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The G8 and Russia: Security of Supply vs. Security of Demand?

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A rapidly changing global energy scene, dominated by volatile oil and gas prices, the emergence of powerful new consumers in the Asia-Pacific region, reserve depletion within the OECD, and instability in the energy producing regions, creates new challenges for all parties involved in the global energy market.[2] It is, therefore, unsurprising that Russia as a G8 chair and the world's largest energy producer placed energy security at the top of the agenda at the G8 summit in St Petersburg.

The current transition to a new energy era is a painful process where producing and consuming nations need to adjust their diverse interests to promote deeper integration within oil and gas markets for the sake of global energy security. The biggest challenge for suppliers and buyers derives from their often different understanding of energy security. Energy importers focus on security of supply which means sustainable energy production and uninterrupted oil and gas deliveries from energy exporters. Producers are concerned with stable revenues and guarantees of demand security from energy consuming nations.

Today, the leaders of global economic growth (USA, EU, and the Asia-Pacific region) depend on stable energy supplies from the champions of global energy production - the Middle East, Russia and Venezuela. The leading energy importing countries are responsible for over 60% of world GDP and less than 10% of global energy reserves. The principal energy suppliers, while contributing around only 5% to world GDP, control almost 75% of global oil and approximately 65% of gas reserves.[3] As the dependence of industrialised nations on energy producers is projected to increase, their governments have been busy arranging new agreements with energy exporters.

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[2] For a thorough assessment of energy challenges see Robert Skinner, Robert Arnott, *The Oil Supply and Demand Context for Security of Oil Supply to the EU from the GCC Countries*, prepared for EUROGULF: An EU-CCG Dialogue for Energy Stability and Sustainability, April 2005, Kuwait City, http://www.oxfordenergy.org/pdfs/WPM29.pdf;
Robert Skinner, *World Energy Trends: Recent Developments and their Implications for Arab Countries*, 2006, prepared for the 8th Arab Energy Conference, Amman, Jordan, http://www.oxfordenergy.org/pdfs/SP19.pdf.
[3] BP Statistical Review of World Energy, June 2006; World Development Indicators (WDI), World Bank; The Energy Challenge, Energy Review Report, Department of Trade and Industry, July 2006.

In this respect, over the past few years some Russian and international observers had build up expectations that the G8 could play an important role in bringing the energy dialogue between consumers and producers to a new level. In Moscow, the G8 framework was often perceived as a real opportunity to strengthen Russian integration with the developed economies of the West.

This scenario was based on several factors:

- The G8's ability to act as the centre of global governance which could establish guidelines and a new regulatory framework for international oil and gas markets.
- The potential of the G8 to act as a global platform for securing Russia's strategic role in world's energy markets.
- The ability of the G8 members to agree on common energy policies within their domains.

However, the G8 has never been an institutionalised international organisation that could develop comprehensive long term guidelines in relation to issues of global concern, including energy security. Moreover, the G8 in its current form does not include important energy consumers such as China and India nor key energy exporting nations of the Middle East. Although, there have been calls to enlarge the G8, it is unlikely to become a centre of global governance in relation to energy markets.

The international media hype surrounding Russia's G8 presidency served only to highlight vthe already known fact – consuming and producing nations have fundamental disparities in their energy outlook. The energy relationship between the European Union and Russia is a good illustration of how energy importers and exporters tend to lose their mutual understanding of how to bring their diverse energy positions closer.

A serious blunder was made in the way some European politicians initially approached energy co-operation with Russia. For example, in the fall of 2003 the then EU Commissioner Pascal Lamy presented a package of requirements that the European Union expected Russia to implement to qualify for WTO membership. Moscow was to liberalise domestic energy prices, allow unrestricted access to its export pipeline infrastructure and eliminate Gazprom's monopoly on gas exports. Some of these requirements may well have appeared reasonable to the Kremlin but the fact they were presented as an ultimatum served only to antagonise policy makers in Moscow.

Further European initiatives inflicted additional damage on an already delicate relationship with Moscow. The European Commission has recently developed a single EU-Russia gas framework which, in Russian eyes, aims to destabilise Gazprom's system of long-term bilateral deals with European partners. Under the existing framework, EU companies working with Gazexport (Gazprom's export subsidiary) are restricted to selling Russian gas within their traditional territories. The European Commission plans to change this practice by requesting Gazprom to sell its gas at the borders of the European Union. This means that Gazprom's European partners will no longer have any territorial restrictions when it comes to selling Russian gas. This policy affects Russian energy interests on a truly massive scale: from Gazprom's export revenues and long-term investments to strategic bilateral relations with individual EU members. It also raises serious concerns in Russia about security of demand in relation to Europe since around 80% of Gazprom's supplies to the EU are based on long-term contracts. Some European suggestions to diversify away from Russia have not been clearly explained to Moscow and are still being perceived in Russia as a threat to its share of EU energy markets.

The Energy Charter process has been another issue where Europe has lost Russia's trust. Russia signed the Energy Charter Treaty (ECT) in 1994 but has never ratified it. In Russian eyes, Article 20 of the Charter's supplement, the Transit protocol, establishes an exemption for member-states of the European Union whose energy relations are covered by the EU's own rules and regulations. Some Russian experts argue that this means that new members of the European Union, many of which are transit countries, are no longer covered by the ECT. As a result, the ECT has been devalued in the eyes of Russian policy makers.

Transit complications between Gazprom and Russia's neighbours have been another major problem undermining the energy dialogue between Moscow and Europe. Russian officials insist that the Russo-Ukrainian gas problems of January 2006 evolved from a commercial dispute between Gazprom and the Ukraine. Gazprom seeks to boost its revenues which are essential for developing new energy projects, thus, it is no longer interested in subsidising the Ukrainian economy in the range of $3-5 billion per annum as it has done in the previous few years. The Russo-Ukrainian gas dispute is not only about gas prices it is also about transit pipeline infrastructure and distribution networks.

Gazprom's plans to acquire downstream assets in transit countries and the EU are often perceived as a potential threat to European energy security since they reinforce Gazprom's monopolistic position in European markets. Russia, on the contrary, argues that Gazprom's access to distribution, retail and generation capacities within the EU could provide Gazprom with a guarantee of demand for its expensive energy projects, such as the development of new gas fields in the Yamal peninsula or the construction of the North-European Gas pipeline. The suggestion by some European politicians to legally block Russian downstream acquisitions in Europe has created serious uncertainties for Russian energy companies and hence the EU-Russia energy relationship.

It is important to note that the Russia-EU energy relationship is also complicated by the diverse interests of different European actors - from national governments and EU bodies to domestic energy companies. As a result, energy policies of the European Union and its member states are reminiscent of patchwork quilts rather than a coordinated European energy effort.

Some recent Russian moves have also boosted uncertainties and misunderstanding between Moscow and Russia's European partners. These include:

- Regulatory regime, fiscal environment and political risks. The Yukos affair and the Kremlin's growing interference (often of an informal nature) in the oil and gas sector have fuelled foreign investors' anxiety. Russia has not ratified the Washington Convention of 1965 which establishes international legal mechanisms for foreign investors to resolve investment disputes. The Russian government has not, so far, offered adequate tax and other incentives to foreign companies which could guarantee foreign investors stable taxes for the duration of the specific project.

- Reserve data**.** Russian oil reserve data is a state secret. The collection of this data considerably differs from international standards. This could prevent adequate and accurate analysis of the available data even if the Russian government agrees to release it.
- Access to pipelines and resources. Latest Russian legislation restricts foreign access to national natural resources and the pipeline system. Gazprom's monopolistic control over gas exports has now been legalised.
- Slowing down of reforms of the Russian electricity and gas markets.
- A threat of underinvestment in new oil and gas fields and the relevant energy infrastructure. The threat seems quite real if one takes into account the projected decline of Russian gas output from the existing fields from 545.1 Bcm in 2004 to 344 Bcm in 2020.[4] Some argue that Gazprom alone requires about $100 billion to develop new gas fields. The existing energy infrastructure that Gazprom inherited from Soviet times also requires considerable investment for modernisation and maintenance.

These developments have resulted in a climate of mistrust between Russia and Europe and have, to a certain extent, undermined the atmosphere of cooperation between Moscow and its G8 partners. As a result, Russia's G8 presidency will be noted for an array of general statements on energy security. Nevertheless, there could be some issues where Russia and its G8 partners could make certain progress, such as JODI. Support for the JODI initiative is becoming a key element in global energy dialogue and was promoted at the G8 Summit at Gleneagles. The fact that the latest WTO member and the largest oil producer, Saudi Arabia, has endorsed JODI has placed pressure on Russia. Russian officials have already hinted that Moscow may make certain positive steps in this direction.

Before the G8 summit in St Petersburg the Acting Secretary General of OPEC Mohammed Barkindo asserted that "energy security has to be seen from two sides of the coin -- supply security and demand certainty". It seems that G8 members have made an important step in recognising, in President Putin's words, that "energy security is a far broader notion [than security of supplies], including production, transportation and sale on the markets."[5]

Nevertheless, the G8 in its current form is only capable of producing declarations of common understanding. What the international community really needs is a comprehensive international legal framework which protects the interests of transit countries, energy exporters and importers. As long as energy consuming and producing nations continue to adopt "a one way approach" to energy security, such a framework is unlikely to emerge.

[4] Jonathan P. Stern, *The Future of Russian Gas and Gazprom,* Oxford: OUP, 2005, p. 32.
[5] RIA Novosti, 17 July 2006.