



## The End of the Pipeline Saga? Southern Corridor and South Stream in the Making

### EVENT REPORT<sup>1</sup>

The conference entitled “The End of the Pipeline Saga? Southern Corridor and South Stream in the Making” took place on October, 4, 2013, at Central European University (CEU), Budapest, organized by the Center for EU Enlargement Studies (CENS) with the kind support of OVB Vermögensberatung.

### Opening Session

The event was opened by **Mr. John Shattuck (CEU President and Rector)**, who welcomed the conference participants at CEU by emphasizing the importance and relevance of the topic to be discussed and also the broader implications of energy security. He stressed the suitability of CEU to host this conference provided its international community and special interest it has in the outcome of the Saga.



The first keynote speaker, **Mr. Péter Hónig (former Minister of Telecommunication, Transportation and Energy of Hungary)** pointed to the fact that transmission capacity being increased in Europe, but without the increase of the quantity of the product, translates either to losses of investment or to the commodity becoming more expensive. He supported the view that gas consumption in the EU countries will not increase significantly in the coming years, thus there is a possibility that the product will become more expensive. Today with Nabucco being stopped and investments of Azeri and Russian concern steadily

---

<sup>1</sup> The event report was prepared by *Mariya Lazarova*, intern at the Center for EU Enlargement Studies, MA candidate in International Relations and European Studies at the Central European University. The views expressed in the event report are those of the respective speakers and they do not necessarily represent the views of CEU and CENS.

increasing, how gas prices and gas transportation will change with the construction of the new pipelines is a matter of a complex debate.

Politicians, in order to secure votes, constantly try to reduce energy prices using various tools, which makes investors undertake more careful, shorter term, approaches. They now prefer solutions which bring quick results usually reducing their operating and maintenance costs. Mr. Hónig also emphasized, in the case of a single pipeline, quality of regulatory measures has to be based on equal requirements. He concluded by expressing the belief that his view, that Hungary should support both South Stream and Nabucco, will be supported in the conference.

After Mr. Hónig, **Mr. Reha Aykul Muratoglu (Head of Department for Transit Petroleum Pipelines, Ministry of Energy and Natural Resources)** took the floor. He began by outlining Turkey's very good location among countries with rich resources of gas and oil and big consumer markets. Turkey has diversified sources of supplies and its primary energy policy goal is to enhance energy supply security by developing a reliable, timely and cost-effective provision of energy. This is in line with the overarching aim to function as a regional transit country. Mr. Muratoglu spent the second half of his speech giving an overview of on-going agreements between Turkey and various other important energy actors – Greece-Italy, Azerbaijan, Iraq, Turkmenistan and Iran. He emphasized that although usually it is time-consuming and difficult (for example, Iraq – energy security issue, impossible to start transportations without a secure environment; Iran – depends on political conditions, on the possible integration of Iran in the international community) to finalize these agreements, they are very beneficial and of great importance to Turkey.

## **Panel I. The European gas market through the producers' glance**

The first panel of the conference, chaired by **Mr. Christoph van Agt (Senior Researcher at the Clingendael Institute, the Netherlands)** discussed how producers see the European gas market in the coming years and what developments they expect to take place.



The first speaker of the panel, **Mr. László Varró (Head of Gas, Coal and Power Division, IEA, France)** assessed Europe's attractiveness for new gas supplies as well as the future possible energy market trends. Mr. Varró outlined the increasing importance of China in the

developing energy market with its astonishing gas consumptions, its willingness to sign long-term contracts and to sign contracts for higher prices than in Europe. He also mentioned that North America has a substantial gas price advantage versus Europe, while coal prices are roughly the same. Additional good news for the European gas industry is that nuclear power is unlikely to keep its position in Europe – now it makes up for about 1/3 of electricity consumption but faces growing difficulties. There are also obstacles for shale development, as there is political and social resistance to fracturing in Europe because of fears that it has been done unsafely. However, expectations of EU gas fired power generation has significantly decreased since 2007 – mainly because of the impact of the Eurozone crisis, of renewable policies (smart technologies – wind/solar energy - effectively constrain gas demand), and of unfavorable spark-spreads.

Solid reform and structural change is needed to restore the competitiveness of gas on the energy market because so far gas plant utilization remains below the level expected at the time of investment. Higher gas consumption should not be an EC policy objective on its own but rather the aim should be a much more cost-efficient energy policy in Europe, which also depends on developments outside Europe.

Next, **Mr. Andrey Konoplyanik (Adviser, Gazpromexport, Russia)** commented that the European energy market is not limited to the EU and we should try to go beyond the “EU consumers – non-EU producers” dichotomy. He identified a couple major factors of change that led to diversification efforts thorough Europe. As demand is going down and supply is going up, domino effects can be expected to spur by over-supply in the market. In 2009, the Third Energy Package changed the EU gas market by altering the mechanism of capacity allocation. However, today we face a completely different situation in which transition will take some time as development of EU gas market now is much more uncertain and unclear. As Mr. Konoplyanik identified, the Russia-Ukraine gas crises between 2006 and 2009 demonstrated the risk of only having one set of rules, without having any alternatives. This is what justifies the development of alternative pipelines.

These crises led to the re-thinking of the whole system by the supplier (Russia), the transit state (Ukraine) and the consumer (EU) all of which responded with one and the same answer: diversification. The EU realized the importance of moving away from the strong dependence on Russian suppliers, of the need to have more suppliers and reserves (alternatives to cover demands) in order to substitute absence of supply. Ukraine resorted to diversification in order to diminish reliance on the single supplier by trying to increase domestic production, to substitute gas with coal or develop shale gas. Russia re-assessed its methods and also found the answer in diversification – developing new pipelines crossing other transit countries to reach major markets in Europe.

Mr. Konoplyanik continued his talk with a comparison of two different models of developing infrastructure – Nabucco and South Stream. Nabucco failed, he argued, because of the lack of capacity – no commitment, shippers not willing and/or not ready to initiate the transfers. In contrast, in the case of South Stream shippers were willing to deliver this commitment. Mr. Konoplyanik called for finding mutual compromise, reduction of political and institutional conflicts between producer and consumer so that South Stream can be developed according to the Third Energy Package rules.

**Mr. Nikolay Kaveshnikov (Head of Department of European Integration Studies, MGIMO, Russia)** took the floor and commenced with outlining the Russian energy policy

with an emphasis on its external priorities. As crucial priorities for future development, he identified the Russian energy sector's need for foreign investment and to increase energy efficiency. Mr. Kaveshnikov also stressed Russia's strategic interest in keeping the EU market share and maximize profit, because the EU is a big, predictable consumer, respects the rules (and also can challenge them) and pays adequate price (at least used to).

Although diversification is among the aims of Russia's external energy policy, especially to the East, it is rather limited at the moment as he predicts no more than 20% of total export to be to the East, while the significant market remains Europe. An even more difficult priority is diversification in the sense of not selling only oil, but oil products; not only gas, but energy. Among the external priorities of Russia's energy strategy is to provide a stable and economically affordable transit – thus, the decision to build two pipelines (North and South Stream) is not only an economic decision, but one tailored to keep security of supply, to increase security of transit. This is not only in Gazprom's interest, but also in the consumers'.

Mr. Kaveshnikov expressed the view that there is a shift in the balance between liberalization and security in the EU – while the main approach during the 1990s was liberalization (idea that security will be provided by the markets), in the last decade energy security started to attract more attention in Brussels. Special measures have been taken to maintain energy security with the ultimate goal of energy policy now being security, with liberalization only the means to reach this. As for EU-Russia relations, he stated that there are a lot of controversial rules, legislations and investment protection agreements with no mutually agreed set of rules. From now on, there are two strategic options for those relations. The bad one being Gazprom and EU starting to act on a basis of simple trade: no stability and predictability of demand, Gazprom not investing more and if there is an increase in demand, it is the consumers' problem and not Gazprom's. The good one is to maintain existing partnership, to take into account the interests of all actors in the system, and to perceive Russia and the EU as the two sides of one big system.

The next speaker, **Mr. Ingilab Ahmadov (Dean of the School of Economics and Management, Khazar University, Azerbaijan)** agreed that the EU is an attractive, useful, reliable and promising market which is unique in terms of perspective of gas demand. However, he added that the EU is also a difficult partner – tough negotiations are needed as it is not a completely united entity. As Azerbaijan has the typical producer's concern – long-term contracts – there is an issue for the producer to find real investment partners who are ready to pay for all risks. The competitiveness in the European market (Russia, Middle East, Norway) brings a lot of uncertainty.

As the single player in Azerbaijan – the state oil company – is relatively young, it is very important for the country to have reliable partners in order to have a long-term gas market for future developments. Although it has good inter-regional negotiation relations, the problem it faces is how to minimize risks – i.e. who must face financial risk when it is going to supply Europe with gas, who will pay for the transportation corridor, etc. Mr. Ahmadov stresses the importance of the Caspian region participation in Europe as being an alternative to Russia in terms of gas supply, but is currently skeptical about a Trans-Caspian Pipeline as it is very difficult to organize cooperation when Azerbaijan and Turkmenistan are typical competitors in the gas market and have disputes over the Caspian Sea.

## Panel II. The economics of new supply in Southern Europe

This panel sought to address the possibilities that may emerge from a different market situation in Europe, as highlighted by the chair, **Mr. András Deák (Associate Fellow, Hungarian Institute of International Affairs, Hungary)**. He also touched upon the limits of analyzing energy market only from an economic point of view and stressed the presence of a high number of small and fragmented markets, for example the Balkans, which pose big questions about macroeconomic sustainability, security of supply and about whether these investments and costly infrastructure are really justified.



**Mr. István Zsoldos (Chief Economist, MOL Group, Hungary)** put forward the radical statement that “The EU could live without Russian gas imports, but Russia could not without gas exports” as Russia, having to choose between quantity or a price, chose the former and thus now it cannot afford to reduce quantity massively. He argued for an integrated European market rather than everybody finding their own resources. He identified the “security of supply” as being in a position that a gas cut-off for you also means a gas cut-off for the rest of the EU. Mr. Zsoldos also argued that South-East Europe does not need its own sources, but it does need to be “interconnected” for which it needs the necessary infrastructure, with the only additional pipeline investment would be to build an interconnector to Zeebrugge.

Mr. Zsoldos identified the gas market as a separate market in Europe with coal as its possible bottom. Although there is room of energy price to go down, he does not expect any large change in price levels (currently Gazprom prices are not that low). He highlighted that the value of the gas is actually in the transport infrastructure thus special attention should be paid to it.

The next speaker in the panel was **Mr. Haris Boko (Chief Advisor at the Energy Institute Hrvoje Pozar, Croatia)**, who referred to the infrastructure as “a kind of clothing,” which leaves the essence hidden. According to him, allocation of resources is crucial in order for the system to function properly. He referred to the power-mix of today – ½ fossil fuels and the rest nuclear energy and renewable sources – suggesting that it is desirable to keep the renewables, but to reduce slightly the share of nuclear and fossil fuels. Mr. Boko

highlighted the crucial importance of collaborating better and communicating more in order to save a lot. If there is coordination within the system, if we are demand-responsible (smart usage of energy), there is a great chance for the costs to be reduced. For Mr. Boko energy efficiency is a very important and cheap source of additional power – we need to start using energy actively, rather than passively for a fundamental and structural change to come about. He also emphasized the significance of having a common plan for the interests of Europe that identifies which projects are of fundamental importance.

The last speaker in the second panel was **Mr. Ilin Stanev (Journalist and Energy Expert, Capital, Bulgaria)** touched upon the smaller trends and the macro markets. He said that Bulgaria is a very small market, not an interesting destination for investors, but it becomes interesting when adding Turkey and conceiving it as a part of an integrated market. He reminded that the big expectation of the market is Turkey and Turkey always fulfills the expectations.

He also referred to the decline of consumption of gas in the region due to the increase in gas prices – not a big drop so far, but an identifiable tendency. As all countries in the region are dependent on Russian gas, the issue of diversification is very important and the necessity of new rules can be felt. Integration of markets, in theory, is very plausible as the countries are well connected, but in practice there are some issues arising. As an example Mr. Stanev referred to the Bulgaria-Romania interconnector being built now through which gas can only flow from Bulgaria to Romania, when actually Romania is a big producer and it is Bulgaria that needs more gas.

Newer forecasts show that demand in Europe is falling thus Gazprom will definitely face a much more difficult market situation. Mr. Stanev expects a lot of competition during the next 5-6 years for relatively small markets. There are new discoveries of off-shore gas in the region, which, combined with the big reserves in the Mediterranean, are huge. There are still some projects to connect Bulgaria and Turkey through an interconnector as the Bulgarian network has a big underutilized capacity and also a potential to be used as a transport route.

He also reminded that Bulgaria has a troubled history with common projects with Russia (not least the disputed building of the nuclear power plant, Belene), thus the government is hesitant to invest even more in a common project with Russia. The building of the South Stream was supposed to start in Bulgaria by the end of September or early October, but as of October 4, 2013, there are no prospects to begin construction before the beginning of the next year. The financial model of the project is not done yet, and consequently there is no base to calculate the transit fees or the profitability. However, Mr. Stanev concluded his overview by stressing the need for such a small market for diversification, connectivity and for South Stream (with regional projects seen as complementary, not contradictory).

### **Panel III.**

#### **Is the rivalry over? Political aspects of the new pipelines**

The third, and last, panel of the conference was chaired by **Mr. Andrej Nosko (Senior Program Officer at Think Tank Fund, Open Society Foundations)**, who welcomed the opportunity to integrate politics and pipelines. He underlined the need of more domestic



interconnectors so that we can achieve an integrated EU energy market as we are far from one now – with prices that are paid differing among Member States.



**Ms. Ana Otilia Nutu (Expert Forum, Romania)** identified as a main problem the internal division of Europe’s energy market, despite some improvements. There is evidence about a resilience tendency in some Member States to implement EU policies, with a majority of them infringed according to the Second Package. Member States should understand the importance of an integrated energy market and true competition without which there could be no common stance. Since large projects are very difficult to implement, Member States have to have similar policies as well as their confidence in the EU should be increased.

She gave the example of Romania, which also has issues with implementing EU legislation because of vested interests, and called for a greater competition and transparency. There is a powerful incentive for Romania not to implement foreign energy policy (Third Energy Package) in order not to liberalize and to ensure cheap energy supply to its people.

The next speaker was **Mr. Elnur Soltanov (Assistant Professor, ADA, Azerbaijan)** shifted the focus of the debate from the EU towards the Caspian region. He identified two stages in Azerbaijan’s energy diplomacy – first, in the 1990s, diplomacy was serving energy, then in the 2000s, energy was serving diplomacy. However, Mr. Soltanov highlighted that energy policy per se was not the purpose, but rather it was used for consolidation of sovereignty. Using the resources as a means for consolidation of sovereignty was also the main and most important aspect of oil policy, which successes were applied also to the gas policy. Azerbaijan is now prosperous and stable and has managed to consolidate its sovereignty beyond expectations. The overarching aim of Azerbaijan’s current energy policy is to maintain the overall position achieved already, as the energy situation is good enough as it is. The natural resources are now the leverage with which Azerbaijan can protect its sovereignty.

Mr. Soltanov moved on to outline Azerbaijan’s relations with its neighbors - Turkey being important for Azerbaijan in every aspect, a new policy being developed towards Georgia, Armenia also been benefiting (because of good relations with Georgia). Azerbaijan has resources to become even more independent with the growing presence of Turkey and

through Turkey – connections to the Western world. There might be some democratic issues in Azerbaijan, but, as Mr. Soltanov highlighted, it is important to bear in mind that the leadership did not decide to go with Russia.

The country has been spending a lot of oil money for military procurements but those weapon purchases are rather used as a bargaining chip. Azerbaijan has become very cooperative with its neighborhood and there are no significant game changing moves in sight as the country has become very predictable. Azerbaijan may keep alternatives open but its direction is clear. To conclude with, Mr. Soltanov expressed the opinion that Azerbaijan deserves more support when it comes to solutions as it contributes to the peripheral security of Europe. It is also a country that has dealt with its natural resources on its own – developed its own policies and managed its own resources.

Next took the floor **Mr. Konstantin Simonov (Director of the Russian Energy Security Fund, Russia)**, who emphasized from the beginning that South Stream is not against Europe, but for Europe and it should be considered accordingly. He said he found it strange that Europe is struggling with South Stream when it should be grateful for this project as its main aim is to increase energy security in the South of Europe. He also stated that while acknowledging that European politicians are anxious that the political influence of Russia will increase, he believes that this concern is not well grounded.

He moved on to touch upon some missed opportunities – for example Romania which refused South Stream and, according to Mr. Simonov, this was not a good decision as now it could have been the transit country and thus able to earn money from this project. There are new possibilities in sight – but in reality only Azerbaijan can be seen as a new player. Iraq is still a failed state, and Turkmenistan is now under control that will never allow the pipeline under the current circumstances.

Mr. Simonov expressed his surprise with the ‘new energy policy of Europe’ according to which Russia was rejected while Europe signed the very same contract with Azerbaijan; Poland has been aiming for diversification but ended up with only one contract with Qatar (which is even for a higher price). Is this diversification, he asked, if there is new gas found but it is more expensive?

The last person to speak from the panelists was **Mr. Vito Bobek (Professor, FH Joanneum University of Applied Sciences, Austria)**, who, as a person involved in long-term strategic planning on local and regional level and dealt with energy concepts, sought to bring the bottom-up perspective to the debate. To the question what the portion of the economic and the political factors is in the pipeline saga, he answered that the energy projects are complementary from an economic perspective, but contradictory from a strategic point of view and in this aspect there was a greater role for the political.

In theory, Member States should support projects that would reduce dependence on Russian gas, but practically the possible maneuvers are very limited and Central Europe is still heavily limited on Russian gas. Geographical diversification of gas and oil imports is good, he noted, because prices become lower – in the current situation, when Europe is dependent on one source, the supplier may set whatever price it wants because there are no other options.

However, diversification is very difficult to achieve under current circumstances, but it is not the only possibility lying ahead of Europe. Mr. Bobek suggested that the economy of the 21<sup>st</sup> century should utilize regional renewable resources thus shifting to a regional



sustainable energy market, which is an alternative long-term approach. The principle of regional strategic planning (with its central focus on energy independence) has been utilized in Austria and has proved to be largely successful. He firmly expressed the opinion that some of the sub-regions in Central Europe or South Eastern Europe have the potential to become self-sufficient in the future.

Mr. Bobek concluded that dependency on external energy supplies can become more reasonable if strategic sub-regional planning is used in a number of synchronized steps (but it is not to be expected that a “big bang change” comes about with strategic planning).

### Concluding Remarks

In his closing speech, **Mr. Péter Balázs (Director of CEU’s Center for EU Enlargement Studies, Hungary)** thanked for the open, honest and straight-forward discussion which brought to the fore various aspects of the Pipeline Saga. Mr. Balázs emphasized that energy is an important feature of the relationship between the EU and its South-Eastern neighbors. The energy issue embraces environment, transport, labor movements and goes beyond possible EU enlargements. From the European Union’s perspective, energy is engaging the whole neighborhood in all geographical directions – Western Balkans, Russia, Eastern countries, Mediterranean region and the Nordic countries – and as such, it is the most extensive issue of the EU neighborhood.



During the conference, three important supplier countries were represented directly – Turkey, Azerbaijan and Russia, as well as six consumer countries, which led to an interesting and fruitful overview of the gas market. The strategic location of Turkey has been stressed; the sensitivity and controversies of the energy relationship with Russia, as well as the specific situation and the increasing importance of Azerbaijan were discussed abundantly.

Mr. Balázs highlighted the complex nature of the economics of energy in a still very fragmented market where costly infrastructure and long-term investments are needed. He expressed the belief that Central and South Eastern Europe can play the crucial role of interconnector in this market with the objectives of decarbonization, higher energy efficiency and cross-border cooperation.

Mr. Balázs concluded with the reminder that next year there will be a new European Parliament, a new European Commission and that the latter takes its mandate with a prepared Multiannual Financial Framework (approved and finalized budget for 2014-2020), which means that the space for maneuver of the Energy Commissioner will be very limited and tight, and it is very important who will take this office and how (s)he will manage the opportunities lying ahead of the European Union.