

Russia's drive for the construction of the South Stream pipeline has recently entered a new era marked by proliferation of intergovernmental agreements. Despite strong signs of support among some member states, the opinion within the EU on the South Stream project and its role for European energy security remains divided.

EU heavily divided on South Stream

| by Roman Kazmin

The South Stream pipeline project, which aims to bring Russian and Central Asian gas directly to the European end-users while avoiding the traditional transit states, in particular Ukraine, has acquired new urgency for Gazprom after the standoff with Ukraine earlier this year. Russia has used the political momentum created by the gas crisis to formalise a number of bilateral agreements on South Stream with Italy, Bulgaria, Serbia, Hungary and Greece, establishing joint ventures that will perform feasibility studies. Similar agreements with Austria and Slovenia are in the making.

In Europe, the ongoing debate surrounding the project has led to the emergence of two camps. The supporters of South Stream argue that the pipeline will increase the flows of gas to the energy-hungry European markets. The opponents point out that the pipeline will increase Europe's already heavy reliance on Russian gas even further. At its basic level, the South Stream project envisions a 900-kilometre

subsea pipeline reaching a maximum depth of about 2,000 metres that would connect Beregovaya compressor station on the Russian Black Sea coast, near the town of Arhipo-Osipovka, with Varna, Bulgaria. The compressor station already serves as a starting point to the Blue Stream pipeline which transports Russian gas to Turkey. The exact route for the South Stream pipeline once it enters Bulgaria has not yet been determined, although the general design proposes splitting it into two major branches: one via Bulgaria, Greece, Serbia and Croatia to Italy, the other through Serbia and Hungary to Baumgarten, Austria. The final route is expected to be announced in December when Gazprom completes the technical feasibility study. Although Gazprom originally said that South Stream, a joint venture between Gazprom and Italy's Eni, will have the capacity to deliver 31 billion m³ (bcm) of gas, this volume is being seriously reconsidered after the recent "gas war" with Ukraine. Alexander Medvedev,

the deputy chairman of Gazprom's management committee, has said that Gazprom is considering boosting capacity to as much as 47 bcm. Eni announced in May that volumes will be doubled to 62 bcm.

Strong support |

Gazprom's choice of partner is not a coincidence, as the company seeks to play a strategic role in Italian downstream markets. Having a major European energy company as co-sponsor will provide political support for the project from one of the EU's key member-states. From a financial viewpoint, Eni's participation will facilitate the financing of the multi-billion euro project.

Many countries in South-Eastern Europe also support the project. During the recent gas crisis, Serbia, Bulgaria, Bosnia and Macedonia faced heavy industrial rationing and even complete cut-offs of certain sectors, and had problems supplying households. For these states, the



Workers welding two pipeline sections together. Photo: Goedan/laif/Corbis

repetition of this scenario is unacceptable. Speaking to EER, Peter Poptchev, the coordinator for pipeline projects with Bulgaria's foreign ministry says, 'South Stream is an inherently European project, but so far it has not been treated as such. The South Stream pipeline is not part of the projects under the important aegis of the EU South gas corridor programme.' Although Bulgaria is generally viewed as one of the strongest proponents, in reality it must face difficult choices, notes Poptchev. 'We would like to see South Stream as a European project, coordinated on a multilateral level, rather than one based on a number of bilateral intergovernmental agreements, as it is now.' So far, says Poptchev, Russia is negotiating with six EU member states, including Bulgaria, Hungary, Slovenia, Greece, Italy and Austria, in addition to non-EU members like Serbia and Croatia. 'Having a common EU approach to this project would make our position much easier at the negotiating table,' he says.

Hungary, which already receives more than 70% of its gas imports from Russia, views the project not only as an opportunity to secure additional gas supplies, but also as an investment into the country's own gas infrastructure. The latest agreement signed between Gazprom and MFB (Hungarian Development Bank) in early March, outlines a 50-50 partnership for the Hungarian leg of the project. At the time of signing the agreement on South Stream, Gazprom also agreed on a joint construction and operation of a new 1.3 bcm gas storage facility in Hungary together with MOL, the country's incumbent oil and gas company. Many of the countries hoping to become transit states are careful not to put all their eggs in one basket. Bulgaria has equally supported both South Stream and the rival EU Nabucco pipeline, which is to bring gas from Central Asia through Turkey, bypassing Russia. The potential transit states have nothing to lose and everything to gain by supporting both

projects. They will gain the benefit of secure and ample gas supplies as well as transit fees. In certain cases, Gazprom has made attractive offers of establishing joint ventures to develop downstream markets and improve infrastructure, as in Hungary. Bulgaria, says Poptchev, wants South Stream to be operated independently of its existing gas infrastructure. 'We have always insisted that Bulgaria's existent system should remain independent from South Stream.' Thus the project's operators would have to construct the pipeline from scratch. This would allow Bulgaria to remain politically and commercially distant from any disputes. The other transit states are taking the same approach.

Out of sync |

There is also opposition to the project in Brussels, coming from Poland and the Baltic states, the traditional opponents of Russia's energy policy. Poland and the Baltic states are seemingly opposed to any

pipeline project that diminishes the role of existing transit states. Furthermore, Poland is one of the staunch supporters of Nabucco and views South Stream as a competitor. Poland argues that South Stream further increases European dependence on Russian gas. So far, this opposition has been regarded as a largely symbolic, incapable of slowing the political momentum for the project.

However, Walter Boltz, chairman of Austrian regulator E-control, criticises South Stream on somewhat different grounds. Boltz says that the current political and commercial framework for the pipeline, based as it is on a series of bilateral agreements, is out of sync with the present European reality. From the perspective of a European regulator, Boltz anticipates that the current framework may be viewed as flying in the face of EU energy and competition policy. 'Intergovernmental agreements are the tools of the past. Some of the new EU members have not realised yet that meaningful agreements with third parties involving complex commercial issues, such as transit, cannot be negotiated any longer on a bilateral basis. For example, the negotiations for the Nabucco pipeline project with Turkey are carried out by the EU rather than the potential consumer

states. These issues are superseded by European regulations and law. On the political level, all the agreements signed between the EU member states and Gazprom on the South Stream project involved non-committal language.'

In addition to political dimensions, Boltz questions Gazprom's commercial motivations. 'Transit through Ukraine remains the cheapest way to bring Russian gas to Europe. It makes much more sense to resolve transit issues with Ukraine on a political level rather than investing into a multi-billion euro project just for the sake of diversification. I think this is largely a political manoeuvre, and I doubt that the project will materialise in the mid-term future. I doubt that Gazprom has a serious intention of actually building this pipeline, certainly in the context of the current timeline with start of operations set for 2015.'

Economically feasible |

The past two EU presidencies, held by Slovenia and France, have supported South Stream on the grounds that it would address the projected growth for gas demand in Europe. The Czech presidency of the EU did not significantly alter the body's position. And at present, there is no formal opposition to South Stream from the governing bodies of the EU or

the European Commission. In fact, the Commission's approach has been one of passive support.

The only position voiced by the Commission over and over again is the rejection of the idea that South Stream and Nabucco are competing projects. The argument is that the more routes we have available to deliver gas to the European markets, the better it is for the European consumers. In an ideal world, these extra volumes should come from sources other than Russia. If this is not possible, the availability of secure gas volumes is what matters at the end of the day rather than the source of this gas.

Unofficially, however, many industry insiders as well as politicians in Brussels realise that the projects do in fact compete. For one thing, for finance. But also on a political level. Nabucco has so far failed to persuade suppliers to commit to the pipeline. South Stream, on the other hand, is sponsored by a supplier confident of its ability to procure sufficient volumes to make it economically feasible. While the underlying political motivation behind Nabucco is diversification of sources of supply, the geopolitical design of South Stream is maintaining the level of Russian supplies to Europe while avoiding the problematic transit states. ■

Sourcing and Costs

Gazprom's estimates for the project's cost range between €19 to €24 billion. Some experts see these figures as overly optimistic.

The most obvious question asked by industry experts involves the ability of Russia, which is facing dwindling production, to supply sufficient volumes for South Stream. The gas is likely to come from existing fields in West Siberia as well as Central Asia. Operating at full capacity, South Stream will require additional supplies, possibly coming from yet to be developed fields in East Siberia—fields located in challenging conditions requiring additional investment during time of global recession. In a scenario where Russia is unable to boost existing production, gas currently being transited through Ukraine might be diverted to South Stream. Thus, construction of South Stream may not necessarily lead to delivery of additional volumes to Europe. Speaking to EER, Mikhail Korchemkin, the executive director of East European Gas Analysis, said that 'pragmatically, the aim of the project is to decrease reliance on transit states, particularly Ukraine rather than boosting supplies to Europe. With the addition of Nord Stream and South Stream, Gazprom will increase its export capacity to about 300 billion m³ (bcm) per year from the present 200 bcm by 2015. I can't imagine that Russia is capable of expanding its production to meet the new export capacity.' Jonathan Stern, director of gas studies at the Oxford Institute for Energy Studies, agrees that the project is very expensive. However, 'the question of financing is made easier by the fact that 50% of the costs will be paid by Eni.' Moreover, 'the final cost of the project will not be determined until construction begins and will very much depend on steel prices at the time', says Stern. Russia, however, can and most likely will turn to Central Asia, Turkmenistan in particular, for additional supplies. If they are necessary of course, in view of the economic crisis.