



The Ukraine War and CEE Energy Security

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THE ISSUE

The Ukrainian crisis has reinforced the belief that the energy security of Central and Eastern Europe (CEE)—especially that of natural gas supplies—is not a given. Until the European Union's energy market mechanisms become efficient and fully developed, CEE's energy security equation will have to include geopolitical as well as economic and infrastructure elements. The stability of energy supplies therefore depends on continuous coordination of the costs associated with these additional yet crucial expenses. Considering the growing complexity of global energy markets, just as internal and external market abuses may provoke energy crises in CEE, opportunities to strengthen CEE energy security exist not only regionally or within Europe, but also beyond, in the United States.

Need for change

The war in Ukraine has triggered many changes in the geopolitics of energy across the region. Since their accession to the European Union, the CEE countries have repeatedly warned of Russia's threat to their own energy security, prompting EU support during the gas crises of 2006 and 2009. Russia's 2014 annexation of Crimea and invasion of eastern Ukraine removed any lingering doubts; its cutting of gas supplies to CEE, coal blackmail and black PR—not to mention the military occupation of Ukrainian territory and Russian nationalization of key elements of Ukraine's energy industry—confirmed the worst-case fears of excessive dependence on Russian energy resources.

Russian President Vladimir Putin has clearly demonstrated one of the worst facets of energy dependence in Ukraine, proving that energy is only another tool for achieving hard power. Despite the obvious nature of this strategy, Russia keeps trying to disguise its political interests as economic arguments, using strong, consistent rhetoric alongside pure propaganda. As a consequence, the Kremlin has once again succeeded in dividing Europe. While the CEE nations bore the brunt of Russia's hardball energy politics, many Western European governments (and energy companies) did not question Moscow's reputation or credibility.

Recognizing weakness

In reality, Russia cannot easily extend its energy mischief in Ukraine to the EU. Even though Russia is Europe's main crude oil supplier—accounting for more than 30 percent of imports on average, and about 75 percent of imports for Bulgaria, the Czech Republic, Finland, Hungary, Lithuania, Poland and Slovakia¹—the structure of the oil market, and its proper functioning, moderate the possibility of Russian abuses. Similarly, the EU's coal business with Russia does not pose a direct peril to member states due to global trade and the availability of multiple suppliers, including CEE nations. Furthermore, Europe's nuclear energy industry can defend itself against corrosive interference from Moscow, even though Russia ranks among the top suppliers of European nuclear fuel services (18 percent of uranium supplies and 26 percent of enrichment services²) and dominates CEE in fueling Russian-designed VVER nuclear reactors. (Only recently has Westinghouse been trying to compete with Russia's TVEL, a subsidiary of Russia's state-owned Rosatom, as a supplier of nuclear fuel).

This leaves the gas trade. It is the weakest link in the EU-Russia energy relationship. Overall, Russia satisfies more than 30 percent of the EU's gas import needs. In absolute numbers, the top consumers of Russian gas are located in the West—namely France, Germany, Italy and the UK. It is in the CEE region, however, where import dependence on Russian gas is greatest. Estonia and Latvia rely 100 percent on Gazprom's resources; until 2014, Lithuania was too. Bulgaria, the Czech Republic, Slovakia, Poland, Hungary and Slovenia also rank high, with dependency rates of 55 to 95 percent. This reliance is what makes CEE states vulnerable to Russia.

3 CEE ENERGY SECURITY

Even after joining the EU, CEE member states remained subjected to the old rules of Russia's hardball energy politics. After the USSR's dissolution, these states continued to rely on a system of pipelines that were originally designed to support communist-era command economies—not a borderless free market for supplying the greatest number of consumers with the most energy at the lowest cost. Russia's monopolistic energy pricing schemes further reinforced the limitations of the old pipeline infrastructure. The net result was that a robust and liberal market for gas supplies had rocky soil in which to grow. Even so, these factors alone might not have been exceptionally onerous on CEE states had Russia treated gas as a normal commodity. Unfortunately, this was not the case. Instead, the Kremlin's relations with downstream consumers became a tool of statecraft.³ Years later, the underlying fundamentals of the old energy regime are unchanged. CEE states remain dependent on Russian gas, which is still transported by pipelines moving from east to west. Despite the availability of some Norwegian gas, as well as new—but limited—capacity to import liquefied natural gas (LNG), Russia continues to dominate much of the CEE market.

Following the eruption of the Ukraine war, Europe began to reassess the risks of relying too heavily on Russian gas imports. In the summer of 2014, for example, stress tests carried out under EU auspices in 38 countries revealed an alarming vulnerability. CEE states would have few options in a crisis. The exercise simulated two scenarios: (1) a complete halt in Russian gas imports to the EU, and (2) a disruption of Russian gas imports along the old east-west transit routes through Ukraine. The results of the tests were troubling. In either scenario, the exercise showed that CEE mitigation efforts would be limited mainly to national markets. Unless regional cooperation efforts were tangibly strengthened, leaders would also resort too quickly to interventionist measures.⁴ The stress test demonstrated how little had changed in the CEE market. Worse, it showed that overreliance on Russian gas remains the fulcrum of energy insecurity in Europe.



New momentum

Discussions on the nature of the European and specifically the CEE gas sector have intensified in the wake of the stress tests. Yet the exercise did not occur in a vacuum. The geopolitical ripples of the Ukraine crisis refocused attention on Russia. Regional decision-makers realized that the best efforts to implement liberalization measures, market competition and contractual transparency, as announced in the EU Gas Directive, cannot yet guarantee CEE countries property energy security.⁵ Despite the potential harm that Russian gas dominance could cause in the region, the EU failed to enact sufficient, functioning defense mechanisms, allowing for integration of CEE gas markets with the old Soviet Union. Hence the need emerged to think and act strategically beyond the existing framework.

On April 21, 2014, the *Financial Times* published an op-ed by then-Polish Prime Minister Donald Tusk titled “A united Europe can end Russia’s energy stranglehold.”⁶ Building on the need to respond to the Russian threat, Tusk proposed a Polish vision of an Energy Union that would mobilize policy-makers to make political decisions and—best of all—allow the free market to function properly. Tusk’s proposal relied on several pillars: increased and better coordination of spending on energy infrastructure; solidarity mechanisms; increased bargaining power of member states and the EU *vis-à-vis* external suppliers; the development of indigenous sources of energy within the EU; diversification of upstream supplies; and strengthening the security of the EU’s neighbors.

By itself, the idea of the Energy Union did not bring about many substantial changes to EU energy policy. However, the bottom-up Polish proposal gave European energy policy a new narrative and new momentum. The EU realized that it must harness market tools to extend lasting energy security to its citizens, while also grappling with the geopolitical dimensions of energy policy—particularly when it comes to CEE.

As the Energy Union gained momentum inside the EU, European Commission Vice President Maroš Šefčovič developed it into a definite political project. It assumed precise time frames that were tailored to the needs of all member states. For CEE states, the Energy Union has clarified priorities.

For starters, the region’s countries have chosen to emphasize technological and political insurance mechanisms, a concept that is best summarized in one word: diversification. These mechanisms require a new approach and new definition of supply security—one that includes tangible infrastructure elements as well as speculative ones, measured by the potential availability of alternative supplies.

“Overreliance on Russian gas *remains the fulcrum of energy insecurity in Europe.*”



Technical insurance

Much of the recent focus of the EU gas industry has been on large pipeline projects such as the Nord Stream, Nabucco, South Stream and Turkish Stream gas pipelines (the latter two have since been abandoned). Meanwhile in the CEE region, several smaller-scale projects (such as cross-border gas interconnectors) could have a longer-lasting impact on the resilience of the regional gas market. Financial and support tools, such as the Baltic Energy Market Interconnection Plan (BEMIP) and various other projects of common interest, will make mammoth infrastructure projects like the North-South Corridor or Intermare possible. The goal for CEE states is to overcome problems caused by the lack of regional infrastructure links to alternative, non-Russian sources. Additionally, these countries seek to eliminate the inefficient use of existing interconnections, legacy transit regimes that result in market foreclosure, and long-term supply contracts with Russia.

As a result of these efforts, Russian gas from the Brotherhood pipeline, traditionally delivered through CEE countries to Western Europe, can now flow in reverse from west to east—for example from the Czech Republic to Slovakia, or to Ukraine from Poland, Slovakia and Hungary. Poland intends to further increase its capacity to send gas eastward, as outlined in the 2014 Gaz-System and Ukrtransgaz agreement to develop a new bidirectional pipeline along the Polish-Ukrainian border. It is also developing interconnections with Germany, the Czech Republic, Slovakia and Lithuania. Hungary likewise has strengthened relationships with neighboring Croatia, Romania and Slovakia through new pipelines and reverse flows.

In response to construction of the Nord Stream 1 pipeline, which diverted significant volumes of Russian gas previously flowing through the Czech Republic and Slovakia to Germany, both countries decided to turn the challenge of adapting to this new infrastructure into a benefit. As a consequence of these interconnection improvements, differences in gas prices in CEE countries have begun to converge to the extent that, for example, the prices that Czechs and Slovaks pay for gas are now similar to German hub prices. This is a new development, and it is an improvement for consumers. Other CEE countries still struggle to liberalize their markets despite Gazprom's dominant position. Nevertheless, gas-to-gas competition is increasing as more possibilities to reroute gas flows open up, and countries' gas storage capacities grow slowly but steadily.

Speculative leverage

Improving the interconnector network is one way to encourage gas diversification, as it allows for freer and more flexible gas flows. Yet the root of CEE's problem is overdependence on Russian gas, whether it is transits Ukraine, gets rerouted through Nord Stream or is sold on the hubs. Hence, CEE needs not only alternative supply routes, but, above all, alternative supply sources such as the above-mentioned reverse flows via existing pipelines; new indigenous onshore and offshore resources; LNG, and Caspian and Middle East resources via the Southern Gas Corridor.

A persistent snag to greater diversification is geography. In the case of CEE markets, the limitations of geography mean that the potential for major diversification improvements are in the hands of a few players. The physical proximity of the Czech Republic and Slovakia to major European hubs has been a great benefit, but also one that is unique to their location. Meanwhile, Lithuania has leveraged its location on the Baltic Sea. That country can now access global gas suppliers thanks to the *Independence*, a persistent, floating LNG terminal that can handle up to 4 billion cubic meters (bcm) per year. The vessel has been operating since autumn 2014. Similarly, Croatia has entertained the possibility of establishing an LNG regasification plant on Krk island.

“CEE needs not only alternative supply routes, *but, above all, alternative supply sources...*”



Nevertheless, the greatest influence could be Poland, located at the crossroads of the east-west and north-south axes, with access to the Baltic Sea and developing interconnections with all its neighbors. The LNG terminal now being built in Świnoujście, Poland, with a capacity of 5 bcm per year (with future expansion up to 7.5 bcm per year), will begin operation in late 2016 using imported Qatari gas. This LNG terminal, plus plans to build pipelines with Norway and Denmark, give Poland the most potential to enlarge the CEE gas market.

However, Polish gas policy is not free of problems and inconsistencies. For instance, the LNG terminal was clearly a political flagship project—targeted against the dominance of Russian gas—that will satisfy almost a third of Poland’s gas needs. But construction problems, gradually decreasing ambitions and contractual controversies as well as substantial delays have undermined the project’s credibility. As a consequence, what could have been a concrete and immediate asset has turned into a temporarily unprofitable burden with only long-term potential for market-based benefits. In reality, the terminal can only make profits if it is fully integrated into the CEE transmission network and becomes part of the North-South Corridor. That, however, requires further interconnection efforts and cooperation of regional actors.

Even though it’s not yet operating, Poland’s LNG terminal has already affected the CEE gas market in terms of speculative attention from potential U.S. and other gas suppliers, thereby deterring Russian attempts at manipulation. Similarly, thanks to its own LNG terminal, Lithuania can claim a victory over Gazprom as once-exorbitant prices for Russian gas have fallen by 20 percent.⁷ This shows that real diversification is possible only through incurring relevant but high costs. The costs of creating transmission overcapacity need to balance the potential benefits of assuring energy supply security in an uncertain future.

Cooperation paths

CEE's existing and planned interconnectors and LNG terminals offer the option of diversifying gas imports. Global growth of LNG markets will allow CEE countries to eliminate oil-indexed contracts and move toward gas pricing hubs. In addition, competition between the LNG market and proposed new Russian pipelines like Nord Stream 2 and Poseidon may further depress gas prices. So for the moment, the United States cannot be an alternative gas supplier to Europe—even if it is perceived as one. Current low oil and gas prices hinder the economic viability of U.S. gas exports to CEE; even if U.S. LNG shipments to CEE were possible due to lowered export barriers, they would still be only marginally competitive with Russian resources.

The long-term outlook is much more promising, however. Taking into account strategic considerations, CEE countries could be willing to pay more for secure U.S. supplies in order to keep Russian influence at bay. The protective character of some energy investments might explain why market conditions were disregarded, for example, by Lithuania and Poland.

Energy security constitutes a double-edged sword. Even if nobody in CEE thinks seriously about completely excluding Russia from the European market, Gazprom feels threatened by CEE integration and diversification choices. It would come as no surprise, therefore, if Russia were to multiply its efforts to ensure demand for its gas by maintaining leverage over the region and by constantly undermining regional energy security. Russian actions may range from beneficial economic incentives (e.g., Hungary's nuclear-gas package deal or gas discounts for Lithuania), through pseudo-market behaviors (e.g., recent gas auctions in the Baltics) and direct warning signals (e.g., temporary reductions in the volume of gas exports to Poland in 2014), to the traditional “divide and conquer” Russian strategy (e.g., the Nord Stream 2 “economic project”).



The latter is a bone of contention throughout the whole EU, but even the positions of CEE countries diverge. East and West disagree on the definition of security and diversification. Reducing dependence on Russian gas in Eastern Europe has nothing to do with the desire of western CEE countries to enrich their portfolios with cheap Russian gas. Second, arguments against Nord Stream 2—such as solidarity with Ukraine, noncompliance with EU laws, loss of transit revenues if use of the Brotherhood and Yamal pipelines decreases, the need to renegotiate terms of existing contracts, costs of alternatives—do not seem convincing to some CEE countries like the Czech Republic (which benefits from Nord Stream 1) or Hungary (which expects Russian political backing in other domains). This results in CEE disunity and the predominance of short-term national interests above regional coherence.

The region should therefore focus on creating a stronger and broader community to resist any Russian pressure. Among the many entities that include the CEE countries, the EU offers an obvious platform for cooperation. Although the EU has proven internal coordination potential, it still lacks self-confidence in external relations, especially with Russia. Yet the economic instability EU sanctions cause restricts Russia's freedom to act more effectively than any direct military action. Therefore, a less obvious, but certainly more impressive, forum of cooperation to deal with CEE energy security could be NATO. First, NATO focuses on the difficult, yet relevant security considerations while dealing with any Russian threat; second, its membership includes the United States and Norway, both major gas producers; third, it is already empowered to act in the field of energy security. It would be a great success if NATO's 28 members agree to make energy security a natural, regular element of discussions.

CEE countries—due to their proximity, shared experiences and sense of solidarity—identify closely with Ukraine and consider its integrity, stability and energy security crucial to their own concerns. Entangled in the endless, so-called “hybrid war” with Russia and deeply mired in economic crisis while dealing with an unpredictable energy balance, Ukraine chose the West; it hasn't bought gas from Russia since July 2015. But the West must support Ukraine's efforts to implement energy reforms such as reducing consumption, increasing efficiency and modernizing and adapting to west-east flows of its gas transmission system. Finally, Washington and Brussels should strengthen synergy of U.S. and EU action in confirming the validity of Ukraine's chosen path. Adequately guided, the EU's CEE members—thanks to their understanding of Ukraine's problems as well as their privileged relationship with the United States—have a potentially huge role to play in these combined efforts.

Endnotes

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