

# Getting Russian Gas to Europe: Old Relationships Sprout New Wings

Written by Morena Skalamera

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MORENA SKALAMERA, SEP 20 2017

In November, 2015, a crisis had erupted between Russia and Turkey after NATO-member Turkey shot down a Russian fighter jet over the Syrian-Turkish border after it had ostensibly crossed into Turkish airspace (Financial Times, 2015). Although the sides managed to avoid further escalation of tensions, relations consequently suffered a major breakdown. Immediately after the Russian-Turkish fallout, many commentators were quick to argue that the Turkish stream pipeline was shelved for the foreseeable future (BBC News, 2015; Johnson, 2015). That seemed logical and in line with the theory, almost *de rigueur*, that equates authoritarianism at home and an adversarial foreign policy. Conventional skepticism is based on the premise that authoritarian regimes are destined to prefer a combative approach to international relations and, if necessary, forego rational economic interests in favor of abrasive posturing in order to satisfy the need for revamped nationalism in the domestic context. Preoccupation with maintaining tight political control at home translates, in the international arena, into an emphasis on vigorous projections of power wherever possible in an attempt to assert status. Such normatively driven theories regard authoritarianism (such as those of Russia and Turkey) as inherently incompatible with a sensible approach to international relations. In the case of the Russia-Turkey affair, I contend, this kind of reading is reductive, and ultimately, unconvincing.

### The Changing Dynamics of Russian Pipeline Diplomacy in Europe

On Dec 1, 2014, Russian President Vladimir Putin abruptly announced the cancellation of the \$40 billion South Stream pipeline via the Black Sea and the Balkans, for which he blamed the EU over its “unconstructive” position. That same day, Turkish BOTAS and Russian Gazprom signed a Memorandum of Understanding for construction of a new offshore gas pipeline named Turkish Stream, with 63 bcm/y capacity to run under the Black Sea to the Turkey-Greece border with the plan of avoiding Ukraine once the current contract on transit through the country expires in 2019. Currently, in fact, still about a quarter of European Union gas comes from Russia, and at least half of that supply flows through Ukraine (Smale, 2015).

In the fall of 2015, Russia’s quest to obtain the good offices of Turkey as part of a solution for the smooth passage of its gas to Europe abruptly failed. Discussions were complicated by Russia’s launch of military action in Syria, thus forestalling Turkey’s goal of toppling the regime of Bashar al-Assad. In early October 2015, Turkish President Recep Tayyip Erdogan suggested that Turkey may diversify away from Russian gas and halt the construction of ongoing energy projects. This statement was followed by an announcement by BOTAS, Turkey’s state-owned pipeline operator, that it would take Russia’s Gazprom to international arbitration over a price discount it said it was promised on imports of Russian natural gas (Farchy & Srivastava, 2015).

Then, on Nov 24, 2015, Turkey shot down a Russian fighter jet after it veered into its airspace for 17 seconds. Bilateral tensions, resulting in the imposition of Russian sanctions (Reuters, 2015), seemed to quickly replace the goodwill that had characterized relations heretofore. These measures limiting trade and tourism did not, however, affect Russian energy exports to Turkey, still at the core of their economic relationship (Tartar & Alexander, 2015). In fact, neither the Turkish Stream pipeline nor the Akkuyu nuclear plant featured in the list of economic sanctions against Turkey (MacFarquhar, 2015).

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## Conventional Wisdom Misses the Substance just beyond the Sensation

Amid the geopolitical impasse, many observers were quick to conclude that to show displeasure and to convey an image of strength upon the increasingly powerful nationalistic fringes in their domestic audiences, both autocrats, Putin and Erdogan, will seek to take a tough stance toward their counterparts. These commentators, however, failed to appreciate that in the past decade Turkey's relations with Russia have significantly improved, especially in the energy realm. In 2010, Turkey brokered a deal with the state-controlled Russian company AtomStroyExport for the construction of Turkey's first nuclear power plant, a project worth \$20 billion. The Russian company will not only build the plant, but will also have a controlling interest in it (Skalamera, 2015). Most instructively, Russia supplies two-thirds of Turkey's natural gas which illustrates why, when Russia retaliated with a set of measures limiting trade, energy was spared.

Nevertheless, given the character of the two authoritarian regimes, seemingly inclined toward saber-rattling foreign policies, advised wisdom had it that the construction of Turkish Stream was halted for the foreseeable future (Roth, 2014). In a brief written in the winter of 2016, I noted that the evidence to support such propositions is scant. Worries about political survival certainly condition the behavior of autocrats in power but even authoritarian countries maintain immutable commercial interests that, in turn, drive foreign policy. Geopolitical tensions, indeed, do not erase basic economic fundamentals – something that should certainly apply to an analysis of the Russian-Turkish fallout in November 2015. What did change in the aftermath of the hostilities, I argued, was the likelihood that Turkish Stream would not launch as early as 2016. I predicted a further delay, something already in the offing before the military incident (due to BOTAS' international arbitration against Gazprom over a price discount), rather than freezing or axing the financing for this project completely.

In a system based on command, a powerful autocrat organizes and enforces law and order. Order is hierarchical and maintained through the dominance of the leader. Bilateral relationships in command-based systems (such as those of Russia and Turkey) can vary widely in terms of the personal predisposition of the leader in power and are also moderated by elements of reciprocity. It was within the parameters of such a system that Erdogan's close relationship with Putin turned into bitter personal enmity virtually overnight.

Yet the more two states become interconnected, the more dependent they are on the actions of the others for the realization of their objectives. As the global economic system in which states operate becomes more interdependent, states increasingly gain or lose depending on what other states do. The ability of even large, powerful, and autocratic states to ensure prosperity on their own diminishes. It is within the purview of these caveats that the Russian Energy Minister Alexander Novak announced in January 2016 that work on Turkish Stream could be resumed. In fact, the one bright spot in Ankara's relations with Moscow has remained their energy relationship. The reason is simple: Turkey, which imports 98% of its gas, buys more than 60% from Gazprom. Turkey needs to buy Russian gas, and Russia needs to sell it.

## The European Need for Gas Resources Outpaces its Desire for Energy Independence

Meanwhile, that same winter, Gazprom strongly increased gas sales in Europe. Gazprom CEO Alexei Miller told reporters "Our traditional customers demonstrated a stable growth of demand for Russian gas in the winter of 2016: Germany (+19% as compared with the same period in 2015), Italy (+8.7%), France (+43%) and Austria (+23%)". In 2017, once again, Gazprom reported record gas exports to Europe – a 21% rise in profit, exceeding expectations (Foy, 2017).

At the same time, Russia's misuse of the so-called "energy weapon" actually weakened its influence in Europe and in the post-Soviet space. Alarmed by the fear of gas cutoffs, the EU has pushed through unbundling and interconnectivity reforms, while looking to alternative sources of supply. Gazprom also faced legal action by the European Commission (EC) for its breaking of EU antitrust rules by "pursuing an overall strategy to partition Central and Eastern European gas markets with the aim of maintaining an unfair pricing policy in several of those member states" (European Commission, 2015). Despite these difficulties, the gas behemoth was determined to maintain a foothold in Europe, by far its most lucrative export market. Fortunately for Moscow, the consequences of mishandling

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its energy relations have not been fatal. Even though the EC expressed a desire to wean itself from Russian gas ever since the Ukraine crisis (when supplies from its eastern neighbor dropped during freezing weather in 2009), Europe will still need Russian oil and gas in large quantities. According to BP, Russia's share of EU gas consumption will rise to 40 percent by 2035 from more than 30 percent now (Mazneva & Shiryayevskaya, 2017).

Russia exports approximately 160 bcm of natural gas to Europe annually, excluding the former Soviet states. This amounts to 90% of the total Russian gas exports in value terms. Even after launching the Power of Siberia pipeline, the only material expression thus far of Russia's much-touted Gas Pivot to the East, the net profit from exporting a thousand cubic meters of gas from the main gas fields in eastern Siberia, namely Chayanda and Kovykta, will be \$38 and \$36 respectively. To compare, the net profit from exporting a thousand cubic meters to Europe is \$160. Thus, the profitability of gas sales to Europe exceeds the profitability of gas sales to China more than fourfold (Khaznah Strategies Ltd, 2014:6).

This explains why Russia is so determined to maintain and nurture its presence in Europe. As such, seen from Gazprom's perspective, it needs multiple Ukraine-avoidance pipeline routes to secure a reliable flow of gas to the lucrative Western European customers.

## North and South Streams: The Paths of Least Resistance

In Northern Europe Gazprom is pushing this goal by expanding the Nord Stream pipeline, though a spur called Nord Stream 2. And while U.S. Senate aims to target Nord Stream 2 in extended Russia sanctions (Foy, 2017), Germany and Austria have condemned the proposal, saying "these measures seek to bolster U.S. economic interests and include an unacceptable intervention in Europe's energy sector, thereby using political sanctions as instruments of economic interests" (Mazneva et al., 2017). The existing Nord Stream link is able to carry 55 billion cubic meters of gas, or two-thirds of German gas demand, and the expansion would double that. North Stream 2 is now embedded in a web of controversy given that thirteen EU member states have protested against it, saying it will divert trade and transit revenues away from them and increase European dependence on Russian gas for decades to come. Poland, unsurprisingly, is the most vocal detractor. Just before the G-20 summit, speaking in Warsaw, President Trump encouraged Eastern European leaders worried about their dependence on Russian energy to consider U.S. gas instead (Reuters, 2017).

For Russia, the logic of securing access to its most profitable Northern and Southern customers is clear: the country remains desperately dependent on oil and gas revenues, which provided about half of its total export revenues in 2016. With the oil price beyond control, Russia has every incentive to maximize its revenue from gas sales and to maintain its share of the European gas market by whatever means.

Having abandoned its massive South Stream project, Gazprom needs an alternative route to reach its main Southern European customers, such as Italy, which still heavily depends on transit through Ukraine. The answer is evidently Turkish Stream, the natural-gas pipeline project that had been suspended the previous year. Fearing another round of global sanctions, Russia recently stepped up laying pipes for Turkish Stream (Forbes, 2017; Daily Sabah, 2017; Georgia Today, 2017). This pipeline is strategically crucial for Moscow given that it would run under the Black Sea to Turkey and then to the Greek border, allowing Russian gas to reach South-West Europe without passing through 'troublesome' Ukraine.

## The Hungarian Answer to the Russian Problem

Turkish Stream has remained a problem since the sharp deterioration of Turkish-Russian relations following the downing of the Russian jet in November 2015. Yet, unforeseen developments are now possible due to a peculiar and potentially game-changing political triangle, that of Putin-Erdogan-Orban.

In the past year, Russian and Turkish officials have worked intensively to reduce the strains in their once amiable relationship. This message was reinforced during Putin's October 2016 visit to Istanbul, his first appearance in Turkey after the November 2015 incident. The official meetings featured statements about the Kremlin's

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reconciliation with Turkey and emphasized the importance of Turkish Stream.

Both leaders had said they wanted to restore robust trade ties, although differences persisted. Moreover, since then, Russia has pursued closer ties with Hungarian President Viktor Orbán a budding authoritarian whose controversial stands against the EU and against liberal society in Hungary have caught the Kremlin's attention. Orbán's potent mix of ethnic nationalism and anti-Western demagoguery has contributed to a sense of unease among Western allies while freeing his hands to reach out to potential partners in the East. Hungary's geographic position is the most relevant in shaping Russia's approach to a gas end-run to southern Europe that avoids Ukraine. Given its position astride both overland transportation routes from the East and between the last large conglomeration of non-EU territory to the South and the EU heartland to the North and West, Hungary can pass on Russian gas easily to Gazprom's main customers in the region, via Austria to Italy, thus solving the Southern conundrum. And in fact, on July 05, 2017, a day before President Trump's promotion of US LNG exports to Poland, Gazprom signed an agreement with Hungary to deliver gas via the Turkish Stream pipeline, as reported by Hungary's Foreign Minister Peter Szijjártó. Budapest now sees a new pipeline for Russian gas as the "only realistic" step toward energy diversification (Lovas, 2017).

Even in authoritarian settings, vital economic interests, albeit embedded in geopolitics, do matter. Russia certainly regards natural gas as a vital instrument of geopolitical influence in Europe. But its reconciliation with Ankara was much more about minimizing the potentially disastrous economic risks, rather than about assuaging dangerous geopolitical tendencies. After Germany, Turkey is Russia's largest gas customer in Europe. This explains why Moscow and Ankara appear to have put the problem of avoiding the escalation of their security crisis and, at the same time, the protection of economic interdependence, at the center of their foreign policy vision. The character of their energy cooperation evolved, but the impulse to trade persisted and remained fundamentally based on notions of economic profit. Ultimately, it was energy interdependence rather than geopolitics that generated incentives for Putin and Erdoğan to try to harmonize these ties again after a period of prideful resistance. After Hungary's recent Turkish Stream-overture, Putin and Erdoğan discussed the project on the sidelines of the ongoing G20 summit in Hamburg. Serbia, a historic Russian ally is unsurprisingly interested in joining the project, and so are Greece and FYROM (Sputnik International, 2017). With these players onboard, the rest will be easy.

## A Surprising Authoritarian Triangle or Why You Should Expect Turkish Stream to Happen

The authoritarian matrix between Putin, Erdoğan and Orbán is giving the Turkish stream project- and their trilateral relations - an unexpected new dimension. The strange convergence between Russia, Turkey and Hungary, rooted in economic necessity but nudged along by complementary personalities, might help Putin's Russia keep a foothold on the European gas landscape for years to come. Even if this appears to be overwhelmingly about Russia's exploitation of energy exports and pipelines for geopolitical ends, it is, in fact, much simpler. More than using economics as power projection, it reflects Russia's use of energy for its economic survival. As already noted, China will be no substitute for the European market. The oil and gas sectors are vital for the survival of Russia's economy, given that they accounted for 43% of the government budget and 53% of total exports as recently as 2015.

From the Russian and Turkish perspective, the benefits of Turkish Stream are clear. From Hungary's perspective the benefits might seem far less clear. Yet, consider this - Hungary, which relies on Russian imports via Ukraine for nearly all of its gas use (Hungary imports around 90% of its annual consumption from Russia), has sought to diversify its suppliers and the geographical range of its imports for years. International interconnectors between Hungary and possible trade partners, such as Romania and Croatia remain to be built, with Croatia not expected to complete a long-planned LNG import terminal (which could, in theory, deliver American LNG) any time too soon. Foreign Minister Péter Szijjártó of Hungary considers gas deliveries by the Turkish Stream to be the most optimal scenario, since other paths of gas supply - through Romania or Croatia - have not been elaborated yet. In his words, "Having the possibility of diversifying the gas delivery method, including via the Turkish Stream pipeline is one of our core national interests. It is also a serious business opportunity for Hungary as a whole" (Euractiv, 2017) Hungary's move toward Turkish Stream might be driven both by commercial and geopolitical goals, and, in light of its increasingly isolated position in Europe these new authoritarian partners are more necessary than attractive. In the long run, vital economic interests are key to decision-making in all regimes, from the authoritarian to the democratic. Indeed, in the

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authoritarianism underlying the Moscow-Istanbul-Budapest corridor, personality seems to grease the wheels of political deal-making, thus allowing the expression of economic necessity that might otherwise be stymied by the inconveniences of authoritarian populism.

Even though relationships here are very much about personal friendships and, occasionally, about posturing — ultimately these countries' leaders are un sentimental pragmatists, and Turkish Stream is the result of their strategic calculus rather than selfless fraternal bonding. What remains to be seen is how quickly these three countries will embrace the new pipeline and how effective, in the lack of clearly defined multilateral rules and institutions governing it, this trilateral relationship can be.

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