

GERMANY & RUSSIA

a 'special relationship' at risk

The German-Russian energy relationship has been flourishing for 35 years. Russia for decades has been Germany's largest single energy supplier. The two countries are planning to build a massive underwater gas pipeline, and Gazprom has invited German firms to help develop a huge gas field in Western Siberia. Yet political animosities cloud the skies between Berlin and Moscow. What companies and entrepreneurs have managed to create, runs the risk of being thrashed by politicians in both capitals, experts say.

| by *Stefan Nicola*

It is December 18, 2007, in a ballroom inside the Moscow headquarters of state-controlled Russian energy giant Gazprom. German Foreign Minister Frank-Walter Steinmeier is smiling as he is putting his hand on a large blue button. Now approaches Dmitry Medvedev, Gazprom's supervisory board chairman and probably the next president of Russia. Just like Steinmeier, Medvedev is smiling, and so are the German and Russian businessmen that flank the pair. They have reasons to be happy – they are about to launch exploration start of the Yushno-Russkoye gas field, which both parties say will secure gas deliveries to Germany for the next two decades. Meanwhile, some 2,300 kilometers northwest in Siberia: A team of 'Gasowiki,' as the Gazprom employees are called here, are standing on a wooden platform next to a black gas well that springs out of the snow like a giant Kalashnikov intending to shoot its fiery load toward the sky. While Steinmeier and Medvedev

are wearing dark business suits, the Gasowiki are wrapped in thick snow parkas, a large furry cap on each head. It is minus 40 °C out here, and murky – in December, the sun only shines for about two hours a day. Back in Moscow, Medvedev puts his hand on top of Steinmeier's and presses down. Some moments later, a flame shoots out of the well in Siberia, and the Gasowiki erupt in cheers and applause. To Yushno-Russkoye!

While the Yushno-Russkoye field is the latest bilateral project, one has to look back nearly four decades for the event that launched the German-Russian energy partnership. At the time, at the height of the Cold War, the West was having its first major crisis with Opec and Europe was thirsting for cheap alternative energy sources. It was German Chancellor Willy Brandt who, despite significant criticism from the United States and Germany's conservatives,

wanted to link up economically with the Soviet Union. In 1970, Brandt and Leonid Brezhnev signed a deal that had Germany send pipelines beyond the iron curtain in exchange for Soviet gas. Brandt's so-called "Ostpolitik", which was aimed at bringing a political détente through economic ties, proved to be rather successful. For over three decades, Russia became a reliable supplier of oil and gas.

However, this record is being questioned ever since Moscow in early 2006 temporarily shut off gas supplies to Ukraine until it agreed to pay higher prices. The row sent officials in Europe scrambling to double-check their energy security strategies. Critics accuse Russia of using its energy assets as a foreign policy tool against former Soviet republics that turn toward the West. Russia contends that it is merely asking these states to forgo preferential rates on energy and pay what the rest of Europe does.



Photo: Kai Senf

Harsher note |

In Germany, Chancellor Angela Merkel has decided to strike a different note when dealing with Russian President Vladimir Putin than her predecessor Gerhard Schroeder did. In 2006, Putin offered to reserve for Germany nearly the entire initial production capacity of the giant Shtokman field (which according to Russian estimates holds between 3 and 4 trillion cubic meters of gas, enough to supply all of Germany's gas consumption for 30 years), adding that Moscow wanted to make Germany Europe's main hub for gas sales. Merkel didn't take the bait and instead a few weeks later signed a bilateral energy alliance with France.

Experts say politicians in Moscow and in Germany with their recent behaviour are endangering the long-time success story that has been the countries' bilateral energy relationship.

Claudia Kemfert, an energy analyst at the German Institute for Economic Affairs says Moscow with the temporary supply stops to Ukraine and Belarus did nothing less than 'shock' Europe. She blames the Kremlin for what she says is an aggressive course aimed at making countries dependent on Russian oil and gas, with Gazprom being the main tool to push through that strategy.

'A lot has changed in Russia since the energy prices rose,' she says. 'Moscow wants to build pipelines to tie Europe down to its supplies. If we are too dependent on a single country's imports, then this allows that country

to manipulate the price.'

'That's why Germany and other energy importers in Europe should push LNG and look for alternate supply countries', she says.

'Even a recent bilateral project like Yushno-Russkoye is no reason to be euphoric,' she says. 'Russia is allowing a pawn to move forward, but the overall strategy looks differently. If the Kremlin wants it another way, then the Western companies will be kicked out again. We have seen this happen in the past.'

Kemfert in her remarks refers to the rewriting of contracts that Shell and BP were forced to go through. Russia argues, however, that these contracts were grossly unfair. They were signed in

to fill them with gas. 'So the dependency goes both ways', he says.

Alexander Rahr, the senior Russia analyst at the German Council on Foreign Relations in Berlin, goes one step further. He says some Western politicians want to keep Russia out of Europe. He adds that German Chancellor Angela Merkel strikes a harsher note with the Kremlin, one that in his view will prove to be wrong when it comes to dealing with the emerging energy superpower. 'We don't yet face a watershed point, but atmospherically, a lot has changed in dealing with Russia,' says Rahr, whose book on the German-Russian energy relationship, called 'Russia and gas - Return of a global power', recently hit

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the early 1990s, at a time when Russia was with its back against the wall, and legalized the exploitation of Russian natural resources, the Kremlin says.

Several energy experts argue that politicians are painting far too gloomy an image, given the long-standing ties that have developed between German and Russian companies over the past decades. Roland Goetz, oil and gas expert at the German Institute for International and Security Affairs, a Berlin-based think tank, said if pipelines are built, the Russians are also intended

the bookshelves in Germany. 'On the one hand, I understand the arguments that Angela Merkel puts forward why one should be more careful with Russia; Moscow doesn't always act civilized when it comes to energy questions, and one doesn't really know the master plan that has been developed in the Kremlin regarding its energy foreign policy. On the other hand, you can't ward off Russia. When German Foreign Minister Steinmeier wanted to use Germany's EU and G8 presidencies in 2006 to create a new "Ostpolitik", the strategy was put



Gazprom Germania office in Berlin. Photo: Kai Senf

on hold by the chancellor's office. So in a way, Merkel calls into question the successful legacy of four chancellors before her - Willy Brandt, Helmut Schmidt, Helmut Kohl and Gerhard Schroeder.'

Rahr argues that the economic ties between Germany and Russia should be expanded to influence Russia, following the tradition of Brandt and his pipeline-gas treaty. 'Change through trade', is the right way to deal with Moscow, he says.

Gamble away |

Steinmeier, a Social Democrat who used to be Schroeder's chief of staff, is known to be of similar opinion as Rahr. Unlike Merkel, who grew up in communist East Germany and intends to place her focus on a strong partnership with the United States, Steinmeier was a key architect of the foreign policy of Schroeder. Merkel's predecessor used to be a steadfast political ally and still is a close friend of Russian President Putin. Steinmeier would like to continue in that tradition. 'We need a new policy of détente ... through renewed and deepened cooperation,' Steinmeier said in late 2007 in a speech in Berlin. 'We must not gamble away the existing ties with Russia, despite the difficulties, which I am seeing as well.'

The popular opinions in Germany about Russia are similarly divided. Some 101 of 128 companies (79 percent) in November 2007 in a poll for German industry association BDI said they believe that investment conditions in Russia will improve in 2008, with some 85 percent claiming they want to expand their business with Russia. On the other hand, there exists a deep mistrust about Russia inside the general population: Every fourth German, according to a January 2008 poll by German census group Forsa, sees Russia as an enemy rather than a friend.

While it will be interesting to see which political strategy will come out on top in Berlin, the existing energy links between the two countries are already substantial. Germany imports from Russia nearly 40 percent of its gas,

and roughly 30 percent of its oil. Some 155,000 kilometers worth of pipelines link Russia and western Europe, with gas travelling from a field in Siberia to Germany in just seven days.

The Yushno-Russkoye exploration deal marks a significant new step in the special German-Russian energy relationship, not only because it lends BASF (through its daughter Wintershall) a 35 percent stake in the field's economic rewards. 'We are not just purchasing gas from Russia and selling it together with Gazprom – we are now producing gas together in Russia, too,' Eggert Voscherau, a senior executive at German chemical giant BASF, said at the launch ceremony. 'That means supply security not just for Germany, but for all of Europe.'

The Yushno-Russkoye field holds recoverable reserves of more than 600 billion cubic meters of natural gas, which alone could meet Russian exports to Germany for the next 15 years (Gazprom currently supplies Germany with about 40 billion cubic meters of gas a year). By 2011, the firms involved want to extract some 25 billion cubic meters a year, to fill with life an even bigger German-

a 49 percent share in a Wintershall subsidiary that produces oil in two onshore concession areas in Libya. The asset swap is an example of Gazprom's strategy of reciprocity. In return for exploration deals in Russia, the energy giant wants assets and access to end consumers in Europe.

Via Wingas, Gazprom and Wintershall since 1990 have been quite active in gas trading in Germany and in Europe. They have invested around €3 billion in setting up and expanding the pipeline infrastructure and in constructing gas storage facilities. Both companies have also signed long-term gas supply deals that run through 2036, a move the firms say will secure German imports in times of dwindling North Sea reserves.

Wingas now wants to invest hundreds of millions in the construction of new natural gas storage systems in Europe, one of them in Jemgum, near the German-Dutch border, and several others in continental Europe. In 2006, Wingas also completed a \$200 million pipeline extension project in eastern Germany.

'When Gazprom and BASF signed the first agreements at the beginning of

Eon Hungary (a regional power and gas utility) and additional monetary compensation.

However, it seems Gazprom wasn't satisfied with the overall offer and now wants direct assets, for example shares in power plants, in Europe. Eon spokesman Christian Drepper didn't want to comment on concrete second-round offers but said the company is optimistic that an agreement can be reached soon. 'While the assets are already identified, their evaluation has not happened yet,' Drepper says in a telephone interview. 'But we are interested in a quick agreement.' Of course Eon is: observers say Gazprom is delaying the deal on purpose because the value of the gas field is increasing by the day, while Eon's assets aren't. It's understandable that the delaying tactic irritates the Düsseldorf-based energy giant.

Eon nevertheless stands for a successful cooperation with Gazprom. Its recent coup was the 4.3 billion acquisition of 72.4 percent of Russian power utility OKG-4, the biggest-ever single investment of a German firm in Russia. The promising Russian electricity market, which desperately needs foreign capital, is being liberalized, and Eon is convinced that it has acquired a gem with OKG-4. 'Russia is one of the fastest-growing power markets,' Drepper says. 'OKG-4 is a very well managed company that already has a well balanced portfolio of power plants. The regions in which it is active furthermore have a potential for high economic growth.'

OKG-4 has some 5,500 employees, owns installed capacities of 8.6 GW and in 2006 reported revenues of €766 million. The spokesman says Eon has made a commitment to build another 2.4 GW generation capacity, but before that happens, 'we will set our focus on the integration of OKG-4 into Eon. After all, OKG-4 is as large as Eon UK.'

And there are more projects of cooperation in the pipeline: Eon ceo Wulf Bernotat said in late 2007 that his company would team up with Gazprom to build power plants all over Europe, including in Germany, Britain and

'The current managers will soon make room for a new generation of Russian businesspeople'

Russian project, the Nord Stream pipeline. Gazprom ceo Alexei Miller called the Yushno-Russkoye deal with BASF an 'important development for gas production in Russia and an example of the heightened cooperation between Gazprom and the world's leading energy companies.'

In return for the right to develop gas directly in Siberia, Gazprom received \$1.2 billion plus key assets in Europe. The Russian energy giant increased its shareholding in the natural gas trading company Wingas (a joint venture between BASF daughter Wintershall and Gazprom) from 35 to 50 percent minus one share. Gazprom also got

the 1990s, no one could have imagined how successful this partnership would become. Today, the ties between the two companies are deep, strong and steadfast', Voscherau says.

Coup |

Eon, through its daughter Eon Ruhrgas, also wants to enter the Yushno-Russkoye project, but has experienced some difficulties recently. In previous reports, Eon said it wanted to spend \$1.2 billion to acquire 25 percent minus one share of the Yushno-Russkoye consortium; it also offered Gazprom stakes of 50 percent minus one share in its Hungarian firms Eon Földgaz Storage and Eon Földgaz Trade, 25 percent plus one share of

Hungary. Alexander Medvedev, deputy head of Gazprom, also in 2007 told the *Frankfurter Allgemeine Zeitung* newspaper that one plant with a generating capacity of 1 GW will be built in Lubmin, near the Baltic Sea, adding that another project in Germany was also in the 'advanced' planning stages. Eon Ruhrgas has sold Russian gas since the 1970s, and as the first western firm acquired Gazprom shares. It currently

over the signing of the Nord Stream deal in Berlin. On December 9, 2005, at a news conference on the launch of the pipeline's construction, Gazprom ceo Alexei Miller announced that Schroeder was chosen to head the Nord Stream supervisory board. Putin had told a surprised Miller about Schroeder's nomination only a few minutes before the conference started, Valery Panyushkin and Mikhail Zygar, two journalists working for Russian business daily *Kommersant*, write in their new book about Gazprom.

the old Soviet collective spirit. They don't trust anyone from outside their culture. Eventually, that makes them non-transparent and won't help them succeed in a country like Germany.'

Gazprom intends to change that. Located in the heart of Berlin, its daughter Gazprom Germania, with 240 employees, has tried to turn around the company's image in Germany. And in one city, it seems to have already succeeded. If you walk through Gelsenkirchen, in the Ruhr area, you will see numerous ordinary Germans wearing a blue T-shirt with the Gazprom logo printed across the chest. They are fans of German football club Schalke 04, with which Gazprom Germania in 2006 signed a sponsoring deal that is speculated to be worth some \$125 million.

'We didn't know anything about Gazprom. We thought this is the Russian Mafia,' Schalke marketing head Andreas Steiniger told Panyushkin and Zygar. 'But when they visited us, it became clear to us that they are normal businesspeople.'

Gazprom likely paid attention to the example of Russian billionaire Roman Abramovich, who with his fortune has turned the once-mediocre British soccer club Chelsea FC into one of the world's most star-struck teams, gaining worldwide recognition in the process. Schalke has an even larger fan potential than Chelsea, one that includes the workers of former mining unions and the bosses of big businesses in the region. The club has likely also been chosen for geographical reasons: the Ruhr area harbours some of Germany's biggest energy firms, including RWE, a company Gazprom has thought about buying in the past, a plan put on hold ever since the European Commission announced its unbundling plans.

Besides the Schalke deal, Gazprom Germania sponsors the goodbye tour of former eastern German ice-skating princess Katarina Witt, German-Russian culture festivals, a competition to prevent youth violence in German soccer and a high school that offers Russian

'Change through trade' is the right way to deal with Moscow

holds 6 percent in the Russian gas monopolist (worth an estimated 15 billion), and its ceo, Burkhard Bergmann, still is the only non-Russian in the Gazprom supervisory board. Despite his retirement in February 2008, Bergmann may stay on the board beyond that date, further retaining is valuable influence there, he told the *Financial Times*.

Nordstream |

Bergmann is also one of the key supporters of the controversial Nord Stream project. The pipeline, to be built and managed by a consortium made up of Eon, BASF and Gazprom, will stretch some 1,200 kilometers under the Baltic Sea to link the vast Siberian gas fields with the German port city of Greifswald. German company Europipe will deliver most of the pipelines, and extensions are planned to link Nord Stream to northeastern Germany and the Czech border. Further links have also been offered to serve Poland, but Warsaw and other countries, mainly Ukraine and the Baltics, have not only refused to be linked up, but also protested heavily against the pipeline, as it bypasses and strips them of transit fees.

International criticism was fairly low-key, however, until Gerhard Schroeder got on board. Ten days before the German elections in September 2005 (which would see Schroeder lose to Merkel), the German chancellor and Putin presided

While Schroeder defended his appointment by claiming it would boost European energy security, the press hacked him for supporting a project politically and later making money with it. Reports surfaced in April 2006 that the German government shortly before Schroeder's ousting as chancellor granted Gazprom federal guarantees worth some €900 million to build Nord Stream. If the pipeline consortium would go bankrupt, the German government would have had to pay the bill. Schroeder denied knowing any of this, and Gazprom has since promised not to fall back on those guarantees.

Gazprom Germania |

This is just one example of Gazprom's key weakness when dealing with Europe – its tarnished image. While the Kremlin believed Schroeder's appointment to be a big coup, it totally backfired, hurting Nord Stream as a result.

'Gazprom needs to pay more attention to how a German or European public is reacting to certain moves. They have pretty much been ignorant to that,' says Gemma Pörzgen, a German journalist who wrote 'Gazprom – Pipeline Power', the first book in German about the Russian energy giant.

Alexander Rahr agrees. 'PR is not taken seriously in Russia,' he says. 'There, PR still is propaganda, either black or white. That's totally out of date and won't succeed in Europe. Russian firms, with very few exceptions, don't employ people who are not born and raised in the former Soviet Union,' Rahr says. 'That's

courses in Berlin. The company boosted its profits significantly over the past two years and owns several daughter firms in Germany, including Berlin-based gas trading company ZMB, and Möthlow-based ZMB mobil, which equips gas-driven automobiles.

'The step with Gazprom Germania is the right one,' Pörzgen says. 'It increases Gazprom's profile in Germany and establishes the company in the many gas and industry unions.'

Romantic |

Judging from the above-mentioned projects, the German-Russia energy relationship looks promising, but experts tend to be careful when talking about concrete future projects. Gazprom can act rather unpredictably, and inside Russia, 'there are circles that don't want a close cooperation with Europe,' Pörzgen says. 'They favour the model of China as a prosperous authoritarian regime.'

Recently, competition has also increased, as more and more European companies are entering the bidding race for assets in Russia. Italian giant Eni has struck multi-billion agreements with Russia in the past two years, and Norwegian, Dutch as well as French companies are courting Moscow for cooperation deals.

So does the German energy industry fear it will eventually lag behind, given the recent political frictions between both countries? 'We are well-positioned in Russia,' Eon spokesman Drepper said. 'But competition there is getting tougher. While we have a good starting

'Some Western politicians want to keep Russia out of Europe'

position, no protagonist is romantic. In the end, it's about assets.'

And it's about gas – a lot of gas, to be straight. Some experts have warned that Russia may not meet its production



German Chancellor Angela Merkel and Russian President, Vladimir Putin. Photo: Corbis

targets because it decided to explore its giant fields in the Barents Sea and Yamal alone, rather than inviting Western investors. Alexander Rahr doesn't believe in a major gas deficit. He says Russia knows exactly how much gas it has and will have, but only wants to produce it once it is sold.

Roland Goetz says Russia's gas production stands and falls with the development of the fields in Yamal. The Bovanenkovskoye deposit is planned to be developed by the Russian gas monopolist Gazprom by 2011-2012. 'If production will start in 2011, as previously announced, there will be no problem,' he says. 'But if the whole thing is delayed by five years or so, there will likely be a gas deficit.'

wasted. Experts say up to 40 percent of the energy consumed in Russia may be saved through efficiency measures – which German companies would like to export to Russia.

Despite the current low in political relations, experts are carefully optimistic for the future.

'In the long run, I expect Russia to develop more democratically than alternative supply countries, such as Algeria or Qatar,' Rahr says. He adds that the current managers at Gazprom, grown up during Soviet times and still ideologically imprinted, will soon leave their posts and make room for a new generation of businesspeople who were educated at western universities. 'These people will lead Russia alongside Dmitry Medvedev,' who is favoured to succeed Putin as Russian president, 'so I am optimistic that the country's way will continue westward,' he says.

Pörzgen certainly hopes for the same, and says that German firms won't be bullied out of their cooperation agreements. 'There is too much hysteria in the German-Russian energy relationship,' she says. 'Much indicates that the existing long-term contracts will last and pay off. Because in the end, both sides benefit from them.' ■