principally promoted by the Energy Charter Treaty, which is aimed at securing international investments (Estrada, 2006, pp. 3774-86.) and thus guaranteeing international oil company access to producer hydrocarbon resources (Wälde, 2008, pp. 55-97). Through the transit protocol, the implicit aim is also to provide third-party access (TPA) to producer pipeline networks.

It seems clear today that these two objectives conflict directly with the gas policy (and the hydrocarbons policy in general) pursued by Russia, which is strongly opposed to the EU's competitive vision and its accompanying regulation policy (Van Der Meulen, 2009, pp. 833-56). Two obstacles in particular should be mentioned.

The first concerns the way in which Russia allows access to its non-renewable resources. While foreign investment is not totally prohibited, the state maintains tight control over such investment through its increasingly strict regulation of the conditions for awarding exploration and development licenses (Kryukov & Moe, 2008). More generally, Russia's refusal to ratify the Energy Charter Treaty indicates the determination of the authorities not to engage in multilateral relations that would diminish their ability to negotiate preferential bilateral agreements with European partners such as Germany, Italy or France. The notion of reciprocity ("asset exchanges", Belyi, 2009) with the bilateral relations that it requires (Gomart, 2007, pp. 90-106), as well as the notion of security of demand (in response to the security of supply sought by importing countries) are at the heart of Russia's hydrocarbon strategy. The agreement concluded between Gazprom and BASF in 2009 provides an indication of this asset exchange strategy aimed at making Russian upstream access for international firms conditional on Russian companies being able to invest downstream in

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<sup>4</sup> The competitiveness of Shtokman LNG on the US market is by no means guaranteed given the low price of natural gas on US spot markets and the high development costs for Shtokman.

Europe. “Downstream access” is proving to be a central element in the relations that Russia intends to develop with the EU.

The second stumbling block concerns the transit protocol and its implications for Gazprom. Implicitly, under the terms of the transit protocol, the Russian gas company would have to open its gas pipeline network to external suppliers, in particular so that gas can be delivered from Central Asia to Europe, and so that the number of suppliers serving the European market can be increased<sup>5</sup>. However, since 2000, Gazprom’s monopoly over the production and export of Russian gas has gone from strength to strength, preventing in particular any increased competition on the European market. In fact if Gazprom agreed to the principle of TPA, the gas producing countries of Central Asia could use the network to reach the European markets (Seliverstov, 2009).

In such a context, in order to achieve liberalization goals and at the same time address concerns over gas supply security and dependence on Russia, the EU must diversify supply sources considerably (and consequently find new export routes) and ensure that it has excess import capacity (Behrens, 2009). According to the International Energy Agency, one of the factors essential to this security is excess production transmission and storage capacity (IEA, 2008).

## **II – Uncertainties regarding European gas diversification via the Caucasus**

There are several possibilities for diversifying sources and export routes. These include the Middle East, in particular Qatar, MENA countries (Algeria, Egypt, Libya) or the so-called Caspian states (essentially Kazakhstan and Turkmenistan). Following the collapse of the Soviet Union, the Caspian states of Azerbaijan, Kazakhstan and Turkmenistan rapidly emerged as a first choice for the EU for diversifying its gas sources, a strategy favoured by the International Energy Agency and the US government. This region was in fact emerging as a credible alternative to European dependence on OPEC for oil and on Russia for gas (Gomart, 2007-2008; IEA, 1998) and is now an important element of the EU’s gas security policy (Second Strategic Energy Review, EU, 2008).

However, the strategy advocated by the EU (Barroso, 2008) of securing gas supplies from the Caspian and more specifically from Central Asia (Kazakhstan, Turkmenistan) is not without problems. First there is the question of how much gas is available, and second there are issues to be addressed concerning the transport of this gas via the Caucasus, using in particular the projected Nabucco pipeline.

### **2.1 The Caucasus route: gas from Central Asia**

The EU’s decision to diversify its gas supply sources by turning to Central Asia is largely justified by the volume of hydrocarbon reserves in this region. Although precise volumes remain unclear, Kazakhstan and Turkmenistan have sufficient reserves to be able to envisage substantial exports to Europe (cf. Table 1). It can be projected that Kazakhstan’s natural gas

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<sup>5</sup> Kazakhstan and Turkmenistan could be major suppliers for the EU, given their reserves, but the problem of transit routes from these hemmed-in states must first be solved. Russia could be the least costly solution if it opens up its gas pipelines to third party access.



output will be of the order of 61.5 Gm<sup>3</sup> by 2015<sup>6</sup> and Turkmenistan's output should reach 250 Gm<sup>3</sup> by 2030<sup>7</sup>.

**Table 1: Proven natural gas reserves of some Central Asian countries, 2008**

	Proven reserves Gm <sup>3</sup>	Output, Gm <sup>3</sup> /yr	Consumption, Gm <sup>3</sup> /yr
<b>Kazakhstan</b>	1,820	30.2	20.6
<b>Uzbekistan</b>	1,580	62.2	48.7
<b>Turkmenistan</b>	7,940	66.1	19.0
<b>Total</b>	11,340	158.5	88.3

Source: *BP Statistical Review of World Energy*, June 2009

If Europe is to diversify with gas from Central Asia and the Caspian it would seem essential that a fourth gas pipeline corridor be created through the Caucasus. At present, three main corridors are used to deliver gas to Europe from Russia, North Africa (mainly Algeria) and the North Sea (Norway and the UK). This new corridor would thus not only contribute to diversification of supply sources but also provide new export routes, which is one of the objectives promoted by the USA<sup>8</sup>.

*- The Nabucco project*

The principal gas pipeline project<sup>9</sup> envisaged through the Caucasus and supported by the EU is the Nabucco pipeline. It is being developed by OMV (Austria), project leader, BOTAS (Turkey), MOL (Hungary), Bulgargaz (Bulgaria) and Transgaz (Romania), with each company holding a 20% stake (cf. Table 2). This pipeline is intended to supply Europe with gas principally from Turkmenistan and Azerbaijan, but supplies may also come from Kazakhstan, the Middle East, Iran, Iraq and Egypt. Its projected capacity for 2020 is of the order of 30 Gm<sup>3</sup>. Half of the gas transmitted via this pipeline will supply the transit countries, with the rest distributed from the Baumgarten hub (Austria) to the Austrian, German and Italian markets. It is expected to go onstream in 2013 and will require investment of the order of 5 billion euros (at 2004 economic conditions) (AIE, 2008). The construction of additional gas pipelines must be envisaged to make this project credible, in particular the Transcaspien

<sup>6</sup> 'Kazakhstan: Government aims to produce 61.5Bcm by 2015', *Cedigaz News Report*, vol 47, n° 30, 14 October 2008.

<sup>7</sup> 'Turkmenistan plans new state firm', *Argus FSU Energy*, 19 September 2008.

Turkmenistan should then be able to guarantee exports of around 200 Gm<sup>3</sup> of gas. 'Turkménistan : hausse des exports de gaz de 50 Gm<sup>3</sup> en 2007 à 125 Gm<sup>3</sup> in 2015', *Pétrostratégies*, 9 June 2008.

<sup>8</sup> According to T. Gomart, op.cit., the United States "(...) is endeavouring to promote a *multi pipeline diplomacy* in order to diversify export routes by avoiding countries whose regimes they consider to be not very accommodating, such as those of Russia and Iran".

The construction of the BTC oil pipeline (Bakou, Tbilissi, Ceyhan) in 1996 was the first materialisation of this new corridor. With a capacity of 1mbd, for the moment the pipeline essentially transports Azeri oil. In the future (and this is imperative if the pipeline is to be profitable), it will also transport oil from Kazakhstan, whose export capacity will increase considerably once the three large oil fields of Kachagan, Karachaganak and Tengiz reach maximum output.

<sup>9</sup> A second major project is the expansion of the Turkey-Greece-Italy Interconnector (TGII).

under the Caspian Sea, which could carry gas from Turkmenistan as far as the South Caucasus Pipeline (Bakou, Tbilissi, Erzerum) which starts in Azerbaijan.

**Table 2: Principal and potential gas export routes from the Caspian to Europe**

Name	Route	Capacity	Gas sources
<b>Trans-Caspian Gas Pipeline (TCGP): project</b>	Turkmenistan, Azerbaijan (Bakou) via the Caspian then Turkey via Georgia, linked with Nabucco	30 Gm <sup>3</sup> /yr	Kazakhstan-Turkmenistan
<b>South Caucasus Pipeline (SCP): completed in 2007</b>	Azerbaijan (Bakou)-Georgia (Tbilissi) -Turkey (Erzurum)	20 Gm <sup>3</sup> /yr	Azerbaijan (Shah Deniz)
<b>Trans Adriatic Gas Pipeline: projected completion 2011</b>	Greece-Albania-Italy	10-20 Gm <sup>3</sup> /yr	Caspian, Middle East
<b>Greece-Italy Interconnector: projected completion 2012</b>	Greece-Italy	8 Gm <sup>3</sup> /yr	Caspian, Middle East
<b>Nabucco: projected completion 2013</b>	Turkey-EU via Central Europe	30 Gm <sup>3</sup> /yr	Azerbaijan, Kazakhstan, Turkmenistan, Iran

Source: 'Caspian And Central Asian Export Pipelines Assume Aura Of Most Serious Game' *Middle East Economic Survey*, 17 March 2008.

## 2.2 Economic risks of the Caucasus route

Diversification of EU gas supply by importing gas from the Caspian and using a corridor through the Caucasus is not without a certain number of constraints and economic risks, which will have an impact on the feasibility of the Nabucco project.

### - Availability of gas supplies

The first uncertainty concerns the actual volume of the reserves or at the very least the capability of these countries to start production of their reserves at the required rate. None of the three countries bordering the Caspian (Azerbaijan, Kazakhstan and Turkmenistan) has even 2% of world gas reserves. However, it is essentially Turkmenistan, and possibly Kazakhstan, (cf. Table 1) that have sufficient resources to guarantee long-term supplies and justify gas pipelines over such a long distance. But these two countries continue to be plagued by serious legal and fiscal instability, which could result in serious delays in the start of production. Disputes between international oil companies and the Kazakh State over the production sharing agreements (signed in the 1990s) and the Kashagan field bear witness to the tensions in this region<sup>10</sup>.

The second uncertainty concerns the availability of Turkmen gas. The possibility of supplying Europe with gas from Turkmenistan is still a long way from reality because of the obstacles to

<sup>10</sup> The experience of ENI concerning the Kashagan field (Kazakhstan) is a case in point. There have been repeated delays in the start of commercial production, originally planned for 2005, and now further postponed until 2012-2013 at the earliest. For more information on this point see Boussena, S., Pauwels, J-P., Locatelli, C. & Swartenbroekx, C., 2006. Kazakhstan is also in the process of adopting a new subsoil law. This could modify the existing production sharing agreements. 'Kazakhstan Warns oil Majors Over New Taxes', *Petroleum Intelligence Weekly*, February 8, 2010.

the construction of the trans-Caspian pipeline. This pipeline appears to be more or less essential to give credibility to an option for carrying gas to Europe via the Caucasus because of the landlocked nature of these countries. The current tensions between Azerbaijan and Turkmenistan cast serious doubts on the completion of this project. These tensions are standing in the way of any agreement being reached by neighbouring states on the status of the Caspian (lake or sea?)<sup>11</sup>.

A third major constraint as far as EU gas supply is concerned is that the Central Asian countries clearly have other markets to which they can export their gas, and Europe will be in direct competition with these markets for their supplies. Compared with the situation in the 1990s, the producing states in the region (Azerbaijan, Kazakhstan and Turkmenistan) have reappraised and noticeably modified their objectives, with regard not only to markets but also export routes, both of which they intend to diversify<sup>12</sup>. Two major regions offering potential alternative markets to Europe and that are attractive from the point of view of their geographical proximity are Russia (Stern, 2005) and Asia. China, India, Pakistan are destined to become big importers of natural gas (Peimani, 2001; Stern, 2008).

The materialization of certain gas pipeline projects, mainly to China from Kazakhstan and Turkmenistan, suggests that in the future significant volumes will be exported to this region<sup>13</sup>, not least because Chinese requirements could increase significantly. To take advantage of this market, plans are under way for the Central Asia Gas Pipeline (CAGP), a huge gas pipeline network linking Turkmenistan to China via Kazakhstan and Uzbekistan (Alba-Saunal, 2009). There is also the possibility of Turkmenistan exporting its gas to India and Pakistan, in this case via a route passing through Afghanistan (cf. Table 3).

**Table 3: Central Asia Gas Pipeline project**

<b>Kazakh section: Uzbekistan-China:</b> (length 1,300 km): Capacity of 4.5 Gm <sup>3</sup> /yr for the 1 <sup>st</sup> phase, reaching 40 Gm <sup>3</sup> /yr by 2013
<b>Turkmen section: Turkmenistan-Uzbekistan</b> (length 188 km): export capacity 30 Gm <sup>3</sup> /yr, end of 2009
<b>Uzbek section: Uzbekistan-Kazakhstan</b> (length 530 km): export capacity 30Gm <sup>3</sup> /yr by 2010.
Different projects between Turkmenistan and Pakistan via Afghanistan (possibly even India) have been discussed since the 1990s, including the <b>Trans-Afghan</b> and the <b>CentGas pipelines</b> . The Transafghan would have a capacity of 30 Gm <sup>3</sup> /yr and a length of 1,680 km. But with the political tensions in the region, notably in Afghanistan, it is difficult to see how these projects could come to fruition in the short term.

Sources: Alba-Saunal, (2009); Brill Olcott, (2006), p. 202-233.

<sup>11</sup> Until agreement is reached on the legal status of the Caspian (sea or lake) there is little likelihood of any investments being committed for the construction of the trans-Caspian gas pipeline. Today there are serious tensions between Azerbaijan and Turkmenistan concerning territorial water limits and consequently the ownership of certain reserves in the Caspian. Disputes concern in particular the Sedar/Kyapaz fields but also those of Chirag and Azeri. 'Caspian row reignites', *Argus FSU Energy*, Vol XIV, 31 July 2009.

<sup>12</sup> Thus, according to the Azeri Energy Minister, N. Aliiev, Azerbaijan has a number of possible export routes for its gas. In addition to the projected Nabucco pipeline, on there is the interconnector between Turkey, Greece and Italy (ITGI), the Trans-Adriatic gas pipeline and the Russian route (Tsakiris, 2009).

<sup>13</sup> Under a long-term contract (30 years), Turkmenistan will start exporting gas to China in 2009 (Chinese CNPC). Under a short-term contract, China could import an additional 10 Gm<sup>3</sup> from Turkmenistan. 'Gazprom woos Turkmenistan', *Argus FSU Energy*, 1<sup>st</sup> August 2008, p. 4.

Russia is also clearly an important market for gas from Kazakhstan and Turkmenistan, and even Azerbaijan (Babali, 2009, pp. 1298-1308)<sup>14</sup>. The volumes are significant for Turkmenistan, with deliveries possibly exceeding 30 Gm<sup>3</sup> by 2012-2018<sup>15</sup>. Supply contracts are accompanied by agreements to improve and extend the gas pipeline system between Turkmenistan and Russia via Uzbekistan and Kazakhstan<sup>16</sup>, and to construct the Caspian pipeline along the Caspian Sea (Kazantsev, 2008, pp.1073-1088). Agreements of this kind suggest that Russia intends to use this strategy as a long-term variable in its hydrocarbons policy.

In these complex relationships, Russia is proving to be a key player. Its hydrocarbons policy is likely to have a big influence on gas relations in Central Asia (Boussena & al., 2006; Ericson, 2009, pp. 28-57). On the one hand, Russia is attempting to control and even limit competition on the European market from Kazakhstan and Turkmenistan through a policy of contracting gas from the Caspian (Stern, 2005) and setting up a pipeline system (the SouthStream) to compete with Nabucco. On the other hand, by agreeing to normalize its relations with the Central Asian countries, Russia is making its market more attractive since it will be profitable (Locatelli, 2008). Gazprom has agreed to pay a “European price” for gas it imports from Central Asia, finally putting an end to the bartering system inherited from the Soviet Union<sup>17</sup>.

In light of these factors, the main constraint affecting the fourth gas corridor to supply the EU, and in particular the Nabucco project, would seem to be the source of the gas that will feed the pipelines. In his report on EU energy security, Claude Mandil, former head of the IEA, pointed out that this gas pipeline could secure provision of no more than 20 Gm<sup>3</sup>/yr of Azeri and Turkmen gas<sup>18</sup> and concluded that: “this is not sufficient to warrant such a huge investment. Nabucco will now only be built if it is supplied with Russian or Iranian gas or both” (Mandil, 2008). In view of what is happening with Iran, it is unlikely that in the short term Europe will resort to such a solution.

#### - The EU new rules

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<sup>14</sup> Gas from Shakh Deniz will be the main source for Nabucco but Gazprom is negotiating a long-term contract with Socar. ‘Gazprom signs Azeri agreement’, *Argus FSU Energy*, 16 October 2009.

<sup>15</sup> In accordance with the agreement concluded in 2003, Turkmenistan supplied Russia with 45 Gm<sup>3</sup> of natural gas in 2008. However, because of the economic crisis, Russia will be reducing gas imports from Turkmenistan. For 2010, imports from this country are not expected to exceed 7 Gm<sup>3</sup>. ‘Turkmen gas returns to Russia’, *Argus FSU Energy*, January 2010.

<sup>16</sup> The aim is to increase the capacity of this system from 45-55 Gm<sup>3</sup>/yr to 90 Gm<sup>3</sup>/yr (Alba Saunal, 2009).

<sup>17</sup> Throughout the 1990s, Russia purchased Turkmen gas partly through swap arrangements and partly through monetary payment. M. Brill Olcott underlines the difficulty of estimating the real price of gas in such a system, given the opaque nature of barter transactions (Brill Olcott, 2006). The new system now in place could result in substantial price increases (between 60 and 70% for Kazakh gas from 2009, according to *Petroleum Economist*, May 2008).

<sup>18</sup> In the case of Turkmenistan, this country is already under contract to deliver certain volumes to China and Russia, and it is unlikely in the short and medium term that it will have any sizeable quantities left for delivery to Europe. Simply to honour its contractual commitments with these two countries, it will need to increase output by over 50% by 2010. ‘Ashgabat prepares for China gas exports’, *Argus FSU Energy*, 21 August 2009.

In the framework of the EU's gas market liberalization policy, the profitability and feasibility of long-distance gas pipelines are in question since the rules on ownership unbundling and third party access (TPA) to networks will likely affect the investment choices of gas firms. This concerns renewing and increasing existing transport capacities (Dorigoni & Pontoni, 2008). In particular, it is difficult to imagine that gas firms might commit themselves to investing in long distance gas pipelines unless at the same time they have reserved transport capacities in the pipelines that are built. In the case of ownership unbundling, since vertical integration (in this case between producer and transporter) will be legally impossible in the EU, if a supplier is not directly involved by holding a stake in the gas pipelines there would be an iterative process between allocation of transport capacity and ensuring security of supplies, which could complicate – and even considerably delay - decision making (IEA, 2008-b). With this in mind, the projected Nabucco pipeline would be given a certain number of exemptions in order to alleviate these problems, indicating the strong support that the EU intends to give to this project.

Finally, security of transit remains an ongoing problem in regions marked by profound political instability. This instability is a result of tensions between former Soviet-bloc countries and the outside influence of certain countries such as Russia, the US, China and Turkey (Yenikeyeff, 2008). These actors could upset balance of power established in the region (Kazantsev, 2008). The conflict between Georgia and Russia in August 2008 confirmed doubts as to the stability and security of a fourth gas corridor via the Caucasus (Winrow, 2009).

### **Conclusion: Should the Russian risk be put more into perspective?**

Supplying Europe with gas from Central Asia via the Caucasus corridor has its weaknesses and limits. New trading configurations could result from the political instability in the countries of this gas corridor. It has long been felt that competition would develop between Russia and the Caspian to supply gas to Europe. Recent events and also the basic principles of economics have shown that the options are more open and no doubt more complex. First, the European market could find itself competing with the Asian market but also the Russian market for gas supplies from Central Asia. At the same time, Russia's aim to diversify its export markets could lead to competition between Europe and Asia for natural gas supplies from this country. Without doubt, these different scenarios represent long-term options, given that the necessary infrastructures would have to be put in place, but they can in no way be discounted. In any event, configurations such as these can pose problems in terms of the EU's gas supply diversification objectives and thus its supply security in a liberalized market. This policy of diversifying supply with gas from Central Asia raises the broader question of relations between the EU and Russia and the renegotiation of a strategic partnership between the two regions.

From this point of view, the Russian risk must undoubtedly be put into perspective. While the EU may well be dependent on Russia for its gas supplies, Russia is just as much dependent on the EU. Europe is, and will remain in the short term, the only profitable export market for Russian gas. While Russia has indeed made known its desire to diversify its markets, any strategies it might have are for the time being merely long-term, given the current state of the gas market. Relations are therefore characterized by interdependence rather than dependence. Furthermore, Russia's declared preference for maintaining long-term contracts severely limits its possibilities of exerting market power. As regards Russia's intentions to gain a foothold downstream in the European markets, this is a familiar strategy in an industrial economy

when a supplier, having to face up to the liberalization of its market, is intent on preserving its market share (Locatelli, 2008).

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