

# TRANSFORMING EU-RUSSIA ENERGY RELATIONS: THE BALTIC STATES' VISION

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## *Abstract*

Recently many European and Baltic researchers have focused their analyses on the EU energy policy, EU-Russia energy relations, or energy security interests of the Baltic States in general. However, very few have attempted to unite these aspects and to provide a deeper analysis of the Baltic States' approach towards the most important aspect of the external dimension of the common EU energy policy, viz., EU-Russia energy cooperation. By concentrating on current relevant events and latest tendencies, this article endeavours to (at least partially) fill this gap. It aims to explain why Lithuania, Latvia and Estonia, though heavily dependent on supplies from Russia, advocate for measures, which are, in fact, impeding the development of closer EU-Russia energy relations. In other words, it analyses the interests of the Baltic States in developing the external dimension of the common EU energy policy.

## **Introduction**

The negotiating power and financial capacities of the Baltic States are too weak to confront the Russian government and Russian companies, such as “Gazprom”, the United Energy System (UES) of Russia, or “Transneft”. Thus, without the contribution of the EU, the Baltic States will hardly escape their status as an ‘energy island’. This is the reason why they express a genuine interest in a stronger EU energy policy and support ideas, such as the creation of a European Energy Community. They also want to shape these processes,

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e.g., by having a meaningful impact on the EU-Russia energy cooperation structure and content.

However, in seeking EU support in energy affairs, the Baltic States face a twofold problem. First, the supranational involvement of the EU in energy affairs is a quite recent phenomenon. Therefore, it has to be constantly promoted, developed, and improved. Second, the EU member states are significantly divided over ways to deal with energy risks and the priorities of the EU internal and external energy policy dimensions. Assuming the high importance of the coordinated and institutionalized EU external energy policy for the Baltic States, this article focuses on the latter's motives and strategies in shaping the strategic position of the EU towards its main energy supplier, Russia.

The research question of this article is as follows: *in which direction do the Baltic States want to shape the EU-Russia energy cooperation?* The analysis neither proposes a magic formula, nor has the ambition of becoming a handbook for Baltic and EU energy policy decision-shapers and -makers. However, it is argued that the absence of a common understanding of the principles of 'solidarity' and 'reciprocity' has a negative impact both on the EU energy policy development and the Baltic States' energy security. It is also presumed that, without a coherent dimension of the external EU energy policy – bearing in mind, first and foremost, a clearly defined and commonly implemented policy towards Russia, – the EU will remain the weaker partner in its relations with Moscow, while the Baltic States will continue to play the role of an easy target for divide-and-rule policies.

In seeking to explain arguments voiced by the Baltic States, this article focuses on the development of the common EU energy policy, which is perceived as the main instrument for securing a stable and sufficient supply of energy resources to the Baltic States. The creation of a common EU energy market (primarily in the gas and electricity sectors) as well as an increase in the level of gas supply diversification will be analysed as instruments, which would limit the dominance of Russian companies. The article also considers the importance of 'consumer solidarity' within the EU and of the 'reciprocity clause' in EU relations with "Gazprom", both of which are considered to be the Baltic States' priorities in EU-Russia energy relations.

## **1. The Baltic agenda for the common EU energy policy**

In the Baltic States, officials and scholars argue that, by exploiting their current competences, the EU institutions could play a crucial role in the creation of a common EU energy market, strengthening the EU's energy ties with 'alternative' energy suppliers and negotiating the conditions of a strategic partnership with Russia in the energy sector. The majority of Western experts and officials, however, doubt the efficiency of involving supranational EU institutions in such matters. Against this background, the Baltic States face a twofold challenge: 1) to convince sceptics that a common EU energy policy can already be effective; 2) to promote further development of a common EU energy policy by arguing in favour of the creation of common electricity and gas markets, and the enhancement of the external dimension. The creation of common EU gas and electricity markets and the diversification of gas supply are two areas in which, according to the Baltic States, the involvement of supranational EU institutions could bring a clear added value both in the long and short term.

However, matching the objectives of a common market with the aims of a common EU external energy policy may not be so simple. As a Dutch researcher rightly claims, the ongoing debate on the external energy policy dimension is about deepening the intervention of governments either directly (e.g. investing into "Nabucco"), or indirectly (via fiscal measures or support for entrepreneurial activities in certain regions).<sup>1</sup> Analysts and politicians on both the EU and Russian sides rightly note that this sort of initiative (as, for instance, the unbundling foreseen in the 3<sup>rd</sup> EU energy package) actually contradicts the free market philosophy. Being among the most prominent supporters of a securely functioning free common market, the Baltic States have a vested interest in finding and promoting a solution to this dilemma.

One possibility would be the creation of a legal base which includes new provisions on 'co-dependency'. This concept acknowledges the consistency of the external EU energy policy with the rules of the internal market, but goes

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<sup>1</sup> Christof van Agt, Senior researcher at the CIEP, interview by the author, 2 March 2010, The Hague, Netherlands.

beyond these if the free market does not work in external relations with non-market energy suppliers. In practical terms, this means a repetition of the pattern set by the European Atomic Energy Community (or Euratom), i.e., the creation of a similar 'community' for the gas sector. Since gas sector security issues do not compare to the much higher security standards that the trade and transport of nuclear materials require, this currently appears to be an unlikely development. On the other hand, the *Declaration on the creation of a European Energy Community*, which will be discussed below in greater detail, is very well equipped to serve the political goals of the Baltic States.

As regards the diversification of the supply, many Western experts deem it reasonable if it is economically feasible. For instance, it is argued that, if it is cheaper to import electricity from Russia than from another country (e.g. Finland), electricity should be imported from Russia. If Russian gas is cheaper than Norwegian gas or LNG, then, again, Russian imports should prevail. Otherwise, consumers will have to share the burden of expensive projects by being forced to accept much higher energy prices.<sup>2</sup> Moreover, it is claimed that, although diversification is the 'motto' of the day for politicians, the practical need for such strategies should not be overestimated. Indeed, there are other, EU-internal and, therefore, more feasible means by which to increase supply security.<sup>3</sup>

Nevertheless, the Baltic States continue to argue for the strengthening of the external EU energy policy dimension, which would help to diversify supply and break existing monopolies. There are irresistible arguments for doing so even today, when Western energy companies and scholars debate the possibility of how to cut the price of wind and nuclear energy, how to increase the consumption of biomass, hydro- and geothermal energy, how to develop solar and hydrogen energy, and how to improve the technologies of horizontal drilling or rock fracturing in order to increase the production of 'unconventional' gas and oil.

As regards the free EU energy market, if functioning, it would enable the Baltic States to import gas and electricity from other EU member states and

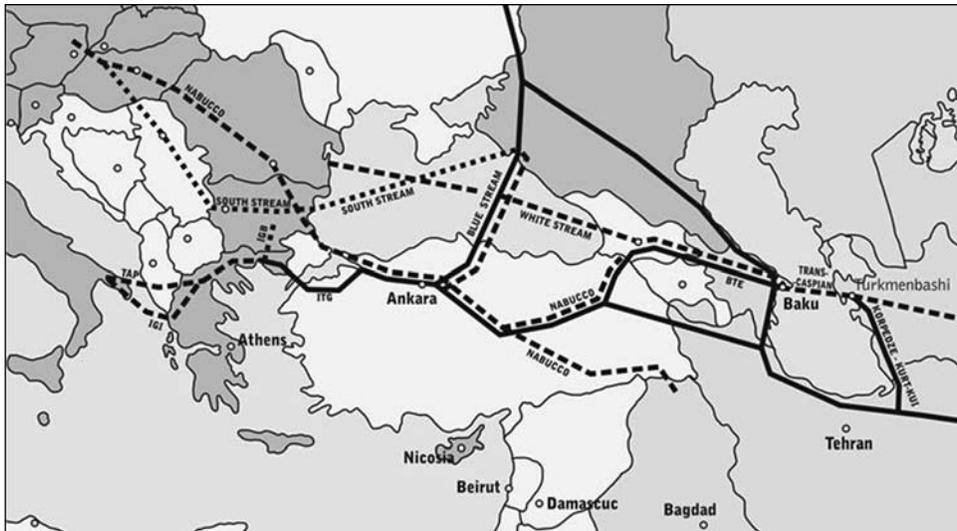
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<sup>2</sup> Dr. Petra Opitz, Manager at DIW econ, interview by the author, 18 December 2009, Berlin, Germany.

<sup>3</sup> Marcel Viëtor, Program Officer for Energy and Climate at DGAP, interview by the author, 10 December 2009 Berlin, Germany.

to rely on their networks for the supply of imports from more remote sources. As a consequence, gas prices should become negotiable. On the other hand, at least partial diversification away from Russian gas and the pipelines, through which it is supplied, is possible even in the short term, without integration into the common EU market. In this regard, the starting point for the Baltic States in the gas sector is the construction of the Southern Corridor (Trans-Caspian, the “Nabucco” and the White Stream pipelines), as well as contracting suppliers in the Caspian Sea Region (see Scheme 1). The Baltic States are also keen on preserving the independence and the speeding-up of the modernisation of the Ukrainian pipeline system, as well as on constructing an interconnection between Poland and Lithuania.

Scheme 1. Gas pipelines to Europe



Source: Jarosiewicz, Aleksandra (2011): “Azerbaijan will decide the shape of the Southern Gas Corridor”, January 2011. <[http://www.osw.waw.pl/sites/default/files/EastWeek\\_237.pdf](http://www.osw.waw.pl/sites/default/files/EastWeek_237.pdf)>, 22 01 2011.

However, lack of will at the European and national levels, insufficient financial mechanisms and active external resistance serve as serious obstacles to the creation of common electricity and gas markets and the diversification of supply. At the same time, there is no foolproof prescription on how to overcome these structural problems. Nevertheless, the Baltic States will most probably

continue to require that the Union do everything possible in order to extend the provisions of the common market beyond its current borders in the nearest future. They will also continue to insist on the development of the external dimension of the EU common energy policy, which is crucial for the diversification of supply. The joint *Declaration on the creation of a European Energy Community* by Jerzy Buzek, President of the European Parliament, and Jacques Delors reads: “Europe needs a stronger, deeper, common energy policy”. In the wake of this initiative, the Baltic States will try to secure political support for any other proposal suggesting a response to “Gazprom’s” dominance.

To sum up, the Baltic States want the EU to stand up for its members and to prevent such developments from entering long term contracts, which other members consider problematic. Therefore, the next chapter will focus on the principle of ‘solidarity’, which is essential, but so far has not been fully implemented. ‘Consumer solidarity’ has not become a concept found in multilateral energy instruments, such as those related to the external dimension of common EU energy policy, or appearing in secondary EU legislation on energy affairs. This is a situation which the Baltic States are trying to amend. The next chapter also focuses on the Baltic States’ tactic of questioning the wisdom of a policy based on denying access to undertakings from third countries that do not reciprocate by allowing market access to their own national systems.

## **2. The Baltic States’ priorities for EU-Russia energy cooperation**

In 2009, Russia withdrew its commitment to provisional application of the Energy Charter Treaty (ECT), an agreement regulating investment protection and transit in the energy sector in Europe and the Commonwealth of Independent States (CIS). In addition, Russia is neither a member of the World Trade Organisation (WTO), nor a signatory to any other international economic agreements<sup>4</sup>. In other words, there is no international legal instrument to

<sup>4</sup> Dreyer, I., Erixon F., Winkler R. “The Quest for Gas Market Competition Fighting Europe’s Dependency on Russian Gas more Effectively.” *ECIPE Occasional Paper*. 7 January 2010. <[www.ecipe.org/press/press-releases/Press%20Release%202010-01-07.pdf](http://www.ecipe.org/press/press-releases/Press%20Release%202010-01-07.pdf)>, 15 01 2010.

limit Moscow's actions in the field of energy policy. As a consequence, the Russian government may use national energy 'champions' for the implementation of its foreign and security policy without hindrance, for instance, by streamlining energy resource export and pricing policy. Such a strategy would negatively affect the effectiveness of a common EU energy policy and is a constant source of worry for the governments of the Baltic States. This chapter will focus on the Baltic States' agenda towards shaping the possible internal and external EU responses, which, if successful, could lead to a situation where relations with Russia would not determine the conditions of access to Russian gas.

### **2.1. Shaping 'consumer solidarity'**

It is widely recognised that, without internal coherence, an effective external energy policy dimension is virtually impossible. It is also a fact that today the EU fails to speak with a 'common voice' on energy affairs<sup>5</sup>. Long-term bilateral energy agreements, such as Nord Stream between Russia and Germany, South Stream between Italy, Bulgaria and Russia and various LNG supply contracts between Spain, France and Algeria, indicate that big member states continue to view energy security as a national policy issue. A German expert claims that some countries have recently started to realize that they are gaining little out of the strategy to 'play' bilaterally with Russia.<sup>6</sup> Nevertheless, politically and economically, EU member states continue to favour the use of bilateral and 'non-institutionalised' (i.e., not regulated by an 'all inclusive' international treaty) relations with external suppliers, as long as they feel that their own bargaining power is greater or equal to that of their suppliers. What is even worse is that the Baltic States' voice arguing in favour of strengthening EU energy cooperation with the Caspian and Black Sea region countries is going almost unheard. Recognising their limited influence in bilateral talks and lack of measures to manage energy supply-related crises, the governments

<sup>5</sup> Braghiroli S., Carta C., "The EU's attitude towards Russia: condemned to be divided? An analysis of the Member States and Members of the European Parliament's preferences." *Electronic Publications of Pan-European Institute*. <<http://www.jhubc.it/ecpr-riga/virtualpaperroom/042.pdf>>, 03 10 2009.

<sup>6</sup> Martin Kremer, Senior fellow, Stiftung Wissenschaft und Politik, Research Division EU Integration, interview by the author, 4 March 2010, Berlin, Germany.

of the Baltic States have discovered another tactic to deal with energy insecurity. The key element of this tactic is to argue for the construction of and strengthening solidarity within the EU in energy affairs<sup>7</sup>.

The Baltic States have drawn an interesting conclusion regarding the main causes of missing EU solidarity. It seems that the main constraint is not the opposition of some member states to the concept of 'solidarity' in energy affairs, but rather different perceptions inside the EU on what 'energy solidarity' actually means. Consequently, building a consensus has turned into the main task for the Baltic States. The various perceptions are determined by differences in the 'starting positions' of the EU member states. Correspondingly, starting positions are influenced by such factors as different attitudes towards the liberalisation of the energy market, different geographical locations, different energy mixes and levels of dependence, and different historical experiences.<sup>8</sup> Therefore, some EU member states perceive 'solidarity' primarily as a short term action in times of crisis, that is, as ability and willingness to support other EU member states should short-term supply disruptions occur. German researchers, for instance, argue that the solidarity clause is important for the German government, but Germany's energy companies do not maintain any considerable interest in investing into unprofitable, solely politically motivated projects.<sup>9</sup> Moreover, some experts underscore the unwillingness of the German government to spend taxpayers' money on European interconnecting pipelines or energy bridges for reasons related exclusively to the 'security of supply', in other words, with no regard for who will supply these pipelines or energy grids with gas or electricity.<sup>10</sup>

However, for the countries of the CEE region, 'solidarity' means more than whether or not investments are made into specific pipelines. Their strategic

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<sup>7</sup> Vaiciunas, Ž., "Common European Union Energy Policy on the Making and the Interests of Lithuania." *Politologija*. 30 September 2009.

<sup>8</sup> Marcel Viëtor, Program Officer for Energy and Climate at DGAP, interview by the author, 10 December 2009, Berlin, Germany; Dr. Franziska Holz, Researcher at the Department Energy, Transportation, Environment, German Institute for Economic Research, interview by the author, 8 December 2009, Berlin, Germany.

<sup>9</sup> Jonas Grätz, Doctoral Fellow, Stiftung Wissenschaft und Politik, Russia/CIS Division, interview by the author, 15 December 2009, Berlin, Germany.

<sup>10</sup> Marcel Viëtor, Program Officer for Energy and Climate at DGAP, interview by the author, 10 December 2009, Berlin, Germany.

long-term goals include the creation of a 'harmonised energy policy' towards external suppliers and transporters, financing of key energy infrastructure projects from the EU budget, and even some type of 'collective security' commitments in the energy sector. By asking for solidarity, the Baltic States are trying to upload to the EU their worries about the Kremlin's national priority to strengthen Russia's role in the world energy market. They argue that Moscow's endeavour to gain state control over the pipelines, the increasing role of Russian companies on the European energy market as well as Russia's closer cooperation with South Korea, China and India on oil and gas matters should be perceived as Russia's ambition to become a leading energy superpower and intention to use this status to improve its standing in European and global politics. In other words, the Baltic States are afraid that Russian energy policy is becoming an instrument for a "new Russian imperialism"<sup>11</sup>. The main elements of this Baltic States worrying policy are:

- *close control of foreign investment*. In recent years, several foreign companies – such as "Shell", "Mitsui", "Mitsubishi" and BP – have faced abuse in Russia<sup>12</sup>;
- *direct ownership of strategic energy assets*. Russia insists that foreign companies wishing to take part in oil and gas exploration in Russia should offer their Russian partners "something in exchange" in their home market;
- *increased participation in oil and gas exploration in the post-Soviet countries, in the Middle East as well as in Africa, Asia, and South America*. Russia is using outright ownership and joint ventures to control the supply, sale, and distribution of natural gas and is buying up major energy infrastructure assets, such as pipelines, refineries, electric grids, and ports. As of 2004, "Gazprom" had invested \$US 2.6 billion in 23 major joint ventures and had purchased strategic infrastructure companies in Georgia, Hungary, and Ukraine. In 1998, "Gazprom" took over shares in "Topenergy", a Bulgarian company dealing with the commercial distribution of gas;

<sup>11</sup> Aalto, P., *The EU-Russian Energy Dialogue. Europe's Future Energy Security*. Helsinki: University of Tampere, 2008, p. 147

<sup>12</sup> For more details see: <[http://www.forbes.com/2007/02/16/bp-russia-energy-markets-equity\\_cn\\_0216markets11.html](http://www.forbes.com/2007/02/16/bp-russia-energy-markets-equity_cn_0216markets11.html)>, 5 10 2010.

- *avoidance of transit countries.* Examples include the cancellation of the Yamal II pipeline that was to be built parallel to Yamal I through the territory of Belarus and Poland, the postponement of the Amber project intended to create a pipeline running through the Baltic States and Poland, and the decision to build Nord Stream, which will bypass all the mentioned countries. The development of the Shtokman gas field is also partly driven by a strategy of the avoidance of transit countries, since gas from this field is to be transported directly to Russia's gas customers either through a pipeline going via Russia and then through Nord Stream, or as LNG from the LNG plant that is to be built just east of Murmansk. To reduce its dependence on the use of the Baltic ports, Russia is currently building ports on the Northern shore of the Baltic Sea;
- *focus on long-term gas supply contracts.* Since the 1970s, the supply of natural gas has been based on long-term contracts agreed for a period of 15-20 years, in order to share the risks of costly pipeline construction and resource development between producers and consumers;
- *threat to diversify its gas market from Europe to Asia.* For instance, in February 2009, Russia and China signed an intergovernmental agreement on the construction of a pipeline branch from Skovordino to the Chinese border and long-term Russian oil supplies of 110 million barrels of crude per year from 2011 until 2030. On the other hand, Asian markets will be more expensive to develop; therefore, Asian markets may be difficult for Russia to dominate.

Due to the differing perceptions of 'solidarity', the concept itself has become problematic and is a hardly achievable objective. For instance, it is widely recognised that Russian companies act as the 'gatekeepers' to the Russian energy market and that the disparity in the rules, which regulate the EU's energy market on the one hand and Russia's energy market on the other, is huge<sup>13</sup>. However, according to both German and Dutch experts, there is only a small hope that the EU and Russia can reach a legally binding strategic agreement, because such an agreement would, first of all, require all EU member states to

<sup>13</sup> Grajauskas, R., "Gazprom Clause" and the Issue of Russia's Europeanization". Centre for Eastern Geopolitical Studies. <[http://www.rytugeopolitika.lt/multisites/rytugeopolitika/images/stories/eu-russia%20pulse%201\(2\).pdf](http://www.rytugeopolitika.lt/multisites/rytugeopolitika/images/stories/eu-russia%20pulse%201(2).pdf)>, 25 09 2009.

demonstrate solidarity with each other. Consensus between small and large member states is hardly possible, since the current state of the legal framework (or its absence), in fact, satisfies the interests of the largest EU energy companies, who are the main players in the national energy sectors. German, French and Italian companies are competing with each other to receive better import conditions; they manage to negotiate access to the Russian upstream energy market and would not like to give up this power to, for instance, the European Commission.<sup>14</sup> In this context, instead of engaging the Baltic States' energy companies in negotiations with external suppliers, Westerners tend to criticise them for refusing to pay the bills related to the development of energy infrastructure, or for unfair attempts to profit from transit fees (as an opposing example of this, the effective energy policy of the Czech Republic is often mentioned).<sup>15</sup> As a practical manifestation of this 'solidarity misuse', the resistance to the construction of the Nord Stream pipeline is sometimes cited. According to this logic, it is claimed that the countries resisting the construction of the pipeline simply do not want to lose their incomes from gas transit and that this has nothing to do with "solidarity in energy affairs" as such.

On the other hand, it should also be recognised that many Western European governments are going through a certain learning process and are gradually changing their attitudes towards the need for cooperation with the smaller EU members. Germany, for instance, was rather sceptical about the importance of having broader discussions and consensus inside the EU when energy agreements with Russia were at stake a few years ago.<sup>16</sup> Today, German politicians are keener to take into account the attitudes of Poland and the Baltic States. They tend to understand the necessity to include, or at least, to consult these countries before starting new cooperation initiatives with Russia.<sup>17</sup> In this regard, Kai-Olaf Lang adopts a rather broad definition of solidar-

<sup>14</sup> Jonas Grätz, Doctoral Fellow, Stiftung Wissenschaft und Politik, Russia/CIS Division, interview by the author, 15 December 2009, Berlin, Germany.

<sup>15</sup> Marcel Viëtor, Program Officer for Energy and Climate at DGAP, interview by the author, 10 December 2009, Berlin, Germany.

<sup>16</sup> Martin Kremer, Senior Fellow, Stiftung Wissenschaft und Politik, Research Division EU Integration, interview by the author, 4 March 2010, Berlin, Germany.

<sup>17</sup> Marcel Viëtor, Program Officer for Energy and Climate at DGAP, interview by the author, 10 December 2009, Berlin, Germany.

ity in energy affairs claiming that today it means to give “support in overcoming the structural weaknesses and fragmentations of the market by providing (among other things) financial assistance to infrastructure projects”<sup>18</sup>. At the same time, however, this does not mean that representatives of German companies will suddenly agree to solve the problems of those who “haven’t done their homework”. Nevertheless, it is a much broader definition than the ‘short-term action in time of crises’<sup>19</sup>.

The Baltic States’ objective of reaching a consensus on the definition of ‘energy solidarity’ has become more plausible since the ratification of the Lisbon Treaty. After the completion of some important structural changes, Catherine Ashton, High Representative for Foreign Affairs and Security Policy of the EU, now has the opportunity to become the first real strategic embodiment of the EU’s ‘single voice’ in terms of foreign and security policy, which also includes energy policy towards external suppliers. New Commissioners, in particular, those responsible for energy and climate, are also starting to play a very important operational role in ensuring that the EU improves the functioning of the internal energy market and that external energy resources are secured by different means. All these developments represent a ‘new momentum’, and it would be inexcusable if the Baltic States failed to grasp this opportunity and to provide solid arguments in favour of the EU putting in place a mechanism reflecting a real EU ‘solidarity’ in energy affairs.

In the current circumstances, one of the main tasks for the Baltic States is to build an appropriate explanation as to why the EU bodies (Commission, external policy officials, structural funds, etc.) or ‘national champions’ in the energy sector should contribute considerably to the energy security of the Baltics. The repetition of *clichés* such as ‘EU solidarity’ and ‘Energy Island’ appears to be insufficient and therefore ineffective. It may be expected that, in the future, the Baltic States will shift towards stressing solidarity as a factor implying political security and having a broader impact on the stability in Europe. It may also be expected that the Baltic States will continue to explain the need for European investments, since local monopolies under companies

<sup>18</sup> Kai-Olaf Lang, Deputy Head of Research Division, Stiftung Wissenschaft und Politik, EU Integration Division, interview by the author, 24 February 2010, Berlin, Germany.

<sup>19</sup> Ibid.

closely aligned to “Gazprom” are not likely to make decisions to invest into additional energy infrastructure. To a certain extent, the Baltic States are right. Allowing “Gazprom” to take over the Baltic States’ key energy assets was also the fault of EU market regulators.<sup>20</sup> Urging the EU to address the consequences and the abuse of these negative developments should now become the subject of internal or governmental debate. On the other hand, persuading the EU member states that the Baltic States’ interests (to prevent or even roll-back the monopolisation in energy affairs) are in line with those of the EU might become quite a complicated process.

## 2.2. Promoting ‘reciprocity’ and legally binding agreements

Russia supplies around 25-30% of total EU oil and gas consumption and serves as an important engine for Europe’s economic growth. By 2020 the EU will need to import approximately 600 bcm of gas, up from ~ 400 bcm today, and at least half of this demand will have to be sourced from Russia<sup>21</sup>. Thus, the possibility that Russia will diversify its gas exports in the future is rightly considered to be a threat to the security of Europe’s gas supply<sup>22</sup>. In addition, as much as 90% of Russia’s total natural gas exports are delivered to the EU. Adding together exports of oil and other raw materials, Russia’s energy exports to the EU account for roughly 75% of Russia’s total export earnings and 40% of Russia’s budget receipts<sup>23</sup>. In other words, the European market is crucial for Russia, and neither Asia, nor North America will constitute a reliable alternative for Gazprom in the foreseeable future.<sup>24</sup> For many Western experts,

<sup>20</sup> Christof van Agt, Senior researcher at the CIER, interview by the author, 2 March 2010, The Hague, Netherlands.

<sup>21</sup> Weafer, Ch., “GAS-OPEC – cooperation or confrontation? Baltic Rim Economies.” <<http://www.tse.fi/FI/yksikot/erillislaitokset/pei/Documents/bre2009/292%201-2009%20Expert%20articles.pdf>>, 3 10 2009.

<sup>22</sup> Poussenkova, Nina (2009): “Gazprom and Russia’s Great Eastern pipe-Dreams.” *Russian analytical Digest* 58. <[http://kms1.isn.ethz.ch/serviceengine/Files/ISN/99249/ipublicationdocument\\_singledocument/C1BC5C37-C974-484D-8DAC-113D364C5560/en/Russian\\_Analytical\\_Digest\\_58.pdf](http://kms1.isn.ethz.ch/serviceengine/Files/ISN/99249/ipublicationdocument_singledocument/C1BC5C37-C974-484D-8DAC-113D364C5560/en/Russian_Analytical_Digest_58.pdf)>, 7 10 2009.

<sup>23</sup> Perret, Q., “The EU, Russia and Gas: Intimations of Mortality and Supremacy of Politics.” <[http://www.lfpr.lt/uploads/File/2007-19/Perret\\_ENG.pdf](http://www.lfpr.lt/uploads/File/2007-19/Perret_ENG.pdf)> 3 10 2009.

<sup>24</sup> It is believed that Russia will not be willing to miss out on the world’s biggest market (500 bcm/year) for relatively small Asian (China and India need 80 bcm/year) or North American (140 bcm/year) markets.

these circumstances imply a 'mutual interdependence'. The problem is that the Baltic States think differently.

Lithuania, Latvia and Estonia recognise that "even though 'love' between Russia and the EU is extremely unlikely to emerge, the necessity for cooperation will remain."<sup>25</sup> Nevertheless, they claim that real reciprocity in EU-Russia energy relations is missing, due to the unequal weight of the two players. In other words, Russia's vulnerability compared to that of the EU is much lower, as it can shift current oil flows easily, and gas exports are relatively unimportant as a source of revenue for the Kremlin<sup>26</sup>. Besides, relevant Russian actors are capable of acting unanimously and strategically, while the EU is internally divided, both structurally and institutionally<sup>27</sup>. Whereas Russian strategic energy interests are usually represented at the highest political level, with the president or the government making all strategic decisions, within the EU and its individual member states, they are represented at the level of private companies. This secures Russian companies the possibility to penetrate into the EU gas market. Russian firms usually not only succeed in securing a direct presence in the EU gas market, but also avoid competition and enjoy the highest profit margin<sup>28</sup>. For instance, Moscow knows that some suppliers are seeking to open or broaden their access to Western markets. Therefore, "Gazprom" is trying to establish permanent control of markets, such as those of Hungary and the Balkans, which are strategically important for transportation before Caspian gas can reach them through the "Nabucco" pipeline.

Another tendency that worries the Baltic States, is the Russian endeavour to 'coordinate' the gas policies of the leading gas exporting countries through measures, such as the construction of new pipeline projects, 'joint' exploration and development of gas fields, and coordination of production schedules.

<sup>25</sup> Marcel Viëtor, Program Officer for Energy and Climate at DGAP, interview by the author, 10 December 2009, Berlin, Germany.

<sup>26</sup> Grajauskas, (note 13)

<sup>27</sup> Gratz, J., "Energy Relations with Russia and Gas Market Liberalization." March 2009. <[http://library.fes.de/pdf-files/ipg/ipg-2009-3/06\\_a\\_graetz\\_us.pdf](http://library.fes.de/pdf-files/ipg/ipg-2009-3/06_a_graetz_us.pdf)>, 03 11 2009.

<sup>28</sup> The distribution business is one of the most profitable areas, while the upstream market requires the largest investment. For more details, see: Aalto, P., *The EU-Russian Energy Dialogue. Europe's Future Energy Security*. Helsinki: University of Tampere. 2008

As a proof of this, in December 2008, Russia, Qatar and Iran formally inaugurated the GECF. Having initiated of this forum, Russia views it as a mechanism for attracting more investment funds into its gas industry and establishing “Gazprom” as a major global force in the LNG business<sup>29</sup>. The GECF has since enlarged and now includes Algeria, Nigeria, Libya, Egypt, Trinidad and Tobago, Venezuela, Russia, Iran, Qatar, Oman, the United Arab Emirates, Brunei, Malaysia, Indonesia and Norway (as observer)<sup>30</sup>. Members of the GECF exchange views and information on project development, supply and demand balances, exploration, production and transportation costs, etc.<sup>31</sup> As such, the GECF clashes with the ‘free market’ approach and competition policy promoted by the EU. Indeed, it makes contracting new exporters without consulting the dominant GECF member (Russia) extremely complicated.

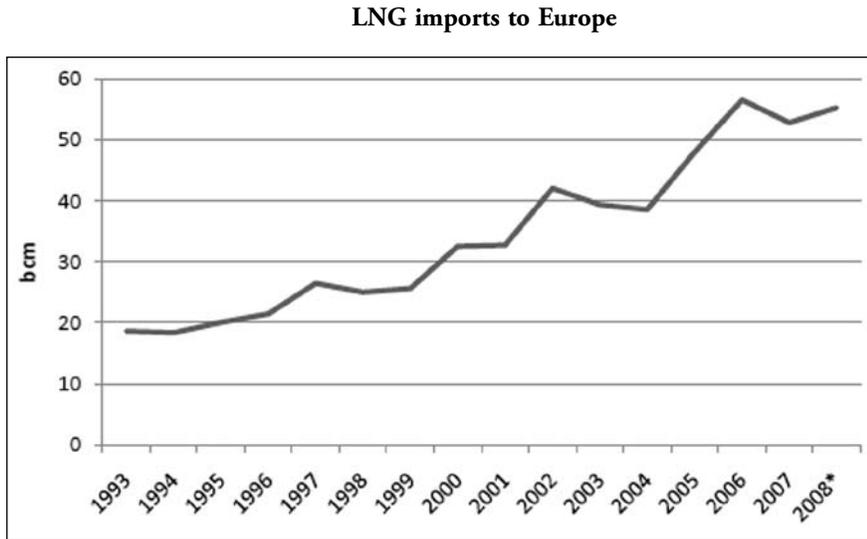
In this situation, the Baltic States have no other choice but endeavour to convince their Western partners that it is necessary to continue negotiations with Russia regarding a new legally binding agreement in energy affairs. Even though in the short term, the Russian government may discard proposals coming from the EU, the so-called ‘U-turn’ in Russian energy policy is not inconceivable. This assumption is based on the fact that Russia’s energy sector lacks investment and, what is even more important, that consumers do find alternatives to Russian energy resources. The construction of new LNG terminals, as well as the latest developments in the shale gas sector, have, in fact, already led to a change in the negotiating position of the Russian government and “Gazprom” in particular (see schemes 2 and 3 on LNG import and consumption in Europe).

<sup>29</sup> Weafer, (note 21).

<sup>30</sup> Hallouche, H. “The Gas Exporting Countries Forum: Is it really a Gas OPEC in the Making? Oxford Institute for Energy Studies.” May 2006. <[www.oxfordenergy.org/pdfs/NG13.pdf](http://www.oxfordenergy.org/pdfs/NG13.pdf)>, 10 11 2009.

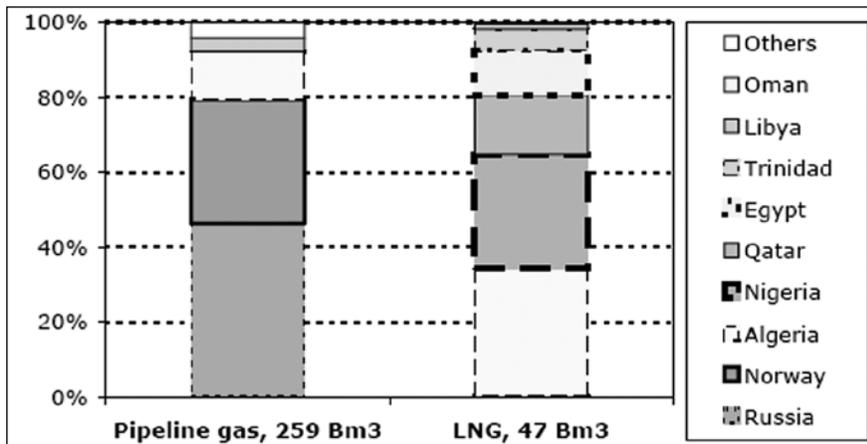
<sup>31</sup> While the weight of the forum in the global pipeline gas trade is not that pronounced (about 38%), its share of LNG production and exports was around 85% in 2007. In contrast, OPEC’s share of world oil supply is barely half the amount, at about 43%. However, it is still too early to say that a ‘gas cartel’ similar to OPEC has been created. The GECF membership has not been stable, nor are all gas exporters members of the GECF. The behaviour of key members may have an important, yet not always positive, impact on the GECF in the future. Finally, Russia cannot afford to fund a world-wide increase of LNG consumption, nor does it want to.

Scheme 2: LNG import and consumption in Europe



Source: Energy Policy Research Foundation (2009): *Russian Gas to Europe, Part Deux*. Washington. <<http://www.eprinc.org/pdf/gazprom-ukrainedeux.pdf>>, 2 11 2009.

Scheme 3: Pipeline and LNG net imports in the EU by countries of origin (in 2007, %)



Source: Kavalov, Boyan/Petri ´c Hrvoje/Georgakaki Alike (2009): "Liquefied Natural Gas for Europe– Some Important Issues for Consideration." *The Institute for Energy*. July 2009. <[http://ec.europa.eu/dgs/jrc/downloads/jrc\\_reference\\_report\\_200907\\_liquefied\\_natural\\_gas.pdf](http://ec.europa.eu/dgs/jrc/downloads/jrc_reference_report_200907_liquefied_natural_gas.pdf)>, 6 11 2009.

Russian officials have become less assertive and more compliant to international policy frameworks, as they have come to understand a simple truth: the continuation of a strategy, which scares away both customers and investors, may result in the loss of a large portion of possible income from oil and gas production. The first practical consequences of this have already manifested themselves. "Gazprom" previously claimed that it would supply Europe with 20% of its gas needs (the rest would be exported to China and the US), but now states that it wants to supply 30%. In other words, "Gazprom" has started to worry that it will lose even this 20% of the EU market. It seems that the Kremlin has become concerned about recent tendencies and may agree to some concessions.<sup>32</sup> Due to this, it may be expected that Russia will soon become interested in reaching an agreement with the EU. Therefore, the Baltic States should do everything in order to ensure that the EU does not miss the opportunity to conclude it.

While discussing the content and essence of a potential EU-Russia agreement in the energy sector, the Baltic States would prefer the EU not to walk away from the Energy Charter Treaty (ECT) as the integral, comprehensive energy agreement. However, in April 2009, Russian President Medvedev submitted a document entitled *A Conceptual Approach to the New Legal Framework for Energy Cooperation (Goals and Principles)* to the European Commission containing Moscow's proposals for a new set of rules under which the global energy market should operate. Sometimes also referred to as 'Medvedev's Concept', this document proposes rules which run counter to the liberalisation of the EU energy market planned by the European Commission and the provisions of the Energy Charter. It demands, inter alia, guarantees and predictability of sales (which means that priority is to be given to long term contracts as a key factor in ensuring energy security), the protection of investments as well as "non-discriminatory access to international energy markets" (which could clash with EU plans to separate supplies and distribution in the EU market). Another proposal concerns the obligation to coordinate energy policies, including infrastructure projects.

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<sup>32</sup> Christof van Agt, Senior researcher at the CIEP, interview by the author, 2 March 2010, The Hague, Netherlands.

The EU has indirectly responded to Russia's proposals by reaffirming that regulation of the European market would be based on the ECT<sup>33</sup>. However, the problem here is that both parties (the EU and Russia) are fairly limited in their ability to make compromises on their market views, especially in the gas sector. Western experts seem to agree that the proposals set out by Russian President should be taken on board. If so, the added value of negotiations would then be to remain involved and to preserve a space for further talks with Russia. Westerners would most probably even accept Russia's 'return' to this treaty without the strategically important Transit Protocol.<sup>34</sup> Article 7 (dealing with transit issues) of the ECT is quite broad in scope and, legally speaking, sufficient to deal with transit issues.<sup>35</sup> The task for the Baltic States is to find and propose solutions in this complicated situation.

As Russia's objection makes proceeding with the ECT extremely complicated, one feasible solution (however, not yet articulated even by the Baltics) is to look for a 'specific agreement' with Russia, without distancing the demands of this new agreement too far from those of the ECT. Other 'specific agreements', such as the agreement between Norway and the International Energy Agency, could be referred to as a model. In any case, such an alternative agreement can only be feasible if Moscow departs from its prejudice that the rest of the world has very few alternatives to secure its energy supply and, therefore, that Russia does not need any legally binding agreements with the EU.

While waiting for a real shift in Russia's thinking to occur, the Baltic States are concentrating on the construction of the internal EU legal framework, which would be applied to external suppliers. Thus, they have adopted the 3<sup>rd</sup> Energy Liberalisation Package without any exceptions or transiting periods<sup>36</sup>. Russia has voiced its opposition to the clause and received strong support from

<sup>33</sup> Paszyc, E., "Moscow's response to the Energy Charter Treaty". <<http://www.osw.waw.pl/en/publikacje/eastweek/2009-04-29/moscows-response-to-energy-charter-treaty>> 25 11 2010.

<sup>34</sup> Christof van Agt, Senior researcher at the CIEP, interview by the author, 2 March 2010, The Hague, Netherlands.

<sup>35</sup> In essence, the Russian side supported the Transit Protocol, as it better accommodates Russia's strategic interests than Art. 7 of the ECT. After the failure of this 'strategy', the Transit Protocol remained unsigned.

<sup>36</sup> Grajauskas, (note 13).

eight EU countries led by France, Germany and Italy<sup>37</sup>. These countries refused to take the path of the so-called 'full ownership unbundling', in which a parent company sells its transmission networks to a different firm. Requirements for vertically integrated companies were softened: they were obliged to meet rather vague 'effective unbundling' and energy security criteria, which would be assessed by both national regulators and the European Commission. Although in practical terms the difference might not prove to be very significant, the Baltic States are very much disappointed with this outcome. They argue that, while the EU tries to address the reciprocity problem at the macroeconomic level by setting equal conditions for all representatives of the sector, Russia continues an effective policy at the microeconomic level, looking for specific deals beneficial to Russian companies. According to the Baltic States, being dubious about the need to unbundle EU energy companies in fact encourages Russian companies to increase pressure and to deal with different member states separately. This is evidenced by "Gazprom's" official claims that the Lithuanian decision to separate sales and transmission activities has hurt its investment in the country and that the implementation of ownership unbundling could cause disruptions of gas supply.<sup>38</sup> This kind of relationship goes back to the 'barter reciprocity' so unacceptable for the Baltic States, where energy assets become objects of barter exchange<sup>39</sup>, and have nothing to do with 'mutual interdependence' or 'strategic reciprocity'.

## Conclusions

In creating a functioning EU electricity and gas market, the Baltic States are trying to convince all EU member states to live up to the letter of the document "Energy Policy for Europe", which puts "a truly competitive, interconnected and single Europe-wide internal energy market" at the heart of

<sup>37</sup> Dimireva, Ina (2009): "Future Energy Policy." *EUBusiness*. <<http://www.eubusiness.com/energy/Energy/future-policy>>, 25 09 2009.

<sup>38</sup> For more details see: <<http://www.bloomberg.com/news/2010-09-30/gazprom-e-on-should-redirect-unbundling-complaints-to-eu-lithuania-says.html>> , 5 10 2010.

<sup>39</sup> For example, a country would allow Gazprom greater access to its energy market to be sure that its energy giants secure energy deals with Russian companies.

Europe's energy policy<sup>40</sup>. As far as diversification is concerned, the Baltic States encourage the EU to take responsibility and develop external relations with potential oil and gas suppliers and transit countries from Eastern Europe, the South Caucasus, Central Asia and the Middle East.

However, despite the hopes of the Baltic States for a common European voice and positive public opinion in the entire EU<sup>41</sup>, governments and private companies in Germany, Italy, the Netherlands, France, Finland, or Denmark prefer to deal with the external energy suppliers on a bilateral basis. These countries, which are crucial to the common EU energy policy, tend to believe that bilateral cooperation is more effective for securing sufficient energy supply. As has been demonstrated, many EU governments consider a common EU external energy security policy, including a common vision towards EU-Russia energy relations, to be ineffective, and worry primarily about the possibility of 'engaging' and 'modernising' undemocratic suppliers in order to avoid gas supply disruptions in the future.

In this regard, the Baltic States are advised to concentrate on national and regional non-political, but economically highly beneficial measures, such as informing people on effective consumption habits, setting up a framework for developing alternative energy resources, integrating national electricity and gas markets and constructing certain energy infrastructure objects. Petra Opitz, for instance, states that, if there is a possibility to import electricity or gas from Belarus at the lowest price, this should be done. If Belarus or Russia is not considered to be a fully reliable supplier, then the Baltic States should make their domestic market attractive for investors who would be interested in building electricity/gas grids/pipelines and profit from the import of energy resources from Finland, Poland and other countries. A new NPP could be constructed if the Baltic States plan to build up an export strategy – this could also gain investors' interest. The decision on the construction of an LNG terminal should be made following the same logic – first

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<sup>40</sup> European Commission, "Communication from the Commission to the European Council and the European Parliament an Energy Policy for Europe" COM(2007). Brussels. <[http://ec.europa.eu/energy/energy\\_policy/doc/01\\_energy\\_policy\\_for\\_europe\\_en.pdf](http://ec.europa.eu/energy/energy_policy/doc/01_energy_policy_for_europe_en.pdf)>, 14 09 2010.

<sup>41</sup> According to an opinion poll carried out for the European Commission in 2005, 47% of the respondents from all 27 EU member states support that decisions on key energy policy issues are taken at the European level, whereas 37% favoured decisions at the national and 8% at the local level.

of all, it should be evaluated whether the market is big enough to sell the imported gas.<sup>42</sup>

Nevertheless, the Baltic States hope to make use of the fact that they have participated in the common EU energy policy from the very beginning. Thus, despite repeated advice to concentrate on national efforts, the Baltic States hope to extend the reach of this very important area of the 'common' EU policy. Two conceptual directions of their strategy – establishing a common EU perception on 'solidarity' in energy affairs and application of the real 'reciprocity' principle within EU-Russia energy relations – were analysed in the third chapter. It was stressed that disputes related to 'consumer solidarity' arise primarily due to differences in the various national discourses and divergent views on how to implement this principle, but not because member states oppose the 'solidarity' idea as such. Nevertheless, it was concluded that the implementation of the principle of 'consumer solidarity', as it is understood by the Baltics, is of prime importance for the Baltic States if they hope to finance nationally or regionally important energy infrastructure development projects from the EU budget.

As regards the debate on reciprocity, the *status quo* of EU-Russia energy relations, according to the Baltic States, cannot be considered as strategic, predictable, and equally beneficial for both parties in the partnership. The Baltic States argue that it represents asymmetrical producer-consumer relations that neither boost the aspired modernisation and transformation of Russia, nor oblige Russia to fulfil its commitments to supply Europe with the promised amount of gas. Therefore, it would be in the interest of the EU to conclude a long-term agreement on energy issues with Russia. However, the revival of, for instance, negotiations on the ECT is hardly possible, as Moscow perceives the ECT to be 'not balanced' and countervailing to Russian interests. The goal of the Baltic States in this regard is not to roll back Russian investment decisions, but to agree on certain stricter terms of how the gas price is established, under which conditions "Gazprom" may invest, etc. In this context, this article has argued that the main task for the Baltic States is to equate the attitude that the EU holds towards "Gazprom's" mo-

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<sup>42</sup> Dr. Petra Opitz, Manager at DIW econ, interview by the author, 18 December 2009, Berlin, Germany.

nopolistic position with the attitude it holds towards, for instance, Microsoft and its monopoly in the IT sector.

The following policy recommendations (addressing the Baltic States' governments) can be deduced from the analysis. First, in contrast to the cases of Western and Southern Europe, the EU has never had a debate regarding the interconnections with the Baltic States. Thus, soon after the EU begins investment in "Nabucco", which is aimed to supply both Central and South Eastern Europe, or to deliberate the Caspian Development Cooperation, the Baltic States should point out the imbalance created by the focus on these projects and propose measures that will similarly benefit *their* situation of supply security.

Second, the Baltic States should base their motivation on reasons of *market structure* and present the desired energy infrastructure development projects as enabling a competitive market structure. In other words, they should explain to their partners that the current market structure is such that some states experience a monopoly risk. Therefore, new pipelines, LNG terminals or NPPs are needed not so much to get somebody out of the market, but rather, to keep prices within certain limits and avoid political influence. In this regard, the Baltic States could argue that, even if the LNG terminal or gas interconnections options are difficult to commercialise, this will not necessarily mean that someone will be losing money. Rather, these assets will serve to definitively limit monopolists' prices and thus benefit consumers. In fact, this difference in prices may even make some non-viable projects viable.