

ENERGY AND THE G8

Sacha Kumaria

ENERGETIC ISSUES

Europe needs to develop a deal with Russia over its energy supplies, and what better moment than the G8 summit? But the continent is far from united on the issue, which raises uncomfortable questions of authoritarianism, nationalism and free markets.

BY JULY 15, WHEN THE G8 IS SCHEDULED TO MEET IN ST PETERSBURG, Russian President Vladimir Putin will have overcome two recent embarrassing issues. The furore surrounding the re-election of President Aleksandr Lukashenko in Belarus is likely to have dissipated, and with Europe reaching its hottest time of year, demand for gas will be at its lowest. This is a good moment for the Kremlin to discuss energy issues with its European trading partners, who lack a common position. As a result of European Commission policy they are embroiled in lawsuits seeking the liberalisation of their domestic markets. Yet Putin would be foolish to believe that Europe has forgotten the events of the colder months.

Gas Shock

Gas prices had been creeping up for weeks before Russia drew attention to the issue in late December by cutting supplies

to Ukraine, and several other neighbouring eastern European nations. Moscow maintained throughout that the row was purely a commercial dispute between Gazprom, the state-owned energy giant, and Kiev. For years Ukraine had, Gazprom claimed not unreasonably, been receiving highly subsidised gas at below market rates – around \$50 per thousand cubic metres. The revaluation – to \$230 per thousand cubic metres – that led to the shortage was therefore simply a ‘market adjustment.’

Yet few in the international community believed such a price hike could have been undertaken without the agreement of the Kremlin. After all, vastly subsidised exports to Belarus, a staunch Russian ally, were unaffected – though they have since been threatened. And many were convinced the move was belated punishment for the democratic victory of Ukraine’s pro-western President Victor Yushchenko a year earlier.

The United States State Department issued a release stating that the incident ‘raises serious questions about the use of energy to exert political pressure’, and Germany threatened to reconsider further energy imports from Russia unless it could demonstrate itself to be a responsible supplier. In the face of growing political pressure, Gazprom recanted, increasing supplies within days to its eastern European customers. Russian Deputy Foreign Minister Grigory Karasin, with considerable understatement, described the episode as ‘inelegant’.

Diplomatic overtures were successful in the short term. Supplies were restored, gas prices have stabilised – though this is partially the result of warmer weather – and work is progressing on a pipeline that will link the Shtokman gas field in the Russian sector of the Arctic sea with north-eastern Germany via St Petersburg.

But the gas shock brought the issue of the continent’s geopolitical predicament into sharp focus – Europe is inextricably dependent on Russia for its energy in the medium to



SACHA KUMARIA is Assistant Director of the Stockholm Network, a pan-European network of market-oriented think-tanks.



long term. It purchases nearly thirty percent of its natural gas and one-third of its oil from Russia, and demand for both is predicted to rise. Europe, and particularly the European Union, which is now aggressively pursuing a common energy policy, must develop a framework within which to negotiate with Moscow.

Thawing

During the Cold War, western European states feared that increasing their reliance on Russian gas imports would leave them vulnerable to Soviet blackmail. With the explicit support of the US, they limited imports to a third of their domestic consumption. Yet even at the heights of tension – for example during Poland's withdrawal from the Warsaw Pact – the subsidised price and flow of gas was maintained. The Kremlin never succumbed to the temptation to politicise its energy policy – the vast revenues it received for gas exports weighing heavily on thinking. American fears of the slow colonisation of Europe through energy dependency were not realised.

Once glasnost and perestroika gave way to the vast 'privatisations' of the former Soviet energy infrastructure in the mid-1990s, the threat was thought to have dissipated entirely. Because of the potential riches of its vast hinterland, massive foreign direct investment followed – halted only briefly by the economic crisis in 1998.

BP has been involved in Russia since 1990, and as recently as late 2004, with the explicit blessing of Putin, ConocoPhillips, an American oil firm, invested two billion dollars in the purchase of Lukoil, a former state-owned firm.

Recent years have seen the curtailment of political freedoms

under Putin, most prominently in the case of Mikhail Khordokhovsky, an oligarch who broke the implicit agreement with the Kremlin to stay out of politics. Following his support for several political parties, his oil firm, Yukos, found itself with an unpayable bill for back taxes, and Khodorkovsky was duly sentenced to eight years in a Siberian labour camp. Yukos, meanwhile, was broken up and sold off in what Andrei Illarionov, then Putin's economic advisor, believes was 'the swindle of the century'.

Unsurprisingly, politicised expropriation on this scale, combined with still stringent laws over foreign ownership, has largely dissuaded overseas investors from supporting the further development of Russia's Soviet-era oil and gas infrastructure. The International Energy Agency (IEA) estimates that to meet European demand Russia needs to invest eleven billion dollars per year until 2030 – mostly in gas production and transport.

Western governments are also aware of the destruction in January of the two pipelines from Russia that supply Georgia's gas. The Baltic states too have claimed sustained interference in their energy supplies, and Poland is furious that the new German-Russian gas pipeline will bypass it.

It is under this cloud that Russia has assumed chairmanship of the G8 ahead of the St Petersburg summit. The European nations – Britain, France, Germany and Italy – and the EU representatives must recognise the underlying causes for concern at home.

An Old Ally

The geopolitical calculus has changed dramatically since the days of NATO-Soviet détente, but the economics has not. With

European nations attempting, through intra-governmental dialogue and at Commission level, to devise a common energy policy in relation to Russia, they would do well to consider the importance of US support.

Washington has considerable interest in maintaining Europe's position as Russia's privileged gas purchaser because of deepening energy links between Moscow and Beijing. In mid-March, Gazprom announced plans to build two new natural gas pipelines with a total capacity double that of China's domestic consumption in 2004. The ten billion dollar project, however, has been criticised by the IEA, which does not believe Russia will be able to meet this new demand once the pipelines begin operating in 2011, without compromising existing commitments to Europe. The US is watching this development with concern and will seek to buttress the European position.

As a result, the EU is likely to gain support for pressing Russia to ratify the 1994 Energy Charter Treaty, which would allow the shipment of Caspian and Central Asian oil and gas through nationalised pipelines to the European market. Russia, having refused to ratify the Treaty since it signed it in the early 1990s, has been unwilling to sacrifice the geopolitical sway that this monopoly distributor position provides.

In April domestic developments in Russia led Illarionov to brand the summit a 'huge disappointment'. He believes Russia's presence in the G8 is economically unjustified, and that its membership legitimises the Kremlin's increasingly authoritarian rule – a sentiment privately shared in many western capitals.

And from a European perspective, it is difficult to disagree with his analysis that 'the best way to secure energy security is to have a free market...that's exactly the opposite of what is happening in Russia.' Yet the absence of a true free market for energy within the EU itself is a problem of similar proportions.

Liberalise

Historically, Europe has always regarded energy policy as the sovereign preserve of national governments. At moments of crisis, most notably the 1973 Arab oil embargos, Britain and France preferred to pursue bilateral arrangements with their suppliers rather than a unified European response. But as national governments began to realise this approach was ineffective, in September 1974 the Council of Ministers adopted a programme drawn up by the European Commission called Towards a New Energy Policy Strategy. This has underpinned much subsequent dialogue on European energy issues.

Tensions are now rising in the EU over energy policy. In early April, EU Energy Commissioner Andrei Piebalgs began fifty legal proceedings against sixteen member states for inadequately implementing existing EU directives designed to liberalise domestic

International Events June 2006

JUNE 2

Parliamentary elections in the Czech Republic.

JUNE 20

Iraq National Reconciliation Conference.

JUNE 26

UN conference on control of small arms.

JUNE 30

Sixtieth anniversary of first nuclear bomb explosion on Bikini Atoll in the Pacific.

INFORMATION FROM FENS, THE FUTURE EVENTS NEWS SERVICE: WWW.FENS.COM

energy markets by July next year.

Britain is a leader, having privatised its energy producers in 1990. Yet certain states, such as Germany and France, have long histories of minimal compliance with EU directives, and have largely focused on building the national champions that now compete powerfully in foreign markets. France's EDF, for example, not only controls 86 percent of its domestic market, but is also the second biggest energy firm in Britain, the third largest in Germany, and the second largest electricity – and third largest gas – supplier in Italy.

As a consequence, Competition Commissioner Neelie Kroes is also preparing to tackle the monopolistic practices of Europe's largest energy conglomerates. This spate of activity is a response to the largely unproductive dialogue between member states attempting to protect their own interests.

The French government recently engineered a merger between two domestic giants, Suez and Gaz de France, to prevent the hostile takeover of the latter by ENEL, an Italian firm. Similarly, Madrid is attempting to block a massive \$28 billion bid from Germany's E.ON for its national champion, Endesa.

Such moves are explicitly contrary to the European single market, and indeed, prices for energy still vary by as much as a hundred percent within the EU. Yet, at least in the short term, these lawsuits, and broader calls for reform, make pan-European cooperation more difficult.

The French government, beset by protests, is facing a difficult election next year, and Italy's new centre-left government may not wish to pursue difficult privatisations, though Prime Minister Romano Prodi, former President of the Commission, is an avowed Europhile. Similarly, Germany's grand coalition may not be willing to risk its future to reform and liberalise its complex

internal energy market.

Recent discussions have reinforced these narrow nationalist positions, with member states rejecting the idea of a common energy regulator. Yet ironically, they were favourably disposed towards the proposal for a common external energy policy. The difficulty, as Commission President José Manuel Barroso recognised when he reiterated that 'nationalist rhetoric will lead the European Union nowhere', is to make national leaders understand that Europe's energy security is, at root, an economic issue, and it would be in their interests to de-politicise it as far as possible.

History shows that nationalised industries are not a viable long-term model, that market liberalisation and integration will best provide both cheaper energy for consumers and greater security overall, and that if Europe is to face down Russia once again, it must recognise and unify behind a common purpose.

Chatham House Events June 2006

JUNE 5 What Terrorists Want

Dr Louise Richardson, Harvard University

JUNE 12 Revive Arms Control and Disarmament

Dr Hans Blix, Director-General Emeritus IAEA

JUNE 14 Iran's Nuclear Weapons Programme

Dr Jack Caravelli, former National Security Council, Non-Proliferation Director

JUNE 21 Democracy and Security in Africa

Lord Triesman, Foreign and Commonwealth Office

JUNE 29 America at Home, America Abroad

Robert Tuttle, Ambassador of the United States

Chatham House has a worldwide reputation for furthering the understanding of international issues.

An impartial research and membership organisation, independent of government and vested interests, it brings together people of all nationalities and from all walks of life.

Membership: +44 (0) 20 7957 5721

Meetings: +44 (0) 20 7957 5732

Conferences: +44 (0) 20 7957 5754

e-mail: contact@chathamhouse.org.uk