

Policy Department External Policies

SECURITY ASPECTS OF THE SOUTH STREAM PROJECT

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CONTENTS

SECURITY ASPECTS OF THE SOUTH STREAM PROJECT	ii
EXECUTIVE SUMMARY	iii
1. INTRODUCTION.....	1
2. THE RUSSIAN CHALLENGE	2
2.1. Deteriorating Russia-West relations	2
2.2. Dependency and Vulnerability	4
3. EU PRIORITY: DIRECT CASPIAN-EU CONNECTION.....	5
4. SOUTH STREAM VS. NABUCCO	7
4.1. The Race is On: Jockeying for Sequencing	7
4.2. Dividing and Conquering Europe with Gas Pipelines	9
4.3. Company Positions	15
4.4. Competing, not Complementary.....	17
5. SOUTH STREAM UNCERTAINTIES	18
5.1. Gas Supply and Financing	18
5.2. Risks of Surplus Capacity.....	20
6. RUSSIAN-ITALIAN PARTNERSHIP FOR THE SOUTHERN CORRIDOR ...	21
7. ADDITIONAL IMPLICATIONS	23
7.1. Azerbaijan and Turkmenistan: Two new gas sources.....	23
7.2. Preventing Ukrainian Integration	25
8. CONCLUSIONS AND RECOMMENDATIONS.....	26
8.1. Key Conclusions.....	26
8.2. Recommendations	27
BIBLIOGRAPHY	29
ANNEX I.....	31

Security Aspects of the South Stream Project

October 2008

South Stream is a joint project by the Russian firm Gazprom and the Italian company Eni to develop a pipeline to transport gas to European markets. If it is constructed, the impact of South Stream, projected to be the most expensive pipeline ever built, will be significant not only for Europe's energy supplies, but also for its security and its foreign relations. This paper aims to provide an insight into security-related issues in the context of this planned project. It is intended as a background document for use by the Committee on Foreign Policy during its deliberations and its preparation of a report on this subject.

The paper seeks to assess whether the South Stream project will subject traditional transit states and their neighbours to outside economic and political influence. Its assessments are based not only on the already existing agreements between the parties concerned, but also on likely future developments. It aims to provide an overall political and security framework for analysing the project, and presents recommendations regarding the development of effective transit mechanisms for the supply of energy resources across EU and non-EU territory.

The present paper was commissioned early in the summer of 2008, when the prevailing sentiment in Europe was in favour of 'mutual dependence' or 'interdependence'. In light of the Russo-Georgian war in August and the likely long-term increase in tensions within relations between Russia and the West, however, a new consensus has emerged on the broader implications of this dependence. Consequently, the paper also assesses the extent to which discussions regarding South Stream do not yet reflect this consensus—and the extent to which the pipeline project may harm the development of a unified EU foreign and security policy, particularly in circumstances when a potential European policy choice may conflict with Russia's expressed interests.

Executive Summary

- South Stream is primarily driven by Russian interests. The Kremlin and Gazprom view South Stream as vital to their *strategic* interests.
- South Stream is ultimately a *reactive* project, as it was designed only after the EU announced its desire to establish a direct (non-Russian controlled) Caspian Sea-Middle East-EU southern gas corridor, primarily through the Nabucco pipeline. South Stream's route is almost identical to Nabucco, as it intends to *pre-empt* the start of the latter project and thus *prevent* new gas from entering European markets independent of Russian control.
- If South Stream is built, it will pull gas from Central Asia and possibly Azerbaijan in its direction, potentially leaving less Caspian supplies for Nabucco or for other east-west gas pipeline projects such as Turkey-Greece-Italy (TGI). Russia could then increase its political control over the Caucasus and Central Asian regions.
- South Stream could also be used for North African or Middle Eastern gas (via swaps), thus denying EU states direct access to additional fields that could be essential for diversification away from Russian or Russian-controlled gas.
- South Stream, along with Nord Stream, is key to the maintenance of Russian political and economic leverage over Europe. South Stream will enable Russian influence to expand in southern Europe, while Nord Stream, connecting Russia with Germany (and bypassing Poland and the Baltic states) will similarly permit Moscow's influence to expand in northern Europe.
- South Stream would provide Russia with surplus transit capacity, which is important to the fulfilment of Moscow's wish to set gas prices in Europe—a wish shared by the potential members of Putin's 'gas OPEC', such as Iran, Venezuela, Qatar and Algeria.
- Russia will also be able to influence markets and policies in Europe through its position in Austria's Baumgarten gas hub—the projected endpoint for both Nabucco and South Stream. Thanks to its partnership with the Austrian firm OMV, Gazprom has secured access to the trading floor there—and along with it access to vital, privileged information about the energy infrastructures of the countries along South Stream's projected route. This relationship provides Gazprom with tremendous potential leverage over the markets, stability and security of the whole continent.
- Russia is clearly not moving in a pro-Western direction; instead, as the recent Georgian crisis has demonstrated, it is reasserting itself as a great power that can challenge the post-Cold War world order. The EU must carefully assess any new strategic energy project that will increase Russian influence (and leverage) over the continent.

- In this context, then, the EU cannot consider South Stream in the same way as it would evaluate any other pipeline. Some of the specific questions that need to be answered about this project include:
 - Will South Stream increase Europe's energy security? If not, and if it may negatively affect the viability of Nabucco, does it make sense for the EU to support it?
 - Where will the gas for South Stream come from? The EU and its member states, especially those along the pipeline route, must have clarity about the nature of the Russian upstream sector, especially since reliable estimates indicate that Russia will not have enough gas to meet all of its supply commitments to Europe. It is possible that South Stream will mainly carry gas exports that currently transit Ukraine and Belarus.
 - Will South Stream increase diversification of energy imports for the countries along the route? What are the domestic and foreign policy implications of these countries' commitment to South Stream? Can these countries and companies come under increased pressure from Russia to advocate its agenda within the EU and NATO?
 - What other opportunity costs exist? If South Stream is built, would other projects (LNG, alternative energy, conservation) be shelved? If the Russian-controlled system is the only viable option, will producers (e.g. in Central Asia) be likely to decide to send more of their gas to China or India instead?
 - What mechanisms are there to enforce transparency and accountability for a pipeline that will be located on EU territory but owned and controlled to a large degree by an increasingly unpredictable non-EU member? Do the countries and shareholders involved with South Stream know what the various agreements on the project actually entail?
 - Given Gazprom's huge debt obligations and the pipeline's exorbitant cost (at least €12.8 billion), how will this non-commercially viable project be financed?

1. Introduction

The South Stream project was first announced to the world on June 23, 2007, when Eni CEO Paolo Scaroni and Gazprom Vice-President Alexander Medvedev signed a memorandum of understanding ⁽¹⁾. According to the memorandum, the pipeline, which will have a planned capacity of 31 billion cubic metres (bcm), will begin in Beregovaya, Russia, and cross the Black Sea to Varna, Bulgaria.⁽²⁾ This segment will extend 900 kilometres beneath the Black Sea, and will reach a depth of greater than 2000 metres—the deepest subsea pipeline ever constructed. Although the details of this venture are still subject to change, and while estimates of final cost vary, the latest projected cost is €12.8 billion (double the original estimate), and most analysts predict it will increase still further. What is clear, however, is that if constructed, the South Stream pipeline will be one of the most expensive pipelines in history.

After it crosses the Black Sea, the pipeline will continue onshore via two branches crossing at least six countries and with a total length of more than 2000 kilometres. The south-west branch will go south from Bulgaria to Greece and then beneath the Ionian Sea to Italy—with a possible second branch continuing on the shorter route via Albania to Italy. The exact route of the northern spur is not yet finalised; the most recent route announced is from Bulgaria to Serbia to Hungary, then via Austria and/or Slovenia into northern Italy. Russia already has reached intergovernmental agreements with Bulgaria, Hungary, Greece and Serbia, and is planning to sign agreements with Slovenia and Austria this fall.

Though nominally a joint project of Gazprom and Eni, South Stream is very much driven by Russia—and specifically by former President and now Prime Minister Vladimir Putin who considers this project critically important for Russian strategic interests. In fact, the project was created following the EU's decision to award Nabucco the designation of a 'priority project' for its supply source and route diversification in 2004 ⁽³⁾. If South Stream is constructed, the likelihood of Nabucco's construction decreases—at least not in the short term, as both pipelines target the same consumer countries and rely upon many of the same potential transit states. While Eni's interest in South Stream is largely commercial, Gazprom is motivated instead by a desire to forestall Nabucco and thus increase its gas monopoly—and thereby the Kremlin's political influence—over Europe. Accordingly, while the technical, commercial, and environmental aspects of South Stream are important and worthy of consideration, the present paper focuses on the issue most prevalent in the calculus of South Stream's creator: security.

⁽¹⁾ The project was alluded to in November 2006, when Scaroni and Gazprom CEO Alexey Miller signed a strategic cooperation agreement.

⁽²⁾ According to Russian daily *Vedomosti*, citing an internal Gazprom document entitled 'General Plan for the Development of the Gas Sector by 2030', Russia needs to construct 2400 kilometres of pipeline on its territory in order to be able to launch the project. Maklova, Irina, Elena Mazneva, and Elena Zotova, 'Medlennyi Potok', *Vedomosti*, 3 October 2008, no. 187 (2209), <http://www.vedomosti.ru/newspaper/article.shtml?2008/10/03/163492>

⁽³⁾ *Trans-European Energy Networks: TEN-E priority projects*, Directorate-General for Energy and Transport, European Commission, Office for Official Publications of the European Union, Luxembourg, 2004. http://ec.europa.eu/ten/energy/studies/doc/2004_brochure/ten_e_priority_projects_2004_en.pdf

In this context, August 8 was a complete game-changing move. Russia's invasion of Georgia and its subsequent actions, including threatening EU and NATO member Poland with a nuclear strike, will lead to a long-term and comprehensive review of EU-Russia relations. The security aspects of the South Stream project will need to be a key part of such an assessment.

2. The Russian Challenge

2.1.Deteriorating Russia-West Relations

Russia's brutal war on Georgia came as a shock to many in Europe. Before 8 August, the days of tanks rolling into sovereign countries in the Western Hemisphere were considered to lie firmly in the past. When President Vladimir Putin imposed a 'moratorium' on the Conventional Armed Forces in Europe (CFE) Treaty, compared U.S. government policies to those of the Third Reich, and threatened once again to aim nuclear-tipped missiles at European targets, few took these threats at face value. Now, such statements need to be given credence—and not merely those of a military nature.

Even before the war with Georgia, it was already clear that the Russian leadership was positioning their country more broadly as a rising power that could challenge the post-Cold War world order. Putin clearly stated this vision for Russia during his speech in Munich in February 2007. Since then, the Russian position regarding Zimbabwe, Sudan, Syria and Venezuela, as well as its politically arbitrary treatment of companies with foreign interests such as TNK/BP, showed that Moscow prefers to play by a different rulebook than that of the members of the G-7.

Russian leaders also made clear their willingness to use energy as an instrument of achieving their goals. When a pro-Western government came to office in Ukraine, Gazprom increased gas prices to the country and threatened it with cut-offs. These threats were carried out in January 2006—symbolically, the cut-off began on the very day Russia took over the presidency of the G-8.

With good reason, Moscow views energy dependence as a tool by which it can weaken the unity of the EU and also that of NATO. There are numerous cases over the past several years in which the EU was clearly divided between West European states (which, in general, prefer to maintain close relations with Russia) and those of Central and Eastern Europe (countries that have previously been under the rule of Moscow and are thus more wary of its machinations). West European countries are in general not as dependent on Russia, with which they have maintained long-term energy partnerships. They consider Russia to be a reliable supplier and are often reluctant to take foreign policy stances that may irritate Moscow. Germany, for example, imports almost 40% of its gas from Russia—the most of any West European country—and plans to increase this figure to over 60% by 2020. By contrast, six East European countries are 100% dependent on Russia for their natural gas imports. And they are also the most vocal about the EU's need to diversify away from Russia, because unlike Germany, they know by experience that Russia is capable of turning off the taps in a second—as it did in Latvia in 2003, Lithuania in 2006 and the Czech Republic in 2008. Moreover, after none of these three did the EU present Russia with

any perceptible reaction. In the face of Brussels' silence, Russia managed to divide the EU by attempting to maintain its reputation as a reliable supplier to Western Europe while continuing to treat Eastern Europe as its 'backyard'. Despite Russia's repeated use of energy as a political weapon in Eastern Europe, West Europeans keep repeating the mantra that Russia has been a reliable supplier to 'Europe'—thus speaking as if the EU never enlarged beyond the Cold War frontier.

The Russian plan is rather simple: Punish countries that refuse to submit to its influence by cutting off supplies or building new gas pipelines that bypass them (such as Nord Stream and South Stream), while rewarding countries and political leaders that cooperate with Russia in lucrative energy deals. Maintaining a monopoly over the transport of Caspian gas to Europe is essential for Moscow to ensure that all those countries that have entered into a 'partnership' with it will then acquiesce to the return of the former Soviet space to the Kremlin's firm control.

Having challenged the West repeatedly while encountering little resistance, Putin presented a more forceful and more public challenge to European and transatlantic unity at the April NATO summit—when the West failed yet again. Thanks to its increasing influence on European foreign policy and its 'divide and conquer' strategy, Russia prevented NATO members from reaching a consensus on offering a Membership Action Plan (MAP) to Georgia and Ukraine. Most countries from Northern, Eastern, and Central Europe agreed with the American position that the two countries should receive MAPs, whereas many Western European states sided with Germany and France, which opposed MAP extension largely due to their desire not to anger Russia. In the end, a non-NATO member was able to exercise an effective veto over the American proposal—the first time this has happened in the history of the transatlantic alliance.

While Georgia and Ukraine were promised 'eventual' NATO membership, an emboldened Moscow immediately intensified its efforts to undermine Georgia's territorial integrity by aggressive actions first in separatist Abkhazia, and then in South Ossetia. Following the war with Georgia, on 26 August, Russian President Medvedev signed a decree recognizing the independence of these two regions. The Russian government has also begun to challenge Ukraine's territorial integrity by claiming sovereignty over Crimea, which needless to say could lead to serious and long-lasting tensions in the Black Sea.

The split within NATO on issues related to Georgia and Ukraine mirrors the rift that has formed on the issue of Europe's energy diversification. Countries that have long-term gas partnerships with Russia—primarily the West Europeans—chose the 'both sides are to blame' approach to the war in Georgia. Countries that are more eager to diversify their sources of energy supply away from Russia—states that, again, are primarily to be found in East and Central Europe—were more critical of Moscow's actions. This ongoing division within Europe continues to send the wrong signals to Russia. The EU has now revealed itself to be incapable of reaching consensus even when directly challenged. What the response to the Georgia crisis tells outsiders—especially in Moscow—is that it is simply not possible for the European Union to be united on any issue in what Russia considers to be its 'sphere of influence'. Since Russia's energy relationships with individual EU member states play such a key role in shaping these approaches to EU-Russia relations, it is important for Brussels to

consider carefully any new strategic energy project that will serve to increase Russian influence. Since increased dependence on Russian gas will only create more divisions within Europe—and since a divided Europe will be unable to form a common foreign and security policy or work effectively with key allies such as the US—the South Stream pipeline would only make a bad situation worse.

2.2. Dependency and Vulnerability

Natural gas is vital to the economies of many European nations—and the fuel's primacy is growing. However, unlike fuels such as coal or oil, the physical properties of natural gas require the construction of costly pipelines that effectively lock consumers into a prolonged contract with producers. This means that Moscow can easily manipulate dependence into political and economic leverage. The prospect of being forced to pay a higher price for that gas, or even having the supply of that gas curtailed, can exert a powerful influence on a country's domestic and foreign policies.

As a whole, the European Union receives over 25 percent of its natural gas supply from Russia, representing more than 40 percent of the bloc's imported supplies. Russia is the EU's single largest supplier of natural gas, a position that may well strengthen in the years ahead, as the North Sea fields mature and the 55 bcm Nord Stream pipeline is constructed. Recognizing the danger in such dependence, the European Commission has made supply diversification a key priority of its energy policy (along with improving environmental sustainability and liberalising the energy market). This policy was outlined in the European Commission's Strategic Energy Review, released 10 January 2007, and confirmed by the March 2007 European Council (⁴).

Yet, despite ongoing talk about formulating a united external energy policy within the European Union to diversify supply sources and routes, the 27 member states have been unable to reach consensus due their differing priorities. Put simply, not all countries have the same concern: while Finland is fully dependent on Russian gas, Spain receives none. The failure to come together is partly because the issue has not been framed correctly. It is a common misconception that unity is needed on all energy issues; realistically, this would be impossible to achieve. In truth, unity is demanded only on the most critical issues, such as how to work with and respond to Russia in general. Since the Kremlin uses its giant gas monopoly Gazprom as an arm of its foreign policy apparatus, energy relations with Russia must be seen first and foremost through the lenses of foreign relations and security policy.

There is simply no other company or country that poses political and economic challenges to the EU on the same scale as does Russia. Gazprom is the third-largest corporation in the world and the Russian state's largest single source of revenue; it is also the engine that has driven Russia's economic recovery. The company is majority state-owned and many of Gazprom's corporate leadership currently hold (or recently held) high-ranking positions in the Russian government. The policies of the Russian government and the projects of Gazprom have been inexorably intertwined. It is indicative that Gazprom's former chairman, Dmitry Medvedev, moved to the Kremlin

⁴ *Communication from the Commission to the European Council and the European Parliament: An Energy Policy for Europe*, COM (2007) 1, 10 January 2007; *Presidency Conclusions of the Brussels European Council* 8-9 March 2007, (REV 1), 2 May 2007.

as President. One of his key subordinates is Konstantin Chuychenko, executive director of RosUkrEnergo (the intermediary company selling Turkmen gas to Ukraine) and head of Gazprom's legal department. The new Gazprom chairman is former Prime Minister Viktor Zubkov—thus further revealing the existence of a 'revolving door' between Gazprom and the Russian government.

By entering into joint ventures with EU energy firms and state utilities, Gazprom creates important commercial ties with what are often very powerful entities in domestic politics. The advent of more such allegedly equal partnerships—in which Gazprom typically demands a controlling share—could very well increase the pressure national governments face from domestic interests pursuing relatively narrow goals that, thanks to these agreements, coincide with Moscow's agenda. Thus, regardless of any original intention to avoid politics and focus solely on commercial considerations in their dealings with Gazprom, European energy firms can find themselves coming under pressure from Moscow to represent these newly common interests before their national governments. Inevitably, EU member states that deal more often with Gazprom and that receive more Russian foreign direct investment (including in non-energy sectors) will be more susceptible to such pressure, potentially exacerbating divergences of interest among EU countries—and, by design, rendering the bloc ineffective when it comes to deciding issues of priority interest to Moscow.

3. EU Priority: Direct Caspian-EU connection

For over a decade, Gazprom has been able to purchase Central Asian gas at below-world-market prices, channel it to lower-paying Russian customers, and sell its own domestic reserves to Western Europe at high prices. Through this mechanism, Gazprom has made billions of dollars of profit and has maintained its influence over the Central Asian region. Gazprom wants to continue to protect its lucrative European markets by freezing out independent Central Asian suppliers. By maintaining and strengthening its monopoly power, the company will strengthen its leverage (and that of the Russian government) over European gas consumers. The establishment of the Central Asia-Europe Energy Corridor therefore is critically important for European solidarity, transatlantic unity, and the future of the vast space that Russia considers to be its backyard.

Already, a direct Caspian-Europe gas connection exists; it is provided by the Baku-Tbilisi-Erzurum pipeline that transports Azerbaijani gas to Turkey and then onward to Greece. The Turkey-Greece pipeline connection began operating in November 2007, and has enabled gas from Azerbaijan to flow all the way to the EU free from Russian control. Construction will soon begin on an extension of the Turkey-Greece connection to Italy, known as the TGI pipeline.

A second and much more ambitious pipeline project has become a litmus test for the ability of the EU (as well as the US) to complete an undertaking that has been declared a 'priority' project. Intended to have a capacity of 31 bcm, the Nabucco

pipeline will enter Europe through Turkey ⁽⁵⁾. The 3,300-kilometre pipeline will traverse Bulgaria, Romania and Hungary, terminating in Austria at that country's Baumgarten gas storage and distribution hub. It was originally suggested by Austria as a way to bring supplies primarily of Iranian gas to European markets, and was listed among the priority infrastructure projects of the EU's Trans-European Networks (TEN) initiative as early as 2004. The project gained increased attention following the Russian gas cut-off to Ukraine in January 2006. By then, Iran was dropped and instead Azerbaijan and Turkmenistan were identified as the main supply source. This move also enabled the US government to support the project.

Starting in 2007, Nabucco became an important EU-supported project designed to increase diversity of supplies; to expedite its implementation, a special EU coordinator was appointed in September. By the end of the year, Jozias van Aartsen, a former Dutch foreign minister, had been given a broader portfolio: EU co-ordinator of NG3 (or Natural Gas No. 3)—the Caspian Sea-Middle East-European Union Gas Route.

Yet after the cut-off to Ukraine, it was not Europe but Russia that moved fastest towards diversification—in Moscow's case, that of export route options. Bypassing “unreliable” countries like Ukraine and increasingly Belarus was important to the Kremlin, as was the goal of preventing the EU from making progress on its non-Russian-controlled pipeline projects.

Even before the 2006 crisis, Russia was already working on a northern bypass; in September 2005 it had reached an agreement with Germany on the North European Gas Pipeline (NEGP) project. It was renamed Nord Stream at its public launch in October 2006. The second, southern bypass project was initially labeled the South European Gas Pipeline (SEGP), and then renamed Blue Stream II, as it would run parallel to the existing Blue Stream pipeline connecting Russia with Turkey.

Russia wanted to reach the Turkish market first so that it could saturate it with its own supplies, thus maintaining a monopoly in the country and keeping Caspian gas out. The absence of Caspian gas in Turkey would also mean that TGI and Nabucco would be able to transport only Russian or Russian-controlled gas to European markets. When negotiations with Turkey dragged on, and when neither TGI nor Nabucco showed interest in Gazprom's involvement (not surprisingly, since the Russian state company's participation would have contradicted the *raison d'être* of both projects), Russia changed tactics.

As soon as it became clear that Nabucco could not necessarily be derailed through action in Turkey alone, Russia moved to bypass it by planning a direct connection to Bulgaria—the first EU territory. By mid-2006, Gazprom had come up with the idea of a sub-sea pipeline of unprecedented length to Bulgaria: South Stream.

⁽⁵⁾ The project's founders gave it this name at a dinner in 2002 after they saw Giuseppe Verdi's opera of the same name. The story is about Jews' plight for independence and freedom from the Mesopotamian tyrant Nebuchadnezzar (in Italian, Nabucodonosor or Nabucco in its short form).

4. South Stream vs. Nabucco

4.1. The Race is On: Jockeying for Sequencing

For Russia, the main purpose of the South Stream gas pipeline project is to prevent Nabucco and TGI from transporting Caspian gas directly to European markets without its involvement. Its main tactics in accomplishing this goal are twofold: first, locking up the markets and keeping out potential competition—which is fairly easy to ensure when Gazprom itself determines the rules—and second, by ensuring a long-term and large-volume gas commitment from Turkmenistan (as well as Azerbaijan, Kazakhstan and Uzbekistan) to its pipelines, thereby preventing a direct Caspian-Europe connection because of a lack of excess capacity.

In 2007, Russia introduced another important gas pipeline project (the ‘pre-Caspian pipeline’) to support this strategy: a pipeline intended to stretch along the Western coast of Turkmenistan to bring those volumes north into the existing Gazprom infrastructure. This pipeline was also conceived as a way to frustrate attempts to bring Central Asian gas westward. It is a direct threat to the ability to bring offshore Turkmen volumes west, which is the real and practical way of supplementing Azeri gas for delivery into Nabucco.

If South Stream goes forward, Nabucco will lose its strategic importance for Baku—and if there is no strategic benefit, then Azerbaijan will not increase gas production in the short term. Therefore, sequencing—that is, the order in which construction begins and supply commitments are reached—is vital. The fortunes of the two pipelines are inversely related.

Baku already receives millions of dollars from its oil sales, and has no need to sell gas to obtain additional revenues. What Azerbaijan *does* need is strategic integration with the EU—otherwise, it would rather leave the gas in the ground than send it to Europe via Russia (which the Russians are trying to get Azerbaijan to do) or to be trapped into selling it all to Turkey.

Therefore, large-scale gas production in Azerbaijan is contingent on direct access to European markets. If Azerbaijan can obtain this, then its gas will flow westward, and Europe will have diversification. If not, then the gas will stay in the ground; Gazprom's pressure on Central Asian producers will increase; and subsequently, westward movement of all gas from Central Asia will take place exclusively through Russian-controlled networks—ensuring that no diversification can happen. [Azerbaijan is expected to supply Nabucco's first phase with 8 bcm; at the second phase, gas from Central Asia will enter the pipeline, while in the third stage, gas from Iraq and Iran, and possibly Egypt, would flow into Nabucco onwards to Europe.]

In other words, South Stream directly competes with Nabucco—the two pipelines target the same markets and utilize almost identical routes. In fact, three of the five countries along Nabucco's route are also part of South Stream's intended route.

Yet, out of fear of a potential Russian reaction, European Commission officials, leaders of countries along both pipeline routes, and companies involved with both projects insist that the construction of one will not hurt the other. Two days before the

NATO summit, EU Commissioner for Energy Andris Piebalgs made clear once again that he did not believe South Stream and Nabucco to be competitors ⁽⁶⁾. Reinhard Mitschek, OMV's managing director of Nabucco has repeatedly made this point over the past few years; as of June, OMV is also a coordinator of South Stream. All of the Nabucco member countries that have also signed up with South Stream have said the same thing publicly—while at the same time privately recognizing that the two are competitors.

In the long-term, giving the rising gas demand in Europe—expected to increase by approximately 300 bcm by 2030—the market can certainly support both of these 31 bcm capacity pipelines—along with Nord Stream, and the increased supplies projected from Norway (Langeled), Algeria (Medgaz and Galsi), and even several new LNG terminals being built or planned throughout the continent. The question, however, is whether Nabucco can be built for Caspian gas, assuming the need to co-exist with South Stream. Moreover, as previously mentioned, while the market may be available downstream in the long term, the question is whether there would be enough gas upstream to support all of them for the same time period given that both projects are scheduled to start in 2013. [Both are likely to be delayed by several years. According to a recent report by the Russian daily *Vedomosti*, citing an internal Gazprom document entitled 'General Plan for the Development of the Gas Sector by 2030', South Stream would start gas deliveries in 2015, rather than in 2013 as previously announced] ⁽⁷⁾.

The answer is no, if South Stream is built first. Nabucco faces a number of financing hurdles even in the absence of South Stream. Investors are uncertain of Azerbaijan's ability to supply Nabucco in time and even more uncertain that a trans-Caspian pipeline will be constructed to bring in the Turkmen gas that many view as necessary for the success of Nabucco. The possibility that South Stream will be constructed and will meet a significant portion of consumer countries' expected short- to medium-term demand will likely be enough to deter investors away from Nabucco.

From an economic perspective, it is utterly impossible to build a pipeline such as Nabucco—which will cost upwards of €7.9 billion—unless investors are confident that there will be sufficient gas supply and sufficient consumer demand for them to make a profit. The important difference between Nabucco and South Stream is in ownership; Nabucco will be privately financed and therefore needs to be commercially viable, whereas South Stream is backed by state-owned Gazprom, which is perfectly willing to finance projects that do not make commercial sense so long as they support the strategic goals of Moscow. Unlike Western companies, Gazprom is also willing to use pipelines at minimum capacity—it loses money in the short term, but in the long term, thanks to the disappearance of competition, it will make tremendous profits as a monopolist. Even though Nabucco will be expensive to construct, South Stream—due to the enormous cost of constructing an undersea pipelines spanning virtually the entire breadth of the Black Sea—will be even more so. South Stream gas will by definition be significantly more expensive than Nabucco. Why should the EU subsidize the construction of this uneconomic pipeline?

⁽⁶⁾'Gas warms EU-Russia ties: No basic change in Moscow's energy policy', *New Europe*, Issue 776, 7 April 2008, < <http://www.neweurope.eu/articles/85173.php>>

⁽⁷⁾ Maklova, Irina, Elena Mazneva, and Elena Zotova, 'Medlennyi Potok', *Vedomosti*, 3 October 2008, no. 187 (2209), <http://www.vedomosti.ru/newspaper/article.shtml?2008/10/03/163492>

Those who still doubt the crucial importance of sequencing should consider the case of Turkey during the late 1990s, when it was approached with two different pipeline proposals. Turkmenistan, Azerbaijan and Georgia, with strong support from the United States, proposed the construction of a trans-Caspian pipeline that would carry gas from Central Asia to Turkey. Russia, which did not want its monopoly power in Central Asia eroded by the construction of additional export routes, instead proposed a pipeline beneath the Black Sea to Turkey. Supporters of the Russian project, which is now called Blue Stream, insisted that current and future Turkish gas demand was large enough to support both projects. Turkish authorities in 1999 claimed the country would need 60 bcm of gas in 2010, and 80 bcm in 2020, to prevent any opposition to the Blue Stream pipeline; and subsequently, many supporters of Blue Stream claimed the two lines were, ‘not competitive’.

Yet at the time, neither Turkmenistan nor the private investors behind the trans-Caspian pipeline believed these figures to be realistic. [Turkey consumed just over 12 bcm in 1999; the figure rose to 35 bcm in 2007; revised estimates are 44 bcm for 2010 and 66 bcm for 2020] And many of those who disagreed were reluctant to challenge Russia and went along; some also did not think it would actually be built. They referred to this project as ‘Blue Dream’ because of its lack of market viability and the need for never-before-used technology to construct a pipeline deep underwater. [Eni’s subsidiary Saipem had developed the technology. Eni is Gazprom’s partner in Blue Stream and now in South Stream] These assertions were quickly proven false, however, because interest in the trans-Caspian project dried up as soon as Ankara signed an agreement to build Blue Stream.

In the end, Blue Stream not only prevented Turkey (and the EU) from having direct access to Turkmen gas, but also increased Turkish dependence on Russian gas to over two-thirds of its demand. Since it came on line, the pipeline has operated at less than a third of its 16 bcm capacity while providing the most expensive gas supplies on the Turkish market. It is worth noting that Vladimir Milov, a former deputy energy minister, objected to Blue Stream as he did not believe it would be in Russia’s commercial interest ⁽⁸⁾. Yet even though it makes little commercial sense, Blue Stream has been a hugely successful project for the Kremlin overall.

4.2.Dividing and Conquering Europe with Gas Pipelines

The Blue Stream experience was encouraging for Russian leaders; they learned that energy could be an effective tool not only against countries in its ‘sphere of influence’, but also against the West, as it so easily fit into a ‘divide and conquer’ strategy. After all, Russia had managed to pull even America’s long-term NATO ally Turkey into its project—regardless of the fact that Ankara’s own declared priority was to serve as a transit country between Central Asia and Europe, thereby also serving its interest in re-connecting with the Turkic-speaking world that had been inaccessible to it during the Soviet period.

President Putin became personally involved in major energy projects, meeting repeatedly with the top leaders in each of the relevant European countries, and

⁽⁸⁾ Vladimir Milov, ‘Towards a common European foreign policy on energy?’ Public Hearing, Committee on Foreign Affairs, European Parliament, Brussels, 28 February 2007.

developing close personal relations with them. One such friendship that has proven extremely useful was that forged with German Chancellor Gerhard Schröder. He became the biggest promoter of Nord Stream as a ‘European project’ even though it would mainly benefit Russia and Germany and actually *divide* Europe by bypassing Poland and the Baltic states. This way, Russia will gain the ability to punish these states by withholding gas from them without jeopardizing supplies to Germany—thus avoiding the negative attention it attracted after the Ukraine cutoff in 2006, which resulted in a domino effect of supply decreases in all countries receiving Russian gas via Ukraine. By creating Nord Stream, Germany has effectively stripped Poland and the Baltic states of the leverage they currently enjoy over Russia as transit countries to Germany. Not surprisingly, then Polish Defence Minister Radek Sikorski argued that the project is ‘reminiscent of...the Molotov-Ribbentrop Pact’—the non-aggression pact between Nazi Germany and the Stalinist Soviet Union that led to the division of Poland and the Baltic in 1939.

Nord Stream also demonstrated how Putin and Gazprom have been able to buy influence and legitimacy: Schröder extended a €1 billion government credit guarantee to Nord Stream just prior to stepping down in 2005. Soon afterwards, Schröder became the CEO of Nord Stream. Germany, and especially Foreign Minister Frank-Walter Steinmeier, Schröder's former chief of staff and, like his old boss, a member of the Socialist Party, (the SPD, which is still in government as part of a ‘grand coalition’) opposed the MAP for Georgia and has been notably reluctant to take a firm position toward Russia even after the invasion in August. Another example of Russia's ability to simply buy political support in EU states is that of Finland; even as Finnish Foreign Minister Alexander Stubb was shuttling between Moscow and Tbilisi in his capacity as chairman of the OSCE, Nord Stream announced the hiring of former Finnish Prime Minister Paavo Lipponen.

Once the Russians saw that Europe did not and likely was not going to stand united, and once Germany signed the Nord Stream deal without even consulting its Polish or Baltic partners, the precedent was set for seeking bilateral deals with other EU member states that could leave out the impact on neighbours and on the union as a whole.

As noted earlier, the easiest option for undermining Nabucco would have been to construct Blue Stream II—which would mean not building South Stream, but instead pushing for the onward transit of Russian gas through Turkey via Nabucco (and TGI). Alternatively, Russia could try first to supply the markets of those countries on Nabucco's intended route: Bulgaria, Romania, Hungary and Austria. All these countries were played against each other, and American and European efforts were undermined at each step.

Below is a brief review of some of the tactics used to coerce or cajole Nabucco countries into also signing up with South Stream. In general, some recurring tactics include: promising significant amounts of investment and turning the country into a ‘gas hub’ for Europe; providing various forms of support to political leaders during election campaigns and then, after they reach office, extracting concessions from them; and working through non-transparent third parties and reaching deals that are hidden from the public. All the countries that joined South Stream insist on the same

mantra: the two pipelines are ‘complementary, not contradictory’. The list below is by no means exhaustive or final.

A death blow to Nabucco could be dealt by sealing off its two final markets for its gas: Hungary and Austria. The first target was **Hungary**, which remained close to Russia even after entering EU and NATO. President Bush’s long-expected trip to Hungary on 22 June 2006 was pre-empted by Alexei Miller, who beat the President by a day to Budapest in order to discuss the SEGP. Among other concessions, Moscow promised to supply Budapest with enough gas to make Hungary a major European energy hub.

Over the next year, as the Americans and the Europeans were distracted with other priorities, Russia moved ahead with firming up Hungary’s commitment to South Stream. Western attention was finally drawn to Russia’s moves in Budapest following a March 2007 article in the *International Herald Tribune* with the title ‘Hungary chooses Gazprom over EU’, in which Prime Minister Ferenc Gyurcsany was quoted as saying ‘The Nabucco has been a long dream and an old plan...But we don’t need dreams. We need projects.’ He continued by underlining that ‘Blue Stream is backed by a very strong will and a very strong organizational power’ ⁽⁹⁾.

While official reaction was subdued, Brussels and Washington privately expressed concern about these statements, urging continued and strong commitment to the EU’s priority project of Nabucco. Subsequently, at a conference held by the European Commission (and hosted by Commissioner Piebalgs) on 14 October, Gyurcsany publicly asserted his support for Nabucco. Yet when Zubkov visited Hungary on 7 December, he secured the Hungarian leader’s commitment to South Stream. The final touches were made when Medvedev visited Hungary on 25 February 2008, followed up by Gyurcsany’s visit to Moscow three days later on 28 February, when he officially signed the South Stream agreement ⁽¹⁰⁾.

Even as negotiations were ongoing with Hungary, Putin and Miller ‘diversified’ their push against Nabucco by expanding their focus to include **Austria** as well. They travelled to Vienna on 23 May 2007, signing a MoU on South Stream cooperation. With Austria, the Russian strategy was this: play up the possibility of Austria becoming the key ‘hub’ for Central Europe (in addition to or instead of Hungary), and at the same time warn it of the prospect of being left out of such major projects; to ensure the best possible transit deal, the Russian side strongly hinted that South Stream could be routed instead via Slovenia—then holder of the EU presidency and hence potentially a useful backer in Brussels.

On 25 January, Alexander Medvedev visited Austria and signed the Baumgarten deal. This represents the biggest victory to date for South Stream, since Baumgarten had

⁽⁹⁾ At the time, the project was conceived as bringing Russian gas to Europe via Blue Stream II.

Judy Dempsey, ‘Hungary chooses Gazprom over EU’, *The International Herald Tribune*, 12 March 2007, <<http://www.ihf.com/articles/2007/03/12/news/hungary.php>>.

⁽¹⁰⁾ Prime Minister Gyurcsany, a former Communist youth leader turned millionaire who has close ties to Putin, was harshly criticized domestically and internationally when he appointed a former KGB-trained intelligence agent as chairman of NATO’s intelligence committee a few weeks earlier.

Judy Dempsey, ‘New NATO intelligence chief was trained by KGB’, *International Herald Tribune*, 3 February, 2008. <<http://www.ihf.com/articles/2008/02/03/europe/nato.php?page=1>>.

already been chosen as Nabucco's end point. Furthermore, in June, OMV agreed to become South Stream's project coordinator—the same key role it plays with Nabucco.

Austrian Economy Minister Martin Bartenstein had previously suggested 'integrating' Nabucco with South Stream and filling the former with Russian gas. Obviously, such integration would completely undercut the whole point of Nabucco: diversification away from Russia.

A second set of countries that Russia has targeted in order to accomplish its goal of killing Nabucco was those along the transit route between its Turkish beginning and Austrian/Hungarian/Slovenian ending points. Romania and Bulgaria are attractive bypass options to Turkey in terms of geography, and both Black Sea littoral states lie on the Nabucco route. However, under President Basescu, **Romania** has ruled itself out due to its consistent policy of independence from and wariness towards Russia; thus, **Bulgaria** became Russia's next alternative choice for the western endpoint of a trans-Black Sea pipeline connecting Russia directly with Europe.

In order to win over Bulgaria as well as **Greece**, the Russian side offered to back the Burgas-Alexandroupolis (B-A) oil pipeline between Bulgaria and Greece that both countries greatly desire. The B-A pipeline was competing with the Turkish Samsun-Ceyhan project for the potential transport of oil from the Black Sea to the Mediterranean; Russia was thus also able to play Bulgaria and Turkey against each other. When it became clear that Greece and Bulgaria were willing to agree to the first Russian-owned oil pipeline in EU territory, US Deputy Assistant Secretary of State Matthew Bryza visited Greece on 12 March 2007—and was followed by Putin three days later. Putin discussed pipeline projects with the Bulgarian president as well. With little opposition from the EU or from Washington, and with continued strong pressure from Moscow, the Greek government on 17 May signed the B-A agreement, surrendering 51% ownership to Moscow. Bulgaria did the same shortly after.

Turkey had hoped Russia's interest in building Blue Stream II might facilitate linkage of that deal to a potentially mutually beneficial partnership on Samsun-Ceyhan. The deal broke when the Russians demanded a controlling share in the latter pipeline, which the Turks did not accept. Greece and Bulgaria, however, consented to the principle of majority Russian ownership—via a holding company to be based in Moscow. On gas also, Russia decided to bypass Turkey with South Stream. Moreover, by reaching the Greek market first, Gazprom could seriously undermine TGI, thereby preventing any Caspian gas from reaching EU territory via Turkey. As TGI could provide Greece with half of its gas needs, this would also be a serious blow to Athens' gas diversification efforts.

Greece and Bulgaria thus became the next EU member countries (after Hungary) to ally themselves with the Kremlin and Gazprom against the common European interest of diversification. Vagit Alekperov, president of the Russian oil giant Lukoil, already in 2001 revealed the thinking behind the Kremlin's strategic energy plan: 'Bulgaria,

whose oil sector is almost entirely owned by Russian companies, will not conduct an anti-Russian foreign policy in the foreseeable future' ⁽¹¹⁾.

After Russia agreed to the B-A pipeline, talks with Turkey on Blue Stream II came to a halt. Turkey had by then become in Moscow's eyes very similar to Ukraine and Belarus: it was a major transit country between Russia and its West European customers that had become an obstacle to be bypassed. As relatively smaller countries, Greece and Bulgaria were far less able to resist Russian pressure; and after their participation was confirmed, South Stream gained significant momentum.

Greece and Bulgaria received both Western and Russian visitors over the following few months; however, the choices made by Washington/Brussels and Moscow reflected the differing priorities of both sides. Russia sent its top political leaders, who offered incentives along with threats, while the US sent senior diplomats—and the EU remained missing in action altogether.

On 23 October 2007, Russian Deputy Foreign Minister Vladimir Titov visited Bulgaria and met with his counterpart in Sofia. US then sent Bryza to Bulgaria on 7 December 2007. On 18 December, Greek Prime Minister Kostas Karamanlis visited Putin in Moscow; then Putin visited Bulgaria on 17 January 2008 and signed the South Stream deal. The agreement was reached despite strong opposition, including a protest against the project in Sofia's central park, the location of the first anti-communist demonstrations held in 1988.

Prior to Putin's arrival, the Bulgarian side had insisted in a majority share of the company that will construct and operate the pipeline on Bulgarian soil; Moscow had refused, instead asking for 51%. In the end, a 50-50 ownership was agreed, although little other information was released as to the terms of the agreement. Prime Minister Sergei Stanishev could only say that Nabucco and South Stream are complementary rather than competitive projects: 'The passage of more transit energy lines through Bulgaria's territory in fact increases our sovereignty and national security rather than make us dependent', the prime minister stated. 'Both the producer and the consumer countries will be interested in Bulgaria's stability and successful development' ⁽¹²⁾.

As with other instances, Putin used his state visit—on which he brought along his soon-to-be successor Dimitri Medvedev—to personally secure a deal on the pipeline. The timing of the visit was also very symbolic: it marked 130 years of Bulgarian independence following the Russo-Turkish War of 1877-78, during which Russian forces liberated Bulgaria from five centuries of Ottoman domination. The parallel with South Stream, a Russo-Bulgarian project bypassing Turkey, was not lost on any of the participants.

Greece resisted until after the April NATO summit, where it used the possibility of its signing up with South Stream as leverage with the rest of the EU and the US in its effort to prevent the Skopje government from using any name other than 'The Former

⁽¹¹⁾ Cited in Fiona Hill, 'Beyond Co-Dependency: European Reliance on Russian Energy', U.S.-Europe Analysis Series, The Brookings Institution, Washington, D.C., July 2005, <http://www.brookings.edu/papers/2005/07/russia_hill.aspx>.

⁽¹²⁾ 'Bulgaria PM: Deals with Russia Don't Make Us Dependent', *The Sofia Weekly*, 26 January 2008, <<http://www.novinite.com/sofiaweekly/print.php?issue=69>>.

Yugoslav Republic of Macedonia'. Karamanlis signed the agreement with outgoing Russian president Vladimir Putin on 29 April in Moscow. The agreement was ratified in August.

Bulgaria ratified the South Stream project on 25 July; before then, in response to criticism, Economy and Energy Minister Petar Dimitrov declared that 'It is extremely important for Bulgaria to have alternative routes for gas supply.' On 4 June, while in Baku to show support for and commitment to Nabucco, he also said that these two pipeline projects were 'not competing' projects. On 18 June, when asked about Brussels' view, he responded that '[t]he EU reaction has been definitely a positive one. It was explicitly emphasized that Nabucco is a priority project, but that South Stream is necessary'.

There are more countries that one could discuss, but even these are sufficient to show a clear pattern: a divided and distracted Europe and a strategic and determined Russia. As long as the EU keeps reciting its mantra that both South Stream and Nabucco are viable and that countries do not need to choose between them, Russia will win. Though all of the Nabucco countries want this pipeline to be built, they are hedging their bets by signing onto South Stream, thereby undermining the very project they need. Yet it is clear countries dependent on Russian gas will not risk the ire of Moscow, and risk gas cutoffs or other forms of punishments. They all want security of supply, as well as develop their infrastructure, receive transit fees and in many ways not be 'left out'. There is no price to pay for undermining Nabucco—all the countries along its route would prefer this option, but none will take a position unless Brussels takes a stand. Individual countries are too small and too vulnerable to deal with Russia; only a united Europe can.

Outside the EU, **Serbia**, another South Stream target along the middle of potential Black Sea-Western Europe pipeline routes, also came under Russian manipulation and political pressure. Russia greatly benefited from the EU/US tension with Serbia over Kosovo's declaration of independence. Moscow strongly opposed independence for Pristina, a position that was viewed in Belgrade as critically important to Serbia. With the West's focus drawn rather narrowly to Kosovo, Russia was able to offer a broad package deal that convinced the Serbian leadership to sign onto the South Stream project.

On 25 January 2008, President Tadic and Prime Minister Kostunica visited Putin in Moscow and officially signed the agreement. Americans and Europeans—once again—were caught by surprise. While they urged a delay, hoping that a new Serbian government might be of a more pro-Western orientation and would and refrain from going forward with South Stream, the West simply had no real influence over Belgrade in light of the upcoming Kosovo decision. Dimitri Medvedev visited Serbia as the likely next president of Russia and on 25 February presided over the South Stream signing ceremony there—one week after the Kosovo independence declaration. Medvedev made clear that Russia had taken full advantage of the Kosovo crisis, stating that the gas deal was indented to show 'our support, moral, material and economic, for a state which is in a very difficult position, a state which unfortunately, by the will of a number of other states, has had its territorial integrity put in doubt [...]

Measures are being taken to break it up into pieces. I mean of course the Kosovo problem' (¹³).

Gazprom wanted Serbia to quickly ratify the agreement—before the 11 May elections that could have brought a pro-Western government into office. However the project has failed to win the approval of the country's cabinet. The deal was blocked by members of the Western-leaning Democratic Party to leave the possibility for renegotiations—including also on the sale of the state oil monopoly NIS—if they came into office. Gazprom publicly berated Serbia for the delay in implementing the deal, which included the formation of a joint Russian-Serbian company on 25 May. As Gazprom feared, following the victory of the Democratic Party, the ratification process stalled—but ratified in September.

Moscow succeeded in exploiting Serbia's fears of being isolated in order to extract as many concessions on energy as it could. These concessions will have lasting effects; even after Serbia becomes part of the European and Euro-Atlantic structures, Russia will continue to have significant influence over Belgrade's domestic and foreign policy.

4.3. Company Positions

The Nabucco project is currently supported by an international consortium of six companies, among which a diversity of opinion prevails concerning the strategic consequences of South Stream's success (¹⁴). Turkey's state-owned BOTAS Petroleum Pipeline Corporation, Romania's state-owned Transgaz, and Germany's privately-owned RWE have no connection with the South Stream pipeline as of yet. Neither Turkey nor Germany has ever been approached as a potential partner in the South Stream venture, while Romania explicitly declined to participate in February 2008.

Among the other three Nabucco International member firms, Bulgaria's state-owned Bulgargaz is participating in a joint venture with Gazprom to construct the Bulgarian section of South Stream.

While the Hungarian government supports South Stream, the Hungarian joint-stock company MOL has generally kept its distance from the South Stream project and remains committed to Nabucco. Budapest has pledged the participation of the Hungarian Development Bank (MFB) in building the Hungarian section of South Stream and will purchase feasibility studies for this section of the pipeline from SEP Co., a joint venture between Gazprom and MOL. In other words, although MOL may be the least committed to South Stream of the three Nabucco International firms that have indicated interest in Gazprom's pipeline, it is by no means disconnected to the Russian project (¹⁵).

(¹³) 'Serbia gas deal 'a show of solidarity'', *The Upstream Online*, 26 February 2008, <<http://www.upstreamonline.com/live/article149432.ece>>.

(¹⁴) The pipeline consortium is equally owned (16.67% each) by Austria's OMV, Hungary's MOL, Turkey's Botas, Bulgaria's Bulgargaz and Romania's Transgaz and Germany's RWE.

(¹⁵) 'Ukraine Surfaced in South Stream Project', *Kommersant*, 29 February 2008, <http://www.kommersant.com/p859205/South_Stream/>.

Of all the Nabucco partners, Austria's state-dominated OMV is the most engaged in South Stream. Both pipelines will bring gas to Baumgarten, which makes it critically important as a clearing-house for gas coming to Europe. It is therefore of great concern that in January 2008, OMV signed a deal giving Gazprom 50 percent ownership in Baumgarten and its trading floor. As we know by now from other such 'partnerships' Gazprom has formed over the years, this nominal half share of 50 percent would not mean equal partnership—Gazprom, and thus the Russian state, would in reality have a much bigger role. To start, access to the trading floor represents a strategic opportunity for the Kremlin. Should Moscow determine that it is, for any reason, in Russia's interest to prevent a particular source of gas from reaching the terminal or from being distributed afterwards, Gazprom would potentially be positioned to implement such a policy.

It is important to note that Claude Mandil, former executive director of the IEA and former managing director of Gaz de France, is serving as energy advisor to the French government during its EU presidency. Mandil's April 2008 report to the French Prime Minister, 'Energy Security and the European Union' recommends including Russian gas in Nabucco. Against American opposition, OMV is leading the effort to bring Gazprom into the project.

South Stream is an Eni-Gazprom partnership, but Gazprom is far more critical to its financing. Estimates of cost vary, but most analysts predict it would cost twice as much as Nabucco. Yet this does not matter for Russia. No Western company has the kind of partnership with its government as Gazprom has with the Kremlin. No Western country or company would build pipelines based solely on such political calculations. None would undertake commercially non-viable projects. The current situation is one in which textbook economic market principles do not apply. Since they do not, why should Europeans instead choose Moscow's interests as the deciding principle for its energy policy?

The operating culture of Gazprom (or of any Gazprom-led consortium) is also very important. Gazprom's strategy depends greatly upon buying a favourable image through public relations companies—several such firms were hired following the Ukraine gas cut-off in 2006 to foster Russia's desired image as a 'reliable gas supplier' and to prepare for the St. Petersburg G-8 Summit, the theme of which being energy security, so as to deflect any concerted opposition from the West. For its more recent projects, Gazprom has relied upon high-level political connections to ensure legitimacy and to create an artificial impression that these are indeed 'European projects'. The hiring of the former German Chancellor and Finnish Prime Minister for the Nord Stream pipeline, and the attempted hiring of the former Italian Prime Minister for the South Stream pipeline, are clear examples of this tactic. Such connections are important to ease concerns that, for example, South Stream and Nabucco are competitors; and to strengthen the belief that both can be constructed in a complementary fashion. Moreover, Russia seeks to obtain for South Stream the 'European project' designation from Brussels—which could even lead to EU financing for the pipeline.

4.4. Competing, not Complementary

Regardless of what political leaders or corporate managers who have interest in the pipeline may claim, a more objective analysis reveals the South Stream pipeline project would undermine the EU's stated objective of external energy supply diversification.

Not only would South Stream increase the amount of Russian natural gas that is imported and consumed in the EU, but it would also decrease the likelihood that the long-planned Nabucco pipeline will be constructed. South Stream would grant Moscow even greater control over gas supplies to Central and Eastern Europe. The gas supply and distribution infrastructure in the region is already dominated by Russia. Gas transit routes in Central and Eastern Europe run primarily along an East-West axis, with limited interconnections between countries. This stifles competition and decreases energy security, not to mention runs counter to the principle of an integrated European market.

South Stream's construction would have detrimental economic and political effects on Europe as a whole, particularly on the states along the pipeline's route as well as their immediate neighbours. Collectively, the countries on and around South Stream's planned route rely on Russia for 63 percent of their natural gas imports. If Italy is excluded, this dependency jumps to 85 percent, with many countries relying on Russia for all their natural gas supplies⁽¹⁶⁾. Of course, these figures represent reliance not just upon a single country, but upon a single *company*: Gazprom. Such a high level of dependence inevitably leads to market dysfunction, which would be maintained—and in some cases enhanced—by the construction of South Stream.

By contrast, the construction of Nabucco would decrease—in some cases dramatically—the level of dependence on Russian exports. While the overall upside potential of Nabucco is only 31 bcm per year—a relatively small amount in a pan-European context—it would be hugely important to countries such as Bulgaria, Austria, and Romania, which could see their reliance on Russian supplies cut in half.

Moreover, shipping gas via Nabucco could be 30-40% cheaper than shipping it via South Stream⁽¹⁷⁾. This would mean Nabucco will have a downward influence on the price relative to what it would be if only South Stream (and in general Russian) gas would be available in Europe. In other words, with Nabucco, Gazprom will be forced to sell its gas at Nabucco's price. This would be clearly beneficial to European consumers, while also denying Gazprom huge profit margins. In addition, the cheaper transport provided by Nabucco would make it more lucrative for suppliers such as Azerbaijan and Turkmenistan to contribute available volumes.

If Nabucco is in fact a 'priority project', and if diversification is indeed Europe's goal, then South Stream makes no sense. It is a threat to both the European Union as a whole and to the European countries involved in the project. Failure to construct

⁽¹⁶⁾ Countries include Austria, Bosnia and Herzegovina, Bulgaria, Croatia, Greece, Hungary, Italy, Macedonia, Romania, Serbia, Slovenia and Ukraine. See Figure 1 in Annex I.

⁽¹⁷⁾ 'South Stream pipeline costs doubling', *Vedomosti*. Cited in *RIA Novosti*, 30 July 2008, <<http://en.rian.ru/analysis/20080730/115274497.html>>.

Nabucco would create the perception that the EU cannot succeed in its goals even on its own territory. Countries such as Russia and Iran will conclude that the EU has no solidarity; that it can be divided and conquered. Perhaps most importantly, the realisation of South Stream would perpetuate and expand Russia's political and economic influence in Europe.

5. South Stream Uncertainties

5.1. Gas Supply and Financing

Both Eni and Gazprom assert that South Stream will supply Russian gas; however, there are many uncertainties about these supplies. A number of analysts and industry experts have expressed serious doubt regarding Russia's ability to increase its natural gas production (¹⁸). Almost all agree that Russia—endowed as it is with the world's largest natural gas reserves—has the *potential* to increase production above its current level of around 650 bcm. However, a number of factors make such an increase unlikely.

First, the fields from which Russia currently extracts the majority of its gas are either rapidly maturing or are already in decline. Developing new fields—many of which are technically challenging and/or located in inhospitable climates—will require tens of billions of euro in investment and a significant amount of time. Second, Russia badly needs to modernize its existing gas infrastructure, most of which was built during the Soviet era. This modernization will also require an investment of several billion euros. It is difficult to imagine Gazprom being able to finance these investments on its own, and it is even more difficult to imagine a foreign energy company—or companies—being willing to put that much money into Russia, given the prevailing poor investment climate.

The Russian government's own projections show Gazprom's production stagnating in the near future, although they predict that formally independent companies such as Novatek or Lukoil will fill the gap. However, Lukoil recently announced a 3% decrease in its 2009 production forecasts (¹⁹). The government also envisions a decrease in domestic consumption, spurred by improved energy efficiency and an increase in the heavily subsidized price paid by Russian consumers (²⁰). Yet, raising domestic energy prices will be extremely unpopular politically, and Moscow will be hard-pressed to make this sacrifice. Indeed, the Economy Ministry recently announced that a price liberalisation plan approved in 2006 will be delayed. According to the plan, adopted under pressure from Gazprom, prices were to steadily increase from \$45 per thousand cubic metres (tcm) to \$125 per tcm by 2011. However, global energy prices have soared since then, and \$175 per tcm is now

(¹⁸) These include former Russian Deputy Energy Minister Vladimir Milov. See Vladimir Milov, Leonard Coburn and Igor Danchenko, 'Russia's Energy Policy 1992-2005', *Eurasian Geography and Economics*, Vol. 47, No. 3, 2006, pp. 285-313.

(¹⁹) 'Lukoil Expects Fall in 2008 Production', *The Moscow Times*, 21 July 2008, <<http://www.moscowtimes.ru/article/1009/42/369057.htm>>.

(²⁰) Alan Riley and Frank Umbach, 'Out of Gas', *Internationale Politik Global Edition*, Berlin, Spring 2007, <<http://en.dgap.org/midcom-serveattachmentguid-68f263b0de9311dbbc30f38bb154c874c874/IP-TIP-Russian+Gas+Shortage+1-07.pdf>>.

quoted as the target ‘liberalised’ price. The Economy Ministry has expressed doubts that the economy could withstand so steep a price increase ⁽²¹⁾.

Credible estimates suggest that Russia may no longer be able to meet its contracted obligations as early as 2010; this is why it is so in need of Central Asian gas. Moreover, the gas that would be sent to Europe via South Stream will be mostly the same gas that would be diverted from the existing route via Ukraine—coming from Central Asia, as well as West Siberia and possibly East Siberia.

In addition to its problems confirming its gas supply, South Stream also has tremendous financial difficulties. Gazprom is already heavily indebted in part due to its massive purchase of assets across Europe and Eurasia, as well as its non-energy related businesses. Sinking billions of dollars into Nord Stream or South Stream does not make any sense financially—but as explained earlier, these are primarily projects serving Russian strategic interests, not the commercial interests of Gazprom. Nonetheless, despite its tight links to the Kremlin, given the global economic downturn, Gazprom may simply be unable to obtain the necessary funding.

Financial issues are also a serious source of concern for the transit countries. Greece and Bulgaria signed onto South Stream when its cost estimate was half the figure quoted now, which is €12.8 billion; the countries along the route are now even more dependent on attracting international investment to complete this political pipeline project.

Moreover, even the €12.8 billion is definitely too low a figure for a number of reasons. First, there have not yet been any proper feasibility studies for the pipeline, i.e. the figure is a mere estimate. Second, the doubling of the price was announced as an outcome of higher steel prices; the project’s capital cost will continue to increase as steel prices go up—but much higher than would be the case for Nabucco or TGI given the need for four parallel pipelines that would need to be constructed across the Black Sea. [The Blue Stream gas pipeline consists of two parallel pipelines, each with a capacity of 8 bcm—the maximum a deepwater pipeline under the Black Sea can handle; for a 31 bcm volume crossing a much longer distance, South Stream would need four pipelines—and accordingly a significantly greater quantity of steel] Even once the pipeline reaches Bulgaria, further price increases linked to construction costs are likely, for example due to onshore terrain difficulties and potential changes in the pipeline route.

The relevant countries need to receive a clear breakdown of the costs, including precisely how much Russia will contribute. Moreover, they do not yet know precisely how much gas will transit their countries and how much they will use domestically.

There are also additional uncertainties following the Russian-Georgian war, and all these numbers are likely going to rise considerably. In the week after the Russian invasion, over \$16 billion in capital has fled the Russian market. Investors are nervous about the direction Russia’s relations with the West are taking. For all these reasons, it

⁽²¹⁾ Of course, \$175 per tcm is still far below the price currently paid by Gazprom’s European customers. ‘Russia may delay gas price liberalization-paper’, *Reuters*, 2 April 2008, <<http://uk.reuters.com/article/oilRpt/idUKL0232592720080402>>.

is risky to commit to South Stream, particularly if doing so also means derailing Nabucco.

5.2. Risks of Surplus Capacity

If South Stream (and Nord Stream) is constructed, Gazprom will actually enjoy a surplus of export capacity while Europe will face a deficit of supply options. This possibility is very troubling. Having a strong monopoly on transit routes into Europe, even if underutilized, still gives Russia significant influence vis-à-vis its ability to grant other producers access to these routes.

Those countries depending on Russian-supplied gas would become captive markets, forcing them to compete with each other for increasingly scarce Russian gas. Prices would certainly escalate, but Moscow would also be able to extract political concessions from consumer countries as those governments that most support the Kremlin would get preference for gas supplies. This leverage is not necessarily exercised through dramatic, blatant acts such as supply cut-offs but instead through subtle and protracted efforts ⁽²²⁾. For example, Russia has been nothing but a reliable supplier to Turkey, even providing emergency supplemental exports in January 2008 when Iran ceased gas shipments due to a price dispute with Turkmenistan. However, since the start of Blue Stream in 2005, Ankara has moved closer to Putin's Russia. Remembering that Turkey once had the option of two pipelines—the trans-Caspian pipeline or Blue Stream—it now is even clearer that the former would have been more in Europe's interest.

Another development that should be of serious concern is the Russian-led formation of a cartel-type organization for natural gas that will allow it to coordinate European supply. South Stream, for example, could be used to ship Iranian and other Middle Eastern gas in addition to Russian supplies.

Russia, Iran and Qatar together already hold 56% of world's reserves (according to BP estimates); with Venezuela, Algeria and Libya joining the group would have about 2/3 of world reserves in their control. This would mean tremendous influence over Europe: both in gas pricing and political influence.

Just as they have done with South Stream, European officials have displayed considerable reluctance to address the implications of the gas cartel. Commissioner Piebalgs even suggested it is 'unhealthy' to talk about the potential formation of a gas cartel, because it would wrongly frighten consumers ⁽²³⁾.

In fact, Moscow is taking clear steps towards just such an organization. There is already a draft charter suggesting that the Gas Exporting Countries Forum (GECF) should become an international platform for elaborating a universal gas pricing formula and discussing routes for new gas pipelines and swap arrangements. From there, it would be an easy step for members to agree to divide up markets, thereby forming monopolies and gaining greater control over prices.

⁽²²⁾ However, as mentioned earlier, supply cut-offs have been employed by Russia against smaller Eastern European countries like Latvia (2003) and Lithuania (2006).

⁽²³⁾ 'Gas warms EU-Russia Ties', *New Europe*, Issue 776, 7 April 2008, <<http://www.neweurope.eu/articles/85173.php>>.

The comprehensive energy partnership agreement Gazprom and the Iranian state company NIOC reached on July 13 is quite significant, given that Russia is supposed to be working with the US and the EU to ensure that Iran has no room to maneuver on its ambition to develop nuclear weapons. While Western firms, most recently Total, are being pressured by their governments to leave Iran and its lucrative South Pars field, Russia's Gazprom may be positioning itself for a long-term strategic partnership with Iran. In addition to assisting Iran with its much-needed energy infrastructure development, Gazprom also seems interested in a possible gas swap deal under which Iran would receive gas from Gazprom in return for exporting the same amount of gas to Russian customers from the Persian Gulf. The Russo-Iranian MoU additionally suggests that NIOC and Gazprom would establish a joint company, which would undertake projects not only in Iran and Russia, but in third countries, including South American and Asian states.

Turkey could also become a participant in the Russian-Iranian partnership. In February Gazprom announced that it will team up with the Iranian Petroleum Ministry and a yet-to-be-named third party in the development of several South Pars phases. It is possible that a Turkish company will be that third party, given that Turkey and Iran already broadly agreed upon such cooperation in July 2007. Iranian Foreign Minister Manuchehr Mottaki recently stated that the Turkish side had indicated a willingness to invest \$6 billion in the South Pars field and to support additional pipeline construction, with the ultimate goal of an Iran-Europe pipeline through Turkey. After several postponements, President Ahmedinejad finally visited Turkey in August 2008, a highly symbolic move as it was the first time he was hosted by a NATO member. The two sides are expected to finalize the agreements over the next several months.

At the same time, Turkey is being pressured by Gazprom, the largest Russian energy supplier and the most expensive source of gas for the country. Reportedly, Gazprom communicated to its Turkish interlocutors that if Nabucco is built, Russia will significantly increase prices for Turkey. Given that Turkey's contract with Gazprom on the western gas route will expire at the end of 2010 and that a new deal has yet to be concluded, there is some nervousness in Ankara, albeit combined with a general belief that Moscow would not treat them the same as Ukraine.

As mentioned earlier, if South Stream project continues its advancement, it will pull Central Asian (and possibly Azeri) gas in its direction. Yet the countries and companies committed to Nabucco will still want to proceed with that pipeline—but then with Iranian and possibly also Russian involvement, as the Austrians and Turks, among others, have been hinting since the start of this year. If that becomes the case, then there will be two major gas pipelines in EU's southern corridor that are controlled by Russia. This, obviously, would further increase Europe's dependence and vulnerability.

6. Russian-Italian Partnership for the Southern Corridor

Playing a similar role to Germany in northern Europe, Italy is Russia's key partner in Southern Europe. Eni, owned 30 percent by the Italian state, is Gazprom's biggest European buyer. The Blue Stream gas pipeline was the first major project for the Eni-Gazprom partnership, which began in the late 1990s. More recently, in November

2006, Gazprom and Eni reached a strategic cooperation agreement. This had three key components: first, Gazprom would have direct access to Italian consumers; second, the two companies would swap assets; and third, they would construct a pipeline between their two countries. Originally this pipeline was to be Blue Stream II, but it was subsequently replaced by South Stream. Indeed, Eni's Scaroni called South Stream the "third pillar" of the 2006 partnership agreement.

According to a report by the *Financial Times*, Putin and Italian Prime Minister Romano Prodi first discussed the South Stream project concept over dinner in the Black Sea port of Sochi in late 2006. On 25 June 2007, Alexander Medvedev visited Italy, and signed the South Stream MoU. On 22 November, Prodi visited Putin in Moscow and further discussed the South Stream project. Reportedly, Prodi, who was to resign in May 2008, was approached by Putin on 4 April during the NATO summit in Bucharest. Later, on 28 April in Rome, Alexei Miller, the Gazprom chief executive and Eni jointly offered Prodi the chairmanship of South Stream—mirroring former German chancellor Gerhard Schroeder's appointment to direct Gazprom's Nord Stream pipeline. As Prodi was previously head of the European Commission, his support would be essential for the pipeline's success. However, Prodi declined the offer ⁽²⁴⁾.

The more important relationship is between Putin and Silvio Berlusconi. The two became close friends during Berlusconi's second term as prime minister in 2001-06. Following Berlusconi's election victory on 14 March of this year, Putin was the first leader to visit Berlusconi—on the island of Sardinia at his house on 17 April. Berlusconi eagerly stated, 'Putin is very friendly. He has shown himself to be a great friend by coming here...This shows a close relationship that has never been interrupted. The Russian Federation is very important for us. We get 30 percent of our oil and gas from them'. Berlusconi is expected to provide huge support for South Stream within the EU. Eni's Scaroni already stated, 'We expect a lot of support from the EU because South Stream is a European project' ⁽²⁵⁾.

Gazprom-Eni cooperation goes even beyond Blue Stream and South Stream. The strategic partnership also involves North Africa, from which the two companies jointly market gas supplies to Europe. In March 2008, Eni agreed to share with Gazprom the Italian company's development quotas for Libyan gas deposits ⁽²⁶⁾. Indeed, Eni, which holds stakes in the Greenstream pipeline [delivering 8 bcm to southern Sicily], the Elephant oil fields, and a liquid natural gas (LNG) processing facility in Libya, is well-positioned for cooperation with Gazprom, which would not shy at the opportunity to entrench itself in Libya so as to exert control over yet

⁽²⁴⁾ Guy Dinmore and Isabel Horst, 'Prodi declines South Stream post', *Financial Times*, 28 April 2008, <http://us.ft.com/ftgateway/superpage.ft?news_id=fto042820081226221176>. Alexander Litvinenko, the former Russian spy and fierce critic of Putin's Kremlin who was murdered in 2006, had accused Prodi of being a friend of the KGB. This is interesting given that before his death Litvinenko had collaborated on a KGB mole-hunt in Italy and had access to highly sensitive information on KGB operations.

⁽²⁵⁾ Judy Dempsey, 'Eni of Italy signs a pipeline deal with Gazprom', *The New York Times*, 23 November 2007, accessed through <<http://acturca.wordpress.com/2007/12/04/Eni-of-italy-signs-a-pipeline-deal-with-gazprom>>.

⁽²⁶⁾ Igor Tomberg, 'Gazprom promised assets in North Africa', *RIA Novosti*, 3 April 2008, <<http://en.rian.ru/analysis/20080403/102917046.html>>.

another European energy source ⁽²⁷⁾. In fact, Putin visited Berlusconi in April on his way back from Libya, where he cancelled \$4.5 billion of Libyan debt and oversaw the signing of deals on arms sales and a joint venture agreement between Gazprom and Libyan National Oil Corporation. On 31 July, the Libyan Prime Minister visited Moscow; Putin announced the intention of working in the oil and gas sector ‘not only in Libya but in other third countries’. Were Gazprom to gain control of Libyan gas and of the southern Mediterranean transit routes, the energy security of European states would be yet further threatened. As mentioned earlier, Gazprom may even seek to form a cartel in the natural gas supply industry, once its links to Libyan and Algerian firms have become more developed ⁽²⁸⁾. Gazprom is also engaged in talks on a project to pipe Nigerian gas to Europe across the Sahara Desert.

The strategic cooperation agreement also includes asset swaps—which could represent a surrender by Eni of assets crucial to Europe's energy security and its unity. In short, the Russian-Italian partnership, and specifically the South Stream project, could provide Gazprom more or less full control over the Southern Corridor in Europe. However, a commercial entity such as Eni cannot be expected to take the EU's general well-being into consideration; that is Brussels' job.

7. Additional implications

7.1. Azerbaijan and Turkmenistan: Two new gas sources

It is important to note that both Azerbaijan and Turkmenistan have significant gas production potential. However, especially in the case of Azerbaijan, which as mentioned above is not dependent on potential revenues from natural gas sales, these fields will not be developed quickly unless there is a strategic benefit. Thus, a green light for South Stream will mean that this source of new and non-Russian controlled gas may not be available to Europe. This simply does not make sense for European energy security. Moreover, it goes against the EU's stated policy priority of enhancing relations with the states of the South Caucasus and Central Asia.

While the Russian-Georgian war has created many uncertainties in this region, the likely outcome will be an increased commitment to Nabucco and other east-west energy projects for a number of reasons. The EU has finally realized the critical importance of this region and will be much more directly engaged in the coming years. Once the initial shock is over, Caspian countries are more likely to try to move away from rather than closer toward Russian domination. Azerbaijan and the energy-rich countries of Central Asia (Turkmenistan, Kazakhstan, Uzbekistan) will all want to have direct connections to European (hence NATO) markets so as to help ensure their sovereignty in the long-term. Georgia will receive a lot of assistance to rebuild its infrastructure, and additional protection mechanisms may be introduced for the east-west transportation corridor—including possibly NATO infrastructure protection, which was discussed previously. Of course, this assessment assumes the West will

⁽²⁷⁾ Judy Dempsey, ‘Gazprom and Eni prepare to join forces to pipe natural gas from Libya to Europe’, *International Herald Tribune*, 9 April 2008, <<http://www.ihf.com/articles/2008/04/09/business/pipe.php>>.

⁽²⁸⁾ Carl Mortished, ‘Gazprom talks sparks fears of gas cartel’, *The Times*, 24 April 2006, <http://business.timesonline.co.uk/tol/business/industry_sectors/natural_resources/article708704.ece>.

stand united and make clear through concrete actions and programs that Russia will not be able to re-establish authority in its former backyard.

Azerbaijan is the closest gas-rich market to Europe. In November 2007, the Azerbaijani government and the western producers operating in its Shah Deniz offshore gas fields announced that there were significantly more reserves than initially thought—enough to supply the first phase of the Nabucco project. Yet, given price disputes with Turkey and lack of political will from the European countries, the Azerbaijani government did not increase production in time to make Nabucco's scheduled start. Since the project's start date is likely to be delayed, if and once there is clear commitment from Brussels to Nabucco, production can take off.

Interestingly, while the US is bullish about Azerbaijan and its potential as a major new gas supplier for Europe, many in Europe remain skeptical about the volumes—possibly because of the Russian propaganda indicating otherwise. In many ways this is a replay of the period before the realization of the BTC pipeline that Russia actively opposed. Just as now with gas, the US was then fully confident in Azerbaijani oil volumes, whereas most Europeans were convinced there would not be sufficient volume to make the oil pipeline commercially viable. Today, the BTC oil pipeline is hailed as very important for European energy security.

On the eastern part of the Caspian, Kazakhstan and Uzbekistan have significant gas that can be exported, and Turkmenistan is believed to possess some of the largest gas fields in the world. The Turkmen government has commissioned a Western company to audit its oil and gas reserves in three fields, and initial results are expected this fall. This will help reduce uncertainty among potential Nabucco investors and—provided that the audit confirms the immense size of Turkmenistan's resource endowment—will alleviate some doubt as to the pipeline's feasibility. Current estimates indicate at least 7 trillion cubic metres (roughly the equivalent of 100 years of present Russian production)—and this figure is based on only three fields being audited; the full potential is likely to be well beyond that figure.

Another positive development for the Caspian-EU gas corridor is the warming of relations between Azerbaijan and Turkmenistan. In March 2008, Ashgabat reopened its embassy in Baku after a seven year absence. The two countries held a number of bilateral meetings and reached sufficient common understanding such that it became possible for Turkmenistan's President Gurbanguly Berdymukhamedov to visit Baku in June. This was the first ever official visit to Azerbaijan of a Turkmen head of state.

A further encouraging development is the increasing attention the EU has given to Central Asia. In April the EU Troika made their third visit to Central Asia, meeting in Ashgabat the foreign ministers of the five nations. The EU delegation consisted of Slovenian Foreign Minister Dimitrij Rupel (representing the EU presidency), French Foreign Minister Bernard Kouchner (representing the upcoming EU presidency), EU Envoy for Central Asia Pierre Morel, and EU Commissioner for External Relations Benita Ferrero-Waldner. Shortly after this meeting, Ashgabat announced that it would be able to provide 10 bcm per year to Europe, and also declared that it would prefer to export this gas via non-Russian-controlled routes.

Hailed as a great success in European capitals, the statement simply indicated a desire—the Turkmen are simply too weak on their own to resist the Russian pressure. They need the EU to reach out to them and ‘pull’ the gas from the Caspian to European markets. There has been a lot of political talk about the Nabucco project but there needs to be follow-up, most importantly a concrete and comprehensive package. Otherwise the Turkmen will once again come under Russian pressure to renege on this commitment. In fact, as expected, the Russians have immediately afterwards shown up in Ashgabat. The time for Europe to act is now—not by proceeding with South Stream, but by reaching out directly to the Turkmen.

7.2.Preventing Ukrainian Integration

South Stream also poses a very real threat to Ukraine, as it would provide Moscow with the ability to disconnect its southern neighbour from the European gas network at any time. This not only threatens Ukrainian domestic consumers—and the risk of human suffering during a cold Ukrainian winter is not small—but also Ukraine's political future. Currently, Ukraine's position as the transit country for approximately 80 percent of Russian gas exports to Europe gives Kyiv some leverage with which to resist political pressure from Moscow. If all or even some of these exports were routed around Ukraine via South Stream, however, Ukraine would become significantly weaker vis-à-vis its northern neighbour.

Moscow has long been clear about its opposition to a Western choice for Ukraine, and has strongly opposed its NATO membership. Ukraine is in a precarious position; there are many in the government and the opposition who wish to reverse course away from the West and embrace the Russian worldview—along with its corresponding political and social values. Whether or not Ukraine continues its progress towards Western institutions and Western standards has much to do with its energy security, which, in turn, has much to do with South Stream.

The EU should not so readily abandon Ukraine to a future in which it will be obliged to follow Moscow's lead. While a variety of domestic factors may well lead Ukraine to choose to maintain close relations with Russia, this is a choice that it should be able to make itself, without Russian pressure.

Instead of backing South Stream, the EU should focus on improving Ukraine's gas transportation infrastructure. In fact, this is one of the reasons why a number of European countries support South Stream. Instead of bypassing Ukraine, transit of gas through the country could be placed under transparent management. Other measures include the establishment of gas metering stations at the borders; and clear separation of gas for transit from gas for internal consumption. The EU should encourage member states to work with Ukraine towards modernizing its ageing infrastructure. Obviously, establishing credible guarantees that the rule of law will be upheld and that corruption will be under check is a prerequisite of such cooperation. These and other measures need to be undertaken if Ukraine is to be part of the European and Euro-Atlantic community.

8. Conclusions and Recommendations

Unless the EU starts treating energy as a foreign and security policy issue, it will continue to be outmanoeuvred by countries that do view it that way.

Europe has been utterly incapable of putting forward a consistent, unified effort to advance Nabucco, supposedly its 'priority' project. Instead, it has allowed its member states—along with Serbia, which wants to join the EU—to undermine the pipeline's prospects by signing up with the South Stream project.

Many European nations are simply afraid of angering Russia. Strong US support was sufficient to counter Russian opposition and European reluctance in the 1990s. However, in the current context, this will not be enough. Thanks to high energy prices, Moscow is much stronger and more assertive now than it was in the 1990s. What is more, the EU lacks the resolve to challenge Russia's monopoly pressure.

Perhaps it is time for energy security to be more firmly integrated in the NATO treaty, as US Senator Richard Lugar suggested at the organization's November 2006 summit. That way, when energy is used as a political weapon to pressure a NATO member, the alliance would stand together in support of the threatened state. At the end of the day, however, this is a European problem that requires a European solution. If the EU is to survive as a united and global actor, it needs not dissension on energy security, but solidarity.

8.1. Key conclusions

1. South Stream does not enhance European energy security; instead, it increases Russian influence over Europe, creating vulnerability for member states in taking decisions on issues relevant to the Kremlin.
2. South Stream is in direct competition with Nabucco—while there will be a huge increase in demand for gas in Europe, but today there is not enough market space for these two pipelines. Unlike South Stream, Nabucco is privately financed and needs the confidence of investors; the European Commission's backing of South Stream would kill Nabucco—at least in the short term and for Caspian gas.
3. South Stream would deny Europe direct access to gas from Azerbaijan and Central Asia, as well as possibly the Middle East and North Africa. Continued monopoly over Eurasian gas flows will enable Russia to reassert its influence over this region.
4. Gazprom may indeed not have enough gas to fill Nord Stream, South Stream, and its two preexisting pipeline networks through Ukraine and Belarus. Yet from Gazprom's perspective, this surplus capacity will have no negative effects. If both Nord Stream and South Stream are constructed, Nabucco will likely not be. Russia's dominant market position will be preserved and enhanced. Thus, European consumers will be left competing against each other for the scarce resources that Russia provides, driving up prices and granting Russia ever-greater leverage.

8.2. Recommendations

While the European Commission is unable to act with a single voice, the European Parliament can and needs to request issues related to security of South Stream to be considered prior to giving its approval.

In General:

- Demand that consortia for pipelines operating on EU soil are fully transparent and comply with all EU regulations on corruption and competition. If not, the mechanism of the Directorate-General for Competition should be used to prosecute and ensure the *acquis* is observed. Like its cousin Nord Stream, South Stream is registered in Switzerland, which is a non-EU country whose banking and corporate sectors are relatively unregulated. In addition, projects such as South Stream need to be evaluated in the context of Gazprom's favourable image that is enhanced, if not purchased outright, by its high-level political connections and public relations firms.
- Include external energy security issue as part of the Common Foreign and Security Policy (CFSP). The European Parliament has already suggested better coordination of a potentially common EU energy policy through the creation of a new post of a 'High Representative for EU Energy Policy'. This has not happened yet, but is essential in light of Russia's divide-and-rule tactics.
- Brussels and Washington need to cooperate much more closely. Following the November US presidential elections, it is possible to renew transatlantic partnership on energy issues. For Washington the key concern is that Europe will not be under Russian influence, so that the transatlantic solidarity remains solid, and that is the main reason for its promotion of non-Russian owned and non-Russian controlled new gas pipelines, especially out of the Caspian.
- Consider both Azerbaijan and Turkey as strategic energy partners and critical in supply source and route diversification. Azerbaijan can export significant amounts of gas to Europe but will only do so if there is direct and meaningful EU-Azerbaijan cooperation. Turkey will remain a reliable transit country for Europe if it is pulled closer to the EU; for that, energy chapter in the membership talks with the EU need to be opened.
- Increase active cooperation with Turkmenistan by offering concrete volume commitments. Overall, enhance partnership with Central Asia—so they will let in Western companies and send their energy westwards, which would also help them reform internally since these companies operate in a much more transparent and accountable manner than Russian ones. This will be good for Russia as well: if it cannot have access to Central Asian gas—which is basically the gas it would transport to Europe as 'Russian gas'—Gazprom would have to invest in domestic production. This would lead to bringing more Western investment and operators, thus open up the system, and make more gas available for Europe.
- Keep the Caspian-EU corridor open by supporting multiple links: LNG and projects such as White Stream.

- There has to be an integrated internal gas market. MOL's idea of interconnected gas pipelines in southeastern Europe needs to be supported.

South Stream Specific:

- Slow down and study the project carefully. By virtue of the fact that South Stream would cross Romania's exclusive economic zone, that country can request extensive surveys and studies be done on the pipeline's economic, environmental, and transportation impacts. While Romania does not have the right to block South Stream, it can delay it significantly.
- Increased tension with Russia, especially in the Black Sea, may lead Ukraine and/or Turkey to further slow down progress on South Stream as the pipeline would have to pass through the exclusive economic marine zones of either one of them. For example, if Russia tries to increase gas prices too much, or challenges Ukraine's territorial integrity, Kyiv could deny approval for South Stream.
- Inform the public about costs and implications. The exorbitant costs involved will be passed along to consumers, who will end up paying much more for gas if all gas coming to Baumgarten is controlled by Russia. There needs to be increased awareness among the European public of the costs and risks—including security risks—associated with projects like South Stream (and Nord Stream)
- If the goal is to diversify supply sources and routes, then provide *credible* political support to Nabucco in order to enable and encourage exploration and development of upstream in Azerbaijan, Turkmenistan and Iraq.

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ANNEX I

FIGURE 1:

	Russia	Total	Dependency
Austria	6.8	8.68	78.34
Bosnia	0.4	0.4	100.00
Bulgaria	2.85	2.85	100.00
Croatia	1.13	1.17	96.58
Greece	2.4	2.86	83.92
Hungary	8.32	10.82	76.89
Italy	23.3	73.4	31.74
Macedonia	0.1	0.1	100.00
Romania	3.95	6.25	63.20
Serbia	2.15	2.15	100.00
Slovenia	0.56	1.1	50.91
Turkey	17.83	27.03	65.96
Ukraine	59.8	66.9	89.39
Moldova			
<i>SS Countries</i>	45.82	216.42	21.17
TOTAL	129.59	203.71	63.61
<i>Excluding Italy</i>	106.29	130.31	81.57