

# Can Gazprom be a Reliable Central Asian Gas Supplier to Europe?

Written by anon

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### Introduction

Reoccurring almost annually from 2006 to 2009, the crises between Russia and Ukraine about gas prices and transit fees resulted in a negative image of the Russian state-owned company Gazprom in Europe[1]. Gazprom was not only perceived as the Kremlin's tool in coercing a renegade government of a neighbour state. It was also perceived as an instrument of Russian neo-imperialism, threatening European energy security and the sovereignty of the new eastern members of the European Union (EU).

In Central Asia, the existing pipeline network to export natural gas to Europe is largely controlled by Gazprom and bound North across Russian territory. With the Ukrainian experience in mind, the legitimate question arises as to whether Gazprom can be a reliable Central Asian gas supplier to Europe. Or, should the European Union seek for an independent solution by taking part, in what was coined in a media-friendly way as being, the "New Great Game" (NYT Anonymous, 1996) over Central Asia's energy resources? This essay argues that the European Union can trust Gazprom. This is based on an encompassing analysis of the economic and political reasons determining the nature of Russian-European interdependence, as well as the specific Central Asian realities in the gas market.

The observations made in this essay are based, to a great extent, on German sources[2]. A German perspective enables broader analytical frameworks than those present in Anglo-Saxon academia. In relation to Central Asia, analyses, especially US-American ones, tend to follow an ideology and doctrine of Russian containment, testifying a mental legacy of the Cold War, which blurs actual European interests at play[3]. The approach through the angle of German influenced Realpolitik taken in this essay differentiates the analysis of Central Asia from that with a Caucasian or East European context. This is because the latter are of a different interest for Europe, consequently deserving another policy.

The first part of the essay discusses Russian-European interdependence, which is necessary in understanding the EU's strategic position and the possibilities for increasing relations in Central Asia. The second part examines the EU's diversification policy and the notion of supply security in the Central Asian context.

### Russian-European Interdependence

The fear of Russian hegemony in the European gas market following the crises in Ukraine has clouded the fact that the relationship between the EU and Russia is not characterized by unilateral energy dependence but, rather, by a tight mutual economical interdependence. This is, in part, due to the technical constraints of the natural gas industry (Andrews-Speed and Vinogradov, 2000). Unlike oil that can be transported to low costs by train or ship, the most economical way to transport gas is through pipelines. The Liquefied Natural Gas technology (LNG), with ships, remains comparatively more expensive, especially if the delivery distances remain short, such as with the land locked Caspian Sea. With a pipeline network, the exporting and importing countries are physically tying together economic interests. In long-term contracts extending over decades, amounts and prices set in relation to the oil price have been agreed on. A politically-originated, lasting uncertainty about price predictability (increases) and supply security (cut-

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offs) would have severe effects on the exporter. In the long-term, that fact that exporters and importers can be bound to cooperate was demonstrated by the different game theoretical analyses of the European-Russian gas relations[4].

Looking at some basic figures, the interdependence of Russia and the EU becomes only clearer. 42% of the gas used in the EU comes from Russia (24% from Norway, 18% from Algeria and 16% from other countries). The average share of natural gas of the total of EU energy consumption is 24% (Westphal, 2009, p.23)[5]. However the European dependency is contrasted by the fact that Russia exports over 90% of its gas to Europe (including the non EU-members such as Ukraine, Belarus, Switzerland) (Götz, 2007<sup>b</sup>, p.22). According to Alexander Medvedev, deputy chairman of Gazprom, his company is making 70% of its benefits from the EU. Through these figures, the European position in its relation with Russia appears stronger than it had actually appeared to be during the Ukrainian crisis[6]. Furthermore, despite the fact that the Russian Government left the economic policy that prevailed during Putin's first presidential term, which focused on the might of Russian natural resources, and is now embarking on a modernisation and diversification of the economy, Russia will still remain highly dependent on the gas sells in Europe in the foreseeable future (Götz, 2007<sup>b</sup>).

Gazprom being labelled as an unreliable gas supplier to Europe because of its close connection with Russian politics that hinders the economical mechanism of interdependence stated above ignores the economic power base of the political regime[7]. Following Douglas North's theory of Limited Access Order (LAO), the Russian political elite strongly anchored in a system of rent seeking in order to cement political power. With this deeper analyse of societal organisation, it has become even more evident that in the long term political actions undermining Gazprom's credibility as a trade partner for the EU have a backfiring effect for the elite. Weakening Gazprom by actions that force European countries to look for more reliable energy sources would reduce, in the end, the size of the regime's economic power. However, even if one recognises the interdependent situation of Russia and Europe and assumes that a long-term collaboration is the only sustainable solution for Russia, two critical questions prevail that affect an analysis of Central Asian gas supplies by Gazprom.

The first question concerns the EU strategy to diversify its sources of energy, especially fossil energy from outside the Union. Despite what is argued above, a diversified energy portfolio remains a prerequisite for European security and stability (Götz, 2007<sup>a</sup> and 2007<sup>b</sup>; IEA, 2002; Westphal, 2009). The Nabucco gas pipeline project starting in the Caucasus, mainly transporting Azeri gas to Eastern Europe, is essential for meeting the increasing European demand for gas. Concerning Central Asia, the question is if such a diversification is politically and economically wise to undertake or not.

The second question is of supply security. This point is raised by the International Energy Agency (IEA, 2002) about whether Russia will be able to provide enough gas in the future to meet the growing European demand, especially while the reserves of the present gas fields are rapidly diminishing. The debate over prognosis and investment projects in new gas fields is difficult to evaluate, partly because of the Russian lack of transparency (Hill, 2004). However, reviewing different Russian and Western estimations, Götz (2007<sup>b</sup>) is arguing that the most dramatic assumptions that forecast Gazprom's physical inability to provide Europe with gas are either assuming an extreme scenario (very high demand opposed to low production) or not taking in account Central Asian gas supplies that are transiting through Russia. The question here centers on how the European Union should position itself in Central Asia, taking into account the fact that the gas resources of this region are an important swing-off for Gazprom.

## In the Central Asian context

### *The diversification strategy*

The diversification strategy, as advocated by the EU, but also by the United States, in Central Asia, argues that an active role in the Central Asian resource market will break the Russian lever over Europe and (especially in an American perspective) positively constrain Russian influence in the region to the benefit of the Central Asian countries (Baran, 2007; Westphal, 2009). A realistic approach to this strategy reveals, however, that the prerequisite to effectively entering the Central Asian gas market involves an economical and reliable transport route from Central Asia (Turkmenistan) westwards to Azerbaijan where the Central Asian gas could be injected in the still-to-be-built

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Nabucco pipeline. As mentioned earlier, the expensive LNG technology is hardly a viable solution for the Caspian Sea at the moment (Götz 2007<sup>a</sup>). The alternative option is the project of the Trans-Caspian underwater pipeline, but the actual realisation of such a project is rather unlikely. Even if Turkmenistan and Azerbaijan would come to an agreement, the project faces strong opposition not only from Russia, but also from Iran. The different legal interpretations of the Caspian Sea, whether it is a sea or a lake and the resulting rights and obligations of it, are used by Iran to oppose such a pipeline. The volatile political context under which a Trans-Caspian pipeline would be built keeps private investors away and delays indefinitely its actualization. It should be noted that private companies are the means of European gas market expansion, since no state-owned or EU-lead energy company exists. Their expansion policy is, therefore, primarily economically motivated (Geden and Dröge, 2010; Westphal, 2009). Consequently, the basic condition of a realistic European expansion into the Central Asian gas market is strongly undermined.

Nevertheless, in the case that this obstacle might somehow be overcome by US backing or because of LNG technology becoming cost-friendlier, Götz (2007<sup>a</sup>) argues that the economical benefits from gas extraction will be too minimal to justify such a move. This is due to the situations in the three gas exporting countries of Central Asia: Kazakhstan, Uzbekistan and Turkmenistan.

In Kazakhstan there is already a strong Chinese presence in the energy market, which now even begins to worry Moscow[8]. Also, China benefits from the geographical advantage over Europe, with an investment in gas pipelines to China being lower because of the shorter distance. Taking the Kazak perspective, it is also questionable if President Nazarbayev would risk an alliance with Europe over that could threaten the on-going efforts towards regional integration through a Free-Trade-Agreement (FTA) with Russia and Belarus or the coordination efforts regarding natural resources undertaken by the Shanghai Cooperation Organisation (SCO) against non-member states.

The Uzbek gas production, however, will pass its peak in a few years and then diminish steadily in quantity. A European investment in the market is likely to be unprofitable in the long-term. As portrayed by Stanislav Zhukov, Uzbekistan is, despite being one of the top ten producing countries in the world, a “domestically oriented producer” (in Pirani, 2009, p.355) because of its large population in comparison to the other Central Asian countries. Nevertheless, building on its presence in the country, Gazprom has acquired, through Lukoil, the rights for the Khauzak field until 2040. Also in Uzbekistan, the Chinese presence is advancing. After moving away from Washington by closing the US base in Karshi Khanabad in 2005, Karimov sealed a first joint venture with China over oil extraction (Hiro, 2009).

With its 8.1 trillion cubic meters (tcm) (Maurer, 2010, p.5) and its location on the Caspian shore closer to Europe, Turkmenistan seems therefore the only promising investment possibility to diversify the sources of natural gas for the EU. What the actual potential for the EU in Turkmenistan might be is still debated. Maurer (2010) sees a chance for the EU because it is able to pay higher prices than Russia and China. He only partially acknowledges the importance of the already existing involvement of both countries in Turkmenistan. Götz (2007<sup>a</sup>) and Schmitz (2008), on the other hand, argue that the already important Chinese presence in strategic areas in Turkmenistan hinder an effective European foothold. A pipeline from Turkmenistan already exists and the Chinese Government has signed long-term contracts and given extensive credits to develop the untapped South-Yolotan field. However, the IEA's estimation is that this field will reach full production only in 2035, leaving Götz and Schmitz doubting whether the total Turkmen production minus the exports towards Russia, China and Iran would be high enough to assure the profitability of a European pipeline. The former Turkmen leader, Niyazov, successfully played out rival parties over Turkmen gas and diversified his export markets with a pipeline across Iran, into Turkey. As a result of this competition, Gazprom's long-term agreement of 2005 guaranteeing Turkmen gas exports until 2028 (Bore, 2006) had to be revised, with Gazprom agreeing to pay higher prices (Hiro, 2009).

In the light of these Central Asian realities, in the mid-term at least, economic, as well as practical, rationales show to be against an independent EU expansion into the Central Asian gas market. The already existing Gazprom pipelines are probably presenting a lower financial burden on European gas imports as an autonomous EU project[9]. But, certainly the supply predictability for the EU through the Gazprom network would be higher than the uncertainties of a

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complete new project with such difficult preconditions. Additionally, regarding the diversification benefits for the EU, Götz (2007<sup>a</sup>) argues that they would be minimal because the share of Central Asian gas would only be about 6-8% of the total needs. Russia and African countries would remain by far the most important suppliers if Norway is counted as a European country. Major changes in gas supplies and increased independency from Russia would only be possible if the world's potentially second largest gas producer, Iran, starts exporting massively towards Europe. The political situation makes it, however, unlikely, and Iran is favouring the Chinese option.

## *The question of supply security*

Three aspects characterise the European supply security in regard of Central Asian gas. The first is the already existing Russian network that can deliver Central Asian gas to Europe and the Russian-European long-term interdependence, which has already been discussed. The second aspect is Gazprom using Central Asian states as a swing-producer to its West Siberian gas fields. Gazprom's main operational gas fields, such as Urengoy and Nadym, were established in the late 1960s and their production is decreasing. In order to meet a constantly growing European demand while new projects such as on the Yamal Peninsula and the offshore Shtokman field in the Barents Sea are developed, Central Asian gas has taken on a key role in assuring a continuous supply. This is especially so for Ukraine and other East European states, which are delivered with cheaper gas from this region. The third aspect concerns the direct danger for European interests by the growing Chinese influence. This parameter is overlooked by analyses focusing on EU-Russia relations, being only in terms of a dichotomy. Europe's biggest risk in terms of supply security is not that Central Asian gas goes northwards through Russia instead of directly to the West, but that it goes to the East.

In addition to the economic arguments opposed to a European initiative in Central Asia mentioned above, a geostrategic point becomes evident. Schmitz (2008) deduces that a European grab for Central Asian gas would weaken Russia's bargaining power towards Chinese interests in the region and would, in the end, have a negative impact for the EU. Concerning the possibility that through the mechanisms of the SCO Russia and China could agree on a coordinated policy over the use of Central Asian gas that would leave Europe in the cold, Maurer (2011) notes that the actual practices have shown that in the gas and oil sector the respective countries prefer independent bilateral approaches with individual Central Asian states. At least in the energy sector, this counters Sakwa's analyses (2008) of the SCO as a coordinating body, strengthening Russia's and China's position.

## **Conclusions**

This essay has shown that the EU's interests in Central Asia are best served through cooperation with Gazprom rather than competition. Russian and European interests lay closer together on a European Central Asian strategy than what American policy advises (Baran, 2007). Because of technological, economical and political rationales, the specific Central Asian context needs a more open-minded approach by the EU, going beyond guiding, yet still limiting policies such as diversification. The biggest challenge to supply security does not come from Russia, which heavily relies on European payments, but from Chinese seizures of Central Asian gas reserves. In the context of the pipeline bound gas market, it is not a metaphor to say that China's interests are hundred-eighty degree opposed to European ones. Through an involvement in Central Asia, the EU is more likely to indirectly undermine its own interest of supply security by weakening the established Russian position. The hazardous nature of a Trans-Caspian project and the questionable profitability of an independent European way in Central Asia are setting the economic and political price for the EU too high. This rationale, combined with highly interdependent Russian-European relations in the European gas market, leads to the conclusion that not only Gazprom can be trusted as a reliable Central Asian gas supplier, but that the EU should actively do so as it has hardly anything to gain from another strategy.

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[1] An example of how disproportionate fears have been fueled is portrayed by the Daily Mirror's comment: "Health experts warned elderly people could be at risk of dying from the cold, especially after Russia cut off gas supplies to Europe through Ukraine, sparking fears of a huge price rise." (Pettifor, 2009).

[2] The majority of sources in German are reports or working papers from the Berlin based think-tank *Stiftung für Wissenschaft und Politik*. Financed by the German government, it is organised as an independent foundation acting as an adviser for international policy and security questions.

[3] See Blank (1995) and Baran (2007). Also see Bore (2006) for an integrated analyse of US-American policy in Central Asia dictated by the two opposed reasons: the quest for security after 9/11 and the issue of energy supplies.

[4] See Zweifel, Krey, and Schirillo (2009); Morbee and Proost (2010).

[5] However, it should be noted that the differences of dependence on Russian gas in the total energy consumption varies highly among European states. See Westphal (2009, p.24). These different dependencies on Russia, though, do not alter a common EU policy about Central Asian gas.

[6] See Geden and Dröge (2010) about the necessity of a unified EU energy policy that is lacking in regard to Eastern Europe (e.g. the need for back-flow pipeline towards Poland and the Baltics).

[7] Compare with Baran (2007) to see the blatant double standards in business conduct applied to Gazprom in relation to the OPEC member states.

[8] See Andrews-Speed and Vinogradov (2000) for a detailed analyse of China's involvement in Central Asia.

[9] No exact comparative cost evaluation could be found for this point. Regarding the fear of a price dictate by Gazprom on Europe, which is articulated by Blank (1995) and Baran (2007), it can be argued, however, that Gazprom is bound to world market prices as a maximum if it wants to sell gas on the European market (European Energy Charta). A competition between the EU, China and Russia for Turkmen gas would most likely only lead to a further price surge in the producing country reducing the competitive aspect on the destination market in Europe.

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