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**THE EU AND RUSSIA IN 2007:
NEGOTIATING A NEW RELATIONSHIP**

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„Good afternoon, ladies and gentlemen, it is very nice to be here in Riga at the invitation of the Baltic Forum and I am glad to be here among so many experts, so many people interested in relations between the EU and Russia and particularly in relation to energy matters this afternoon. It was said at the beginning that I am an associated research fellow at the Center for European Policy Studies in Brussels. Perhaps more pertinently, I am also a professor at City Law School in London, which is, of course, a free market heart of the capital in the global financial center, where we believe strongly in free markets, and, perhaps even more pertinently, one of our alumni is Margaret Thatcher, who studied law at the City Law School. That can, to some degree, color my view.

My thesis this afternoon is very simple. It is this: that the Russian approach to running its gas market by taking a far more statist approach than a free-market, competitive approach threatens both Russia and Europe, particularly in the matter of energy. Essentially, the Russian gas market is one in which GASPROM is dominant, GASPROM is king. The former head of the Russian antimonopoly service referred to all the other participants in the Russian gas market as mere vassals of GASPROM. There is very little competition in the market place. GASPROM is, in fact, going around acquiring independents. They have an export monopoly and fixed low domestic prices. So we have a little competition, a little market liberalization and a lot of inefficiency.

My approach is this. Taking that non-market approach to running your gas market is very, very dangerous. There are various variants of market that you can have, but the market approach is the one which you must take; otherwise you will suffer. You may not suffer immediately, but you will suffer. And already you can see the consequences of that. One issue is in relation to the prospect of significant supply shortages from GASPROM and the Russian supply system over the next few years. The issue of that is being outlined by a whole series of authors from Jonathan Stern in his book about GASPROM recently through to a British defense paper, which I recommend you to read; this published by the British Ministry of defense. It is called "GASPROM in crisis". The paper uses a number of different sources, both Russian and foreign. There is my own paper published by CEPS and a number of other works on this issue. And essentially the thesis is this. As the existing old Siberian fields decline, GASPROM has not put enough investment in new fields. There is a prospect of getting gas from Central Asia, but there is a very serious question about how much gas is available. In addition to which, one way solving it would be to raise prices and encourage investment, well, there is an idea about raising prices to high levels by 2011 in Russia domestically, but there is a big question mark at whether that will actually be achieved. And potentially we are looking at serious gas supply shortages, potentially of the order of 100 billion cubic meters and more by around 2010. In the British Ministry of Defense paper the suggestion is that the gas supply shortages are already with us. Last winter a whole serious European countries didn't see the full nominated supplies of contracted Russian gas. And the prospect of this supply shortage problem will grow. This is just one example of the dysfunctional approach to running the gas market. But there are others. Take, for example, the Nordstream, the North European pipeline. This is another example on non-market approach to running your energy markets. Now the problem with this is that it may be great foreign policy, but it is lousy economics. The basic problem is this – if you build a pipeline under the sea it is going cost more than building it on land and the consequence of that is

that ultimately consumers will have to pay more for the gas. And the particular problem with the particular piece of see they decided to build the pipeline under is that, first of all, you have got old munitions in the Gulf of Finland, and then you got chemical weapons in the deep central part of the Baltic Sea. Aside from all environmental issues, dealing with that will cost money and increase prices and, ultimately, will increase the price of the gas. In addition, there are topographical problems. There was no proper survey. Again, it was done as a foreign policy objective. They have only now surveyed the floor of the relevant part of the Gulf of Finland. And, lo and behold: it's very uneven, and it will be very expensive to level it. So we have another expense there. So, we have all of those problems. And there is also another major factor. By 2015, when the pipe-line may eventually be built, the problem is going to be this: we will have achieved gas market liberalization in Europe. So the problem is how you are going to get the poor German consumer to buy the Nord Stream gas. Because gas will be coming in from elsewhere. Cheaper gas. The danger is that the very expensive pipeline will not find any gas for going through it. So this is another example of non-market approach to running your gas. I may well think: well, at the end of the day, we will have to buy gas from Russia, because there is no alternative. We just have to put up with this. Well, unfortunately, there is a lot of other gas available. There is three time more gas reserves around than there is oil. The gas market liberalization in Europe will make that gas available. And perhaps most interesting of all is that because, if you like, Britain and Russia are at the opposite sides of Europe (Russia has the most statist approach to running the gas market, we have the most liberal approach to running the gas market) and the liberalized British gas market can now generate far more than it needs and it can export it to the rest of Europe. Because of the incentives we have created in our gas market, we have gas coming from the Norwegian pipelines, we have four liquid natural gas terminals (LNGs). We have LNG tankers coming into those terminals. Next year we will be able to generate 180 billion cubic meters of gas, while we only use about 100 billion cubic meters. So effectively the UK can supply half the Russian gas exports to Europe. We can provide a substantial alternative supply of gas to Russia. If Russia does not look again at its marketplace, if it does not take on a more liberalized approach, what it is likely to find is that its supplies will be replaced by supplies from elsewhere, and, substantially, by British supplies. If you do not run a liberalized market, the danger is that you will be replaced in the marketplace as your systems fail. For Europe, we may be faced with a temporary supply crisis as a result of shortages from Russia. But the solution to that is to press on with gas market liberalization, to build interconnectors, linking up the Baltic gas island and ensuring that gas can flow around Europe. For Russia, the challenge is much more serious. What I suggest is for Russia to look again at its statist approach. Is it really going to work? Gazprom already has about 35 billion dollars worth of debt. If you build expensive infrastructure, which is going to cost you a lot of money and which you are going to get no return from, the 35 billion is likely to become 45 billion. So there is a serious question: is this statist approach good for you? Aren't there alternatives that you can look at? And one of the alternatives is to look at the prospect of liberalising the gas market; to have another look at the Energy Charter treaty and the liberalization principles enshrined in it. One particular point about the energy charter treaty is that, in relation to building this energy transport infrastructure. One of the reasons for Nordstream is that it was built because of the problem of transit problems with other states. Legitimate problems, such as gas theft in Ukraine, and so forth. Would not the transit protocol, which was very strong and imposed discipline on transit countries be a better and cheaper option than building expensive infrastructure like Nordstream? My suggestion is that the Russians have a stronger look at liberalization. Have another look at what Mrs. Thatcher said, that at the end of the day, you cannot book the market. Even Mr. Putin; even Gazprom".